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"Climate change: the financial sector and pathways to 2°C"

Speech by François Villeroy de Galhau, Governor of the Banque de France

Ladies and Gentlemen,

This conference organised by the 2°C initiative, the Oxford Martin School and France Stratégie for the opening of the COP21, is a major event in which I am delighted to participate. I would like to make some comments on a topic that has steadily gained ground in the climate change agenda, namely the way central banks and prudential authorities take account of climate-related issues.

This is in fact a relatively new question. We were already committed as both citizens and public policy-makers, but monetary and prudential authorities are today concerned by three broad categories of risk:

- **Direct physical risks**, related to the increase in both the frequency and the magnitude of extreme climatic events, which raise questions in terms of insurance costs.
- **Liability risks,** related to the financial impacts stemming from compensation requests from those who have suffered loss or damage due to climate change.
- **Macroeconomic risks related to the transition between two production models,** which can result in disorderly adjustments in sectors too heavily exposed to global warming or that become unviable due to the governments' climate change commitment.

In practice, we already observe some financial imbalances in carbon-intensive industries facing rising costs, disruptive technologies, and regulatory uncertainties[1]. The market value of most carbon-intensive industries has already been impacted. And re-pricing may occur rapidly and abruptly.

What is less clear at present is how we should react to such a development since the horizon at which climate change risks materialise largely exceeds the traditional horizon of most economic agents, and notably financial players. This is what Mark Carney famously referred to as the “tragedy of the horizon” [2].

We all agree that a higher carbon price would send the right economic signal. But we are aware of how difficult international decision-making is in this area. Given my responsibility, and while awaiting such decisions, the following questions thus arise: how to ensure that investors and financial intermediaries are aware of their actual exposure to risks? And how to prevent a misallocation of capital to carbon-intensive sectors or stranded assets?

To address these questions, I will start by stressing that, fortunately, the financial sector and civil society are already mobilised (I). Next, I will discuss the need for public intervention to ensure an alignment of interests (II).

I/ The financial sector and civil society are already mobilised.

This mobilisation, which has yielded progress, appears to have occurred in three main phases.

First, **the major public financial institutions** were at the forefront of this movement. This is the case for the European Bank for Reconstruction and Development or the Caisse des Dépôts, with its subsidiary CDC-Climat. The European Investment Bank estimates that it currently grants 25% of its loans – over EUR 20 billion per year – to “green” projects.

Second, under the aegis of the United Nations, projects were launched such as the UNEP finance initiative, a partnership between the United Nations Environment Programme and 200 financial sector institutions, which make environmental sustainability a collective responsibility, share best practices and establish principles for green financing. Thanks to the Montreal climate change protocol, or to the Portfolio Decarbonization Coalition, signatory investors commit to measuring and disclosing the carbon footprint of their portfolios. The

[1] Cf. Moody’s, “Impact of carbon reduction policies is rising globally”, March 2015

[2] Mark Carney, “Breaking the Tragedy of the Horizon – climate change and financial stability”, speech given at Lloyd’s of London, 29 September 2015

objective is ambitious: reduce investment in carbon-intensive projects by several hundred billion dollars.

Lastly, **financial institutions** are now making more direct commitments. French banks and insurance companies have recently announced that they have withdrawn their support for the coal industry and increased their financing of renewable energies. Paris Europlace called for the creation of an energy transition fund, which would be invested in by French banks, insurers and asset management companies, and which could in turn invest EUR 10 billion by 2020, with a view to financing projects to improve energy efficiency or promote renewable energies. This is a commendable initiative.

II/ To best align these private initiatives with the fight against global warming, which is a public good, public intervention is nevertheless necessary.

For central banks or prudential authorities, three questions arise: that of **financing** –and interaction with monetary policy–, that of **information** – and of disclosure–, and lastly that of **time horizons** –and stress tests–.

1- **The question of financing: what interaction with monetary policy?**

Climate change is likely to affect the price of goods and services. It has a direct impact on food prices. But it will also more generally affect growth and the allocation of resources. Against this backdrop, central banks should remain vigilant about, and possibly monitor the economic consequences of climate change. And monetary policy will have to play its role of contributing to a smoother rebalancing of price structures, in line with its price stability mandate.

Article 2 of the European System of Central Banks statute states: "Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community, with a view to contributing to the achievement of the objectives of the Community [economic activities, sustainable and non-inflationary growth respecting the environment…the raising of the standard of living and quality of life].

Some would like to go a step further, using the quantitative easing tool to help finance the energy transition, purchasing "green" assets, granting favourable treatment to green assets that are eligible as collateral, or setting up dedicated long-term facilities; the list of possibilities is long.

However, we must bear in mind the ultimate aim of monetary policy. It is designed to achieve macroeconomic objectives, not sector-specific goals. The underlying assumption for direct monetary policy intervention is that the central bank is better equipped than private agents to ensure an efficient allocation of resources. But it is not a given that central banks would have such an informational advantage. Quantitative easing therefore does not aim to promote some types of assets over others but merely to free up capacity to finance the economy. For instance, current monetary policy encourages investment in longer-term projects, with better returns than government bonds, such as infrastructures and energy transition. But with one prerequisite: prudential regulations must be consistent, which may require adaptations to the framework laid down by the Solvency II insurance Directive. I welcome a number of recent proposals promoting infrastructures made by the European Commission, which are a step in the right direction.

2- The information challenge: the role of disclosure

The potential risks posed by climate change to the financial sector are complex and we have only just started to understand them. The most urgent need is probably better information.

Much high-quality work has been carried out in recent years to improve disclosure on climate-related issues. The French act on energy transition, which was enacted on 17 August 2015, strengthens the requirements regarding the disclosure and management of environmental risks. Article 173 requires institutional investors to include environmental objectives in their annual reports, in particular the exposure to climate risks, by measuring the carbon footprint of the assets that they finance and the "green" share of these assets relative to a set of targets. The implementing decree of the act, which is currently being drafted, will specify the information concerned and its presentation.

From a broader perspective, we should aim at greater clarity: there are about 400 climate-related information disclosure schemes. Imposing requirements or formulating recommendations in terms of information disclosure can be a powerful instrument for ensuring market discipline, as long as the information is targeted and pertinent, as evidenced by a number of successful examples. At the international level, under the aegis of the Financial Stability Board, a first task force known as the "Enhanced Disclosure Task Force" and composed of sector representatives had already issued recommendations in 2012 to improve, simplify and focus the communication of systemically important banks on the nature of their risks. At the national level, the guide on the relevance, consistency and readability of financial statements published by the French financial markets Authority in July 2015 is another positive example.

Clarification is a challenge to be taken seriously. We have therefore decided, within the Financial Stability Board and with the support of the recent G20 in Antalya, to set up very shortly – by the beginning of 2016 – another dedicated task force (EDTF). Its work should be completed within one year in order to rapidly ensure the effective disclosure on climate risk. It will formulate recommendations for voluntary disclosure, **according to harmonised and therefore comparable methods**. This should enable stakeholders and the public to find out about the share of financial sector assets linked to carbon emissions and the sector's exposure to climate risk.

3- The time horizon challenge: the gradual implementation of stress tests

Stress testing is an integral part of risk management by financial institutions. It is particularly developed in the **insurance and reinsurance sectors**. Modelling disaster risk and capital levels – as set out in Solvency II – takes into account some of the climate risks. But the current regulatory framework for **banks** somehow overlooks climate change as a source of risk. Yet this would be the way to handle the question of the time horizon. In this respect, the Act on energy transition provides for the submission by end-2016 of a report on the implementation of a scenario of stress tests representative of the climate risks for banks.

However, achieving this raises serious questions. Two approaches are possible. Either comprehensive stress testing, covering all risks and associated asset classes for financial institutions, which would allow supervisors to monitor the total exposure to climate risk. Or granular stress testing, focusing on assets that are more specifically exposed to climate risk, which would be more appropriate for analysing specific sectors and financing needs, such as the financing of the oil sector.

Whatever the approach chosen, the main challenge would be to take account of climate risks, either through economic estimates that we master – such as GDP observed under stress – or directly through climate variables – such as the rise in temperature – which would require developing new methods and gathering new information. This, of course, would mean relying on expert judgment on these issues, in a context where financial institutions do not have enough experience to understand future risks. We will work on this with the ACPR and the public authorities concerned.

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Understanding and analysing climate risk is essential. The regulations currently being drawn up – the Act on energy transition and the work of the Financial Stability Board – on information disclosure are useful tools to ensure that the transition to a greener economy is active and therefore under control. These initiatives could also contribute to making market participants more aware of the need to use a discount rate that is more compatible with the transition to a greener economy. The Canfin-Grandjean report of June 2015 also includes many interesting avenues.

However, we must at the same time remain modest. We, the public authorities, do not know everything. And we cannot substitute ourselves for private players, whether financial or non-financial. We need to ensure that any new requirement provides the right incentives to financial institutions, gives a certain degree of flexibility to the authorities and does not create disincentives to make headway in the energy transition process.

Modest, adaptable, yet determined. Because there is a battle to be won and because the current market signals – overly low carbon prices and an overly short time horizon – are insufficient to ensure full mobilisation. There are a large number of private initiatives. But there is also a need for a public framework to ensure the general and lasting alignment of interests. We are determined to play a full part, from Basel to Paris and elsewhere. Thank you.