



Financial statements with Nicolas Veron

“A holistic perspective on climate and financial policies”

Pierre Wunsch | Peterson Institute

9 October 2024

How should the financial system adapt or contribute to the climate transition ?

The climate transition is the first policy-induced industrial revolution

- It comes with substantial technological but also regulatory uncertainty and risks
- Some green technologies are already competitive but many others depend on policy support to be profitable

Broad implications for the financial system

- Client information & related ESG/green taxonomy initiatives
- Financing needs
- Credit risks, stranded assets & financial stability
- Impact on inflation and monetary policy

Broad consensus on the basics but less on how unique the climate transition is for the financial system

- Compared to the many other risks/economic developments
- In terms of the role assigned to the financial system (e.g. “greening” the financial system)

Setting the scene : is it macro critical ?

How big?

- “(Keynesian) new growth strategy” view vs “(large) negative supply shock” view
- Size of supply shock is essentially in line with oil shock of the 70^{ies}: ~2-3.5% of GDP (based on an average abatement cost of ~150USD/ton) = -10bp of growth per year for a country like Belgium
- ...but spread over >25 years...and not as sudden: more predictability

With, as a result:

- Need for major resource reallocations (workers and investments)
- Higher aggregate investments (~2% of GDP on a net basis)
- Higher r^* (and inflation?)
- Lower consumption

And also:

- Significant distributional - and therefore fiscal - consequences (vs. « double dividend » argument)
- Still, net impact on public finances (0.5-1% of GDP) is typically much lower than, e.g. the cost of aging

Climate-related and environmental risks in CRR3/CRD6, CSRD and CSDDD: implications for banks

1. Overall context

Banks are subject to new prudential regulation regarding ESG (CRR/CRD) and to EU general economic ESG-related regulation on disclosure and due diligence (CSRD and CSDDD)

2. CRR3 - Capital Requirements Regulation

CRR3 elaborates the scope of pillar 3 disclosures and introduces supervisory reporting on ESG risks

3. CRD6 - Capital Requirements Directive

CRD6 incorporates several mandates to EBA to develop guidelines for the supervision of ESG risks, ESG risk management, and requires the set up of prudential "transition plans"

4. CSRD - Corporate Sustainability Reporting Directive

CSRD ensures that stakeholders have access to standardised ESG information from undertakings

5. CSDDD - Corporate Sustainability Due Diligence Directive

CSDDD aims to foster sustainable and responsible corporate behaviour and requires the set up of strategic transition plans



Greening the financial system : general considerations (I)

Ambiguous agenda/ambition

- Is it about transparent information
- Or about financing the transition
- Or about credit risk/stranded assets
- Or about making the financial system “greener than the underlying economy or policy setting” (cheaper green loans, exclusions...) ?

From the relatively consensual but not very impactful (?!) ...

- Nobody can be against informing customers
- Still, the devil is in the details and potential questions over the proportionality of the regulation → cfr. Draghi report
- So far, the cost of green bonds has been only marginally cheaper than that of brown bonds

... to the more complicated

- Green taxonomy & stop financing oil (next slides)
- Gaming & green washing
- ESG backlash in the US and elsewhere
- Proliferation of green financial instruments → lack of focus and scale (P. Bolton, Bruegel AM, 2024)

Greening the financial system : general considerations (II)

Risk of overburdening the financial system with too many (sensitive) issues

- We are creating a grey zone between legal... and legal but not OK
 - Is subcontracting to the financial sector a good idea (vs. policy making and democratic debate)
 - Examples : shooting clubs, Belgian industry and airlines...
- The regulatory/reporting burden is becoming substantial : Basel III+AML+Cyber+ESG...
 - I meet a lot green friendly but quite desperate bankers

Why do we need the taxonomy or climate plans in a Paris-aligned economy?

EU climate legislation= Paris-aligned → Why do we need the taxonomy or climate plans?

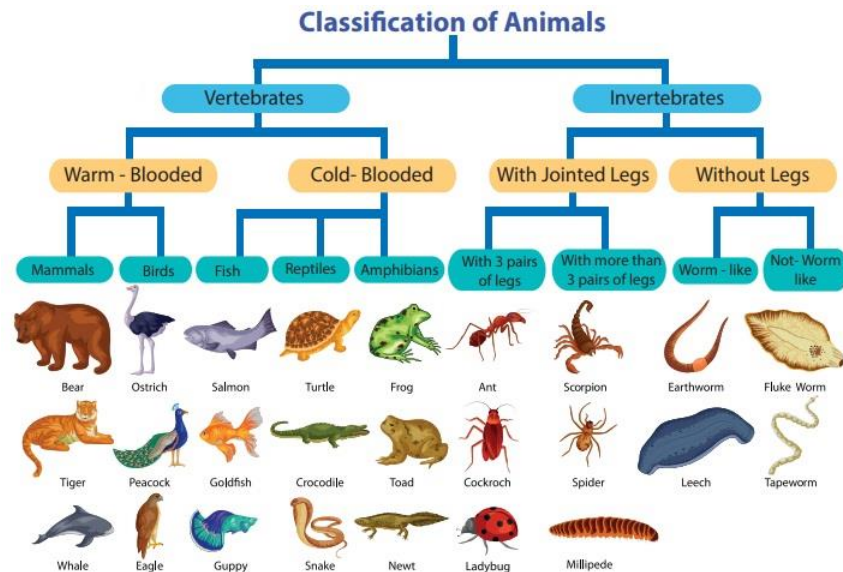
- To inform customers or investors: voluntary carbon markets to date mostly unregulated
- To deal with GHG emissions in third countries
- To support environmental concerns beyond climate

But there is a risk of pushing for “dark green” solutions:

- Energy performance ratings: not all houses can be insulated quickly or cheaply
- A change in heating technology (e.g. via heat pumps) could be cheaper than relying mostly on insulation
- Risk of too high an ambition for green hydrogen – might need blue or turquoise H2 to kickstart infrastructure in time

Climate plans have not resisted contact with the enemy

- Many downwards revisions and/or unclear MT targets
- Likewise for green hydrogen plans in the EU and Korea that have been confronted with BIG cost revisions



Supply destruction may not be such a good idea



Fossil fuel prices will ultimately have to increase

- The higher price can either go to Russia, Iran and Venezuela...
- ... or to governments as tax revenues

Energy demand being inelastic, a small supply destruction can have BIG price impacts

- And immediate political consequences (like officials travelling to the Middle East)

IEA (2021, 2023): Text in full

- "The trajectory of oil demand in the NZE means that no exploration for new resources is required and, other than fields already approved for development, no new oil fields are necessary. *However, continued investment in existing sources of oil production are needed.*"
- "Sequencing the increase in clean energy investment and the decline of fossil fuel supply investment is vital if damaging price spikes or supply gluts are to be avoided."

Financing the transition

“We need to *find* hundreds of billions for the transition”

- We used to be in a World with excess savings and negative rates
- How much crowding-out of green investments on other investments ?
- (Less than) 2% of GDP is well without the historical variation of investments in Europe

“We cannot finance the transition without a Capital Market Union”

- EV's and heat pumps : Banks can do it
- Industry : Banks and the bond market should be able to do it
- Innovation & start-up : CMU would help but more of an issue for digital & AI than the green transition

My take :

- The issue is not about “finding” money as such
- But rather who should pay for the transition and how (policy instruments)
- And whether the public will remain supportive

When the concept of risks becomes somewhat blurred (1)

Credit risks

- No brainer in theory, like any other risk
- Prevailing idea that the banks or the markets “do not get it” or that the risks should be “huge”
 - True if we do nothing in the (very) long run
 - Probably much less so considering (1) the typical duration of a banking credit portfolio and (2) the gradual impact of the transition (no like a “shock”)
- I would focus more on project finance and mortgages, not on short term credits

Financial stability & stress testing

- How to deal with regulatory risks ?
 - See ECB disorderly scenario with ETS price equivalent to 450 USD per barrel of oil → Now, is it realistic to believe authorities would impose such price without compensatory measures ?
- Stop assuming static balance sheet until 2050 : In the US, most firms would disappear anyway (less so in the EU)

Stranded assets

- Overall estimate of around 1-2 trillion USD worth of assets that could be stranded by 2050 (~1% of global GDP) – but this highly depends on how well transition is managed. Moreover, the net present value of long-lived assets is relatively low ($1,05^{30} = 4,3$, assuming a discount rate of 5%)

When the concept of risks becomes somewhat blurred (2)

Green bubbles ?

- No, but green investments are risky and have not done well recently
- Significant overcapacity in China
- Losses or issues with wind industry in Europe, green H2 costs, investments in recycling
- Reducing transition risks to some sort of carbon intensity metrics is unlikely to work

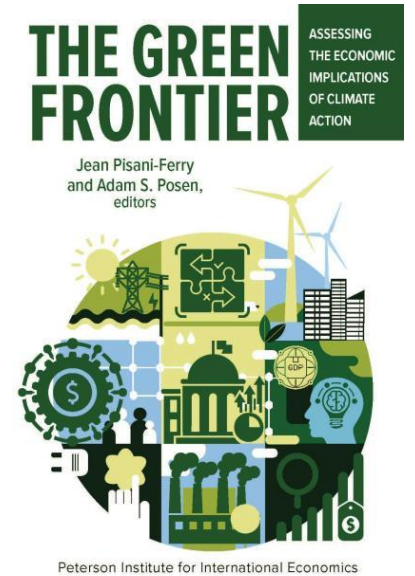
“Knightian” uncertainty justifying additional buffers ?

- Uncertainty is indeed significant but, again, not a “shock”. We should have some time to learn about risks
- Physical risks will increase over time → Actually an opportunity for insurers (protection gap issue) ?
- Transition risks : we do not start from nothing. The war in Ukraine is a good proxy for an carbon price increase; much more sudden than regulation is likely to be
- Credit risk analysis is a data intensive and heavily regulated business, with well defined metrics and back testing of models. I would not replace it with guts feelings without a fight.

- We need to remain disciplined when discussing risks : policy issues vs. credit risks stricto sensu (e.g. collateral framework)
- I do not buy the argument that risks are so significant and uncertain that financial regulators have a mandate to impose additional buffers BUT the pressure is real (see also the role of monetary policy)

Role of central banks

- The no brainer: study the impact of climate change on the macroeconomy
 - For decarbonization: need to get one's hands dirty by looking at technologies beyond single agent models or production functions
- The conceptually clear but maybe overblown: understand the impact on credit risks
 - See previous slides
- The controversial: act on relative prices
 - Tilting of monetary policy portfolio; green supporting factors in capital regulation; collateral framework
 - Here, the Atlantic divide is HUGE, which is a first indication that the issue has a political dimension



What falls under ECB's remit? Article 3

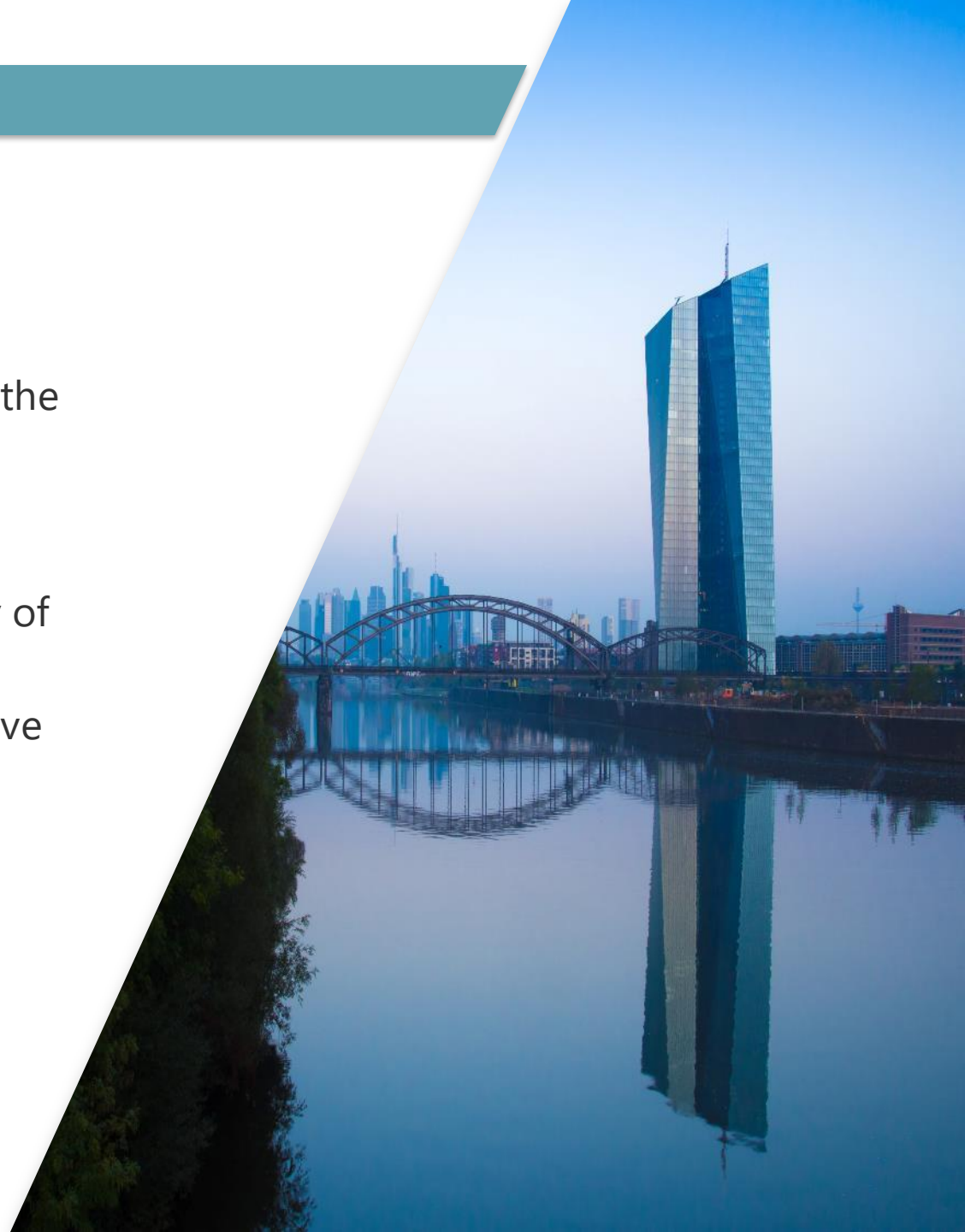
ECB mandate is anchored in the EU Treaty:

- price stability is the primary objective
- without prejudice to that objective, support the general economic policies in the EU with reference to Article 3 of the Treaty

Article 3 lists many objectives:

- a high level of protection and improvement of the quality of the environment ...
- ... but also balanced economic growth, a highly competitive social market economy, full employment, social progress, scientific and technologic advance, social exclusion and discrimination, equality of women and men, ...

➡ Risk of cherry picking : "Animal Farm" reading of the Treaty ("All animals are equal but some are more equal than others")



My take on it

“Supporting” is not well defined and the constraint is not binding

- As soon as one recognises that fighting climate change implies trade-offs, there is a very fine line between supporting policy and making policy
- The “without prejudice” constraint is not a binding : one can give a 100bp subsidy for green credit without jeopardising our primary mandate (one only needs to hike the policy rate to compensate)
- At the end of the day, the question is whether central banks have an instrument that is not available to policy makers and that is part of the first or second best solution
- Textbooks: generally no role for central banks in allocative efficiency

Supporting policy : for EU industry, the Emissions Trading System (EU ETS) is close to a first best solution

- Discrimination between firms that fall under the EU ETS (tilting against some of them) is against the objective of an efficient allocation of the effort → flirting with autonomous policy making
- Discrimination against firms that operate in jurisdictions that are not « Paris compatible » (or less ambitious than the EU) may be closer to supporting EU policy → Depends on the efficiency of the Carbon Border Adjustment Mechanism (CBAM), and on whether firms operate in sectors covered by CBAM
- But this points to the issue of “extra-territoriality” : should one, e.g. EU Multinational firms or banks, follow EU emission targets (net zero) or a weighted average of targets in jurisdictions in which they operate (see scope 3 issue)?

Thank you for your attention

Pierre Wunsch | 5 June 2023

