Will tackling climate risk still be a major priority post-Covid?

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Climate change as a source of challenges for the Eurosystem's monetary policy

Climate change is a legitimate and serious source of concern for central banks in their role of defining and conducting monetary policy.
Indeed, climate change will affect monetary policy in two ways. On the one hand, most economic variables that are critical for the diagnosis underpinning monetary policy objectives and decisions, such as production, productivity and prices, will be affected by climate change, because of more frequent and more intense extreme weather events and gradual warming and because of the adverse outcomes caused by the transition to a low carbon economy. On the other hand, the transmission mechanism of monetary policy itself is vulnerable to climate change because of the latter's potential negative reverberation on the functioning of financial markets and the strength of financial institutions' balance sheets.

The Eurosystem, confronted with such climate-related challenges, intends to address them candidly.

Against this backdrop, central banks face a threefold challenge. First, climate shocks can be non-linear, making the evolution of climate-related risks difficult to predict and a significant source of uncertainty, which will make it more challenging than today for central banks to evaluate their own policy space. Then, the question for them is the following: how to assess thoroughly the implications of such uncertainty for the design of their monetary policy? With respect to inflation targeting, this may include parameters that are critical for central banks' credibility, such as the nature of the policy target, its level, or the horizon over which this target should be met. Second, central banks need to beef up rapidly their analytical capabilities to be able to factor in climate-related shocks in their models and assessments. Third, central banks should look thoroughly at the implications of climate change for their monetary policy operational framework.

That includes the eligibility, mobilization rules and the valuation of the collateral they accept in their credit operations to the extent that these assets carry climate-related financial risks, which are not properly factored in by financial markets. From a broader perspective, central banks also need to determine if and how they could play a catalytic role and foster collateral and financing practices in the financial system that are aligned with meeting the Paris Agreement 1.5°C objective. Acting as a catalyst does not necessarily mean changing the mandate of the central bank. Rather, it would imply to factor in, when this is feasible and relevant, climate-related considerations in the design of monetary policy operations.

The Eurosystem, confronted with such climate-related challenges, intends to address them candidly. Accordingly, the monetary policy implications of climate change are one of the main workstreams of its on-going strategy review, which is due to conclude in the course of 2021. ●

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Encouraging sustainability – managing risk

Most environmental scientists now agree that climate change represents significant risks to society. Increased temperatures are causing the loss of glaciers and rising sea levels as well as extreme weather events such as droughts, storms and heatwaves. In Japan, heavy rains, floods and landslides have become more frequent and data from the Japan Meteorological Agency shows that the 10 years from 2010 to 2019 extreme rainfall events with precipitation of more than 400 mm per day -- the level likely to cause landslides or floods -- rose 170% compared with 10 years from 1976 to 1985. The possible relationship between the problem and climate change is pointed out.

Even a 1.5 degree C rise in temperatures above pre-industrial levels may bring catastrophic change. A managed ▶

transition to a sustainable, decarbonised future is essential and many are now urging policy makers and authorities to take immediate action. This requires a coordinated set of ambitious policy responses, backed up by regulations that are clear, consistent and broadly applied.

Such policies and regulations must seek both to encourage the move to sustainability and to force economic actors to manage the risks of climate change.

The approach of the EU Taxonomy regulation, broadly speaking, is to encourage the transition towards sustainability. It will drive the necessary change by creating a unified system for determining whether an economic activity or investment qualifies as environmentally sustainable. This introduces consistent criteria for labelling a product as "green", which will be used by Member States and financial market participants respectively in the labelling and marketing of financial products.

...as providers of credit and liquidity banks must be agents for change.

Certain national regulators have focused on risk management. In the UK the PRA and FCA have encouraged regulated firms to manage climate change risk by requiring their Boards and senior management to focus on their risk management systems and controls and have co-chaired the Climate Financial Risk Forum, which has recently published guidance to advance the sector's responses to the financial risks from climate change. This covers:

- Risk management – to enable better decision-making and resilience building;
- Scenario analysis – to assist in understanding and responding to future risks;
- Disclosures – to improve transparency and help stakeholders assess the future value of assets;
- Innovation – to encourage new services and products enabling a firm to respond to climate change and contribute towards a decarbonised economy.
- The PRA has now consulted on plans for its 2021 Biennial Exploratory Scenario, which will be a bottom up stress test of the resilience of the UK's largest banks to climate change risks, further informing the UK's early-stage but comprehensive set of tools for assessing and mitigating climate change risks.

Banks are subject to the risks of climate change but as providers of credit and liquidity banks must be agents for change as well. The financial sector must encourage sustainability and at the same time manage its own risks. As ever, the winners will be those firms that respond best to the opportunities and obligations presented in the years to come.

Bernhard Langer

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Investing for sustainability- turning an art form into a science

Sustainability and responsibility in investments are on everyone's lips, with climate change and environmental protection enjoying high attention. The 2015 Paris Agreement marked a significant step as governments acknowledged that actions are required to mitigate global warming and the impact of climate change. While historically the assessment of ESG risks was considering more of an art form than a science, the increasing availability of quantitative data allows for controlling portfolio exposures towards sustainability risks both in dedicated ESG investment strategies as well as conventional ones.

Invesco Quantitative Strategies is convinced that a prudent risk management should include forward-looking environmental risks.

While ESG is clearly a multi-dimensional problem, certain aspects are clearly salient drivers: the aggregated ESG score as well as the carbon footprint of a portfolio. Managing the latter leads to the limitation of two types of risks at the same time: the contribution of the portfolio to global warming as well as the risk of global warming to the portfolio. In a recent study, we compared a portfolio with explicit carbon management to another one lacking this dimension.

The carbon-controlled portfolio aligned to the 2-degree Paris target, whereas the

naïve portfolio aligned to 3.95-degree global warming scenario. Furthermore, the financial transition risk in a 1.5-degree scenario could be dramatically reduced from a portfolio impact of -5.1% to -3.4%.

Developing climate scenario analysis is a high priority for the financial

industry and financial regulators in order to be able to measure forward-looking climate risks. The results are promising but the models are only as good as the data and assumptions that underpin them, where more work is likely to be needed. Ensuring access to reliable and comparable sustainability data is therefore essential to further these developments. Beyond climate, there is increasing evidence that other environmental and sustainability risks are likely to be equally relevant, both for the planet and for investors.

The coronavirus pandemic has served to highlight the issue of biodiversity and deforestation, as well as social risks. While investor awareness of these issues is increasing, we still have some way to go before the quantification of these risks reaches the same level of sophistication as for climate risks. Invesco Quantitative Strategies is convinced that a prudent risk management should include forward-looking environmental risks. We have developed a toolset to explicitly control the carbon emissions of a portfolio without sacrificing return expectations. Those techniques play a crucial role in supporting the Net Zero goal from a financial perspective. We expect that over time, this will evolve to cover other environmental and sustainability risks as the scientific evidence increases.

Burkhard Eckes

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Sustainable Finance/ESG – Further progress to be made in "S" and "G"

The EU had committed itself in 2015 at the Paris Climate Summit to achieving various climate targets by 2030, embarked on an intensified course in spring 2018 with the publication of the Sustainable Finance Action Plan and then proposed a further strengthening of its efforts with the Green Deal. Europe is thus currently very consistently and purposefully oriented and the question arises as to whether this goal, which can ultimately be described as a strategy, can be achieved and whether further measures are required.

On the regulatory side, the Sustainable Finance Action Plan is initially unilateral in its approach to financial services institutions. The idea here is fundamentally correct. After all, if triple-digit billions are to be invested in environmental protection measures every year, regulation can be used to persuade the financing institutions to steer the funds in the right sustainable direction as early as the financing stage. In order to decide which investments are sustainable, uniform criteria are needed, which are successively developed by the taxonomies.

In addition, the financing institutions also need data from the investing companies in order to be able to apply the taxonomy. It will therefore also be necessary to persuade companies in the real economy to publish this data. And it will not be enough to focus only on the large companies. Many small and medium-sized banks in particular do not finance large companies at all, but at the same time they have to comply with the requirements of the Financial Services Action Plan.

The Action Plan initially focused on climate risks, even though the terms "S" for social and "G" for governance are already used in the other regulations published in 2019/20. The Covid-19 crisis in particular, but also recent business scandals, show that, in addition to "climate", progress must also be made very quickly in the areas of "social" and "governance".

Therefore, taxonomies need to be developed in these areas as well. And here, too, the second step will be to find out how financiers can obtain data for these areas. Especially for financial institutions the requirements regarding Sustainable Finance/ESG will have a huge impact on business strategy, client approach and segmentation, products/services and prices, production/provision and operating model but also on risk management, finance and capital.

> *It will become a huge challenge for Financial Institutions to collect datas from investing companies they need to be able to apply the taxonomy.*

Ultimately, Europe seems to be developing very quickly and strongly in this environment. In America and Asia there are currently no comparable consistent developments to be seen. However, one continent cannot act alone on global financial and goods markets in the long term. We must therefore try to roll out the good European approach globally. Otherwise a potentially positive competitive factor for companies and institutions in Europe will quickly turn into a disadvantage.