Options for greening the Bank of England's Corporate Bond Purchase Scheme

UK Finance response to the Bank discussion paper

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Overview

UK Finance is the collective voice for the banking and finance industry operating within the UK. Representing around 300 firms across the industry, we act to enhance competitiveness, support customers and facilitate innovation.

We are supportive of steps already being taken by the Bank of England ('the Bank') and the Prudential Regulatory Authority (PRA) in support of banks and insurers mainstreaming climate responsibility into their governance and strategy, including the setting out of supervisory expectations under SS3/19 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change', as clarified by the 'Dear CEO' letter 1 July 2020, and the current Climate Change Biennial Exploratory Scenario analysis. We are also appreciative of the leadership role that the Bank and PRA have been playing in key international fora, not least within the G20 Financial Stability Board (FSB) and the Network for Greening the Financial System (NGFS), and through support and advocacy for the FSB-appointed Task Force on Climate-related Financial Disclosures (TCFD). These steps are indicative of the Bank's broader approach to supporting an *orderly* climate transition.

We further consider the revision of the Bank's remit and recommendation letters from the Chancellor to the Bank's policy committees to include specific reference to the transition to a net-zero economy as part of the government's economic strategy that the committees must 'have regard to' as a natural progression and in keeping with both the UK government's statutory objective for achieving whole economy transition to net zero carbon emissions by 2050 and the priority placed on tackling climate change from the perspective of the risks it poses for the financial system.

UK Finance for its part has been running a structured dialogue with members under a 'COP26 and Beyond' programme in which we have sought to delve into issues concerning climate responsibility and the setting of net zero targets. Our Board in May passed a formal resolution expressing support in principle for the global Net Zero Banking Alliance (NZBA), formed as part of the Glasgow Financial Alliance for Net Zero (GFANZ) announced only the month before, and encouraging all members to embed climate responsibility into their governance and strategy in support of whole economy transition to net zero by 2050 premised upon *just transition* principles.

Turning to the discussion paper, at £20 billion the Bank Corporate Bond Purchase Scheme (CBPS) is modest within the context of global capital markets, in fact accounting for only 6.5% of the sterling corporate bond market. Moreover, the Bank is currently not making active purchases and reinvestment is expected to run at only a billion pounds per year in the near term.

The paper explains that the stated intention is for the Bank to contribute to the direction of travel being taken by central banks and supervisors, both in Europe and internationally, and influence the approach being taken by financial market participants. It is important therefore that in designing its scheme, the Bank places full emphasis on the consequence of its approach being applied within this broader context.

The paper recognises that there are various counterfactuals and that it needs to be recognised that the approach will need to develop over time given gaps in knowledge and understanding that are still being filled, including definition being given to sectoral pathways to net zero. Engagement is key.

Broadly speaking, an exclusion framework with escalation over time looks to be the right approach. The proposed framework and the proposed four key tools – targets, tilts, eligibility and escalation – look suited to the objectives for the regime. We comment further on this in our response to the online questions raised by the discussion paper.

Online response to the discussion paper questions

Q1: Principles for greening the CBPS
Do respondents agree the Principles set out in Section 3 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? Should any considerations be dialled up or down; and have any been overlooked?

As paragraph 3.2 of the paper explains, every investor's approach to supporting net zero will be shaped by their specific investment objectives, and for the Bank this means:

- The purpose of the CBPS being to implement monetary policy
- The CBPS investing public money
- As a public body, the bank needing to conduct its operations in a clear, transparent and evidence-based way

This is the backdrop against which the Bank has proposed three guiding principles for the greening of the CBPS:

- Incentivising companies to take decisive actions to achieve net zero, i.e. wanting firms whose debt the bank may hold to change their behaviours in meaningful and lasting ways in support of an orderly transition to net zero by 2050
- Leading by example, learning from others, drawing upon relevant market-wide initiatives; seeking to influence that thinking where appropriate and illustrate how comparable investors might approach similar challenges
- Ratcheting up requirements over time, with the approach becoming progressively more demanding with higher expectations and sharper incentives, as data and

metrics on transition pathways and firm-level emissions improve, and issuers have the opportunity to develop credible net zero strategies

We would agree these to be the right Principles for the scheme. But we would say that this is the case not only by reference to the Bank's position as a public institution and its broader responsibility for monetary and financial stability, but by reference to setting the right approach in keeping with incentivising climate disclosures and the setting of credible transition plans. As Box C explains, the aim should not be just to hold low-emission issuers as there is more to be gained from investors adopting a more engaged strategy. Figure A amply illustrates, and rightly distinguishes between, the contrasting dynamics of what can be called a 'vicious' cycle and a 'virtuous' cycle.

The Bank rightly seeks an approach under Principle 2 that if adopted sufficiently broadly would support economy-wide transition and encourage engagement with investors and those developing frameworks for green investing. While rapid progress is anticipated on data and metrics on transition pathways and firm-level emissions, gaps clearly exist and so a progressive approach that becomes more demanding over time as envisaged under Principle 3 looks entirely appropriate.

Given the expectation, under Principle 2, that the scheme influences the approach to be taken by others, proportionality would appear understated, other than paragraph 3.12 observing that investors should increasingly discriminate between firms which have credible prospects of aligning with a pathway to net zero and those which do not 'to the extent that it is feasible'. This said, we would not wish to imply that smaller firms are insulated from transition risk.

We would also consider that, in its review of the CBPS's alignment against net zero objectives, the Bank may be well served looking at any potential structural impediments and level playing field issues for low carbon market entrants. Central bank bond buying programmes and their eligibility criteria (e.g. external credit ratings etc.) can benefit established actors in markets and allow incumbents lower cost of capital against these newer entrants. We would encourage the Bank to review the eligibility criteria and market impact of these programmes and investigate if this creates unwarranted barriers to entry for low carbon market entrants, while retaining a prudent approach to the financial risk of these in bond buying programmes.

Q2: 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)?

In determining portfolio-level targets, the Bank will need to be mindful of the broader monetary policy and financial stability objectives of the CBPS. The very fact that the bond buying programme can expand substantially during times of economic stress suggests that carbon intensity would represent a better metric for the CBPS than an absolute target albeit within the context of the ultimate goal of achieving net zero by 2050.

In setting targets, the Bank may also wish to take into account the fact that what can reasonably be expected in terms of net zero pathways will vary between different activities and that progress is best judged within the context of the industrial sector in question.

In terms of point-in-time emissions vs forward-looking metrics, a consideration may be the due diligence involved and whether the Bank has the expertise or the human resource involved in validating forward-looking metrics. For instance, where a corporate says they will reduce their emissions by a certain amount, but do not have the policies in place to achieve this or are over-reliant upon untested technologies, would the Bank have the capacity to factor this in? Arguably the market does a better job at identifying climate laggards, although there is evidence to suggest (e.g. European Central Bank) to suggest that the market is not efficiently pricing in climate risk.

Point-in-time emissions are useful for risk management of a portfolio but this will always reflect the status quo (i.e. favouring those companies that are performing well today). Given the Bank's remit to support the green transition of the UK in the lead up to 2050, it will need to incorporate forward-looking metrics as well. Science-based targets are a useful basis in the near term and, as modelling techniques mature over time, we would propose that additional metrics be incorporated into the portfolio management process.

We would advocate credible external validation such as the science-based targets initiative (SBTi) be used in target setting in the first instance to have a meaningful scientific basis. Several asset managers are using this as the basis for fund level target setting (i.e. that all constituent level firms in a portfolio have set a SBT) on the basis that it demonstrates that thought has been given to transitioning their portfolio to net zero by 2050.

The Bank should consider a tender process for several external ESG data providers to support its selection process. This would add a degree of objectivity to the process – and potentially enable the Bank to apply 'tilting' on a more progressively - while noting of course that final say on selection should be with the Bank itself

While the approach may vary over time, the expertise needed and the work involved should not be underestimated. This is also relevant to our observation above on the need for proportionality when it comes to the expectations to be placed upon market participants at large.

We note that, over time, the Bank will look to purchase eligible green corporate bonds as the new sterling green gilt programme catalyses issuance. While this has to be appropriate,

the proportion should be in keeping with the objective of achieving an orderly transition to net zero. While we see grounds for guarding against premature ‘exclusion’ or ‘tilting’, some see a benefit in the Bank being somewhat overweight green bonds and green issuers given the signal this would send to the market around supporting this asset class.

Q3: 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?

We can see grounds for eligibility for the CBPS being made conditional upon climate-related actions by issuers and agree that the early priorities for this should include the reinforcing of the Government’s timeline towards mandatory climate disclosures and the selective exclusion of issuers involved in certain activities deemed incompatible with transition to net zero. These two examples of themselves are interesting in that we would say that the criteria for making good, quality climate disclosures should in effect represent an entry standard that – on a basis consistent with statutory and other disclosure requirements - can be expected to be applied on a near universal basis (though see below). Exclusion on the grounds of activity, on the other, should be extremely targeted in the first instance, and may be dependent upon whether the activity is pre-existing or new. It would be expected that restrictions of this nature would tighten over time or, put another way, ratchet up over time.

Eligibility should be viewed on a sector-by-sector basis and any incompatible activities should be determined on an individual sector basis – noting there are meaningful deltas between climate leaders and laggards within a sector. The Bank may wish to consider setting up an advisory panel with leading climate scientists to ensure its approach remains scientifically valid. Industry understanding, and the science supporting this, is evolving rapidly so periodic checkpoints with a cross-body stakeholder group could assist with informing the nature of incompatible activities the remedial steps needing to be taken. While this should inform the refined eligibility criteria, for existing holdings in corporate debt, the Bank should engage directly (see escalation below) in order to encourage revisions in transition plans.

Q4: 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)?

Paragraphs 4.27 and 4.28 of the discussion paper explain the intention to tilt CBPS purchases towards issuers who are performing more strongly on climate grounds, and away from weaker performers, as a near-term action. While this is in keeping with NGFS aspiration for central banks to positively influence markets, there is also a need for this tactic not to be deployed prematurely given that sectoral transition pathways remain at varying degrees of development. As the discussion paper acknowledges, such pathways remain in their infancy.

There is also a need to ensure that scorecards used give sufficient credit to high-emissions firms with ambitious and credible emissions reduction plans. Forward-looking KPIs (and performance against these) may have relevance.

It is also relevant to note that in looking to build approaches, the Bank may need to consider whether the sectoral pathway need be determined by reference to Scope 1, 2 and 3 emissions or whether good, quality information about Scope 1 and 2 might in fact provide the core of what is needed.

We should add that reliance should not be placed entirely on companies plans, but also depend upon third party verification.

Individual components of the scorecard can over time evolve, thereby giving flexibility. The tilt can be based on 3 or 4 key criteria such as: i) current emissions impact (Weighted Average Carbon Intensity (WACI)); ii) rate of improvement of emissions (e.g. delta WACI); iii) transition plans; iii) alignment to UN Sustainable Development Goals (SDGs). We see positives in the setup of the Climate Transition Index as a template for portfolio 'tilting' given that it incorporates a blended approach.

It is possible that set reductions based on sectoral transition pathways could provide latitude for good performers to take their 'foot off the pedal'. We appreciate, however, that this may contribute to the practicality of implementation. Sector-based pathways could be used in a first phase and consideration given to replacing these later with individually defined pathways.

While we are inclined to the view that a failure to meet statutory and other requirements for climate disclosures lends itself to exclusion, the fact that only 54% of CBPS eligible firms even produce a TCFD-equivalent disclosure, as related in paragraph 4.32, suggests that a tilting mechanism for this may also be appropriate over the near term. We would guard against a premature triggering of exclusion, however, given companies within carbon intensive sectors can be said to have prioritised carbon reporting and the setting of targets in comparison to companies within less impactful sectors. These need to be given the opportunity to catch up.

Tilting is perhaps better suited to building in criteria where performance against net zero targets is expected to improve over time, whereas exclusion may best be used in support of the setting of near universal expectations across all companies, most notably maintaining market standard climate disclosures.

Q5: 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?

It is important to keep at the forefront of thinking that the overarching goal is for the CBPS to work in support of an orderly transition to net zero. This points to an approach which gives a clear signal as to the consequence of not placing sufficient priority on meeting climate expectations while at the same time moving at a pace that provides opportunity for engagement to influence behaviour.

Engagement is key. Periodic discussions should be held with the firms in question to understand pain points with the aim of helping them to remediate or repoint their action plans. The expectation then should be for active management, with an agreed timeline, say six months, for remediating actions to be put into flight.

It needs to be appreciated overall that stewardship takes time and does not reap rewards overnight.

Q6: Overall approach
Are the four main tools identified in Section 4 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?

The four main tools would look to us to provide a suitable basis for the Bank's approach. As set out in the paper, within the context of the three broad principles, the approach would appear well designed, subject to care being taken in terms of the timing of restrictions and the pace at which requirements are tightened. There is also a need for the Bank to consider the practicality of its approach in terms of the nascent nature of developing pathways, data gaps and capacity issues when it comes to making the complex assessments involved.

Whilst forward-looking climate scenario analysis / portfolio modelling is still in its infancy, this should be incorporated into the tilting mechanism as and when it is ready to help drive towards climate transition. Static metrics such as WACI and carbon footprint are fine in managing the 'as-is' risk, but the Bank needs to incorporate the forward-looking view in order to help accelerate the transition plans for corporates.

Finally, while the proposals are climate-focused, the Bank should consider adding in some minimal environmental and social safeguards e.g. loss of biodiversity in the development of solar fields.

For further information on this submission please contact Paul Chisnall, Director, Sustainability, UK Finance paul.chisnall@ukfinance.org.uk