The macroprudential interest in the climate crisis

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Introduction

- Climate change represents a clear and present danger to the health and wellbeing of current and future generations
- It also has potentially significant risks for the financial system and the financial system has an important role to play in the transition to a low carbon economy
- And as such, central banks have been active in considering their role in this process

- This talk: What is the ***macro***-prudential interest in climate change?

Why did we invent macropru?

"When the music stops, in terms of liquidity, things will be complicated… but as long as the music is playing, you've got to get up and dance."

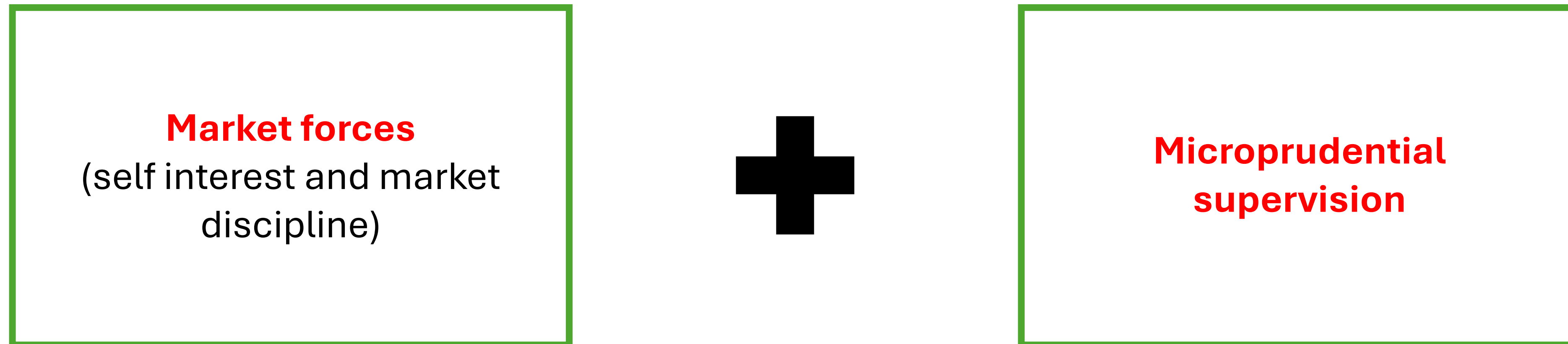
"Macroprudential policy has to intervene to lean against defensive actions to build individual resilience that would weaken the system as a whole." Sarah Breeden (BoE)

Why did we invent macropru?

- Concerns that microprudential bank supervisors:
  - might be captured
  - may not “see the wood for the trees” given their focus on individual institutions
  - may not internalise the macroeconomic consequences of a sharp tightening in credit conditions

Why did we invent macropru?

- Macropru then is about guarding against failures of:



- So what are the potential failures of market forces and microprudential supervision when it comes to risks from climate change?

Market failures in dealing with risks of climate change

- The risks of climate change are likely to play out over a longer horizon than conventional FS risks
  - Eg BoE's climate stress scenarios run out to 30 years
- Can't financial institutions manage this type of slow-moving risk by reducing their climate exposures?
  - As the repricing maturity of bank loans and insurance contracts tends to be far shorter, banks and insurers have a get-out option

Market failures in dealing with risks of climate change

- Climate disaster myopia (Carney)
  - Climate risks lie just beyond the planning horizon of bank boards
  - It's also hard to gauge their true extent given limitations in data and modelling
- Is this a role for macropru?
  - Responsibility for identifying shortcomings in data and modelling at individual firms and driving them to best practice should lie with micro-pru
  - Perhaps a role for macropru if there are concerns of a system-wide failure to make satisfactory progress?

Market failures in dealing with risks of climate change

- Chuck Prince all over again?
  - Risk of banks retaining significant climate exposures, even though those exposures will pose a grave threat to their stability when the transition occurs
- Is this a role for macropru?
  - Are micro-pru supervisors not aware of this risk?
  - “Climate change is now firmly in the focus of prudential regulators across the globe”, Sam Woods

Implications

- To understand the appropriate policy stance of macropru in addressing climate risks, we need to ask:
  - Will market incentives and micro-prudential regulation lead financial institutions to retain their carbon intensive exposures for too long?
  - Or will they create incentives to divest too quickly?

Why might rapid divestment occur?

- Because risks become too difficult to calibrate, and it makes more commercial sense to cut exposure than to address the problem
- Or because there are strategic complementarities around reputational considerations that lead to a mass exit (Dong (2024))

Policymakers seem concerned about this possibility

“the financial sector cannot run ahead of the real economy: we need real change to make the economy more energy efficient and expand the provision of renewable energy. While that process takes place, banks and insurers need to provide finance to more carbon-intensive sectors of the economy, precisely in order to allow them to invest in the transition. Cutting off finance to these corporates too quickly could prove counterproductive, and have wide-ranging macroeconomic and societal consequences”

Sam Woods

“the overall health of the economy and financial system requires an orderly rotation. In particular, there are immutable constraints on the speed at which green forms of energy production can be ramped up. There needs to be adequate credit made available to carbon-intensive firms so they can invest in greening during the transition period and so that the overall energy supply for the economy is adequate. If everyone cuts off the carbon-intensive producers indiscriminately and too quickly, that could be calamitous for the economy.”

Anil Kashyap

The role of macropru in the climate transition is not clear

- Whether the job will be to encourage a faster transition to net zero or to slow down a disorderly exodus from lending to carbon-intensive companies will depend on which gaps emerge in both the risk management of financial firms and in the response of their micro-prudential counterparts
- It’s likely that the micro-prudential authority will have its foot on the accelerator
  - helping to raise standards on climate disclosures; nudging regulated institutions to raise their game on measuring, modelling and managing climate risks; and adjusting regulatory capital requirements
- That leaves macropru with a perhaps uncomfortable role to play, in periodically applying their foot to the brake, tackling the risks that might arise in a boom in green finance or slowing the withdrawal of credit or insurance services to carbon-intensive sectors

Some questions we should ask

- What are the specific reasons that lead us to believe that private self-interest and market discipline cannot be relied upon to manage a risk that plays out over several decades?
- Is climate disaster myopia a widespread problem? Will regulatory efforts to tackle disclosures and other data shortfalls, and improve modelling capabilities mitigate that problem?
- Left to its own devices, would the private sector withdraw too fast or too slow from climate exposures?

Some questions we should ask

- Why should we expect that microprudential supervision will fail to address this risk adequately? Is it more likely that supervisors will be too soft on green or on carbon-intensive exposures?
- How significant are the risks of a ‘boom’ in green finance, in the form of an imprudent relaxation in credit standards on green exposures?
- What role should macroprudential policymakers play in driving a multi-decade industrial policy to achieve the optimal transition to net zero? Should they play a similar role in tackling other social objectives, including weak productivity?