



BANK OF ENGLAND

Speech

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Secretary General, your Excellencies, Ladies and Gentleman.

A new, sustainable financial system is being built.

It is funding the initiatives and innovations of the private sector, it has the potential to amplify the effectiveness of the climate policies of your governments and it could accelerate the transition to a low carbon economy.

But the task is large, the window of opportunity is short, and the risks are existential.

And like virtually everything else in the response to climate change, the development of this new sustainable finance is not moving fast enough for the world to reach net zero.

To bring climate risks and resilience into the heart of financial decision making, climate disclosure must become comprehensive; climate risk management must be transformed, and sustainable investing must go mainstream.

Here's how.

First, on disclosure. Catalysed by the G20 and created by the private sector, the Task Force on Climate-related Financial Disclosures (TCFD) is a comprehensive, practical and flexible framework for corporate disclosure of climate-related risks and opportunities.¹

The demand for TCFD disclosure is now enormous. Current supporters control balance sheets totalling \$120 trillion and include the world's top banks, asset managers, pension funds, insurers, credit rating agencies, accounting firms and shareholder advisory services.²

The supply of disclosure is responding, with four fifths of over 1100 top G20 companies now disclosing climate-related financial risks in line with some of the TCFD recommendations, and three quarters of users of the information seeing a marked improvement in the quality of climate disclosures.³

The next step is to make these disclosures mandatory. The UK and EU have already signalled their intents.⁴

It's time for every country to get involved because the world won't get to net zero if the financial sector doesn't know how our companies are responding. In order to watch we must be able to see.

¹ Recommendations of the Task Force on Climate-related Financial Disclosures (June 2017) available at: <https://www.fsb-tcfd.org/wpcontent/uploads/2017/06/FINAL-2017-TCFD-Report-11052018.pdf>.

² Full list of current TCFD supporters available at: <https://www.fsb-tcfd.org/tcfdsupporters/>.

³ Task Force on Climate-related Financial Disclosures: Status Report (June 2019) available at: <https://www.fsb-tcfd.org/wpcontent/uploads/2019/06/2019-TCFD-Status-Report-FINAL-053119.pdf>.

⁴ The UK has already announced in its Green Finance Strategy published in July 2019 that it expects all listed companies and large asset owners to report climate risks by 2022. A joint taskforce with UK regulators is considering the most appropriate path to mandatory disclosure. Details available at: <https://www.gov.uk/government/publications/green-finance-strategy>.

Over the next two years, the current process of disclosure by the users of capital, reaction by the suppliers of capital, and adjustment of these standards will be critical to ensure that the TCFD standards are as comparable, efficient and as decision-useful as possible.

Second, risk management. The providers of capital – banks, insurers, asset managers *and those who supervise them* – all need to improve their understanding and management of climate-related financial risks.

Changes in climate policies, new technologies and growing physical risks will prompt reassessments of the values of virtually every financial asset. Firms that align their business models to the transition to a net zero world will be rewarded handsomely. Those that fail to adapt will cease to exist. The longer meaningful adjustment is delayed, the greater the disruption will be.

To develop the essential climate risk management skills and techniques, the Bank of England has just set out its supervisory expectations for the governance, management and disclosure of these risks by the banks and insurers in the world's leading international financial centre.⁵

And the Bank will be the first regulator to stress test its financial system against different climate pathways, including the catastrophic business as usual scenario and the ideal—but still challenging—transition to net zero by 2050 consistent with the UK's legislated objective.⁶

This test will mainstream cutting-edge risk management techniques, and it will make the heart of the global financial system more responsive to changes to both the climate and to government climate policies.

As with climate disclosure, this new risk management needs to go global. That is one reason why the Bank is developing its stress testing approach in consultation with industry, the credit rating agencies and the Network for Greening the Financial System (NGFS) – a group of 29 central banks and supervisors representing half of global emissions.

Finally, returns. Financial markets increasingly recognise that sustainable investment is the new horizon that can bring enormous opportunities ranging from transforming energy to reinventing protein.

For sustainable investment to go truly mainstream, it needs to do more than exclude incorrigibly brown industries and finance new, deep green technologies. Sustainable investing must catalyse and support all companies that are working to transition from brown to green.

⁵ Available at: <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisorystatement/2019/ss319.pdf?la=en&hash=7BA9824BAC5FB313F42C00889D4E3A6104881C44>.

⁶ The Bank of England set out in its July 2019 FSR its intention to test the UK financial system's resilience to the physical and transition risks of climate change. It will gather views on the design of the exercise and, as a first step, will publish a discussion paper in autumn 2019. More information available at: <https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2019/july-2019.pdf>.

Such “tilt” investment strategies, which overweight high environmental, social and governance (ESG) stocks, and “momentum” investment strategies, which focus on companies that have improved their ESG rating, have outperformed global benchmarks for close to a decade.⁷ The mainstreaming of such strategies and the tools to pursue them are essential.

At present, one of the biggest hurdles to doing so is the inconsistent measurement of ESG.

We need a common taxonomy to help financial markets rigorously identify environmental outperformance and to direct investment accordingly.

The EU’s Green Taxonomy and the Green Bond Standard are good starts, but they are binary (dark green or brown). Mainstreaming sustainable investing will require a richer taxonomy – 50 shades of green.

One promising option, highlighted in this week’s initiative of UN’s Climate Financial Leaders, is the development of transition indices composed of corporations in high-carbon sectors that have adopted low-carbon strategies.⁸

Such approaches are essential for our citizens to make sure their money is invested in line with their values.

To conclude, a financial market in the transition to a 1.5 degree world is being built, but we need to move much faster. Now it’s time for a step change to bring the reporting, risk management and return optimisation of sustainable finance into everyday mainstream, financial decision making.

Ultimately, the speed with which the new sustainable financial system develops will be decided by the ambitions of your climate policies.

If more countries, like the UK, turn their Paris commitments into legislated objectives and concrete actions, the financial system will amplify the impact of their efforts by pulling forward sustainable investments and shutting down unsustainable activities.⁹

It is within our grasp to create a virtuous cycle of innovation and investment for the net zero world that our citizens are demanding and that future generations deserve. Let’s seize it

⁷ Nagy, Z, Kassam, A, and Lee, L-E,. (June 2015). Can ESG add alpha? Available: <https://www.msci.com/documents/10199/4a05d4d3-b424-40e5-ab01-adf68e99a169>.

⁸ Such indices highlight those who have shown the highest rate of improvement in lowering carbon intensity. As described in ‘Financing the Low Carbon Future’ (CFLI, September 2019). Available at: https://data.bloomberglp.com/company/sites/55/2019/09/Financing-the-Low-Carbon-Future_CFLI-Full-Report_September-2019.pdf

⁹ The policy frameworks with the greatest impact will be: time consistent; transparent; target-based; and committed, through treaties, nationally determined contributions (NDCs), domestic legislation and consensus. The COP 21 Agreement is catalysing national policies to limit the global rise in temperatures to two degrees. 20 countries, which account for 17% of global GDP, have already committed to or legislated for a net-zero emissions goal, with the UK becoming the first in the G7 to do so.

Insurance, Risk Financing and Development event, 22 September 2019

I would like to speak briefly about the role of insurance in smoothing the transition to a 1.5 degree world. This sector brings three things: expertise, money and perspective and those are all crucial in helping society adjust to the reality of that transition.

My message is, whether it's reducing the protection gap, financing resilient infrastructure or improving reporting, risk management and return optimisation across the financial sector, your contributions could be decisive. The insurance industry has a unique contribution of large capital (over \$30 trillion), deep risk management expertise and long-term perspective.

Insurers are well aware that the physical risks of climate change are being felt across the globe with a plague of extreme weather events.

The human costs are immeasurable.

The financial losses however can be measured and they are significant. Insured losses in 2018 were \$80 billion, double the inflation-adjusted average for the past 30 years.¹⁰

But protection gaps in low and middle income countries mean that even greater costs are being borne by the uninsured. In 2017, the record \$140 billion of insured losses were eclipsed by an additional \$200 billion of uninsured ones.¹¹ In some of the countries most exposed to climate change - Bangladesh, India, Vietnam, Philippines, Indonesia, Egypt and Nigeria - insurance penetration is under 1%.¹²

The potential economic benefits of closing the insurance gap are striking. Lloyd's of London estimates that a 1% rise in insurance penetration can translate to a 13% reduction in uninsured losses and over 20% reduction in disaster recover burden on taxpayers. Substantial macroeconomic benefits include increased investment, higher output (potentially up to 2% of GDP) and greater climate resilience.¹³

Despite this prize, progress is proving stubbornly slow – over the past 30 years the gap has narrowed by only from 78% to 70% globally, underscoring the importance of the IDF's work.¹⁴

The role of insurance for adaptation and resilience

So what should be done?

¹⁰ Munich Re (2019), The natural disasters of 2018 in figures, See: <https://www.munichre.com/topics-online/en/climate-change-and-natural-disasters/natural-disasters/the-natural-disasters-of-2018-in-figures.html>.

¹¹ Swiss Re institute (2018). See: <https://www.swissre.com/institute/research/sigma-research/sigma-2018-05.html>.

¹² See Lloyd's of London global underinsurance report (2018). Available online at: https://www.lloyds.com/~media/files/news-and-insight/risk-insight/2018/underinsurance/lloyds_underinsurance-report_final.pdf.

¹³ Lloyd's City Risk Index, 2015-2025 (2015), available at: https://www.jbs.cam.ac.uk/fileadmin/user_upload/research/centres/risk/downloads/crs-lloydscityriskindex-execsummary.pdf.

¹⁴ Geneva Association, Understanding and Addressing Global Insurance Protection Gaps (2018). See: https://www.genevaassociation.org/sites/default/files/research-topics-document-type/pdf_public/understanding_and_addressing_global_insurance_protection_gaps.pdf.

Both sides of insurers' balance sheets need to respond.

On the liability side, the focus must be reducing the protection gap and supporting the resilience of households and companies to growing climate risks.

Better understanding of past losses can obviously help. Projects like the open-source Oasis Loss Modelling Framework of the IDF are leveraging the expertise of the private sector, the public sector and academia to improve the data available for risk analysis in low and middle income countries.¹⁵

New products, such as insurance-linked securities based on parametric triggers, are vital to help reduce macro protection gaps and increase resilience. These are generally cheaper to structure and administer and more efficient to blend with commercial finance if required.

Of course, increasingly climate-related tail risks could prove uneconomic for private sector insurers to cover. That is where development agencies and Multilateral Development Banks can step in. Disaster reinsurance could be one of the most effective uses of development financing.

On the asset side, infrastructure investments will be essential. To transition to net zero, all countries need to step up their investments in sustainable energy. The reality of climate change also means that all countries, but particularly developing and emerging economies, will need to invest in new climate-resilient infrastructure in order to adapt to the new realities of a hotter and more volatile climate.

There are various estimates – they are all enormous - ranging between US\$70-90 trillion over the next decade, three quarters of which are in emerging and developing economies.¹⁶

It's imperative to act now to create practical tools and frameworks to support climate-resilient infrastructure investments – ranging from broader use of catastrophe bonds to greater risk pooling for the most vulnerable countries.

Climate-resilient infrastructure assets are well suited to life insurers that need reliable returns over long-term investment horizons. This is even more compelling in a low-for-long interest rate world. However, as the IDF has flagged at present only 2.5% of insurance assets managed are allocated to infrastructure¹⁷.

So the world needs much more investment in infrastructure, and greater risk sharing of climate risks. Insurers have a unique ability to meet both needs.

¹⁵ See <https://oasislmf.org/>.

¹⁶ Global Commission on the Economy and Climate (2016), The Sustainable Infrastructure Imperative. See: <https://newclimateeconomy.report/2016/>.

¹⁷ World Bank (2017), Risk and Capital Requirements for Infrastructure Investment in Emerging Market and Developing Economies. Available at: <https://www.worldbank.org/en/news/feature/2017/12/22/risk-and-capital-requirements-for-infrastructure-investment-in-emerging-market-and-developing-economies>.

In this context, the impact of regulation on the provision and cost of infrastructure finance must be carefully considered.

As World Bank studies have shown, there is evidence that infrastructure debt can be lower risk as it has more predictable and stable long-term cash flows and has low correlation to other assets. The historical default experience of infrastructure debt suggests a 'hump-shaped' credit risk profile, which converges to investment grade quality within a few years after financing has closed.

However, such robustness is not reflected in the standardised approaches for credit risk in most regulatory frameworks. The World Bank study suggests that capital charges could decline significantly for a differentiated regulatory treatment of infrastructure debt as a separate asset class. Now, the International Association of Insurance Supervisors (IAIS) is reviewing the data sources and gaps and considering the risk case for a differentiated capital treatment for infrastructure under the global Insurance Capital Standard – ICS 2.0.

We also need to develop the conditions to make infrastructure assets more readily investable and more easily tradable. Under the Argentine G20 presidency last year, with support from the World Bank and OECD, the G20 designed a roadmap to make infrastructure a more coherent asset class. The foundation is greater standardisation through greater commonality in terms, conditions and financial frameworks. This allows the assets to become easier to invest in, easier to insure, and project risks to be better managed.

Data on the input and impact of infrastructure projects can also be improved. For instance, data on project phases would allow comparisons across construction phases of infrastructure versus non-infrastructure assets. Information on the types of concessions and licenses offered in different regions are important as they determine the kinds of revenue arrangements for infrastructure projects, which ultimately influence cash flow stability – critical information for investors. The IAIS is developing a workplan to examine these data gaps in the coming year.

Reporting, risk management and return

Turning to mainstream investing.

Changes in climate policies, technologies and physical risks in the transition to a net zero world will prompt reassessments of the value of virtually every asset. The financial system will reward companies that adjust and punish those who don't.

Insurers can be highly influential in bringing the realities of climate change into mainstream financial decision-making.

To do so, we need a step change in three areas: reporting, risk management and return.

Reporting

Better corporate disclosure of climate-related financial risks is essential and the next few years will be decisive.

On the demand side, current supporters of the Task Force on Climate-related Financial Disclosures (TCFD) are responsible for assets totalling \$120 trillion and include the world's globally systemic banks, top 10 global asset managers, leading pension funds and insurers.

Not surprisingly, supply is responding. Users of capital are providing increasingly sophisticated decision-useful information. Four-fifths of the top 1,100 G20 companies surveyed in a recent TCFD report are now disclosing climate-related financial risks in line with the recommendations.

Now is the time to get involved. The IAIS and UN Sustainable Insurance Forum are monitoring developments in disclosures closely: with a systematic survey of TCFD adoption by insurance firms and they will be publishing a paper on this early next year, including recommendations for any changes. The Climate Change Research Initiative (CCRI) will do the same.

The next step is to make these disclosures mandatory. The UK and EU have already signalled their intents.

But it's time for every country to get involved because the world won't get to net zero if the financial sector doesn't know how our companies are responding. To watch we must be able to see.

Over the next two years, the current process of disclosure by the users of capital, reaction by the suppliers of capital, and adjustment of these standards will be critical to ensure that the TCFD standards are as comparable, efficient and as decision-useful as possible.

Risk management

With better information, the frontier will be to upgrade risk management and optimise returns.

As the supervisor of the world's fourth largest insurance industry, the Bank of England knows that general insurers and reinsurers are on the front line of managing the physical risks from climate change. Insurers have responded by developing their modelling and forecasting capabilities, improving exposure management, and adapting coverage and pricing. In the process, insurers have learned that yesterday's tail risk is closer to today's central scenario.

And leading insurers also understand that the breadth, magnitude, and foreseeable nature of climate risks—mean the biggest challenge will be to assess the resilience of firms' strategies to transition risks.

That's why, the Bank of England just set out our supervisory expectations for banks and insurers regarding their governance, risk management, strategic resilience and disclosure of climate-related financial risks.

And in June the Bank announced that we will be the first supervisor to stress test our financial system for resilience against different climate transition pathways: ranging from early and orderly to late and disruptive.

The test will motivate banks, insurers and asset managers to address data gaps and to develop cutting-edge risk management approaches consistent with a range of possible climate pathways.

The Bank will develop the approach in consultation with industry, including best practice insurers, and other informed stakeholders including experts from the Network for Greening the Financial System and the PRA's Climate Financial Risk Forum.

Return

There is increasing evidence that sustainable investment can generate excess returns, particularly for investors, like insurers, with longer term horizons.

One of the biggest hurdles to channelling mainstream finance to sustainable investment is the inconsistent definition and measurement of environmental, social and governance (ESG) criteria.

An agreed taxonomy would allow markets to understand better where there is real outperformance and direct investments accordingly.

The EU's Green Taxonomy and the Green Bond Standard are good starts but they are binary (dark green or brown) and don't account for progress from brown to green – progress that could make a significant contribution to our climate goals.

One possible solution, as recommended by the UN's Climate Financial Leaders Initiative, could be the development of transition indices which track companies in high-carbon sectors that adopt low-carbon strategies.

Such approaches are essential for our citizens to make sure their money is being invested in line with their values.

Conclusion

Ultimately, the speed with which the new sustainable finance develops will be decided by the coherence and credibility of countries' climate policies. Finance will complement - and potentially amplify these initiatives– but it will never substitute for climate policy action.

The policy frameworks with the greatest impact will be: time consistent; transparent; target-based; and committed, through treaties, nationally determined contributions (NDCs), domestic legislation and consensus. The 20 countries – including the UK – that have plans to legislate for net zero show what can be done.

If countries build their track records, their credibility will grow, and the market will allocate capital to deliver the necessary innovation and growth and pull forward the adjustment to a low carbon future.

The more prolific the reporting, the more robust the risk management and the more widespread the return optimisation, the more rapidly the insurance sector can build resilience while promoting the transition that our citizens demand.