# Building a sustainable financial system: the state of practice and future priorities

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# Building a sustainable financial system: the role of central banks

- **A striking shift since 2015:** Over 60 central banks committed to taking action to respond to climate risks and help green the financial system up from a handful five years ago
- **What does this new normal look like?** Moving from awareness raising and micro-prudential supervision to macro-prudential action, monetary policy and scaling up green finance.
- **What challenges lie ahead?** Definitions, assumptions, scope, regimes and, of course, COVID-19 crisis response
- **How is the Grantham Research Institute contributing?** The International Network for Sustainable Financial Policy Insights, Research and Exchange (INSPIRE)

# 1. The rise of central bank action on climate and sustainability

- **Signal:** Speech by Carney (2015) on the "Tragedy of the Horizon" a early signal for central banks and financial supervisors, outlined the novel threat of climate change for financial stability, transmitted through physical, transmission and liability risk.

- **Mandate:** Central banks and supervisors have increasingly recognised sustainability as relevant to their core mandates and functions and have successfully developed a compelling narrative for their involvement, which respects their specific functions and mandates (notably around risk and stability), separate from political imperatives.

- **System-wide** Equally, it is increasingly recognised that the macroeconomic implications and regulatory consequences of unabated climate change for central banks are system-wide, for prudential as well as monetary policies (Cœuré, 2018).

- **Cooperation:** Supported by the growth in international cooperation (such as TCFD/FSB and NGFS). Since 2018 the NGFS, a "coalition of the willing", has grown to 66 members and 12 observers.

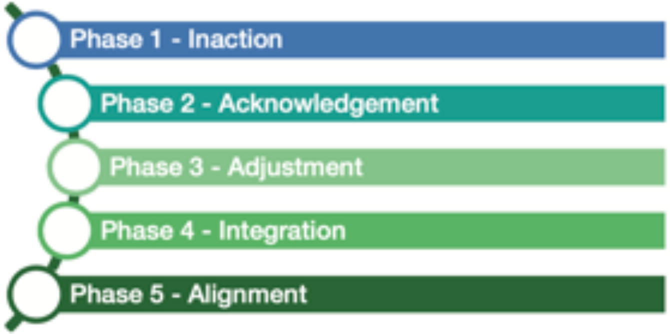
# 1. Entering the third phase of central bank engagement

- Traditionally, central banks believed that they had no role to play in confronting climate change and sustainability

- We are moving into a more action-oriented phase focusing on adjusting existing central bank policies and activities.

Figure 1

**PHASES IN THE ENGAGEMENT OF CENTRAL BANKS AND SUPERVISORS IN CLIMATE AND SUSTAINABILITY**




**SOURCE:** Compiled by authors.

# 2. The new normal: five main areas of activity

- **The bulk of the focus has been on the threat of climate change and there is broad agreement on the two main transmission channels, namely physical and transition risk.**

- **Most of the policies and initiatives of this "new normal" can be clustered around five main areas of activity:**
    1) Awareness raising and capacity building.
    2) Micro-prudential supervision.
    3) Macro-prudential action and financial stability
    4) Monetary policy.
    5) Scaling up green finance.

# 2. The new normal: raising awareness and focusing on supervision

1) **Awareness raising and capacity building**
   - Beyond binding regulation and supervisory expectations, a central role for monetary and supervisory authorities lies in educating financial institutions on the implications of climate change for their operations to ensure that risks are understood, disclosed and managed.

2) **Micro-prudential supervision**
   - Climate- and wider sustainability-related risks have direct implications for the goals of micro-prudential regulation to ensure the safety and soundness of individual financial institutions, cutting across the classic pillars of risk-weighted capital, supervisory review and market discipline through disclosure.
   - Promoting market discipline through enhanced disclosure has been the main focus for central banks and supervisors
   - Discussion has also focused on the effectiveness of differential capital adequacy ratios, which distinguish between low-carbon (or "green') and high- exposure (or "brown") assets

# 2. The new normal: extending to encompass systemic risk

## 3) Macro-prudential action and financial stability

- Environmental and climate change-related risks also have implications for the financial stability of the system as a whole and are relevant for macroprudential policy
- While standard macroprudential approaches do not explicitly take climate risks into account, approaches "green macroprudential policy" have started to be developed (Monnin, 2018; and Schoenmaker and Van Tilburg, 2016).
- Instruments along the cyclical and structure pillar can be adjusted to take account of **systemic** climate and sustainability risks
  - Countercyclical capital buffers, capital instruments (risk weights) and caps calibrated to take account of systemic climate and sustainability risks
  - Large exposure restrictions, capital surcharges for SIFI calibrated to address the exposure concentration to unsustainable investment
- Centrally relies on the understanding and disclosure of risk and effective disclosure requirements can play a vital facilitating role.

# 2. The new normal: moving into monetary policy and scale up

4) **Monetary policy:** Climate change can potentially directly affect price stability and therefore has implications for monetary policy. In addition, broad implications for monetary operations (including quantitative easing).

5) **Scaling up green finance**

- Climate change requiring a substantial reallocation in financial flows to scale up investments in sustainable solutions (Elderson, 2019)
- Central banks can engage in the scaling up of green finance for two main reasons.
    - First, the mandates of some central banks may oblige them
    - Second, due to the endogenous nature of climate risk, the scaling up of green finance can be seen as a long-term risk management strategy
- The greening of central bank portfolios (monetary institutions can "lead by example" while staying within their mandate (Cœuré, 2018; NGFS, 2018).
- The development of green financial markets
- Green credit allocation (mostly relevant in emerging markets)

# 3. Challenges and new horizons

**Clarifying core definitions, disclosures and differentials**

- system-wide adoption of definitions, identification of assets and activities that are "system enhancing" from a sustainability perspective and which are "system degrading"
- ensuring consistent, reliable and market-wide disclosure

**Reflecting on strategic assumptions to guide the greening of the financial system**

- Market neutrality in the context of climate neutrality

**Broadening the scope from climate change to sustainable development**

- social implications involved in greening the financial system, as well as the core social objectives of the SDGs such as ending poverty, reducing inequality and ensuring universal access to essential financial services.

**Building supportive international regimes for central bank action**

- Key initiatives have been the sector-focused coalitions Sustainable Insurance Forum, Sustainable Banking Network, NGFS, FSB's TCFD and INSPIRE

**Covid 19 and the need for a sustainable recovery:**

- A Toolbox for Sustainable Crisis Response Measures for Central Banks and Supervisors (***forthcoming*** INSPIRE briefing paper)

# 4. Sustainable finance & central banks at LSE/GRI

**Grantham Research Institute: Sustainable Finance research theme**

- Working with central banks and supervisors a key focus

**GRI is co-hosting of the International Network for Sustainable Financial Policy Insights, Research and Exchange  (INSPIRE)**

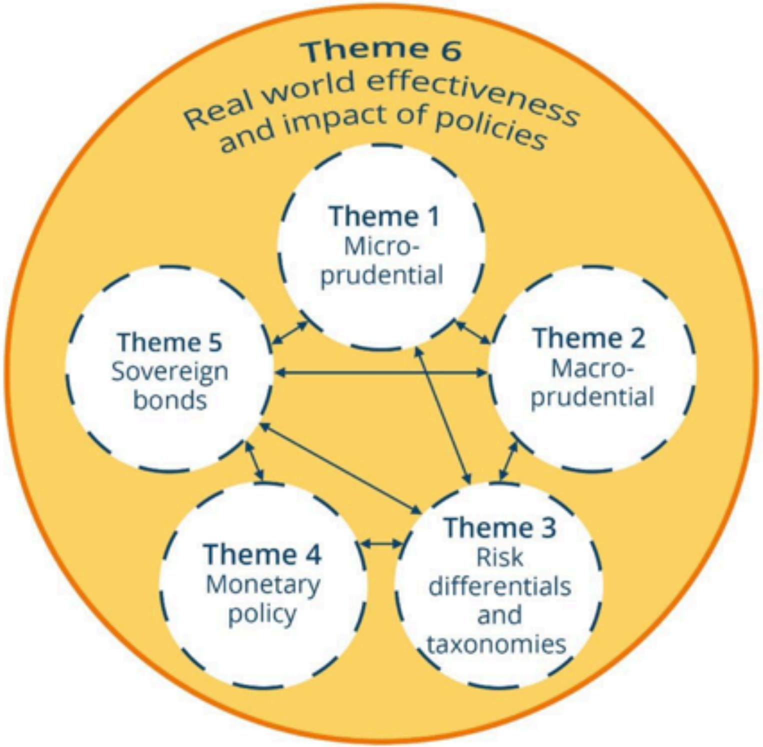
- independent research network designated to support the central banks and supervisors of the Network for Greening the Financial System (NGFS)
- **One of two global research stakeholder of the NGFS**
- **Three-point mission:**
    - To commission research and policy analysis on central bank and supervisory practice
    - To convene researchers, policymakers and practitioners
    - To communicate the results widely

INSPIRE

# 4. INSPIRE: commissioning and convening research

1. **INSPIRE-commissioned research outputs**
   - 3 calls for research proposals
   - 26 commissioned INSPIRE projects
   - Across 6 INSPIRE research themes thus far
   - For further details see INSPIRE (2020)
   - Special reports: Crisis response toolbox

2. **NGFS-commissioned research products**
   - Occasional papers (to support the efforts of NGFS Workstream 1 on ‘Microprudential and Supervision)
   - Development of reference scenarios (to support NGFS Workstream 2 on ‘Macrofinancial’)



# References

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Dikau S, Robins N and Volz U (2020, **forthcoming**) *A Toolbox for Sustainable Crisis Response Measures for Central Banks and Supervisors*. *INSPIRE Briefing Paper.* London: Grantham Research Institute on Climate Change and the Environment, London School of Economics and Political Science and SOAS Centre for Sustainable Finance.

# Thank you!

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