Frank Elderson: Taking into account climate and nature in monetary policy and banking supervision around the world

Remarks by Mr Frank Elderson, Member of the Executive Board of the European Central Bank and Vice-Chair of the Supervisory Board of the European Central Bank, at an event on climate-related financial risks, hosted by the Central Bank of Brazil, Rio de Janeiro, 27 March 2024.

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Many thanks to the Banco Central do Brasil for inviting me here today. I am honoured to be speaking in Rio de Janeiro's botanical garden. It is home to more than 6,500 different species – just a fraction of the more than 130,000 species that are estimated to be found in Brazil, the most biodiverse country in the world. But even this little glimpse into Brazil's biodiversity is more than sufficient to appreciate the concept of natural capital and the tremendous value it represents.

At the same time, global heating and nature degradation are putting this natural capital at risk. And central banks and supervisors around the world recognise that this poses a serious threat to the stability of our economies and the robustness of our financial system.

Let me be clear from the outset: central banks and supervisors are not, and do not intend to be, policymakers in the area of climate and nature. It is governments that are responsible for climate and nature policies. In my remarks today, I will explain why central banks and supervisors have no option but to take the ongoing climate and nature crises into account to deliver on their monetary policy and banking supervision mandates. And that is exactly what central banks and supervisors around the world are doing. We at the European Central Bank (ECB) are not alone in this work, as can be seen from the work being done by the Banco Central do Brasil and most other central banks and supervisors around the world.

The relevance of climate and nature for central banks and supervisors

Human-induced global heating and nature degradation are scientifically established facts. Their devastating consequences are becoming all the more apparent in the increasing number of hazards we are seeing around the world. We don't yet know exactly how the climate and nature crises will continue to unfold, partly because governments are taking mitigation and adaptation measures. This uncertainty also means that we don't know exactly how the economy and the financial system will be affected.

At the same time, analysis consistently shows the vital importance of climate and nature for central banks and supervisors.

First, whatever happens, the economic impact will be profound. If left unchecked, global heating and nature degradation will contribute to increased macroeconomic volatility as climate and nature events become more frequent and have a greater impact on the economy. A successful transition to a green and sustainable economy, meanwhile, will require vast investment flows that will alter the way our economies function.

Second, the economic benefits of a timely transition far outweigh the costs, especially when considered against the alternative scenarios of doing nothing or doing too little too late.[1]

Third, climate-related risks translate into financial risks. Early work by the Basel Committee on Banking Supervision (BCBS) shows that climate events are a driver of each traditional type of risk considered in the regulatory framework, from credit risk, liquidity risk and market risk to reputational and operational risk, including legal risk.[2] Floods, for example, could damage a company's production facility, which could affect its ability to repay a loan, in turn leading to higher credit risk for the bank that provided the loan. Or consider what might happen if your house is built in an area vulnerable to wildfires. Your home could fall in value, leaving the bank that granted you the mortgage with higher risk on its balance sheet.

And these financial risks are not related solely to climate change. Last year, when looking at more than 4.2 million individual companies that account for over €4.2 trillion in corporate loans, we found that nearly 75% of all bank loans in the euro area are to companies that are highly dependent on at least one ecosystem service.[3] Examples of these services include the products we obtain from ecosystems, such as food, drinking water, timber and minerals; protection against natural hazards; or carbon uptake and storage by vegetation. If these ecosystem services continue to experience the level of degradation they are currently facing, the stability of individual financial institutions and the broader financial system will be at risk.

International standard-setting bodies driving global action

Recognising the relevance of climate and nature-related factors for the economy, including the financial system, international standard-setting bodies are increasingly turning their attention to this topic. This has resulted in substantial progress at the global level, although more work lies ahead of us.

For example, the BCBS has a dedicated Task Force on Climate-related Financial Risks, whose meeting this week is kindly hosted by the Banco Central do Brasil. Based on the work of this task force, the BCBS has taken concrete steps to incorporate climate-related financial risks into the Basel framework for the global prudential regulation of banks. And progress has been made across all three pillars of the prudential framework: regulation, supervision and disclosures. On the topic of disclosures, late last year the BCBS issued a consultation paper on a proposed climate-related disclosure requirements framework, building on the work done in various other fora. The deadline for comments was two weeks ago and we are now carefully assessing the feedback received.

Meanwhile, there is also progress on nature-related risks. In view of the Brazilian G20 Presidency's priority to deepen work on sustainability-related risk, the Financial Stability Board (FSB) will this year complement its climate-related work with a stocktake of current and planned regulatory and supervisory initiatives regarding nature-related financial risks. This may build on the work already done by the Central Banks and Supervisors Network for Greening the Financial System (NGFS). Last year the NGFS – which has 138 members worldwide, including the Banco Central do Brasil – published a conceptual framework to guide action by central banks and supervisors in the area of nature-related risks.

The work currently being done by the BCBS, the FSB and the NGFS will ultimately find its way to other international standard-setting bodies and translate into concrete practices by individual central banks and supervisors.

ECB measures to take climate and nature into account

Let me give you some examples of actions we have taken at the ECB.

In 2021 we unveiled an ambitious climate action plan covering macroeconomic modelling, financial stability monitoring, data collection, risk assessment capabilities and our monetary policy operations. Many of the actions we planned have now been delivered. For instance, we have made significant progress in improving the models that we use in macroeconomic analysis supporting our monetary policy decisions. Moreover, we have in place a methodology to tilt the purchase of corporate bonds towards issuers with a better climate performance – if we ever need to buy corporate bonds again in the future. In the collateral framework for our lending operations, we only accept assets that comply with the relevant sustainability reporting requirements and we are looking at setting limits on the share of assets issued by entities with a large carbon footprint.

In the area of banking supervision, we have urged banks to ensure the sound management of climate and nature-related risks, using the supervisory expectations we published in 2020 as a starting point. These expectations give guidance on how banks should integrate climate and nature-related risks into their strategy, governance and risk management. It is very much consistent with the general supervisory principles that have been established by the BCBS.

Since the ECB first started discussing climate and nature-related risks with banks back in 2019, progress has undoubtedly been made. Banks have taken steps to integrate these risks into their strategy, governance and risk management. Although at present none of the banks under our supervision fully meets all our expectations, each of our expectations has already been fulfilled by at least one bank. It shows that progress is possible, and that it is not just taking place among a few banks, but across the board. This is good news, since we expect all banks under our supervision to be fully aligned with our supervisory expectations by the end of 2024. We will enforce this final deadline as well as several interim deadlines. In fact, a number of banks under our supervision have already received binding requirements to remedy shortcomings by a certain date. If they do not comply, they will have to pay a penalty for every day that the shortcomings remain unresolved.

Building on the results achieved and progress made, earlier this year the ECB announced a new climate and nature action plan. It sets out concrete steps to consider how, within our mandate, we can further support the green transition, assess the physical impacts of climate change and explore the materiality of nature-related risks. Moreover, when we completed a review of our operational framework for implementing monetary policy two weeks ago, we announced that climate change-related considerations will be incorporated into the design of future structural monetary policy operations.

Conclusion

Let me conclude.

The Amazon river is subject to the "Pororoca", one of the largest tidal bores in the world. It is an enormous wave travelling from the mouth of the Amazon on the Atlantic coast up to 800 kilometres upstream.

The climate and nature crises are unfolding. Together they are overflowing the economy and the financial system, very much like the "Pororoca" overflows the Amazon basin. Even if mitigation and adaptation measures are taken, one thing is certain: the world, the global economy and the financial system will see profound change.

In the words of Brazilian author Paulo Coelho: "You drown not from plunging into the water, but from staying submerged in it." Emerging from the climate and nature crises requires action from all authorities within their mandate. For central banks and supervisors, this means taking climate and nature into account in the pursuit of their monetary policy and supervisory objectives. If they failed to do so, they would be failing on their mandate. The work that we are doing individually and collectively proves that we will not allow this to happen.

Thank you for your attention.

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[1] Emambakhsh, T. et al. (2023), "The Road to Paris: stress testing the transition towards a net-zero economy", *Occasional Paper Series*, No 328, ECB.

[2] Basel Committee on Banking Supervision (2021), *Climate-related risk drivers and their transmission channels*, April.

[3] Boldrini, S. et al. (2023), "Living in a world of disappearing nature: physical risk and the implications for financial stability", *Occasional Paper Series*, No 333, ECB.