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# *“Greening central banking”*

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# Introduction: Sustainability & Climate Change

- Sustainability is a broad concept that encompasses:
  - ❑ environmental (climate change, pollution, renewable energy, biodiversity, ocean)
  - ❑ social (financial inclusion) and
  - ❑ economic aspects (including inequality and debt sustainability).
  - ❑ There are importance governance and ethical issues too.
- We have moved from CSR to ESG to SDGs.
- Taxonomies of green assets and ESG and accounting standards are proliferating.
- **Sustainability is a very broad mandate.**
- **In contrast, price stability is a narrow mandate.**

# Measuring and Reporting

- In 2021, the IFRS Foundation Trustees announced the creation of a new standard-setting board—the International Sustainability Standards Board (ISSB) sitting parallel to the International Accounting Standards Board to establish high-quality, transparent, reliable and comparable reporting by companies on climate and other environmental, social and governance (ESG) matters. These sustainability-related disclosure standards will provide investors with information about companies' risks and opportunities to help them make informed decisions. It has been hailed as a major step towards convergence of the currently fragmented reporting landscape.
- The Task Force on Climate-related Financial Disclosures (TCFD) formed by the Financial Stability Board seeks to strengthen and protect global financial markets from systemic risks such as climate change; provide guidance to market participants on disclosure of information on financial implications of climate-related risks (physical risks, transition risks, liability risks).
- How to include the new green agenda in the measurement of debt sustainability. A DSA is not a precise science and legal parameters can add clarity and predictability.

# More taxonomies

- **Definition of 'green' sustainability in the EU** further to the taxonomy on sustainable activities  
The EU taxonomy is a classification system, establishing a list of environmentally sustainable economic activities. The Taxonomy Regulation establishes six environmental objectives: (1) Climate change mitigation (2) Climate change adaptation (3) The sustainable use and protection of water and marine resources (4) The transition to a circular economy (5) Pollution prevention and control (6) the protection and restoration of biodiversity and ecosystems  
[https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities\\_en](https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en) Sustainable finance is about re-orientating investment towards environmentally friendly economic activities. The EU Taxonomy claims to be “a science-based transparency tool for companies and investors” whose purpose “is to avoid greenwashing and to drive investments towards the transition”
- In 2022 the Commission published [https://ec.europa.eu/info/publications/220202-sustainable-finance-taxonomy-complementary-climate-delegated-act\\_en](https://ec.europa.eu/info/publications/220202-sustainable-finance-taxonomy-complementary-climate-delegated-act_en) including under strict conditions, specific nuclear and gas energy activities in the list of economic activities covered by the EU taxonomy.
- **The NGFS (Network for the Greening of the Financial System)** is a network of 83 central banks and financial supervisors that aims to accelerate the scaling up of green finance and develop recommendations for central banks' role for climate change. [The NGFS was created in 2017 and its secretariat is hosted by the Banque de France: <https://www.ngfs.net/en>]
- SEC on March 21<sup>st</sup> proposed rule changes that would require registrants to include certain climate related disclosures in their registration statements and periodic reports, including greenhouse gas emissions. See <https://www.sec.gov/news/press-release/2022-46>

# Broadening of a narrow mandate

- That central banks need to adjust to the challenges of their times is not a unique feature in their history. Indeed, central banking has been characterized by its evolutionary character (dynamism) since the Riksbank and the Bank of England were established in the 17<sup>th</sup> century. Dynamism is reflected in the evolution of its objectives, status and functions and the law reflects this dynamism.
- The emphasis on price stability - a **narrow mandate** - in central banking is a development that needs to be understood in the historical context of the latter part of the XX<sup>th</sup> century. From the early 1990s a consensus developed around a **“central banking model”** in line with the Tinbergen rule – of one agency (the central bank), one primary objective (price stability) and one main instrument (interest rate policy). This became the norm: from the EU Member States that signed the Maastricht Treaty to many countries that revised their central bank laws, often based on IMF recommendations.
- The **“central banking model”** was based on the notion of monetary independence in order to control inflation: a narrow mandate. This model facilitated accountability, preserved the legitimacy of a technocratic agency, and safeguarded the much cherished independence.

# Broadening of the mandate

- But the consensus around this *model* started to change with the GFC. **Black swan event according to Taleb.** Not only did central banks such as the ECB, the Bank of England or the US Fed, enter uncharted territories with the use of unconventional monetary policy measures; they have also been facing unprecedented challenges given the complex dynamics between monetary, fiscal, and sovereign debt policies and the renewed emphasis on financial stability.
- That they managed to maintain their credibility when confidence was lost in the financial system at the peak of the GFC was a testimony to the confidence in the *model*. Such credibility vis-à-vis political authorities and financial market participants is worth preserving according to the 2021 House of Lords Report on *Quantitative easing: a dangerous addiction?*
- A new model of central banking emerged post GFC, one in which CBs have multiple objectives (price stability, financial stability and others) and functions (macroprudential policy and crisis management in addition to monetary policy, supervision, and others). A broadened mandate leads to new challenges: tension between different objectives, communication strategies and - in the EU - jurisdictional domains.

# Further broadening of the mandate

- The expanded role of central banks as 'crisis managers' in the context of the GFC, the pandemic and now climate change and sustainability raises important issues of adequacy of legal mandates, conflicting objectives, legitimacy, independence and accountability.
- Central banks recognize climate change as a source of systemic risk. **The question is not if but how and who?** What is the best distribution of tasks between political authorities and depoliticised agencies with narrower mandates? (Tax is a better tool from the perspective of distributional justice).
- These issues require a concerted effort nationally and internationally with credible commitments involving both public and private entities. The challenge now is how to incorporate climate change as a source of systemic risk to financial stability?
- **From black swans to green swans (and blue swans)**

# Implications of a broadened mandate for CBI

- As the mandate becomes broader or multi-faceted the consensus surrounding the goal/s gets questioned and with it the importance of independence diminishes (given its instrumental nature).
- With multiple objectives and functions, as well as shared responsibilities with 'political authorities' the design of independence and the instruments of accountability ought to be adjusted.
- There is a clear danger of re-politicisation. Otmar Issing in oral evidence to the House of Lords (2021) as part of its EAC QE Inquiry stated that:

*“Central banks have come closer to political decisions during the financial crisis and now in the context of the pandemic”.*

- How can we reconcile a broadened mandate with the primary objective of achieving low inflation while Exiting QE?
- Powell in a speech on 21/03/2022 clearly emphasized: “the ultimate responsibility for price stability rests with the Federal Reserve”.



# Climate change and sustainability

## ■ Aligning objectives and functions

- Note issue (**digitalization**), government finance, bankers' bank, LOLR, banking and payment system supervision, monetary policy, management of gold & foreign reserves, development tasks, resolution, macro prudential policy, etc

## ■ Do we need a revision or interpretation of the CB law? As part of the secondary mandate to support the general economic policies of the government without prejudice to the primary objective of price stability:

- **ECB (interpretation and implementation)** - The secondary mandate of the ECB (Article 127 TFEU in conjunction with Article 3 TEU), was discussed during strategy review of the ECB launched by President Lagarde in January 2020. The ECB secondary mandate is broad and discretionary and includes employment, growth, climate change and environmental and social sustainability. See inter alia <https://www.ecb.europa.eu/ecb/climate/roadmap/html/index.en.html>
- **Bank of England (revision)** – At the March 2021 Budget, the Chancellor updated the MPC's "remit to reflect the Government's economic strategy for achieving strong, sustainable and balanced growth that is also environmentally sustainable and consistent with the transition to a net zero economy by 2050." The change means that the Bank will change its approach to buying corporate bonds as part of its corporate bond purchase programme. The Bank have said that it will adjust its approach to corporate bond buying "to account for the climate impact of the issuers of the bonds we hold". "The MPC and the Financial Policy Committee should continue to have regard to each other's actions, to ensure coordination between monetary and macroprudential policy."

- **Fed's legal authority is constrained where climate change is concerned (Christina Skinner)**

# Climate change and sustainability

- What are the tools that central banks (and supervisory agencies) have to address environmental and social challenges?
- (1) **Monetary policy**
  - Traditional interest rate policy. Green inflation in transition to clean energy?
  - Green QE? Problems of picking winners and losers. **Collateral policies (TAXONOMY)**
  - Inequality (social sustainability) and issues of distributional justice
- (2) **Macro-prudential policy**
  - Definition and measurement of new systemic risks
  - Macroprudential tools and application to carbon markets etc (we have specific housing/mortgage market tools like LTVs.) Need to involve the private sector too.
- (3) **Micro-prudential supervision and regulation**(for banks and insurance companies)
  - Licensing, supervision *stricto sensu*, sanctioning and crisis management
  - CAMELs reinterpretation (internal ratings). **Harmonising a green taxonomy.**
  - **Stress tests.**
  - ESG criteria. Sanction unsustainable activities (e.g. lending linked to deforestation)? Soft law principles that can then turn into binding legal commitments.

# Bank of England

- In addition to the **green remit of the MPC**

<https://www.bankofengland.co.uk/-/media/boe/files/letter/2021/march/2021-mpc-remit-letter.pdf?la=en&hash=C3A91905E1A58A3A98071B2DD41E65FAFD1CF03E>

- Climate change also features in the **FPC's remit letter**

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/965778/FPC Remit and Recommendations Letter 2021.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/965778/FPC%20Remit%20and%20Recommendations%20Letter%202021.pdf)

- And the **PRC's remit letter**

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/972443/CX Letter - PRC Remit 230321.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/972443/CX_Letter_-_PRC_Remmit_230321.pdf) As with the MPC

letter these include obligations in relation to climate-related matters tailored to the specifics of each Committee.

- There is a new statutory “have regard” for the PRA to have regard to the net zero target when making CRR rules – see 144C in the Financial Services Act 2021

<https://www.legislation.gov.uk/ukpga/2021/22>

# Greening central banking - UK

- The Bank has a Climate Change webpage [Climate change | Bank of England](#), including pledges given during COP 26.
- The following provide a good resource to gain a view of the Bank's approach:
  - Second TCFD disclosure in June 2021  
<https://www.bankofengland.co.uk/prudentialregulation/publication/2021/june/climate-related-financial-disclosure-2020-21>
  - Second Climate Adaptation Report <https://www.bankofengland.co.uk/prudentialregulation/publication/2021/june/climate-related-financial-disclosure-2020-21>
  - Greening of the Corporate Bond Purchase Scheme <https://www.bankofengland.co.uk/markets/greening-the-corporate-bond-purchase-scheme>
- HMT is reviewing the UK Regulatory Framework with a view to introducing a Financial Services Bill: This Framework [Consultation](#) proposes the incorporation of climate change into the existing FSMA regulatory principles.
  - See paragraph 3.24  
3.26. [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/1032075/FRF\\_Review\\_Consultation\\_2021\\_-\\_Final\\_.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1032075/FRF_Review_Consultation_2021_-_Final_.pdf)

# Adjusting instruments of supervision

- Reports and statistical requirements
- On-site examinations or inspections (investigatory powers)
- Internal audit and consultations with senior management
- Ratings (CAMELS)
  - SREP – Supervisory Review Examination Process (1,2,3,4, F)
  - ICAAP – Internal Capital Adequacy Assessment Process
- **Stress tests** (medium to long term)
- Others (disclosure, fiduciary duties)
- Loans (classification – NPLs) & Investments (green taxonomy)
- **External gate-keepers**: Independent external audit and external ratings by credit rating agencies

# Adjusting CAMELS to climate change

## ■ Capital

- Pillar 1 – risk weights
- Pillar 2 – supervisory review
- Pillar 3 – disclosure obligations

## ■ Assets – taxonomies and classifications (value of high carbon assets declines)

## ■ Management

- Professional qualifications and ‘green’ credentials and standards
- SMR

## ■ Earnings

## ■ Liquidity (though capital and liquidity provide lines of defense)

## ■ Sensitivity to risk

# Adjusting risk management and risk control

- Credit risk, Market risk, Liquidity risk, Operational risk
- Legal and reputational risk (including litigation)
- Systemic risk (evolution of the concept)
  - Understanding **transitional risks** and **physical risks** due to losses resulting from climate change
  - Understanding the different needs of developed and developing countries
- **GOOD PRACTICES** (green investments and ethical investments)
  - Norway's SWF uses several tools to promote their role as responsible (activist) investor: observations and exclusions (leading to divestments) & relies on international collaboration.
  - Product-based exclusions (weapons, tobacco, thermal coal etc) and conduct-based exclusions (child labor, corruption, environmental damage etc).
  - Learning from Norway's ethical SWF guidelines – SOFT LAW

# Basel principles for the supervision of climate-related financial risks

- The Basel Committee of Banking Supervision issued in Nov '21 for comment by Feb' 22 a Consultative Document Principles for the effective management & supervision of climate-related financial risks
- <https://www.bis.org/bcbs/publ/d530.pdf>
  - *Principle 4 – Internal controls - Banks should incorporate climate-related financial risks into their internal control frameworks across the three lines of defence to ensure sound, comprehensive and effective identification, measurement and mitigation of material climate-related financial risks*
  - *Principle 5 - Capital & liquidity adequacy - Banks should identify & quantify climate-related financial risks and incorporate those assessed as material over relevant time horizons into their internal capital and liquidity adequacy assessment processes.*
  - *Principle 6 – Risk Management - Principle 6: Banks should identify, monitor and manage all climate-related financial risks that could materially impair their financial condition, including their capital resources and liquidity positions. Banks should ensure that their risk appetite and risk management frameworks consider all material climate-related financial risks to which they are exposed and establish a reliable approach to identifying, measuring, monitoring and managing those risks*



# A few words about accountability

- With expanded mandates, central banks and supervisory and regulatory agencies require commensurate mechanisms of accountability.
- Accountability is not simply an ‘add-on’ to justify independence. Accountability - ex ante and ex post - is a constitutive part of the design of an independent agency in particular in a democratic system.
- An accountable central bank should be judged for the reasonableness of its actions, by Parliament, by the executive, by the public and – in my opinion - by the competent Courts of Justice.
- Justiciability of monetary policy? Not in the USA but in the EU:
  - The CJEU assessed the legality of OMT (Gauweiler case)
    - The Court is not to supplant or replace the decision taken by ECB.
    - But need for competence and expertise also in climate change matters.

# International dimension key in the new design

- New mandate for IFIs? Article 1 of the IMF Articles of Agreement (Role of FSB, IEA)
- Financing the transition to decarbonization and clean energy investments in developing countries and LICs with limited fiscal space (a different navigation strategy)
  - A new Marshall Plan? DSSI
  - Debt restructuring techniques (Example of Belize linking debt restructuring to marine conservation)
- Adjusting IMF Surveillance and conditionality
  - Green conditionality (and its dangers...)
  - Surveillance and FSAP
- Incorporating climate change into DSAs