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INSTITUTE FOR CLIMATE ECONOMICS
Une initiative de la Caisse des Dépôts et de l'Agence Française de Développement

Improving the supervision of financial players

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Avec la contribution
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The traditional roles of financial regulation

First objective: proper market functionning

It deals primarily with information

- Market efficiency: all relevant information regarding traded securities and bonds and their issuers is available (informational efficiency)
- Investor protection: proper and clear information about risks and rewards is provided to professional investors
- Consumer protection: protecting retail customers from asymmetry of information and behavioral biases

=> The main instrument is disclosure (reporting requirements)

Second objective: financial stability

Financial stability

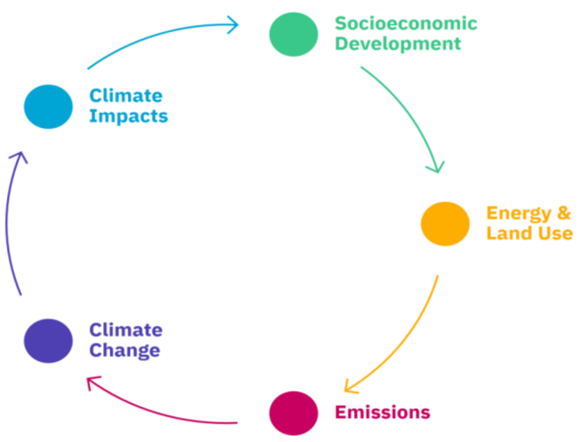
- Preventing the collapse of individual financial institutions
- Preventing contagion among financial institutions
- Preventing systemic crisis

Two types of regulatory measures

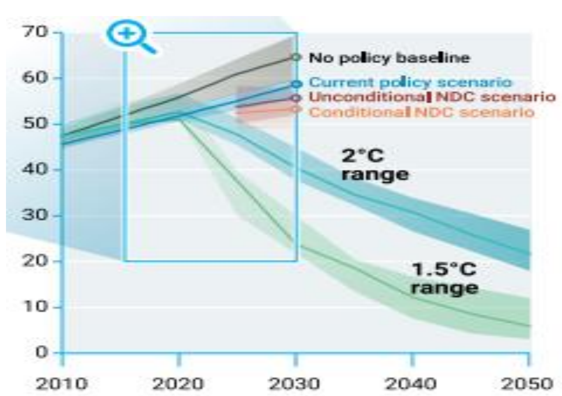
- Micro prudential measures ensure the financial soundness of individual actors
- Macro prudential measures ensure the overall financial stability

Challenges to supervise Climate Risks

Radical uncertainty of climate-related risks



Source: SENSES project, Scenario Primer
https://climatescenario.org/primer/



- ✓ The complexity of the climate system makes it difficult to model (with non-linear evolutions or tipping points)
- ✓ The loop of interactions between climate change socio-economic systems
- ✓ The uncertainty related to "socio-economic pathways"
  - Which low-carbon trajectory will finally be followed toward the low-carbon economy?
  - Which kind of economic transformation does it imply to decarbonize?
  - Who are the losers and the winners in the future economy?

The « tragedy of the horizon »

Time horizon of the analysis: the « Tragedy of the horizon »

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The tragedy of the horizon: *"The horizon for monetary policy extends out to two to three years. For financial stability it is a bit longer, but typically only to the outer boundaries of the credit cycle – about a decade. In other words,* ***once climate change becomes a defining issue for financial stability, it may already be too late****."* *(Carney, 2015)*

Overcome the « risk-measuring deadlock »

Overcome inconsistency between climate-related risks and standard risk analysis framework:

Financial models to assess risk are looking backward, based on historical data…

Do you look at the rear-view mirror to find your way forward?

… and financial models only take into account 2 to 10 years projections…

So existing financial models are unable to integrate climate-related risks and opportunities

In the current financial framework, financing the energy transition and adaptation to climate change won't happen at the needed pace without targeted efforts / constraints:
Mark Carney's « Tragedy of horizons »

Need for scenario analysis

This unprecedented evolution results in the lack of historical data → scenario analysis

Predicting climate-related future is impossible. Yet, scenarios can help explore the possibilities:

- ✓ Scenarios are not predictions of the future
- ✓ They are projections of plausible climate change futures
- ✓ Or possible pathways to reach specific targets

Dealing with climated-related risks requires a forward-looking analysis based on scenario analysis:

- ✓ On the low carbon trajectory that we will be taking
- ✓ On the climate change trajectory

The need to reconsider financial supervisors' role

"For an articulated approach to economic policy and financial regulation to deal with climate challenges"
I4CE - December 2023

The EU favours a silo approach

- Economic instruments (budgetary, fiscal regulatory) are used primarily to shift non-financial actors toward low-carbon transition

- Financial regulation (non prudential) seeks to ensure the financing of the transition through market mechanisms

- Prudential policy is aimed at ensuring financial stability and preventing systemic risk

It undermines the efficiency of public action

Large financing gap to achieve a net-zero economy

- Economic signals remain insufficient to deeply and rapidly change financial behaviours
- The increased transparency of financial markets related to climate is a complex process and the impact is still limited
- The « narrow » risk approach is not sufficient to effectively limit the systemic risk coming from Climate change

An articulated approach is essential (1/2)

Appropriate economic policy is key

- Design the transition strategy and set the economic signals
- It cannot be replaced by financial regulation
- Articulation can improve the effectivness of public action

Financial regulation could supplement economic policy …

- By enhancing the impact of price signals
  - e.g. capital requirements or capital buffers
- By using other transmission channels to change the behaviour of financial actors
  - e.g. mandatory transition plans for banks and insurance

An articulated approach is essential (2/2)

…and enable prudential supervisors to fulfil their mandate

- Supporting the financing of a smooth transition is the best way to limit climate risks and prevent systemic risk
- The articulated approach is a preventive approach which encourages the reallocation of financial flows
- It takes into account the largely endegenous nature of climate risks
- It ovecomes the « risk measurement deadlock » by setting « conventionnal » prudential rules

Enhance the current approach (building resilience) by a preventive and precautionary action (limiting climate risks)

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Thank you for your attention

A PROPOS DE CETTE PRESENTATION

La Commission européenne n'est pas responsable de l'usage qui pourrait être fait des informations qu'elle contient.

Ce travail ne reflète que le point de vue d'I4CE – Institut de l'économie pour le climat. Les autres membres du Consortium Finance ClimAct ne sont pas responsables de l'usage qui pourrait être fait des informations qu'il contient.

A PROPOS DU PROJET FINANCE CLIMACT

Le projet Finance ClimAct contribue à la mise en oeuvre de la Stratégie Nationale Bas Carbone de la France et de la politique européenne en matière de finance durable. Il vise à développer les outils, méthodes et connaissances nouvelles permettant (1) aux industries énergo-intensives de favoriser l'investissement dans l'efficacité énergétique et l'économie bas-carbone, (2) aux institutions financières et à leurs superviseurs d'intégrer les questions climatiques dans leurs processus de décision et d'aligner les flux financiers sur les objectifs énergie-climat, et (3) aux épargnants d'intégrer les objectifs environnementaux dans leurs choix de placements.

Le consortium coordonné par l'Agence de la transition écologique, comprend également le Ministère de la transition écologique, l'Autorité des marchés financiers, l'Autorité de contrôle prudentiel et de résolution, 2° Investing Initiative, l'Institut de l'économie pour le climat, l'institut de la Finance Durable et RMI.

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Finance ClimAct

Avec la contribution du programme LIFE de l'Union européenne