Can financial regulation address the risks related to climate change?

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The usual disclaimer applies: the views expressed in this presentation are mine and do not necessarily reflect those of the Banque de France.

Introduction

2 contributions from

- Mireille Martini: “Greening Basel 3”
- Rens van Tilburg: “What role for financial supervisors in addressing systemic environmental risks?”

Introduction

- The two papers focus on the role financial (banking) regulation could play in facilitating the transition to a low carbon economy or in addressing some of the risks related to climate change
- They take a different perspective: Mireille remains in the "microprudential" world, focusing on the risk weights framework but proposing a risk hierarchy based on carbon footprint rather than on standard risks measures ; Rens takes a rather "macroprudential perspective", focusing on systemic financial imbalances resulting from ecological pressures
- They end up with different policy recommendations, in particular in terms of supervisory tools: Rens in particular reject the use of risk weights
- The French Banking Association has recently proposed a "green supporting factor" that works as the SME supporting factor in CRD IV (0.7619 applied to risk weights)

Outline of my discussion

1/ What are the main issues at stake?

2/ Are there market failures motivating regulatory interventions/changes ?

3/ To what extent does the current regulatory framework captures the financial risk associated with climate change?

4/ A discussion of the proposals and a presentation of ongoing regulatory developments

1/ Main issues at stake

- Climate change is now a certainty but its impacts remain difficult to anticipate/ evaluate
- Huge financing needs to meet the 2° target agreed in Paris (up to $53tr according to the International Energy Agency). Delaying the adjustment may dramatically increase the transition costs and lead to hard landing
- So far, current market pricing seem to reflect a lack of awareness of the financial risks induced by climate change
- New regulatory standards (Basel 3) may weight on bank lending, impairing the ability of the banking system to finance the transition to a low carbon economy; may be in addition biased and detrimental to green finance, explaining the financing gap

2/ Market failures?

- Climate change risks do not seem to be adequately priced by markets and financial institutions: lack of awareness due to information asymmetries or some form of opaqueness
- "Tragedy of horizon" (Mark Carney): the horizon of materialization of climate change risks is uncertain and way beyond the horizon at which investors take their decisions (short-termism)
- Negative externalities: systemic risk arises from the current unstainable growth path (i.e. inconsistent with the 2° limit) and the built up of financial imbalances (the carbon bubble)

3/ Climate risks

From a financial stability perspective, 3 main risks have been identified:

1/ Physical risks: arise from increased frequency and severity of extreme climate related events: ultimately mostly borne by the insurance sector (up to the point that risk become uninsurable for a significant share of the population);

2/ Transitional risks: related to the pace and the amplitude of the adjustment towards a lower carbon economy: risk of asset meltdown for some industries (stranded assets – jump to distress pricing)

3/ Liability/litigation risks: stem from parties who have suffered a loss from climate change and who are seeking compensation from those they hold responsible

3/ Basel risk weights framework

- Microprudential standard: its main objective is to protect investors or clients for direct losses. Focus on the stability of the individual institutions
- There are risk categories: market risk; interest rate risk ; liquidity risk; counterparty risk; credit risk; operational risk
- There are asset classes associated with risk weights: e.g. zero risk weights (cash, sovereign exposures); 20% RW (interbank exposures OECD countries); 50% (mortgages; localities); 100% (Retail or corporate lending, real estate…)

3/ Could climate risks be factored in the current Basel framework?

To some extent, yes:

- Liability/litigation risks belong to operational risk
- Physical and transition risks belong to counterparty, credit and market risks

But one could argue it is insufficient:

-scope for introducing a new asset class related to climate risks?

-scope for modifying the hierarchy of risk by introducing an additional factor (like Mireille)?

-scope for taking a holistic/systemic perspective (Rens)?

4/ discussion of the proposals

- If you are considering that climate change risks are not factored in, or insufficiently, by the current regulatory standards, then you should increase the risk weights rather than decreasing them (unlike Mireille or FBF proposals): this would both increase the resilience of institutions and preserve the good incentives and resource allocation.
- If you are convinced that climate change risks should override the current Basel risks, then you should completely get rid off the Basel Framework: Climate risk is first order and Basel risk weights are too blunt and inappropriate to fully address climate risks

4/ discussions of the proposals

- If you consider that there is some form of systemic risk related to climate change, then microprudential tools are inappropriate: what would be here a relevant macroprudential approach?
- Rens argues for hard exposure limits: but shouldn’t this trigger an asset price meltdown with banks insufficiently capitalised to cope with it?
- Some institutional investors are currently implementing divestment strategies: what about the financing of the investments needed to facilitate the transition? Green vs. greening

4/ on going developments

- Promoting green finance: e.g. green bonds but issue of labelling (risk of green washing): G20 initiative
- Stress-testing (e.g. Context of the French law): main objective is to raise awareness about the risks and the exposures related to climate change. Should also facilitate and complement enhanced disclosure (e.g. FSB task force)

Conclusion

- Overall, given the financial needs, the financial sector is and will remain at the forefront of changes
- Regulatory standards might help but are second order and are not designed to allocate capital: this should be the role of macroeconomic policies (fiscal) or industrial policies
- A crucial issue is the raise investors' awareness: enhanced disclosures regarding exposures to climate risks and stress tests might help
- International standards required for the development of green finance