Sabine Mauderer: Central banks – a crisis manager for the climate?

Speech by Dr Sabine Mauderer, Member of the Executive Board of the Deutsche Bundesbank, at the Deutsche Bundesbank's second financial market conference, Frankfurt am Main, 29 October 2019.

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INTRODUCTION

Ladies and gentlemen,

I, too, would like to warmly welcome you to what is the Bundesbank's second financial market conference, and the first dedicated to the subject of sustainability.

It's great to see such a huge turnout! There are 540 of us here today – if that's not a sign that we're really concerned about sustainability, I don't know what is. And I am also pleased that Bundesbank President Jens Weidmann and our panellists have just underscored the significance of climate protection and sustainable finance.

The heading of our conference today asks whether sustainable finance is a game changer for our financial system. A game changer is something that disrupts everything – the way we think, and the way we act. Sustainability is just such a game changer.

We need to make sustainability a key principle so that we can preserve the foundations of how we live and do business.

Climate change makes a particularly urgent case for this. The United in Science report[1] for the most recent UN Climate Action Summit writes that the average global temperature for 2015–2019 is on track to be the warmest of any equivalent period on record. The authors also observe that climate change is putting pressure on the environment's ability to support and supply food, water, health and wellbeing, and note its potentially threatening consequences for the economy, security and civil unrest.

The challenge has staggering dimensions. In order to bring global economic growth into line with the Sustainable Development Goals and the Paris Agreement, the OECD, the World Bank and the UN estimate that infrastructure investment alone would be needed to the tune of US$6.9 trillion. That's the figure each year, up to 2030.

At present, there is no telling what share of this will be taken on by private players in the financial market and how much will be shouldered by the public sector.

But it's not only a matter of who pays what. It's just as much about getting clear answers to the questions:

Who plays what role?

Who needs to decide what, and what action is required?

Politics, finance and the real economy, and central banks, too – they each have different tasks. Protecting the climate calls for a clear allocation of roles. Many different agents need to pull together as a team – and pull in the same direction as well.

Let's begin with the central banks.

A. CENTRAL BANKS

I joined the Bundesbank's Executive Board just over a year ago, and during this time, I've been to many green finance meetings where the remark was made:

"Just leave it to the central banks to save the climate as well!". That demand sounds alluring – after all, if a single institution could take on this whole issue, wouldn't that make things so much more straightforward?

Why do some people think that this task would be child's play for central banks? Central banks have been thrust into a starring role once before – in resolving the recent crises. You won't be surprised to learn that the Bundesbank's response to this was reserved. The impression emerged at that time that central banks were the "last man standing", and also that they had very deep pockets. We operated as a crisis manager.

So if central banks already have a track record in managing financial crises, why can't those seemingly mighty institutions manage a climate crisis, too?

There's no shortage of advice when it comes to regulatory and monetary policy matters:

- give privileged treatment to green financial instruments – for example, by requiring less capital backing for green loans or securities,
- favour green collateral in monetary policy credit operations,
- or even green asset purchase programmes, ranging from green QE to ultimately financing public investment to promote the transition to a low-carbon economy.

Let me be clear about this:

Climate risks are a source of considerable financial risks, which is why climate change is a hugely important topic for central banks. This can be said for financial stability, banking supervision, financial markets and, in some respects, for monetary policy, too.

But central banks are ill-suited for the task of crisis manager for the climate. The ground rules which keep the economy's and society's footprint on the environment in check are set by politicians. They have the democratic legitimacy to do so – central banks don't. That is also the reason why we, as central banks, are not permitted to conduct economic or environmental policy, even if forward-looking decisions are urgently needed on these fronts.

However, central banks will do everything they can and must do, within the scope of their mandate, to protect the climate.

Central banks around the world have long since recognised their importance in matters of climate protection. This is why eight central banks and banking supervisors got together at the end of 2017 to establish a global network. The Bundesbank was a founding member of this Network for Greening the Financial System, or NGFS for short. It today boasts 46 central banks and supervisors as well as nine observers, including the IMF, the BIS and others.

Our aim is to act in an internationally consistent manner and pool our expertise. Only thus can we mount a global response to this new challenging financial risk. We are focusing on how we can mitigate the financial risks stemming from climate change, particularly in the monitoring of financial stability and in banking supervision. On top of that, we are also looking at how sustainable finance can be given a more prominent role – including in central bank portfolios.

I myself presented an NGFS investment guide on sustainable portfolio management at central banks on the margins of the last annual meeting of the IMF and the World Bank. This handbook also contains the results of a survey among the NGFS member central banks. One finding is that a growing number of these central banks also take sustainability factors into account in their portfolio management. To be more precise, 25 of the 27 central banks surveyed are already

investing sustainably or planning to do so. The survey also reveals that, alongside reputational risk, risk-return considerations are among the key drivers here.

Central banks can pave the way for more sustainability. Particularly with portfolios that are not geared towards monetary policy, but also as fiscal agents. At the Bundesbank, we are currently reviewing how sustainable our euro-denominated own funds portfolio already is and where there is still room for improvement.

Right now, this portfolio is worth around €12 billion and is invested exclusively in fixed-interest covered bonds denominated in euro. Besides this, in its role as a fiscal agent, the Bundesbank holds portfolios for external public sector clients such as central government and a number of federal state governments, which involves managing amounts in the high two-digit billions. Four of the 16 portfolios already follow an ESG approach[2] or are invested in green bonds. So all in all, we're talking about a figure in the high single-digit billions. What's more, four federal states – Hesse, Baden-Württemberg, North Rhine-Westphalia and Brandenburg – have recently followed Berlin's lead and commissioned tailored sustainability indices as a benchmark. This involves assessing enterprises according to ESG criteria; the Bundesbank can apply the resulting benchmark to the portfolios of the federal states.

The public sector is therefore leading by example. This is crucial to the acceptance of sustainable finance in Germany.

As guardians of financial stability and as banking supervisors, we central banks see climate change as a source of financial risk. We need to get to grips with the effects of climate change on the stability of individual institutions and on the stability of the financial system overall. That's why central banks are calling for greater market transparency and better data availability.

Who is affected by climate risks and how – via loans to certain industrial sectors, for instance? These are some of the important issues that the Bundesbank will also be tackling in this year's Financial Stability Review.

Financial institutions need to pay proper attention to climate risks in their risk management. In terms of financial supervision, key factors therefore include better risk models at individual institutions and better awareness of how climate risks are distributed within the financial system. Financial supervisors will need sophisticated methods to identify the vulnerabilities caused by climate risk more clearly. A "climate stress test" should form part of our toolkit. But before this can happen, we need the right data and a better understanding of the basic issues.

We need to apply a longer time horizon to our entire analytical framework if we are also to factor in longer-term climate effects.

So our intended course of action is not simple, but it is effective – and we are not alone. Two weeks ago, I was in Washington, D.C., where I took part in a panel discussion with Kristalina Georgieva, the new head of the IMF, who emphasised that the IMF is losing no time in preparing to incorporate climate risk into its country analyses.[3]

B. POLICY

The IMF is a sort of interface between central banks and policymakers. This brings me to the most important of the parties involved when it comes to creating a framework for the transformation we need: political stakeholders.

The framework established by policymakers needs to be environmentally and economically effective. It must offer planning certainty to the real economy and the financial markets alike. The key is to keep the costs of transitioning to a low-carbon economy as low as possible for the economy and to distribute these costs efficiently and, at the same time, fairly among society.

The German government's climate package is a good start. But it's clear that further steps will also be needed. The cornerstone of this climate package is a more comprehensive CO2 pricing system. This approach has been endorsed by numerous experts. It will probably need to be readjusted as time goes by; a fact we are fully aware of. What this will boil down to is a balancing act between comfortably meeting climate goals and clear prospects for economic agents.

What do we need from political stakeholders in terms of the financial markets?

The answer is: solid guidelines for sustainable finance reforms, ideally at the international level. Financial regulation isn't a climate policy instrument; instead, it serves to safeguard the stability of the financial system. What's crucial here is the focus on financial risk rather than on promoting economic growth. And that mustn't change.

BaFin recently published a notice providing supervisory guidance to institutions on dealing with the increasingly important issue of sustainability risks. In other areas, the EU is taking action with its sustainable finance action plan – in the form of its new taxonomy that defines which economic activities are considered "green", for instance. The European Council hopes that the taxonomy will be fully implemented by the end of 2022.

Disclosure standards for increased transparency are just as important. Who is exposed to what climate risks? The recommendations issued by the G20 Task Force on Climate-related Financial Disclosures are aimed at establishing consistency in climate-related reporting. A great deal is riding on these recommendations, since financial markets can only distribute capital efficiently with regard to climate risk and perform its guiding role properly if transparent, price-relevant information is available.

Nor must we underestimate the growing importance of sustainable finance within the EU as a location factor. The Federal Government has recognised this and wishes Germany to play a leading role as a hub for sustainable finance. The Sustainable Finance Advisory Council is to act as coordinator here, providing the government with strategic advice and specific recommendations for action. The Council has already outlined the first topics it believes should now be tackled in more detail. The first progress report should be ready as early as the start of 2020, in view of Germany's EU presidency in the second half of next year, amongst other factors. What's crucial here is that the government will receive specific, workable recommendations within the next year.

However, policymakers themselves can lead by example when it comes to sustainable finance. And that's exactly what they are doing. Central government and several federal state governments have decided to invest their pension portfolios according to sustainable criteria.

C. FINANCIAL SECTOR

This brings me to the financial sector itself. Here, too, we have been seeing attempts to adjust to climate change for a long while: by the banking industry, insurers and funds. A huge amount of capital needs to be mobilised for the transition to a climate-friendly economy – public capital, but even more private capital. In future, this will also mean that sustainable financial products will grow more important in the investment advice given to retail investors – which is what the EU wants.

At the same time, financial institutions have to comply with regulatory ratios concerning liquidity and solvency, for example. That's not always an easy task. Nonetheless, the past few years have seen a lot of movement in sustainable and, in particular, green forms of financing, both at financial institutions and in the financial markets.

Financial institutions and financial markets play a central role in the effective and efficient allocation of capital in the real economy.

Financial institutions and financial markets help decide which projects are financed – and which ones are not. We need to leverage this steering effect and thus support the necessary structural change – the transformation of the real economy.

Here, financial markets have two special features:

First, financial markets respond faster to new information than the real economy can.

Second, the financial system is a global network – this means that climate risks do not remain confined to local or regional areas: they can travel.

For their own risk management, financial institutions have to constantly ask themselves anew: which risks are looming where in the balance sheets? How high is the danger of those risks materialising? With climate risk, it is vital to extend the observation horizon. The search for yield is sometimes focused on the short term. Climate risk, on the other hand, is of a more medium to long-term nature. It has to form part of the analysis – chiefly because some of the consequences of climate changes are irreversible.

But besides risks, there are also opportunities for the financial sector. By allocating capital in a smart way, the financial sector can generate returns and at the same time act as a driver of innovation and growth in the fight to mitigate climate change.

The UN has recognised this potential and brought together a group of the world's largest pension funds and insurers.[4] The group is called the "Net-Zero Asset Owner Alliance", and is responsible for investments worth more than US$2.4 trillion. The institutions within the group have committed to transitioning to carbon-neutral investment portfolios by 2050.

In the financial market, demand for green investments has so far well outstripped supply. No doubt many of you can attest to this – it really isn't that easy to invest sustainably. But when market mechanisms function properly, the imbalance between supply and demand is gradually redressed.

Still, the market for green bonds has considerable growth potential.

In 2007, the European Investment Bank laid the foundation for the green bond market segment when it issued its first Climate Awareness Bond.

Since then, green bonds have become more attractive and accepted, primarily for investors interested in sustainability. Europe is aiming to become a leader in sustainable finance. However, outstanding green bonds only account for just under 2% of the international bond market as a whole, despite appreciable growth rates.[5]

Further market growth will have a positive effect as long as it is "healthy". In other words, the market cannot simply be greenwashed with green labels. What's "green" on the outside is "green" on the inside, too. Clear rules and regulations and reliable frameworks for green investment are therefore crucial, and that's a task for policymakers.

But financial market participants themselves are also called upon to ensure we have reliable market indices and market standards.

Much has already been achieved in both areas. Market standards such as the Green Bond Principles already provide guidance for issuers, but also for investors. The EU's new Green Bond Standard aims to build on these market practices and on the taxonomy, and promote market integrity. Rating agencies are integrating ESG information into their ratings and other scores. This is another building block to better price and track climate risk in the financial system and the real economy.

Another driver of growth in sustainable bonds would be a positive risk/return profile compared with conventional bonds. The October 2019 issue of our Bundesbank Monthly Report compares secondary market trading in conventional and green bonds issued by the KfW and the EIB. According to the report, there are no clear patterns, at least when it comes to yield spreads. But the analysis is merely a snapshot.

Of course, it's not enough to look at the bond market alone; we also have to consider the equity market. A study of the equity market shows that investing in sustainable enterprises can be financially attractive for investors and, at the very least, does not have to put them at a disadvantage. The October issue of the Monthly Report comes to this conclusion based on a comparison between the very broad MSCI World stock index and its sustainable sub-index MSCI World ESG Leaders over the past ten years.

D. ECONOMY

Ladies and gentlemen,

after central banks, policymakers and the financial sector, there is one player left to discuss. It is the most important player, and represents the crux of the transformation: the real economy.

The real economy should set its sights firmly on innovation.

Climate change poses financial risks to businesses, too, not just the financial sector. The faster enterprises transform, the better their ability to combat those risks. It is important for each individual sector of the economy to ask itself whether the transition is proceeding rapidly enough: that means industry and the services sector, and the agriculture and forestry sectors alike. Many enterprises have noticed that new products and services that make sparing use of natural resources are good for business. These products and services should touch on all areas of life, making the adjustment easier for households as well.

To achieve the necessary transformation, we need to reach out to all corporate sectors – not just those that have already "gone green". This will enable us to minimise the risks involved in moving to a low-carbon economy. The production sector, in particular, is taking important steps to run more climate-friendly operations.

Global competition to come up with the best ideas, the most viable innovations for the future, is already bearing fruit – including in Germany.

The automotive industry, which is so important to Germany, is one example of a sector that is responding late, but hopefully not too late, to the changes brought about by climate change. Without the automotive industry, a transition in forms of mobility would be unthinkable.Engineers are busy working on various alternative engine types.

Openness to new technologies is the watchword, not just when it comes to types of engine in the automotive industry. We cannot let ourselves become fixated on one path and one path only – many roads lead to more sustainability.

Attitudes are clearly changing in many industries. Take, for example, the development of synthetic fuels for aviation and maritime transport, say, or measures to use waste heat and air in the cement industry, or ways of storing greenhouse gases underground, otherwise known as "carbon capture and storage". What I'm saying is that some of the innovative products and processes to better mitigate climate change already exist.

CONCLUSION

Ladies and gentlemen,

I'd like to end on this positive note and return to the questions I posed at the beginning:

Who plays what role in mitigating climate change?

Who needs to decide what, and what action is required?

Policymakers set the legal framework for business and society to act in a climate-friendly way. The financial system takes a risk-aware approach to directing financial flows into a sustainable economy. Central banks' climate focus is mainly on financial stability, but also on banking supervision, the financial markets as well as, to an extent, the impact on monetary policy.

But it will be crucial for the real economy to transform, particularly the production sector. For this to happen, though, ultimately consumers have to change their consumption patterns and demand environmentally friendly products and services.

Every one of us bears responsibility.

The appetite for change exists. All we need to do now is act with determination. Let me end today's speech with another Goethe quote, then:

"Enough words have been exchanged; now at last let me see some deeds!"

Thank you for your attention.

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[1] www.un.org/sustainabledevelopment/blog/2019/09/unite-in-science-report/

[2] ESG stands for environmental, social and governance.

[3] "The IMF is gearing up very rapidly to integrate climate risks in our surveillance work."

[4] www.un.org/en/climatechange/assets/pdf/CAS_main_release.pdf

[5] See Deutsche Bundesbank, Monthly Report, October 2019.