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# 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 BHAVYA 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 pose "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 (CRFRs) in light of their role as regulatory institutions entrusted with preserving financial stability.

Aiming to become the leading centre for green finance in Asia, Singapore launched its Green Finance Action Plan in 2019, built around increasing the resilience of financial systems to climate change associated risks and a commitment towards developing a common taxonomy of green activities and assets. BT FILE PHOTO

## GREENING OF PRUDENTIAL REGULATIONS

There are multiple manifestations of CRFRs, 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.

For example, 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 particular sectors.

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

The goal of greening 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 climate-related shocks.

## WHAT ELSE CAN CENTRAL BANKS DO?

Central banks' role in mitigating CRFRs ought not to be just reactive – in that they try to minimise the physical and transition risks to the financial system – but also preventive in terms of pre-empting the impending climate change reality and nudging financial entities to shift their focus away from carbon-intensive assets to carbon-less ones.

Several central banks have intervened directly in the markets to encourage green finance by purchasing green bonds (common in the US, Europe, and Asia) and promoting green loans (common in Asia), though more clarity is needed on what classifies as green activities. This is one area where central banks can work collectively to develop a common set of standards and taxonomy providing information about the environmental risks posed by different assets.

The Networking for Greening the Financial System (NGFS) was formed in 2017 by the Banque de France to coordinate policy research and findings on the impact of climate change on financial stability and propose solutions to accelerate green finance.

Beginning with a handful of central banks, its membership has today spiralled to include over 83 member countries and 13 observer international organisations. The US became its most recent member in December 2020, bolstering the legitimacy and capacity of this voluntary body of central bankers.

Despite the greening of central banks, it should be noted that there is an ongoing debate, especially in Europe, on the normative question of how much and in what capacity central banks should intervene to combat climate change in the first place.

The argument against their intervention stems from a concern about "mission creep" in central banks' objectives as they step beyond their mandates to assume less neutral and more defined, nuanced roles on contentious topics, particularly with regard to the greening of monetary policy as suggested initially by European Central Bank (ECB) president Christine Lagarde.

## 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 2030 target.

China was among the first countries to have developed macro-prudential policies to promote green finance, including risk assessment of individual banks and 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 a 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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Views expressed are personal.