Bailey, Powell and Lagarde; the new eco-warriors?

by Robert White, CFA

For all the column inches dedicated to central bank meetings this month, one potentially seismic change to monetary policy has slipped under the radar over the last few weeks. In the most recent UK budget, chancellor Rishi Sunak announced that the Bank of England should reflect the "importance of environmental sustainability" in policy decisions, which includes asset purchases. The prospect of central banks determining which assets to support based on environmental credentials points to a significant increase in the importance of environmental, social and governance (ESG) factors for investors, and also raises questions about the appropriate role of central banks going forward.

Rishi Sunak's announcement has certainly not emerged from a vacuum; the Bank of England conducted a review of climate risks to the insurance sector in 2015, expanding this to the banking sector in 2018. Outside of the UK, Christine Lagarde has sought to make climate policy a key part of the ECB's strategic review and has already introduced new climate stress tests for Eurozone banks. Even the Fed is now flagging the dangers that climate change poses to financial stability in the US, although it remains a politically contentious issue in Congress.

Before the financial crisis, this sort of ambition from central bankers was near unthinkable; governors were expected to be independent of politics and predominantly focussed on controlling inflation. The rationale behind this remains sound; politicians are required to retain office every few years through elections, and so may have ulterior economic motives which are incompatible with long term price stability.

After two historic global recessions, the role of central bankers is now much broader. Not only have large quantitative easing programs become the norm, but so has buying direct corporate bonds and equity ETFs (the Bank of Japan is now the largest owner of Japanese stocks). Even the notion of political impartiality has been stretched, with the likes of Janet Yellen and Mario Draghi moving into high profile political roles shortly after their tenure as leaders of the two most important banks in the world came to an end.

Of course, the widening remit of central banks can rightly be justified by their mandate for ensuring financial stability. Increased flooding, droughts and storms are just some of the potential damaging effects of climate change, and it is difficult to argue that these will not create problems for the financial sector. Furthermore, the risk of delaying climate action now could create problems associated with a rushed, disorderly transition to a low carbon economy later. To some however, there is a question as to how much power should be in the hands of unelected technocrats. Are central bankers best placed to determine which companies are the worst polluters? Such decisions are not trivial, and there is plenty of nuance when you delve into the weeds.

Here at Momentum, we believe that you need much broader participation from a range of institutions to tackle environmental issues meaningfully. The change in mindset from central bankers is certainly welcome, but individual companies and investors also need to think in ESG terms. Active managers are particularly well placed in this regard as they have more involvement, knowledge, and influence over the companies in their portfolios. At Momentum, our business was among the first to sign the UN Principles for Responsible Investment back in 2006. We acknowledge that we are in a privileged position to act as fiduciary to our clients and stakeholders, and we take our ESG responsibilities seriously. With the most important global financial institutions now changing policy, it could be costly for investors to ignore.

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