Options for greening the Bank of England's Corporate Bond Purchase Scheme

Positive Money welcomes the opportunity to respond to this Bank of England consultation

Positive Money is a not-for-profit research and campaigning organisation, working towards reform of the money and banking system to support a fair, democratic and sustainable economy. We are funded by trusts, foundations and small donations.

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Q1: Principles for greening the CBPS

Do respondents agree the Principles set out in Section 3 of the Discussion Paper are appropriate, in light of the role of the CBPS and the trade-offs the Bank faces as a public institution focused on the maintenance of monetary and financial stability? Should any considerations be dialled up or down; and have any been overlooked?

We are delighted that the Bank is taking steps towards decarbonising the CPBS, and to have the opportunity to respond to the approach set out in the discussion paper.

We broadly agree with principle 1, but we submit that the Bank's approach grossly overestimates its ability to incentivise fossil fuel (and other particularly high-carbon) companies to align themselves with the government's environmental goals. The Bank is assuming that fossil fuel companies will be able to meaningfully align with net zero, and that doing so would be in the interests of the shareholders to whom they are responsible. However, the profitability of oil companies such as Shell and BP and maximisation of value for their shareholders will depend on the continued extraction of oil reserves for as long as possible, which in turn depends on high demand for these energy sources to be maintained. Internal rates of return for fossil fuels are three to four times higher than renewable energy sources. A green transition in line with the Paris Agreement will require fossil fuel companies to shrink, which these companies and their shareholders have material interests in resisting.

For those firms whose short-term interests are opposed to the transition, immediate exclusion and divestment will be a more powerful tool to support an economy-wide transition. Divestment strategies by other investors have already played an important role in tightening financing conditions for fossil fuels and have even resulted in the abandonment of particularly environmentally harmful projects. Immediate exclusions and divestments targeting fossil fuels in the CBPS would send a strong signal and would reduce the climate-related financial risks in the Bank's portfolio.

With regard to principle 2, we agree that the Bank should "lead by example". This strengthens the case for immediate divestments from companies most deeply engaged in environmentally harmful activities. While the Bank should “learn from others”, it must develop new standards for best practice and not rely solely on existing ones.

With regard to principle 3, we agree that for companies that remain on the Bank’s balance sheet, requirements should be ratcheted up over time. However, we maintain that the Bank should not hesitate to apply the harshest of measures - exclusions, divestments, and strong negative tilts - immediately for the most carbon-intensive companies. Over time, if these companies make progress on environmental indicators, these measures could be reversed. This would allow the Bank to achieve a strong signaling effect, while continuing to incentivise positive environmental behaviour.

Finally, we would propose a fourth principle of ‘proportionality’. Currently, the Bank’s approach would apply the same requirements, and timelines for their implementation, to all companies, no matter their current performance on environmental indicators. We submit that the Bank should consider calibrating requirements and implementation timelines based on companies’ past and current emissions profiles, setting more stringent requirements and timelines for any of the more high carbon companies that remain (at least initially) on its balance sheet, and more lenient requirements for lower-carbon companies.

Taking bold measures to align the CBPS with environmental objectives is consistent not only with the new environmental provisions in the Bank’s updated remits, but also with its primary objectives of price and financial stability. As argued in “The Green Swan” book, “the stability of the Earth system is a prerequisite for financial and price stability.”

Q2 – Tool 1: Portfolio Targets

What approach to setting portfolio-level targets for the CBPS is likely to provide the best support to economy wide transition to net zero by 2050, taking into account the current maturity of climate metrics, transition pathways and models, as well as the Bank’s wider responsibilities to preserve the ability of the MPC to achieve its inflation target, to protect public money and to rely only on sufficiently robust data and metrics? What challenges would need to be overcome in order to operationalise such an approach, and how might that best be achieved?

The Bank should set an ambitious and short-term target for assets to be fully aligned with the transition. However, given the high level of uncertainty related to the transition and the contested assumptions used in the development of transition pathways and other forward-looking metrics, the Bank should prioritise metrics and targets based on past and current performance. The Bank should set annual targets for reductions in the CBPS’ weighted average carbon intensity (WACI) and use measures of point-in-time emissions to assess whether or not companies are abiding by their emissions reductions targets.

In order for engagement to have any (even if limited) impact, targets must be ambitious and combined with deadlines for exclusion and divestment. The main goal of engagement should be to get companies to develop and enact credible net-zero strategies. The Bank should exclude and divest from companies that are relatively high-carbon, fail to rapidly outline such plans, or show signs they are not abiding by them.

The Bank should look at how green bonds, and bonds issued by low emissions companies, could readily replace bonds issued by high-carbon companies. This does not necessarily require a target, but should instead be led by needs to maintain the size of the CBPS at the level required by the MPC, in response to divestments and exclusions. In doing this, the Bank must ensure it is applying a stringent classification of what activities may or may not reasonably be defined as 'green'. This does not necessarily require waiting for the government's green taxonomy. The Bank of England should consider the two detailed scenarios showing how high-carbon bonds could be replaced by low carbon bonds, provided by Dafermos et al. (2020): https://neweconomics.org/uploads/files/NEF-Decarbonise-BoE-report.pdf.

Q3 – Tool 2: Eligibility

Which climate related criteria for CBPS eligibility could most effectively support economy wide transition to net zero, now and in the future, taking into account the availability and coverage of metrics, as well as the Bank's wider responsibilities to preserve the ability of the MPC to achieve its inflation target, to protect public money and to rely only on sufficiently robust data and metrics?

1. **How could eligibility criteria best be used to incentivise companies to take meaningful actions towards transition?**
2. **How can investors including the Bank best judge the pace of tightening eligibility criteria, to sharpen incentives, while giving firms time to respond to these and relying only on robust data?**
3. **How should the Bank approach changes over time in expert opinion as to which activities are incompatible with transition to net zero, given the Bank's broader responsibilities, and the need to rely on robust evidence and metrics?**

We recommend that the Bank of England immediately divest from companies whose revenues are for the most part derived from the extraction of fossil fuels (not just coal-related) and/or who are involved in any new fossil fuel projects beyond those already committed to in 2021. Fossil fuel companies like Shell and BP have clear vested interests in delaying the transition and will not sacrifice profitability for the privilege of being included in the CBPS. Divestment from such companies would be consistent with the International Energy Agency's recent finding that new fossil fuel projects beyond 2021 would be incompatible with reaching net zero emissions globally by 2050. Companies more minimally involved in fossil fuel activities should face exclusion from the CBPS, and ultimately also divestment if they do not rapidly phase-out their fossil fuel activities. Immediate exclusions and divestments would reduce climate-related financial risks on the Bank's balance sheet and would send a strong signal to other investors, as well as companies and consumers, thereby resulting in a far more decisive impact than would be possible via engagement.

For companies that remain part of the scheme following an initial round of exclusion and divestment, making eligibility conditional on credible and verified transition plans should be a near-term action rather than a "long-term aspiration", as the discussion paper currently suggests. More basic requirements, such as requiring disclosure of (scope 1, 2 and 3) emissions should be even more near-term. The Bank should set out a clear timeline for implementing these requirements, which, in line with a new fourth principle of proportionality, should be more ambitious for relatively carbon-intensive companies and more lenient for low-carbon companies. This would address the Bank's concern about its requirements having the unintended effect of increasing the carbon-intensity of the CBPS in the short term.

If excluded high-carbon companies do eventually manage to meaningfully align with the government's climate commitments, such as those made through the Paris Agreement, there is no reason why their eligibility for the CBPS shouldn't be reinstated. Therefore, we support the Bank's own suggestion of maintaining an 'open door' approach for future eligibility. If the Bank believes that eligibility for the CBPS can incentivise companies to change, this should be an equally effective way of ensuring such incentives are in place, while still guarding against the risk of the Bank finding itself supporting companies who, beneath their superficial decarbonisation pledges, are undermining the green transition and therefore compromising the Bank's stated aim to support the government's net zero target.

Q4 – Tool 3: Tilting

What might provide the most effective basis for tilting CBPS purchases to provide effective incentives to firms to take actions towards net zero emissions, taking into account the availability of metrics and transition pathways, as well as the Bank's wider responsibilities to preserve the ability of the MPC to achieve its inflation target, to protect public money and to rely only on sufficiently robust data and metrics?

1. **How might one design an approach to tilting which is consistent over time, while incorporating sufficient flexibility to adapt as data, metrics and toolkits improve? Do respondents agree there is merit in a 'scorecard' approach, which weights together different climate metrics?**
2. **Are sectoral transition pathways yet robust enough to define required reductions in emissions and, if not, what rate of improvement should sectoral or aggregate tilts be set in reference to?**
3. **Which forward-looking metrics capturing (credible) plans for emissions might be the most useful inputs to a tilting approach at present, and which have the greatest potential over coming years?**
4. **What affects whether a metric is better suited to use as a portfolio eligibility criterion (producing a binary outcome in/out for an asset) versus as a basis for 'tilting' purchases between eligible companies (allowing it to be counted, without leading to exclusions)?**

It is important that the Bank of England's 'tilting' approach is not seen as a replacement for exclusions and divestment. The discussion paper mentions "material risks to public money" as a justification for not divesting at scale, but as the transition accelerates, holding fossil fuel assets on the Bank's balance sheet poses a far bigger risk to public money than holding higher concentrations of bonds issued by a smaller pool of lower carbon companies. Furthermore, rather than a light and slowly escalating tilt, the Bank should implement an early and heavy tilt (as we discuss in question 5), bearing in mind that this tilt could subsequently be softened if companies substantially improve their record at a later date.

We are in favour of the Bank's proposal to base the tilt on a 'scorecard' of metrics. Using a variety of both backward and forward looking metrics would ensure that the tilting strategy is comprehensive and does not set up any perverse incentives. Early on, it's particularly important that considerable emphasis is placed on past and current emissions. Placing too much emphasis on transition plans, for example, could result in high-carbon companies with transition plans benefiting from a positive tilt and lower-carbon companies without transition plans being penalised by a negative tilt.

Q5 – Tool 4: Escalation

How best can we build an escalation strategy into our approach, and what properties should this exhibit?

1. **Enhancements in data and metrics should allow us to discern more accurately between firms on the basis of climate performance over time. Which developments in the coverage and / or type of available metrics will be most important in this regard? Over what timeframe are these changes likely to take place, and are there obstacles?**
2. **How can investors in corporate bonds, including the Bank, best deal with firms with relatively poor climate performance? What factors affect how long incentives should be given to take effect before further actions are taken, and what 'ladder' of actions is most effective?**

The escalation strategy laid out by the Bank is premised on the idea that "in all but the most serious cases", it will start off with incentives, and then over time consider negative tilts, exclusions, and divestments. The discussion paper even suggests that some companies' actions might merit a positive tilt now but exclusion or divestment further down the line. This is concerning, as it implies the Bank could initially positively tilt towards companies that are meeting very low requirements and showing no sign of moving in the right direction. The Bank should consider the reverse approach, excluding highest emitters now and implementing an early and significant negative tilt for remaining relatively high-carbon companies. Over time, if these companies meet the Bank's criteria, they could regain their eligibility and benefit from positive tilts. This would ensure that the Bank has incentives in place to support an economy-wide transition, but also that it doesn't continue to implicitly subsidise companies that are undermining the government's climate goals.

The Bank's discussion paper implies that the Bank is hesitant to move much faster than other market participants when it comes to negative tilts, exclusions, and divestments. But the Bank has significant signalling power via the CBPS. Not only does eligibility for the CBPS affect bond pricing and therefore companies' financing conditions, the way the Bank manages risks in its portfolio also sets a precedent for other financial institutions. As a public institution and a financial supervisor, the Bank has a responsibility to lead the way, rather than follow a slow-moving market, on climate risk management and net-zero alignment.

Q6 - Overall approach
Are the four main tools identified in Section 4 of the Discussion Paper the right building blocks for the Bank's approach? Are any unnecessary, or are there tools that should be considered that are missing?
How might the four tools best be combined into a coherent and effective overall approach to greening the CBPS? What are the most important trade-offs affecting which combination to choose? Have any potential valuable components been omitted?

A dramatic shift is required to bring the Bank's portfolio down from its current alignment with 3C of warming and in line with the 1.5C target the government is committed to through the Paris Agreement. We are concerned that the current approach relies too heavily on firm-level engagement, which is likely to prove a weak and slow mechanism.

As previously noted, the Bank's engagement strategy will be particularly ineffective in sectors where profitability is closely tied to environmental destruction. The risk is that the CBPS continues to implicitly support companies that are not sufficiently incentivised to change their business models and continue to undermine the government's net zero target. In these cases, repricing effects across financial markets, resulting from exclusions and divestments, are likely to be a far more powerful 'stick' than the modest 'carrot' that CBPS eligibility offers.

In addition to including a fourth principle of 'proportionality', the Bank's overall approach must also address nature-related financial risks and impacts, such as those related to biodiversity loss, which will also pose material risks to the CBPS. Not only do these risks interact and exacerbate climate risks, but they are also emerging over a far shorter time frame than longer-term physical climate risks (Kedward et al. 2021: https://www.suerf.org/suer-policy-brief/27301/understanding-the-financial-risks-of-nature-loss-exploring-policy-options-for-financial-authorities#f2). As part of its commitment to dynamically review and update environmental policies for the CBPS, the Bank should conduct preliminary analyses of nature-related risks and impacts within monetary policy operations.

Beyond the CPBS, the Bank must also take action to green its other monetary policy operations, such as the collateral framework and TFSME. Beyond monetary policy, the Bank's new green remits also extend to its regulatory and supervisory functions, where the Bank should have an even bigger impact and is currently moving too slowly. For example, there is a strong case for the Bank to increase capital requirements against dirty exposures now in order to protect financial stability and support net-zero. Modelling exercises (like the CBES) and more data are not necessary for the Bank to take immediate and meaningful climate-related regulatory action.

In addition, the principles informing the CBPS should recognise that the Bank can and should move much faster to regulate other investors, for instance by requiring the financial institutions it regulates to outline credible net-zero plans, and encouraging the government to do the same for all other financial institutions. To fulfill its remit to manage systemic financial risk, the Bank should recommend stronger regulation from the government. This would allow the Bank to achieve the signalling effects of divestment, while also being less concerned about other investors not engaging with companies on climate.

Finally, we would like to emphasise that there is strong public backing for the Bank to move further and faster to operationalise its green remits in the narrow window remaining before COP26. Earlier this year, 65,000 people signed a petition calling for the Bank of England and the Treasury to stop supporting fossil fuels through its own operations, and strengthen regulation to prevent UK financial institutions doing the same (https://positivemoney.org/2021/02/sunak-urged-to-stop-bankers-fuelling-climate-crisis-in-budget/).