

Briefing: monetary policy, climate change and nature loss

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This briefing outlines the implications of climate change and nature loss for monetary policy, the Bank of England's progress on integrating climate and nature into monetary policy, and options for the Bank to make further progress in this area.

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Background: Climate change, nature loss and central banking

Climate change and nature degradation are relevant to central banks' primary objectives, as they pose threats to both financial and price stability:

- **Financial stability:** the physical impacts of climate change and nature degradation, as well as the impacts of the transition to net zero and nature-positive economy, could impact the value of financial assets. Disorderly re-pricing as a result of severe, acute climate impacts, or a poorly coordinated green transition, could trigger a financial crisis ([BoE, 2024](#)).
- **Price stability:** climate change and nature degradation, and the transition to a net-zero and nature-positive economy, have implications for the ability of central banks' to achieve price stability targets. Current policies are not sufficient to mitigate these impacts, meaning they are likely to increase over time ([NGFS, 2024](#)).

Many central banks, including the Bank of England, have secondary objectives to support Government economic policy, which often include climate change and nature loss mitigation and supporting the net zero transition (see Annexes for background on the Bank of England's remit). It is increasingly recognised that central bank support of the green transition will also be necessary in order for central banks' to achieve primary objectives ([Schnabel, 2022](#)).

The implications of climate change and nature loss for monetary policy

Acute (e.g. extreme weather events) and chronic (long-term shifts in climate and weather) physical impacts of climate change and nature loss have economic impacts that are relevant to monetary policymakers.

Climate change and nature loss will reduce global economic output:

- The Network for Greening the Financial System's (a global network of central banks and financial supervisors) most recent models foresee a 15% loss to global GDP by 2050 under current policies. This is a significant increase from the 5% estimate in their previous 2023 models ([NGFS, 2024](#)).

- The Green Finance Institute estimates that nature loss could result in a 12% loss to UK GDP by the 2030s ([GFI, 2024](#)).
- Importantly, estimates of damages vary widely and are difficult to quantify due to significant uncertainties (such as precisely when and how impacts will occur), and model limitations including the omission of climate tipping-point dynamics, socioeconomic impacts (like migration and conflict), as well as compounding risks.

Climate change, nature loss and global energy markets are sources of price instability:

- Fossil fuel prices driving inflation is a longstanding phenomenon, most recently triggered by Russia's invasion of Ukraine, with energy prices contributing up to 75% of UK inflation between 2019–23 when direct and indirect impacts are combined ([Positive Money, 2023](#)).
- The inflationary effects of climate change occur primarily through reductions in agricultural activity and damage to crop yields, which drive supply-side shocks. ECB researchers have forecast that climate change could lead to an increase in food price inflation alone of up to 3.23 percentage points per year by 2035 ([Kotz et al., 2024](#)).
- The emergence of climate- and nature-related financial risks that impact the values of assets, collateral and cash flows, can have knock-on impacts for credit risk, access to capital and financial values, which can impact credit flows with inflationary effects.

The case for greening monetary policy

In response to inflation driven by energy price shocks and climate impacts, the conventional response of raising interest rates is counterproductive for achieving price stability:

- Rate rises cannot mitigate the drivers of these sources of inflation, and reduce the competitiveness of renewable projects, which are particularly sensitive to the rising cost of capital ([Wood McKenzie, 2024](#)).
- Despite recent drops in Bank Rate, rates remain high, with evidence to suggest this higher costs of capital has contributed to delays and cancellations of green energy projects (e.g. Vattenfall delayed its UK offshore wind project in 2023 ([Reuters, 2023](#))).

Many tools for managing inflation driven by fossil fuels and climate change lie outside of the scope of central banks, and there is a case for rethinking the mix of fiscal and monetary policy in response to future shocks, as has been recently proposed by the Deputy Governor of the Bank of France ([Bénassy-Quéré, 2024](#)).

However, central banks can adapt the tools at their disposal to ensure that they do not run counter to the transition to a net-zero and nature-positive economy, and in doing so, support the achievement of both their primary and secondary objectives.

Options for greening monetary policy

Greening the collateral framework:

- Central banks accept financial assets as collateral as part of day-to-day provision of

liquidity to commercial banks. Assets have valuations called 'haircuts' applied, with greater haircuts applied to assets deemed to be riskier.

- Assets accepted by central banks, and with more favourable (lower) haircuts, receive a premium from commercial banks, enjoying better borrowing conditions.
- Screening collateral to exclude the most environmentally damaging assets, and varying haircuts to reflect climate change and nature loss risks and impacts can be used to align the framework with the green transition.
- Most collateral frameworks are biased towards high carbon assets, because central banks accept the most creditworthy assets, which tend to be from large issuers.

Introduce a 'dual interest rate' scheme to pass lower interest rates for green investment:

- The Bank of England could repurpose its existing Term Funding Scheme (TFS) to incentivise banks' to lend to green sectors.
- The TFS offers cheap funding to banks (at or close to Bank Rate), provided they demonstrate they have expanded lending to households and businesses. The most recent iteration offered additional incentives for SMEs (TFSME).
- With the Bank now easing monetary policy, the scheme could be adapted and re-opened to ensure that the Bank's rate cuts are passed through to green sectors, or to offer below Bank Rate funding for lending that would particularly support price stability, such as retrofits and renewable energy.

The Bank of England's progress on greening monetary policy

The Bank greened its corporate asset purchase programme ('corporate quantitative easing'), however this is no longer an active monetary policy tool:

- The Bank of England emerged as an early leader in greening monetary policy by greening the asset purchases made under the Corporate Bond Purchase Scheme as part of Quantitative Easing. The Bank made these changes based on the rationale of 'support[ing] an orderly economy-wide transition to net zero' ([BoE, 2021](#)).
- This policy is no longer active, as the Bank has now sold most of the bonds purchased under the CBPS.

Some changes have been made to collateral eligibility for residential mortgages:

- In May 2024, changes were introduced to eligibility and haircuts for residential mortgages based on energy efficiency (a proxy for transition risk) and physical climate risks, such as exposure to flooding ([BoE, 2024](#)).
- Three main changes were introduced: 1) Buy-to-let mortgages are required to meet Minimum Energy Efficiency Standard Regulations (currently EPC E) in order to be eligible as collateral; 2) Increased haircuts were applied to owner-occupied mortgages with lower (or missing) EPC ratings; 3) Increased haircuts have been applied to residential mortgages in areas exposed to flood risk.
- These changes could encourage improvements in property energy efficiency and flood risk resilience, but a stricter application of this approach could penalise lower-income homeowners with inefficient properties or those in high flood risk areas, who may be unable to afford to adapt their homes.

- To mitigate the risk of such impacts slowing the uptake of energy efficiency and climate resilience measures, Government support (such as through grants and affordable loans), should be made available to households. The Bank of England could also adopt policies to make such measures more affordable, such as adapting its Term Funding Scheme to support cheaper lending to these activities, alongside other green activities that would help to mitigate physical climate risks.
- Crucially, the Bank has not yet adjusted collateral eligibility and haircuts for corporate and bank assets in relation to climate change and nature loss, missing an opportunity to send a clear signal to the private sector.
- The Bank should follow the precedent set by its approach to greening the Corporate Bond Purchase Scheme (CBPS), and apply exclusions to assets from issuers whose main economic activity is misaligned with climate objectives. At minimum, in line with the most recent International Energy Agency Net Zero Roadmap, exclusions should apply to assets from issuers whose main economic activity is fossil fuel expansion ([IEA, 2024](#)). Further exclusions could be made for activities most damaging to biodiversity.
- Beyond this, haircuts should be calibrated according to environmental impact, and eligibility could be extended to assets from 'green' issuers.

The Bank has yet to address the impact of high interest rates on clean energy, though MPC member Megan Greene has previously argued in support of repurposing the TFSME to support green investment ([Greene, 2022](#)).

In the September 2024 update to the Green Central Banking Scorecard, the Bank of England fell to 7th place amongst G20 central banks' for green policies:

- Whilst the Bank still received a 'C' grade, it has been outpaced by other countries and dropped from its previous position of 5th in 2022, and 4th in 2021.
- The ECB, and the central banks of Germany, France, Italy, Brazil, Japan, China and Indonesia have all committed to, or implemented, more and/or higher impact green monetary policy initiatives than the Bank of England, resulting in them outranking the BoE when ranked according to green monetary policy ([see full rankings here](#)).

Suggested questions for HM Treasury

- What is the government's assessment of the need to rethink the current approach to managing inflation driven by supply-side shocks such as fossil fuel prices and extreme weather events driven by climate change?
- What implications do the new edition of climate scenario models from the Network for Greening the Financial System have for the Government's policies?
- What assessment has been made of the impacts of the Bank of England's fall from 5th to 7th place in the 2024 Green Central Banking Scorecard, for the Government's goal for the UK to be the leading green finance centre?
- What estimate has been made as to how much additional financing could be delivered by repurposing the Bank of England's Term Funding Scheme to pass through lower interest rates to clean energy companies, and the implications for energy bills?

Annex: The Bank of England's remit and climate change

The primary objectives of the Monetary Policy Committee (MPC) and Financial Policy Committee (FPC) are to support price and financial stability. Acting on climate change and nature loss is relevant to the Bank's primary objectives, given the risks posed to price and financial stability, as the Bank itself has stated (see [Talbot, 2024](#); [Mann, 2023](#); [Breedon, 2023](#)).

Subject to primary objectives, the MPC and FPC have secondary objectives to support Government economic policy, which the Chancellor is required to set out at least once every 12 months in annual remit letters. For the FPC, the Chancellor also specifies in the remit letter: matters relevant to the financial stability objective; the responsibility of the FPC for achieving that objective; and the responsibility of the FPC in relation to supporting the Government's economic policy.

In recent years, climate and the net zero transition have been part of both committees' secondary objectives. Changes in emphasis has shown to impact upon the Bank's strategy and resourcing of this work, with the Bank in February 2024 stating it had reduced its resourcing of climate change work in response to the removal of, *'align[ing] private sector financial flows with environmentally sustainable and resilient growth'* as a policy priority for the financial services sector in the November 2023 remit letter to the FPC. This was criticised by over 50 economists and experts, given the relevance of climate to the primary objectives ([Positive Money, 2024](#)).

In November 2024, the remits of the MPC, FPC and PRC were updated, emphasising both climate and nature risks and the role of the financial sector in supporting the net zero transition. Key points included:

- Listing, *'accelerate the transition to a climate resilient, nature positive and net zero economy'*, and enhancing the financial sector's role in *'supporting the transition to a net zero economy'* within the government's economic priorities in letters to the MPC, FPC and PRC.
- Listing, *'leading the world in sustainable finance by making the UK a global hub for green and transition finance activity, and delivering a world-leading sustainable finance regulatory framework'* as a priority for the financial services sector to which the FPC, PRC and FCA should have regard.
- Highlighting the relevance of climate change and nature loss to the FPC's primary objective for financial stability.