

CENTRAL BANK'S REGULATORY RESPONSE TO SUSTAINABILITY ISSUES

WHAT CAN WE LEARN FROM THE POLICY RESPONSE TO THE GLOBAL FINANCIAL CRISIS?

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In this article we explore what the UK central bank's policy response to sustainability issues and what this might mean in the short and longer run for the providers of finance regulated by the Bank of England (BoE) in the UK and perhaps in a wider international context; the European regulator also has a strong green agenda.

BACKGROUND - PURSUING THE NET ZERO OBJECTIVE

Since the independence of the Bank of England (BoE) on the first day of Tony Blair's Labour Government on 6th May 1997, the UK central bank has been focused on price stability and, more recently, prudential regulation of the financial sector after this was bought under the Bank's ambit when the FSA was dissolved on 1st April 2013. In March 2021, the UK Chancellor of the Exchequer, Rishi Sunak, added a climate change dimension to the Old Lady's purview, handing two letters to the BoE; one to the Monetary Policy Committee (MPC) and one to the Financial Policy Committee (FPC). The MPC letter states: "I am today updating the MPC's remit to reflect the government's economic strategy for achieving strong, sustainable and balanced growth that is also environmentally sustainable and consistent with the transition to a net zero economy." *Letter to the Governor of the Bank of England from Rishi Sunak 3rd March*

2021. The 2% inflation target remains. The Chancellor's letter to the Governor on the FPC's remit states: "the Committee should continue to act with a view to building the resilience of the UK financial system to the risks from climate change and support the government's ambition of a greener industry, using innovation and finance to protect our environment and tackle climate change."

WORKING TOWARDS THE GREEN MANDATE

The regulation of the financial system is one of the policy levers that governments have at their disposal to help achieve the below 2°C global temperature rise enshrined in the Paris climate agreement. The 92 members (including the G7 central Banks) of the Network of Central Banks and Supervisors for Greening the Financial System (NGFS) are now playing a key role in the international regulatory response. The BoE's so-called "Green Mandate" is an example of this: the BoE is planning to adjust its bond buying program to take account of the Green Mandate by the last quarter 2021. Although as far back as June 2019 the BoE saw "A smooth transition to a low-carbon economy through mainstreaming climate-related disclosures, launching climate stress tests and promoting climate risk management" as one of its objectives: *Future of Finance Chaired by Huw van Steenis*.

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POTENTIAL POLICY RESPONSES

The Central Banks are approaching the climate change issue from two angles: What are the threats from climate change to financial stability and, how the financial markets can be mobilized to steer “the necessary transformation of the real economy towards higher levels of sustainability” *Sustainable Finance Market Dynamics and Overview*” NGFS Technical Document March 2021.

Taking the second of these aspects the NGFS paper cites three aspects: Disclosure, Risk Management and Mobilization of Capital:

- **Disclosure**

- Of ESG risks and the impact that these may have to the long-term value of assets. Whilst there are a number of standards that have been developed and have emerged in recent years there is a drive for a single global sustainability standard.
- Critically this now includes accounting frameworks and the IFRS has proposed setting up an International Sustainability Reporting Board.

- **Risk Management**

- Whilst there is an increased incorporation of climate, sustainability and other ESG issues in financial institutions risk management assessments, these are not fully developed and lack transparency.

- **Mobilization of Capital**

- The deployment of capital in support of the sustainability requirements is, in part supported by disclosure and reporting.
- There is investor demand for “green” investment opportunities.
- But, avoiding greenwashing.

The central banks, and we cite the BoE, are coming under, and will come under political pressure to ensure that they play their part in the climate change and broader sustainability agendas of the public and their political masters. We note that the European Central Bank (ECB) also has been given a role to play in making Europe the world's first climate neutral continent by 2050, an EU political objective. The European Banking Authority (perhaps more interventionist than the BoE) has proposed the use of Green Asset Ratios (GARs) to force the banks to re-assess the costs and benefits of financing environmentally impactful businesses, particularly green-house gas (GHG) emitters and to drive increasing disclosure of environmental impacts of bank's funding decisions.

If we think of the central banks'/regulators policy responses in relation to market participants after the global financial crisis and the call for better managed and more stable banks, we can see that much of the detail around risk management and disclosure was pushed down to the market operators, particularly the banks with oversight and adjudication from the regulator.

Whilst at the macro level, the central banks were highly active in pursuing the goal of greater capitalization of the banking system through Basel capital and liquidity measures, at the more micro risk management level the central banks' approach was to set the objective and allow the banks to develop their own responses, with the central bank acting as judge and jury on what was developing as good practice. Their approach seemed to be “tell us what you are planning to do (say on stress testing) and we will review and let you know if it is good enough”.

The BoE was clear that it would not act “a consultant” to guide the banks on how to respond to the requirement for stress testing or wrong way risk reporting and capture, as two examples. The approach seemed, from the bank's side of the desk, that the regulator

was happy to “let a thousand flowers bloom” and then see which approaches were the most effective; focusing its demands on outcomes not methodology. It seems likely that, in its regulation of the banking sector in respect of the BoE's sustainability and climate change objectives, its instincts may be to follow a similar approach. But with the EBA's GARs in the public domain will the BoE feel the need to follow suit?

Factoring climate and other ESG risks are already aspects of many banks' and other financial institutions risk assessment and management frameworks, indeed several banks are developing methodologies to align their lending portfolios with the Paris Agreement goals. However, in the UK the increased impetus and focus on these aspects as a result of the 3rd March Rishi letters, means that the regulatory focus of the BoE is now not just on the risk management aspects of climate and sustainability but formally on the active pursuit of climate and sustainability objectives.

BANKS WILL FACE INCREASING PRESSURE TO MANAGE ESG RISKS

Banks, and other regulated financial institutions are facing increasing pressure from regulators to demonstrate how they are factoring in climate and sustainability not only into their management of risk and disclosure of climate, environmental and other ESG factors, but also into economic and capital allocation based on these factors, including how these factors feed into financing, investment, portfolio and pricing decisions, which in turn will pressurize companies to improve ESG disclosure.

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EFFECTIVELY MANAGING THE ESG PROCESS – CAPTURE, REPORTING AND DECISIONING

We believe that the process will follow a similar pattern to that witnessed post the financial crisis, which when applied to the environment and sustainability may look rather like this:

The first step: capture

- What processes and methods does the financial institution (FI), a bank for example, have for capturing and measuring environmental exposures and impacts at the borrower and the portfolio levels?
- How does the FI capture its general exposure to climate risks (increased extreme weather events, flooding and the like) and how does its financing decisions increase or help abate climate impacts, both by individual borrower and at the portfolio levels?
- How is “greenwashing” avoided?

The second step: reporting

- How is the information collated and reported to senior managers including risk committees and the Board in such a way that is useful for decision making?

The third step: decisioning

- ESG information that is gathered and reported to decision making functions, including the Board and the Board risk committee (or equivalent), is considered and factored into a bank's decision-making process.
- Decisions that take account of the environmental and sustainability criteria must be at the individual exposure level, including pricing, and at the portfolio and overarching limits and capital allocation levels.

The regulatory pressure is for banks to have environmental and sustainability policies, limits (including risk appetite or similar, carbon appetite anyone?) and procedures in place to manage and report the climate impact of the bank's lending decisions.

CONCLUSION

The pressure on financiers to measure, manage and report the environmental impact of their decisions will feed down to the level of reporting that borrowers are required to produce so that how much carbon or other environmental impacts are being financed can be assessed. One could even imagine a scenario in which a net carbon sequestering borrower would get favorable pricing as it would allow a bank to lend to a carbon producing borrower giving the lender a net zero carbon impact from its lending decisions. All this may be a little way off yet, but it seems that Mr. Sunak has set the ball rolling with the BoE as the EBA has done in Europe, with these requirements set to gather pace.

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