OPTIONS FOR GREENING THE BANK OF ENGLAND'S CORPORATE BOND PURCHASE SCHEME

This is Third Generation Environmentalism (E3G)'s response to the Bank of England's consultation for options to greening the Bank's Corporate Bond Purchase Program

About E3G

E3G is a not-for-profit public interest organisation with offices in London, Brussels, Berlin and Washington DC. E3G's mission is to accelerate the global transition to a climate-safe world. E3G has a track record of experience and expertise on sustainable finance and international climate finance.

Overview

On 21 May 2021, the Bank of England published a Discussion Paper setting out options for taking climate considerations into account in the design of its Corporate Bond Purchase Facility (CBPS). With thinking on climate conscious investing developing rapidly, we are keen to hear from a wide range of respondents on the proposals and questions posed in this paper, including: firms that issue debt; investors; academics; advocacy groups; international organisations; and the public. Comments should please be submitted no later than Friday 2 July 2021.

Outline

Our response addresses the following topics:

1. **Principles for Greening the CBPS**
2. **Tool 1 – Portfolio Targets**
3. **Tool 2 – Eligibility**
4. **Tool 3 – Tilting**
5. **Tool 4 – Escalation**
6. **Overall Approach**

E3G

Consultation Response

Question 1 - Principles for greening the CBPS.

a) **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?**

b) **Should any considerations be dialled up or down; and have any been overlooked?**

- Recognizing that there are a multitude of objectives for the Corporate Bond Purchase Scheme, we welcome the recognition by the BOE of the importance of updating the CBPS to reflect this risk. We recognise that the primary objective of the CBPS remains supporting monetary and financial stability, while the secondary objective is now to support the Governments targets on NZ. Balancing these objectives will be an ongoing task, and the creation of incentives for companies to transition is needed. However, we emphasise the interlinkage of these objectives. The Bank will only be able to achieve its primary objective if the physical and transitional risks associated with climate change are integrated into its decision making, and it supports the broader economy in incorporating these risks. Given the well substantiated and material risks of climate change to and from the finance sector, (See Big Smoke Report The Big Smoke report | WWF), E3G welcomes this recognition by the Bank of England of climate risk as a material consideration on both the macroprudential and micro prudential levels. We also welcome the acknowledgement in the discussion paper of the need for an orderly and managed transition to net-zero to maintain monetary and financial stability. It follows then that the Bank of England must go further than just 'echoing' the Government's policy in relation to the net zero transition – as this will be a matter of market compliance. This necessitates more forward looking and ambitious updates to its toolkit – including CBPS.

- E3G supports the updates to the principles to the CBPS, in particular the recalibration of the concept of market neutrality in line with the monetary policy committee (MPC)'s new secondary objective to support the Government's objectives on climate. We note that many commentators have now argued that the market neutrality actually needs rethinking in order not to discriminate against green firms as the economy transitions (See https://www.e3g.org/news/lcaw-rapid-relief-sustainable-recovery-central-banks-inspire-seacen/)

- The CBPS has also been historically weighted towards fossil fuel intensive industries, with around 39% of the current CBPS holdings in high emitting sectors: Electricity, Energy, Gas, Industrial, and transport sectors, with a further 6% in Property (Climate Bonds, 2021). This consultation is a positive next step in changing this. However, the proposed updates indicate the bank is not doing enough to actively support a managed transition towards **net-zero [in the words of the NGFS1].** The Bank is not requiring CBPS-eligible companies to do anything more than many will be required to by law or regulation e.g. TCFD disclosures. It is not following leadership from other areas of government including mandating net-zero targets and transition plans for companies eligible for government procurement, and alignment with a strong green taxonomy together with an exclusion list. Without this, these principles will not be sufficient to support meaningful change and transition. It is therefore **important that the entire toolkit of the Bank of England is aligned with the Paris targets**, and eligibility for the CBPS scheme is built around this requirement.

    - Other supportive mechanisms include:
        - Eligibility requirements and criteria based around Paris Alignment.
        - A strong exclusion list;
        - Ambitious timeline on TCFD alignment for CBPS purchases;
        - Apply these changes immediately to align CBPS portfolio not only with new purchases but with existing bond holdings;
        - Penalise unsustainable lending; and
        - Support green investment.

- There have been several other positive developments from Government over the past year on climate, including, the Prime Minister's 10-point plan, the launch of the UK Infrastructure Bank, the announcement of the UK Green Taxonomy, and the update to the mandates of the key financial regulators to take account of the Government's commitments on Climate. Moreover, given the wave of net zero commitments from private finance over the last year, there is clear appetite for better data and guidance on what good looks like in terms of net zero from the finance sector.

- The Government should therefore include updates to the Bank of England mandate within a broader suite of policy and regulatory mechanisms which constitutes a plan for financing the UK's net zero transition and include actions to be taken by fiscal, prudential, and monetary authorities.

[1] NGFS

This could be outlined in the Net Zero Strategy and be elaborated in the 2022 review of the Green Finance Strategy.

Question 2 - 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?

a) How should investors, including the Bank, approach target setting in light of the considerable uncertainty around the timing and nature of transition?

b) What are the advantages and disadvantages of framing targets in terms of point-in-time emissions vs forward-looking metrics (e.g. portfolio temperature rise measures or emissions reduction targets of issuers in a portfolio), and how might this balance evolve over time?

***c)* What role might there be, now or in the future, for targets defined in terms of designated green activities (e.g. green bond holdings, share of classified green revenues)?**

- **Paris Aligned portfolio target.**

- As mentioned in the response to question one, according to Climate Bonds, around 39% of the current CBPS holdings are in high emitting sectors: Electricity, Energy, Gas, Industrial, and transport sectors, with a further 6% in Property. These sectors need to decarbonise rapidly.
- The Bank should set a target to align its CBPS portfolio with the Paris Agreement. This does not imply immediate divestment from all carbon intensive companies, but rather creates an implied and managed expectation for companies accessing the CBPS scheme to decarbonise. This would mean all issuers eligible for bank purchases of bonds should have in place a credible Paris-Aligned target and transition plan in line with the Bank's targets. Corporates should also be auditing their activities to develop strategies anticipating climate risks broadly consistent with the recently published 'orderly transitions' NGFS scenarios or their own similar scenarios.
- For those companies which do not put in place a net-zero target or a transition plan, and have no intention to do so, they should be excluded from

access to the CBPS.

- **Targets and Metrics**
    - Point in time emissions are a suitable way of setting intermediate (5-year) targets and should be applied with a consistent set of trajectories across a sector. The Committee on Climate Change should be consulted, and the Bank should make use of five-year budgets to decide economy wide reductions targets.
    - Forward looking metrics will need to be used particularly in the early years of transition, but some synthetic metrics should be treated with care and potentially avoided. For example, metrics based on the implied temperature change from emissions introduces substantial uncertainty due to changing scientific assessments of climate sensitivity.
    - PRA should apply carbon prices along the lines those proposed in the BES's (climate stress test) net-zero scenario to assess the company's viability under an orderly transition.
    - The Bank should decrease its reliance on short-term metrics to assess performance of bond purchases as this tends to reinforce biases to existing companies and business models., e.g. liquidity of the bond, the size of the issuance or the requirement for a CRA to assess the company as 'investment grade'.
    - Over time, metrics to do with performance on climate objectives, net zero targets and resilience targets should be built into bond evaluation. The Bank should also explore incorporating social objectives such as good quality job creation.

- **Green Bonds**
    - Corporate green bonds (aligned with UK's or internationally recognised taxonomies) are a good way of assessing the amount of investment in Paris Agreement aligned activities and the amount of issuance as a share of overall investment is a useful KPI. Over time corporate issuers should be increasing the share of green bonds being issued. This does not necessarily require a target but should be in size led by the overall purpose of the CBPS to support monetary policy, given once new climate related exclusions and eligibility criteria are included, and necessary divestments have been made.
    - The bank should also play a role in supporting innovation in the market for green bonds, and in sustainable finance more generally. An example to

look at is the European Central bank when it included sustainability-linked bonds in its corporate sector purchase programme and collateral framework.2

Question 3 - 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?

a) ***How could eligibility criteria best be used to incentivise companies to take meaningful actions towards transition?***
b) ***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?***
c) ***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?***

- **Eligibility and TCFD**

  - Eligibility criteria are critical to ensuring that climate considerations are appropriately included within the CBPS. Eligibility criteria should cover disclosure and prohibited capital investment plans.

  - This relates to the linking of eligibility to TCFD disclosure. We would expect TCFD criteria to be a minimum requirement. However, this should not merely be in line with the TCFD Roadmap but rather be more ambitious. For the CBPS, the timeline for timeline should be significantly accelerated. This will support both in data availability for the market and for the bank to design its own climate strategy, and secondly the existing overweighting of CBPS towards fossil intensive bonds.

  - Appetite for setting an expectation of reporting transition plans within TCFD disclosures is growing (See Aldersgate Group's recent report 'Financing the future: Driving investment for net zero emissions and nature: restoration' https://www.aldersgategroup.org.uk/our-reports). Eligibility criteria should also include the disclosure and implementation of net-zero targets, and short-, medium- and long-term targets – i.e. transition plans. The inclusion of mandatory climate transition plans is important in the context of greening the UK finance sector, as increased transparency from firms on their transition plans will help financial

[2] https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200922~482e4a5a90.en.html.

institutions make better climate-informed decisions and manage their own transition. The launch of the Glasgow Financial Alliance for Net Zero (GFANZ) in April 2021 and the associated ramp up in the quantity of net zero commitments from financial institutions underscores the need for transition plans. If these targets are to be delivered on time, then the financial sector will need expansive and robust disclosures from companies in the real economy.

- **Exclusion list**
    - The bank should put in place an exclusion list for companies whose activities are incompatible with the Paris goals or are associated with a high level of transition risk, including: coal and unconventional oil and gas activities, and companies building new fossil fuel capacity and reserves.
    - The Bank must ensure it follows the latest scientific and evidence-based analyses, and this exclusion list should eventually align with the findings of the UK green taxonomy.
    - The Bank should draw on existing work to develop its exclusions. The following resources may be useful:
    - The IEA Net Zero Roadmap (https://www.iea.org/reports/net-zero-by-2050) and the IPCC 1.5C Special Report (https://www.ipcc.ch/sr15/) provide reference points for what activities should be deemed incompatible with the transition
    - The Norwegian Government pension fund has a good framework for excluding firms from its (equity as well as bond) investment https://www.nbim.no/en/organisation/governance-model/guidelines-for-observation-and-exclusion-from-the-fund/
    - The exclusion criteria proposed by Reclaim Finance (https://reclaimfinance.org/site/wp-content/uploads/2020/05/Report-Quantitative-easing-the-ECBs-dirty-secret-RF.pdf at p.5),
    - The exclusion criteria and thresholds for coal, oil and gas companies adopted by the Banque de France (https://www.banque-france.fr/sites/default/files/medias/documents/responsible_investment_policy_reinforcing_exclusions_with_regard_to_fossil_fuels.pdf)
    - The activity exclusions adopted for EU Paris-aligned Benchmarks (https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020R1818 at Article 12)

- The Global Coal Exist List which includes divestment criteria for screening coal companies from investor portfolios (https://coalexit.org/).
- EU's Paris Aligned Benchmark. This excludes firms with the following exposure: Coal (>1% of revenues), Oil (>10% revenues), Natural Gas (>50% revenues), Electricity producers with carbon intensity of lifecycle GHG emissions higher than 100g CO2e/kWh (50%+ revenues)
- MSCI exclusion list https://www.msci.com/eqb/methodology/meth_docs/MSCI_Global_ex_Fossil_Fuels_Indexes_Methodology_Nov2019.pdf

- **Eligibility and Climate targets**
  - Due to the deep linkage between the primary and secondary objectives of the bank – financial stability and climate change – it is insufficient for the Bank of England to state that requiring credible Paris-aligned strategies should be a "long-run aspiration" for the Bank. The Bank should reconsider this position.
  - As above, a condition of eligibility for green bond purchases should be Paris alignment and interim targets for companies – especially those in carbon intensive sectors such as energy. The ideal would be for this to be across the whole market, reflecting updates to HMG procurement decisions. This will involve the bank working with government and the other regulators to set guidance for what makes a strategy credible, and whether it remains credible as awareness of data and methodologies improve over time. Key elements of a credible strategy include:
    - Put in place a credible net zero Target before 2050;
    - Disclosure and implementation of credible Transition plans including short-, medium- and long-term targets for emissions targets, together with a principle of reducing all possible Scope 1, 2 and 3 emissions before making use of carbon offsets or carbon capture technology.
    - Supportive resources can be found in the "Measuring Portfolio Alignment" report of the COP 26 Private Finance Hub: https://www.tcfdhub.org/wp-content/uploads/2020/10/PAT-Report-20201109-Final.pdf , which includes an overview of methods at p.48). The Bank can assess the robustness of existing tools and metrics as part of developing its own assessment process.

E3G

Question 4 - 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?

a) 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?

b) 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?

c) 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?

d) 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)?

- **Tilting**
  - We welcome tilting as part of the bank's approach to greening the CBPS. However, it should not be seen as the only or main mechanism to influence change in companies to incorporate climate risk. It should be used in combination with eligibility criteria which include accelerated TCFD implementation and transition plan disclosure and implementation, as well as a strong exclusion list.
  - The principle of the tilt should be to encourage funding of firms with credible forward strategies to address climate mitigation risks. This will be insufficient by itself to transition companies, and so should be used in combination with eligibility criteria and an exclusion list. These criteria should be introduced relatively quickly (2-3 years) in line with the mandatory TCFD regulations being brought in.
  - Investment should be strongly tilted to firms scoring well in the balanced scorecard and especially with ambitious plans to decarbonise quickly and appropriate Paris Aligned investment programmes that meet sectoral

goals as specified by a neutral third party e.g. SBTI, Transition Pathways Initiative.

- A check-list approach could be used, with the following elements taken from CBI's paper Financing Credible Transitions (https://www.climatebonds.net/transition-finance/fin-credible-transitions). Strategies should be reviewed to ensure they are:
    - In line with a 1.5 degree trajectory;
    - Established by science;
    - Excluding offsets;
    - Applying viable technologies even if more expensive;
    - Setting out actions not pledges.

Question 5 - Tool 4: Escalation

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

a) 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?

b) 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?

We support the principle of ratcheting up requirements over time for CBPS eligible purchases, including the following elements:

- TCFD disclosure requirement on a more ambitious timescale than HMG's timeline of 2025, and increasing the scope of TCFD requirements over time to include transition plans, and scope 3 emissions.
- Setting out a roadmap for increasing the scope of companies eligible for assessment against eligibility requirements including reducing the size of company to which these criteria apply over time to capture the bulk of the market.
- CBPS rules could be relaxed to also include smaller ticket sizes for issuers with high proportion of assets that comply with the UK's green taxonomy.

E3G

- Using a carrot and stick approach of eligibility criteria and exclusion list to incentivise firms to put in place credible net zero targets and transition plans and require clear decommissioning strategies for non-green assets. This could be part of a process over time to support fossil intensive industries to decarbonise their business models.
- As part of a ladder of actions, over time maturing debt should be refinanced with labelled green debt. All CAPEX should comply with the UK taxonomy as soon as possible.

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?

- Exclusions and eligibility criteria are the most important tools to green the CBPS. Tilting and escalation are useful, but they will not have significant impact by themselves. It is unclear whether the Bank currently has the necessary resource, capacity, and tools to effectively put pressure on companies through these tools (tilting, escalation, and engagement) and exclusion lists and eligibility are lower resource, higher impact tools.
- The Bank should also be ambitious in terms of using its exclusion list to exclude fossil intensive companies from its balance sheet now – as this will send strong signals to the market, investors, and other companies. This should also be combined with alignment with the UK Green Taxonomy, to ensure that it is clear which companies are incompatible with the UKs targets on net-zero and resilience. In line with the IEA report, the bank's eligibility and exclusion criteria should exclude any companies planning new exploration and production of fossil fuels beyond what has already been committed to in 2021.
- Regarding companies that remain eligible for the corporate bond purchase scheme, the Bank must ensure it sets strong environmental requirements and ambitious timelines for their implementation. Eligibility requirements for companies should include transition plans, with short, medium, and interim targets and associated detail on how these targets will be delivered through the business's strategy. These should be aligned with

Paris, in accordance with the government's commitments on climate change.

- The CBPS should take a long-term perspective about the corporates whose bonds it purchases. This is particularly an issue where the issuing company's strategy towards climate risk 10-20 years hence is ill defined or incompatible with net zero. The recent IEA report stated that no new investments in fossil fuels are compatible with NZ. The bank should therefore use this as a guiding reference when developing its exclusion list. It should also develop a range of metrics to assess companies for eligibility.

- The CBPS is not the only monetary policy tool available to the Bank of England. The collateral frameworks are also important. This being so, the principles might encompass principles applicable to asset classes other than corporate bonds, e.g. mortgage loan books, asset backed securities. The Bank must move rapidly beyond the corporate bond purchase scheme and green its other monetary operations as well as its financial policies, for example by penalising dirty lending with higher capital requirements. The CBPS needs to be coherent with other policy signals, and so the Bank should work more closely with other public bodies to stop banks and financial institutions from funding environmentally harmful companies and instead incentivise investment in sustainable jobs and companies. These measures should also be part of a wider strategy from HMG to finance the transition.

- These requirements should not only focus on mitigation. The bank's expectations on firms should include an element of adaptation and climate-proofing.

- Resilience is also critical to achieving a long term sustainable financial system. This is due to nature related risks beyond climate change also posing a potential threat to financial stability. These types of risks interact with and exacerbate climate risks and are also closer on the horizon in terms of physical risks than climate risks. Some useful resources can be found here: https://www.suerf.org/suer-policy-brief/27301/understanding-the-financial-risks-of-nature-loss-exploring-policy-options-for-financial-authorities. The Bank should urgently implement policies to mitigate nature-related financial risks and impacts, such as those related to biodiversity loss, in its own investments and across the financial system. The bank could include nature-related financial risks as part of the eligibility criteria in the CBPS framework in due course e.g. biodiversity loss. It could also undertake analyses of nature-related risks and impacts associated with its monetary policy operations.