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The Bank of England is holding back the government's economic missions: here's how it should support green growth

Marking the 10-year anniversary of former Governor of the Bank of England Mark Carney's landmark, '*Tragedy of the Horizon*', speech, which warned of the catastrophic risks posed to the economy and financial system from climate change, this briefing has been developed by 11 leading civil society organisations: Positive Money, the New Economics Foundation, Green Alliance, WWF-UK, E3G Global Canopy, Finance Innovation Lab, ShareAction, Leave it in the Ground Initiative (LINGO), Greenpeace, and Reclaim Finance.

This government has set missions for the UK to achieve the highest sustained economic growth in the G7, to raise household income in every part of the country, to attain an employment rate of 80%, and to achieve clean power by 2030. The UK's statutory net zero commitment, and legally-binding carbon budgets, are backed by widespread public support for climate action. Together, this amounts to a vision for a fast and fair green transition, and ensuring all parts of society benefit from increasing national prosperity.

However, the Bank of England's current policies are undermining climate action and green growth. The UK just experienced its worst inflationary crisis in four decades, triggered by fossil fuel price spikes and supply chain bottlenecks, which the UK's monetary policy approach proved ill-equipped to address. Now, interest rate hikes are contributing to rising unemployment, depressed real wages, high government borrowing costs and decreased business investment, with little impact on the underlying drivers of inflation. Meanwhile, the Bank's own policies are providing favourable financing conditions to high-emitting companies, and the Prudential Regulation Authority and Financial Policy Committee are not taking the required action to mitigate risks to firms' safety and soundness and financial stability arising from the financial sector's continued financing of harmful activities.

By undermining the green transition, the Bank is failing its primary objectives to control inflation and ensure financial stability. Continued fossil fuel dependence will make the UK vulnerable to future fossil fuel price shocks, and will contribute to supply-side inflation driven by the effects of environmental breakdown, which are already contributing materially to UK inflation such as via reduced crop yields.

Allowing the financial system to fuel climate change and nature loss will increase these economic threats. In doing so, the Bank is also failing in its secondary objective to support the economic policies of the government, which explicitly include sustainable economic growth and net zero.

For long-term economic prosperity, the UK needs the Bank of England to fulfil its objectives by supporting, rather than hindering, the net zero transition. The government has set momentum – now the Bank must be given clear direction to support this effort.

This briefing outlines four key areas in which the Bank of England must act now to support the UK's green growth objectives.

1. Align the Bank of England's collateral rules with the green transition

A core function of the central bank is to provide liquidity to the financial system by supplying central bank reserves, which are lent to banks secured against financial assets. A set of rules called the 'collateral framework' sets out which assets are accepted and the terms applied, with different valuations applied to assets depending on their perceived riskiness. Empirical evidence shows that firms whose assets central banks accept, and on more favourable terms, benefit from better financing conditions.

Central banks typically underestimate climate and environmental risks in their collateral frameworks, as they are poorly captured in their own conventional economic models and those of credit rating agencies whose ratings are incorporated into central bank risk assessments, and capital markets have a strong carbon bias as large public companies are typically higher emitters. As a result, collateral frameworks currently favour environmentally damaging companies instead of supporting greener ones.

The Bank amended eligibility and haircuts for mortgage loans based on energy efficiency and flood risks in 2024, but it has yet to reflect the climate and environmental impacts of corporate assets, such as bonds from companies expanding fossil fuel production, which the Bank currently accepts as collateral. In July, the European Central Bank (ECB) announced it will adjust its treatment of non-financial corporate assets in its collateral framework according to the green transition. There is no good reason why the UK should not do the same. Like the ECB, the Bank of England could draw on the methodology already developed for greening its corporate bond purchases.

The Bank should amend its collateral framework to remove the bias towards environmentally harmful companies and instead support the green transition by:

- **Applying exclusions for the most environmentally damaging companies such as those pursuing fossil fuel expansion**
- **Expand acceptance of assets supporting strategic, green sectors such as green energy production, to lower their cost of financing**
- **Adjusting haircuts of all assets accepted according to climate and environmental impacts**

2. Adapt the Bank's targeted lending schemes to support green investment

High interest rates have disproportionately harmed investment in clean energy. Though savings are made once operational, renewables require a large amount of up-front investment. Therefore the cost of capital is often the largest proportion of project costs, which means high interest rates have harmed the business case for renewable projects. Fossil fuel price shocks have also been one of the main drivers of UK inflation – both in recent years, and throughout history. Stymying investment in renewables with undifferentiated high interest rates not only hinders the government's Clean Energy mission, it is also counterproductive to the Bank of England's objective for managing inflation.

The Bank of England's Term Funding Scheme was introduced in 2016 to encourage the passing of lower interest rates to non-financial firms, and in 2020 the scheme was adjusted to incentivise lending to SMEs. The scheme, now closed to new applicants, could easily be repurposed to pass on lower interest rates to green energy investment, supporting both the Bank's price stability objective and the government's Clean Energy mission.

The Bank of England should repurpose its Term Funding Scheme to pass on lower interest rates for green investments that support the Clean Energy Mission.

3. Regulate for environmental risks

Climate change and environmental degradation pose systemic risks to financial stability. A disorderly or delayed green transition could result in a sudden fall in the value of fossil fuel assets, whilst physical impacts such as extreme weather damaging assets like housing could trigger large losses that reverberate through the financial system. Senior Bank staff members have recently raised concern that risks are not being taken seriously.

Crucially, climate and environmental risks are not properly captured in capital requirements – the rules that set the amount of shareholder equity and retained profits that banks must hold to ensure they remain solvent, in order to protect taxpayers from bailouts and the wider economy from risks of financial crises. As the Bank of England itself has recognised, capturing the full scale of environmental risks in the models used to calculate capital requirements is incredibly challenging. Major UK investors have argued that these risks may never be able to be quantified sufficiently, and called for a proactive approach.

The best way to protect against financial instability resulting from climate change and environmental degradation is for the Bank to support an orderly, government-led green transition. But this will not protect against all future instability. To address the underestimation of environmental risks, the Bank should increase risk-weights for assets most clearly misaligned with the green transition (such as those linked to fossil fuel assets, which European financial supervisors have recently recommended), and introduce a 'systemic' capital buffer against environmental risks to the whole financial system. Though banks have long argued for the lowering of capital requirements, evidence from the Bank for International Settlements suggests that a well-capitalised banking system enhances financial stability and can even increase lending, supporting green growth objectives.

The Bank of England should increase risk-weights in the calculation of capital requirements for new and existing fossil fuel exposures, and introduce an environmental systemic risk buffer.

4. Coordination for green investment and inflation preparedness

Ultimately, the most effective way to deliver economic stability is through rapid and orderly action to mitigate and adapt to environmental risks. The above steps can and should be taken by the Bank to ensure that its own activities support, rather than undermine, this effort, and would wholly support the Bank's existing objectives of monetary and financial stability. However, better mechanisms for coordination between the Bank and the Government would increase the overall effectiveness of the UK's macroeconomic policy framework and could enable the use of a wider range of policy tools, such as quantitative limits or targets on lending to certain activities and sectors, as has been an effective tool of industrial policy throughout history.

Improved coordination is also a political imperative to prevent a repeat of the UK's response to inflation in recent years. Not only was the UK's reliance on interest rate rises as the principal tool to respond to post-pandemic inflation ineffective in bringing down inflation, but it also had adverse distributional impacts, contributed to significant costs to the Treasury through their interaction with quantitative tightening, and adversely impacted private investment in green technologies. The multi-pronged approach taken by countries such as Spain and France shows that a mix of more effective tools can be used to bring down prices.

To prepare for future inflation driven by supply-side shocks, the Government should:

- **Commission an independent review of the UK's monetary policy framework, examining the mounting supply-side pressures posed to price stability and assessing whether the tools the Bank of England relies on are capable of responding.**
- **Instruct the Bank to set out a strategy detailing how it will support the UK's climate and nature goals and the Government's green energy missions across its policymaking committees and functions.**