Climate change: Basel must meet Paris.

Regulation of the financial sector needs to now count climate-change as a serious risk and design the oversight framework accordingly

A delayed response or measured indifference to this issue could turn out to be irreparably expensive for the financial sector.

By Runa Sarkar & Partha Ray

In a first in the history of the Global Risks Perception Survey of the World Economic Forum's, in 2020, the risks of climate change and related environmental issues occupy the top five spots in terms of likelihood. Managing these risks require large scale investments, and inaction could cost the global economy $150 billion annually (2014 White House report). The International Finance Corporation of the World Bank estimates that the Paris Agreement opened up an $23-trillion opportunity (till 2030) for climate initiatives in EMEs that account for 70% of the total global climate investment requirement. However, according to the Climate Policy Initiative, current climate investments are a mere 2% of the total required. If the targets for climate-focused investments are to be met through banks and capital markets, a major shift is required in the current trajectory.

While there is a general agreement that the Paris target on limiting global temperature rise is inadequate, achieving even this requires a substantial reallocation of global investments. Some movement on green investments is visible, but changes in the regulatory and oversight framework of the entire banking system is needed. The share of green loans in the banking system is low (around 4% for India and China, for instance) and, less than 1% of the $180 trillion of institutional investors was put into green/climate areas.

The Basel-based Bank for International Settlement (BIS) has flagged climate change as a central concern for the financial sector. In a May 2021 document, brought out by the Financial Stability Institute of the BIS, interesting principles for prudential regulation of the financial sector, based on the recommendations of central banks and Supervisors Network for Greening the Financial System (NGFS), have been proposed. RBI joined NGFS on April 23, 2021. Broad recommendations are: supervisors must determine the path of transmission of climate-related and environmental risks to their economies and financial sectors, and identify material risks for supervised entities.; national authorities (regulators and central banks) need to develop a strategy that supports the integration of these climate-related and environmental risks in the supervisory work; supervisors need to identify financial institutions' exposures to these risks and assess their potential losses; clear supervisory expectations need to be set with regard to a number of issues, such as, governance arrangements, "including the need for financial institutions' to assign management responsibilities for climate and environmental risks, board-level responsibilities, and fit and proper requirements for senior executives and board members"; and, supervisors need to ensure "adequate management of climate-related and environmental risks by financial institutions" and take appropriate actions wherever necessary.

Admittedly, these recommendations do not enumerate any specific dos and don'ts. Instead, they are broad principles. In its first comprehensive report in 2019, the NGFS recommended the integration of climate-related risks into micro-prudential supervision.

Of course, the power of the NGFS is quite limited—it is a voluntary, consensus-based forum whose purpose is three-fold: (a) to share best practices, (b) to contribute to the development of climate- and environment-related risk management in the financial sector, and (c) to mobilise mainstream finance to support the transition towards a sustainable economy.

More recently in May 2020, the NGFS came out with a fairly detailed technical document that has several illustrations of how many central banks have started taking climate-related and environmental risks seriously. Illustratively, the Reserve Bank of New Zealand has a climate change strategy, the Malaysian Central Bank has set up an internal network for this purpose, and the Bank of England assessed mortgages against flood-risks.

The global financial crisis added prudential regulation as an essential component in the toolbox of central banks/financial regulators. The current instances of climate-change impact are a wake-up call to include climate-change in the regulators' toolbox as well. A delayed response or measured indifference to this issue could turn out to be irreparably expensive for the financial sector.

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