Greening the Bank of England's Collateral Framework

Policy briefing

Summary

The Bank of England's collateral framework sits at the heart of our financial system, and plays a key role in the transition to a green economy. Central banks globally recognise the threat that climate change and ecological degradation poses to monetary and financial stability, and the UK government has given the Bank of England a mandate to support the net zero transition. Despite this, the Bank's progress appears to have stalled.

The collateral frameworks set the rules by which financial firms can borrow central bank reserves. It outlines which assets the central bank accepts as collateral in exchange for lending reserves, and the terms on which they are accepted. The Bank of Englanddoes not currently integrate environmental risks into its collateral framework, resulting in it advantaging environmentally harmful assets. Other major central banks' have now begun integrating environmental considerations into their collateral framework.

To remove the bias towards environmentally damaging assets in it's collateral framework, the Bank of England should:

1. Develop a science-based framework to assess the environmental footprints of assets and their issuers, and define the most harmful activities
2. Negatively screen for and exclude assets from issuers whose main economic activity is incompatible with climate and environmental goals
3. Introduce higher haircuts to assets based on the environmental footprint
4. Increase transparency over the Bank of England's current collateral operations, including disclosing the environmental footprint of holdings

What is the Bank of England's collateral framework

A key role of a central bank is to provide central bank reserves to financial institutions, which they then use to settle payments between each other. The central bank supplies reserves by lending them to firms in exchange for accepting financial assets as collateral, to protect itself in the instance that borrowers are unable to repay.

The collateral framework is the set of rules that the central bank sets for this lending. It outlines which counterparties the central bank agrees to lend to, what assets it accepts as collateral, and at what terms these assets are accepted. The terms are set by applying a 'haircut' to assets accepted, which simply means that a discount is applied to the market value of the asset. For instance, if an asset has a market value of £1 million and a 20% haircut is applied, the borrower would receive a loan of £0.8 million in reserves.

The collateral framework sends powerful signals to financial markets, as assets accepted as collateral, and on more favourable terms, are seen as more valuable, as they can easily be exchanged for reserves in times of crisis. This means that companies issuing eligible assets tend to benefit from better financing conditions. This impact reverberates beyond the central bank liquidity facilities and into the wider financial system, as the collateral framework is used as the basis for lending between financial institutions.

How the collateral framework advantages environmentally harmful companies

Assets eligible for use as collateral, and with lower haircuts applied, tend to see a boost to asset values and more favourable credit conditions. This is because they are seen as more valuable on the market, increasing demand for these assets. Importantly, haircuts do not currently account for the environmental risks posed to asset values nor the impacts of assets, meaning they provide this advantage to damaging companies.

Private financial institutions, including non-banks, also use collateral and haircuts when lending to each other. The terms on which they lend are heavily influenced by those of major central banks such as the Bank of England and the European Central Bank, meaning that the collateral frameworks of central banks' reverberates throughout the financial sector.

Importantly, the impact of collateral eligibility and lower haircuts can still have a significant impact on asset values and financing conditions regardless of the actual usage of collateralised lending facilities, meaning much of the impact does not appear on the central bank's balance sheet. Therefore it is critical to consider the entire framework, rather than just the environmental footprint of collateral holdings that can be measured on the central bank's balance sheet.

Other central banks, including the European Central Bank, have been first movers in integrating environmental considerations into their collateral frameworks. However, there are significant downfalls to the approach taken by other central banks' that the Bank of England should avoid, and in doing so, can reassert itself as a leader on this agenda.

Recommendations for Greening the Bank of England's collateral framework

Most importantly, the Bank should commit to taking an 'environmental footprint' approach to greening the collateral framework. This means it should base its adjustments by environmental impact or 'footprints' of assets, rather than by attempting to estimate the financial risk posed to the asset from climate change, which cannot be accurately quantified in financial terms. Steps the Bank should take:

1. Develop a science-based framework to assess the environmental footprints of assets and their issuers, and define the most harmful activities
2. Negatively screen for and exclude assets from issuers whose main economic activity is incompatible with climate and environmental goals
3. Introduce higher haircuts to assets based on the environmental footprint
4. Increase transparency over the Bank of England's current collateral operations, including disclosing the environmental footprint of holdings

Read the full paper: ['Greening the Bank of England's Collateral Framework']