Financial Stability Institute

# The regulatory response to climate-risks: some challenges

FinSAC Annual International Conference, 18 May 2022

Rodrigo Coelho, Head of Policy Benchmarking, FSI, BIS

# Agenda

- Introduction
- The relevant risks
- The microprudential framework
- The macroprudential framework
- Concluding remarks

# Introduction

- A clear case for a determined and comprehensive policy response to foster a swift and orderly transition towards a low-carbon economy
- The financial sector has a role to play in facilitating the massive reallocation of resources that the economic transformation requires
- Prudential regulation can support an orderly transition by ensuring that the financial system adequately manage climate-related financial risks
- This presentation is about HOW?

# The relevant climate-related risks (CRR)

- Two types for risk for financial institutions:
  - Physical
  - Transitional
- Broadly fall under standard prudential taxonomy: credit, market, operational
- Banks’ collective behaviour may affect system-wide risks

# The microprudential framework (1)

- Objective: to safeguard the safety and soundness of individual financial institutions against CRR
- …CRR likely not to be fully captured by current prudential framework:
  - Materialisation over long horizons
  - Forward looking nature (history does not help much)
- Can we do it better? Data and analytical gaps (including robust taxonomies) constitute a major obstacle for better assessing banks' exposures and identifying policy responses
- Adjustments of Pillar-1 (eg risk weights) are particularly challenging
  - Hard to estimate unexpected losses (VaR-like methodology) over long horizons
  - Need to embed management actions (ie dynamic balance sheet)

# The microprudential framework (2)

- Pillar-2, in principle, more suitable
  - SREP may make use of both capital-based and non-capital based measures
  - Consider both loss-absorption and management actions in different scenarios
  - Ensure internal consistency through climate-stress-tests
  - But, challenging for a level playing field across entities and jurisdictions
  - Need of specific international guidance

# The macroprudential framework (1)

- Two objectives:
  - To increase the resilience of the financial system towards CRR
  - To contain systemic CRR by affecting banks' credit policies.
- First objective (resilience) is also covered by the micropru function (eg by climate stress tests).
- Second objective (CRR mitigation) is elusive
  - Small effect of changes in capital requirements on credit policies (unless very large)
  - ---and, importantly, possible perverse effects on aggregate risks
  - Green supporting factor can make things even worse.
- Therefore, no clear case for a macroprudential approach for CRR at this stage

# The macroprudential framework (2)

| Risk | Instrument | Objectives | |
|---|---|---|---|
| | | Resilience | Systemic risk reduction |
| Excessive credit growth | Cap ↑ | ++ | + |
| Physical CRR | Cap (brown) ↑ | ++ | = |
| Physical CRR | GSP | - | = |
| Transition CRR | Cap (brown) ↑ | ++ | - |
| Transition CRR | GSP | - | - |

GSP: Green supporting factor

# Concluding remarks

- Adaptation of prudential policies to climate related risks is essential, albeit technically complex
- ...and subject to relevant trade-offs
- Actions need to be focused on delivering on core safety and soundness mandate
- For which Pillar 2 (SREP) looks, at present, better suited than Pillar 1 (eg risk weights)
- No obvious scope for macroprudential framework aimed at targeting directly systemic CRR
- Synergies with government policies exist and can be exploited while respecting the separation of policy mandates