Incorporating climate risk in QE

The case for greening central banks' balance sheets

by Danae Kyriakopoulou in Geneva

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In the decade since the 2008 financial crisis, central banks' spheres of influence have grown in substantial and occasionally controversial ways. Over the last few years, that influence has begun to expand to addressing climate change-related disruption.

Ensuring climate-related risk does not translate to financial instability is a key concern for central banks, but not an exclusive one. Central banks are tasked with safeguarding prosperity, which in turn requires that prosperity be generated sustainably. Monetary authorities should lead by example by supporting the transition to lower-carbon economies and combatting climate change in their roles as investors.

This could involve strategies for greening central banks' non-monetary policy portfolios, including their own funds, as well as the management of reserves. Frank Elderson, executive board member at De Nederlandsche Bank and chair of the Network for Greening the Financial System, announced at the panel discussion co-hosted by OMFIF and the United Nations Conference on Trade and Development at the World Investment Forum in Geneva on Friday 26 October that DNB would be the first central bank to sign up to the UN's Principles for Responsible Investment.

The green bond market is a prime example of channelling funds towards green initiatives. While still small (green bonds outstanding total around $400bn), the market is growing fast and expanding into other areas. On 29 October the Seychelles became the first sovereign to issue a 'blue bond', a 10-year $15m issuance earmarked for the protection of marine life.

A more controversial approach would be for central banks to take climate risks into account in the purchases that form part of their quantitative easing programmes. In its first progress report published in October, the NGFS admitted that 'climate- or environmental-related criteria are not yet sufficiently accounted for in internal credit assessments or in the models of credit agencies'… which many central banks rely on for their operations.' This reveals an uncomfortable contradiction for central banks like the European Central Bank, which, as a member of the NGFS, is seen as admitting that risk is improperly accounted for in the current ratings system while at the same time using that system for deciding which assets to buy for its asset purchase programme. Reacting to this contradiction could range from supporting rating agencies in developing a system of accounting for climate-related risks, to a more active approach of central banks developing their own such system.

Climate could be only the start. The framework developed by the NGFS to understand and address the link between climate change and financial stability could be extended to other risks to sustainable growth forming part of the UN's sustainable development goals. This could prove a source of further controversy as central banks tread the fine line between adhering to their mandates and expanding their remits.

Danae Kyriakopoulou is Chief Economist and Head of Research at OMFI. More information about the OMFIF-Unctad panel on the role of central banks in greening the financial system can be accessed on the World Investment Forum website . This is the second of two articles on central banks' approach to climate risk. The first in the series was published on Wednesday 31 October .