Nick Robins January 18th, 2023

Sustainable central banking: clear green water between the Fed and the ECB?

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All major central banks recognise that the climate crisis and nature loss pose material threats for the financial system. But central bank mandates and political environments vary. Action on sustainability is a bipartisan issue in Europe, while in the US parts of the Republican Party are leading an anti-ESG campaign that is out of line with science and at odds with a prudent view on financial management. ***Nick Robins*** *writes that a second phase of sustainable central banking is needed to minimise the environmental threats to banks' core mandates, as well as the other goals they are set.*

This article is part of a series by LSE's Grantham Research Institute on Climate Change & the Environment (visit website).

One of the big sustainable finance priorities for 2023 is how central banks will grapple with deepening climate and nature risks alongside high inflation and rising interest rates. One thing is clear: all major central banks recognise that the climate crisis and nature loss pose material threats for the financial system, requiring them to act to understand and address these challenges. Where they diverge depends very much on the mandates they are given by legislators, the interpretations they make and the political environment in which they operate. These differences were clearly on display in January in interventions from US and European central bankers.

The United States Fed chair Jay Powell stressed that the Fed will not become a "climate policymaker". But few believe that the Fed should take that role, rightly leaving climate policymaking to national and state-level government agencies, not least in the US where President

Biden's Inflation Reduction Act is creating green market ripples across the world. What people *can* expect is that the Fed takes tough-minded action within its mandate, bearing down on sustainability risks as they manifest in implications for price and financial stability. Here, Powell recognised that the Fed does have a responsibility to deal with the climate imperative in banking supervision, and the Fed will be conducting a pilot climate scenario exercise with six major US banks this year. The confirmation last week that the Securities and Exchange Commission (SEC) will publish its rules on climate-related disclosures in April is a welcome step forward in the US market and one that the Fed should look to build on.

But from the remarks he gave this month, Powell's menu for action on climate risk looks too limited and the Fed will need to go further if it is to fulfil its mandate in two key areas. First, it needs to step up its assessment of how environmental factors are influencing prices (for example, through climate shocks to agriculture), and then integrate these into its monetary responses. Second, the Fed has a specific mandate to support maximum employment. Given that climate change will restructure the world of work, challenging jobs in high-carbon sectors and creating new net zero opportunities, it would be remiss of the Fed if it did not understand these issues and take action within its purview on the employment dimension of the green transition, potentially deploying its legislated role to promote community reinvestment to support a 'just transition'.

On the other side of the Atlantic, European central banks have been confronting climate- and now nature-related risks for longer than the Fed. Action on climate and sustainability remains a largely bipartisan issue in Europe, unlike the US where parts of the Republican Party are leading an anti-ESG campaign that is not only out of line with science but also at odds with a prudent view on financial management. European central banks often have explicit statutory or policy requirements to address policy priorities such as environmental threats. In the UK, for example, environmental risks are incorporated into the remit of the Bank of England's work on prudential supervision, financial stability and monetary policy. On top of financial and price stability, the European Central Bank also has a secondary mandate to support broader EU economic policies. According to ECB executive board member Isabel Schnabel, this means ensuring "all of the ECB's policies are aligned with the objectives of the Paris Agreement". The ECB is steadily working through the climate action plan it released in 2021.

Like Powell, Schnabel was clear that the heavy lifting on climate action needs to be taken by governments – through fiscal policy, for example. She was also confident in setting out the complementary role that central banks have to play, arguing forcefully that "the ECB needs to intensify its efforts to support the green transition", including on a range of monetary policy fronts.

One up-and-coming issue Schnabel highlighted was the need to align the Bank's portfolio of sovereign bonds with net zero, for example by increasing the share of government green bonds and tilting bond purchases from supranational institutions and agencies towards sustainable assets. Another priority is the need to green the ECB's lending portfolio to business, including its collateral framework. In a recent Grantham Research Institute policy paper, Jens van 't Klooster showed how to green the ECB's Targeted Longer Term Refinancing Operations (TLTROs). As interest rates look set to stay higher for longer, this is not something that should be parked for the long-term, but rather needs to be actively explored by the ECB in 2023.

In the face of the profound geopolitical, economic and environmental threats undermining stability in 2023, central banks face a new task. The first phase of sustainable central banking kicked off in 2015 and was all about recognising climate and wider environmental risks, building top-down assessment frameworks, such as the NGFS Climate Scenarios, and signalling initial expectations. Some eight years on, varying degrees of action are being taken, but the financial system remains out of step with what's needed to confront these clear and present dangers. At the most recent UN COP27 climate summit, the governments of the world agreed that a 'transformation of the financial system' was required – and that included a specific role for central banks.

A second phase of sustainable central banking is needed, one in which central banks move from assessment to integration and alignment. For example, central banks need to consistently integrate climate implications into monetary frameworks and models to adequately account for the impacts on macroeconomic outcomes and employment. In addition, central bank instruments and policy portfolios need to become operationally aligned with net-zero. On the financial stability side, prudential supervisors should make net-zero a core element of supervisory practice at micro and macro levels, aligning supervisory expectations and prudential instruments with net zero. This could involve requiring all regulated financial institutions to submit net zero transition plans, as well as addressing climate risks in regulatory ratios. These steps are essential to minimise the environmental threats to core mandates of financial and price stability, as well as the other goals they are set, such as support for wider economic policy in the EU or employment in the USA.

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