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Financial Regulation, Climate Change, and the Transition to a Low-Carbon Economy
A Survey of the Issues

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OUTLINE

• Climate change and the financial sector: A Timeline

• Key Questions / Key Findings

• Closing information gaps, improving disclosure, promoting standards

• Climate risk analysis: the state of the art

• Should Financial Policy and Regulation Promote Low-Carbon Transition?

• Walking a tightrope to net zero
Climate change and the financial sector: A Timeline

- **2000**: First insurance industry reports on climate-related risks
- **2005**: First IPCC report on economic impact of climate change; First UNEPFI report
- **2010**: Paris Agreement
- **2015**: G20 calls on FSB to “review how the financial sector can take into account climate issues”
- **2020**: First regulatory attempts to analyze climate risks for insurers
  - First “stress tests” for banks
  - First speeches by major central bankers on climate risks

Growing investor interest in ESG
Key Questions

• What is the role of financial sector policies in the transition to a low-carbon economy?
• What is the role of central banks and financial regulators?
Key Findings

• “Trying to see through a glass, darkly”

• “Brave New World”

• “Walking a tightrope to net zero”
Closing information gaps, improving disclosure, promoting standards

- **DATA GAPS**

- **CLIMATE-RELATED DISCLOSURES**

- **STANDARDS**
Climate risk analysis: the state of the art

• Well-established risk management tools in the financial industry (e.g. Value-at-Risk models and stress tests) cannot be used off-the-shelf to measure climate-related risks

• Exploratory scenario-based impact assessments have to be used instead
Climate risk analysis: the state of the art

Specificities of climate scenarios

|                        | Standard scenarios                                      |
|------------------------|--------------------------------------------------------|
| **Horizon**            | Short to medium run                                    |
| **Scenario drivers**   | Economic and financial                                 |
| **Shock values**       | Guidance from historical data                          |
| **Aggregation**        | National                                                |
| **Feedback loops**     | Work in progress (e.g. macro models with financial frictions) |
Climate risk analysis: the state of the art

**ISSUES**

- Model risk
- Time horizon
- Poor basis for policy action
- Not necessarily risks to financial stability
Climate risk analysis: the state of the art

ADVANTAGES, nonetheless

• Sizing risks vs testing firms’ capital adequacy / setting capital requirements
• Raising awareness
• Providing incentives
• Strengthen supervisory frameworks
Should Financial Policy and Regulation Promote Low-Carbon Transition?

• PROPOSALS (in the literature)
  • exposure or concentration limits
  • designation of systemically important financial institutions (SIFIs)
  • adjusting risk weights
Should Financial Policy and Regulation Promote Low-Carbon Transition?

• ...BUT
  • how to distinguish ‘green’ from ‘brown’ assets
  • ‘greenness’ is not necessarily equivalent to low risk
  • using regulatory tools to promote climate transition would complicate the conduct of policy
  • ...and, based on the available evidence, it is unlikely to be effective
Should Financial Policy and Regulation Promote Low-Carbon Transition?

- The GSF has a **very limited impact** on the conditions for financing green projects…

Chamberlin, B. and J. Evain (2021), Indexing Capital Requirements on Climate: What Impacts Can Be Expected?, September 2021
Should Financial Policy and Regulation Promote Low-Carbon Transition?

• … while for the penalizing factor (PF) to have a significant impact on the cost of a project, its calibration must be (very) high …

... but a high PF affects the capital of banks, which might respond by rationing credit

Chamberlin, B. and J. Evain (2021), Indexing Capital Requirements on Climate: What Impacts Can Be Expected?, September 2021
Should Financial Policy and Regulation Promote Low-Carbon Transition?

Figure 4. Key Challenges in Incorporating Climate-Related Risks in the Supervisory Process (responses by jurisdictions)

- Data availability: 10
- Methodological challenges: 7
- Risk transmission channels: 5
- Capacity/resources: 4
- Time horizon misalignment: 3
- Climate-related forecasts: 2
- Degree of awareness: 2
- Credit rating regime: 2
- International coordination: 2
- Taxonomy: 2

Source: BCBS (2020).
Should Financial Policy and Regulation Promote Low-Carbon Transition?

• *Does a more ‘green-promoting’ role require a change in central banks and financial regulators’ mandates?*

• *It would raise major governance and operational challenges while having most probably a limited real-world impact → would it stand up under a cost-benefit analysis?*
Walking a tightrope to net zero

• The road towards a low-carbon economy is going to be bumpy

• In this complex environment, central banks and financial regulators have to tread a fine line
Walking a tightrope to net zero

- Financial policy and regulation cannot deliver the transition to a low-carbon economy by itself
- Markets need a “critical signal for re-directing private investment and innovation to clean technologies, and to incentivize energy efficiency” (Georgieva 2021)
Walking a tightrope to net zero

• For central banks and financial regulators ...
  • A role to play in the transition to a low-carbon economy ...
  • ... but without overestimating their abilities or their toolkit, overstepping their mandate, or disregarding the possible unintended consequences of their actions
  • Always acting in concert with government climate policies ...
  • ... and avoiding to find themselves (again) in the role of ‘the only game in town’
Walking a tightrope to net zero

“Mission critical” ...

or

... “Mission vigilant” ?
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THANKS!