Asian central banks are ahead of the green curve

Asia should maintain momentum in promoting green finance, and developing and enforcing green macro-prudential policies regionally and globally.

BY RAMKISHEN S RAJAN AND BHAYATA GUPTA

While 2020 will no doubt be remembered for the global outbreak of Covid-19, it was also among the hottest years on record and witnessed unprecedented extreme climate events such as droughts, wildfires, hurricanes and floods worldwide.

Beyond the humanitarian consequences of these disasters, the steadily increasing frequency of extreme climate events poses “green swan” or tail risks to the stability of entire financial systems. Despite this, actions to minimise these risks have, until recently, been rather limited.

Driven in large part by the intellectual leadership of former Bank of England governor and current United Nations Special Envoy for Climate Action and Finance Mark Carney, central banks have increasingly taken cognisance of climate change-related financial stability risks (CFSRs) in light of their role as key regulatory institutions entrusted with preserving financial stability.

GREENING OF PRUDENTIAL REGULATIONS

There are multiple manifestations of CFSRs, including physical risk and transition risk. The former refers to the costs of economic and financial assets destroyed or devalued after extreme climate change events. While droughts or wildfires occurring due to climate change pose immense losses to businesses, adversely impacting their balance sheets and sending insurance claims soaring. They also inflict a secular setback on household consumption and investment with implications for macro and financial stability.

The latter refers to the costs imposed on the financial system as societies decarbonise and the differential impact this has on different categories of assets and the credit strength of companies. While monetary policy could be used to alleviate shocks emanating from physical risks, prudential policies are better placed to address transition risks, since they have the ability to influence the availability and type of finance and can direct investment towards carbon-intensive sectors.

Making the transition from a high to low-carbon economy requires massive investments in renewable energy assets and the consequent need for green financing.

The goal of green prudential policies is to incentivise investors to invest in green assets also known as green finance – and penalise them for investing in fossil fuels and allied assets.

From a systemic viewpoint, macro-prudential policies also serve to augment the capacity of the overall financial system to withstand secular shocks, including those emanating from climate change.

This requires a recalibration (and perhaps expansion) of counter-cyclical capital buffers, along with stress testing of the resilience of the financial system to endure secular shocks, including those emanating from climate change.

WHERE DOES ASIA STAND?

Asia is responsible for about half of global greenhouse-gas emissions, and many regional countries are among the most vulnerable to the impacts of weather-related loss events such as heat waves, storms, and floods.

Currently, 10 Asian economies are members of the NGFS, six of which are from South-east Asia. A handful of Asian economies have made important strides in promoting green finance in the last few years.

Aiming to become the leading centre for green finance in Asia, Singapore launched its Green Finance Action Plan in 2019. This plan is built around increasing the resilience of financial systems to risks associated with climate change, encouraging the availability of green finance by financial institutions, as well as a commitment towards developing a common taxonomy of green activities and assets. Singapore’s financial sector can play a big part in helping the Republic achieve its Green Plan 2020 target.

China was among the first countries to have developed macro-prudential policies to promote green finance, including risk assessment of high-carbon and green loans based on their portfolio of lending to green and brown sectors, attribution of differential weights to these categories to encourage green lending, mandatory disclosure requirements, and creation of green private-equity funds. Bangladesh holds the distinction of being one of the earliest adopters of green finance in Asia back in 2011. It is also one of the few countries with mandatory green finance regulations applicable to both the banking and non-banking financial sector. Some of its policy tools include requirement from commercial banks to assess and monitor environmental risks in their risk management models, lower equity margin requirements for relatively green projects, lending a particular portion of their corpus to green activities, as well as making the physical banking infrastructure more environmentally sustainable.

The Reserve Bank of India has mandated commercial banks to extend priority sector lending to renewable energy and environmentally sustainable projects and has proposed setting up a “green bank” to specifically fund green energy and infrastructure projects.

Malaysia is one of the few Asian economies to begin developing a national taxonomy of green activities to facilitate transparency among investors and financial institutions.

Green financing has also gained traction through the extension of green loans and green bonds under the Islamic banking system.

MOVING FORWARD

While Covid-19 remains an ongoing challenge, the climate crisis poses the greatest existential threat of our time. International coordination and cooperation are of paramount importance, as both global finance and climate change transcend national borders.

Asia currently appears to be ahead of the curve in terms of promoting green finance and in the development and enforcement of green macro-prudential policies, although their effectiveness and impact on financial stability remains to be seen. Asian central banks should maintain this momentum while stepping up engagement regionally as well as globally.

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