

A network of central banks and regulators committed to climate action

Jean Boissinot Head of Secretariat - NGFS

March 30 2023



The financial sector is increasingly mainstreaming climate-related risks into its analyses, in particular through the action of the NGFS, an international network of central banks and regulators. Details and analyses from Jean Boissinot, Deputy Director for Financial Stability at Banque de France and Head of the NGFS Secretariat.

In what way does climate change pose a risk for banks and financial institutions?

Climate change is no longer a hypothetical phenomenon. Since the beginning of the year, there have been an increasing number of heatwaves, droughts, floods, large-scale forest fires and so on, often with an intensity rarely seen and sometimes in regions where these phenomena were quite unprecedented. These events are a tragedy for the people who are victims of them. **In addition to their human cost, they also have an economic and financial cost.** The damage caused by natural disasters can be estimated at some \$270 billion in 2021. The indirect economic repercussions are at least comparable and probably of an even greater order of magnitude.

However, the economic and financial impacts of climate change were for a long time a “blind spot” of financial analysis, despite the fact that they were known. These physical risks, such as the transition risks involved in strengthening climate policies (in particular if they are not anticipated), are no longer negligible, although they wouldn’t appear to be serious enough to destabilize the

financial system at this stage. **But what gives cause for concern is the rate at which these risks may increase in the coming years if they are not managed proactively.** Climate change is a “green swan”: a huge and unavoidable risk (the only uncertainty concerns the timing and form of this risk).

PHYSICAL RISKS

“Physical risks” arise from **the effects of climate change on economic actors.** This may involve chronic risks (increase in average temperatures, change in rainfall patterns, rising sea levels) or acute risks (extreme weather events, forest fires, etc.).

TRANSITION RISKS

“Transition” risks cover **all the risks resulting from structural changes in the economy during its transition towards carbon neutrality:** regulatory shocks or the technological obsolescence of assets involved in the use of fossil fuels, changes in consumer behavior, risks of bubbles and overinvestment, etc. In most cases, these risks arise from mismatches between the expectations of players and the actions of others.

How have regulators and supervisors taken up the issue of “climate financial risks”?

In the lead-up to COP21 in 2015, central banks became more aware of the nature of the financial risks related to climate change and the “macro-economic” nature of the transition to a carbon neutral global economy more generally. **They took an interest in climate change, not despite or beyond their mandates, but in the actual context and precisely because of these mandates** (i.e., price stability, financial stability).

This approach may seem a little distant compared to other development stakeholders who are directly engaged in financing the transition. While it is perhaps more discreet, it is equally important: the success of the transition depends on our collective capacity to not only make “green investments”, but also to ensure the overall coherence of capital allocation with climate constraints. In practical terms, **seven years after COP21, this agenda, which resonates with Objective 2.1.c of the Paris Agreement,1 is now in an implementation phase: supervisors are starting to draw operational conclusions from stress tests.** In the same vein, the macroeconomic developments involved in the current energy crisis and its interactions with the transition are very much in the minds of central banks when they decide their monetary policy.

The success of the transition depends on our collective capacity to not only make “green investments”, but also to ensure the overall coherence of capital allocation with climate constraints.

In this context, what is the role of the NGFS, which gathers 121 central banks and financial supervisors from all over the world?

Central banks very quickly understood the practical implications of the obligation to take climate issues into account in all their activities. For example, there was clearly a need to conduct stress tests. However, this was hampered by the unavailability of scenarios translating the IPCC conclusions into macro-financial terms. **But these projections are too complex to be produced by an individual institution.** The need for a collaborative platform between central banks therefore rapidly emerged and in December 2017, at the initiative of Banque de France, eight central banks (China, France, Germany, Mexico, Netherlands, UK and Singapore) and supervisors (Sweden) created the NGFS to develop this collaborative approach.

The collaboration has developed around various issues: formalization of best practices for supervision or investment for non-monetary portfolios, development of scenarios, work on data and so on. **This is one of the strengths of the NGFS: the work undertaken is first and foremost technical and any differences of political assessment are a matter for other discussion forums (G20, FSB and so on).** Furthermore, a number of other institutions have clearly seen the value of the collaboration. They have joined the network to contribute to it, but also to “ramp up” their own expertise by participating in the work. Seen from the Secretariat, the dynamic is impressive, both in terms of the subjects covered (all the activities of central banks are now addressed) and in terms of the depth and quality of this work.

A number of other institutions have clearly seen the value of the collaboration.

In your opinion, can this risk-based approach encourage the private sector to invest in adaptation?

Investment in adaptation is both an absolute necessity and a real challenge. An absolute necessity insofar as even if we achieve a rapid transition towards carbon neutrality, the inertia of the climate system will increase the physical risks for another 15 to 20 years. This poses a real challenge, as adaptation is first and foremost a way of limiting future costs and there are not systematically cash flows to build a business model on. **The risk-based approach makes little difference to this second point, but by better identifying the risks, we also make a better assessment of the value of adaptation.** The financial sector consequently goes for appropriate investments, in the absence of specific investments in adaptation, which often remain the responsibility of public authorities.