CLIMATE RISKS

On 14 October 2021, Toronto Centre convened a meeting of central bank governors and heads of supervision authorities from developing and developed countries to explore the impact of climate change on their countries and on their financial sectors, and to discuss what central banks and supervisors can do in response to climate-related risks.

This was the first roundtable discussion hosted by Toronto Centre on this important subject. Babak Abbaszadeh, CEO of Toronto Centre, welcomed the participants, outlined the objectives of the discussion and thanked funders for their support of the Centre's mission. Babak noted that Toronto Centre has been incorporating climate risks into its programmes since 2016, and had recently issued a climate risks toolkit to help financial supervisors address climate-related risks.[1]

Previous discussions hosted by Toronto Centre during the IMF and World Bank autumn and spring meetings had focused on how financial supervision can enhance the benefits of fintech for financial inclusion and gender equality.

The discussion was moderated by Alan AtKisson, Assistant Director-General, Swedish International Development Cooperation Agency (Sida). He opened the discussion by emphasizing the importance and timeliness of this topic and its links to financial stability, financial inclusion and gender equality.

Alan invited the keynote speakers and other participants to focus on the impact of climate change on their countries and on their financial sectors, and to describe the actions their authorities have taken in response to climate-related risks.

The discussion focused on central banks and supervisors responding to climate-related risks by:

- Understanding the impact of climate change on their countries and on their financial sectors.
- Careful consideration of how climate-related risks relate to an authority's mandates and objectives, for example for financial stability and financial inclusion.
- Dialogue with financial institutions and other stakeholders.
- Issuing guidelines or using "convening powers" to direct or encourage financial institutions to improve their management of climate-related risks.

[1] The Toronto Centre Toolkit can be found at https://res.torontocentre.org/guidedocs/Climate%20Risk%20Toolkit.pdf

RECORD OF PROCEEDINGS

Panel session

Dr Reza Baqir, Governor of the State Bank of Pakistan, began by noting the severe consequences of climate-related risks for Pakistan. In 2010, flash floods and landslides caused by unusually heavy monsoon rains caused widespread flooding in North West Pakistan, affecting up to 20 million people (12 percent of the population) and destroying or damaging 1 million homes. Devastating rainfall in 2020 also caused considerable damage. Moreover, temperature warming is running at a higher rate in Pakistan than the global average.

As in other countries, there was a lot of debate in Pakistan about central bank activism in response to climate issues. The primary goals of the State Bank of Pakistan are price and financial stability. Nothing should come in the way of meeting these goals, because of the considerable benefits of delivering price and financial stability. That said, there is scope for a central bank and supervisory authority to work actively on issues relating to climate risk, not least because of the impact of climate events on the economy and on the financial sector.

Focusing on the financial sector, climate-related risks increased credit risks, with a disproportionate impact on the provision of credit to more vulnerable and poorer borrowers, leading to greater inequality and an overall reduction in investment. In addition, bank branches closed or became inaccessible during severe climate events, accentuating the impact on already low levels of financing and inclusion.

The State Bank of Pakistan has issued green banking guidelines on climate-related risks, intended to reduce vulnerabilities by reminding financial institutions of their responsibilities to provide finance for climate resiliency and protecting the environment. The central bank also has powers to lend to commercial banks for on-lending for specific purposes. It has used these powers to establish a refinancing scheme for solar energy. This has expanded rapidly, and has led to intermediaries offering solar schemes to smaller corporates, not just to households.

The State Bank of Pakistan has also been active in trying to reduce the gender gap. Its Banking on Equality policy[2] mandates financial institutions to increase financial inclusion and equality, in part through providing specific products that meet the needs of women – for example, calling on banks to research opportunities for lending to the types of businesses typically run by women. Other elements of the policy include the digital on-boarding of customers (through remote biometrics, including through mobile phones) and the removal of any need to provide proof of employment or income for small deposits.

Beyond this, the State Bank of Pakistan sees a link between a better gender balance and protecting the environment – financial inclusion can provide resources to enable women to protect the environment and to be better prepared for climate-related risks. In addition, some research suggests that increasing the number of women in senior roles may lead to longer-term thinking and less risk-taking.

Irene Espinosa Cantellano, Deputy Governor of the Banco de México, echoed the experience of Pakistan in describing the huge impact of climate change on Mexico, which is

[2] Details of this policy can be found at: https://www.sbp.org.pk/BOE/Index.html

also very exposed to climate change and its consequences. Climate change is already affecting the economy, with a massive impact on people's lives.

Mexico is a vast territory, with extended coasts on the Pacific and Atlantic Oceans. The country is exposed to extreme weather phenomena (hurricanes, floods, etc.) and chronic weather phenomena (high temperatures and drought). It has experienced increasingly severe floods and landslides in almost all the country. Highly populated states in the centre of the country have been harshly affected. Climate events have damaged thousands of private properties and devastated agriculture (livestock and crops). Earlier in 2021, wildfires and heat weaves affected more than 80% of the total forest area.

In addition to the direct economic impact, the Bank of Mexico has also noted significant inflation risks arising from shortages of agricultural products, and an adverse impact on public finances as resources are directed to mitigating the impact of climate events.

Mexico is also a high carbon-intensive economy, so achieving net-zero emissions is a massive task. It requires profound structural transformation in investment, technology, employment, education, and consumer habits. Significant local and international resources will need to be reallocated, and perhaps actively diverted, to green projects. The potential net costs of not acting are much larger than those of acting.

There are various channels through which climate-related risks might alter the functioning of the financial system. A primary concern of a central bank is financial stability - the ability of financial intermediaries and financial markets to continue allocating funds and rendering other vital services to the economy despite the materialization of shocks and the presence of financial imbalances.

Natural and climate disasters can have a direct impact on businesses and their solvency, which in turn can generate risks (credit, insurance underwriting and market risks) to financial institutions. Climate events can therefore test the resiliency of the financial system. Even before a natural disaster occurs, climate-related risks may affect the financial system in different ways, including through the rising cost of insurance and the appetite of investors for climate friendly opportunities. The bond market is rapidly changing to take into consideration ESG criteria, and new financial instruments are emerging to meet the increasing appetite from investors towards green and transition bonds.

In response to climate-related risks, financial supervisors can set the platform for constructive dialogue and cooperation between the authorities and private financial sector participants, in particular to make progress on:

- Better integrating climate and environmental risks into financial decisions.
- Setting clear rules for companies and financial intermediaries to identify and disclose climate-related risks.
- Defining a national taxonomy for sustainable investments.
- Setting a proactive plan to capitalize on opportunities associated with the transition to a low-carbon economy.

On disclosure by listed companies, the Bank of Mexico is planning to set up a Task Force on Climate-related Financial Disclosures (TCFD) consortium in Mexico, emulating the successful case of the TCFD consortium in Japan. The Mexican TCFD consortium would be a private sector platform, with some financial authorities as observers, focused on implementing the TCFD recommendations on the disclosure of governance, strategy, risk analysis, and metrics relating to climate risks. It will expedite the disclosure of material information and the use of such information by investors.

These actions by financial authorities should respect the mandate of each authority. Climate change is a source of economic and financial risks and therefore falls within the mandate of central banks and supervisors. Climate-related risks should be integrated into financial stability monitoring, micro-supervision and disclosure requirements. For central banks, sustainability factors can also be incorporated into portfolio management. But financial authorities do not typically have a mandate for actions directed towards limiting climate change itself.

Roundtable discussion[3]

Participants from many countries agreed with the opening speakers that the actual and potential costs of climate change are huge, be it through floods, drought, rising sea levels, or higher temperatures, even if an individual country is not itself a significant contributor to global climate change.

This will become a financial stability issue if governments do not take the necessary actions to reduce climate change. Since central banks are at the vanguard of price and financial sector stability they must take a lead in balancing the risks and rewards while devising policies in this regard.

Some participants noted that they had begun analysing the potential impact of climate change on their economies many years ago, and one mentioned having set up a committee of scientific advises to contribute to this analysis. It was also noted that there should be a focus on adaptation to climate change (and on the financing of adaptation projects), not just on mitigation, because of the possibility that global efforts to reduce climate change will prove to be inadequate.

In terms of the steps that might be taken by central banks and supervisory authorities, participants mentioned a wide range of possibilities, including:

- Building supervisory capacity to overcome any lack of knowledge and skills about climate risks.
- Using a central bank's "convening power" to encourage the private sector – and financial institutions in particular – to change their behaviour.
- Issuing guidance to financial institutions on the management of climate-related risks and on climate-related disclosures.[4] Financial supervisors and central banks can set change in motion by influencing the governance and risk management practices of financial institutions and by requiring them to hold capital buffers to cushion against the crystallisation of climate-related risks.
- Encouraging financial institutions to join one of the many initiatives for sustainable investment, for example the Global Investors for Sustainable Development (GISD) Alliance, convened by the United Nations and supported by Sida.

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[3] The discussion was conducted under the Chatham House rule – the themes reported here reflect the sense of the discussion but do not attribute observations to individual participants.
[4] See, for example, the guidance issued by the Central Bank of Kenya in October 2021: https://www.centralbank.go.ke/wp-content/uploads/2021/10/Guidance-on-Climate-Related-Risk-Management.pdf

- Promoting climate-related insurance. For example, one participant mentioned a scheme to rebuild mangrove swamps as soon as they are damaged, because of their contribution to bio-diversity and the protection they offer against hurricanes. Another participant suggested that governments might need to provide guarantees or supplementary insurance to support the availability of private sector insurance against climate-related risks.
- Harmonising international standards to guide national authorities on the standards they might introduce domestically and to provide a more level playing-field. The Network for Greening the Financial System was mentioned by some participants as a helpful source of standards for climate-related risk management by financial institutions. International disclosure standards might help in limiting the ability of internationally mobile financial institutions such as fund managers moving location to avoid climate-related disclosure requirements or other climate-related regulations.
- Strengthening the climate information architecture to promote transparency and the global comparability of data, including harmonised disclosure standards and globally agreed principles for the classification of sustainability.[5] Better data could also help to raise awareness of the threats posed by climate change to financial stability; improve understanding of the issues; and support relevant research on the transmission of climate risk to the financial sector.
- Making the State Bank of Pakistan’s "Banking on Equality" policy a global initiative to support a green and inclusive recovery.

Conclusion

Participants concluded that climate-related financial risks can be substantial and can pose a threat to financial stability. There is scope for financial supervisors and central banks to act within their mandates to improve the climate-related risk management of financial institutions and the disclosure of climate-related information by listed companies and by all financial institutions; to contribute to the development and harmonisation of international standards; to encourage financial institutions to sign up to internationally agreed principles for sustainable lending, insurance and asset management; and to address the inter-linkages between climate change and financial exclusion.

[5] See the IMF publication: https://www.imf.org/en/Publications/staff-climate-notes/Issues/2021/09/01/Strengthening-the-Climate-Information-Architecture-462887