Briefing

Why climate and nature risk should be a Bank of England priority

green alliance...

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Summary

The Bank of England played an important early role in waking central banks up to the dangers of climate change. But its world leader status has diminished since 2020, hindering the UK's reputation as a climate leader and efforts to consolidate the country's position as the world's pre-eminent green financial centre.[1]

The Bank's lessened commitment to tackling climate risk and lack of a framework to act on nature degradation risks could have a bigger impact though. These risks have serious consequences for the economic, price and financial stability that underpin the UK economy, casting doubt on whether the Bank can fulfil its statutory objectives.

But the Bank has the tools to act, from ensuring that renewables projects can access affordable funding, helping to keep prices stable, through to capital buffer requirements to make banks and insurers more resilient to the financial risks that climate change and nature degradation expose them to.

Ultimately, the Bank needs to take preventative action that changes the underlying climate and nature risk profile of the wider UK economy, by redirecting financial flows for activity that causes climate change and nature degradation, towards nature positive and net zero economic activity. This would be in line with the Bank's own primary objectives and the government's economic objective for a "climate resilient, nature positive, net zero economy".[2]

Environmental shocks increase price and financial instability

The Bank of England ('the Bank') has three primary objectives that task it with ensuring price stability, financial stability and the safety and soundness of financial institutions. Its monetary policy committee (MPC), financial policy committee (FPC) and prudential regulation committee (PRC) are tasked by parliament with achieving these objectives respectively. Each has a secondary objective to support the economic policy of the government.

Climate change and nature degradation, together fuelling an environmental and economic crisis, will make achieving these objectives more difficult. Chancellor Rachel Reeves stated in her remit letters to the Bank's monetary

and financial policy committees that “the climate and nature crisis is the greatest long-term global challenge”.

As set out unequivocally in the Treasury commissioned Dasgupta Review on the economics of biodiversity, the economy is dependent on and nested within nature.[3] Empirical research by the Green Finance Institute (GFI) and Oxford University, building on the Dasgupta Review, shows that the UK economy as measured by GDP could be six per cent lower in 2030 than it otherwise could be, if biodiversity loss and environmental degradation are not halted. [4] This would be greater than the GDP impact caused by the 2008 global financial crisis.

Economic, price and financial system volatility will increase as the scale and frequency of nature and climate shocks rise. [5] The nature shocks will range from physical risks causing price shocks, such as soil health decline causing failed harvests and deforestation causing flooding and droughts; through to a major fall in financial asset prices causing system wide disruption. Some central banks around the world are waking up to this new reality. The Monetary Authority of Singapore and the European Central Bank are leading the way by incorporating nature risk into their frameworks, with both including nature risk in their expectations of financial firms’ risk management practice.

Monetary (price) stability, meaning low and stable inflation, is important for the economy and determining the cost of living. Inflation spiked drastically between 2021 and 2024, with analysis estimating that 60 per cent of food price inflation in 2022 and 2023 was driven by climate change.[6] Inflation, coupled with low economic growth, has caused the ongoing cost of living crisis which has led to seven million UK households reporting that they went without essentials, such as heating, food or showers, during 2024.[7]

Increased price shocks from the climate and nature crisis will make monetary policy analysis more difficult, making it harder for central banks to control inflation.[8] In addition, it is also more complicated for a central bank to control inflation caused by supply side shocks, which will increase as a result of climate change and nature degradation, as inflation and economic activity move in opposite directions. Increasing interest rates to tame inflation will further reduce economic activity, doubly affecting the cost of living.

Financial stability, meaning a financial sector that is functioning effectively by providing loans and insurance to businesses and households, is also important for the economy and the cost of living. Financial instability during the global financial crisis caused an economic recession, a collapse in lending to business and households, job losses and business failures, and a subsequent fall in household disposable income.[9, 10]

The safety and soundness of individual banks and insurers, and the interconnections between them, are both critical for ensuring financial stability. As the climate and nature crisis worsens, causing more regular

shocks, the risk increases of a sudden and significant change in the price of financial assets, such as loans to a specific sector of the economy, meaning financial instability is likely to increase.

For the Bank to fulfil its objectives in the medium to long term, the climate and nature crisis needs to be addressed, otherwise its ability to control inflation and financial instability will become increasingly limited.

The Bank was an early leader on climate risk

The Bank was an early leader in identifying the importance of mitigating climate change in meeting its objectives and it began putting in place policies to support this view. These included requiring banks and insurers to assess and manage the financial risks from climate change, through 2019 guidance (supervisory statement (SS) 3/19), and the 2021 exploratory stress test for the largest banks and insurers focused on climate change, known as the climate biennial exploratory scenario (CBES).[11,12]

Given the climate and nature crisis will negatively impact the Bank's ability to fulfil its objectives and the actions it took to mitigate this, it could be expected that the Bank would continue its efforts. But the Bank of England governor's comment in February 2024, to the Lords Economic Affairs Committee, that it was scaling back on climate work to focus on "core financial stability risks", demonstrates a failure to understand and accept that climate change and nature degradation are core financial and price stability risks, and that they will increase in magnitude over time.[13]

The letters the chancellor wrote to the MPC and FPC in November 2024 setting out their new remits, gave an important counter steer to the Bank.[14,15] The letters state that a "climate resilient, nature positive and net zero economy" is part of the government's economic policy that the committees must support, while meeting their primary objectives. The FPC letter went further, reinstating climate and nature risk as a direct consideration for meeting the committee's primary objective of financial stability.

Government policy remains the primary mechanism for tackling climate change and nature degradation, including through public spending, regulation and building public support for action. The Bank has an important complementary role to play as the overseer of the cost of borrowing and financial risk in the banking and insurance sectors. But it has since fallen behind other central banks in tackling both climate and nature risks.[16]

The Bank's primary objectives cannot be fully met unless climate and nature risks are addressed

Despite 2019 guidance requiring firms to manage their financial risks from climate change, the Bank did not include nature risks in a November 2024 update, even though nature risks both amplify climate risks and are a direct financial risk.[17,18] It also does not set firms capital requirements to use as a

buffer against losses caused by climate and nature risks, as it does for many other financial risks.

Capital requirements are an important tool for meeting the Bank's objectives to promote the safety and soundness of individual financial institutions and financial stability. The Bank's reason for not setting capital requirements is, in part, that the normal one year horizon for assessing an individual bank's or insurer's expected losses in a severe but plausible stress event, and therefore sizing capital requirements, is appropriate for climate risks. It is relying on companies' financial disclosures of their analyses of their longer term risks from climate and nature to bring sufficient market discipline.[19] But climate and nature risks are already here and are already likely to be having a significant impact on the UK's economy and financial stability by 2030.[20,21]

The Bank acknowledges that the systemic nature of climate risk means that setting capital requirements at the individual firm level may not adequately capture the build up of total financial sector risk. But it does not set capital requirements on groups of firms (a tool known as macroprudential capital requirements) like insurers, to mitigate these systemic risks, despite being in the FPC's power to do so.[22]

The Bank's approach to climate and nature risks is that it should wait for a precise measurement and forecasted timing of the risks before deciding if corrective action is required, but this may not be possible until it is too late and the risks are already reducing its ability to meet its objectives.[23] Simply requiring risk management and disclosure of risk by banks and insurers is insufficient to redirect finance away from activities that contribute to climate change and nature degradation.

Instead, the Bank should take preventative action to change the underlying climate and nature risks to price and financial stability, in addition to monitoring and measuring it.[24] It can do this within the confines of its remit, in two ways. First, by acting to discourage the firms it regulates from financing activities that cause climate change and nature degradation; and, second, by encouraging them to finance nature positive and net zero economic activity, in line with the government's economic objective. This will improve its ability to meet its own primary and secondary objectives in both the short and long term.

The Bank has the tools to act

The Bank and the government have interdependent roles to play in reducing the risks of climate change and nature degradation and the Bank already has many of the tools it needs to act.

Price stability

To meet its price stability objective, the Bank has a precedent for making funding available to banks and other credit providers at reduced interest rates for onward provision to a defined cohort. The Term Funding Scheme

with Additional Incentives for Small and Medium Sized Enterprises (TFSME), did just this, to ensure a consistent flow of credit to SMEs suffering economic disruption during the Covid pandemic.

During the recent period of the highest inflation for 41 years, driven by volatile international gas prices, the Bank has raised interest rates significantly. This has had the perverse effect of making renewables, the solution to reduce dependence on gas for producing electricity and home heating, more expensive to build. Renewables have high upfront capital expenditure but very low running costs, so the price of renewable energy is particularly sensitive to the interest rate at the time of financing. By raising interest rates to tackle inflation, driven by the price of fossil fuel gas, the Bank has unintentionally made tackling climate change, and therefore meeting its own objectives, harder.

To correct this, the Bank should introduce a new term funding scheme that facilitates lower commercial lending rates to renewable energy developers, which will complement investments in renewable energy and its supply chains made by Great British Energy and the National Wealth Fund.[25,26] This could unlock savings of up to £1.9 billion (£24 per household) per year on energy bills, if the cost of debt funding for offshore wind was reduced by 2.5 per cent through the scheme.[27]

Introducing this scheme would directly help the Bank to meet its price stability objective as renewable energy will insulate the UK from the fossil fuel price volatility that caused inflation to spike in 2021. It would also contribute to the Bank's secondary objective to support government economic policy. The Bank of Japan has been doing this since 2022, explicitly to help meet its price and financial stability mandates.[28]

The government should also introduce a science-based green taxonomy, which can be used to expand the term funding scheme to finance investment in other climate and nature positive economic activity.[29] This would help the Bank fulfil its primary price objective and its secondary objective to support economic policy for a "climate resilient, nature positive, net zero economy".

Financial stability, safety and soundness

The Bank has a range of tools to meet its financial stability and safety and soundness objectives.

When the Bank is unsure of the scope and scale of a risk, it can assess the financial system and an individual firm's exposure to it through an exploratory stress test.[30] It did this in 2021 for climate risk and could do so again for nature risks. This would have the dual benefit of building both the Bank's and the financial sector's knowledge and understanding of nature risks and how to manage them, consistent with the direction set in the FPC remit letter.

The Bank provides guidance to banks and insurers on a range of topics through supervisory statements that set out its expectations for how a firm should manage itself. It has done this for the financial risks from climate change, and should do so for nature risks, building on GFI's work.

The Bank also issues Statements of Policy that outline its approach on a given topic for firms. It has done this for how it will set capital requirements for financial risks not covered by internationally agreed standards, for both banks and insurers. But, as previously noted, it does not include climate or nature risk in this. [31,32] The Bank should develop an approach for how it will apply capital requirements to individual banks and insurers (known as microprudential) and to groups of firms (known as macroprudential) to mitigate the systemic risk from climate change and nature degradation, as detailed earlier.

What the bank should do and how the government can support it

The Bank has comprehensive tools to mitigate the risks to its primary and secondary objectives from climate change and nature degradation. It should:

- introduce a term funding scheme for renewable energy development, linked to a wider science-based UK green taxonomy (if and when that is introduced by government);
- by the end of 2025, set expectations on the approaches taken by banks and insurers to managing the financial risks arising from nature degradation by integrating the risks into an updated supervisory statement 3/19;
- commit to consulting by the end of 2025 on Pillar 2 methodologies for sizing capital requirements on banks and insurers, in relation to climate change and nature risks;
- in 2027, undertake a nature risk biennial exploratory scenario stress test to assess financial risks from nature degradation in the financial sector and at the individual bank and insurer level;
- integrate climate change risk no later than 2027 and nature degradation risk no later than 2029, into the biennial cyclical stress test scenarios for banks and insurers.

To support the Bank in its actions, the Treasury should:

- enhance the Bank's leadership on climate and nature by:
    - appointing a minimum of two individuals with climate and nature expertise to the MPC, FPC and PRC;
    - including climate and nature financial risk expertise in the job requirement for the Bank's next governor, due to be appointed in 2028;

- creating an independent scientific advisory committee on climate and nature for the MPC, FPC and PRC.

– Introduce a science-based green taxonomy.

– Update the MPC, FPC and PRC remit letters so that all three have specific priorities on climate and nature risks, with nature put on an equal footing with climate change.

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Endnotes

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