

Central banks greening financial system

Climate change as source of financial risk and opportunity

by Danae Kyriakopoulou in Geneva

Wed 31 Oct 2018

Central banks' remits have changed profoundly since the 2008 financial crisis, notably – and sometimes controversially – in relation to their monetary policy practices and quantitative easing policies. Their remits are beginning to expand into another, unexpected field: climate change.

The recognition of climate-related disruption as a source of financial risk is propelling this expansion, and ensures that addressing these issues does not require further (potentially controversial) expansion of central bank mandates. Instead, it translates climate-related risks into categories of financial risk that central banks already monitor. This was a key message at [a panel](#) co-hosted by OMFIF and the United Nations Conference on Trade and Development at the World Investment Forum in Geneva on Friday 26 October.

There are at least two channels through which climate- and environment-related changes can become relevant to the financial sector. The first relates to the physical risk to the value of financial assets from natural disasters and changes in weather patterns. These can affect the macroeconomy on both the demand side, through influencing the wealth, consumption and investment patterns of households and businesses, and on the supply side, through resource shortages, damages to the capital stock and infrastructure, and associated reductions in productivity. The second channel, that of 'transition risk', relates to the legal and adjustment cost that the financial sector will incur in transitioning towards a lower-carbon economy. While such risks may only be realised over an extended time horizon, immediate action is needed to mitigate the long-term impacts.

Central banks can leverage their influence through their capacity as both regulators and as reserves managers. As supervisors tasked with safeguarding financial stability, they can stress-test firms' ability to deal with climate shocks. Central banks can also encourage, incentivise or even require climate-related disclosures from the institutions they supervise. This would enable investors to price climate risks correctly. A monetary authority may even set capital requirements for institutions to account for climate-related risks.

The insurance industry is one part of the financial sector in which climate risk analysis is already in the mainstream. It was at the insurance firm Lloyd's of London that Mark Carney, governor of the Bank of England, first spoke in September 2015 about the [tragedy of the horizon](#) linking climate change and financial stability.

Financial institutions have made considerable progress since then. The Financial Stability Board established the [Task Force on Climate-related Financial Disclosures](#) in December 2015. In 2016, the G20 Sustainable Finance Study Group was created. Last year OMFIF, together with the Bank for International Settlements, German finance ministry, Amundi, DZ BANK, HSBC and other institutions, launched the ['Focus on green finance'](#) initiative. Its first [symposium](#) was held at the Deutsche Bundesbank in July 2017.

In December of that year, the Banque de France established the Central Banks and Supervisors Network for Greening the Financial System. Starting with eight founding members, the network now includes 18 central banks, in addition to observer members including the Organisation for Economic Co-operation and Development, BIS, World Bank and International Finance Corporation. In October, the Prudential Regulation Authority, the Bank of England's banking and insurance supervisory arm, became the first major financial regulator to specify how it expects banks and insurers to take climate change into account when managing risk.

Such decisions illustrate how central banks are moving on from understanding the analytical framework linking climate change to their mandates and taking action.

Danae Kyriakopoulou is Chief Economist and Head of Research at OMFIF. 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 first of two articles on central banks' approach to climate risk. The second in the series will be published later this week.