NEW ECONOMICS FOUNDATION

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Dear Andrew Bailey and Sam Woods,

Climate change poses a grave and growing threat to the financial system and macroeconomic stability, and the Bank of England has an important role to play in mitigating those risks. This includes increasing capital requirements on the most climate-risky activities and assets to break the finance-climate 'doom loop' in which financial activities continue to fuel climate change and in turn increase risks to the financial system itself.

As the Bank and the Prudential Regulation Authority (PRA) are about to host the Climate and Capital conference, we welcome your work on exploring how the Bank's capital framework should be adjusted to take account of climate-related financial risks.

Besides the near-term impacts of the post-pandemic supply chain disruption and of Russia's illegal invasion of Ukraine, we are likely to be entering a longer term era of 'great volatility' with unmitigated climate change a major driver of future disruption.[i] Crucially, the decisions taken by financial regulators today will influence the future trajectory of human-induced climate change and could help limit the risks it will pose.

Climate-related risks pose a huge threat to financial stability in two ways:

1) By not acting to address risks associated with activities that directly contribute to climate change, notably fossil fuel exploration and production, the Bank is allowing the build-up of physical risks leaving the financial system exposed to significant losses, both via direct balance sheet losses and indirect losses stemming from environmental damages to the wider economy.

2) As the UK and other economies transition towards net-zero emissions, fossil fuel assets will increasingly decline in value and eventually become 'stranded', leading to balance sheet losses that will reverberate across the financial sector. By not recognising those risks, the Bank is allowing the build-up of transition risks which will undermine the UK's financial stability, with the costs greater according to Bank's own analysis in a delayed disorderly transition scenario.[ii]

Governments will lead the way in responding to the challenge of climate change, but central banks and financial regulators have a key supportive role to ensure financial stability and an orderly transition. As things stand, however, the Bank and the PRA fail to meaningfully account for climate-related risks in their prudential framework.

The Bank and the PRA must use the ongoing review of the capital framework to account for the particular characteristics of climate-related financial risks and adopt a prudent, precautionary approach.[iii] **To address these risks, the current capital framework should embed a strong macroprudential approach[iv] aiming to reduce systemic risks:**

1) High prudential risks associated with exposures related to the exploration and production from newly developed fossil fuel reserves should be mitigated with higher risk weights in line with a 'one for one' rule, where each pound of financing for such activities must be matched with one pound of a lender's own funds.[v] The International Energy Agency concluded that new fossil reserve exploration is not compatible with the Paris Agreement so that any such investments will most certainly become stranded.[vi] As such assets will therefore fall in value, potentially to zero, banks should hold more capital to guard against default risks of lending to new fossil fuel projects.

2) Capital requirements for exposures to existing assets associated with fossil fuel production should also also be adjusted, with their risk weighting increased in line with the approach to higher risk assets under the Basel framework.[vii] These assets will also increasingly lose their value over time as fossil fuel consumption needs to be significantly reduced in order to limit the global warming below 2C. Recent research estimated such exposures from the five largest UK banks at £71.6bn, with the additional capital they would need to raise under the proposed 'higher risk' weighting equal to approximately 4.23 months of their profits at 2021 levels, which could be feasibly achieved over an appropriate phase-in period.[viii]

The uncertainty over when those risks will materialise should not be a reason to disregard them in prudential regulation. The systemic nature and complex dynamics of climate change including environmental tipping points pose risks of severe and irreversible environmental disruptions with major impacts on financial stability. Even short-term financing contributes to a build-up of risk in the long-term.

Supervisory measures on their own, such as possible supervisor add-ons, or setting concentration limits on banks' fossil fuel exposures, would not be so effective in increasing loss-absorbing capital, internalising systemic risks or preserving a level playing field between banks, although they could be useful as supplementary measures.

The Bank has long been one of the thought leaders in considering the risks emanating from climate change, such as through its 2021 Climate Biennial Exploratory Scenario. However, what the gravity and urgency of these risks demand is leadership in action. We call on you to implement prudent and impactful measures to address climate-related financial stability risks. You can count on our support in these efforts, and we look forward to hearing of your next steps.

Best wishes,

The undersigned

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