

Central Bank Mandates, Sustainability Objectives and the Promotion of Green Finance

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NGFS-Bundesbank-CEP Conference on Scaling up Green Finance:
The Role of Central Banks
Deutsche Bundesbank, Berlin, 8-9 November 2018

Deutsches Institut für
Entwicklungspolitik

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Overview

- Why should central banks (CBs) care about climate change and other environmental challenges?
- The limits to an environmental role of CBs
- What do CB mandates tell us?
- Conclusions

**Why should CBs care about
climate change and other
environmental challenges?**

Distinction between...

- 1) CBs' responses to environmental externalities affecting their traditional core responsibility of safeguarding macroeconomic and financial stability
 - CBs may need to incorporate environmental factors into existing frameworks, for instance into macro-prudential frameworks, without pursuing a “sustainability agenda”
- 2) Activist role of CBs in “greening” the economy
 - Some CBs may be mandated to actively use the tools at their disposal to promote green investment or discourage brown investment and play a “developmental role”

The financial & macroeconomic risk argument

- Climate change may have direct consequences for price stability
 - Potential impact on food and energy prices or employment in crucial sectors (agriculture, natural resources)
 - McKibbin et al. (2017): different climate policy regimes – e.g., carbon taxes, permit trading systems – could affect different monetary policy regimes
- Climate and environmental risk constitute a significant systemic risk for the financial sector
 - Transitional risk
 - Physical risk
 - Liability risk
 - CBs need to consider ESG risks when managing their own portfolios

Correcting market failures

- Correcting credit market failures
 - The provision of credit to socially undesirable activities – such as carbon intensive businesses – can be characterised as a credit market failure
 - Green financial regulation as an application of the theory of the second best
- Developing missing markets
 - E.g., green bond markets
 - Reserve management according to SRI principles could help market development

CBs as credible and powerful actors

- CBs are usually among the most powerful public institutions
 - Have high convening power in financial markets
 - “Leading by example”
- Historically, the CBs of most countries have played a crucial role in economic development by supporting financial market development or targeted sectors in industry
- “Activist” role of CBs in greening the financial system is controversial

Potential policy tools to impact on investment decisions & the creation and allocation of credit

- Green Micro-prudential Regulation
 - Disclosure Requirements
 - E&S Risk-management Standards
 - Reserve Requirements
- Green Macro-prudential Regulation
 - Climate-related Stress Testing
 - Counter-cyclical Capital Buffers
 - Differentiated Capital Requirements
 - Loan-to-value and Loan-to-income Caps
 - Large Exposure Restrictions
 - Identification of Systemically Important Financial Institutions and Capital Surcharges
- Green QE
- Green Financial Market Development
 - Information Disclosure Requirements
 - Green Bond Guidelines
- Green Credit Allocation
 - Targeted Refinancing Lines
 - Minimum and Maximum Credit Quotas
 - Preferred Interest Rates for Priority Sectors
 - Central Bank Assistance to Development Banks
- Other Supportive Green Central Bank Initiatives
 - Green Finance Guidelines and Frameworks
 - Convening Power

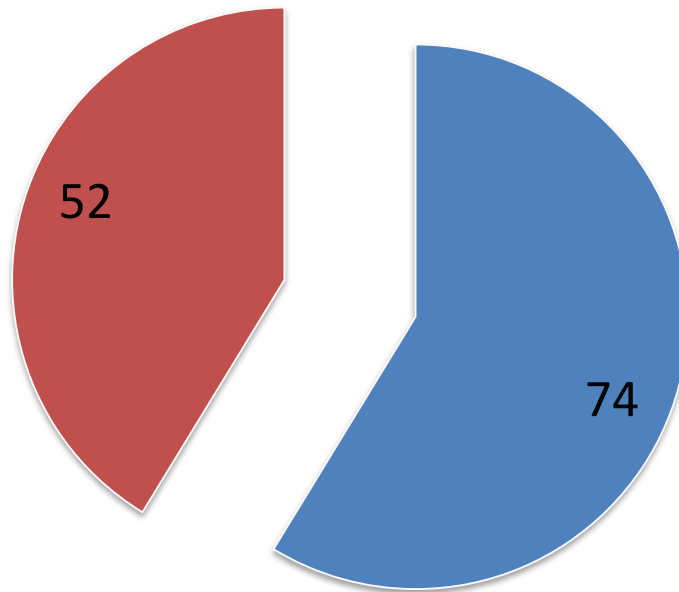
The limits to an environmental role of CBs

- On a functional level, CBs will encounter problems if they are supposed to achieve too many objectives and have too few tools / policy instruments
 - Tinbergen rule
 - Conflicts with other objectives?
 - CBs need to be equipped with effective instruments in order to achieve sustainability goals without compromising other goals
- Danger of vesting too much power in unaccountable institutions
- CBs becoming politicised
 - “Neutrality” of central banking may be at risk
- Overstretching mandates

What do CB mandates tell us?

- To what extent do CB mandates currently include objectives that task them to enhance sustainability and mainstream green finance?
- To this end, Dikau & Volz (2018) examine the IMF Central Bank Legislation Database
 - Covers mandates of 123 CBs and 3 monetary unions
- We identified mandates assigning CBs an objective to either
 - 1) enhance, promote or support “sustainability” or “sustainable development/growth”, or
 - 2) support the government’s economic objectives or policy goals
 - CBs with this second objective are included because governments’ economic policy goals may comprise sustainability
- CBs with an objective to promote “sustained” growth or development are not considered to have a sustainability-enhancing mandate

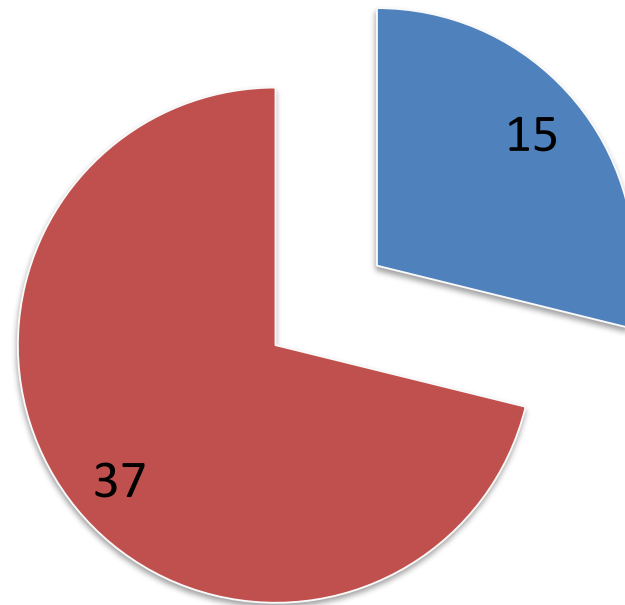
Number of CBs with and without “sustainability” mandates



- No direct or indirect "sustainability" mandates
- Direct or indirect "sustainability" mandates

Number of CBs with explicit and potential “sustainability” objectives

“Sustainability” objective is in almost all cases subject to not impeding the CB’s ability to pursue the primary objective, which usually is price stability



Czech Republic, Fiji, Gambia, Georgia, Hungary, Iraq, Malaysia, Nepal, Philippines, Russian Federation, South Africa, Tanzania, Ukraine, Zimbabwe & West African Monetary Union (WAMU)*

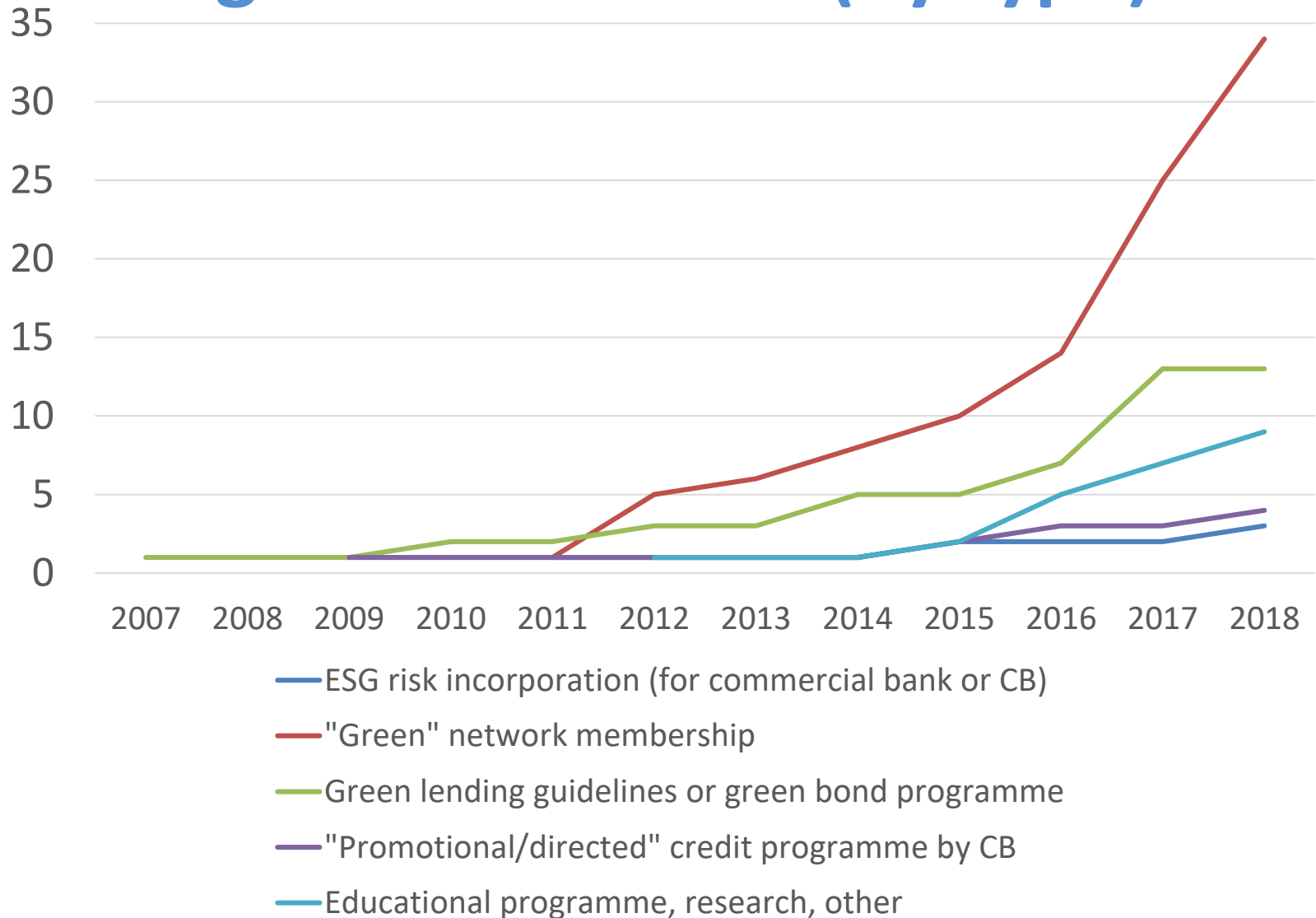
- Explicit "sustainability" mandate
- Support for government policy objectives

* In 2014, the Netherlands updated its CB’s mandate to include “sustainable prosperity” – this is not yet covered in the IMF Central Bank Legislation Database 14

- 12% of the investigated CBs have explicit sustainability mandates and 29% are mandated to support their government's policy priorities and hence potentially sustainability
- 59% have no direct or indirect mandate covering the CB's engagement with climate change related topics
 - At least 18 of these CBs have started to address climate change-related risks and sustainability challenges

- Most “green” CB activities are aimed at incorporating climate change-related risks into the financial system, as well as at mainstreaming and pricing-in more general ESG risks into the activities of financial institutions by providing them with tools, knowledge and adequate green guidelines
- Most of these policies aim at enhancing the efficiency of policy implementation frameworks for achieving CBs’ core objectives (mostly price or financial stability)

Number of CBs that have adopted “green” activities (by type)



Example: European System of Central Banks

- Article 127 (1) of the Treaty on the Functioning of the European Union clearly defines price stability as the primary objective of the ESCB
- It also states that “[w]ithout prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union.”
- Article 3 (3) of the Treaty on European Union includes the objective of “sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and *improvement of the quality of the environment*”
- This means that the ESCB’s mandate includes, inter alia and without prejudice to the objective of price stability, supporting the European Union’s environmental objectives
- This opens up the question to what extent the political authorities and the public at large want the ESCB to play an active role in supporting environmental objectives
 - In December 2017, the European Parliament passed a resolution calling on all public and private institutions to divest from fossil fuels
- As the current discussions in the Eurozone show, it is not solely up to the CB to interpret its mandate – ultimately, CB policies need to be based on public and political support

Conclusions

- To the extent that CBs are responsible for financial and macroprudential stability, incorporating ESG risk considerations into existing monetary and macroprudential frameworks is already part of existing core mandates
- Whether CBs should also play a promotional role to support green investment is fundamentally a political question that requires careful consideration
 - Limits to environmental role need to be taken seriously

- A growing number of CBs has started to incorporate ESG risks into their operations even in the absence of explicit sustainability mandates in order to be able to efficiently achieve their core price and financial stability objectives
- CB activities depend in practice not only on the formal mandate but also its interpretation, which can be ambiguous

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