Bank of England

Lord Bridges of Headley MBE
Economic Affairs Committee
House of Lords
London
SW1A 0PW

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Strategy and Risk

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Dear Lord Bridges,

Thank you for inviting the Bank of England to provide evidence to the Committee's inquiry on UK energy supply and investment. I am responding on behalf of the Bank to the recommendation in the report for the Financial Policy Committee (FPC) and the Prudential Regulation Committee (PRC) to set out the principles by which they are interpreting the Chancellor's instruction on energy security.

As noted in your report, in April 2022 the FPC and PRC received a letter from the then Chancellor setting out additional recommendations on the Committees in relation to the then Government's energy security strategy.

The letter recommended that where practical and relevant, the FPC and PRC should have regard to the Government's energy security strategy and the important role that the financial system will play in supporting the UK's energy security - including through investment in transitional hydrocarbons like gas - as part of the UK's pathway to net zero. This additional recommendation was supplemental to those set out in HM Treasury's March 2021 remit and recommendations letters to the FPC[1] and PRC[2], which address how net zero should be considered by each committee.

[1] FPC_Remit_and_Recommendations Letter, 3 March 2021
[2] PRC Recommendations Letter, 23 March 2021

The Bank acknowledges the importance of the energy security strategy and the Government's desire to add this consideration into our policymaking. The FPC considered the addition to its remit and agreed that they would, as required by statute, publish a formal written response to the recommendation in the usual way as part of its response to the Chancellor's annual remit and recommendations letter. The PRC intends to take this addition to the remit forward in line with the relevant statutory processes that apply and would thus make clear where this recommendation has been a relevant factor in policymaking, as it does with its other 'have regards'. Where relevant, this will include a summary of any notable policy developments in the annual report.

The importance of energy security was highlighted by the price volatility experienced in energy markets earlier this year, following the Russian invasion of Ukraine. The FPC subsequently assessed the vulnerabilities in energy (and other commodity) markets and set out its conclusions in the July 2022 Financial Stability Report[3]. The FPC will continue to monitor signs of stress building in commodity markets that could impact on financial stability and will engage with other authorities as necessary to ensure the resilience of the UK financial system to such stress, and seek to increase transparency in commodity markets.

As noted in the April 2022 recommendation letter to the FPC, the then Government viewed its energy security and climate change strategies as interrelated and mutually supportive, a view we shared. The Bank and the PRA are currently undertaking a series of initiatives to address climate-related financial risks and will have regard to the Government's broader policies on net zero and energy security as it does so. A brief update of these initiatives is included below.

Climate Scenario Analysis

As mentioned in your report, we released the findings from our Climate Biennial Exploratory Scenario ('CBES') exercise on 24 May 2022. This represented an ambitious bottom-up exercise that explored a number of areas that have not been looked at before. Whilst this was not a stress test, it used three climate scenarios to explore different evolutions of transition and physical risks over a thirty year period. The results suggest that participants are making good progress in some aspects of climate risk management, but the Bank's assessment is that UK banks, building societies and insurers still need to do much more fully to understand and manage their exposure to climate risks.

The CBES also provided insights on some aspects of energy security. As part of the process, participants explained how their business model might react to the three climate

[3] **July Financial Stability Report, Bank of England, July 2022**

scenarios. Collectively, the responses suggested a risk that finance could be withdrawn from carbon intensive firms before compensating renewables are in place or energy efficiency measures reduce demand. If this situation was to arise, there would be economic and energy security consequences. A key message from the CBES was that firms need to take collective steps to help counterparties (and the broader UK) transition in an orderly way. Whilst this is a complex task, it is one that should become easier as governments provide more clarity on national net zero and energy security plans.

Since the CBES release we have been engaging with firms bilaterally to discuss results from the exercise and providing specific feedback that helps them to improve climate risk management. Furthermore, we are working both internationally and domestically to help develop climate scenario frameworks and resources. For example, until recently the Bank chaired the international Network for Greening the Financial System's workstream on scenario analysis. Within the UK, the PRA also co-chairs the Climate Financial Risk Forum (CFRF), which has published resources to help firms undertake scenario analysis – including the recent release of an online climate scenario analysis narrative tool.

Measurement of climate risks

The Bank has been working with the firms it regulates since 2015 to build frameworks that more effectively identify and measure the financial risks from climate change. These frameworks will take a long time to embed, but as noted above, firms continue to make steady progress. In doing this work, the PRA has noted that it does not consider it to be its role to determine what assets firms should hold. Instead, as with all risks, its focus is on ensuring that firms maintain appropriate controls over risks and resources to address them should they crystallise.

Some external commentators suggest carbon-intensive energy sources will necessarily become less economic and more risky as the UK transitions towards net zero. As a result, they argue that the PRA should intervene to ask firms to hold more capital against investments in these assets now, either directly or through a "penalising factor." The PRA does not believe that such an intervention is currently supportable on prudential grounds as the speed at which associated transition risks will crystallise will depend on the role these assets play in countries' energy strategies. Capital levels will continue to be informed by the impact of government policy on firms' own risk assessments.

Green taxonomy

Currently, there is not an accepted definition of which economic activities count as environmentally sustainable. As a result, the then Government, as part of the Sustainability Disclosure Requirements, began work to develop a UK Green Taxonomy ('the Taxonomy') which is intended to set out the criteria that specific economic activities must meet to be considered environmentally sustainable - 'Taxonomy-aligned'. The Bank has supported this work and believes the Taxonomy, as part of a broader sustainability toolkit, will further transparency and generate valuable information. In turn, this should help the financial sector to allocate capital in a way that aids the transition to net-zero emissions and will help firms to manage climate related financial risk.

Whilst the taxonomy has been primarily designed as a tool to aid financial flows that facilitate a smooth transition to net zero, it could also help to channel funds in ways that support energy security. For example, this could be achieved if the taxonomy was used to channel funds towards greener, UK-based energy providers. However, as touched on above, this would need to be undertaken in a way that ensured non-green energy sectors receive the funding they require to maintain supplies whilst green alternatives are not in place. Whilst the Government is in the lead in developing this taxonomy, the Bank remains actively engaged.

Solvency II

The Bank continues to work closely with HM Treasury (‘HMT’) on its review of Solvency II (the 'Review’). The Bank is committed to ensuring that any reforms to the Solvency II regime support insurance firms to provide long-term capital to underpin growth, including investments in infrastructure as well as investments consistent with the Government's climate change objectives (Objective 3 of the Review) without compromising policyholder protection and the safety and soundness of firms (Objective 2 of the Review). HMT's Consultation Paper, published in April 2022, includes reform proposals in relation to Matching Adjustment eligibility that the PRA is supportive of, and which should support the Government's net zero policy and energy security strategy as appropriate.

Yours sincerely,

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