Rebuilding the Global Economy

A series outlining policy priorities and solutions

MEMORANDUM ON

BUILDING A FINANCIAL SYSTEM TO SUPPORT THE TRANSITION TO NET ZERO FOR THE FINANCIAL STABILITY BOARD (FSB)

To: Chair of the Financial Stability Board
From: Mark Carney, UN Special Envoy for Climate Action and Finance
December 2020

The Financial Stability Board (FSB) has been a paragon for international cooperation to solve issues that transcend national borders. Established in 2009, it develops regulatory, supervisory, and other financial sector policies that promote stability in the global financial system. With its clear mission and strong political backing, diverse membership, deep expertise, and consensus-based approach to policy reform, the FSB has been able to agree to a wide range of reforms needed to increase the resilience of the global financial sector. Its efforts helped ensure that the financial system was able to support the world's economies during the current health and economic crises.

But FSB members know that they can never rest on their laurels. Complacency is the enemy of financial stability. There are new vulnerabilities—in market-based finance, in cyber and operational risks—and there is an existential risk whose very resolution could threaten financial stability if we do not prepare now: climate change.

The catastrophic impacts of climate change will be felt beyond the traditional horizons of most banks, investors, and financial policymakers, imposing costs on future generations that the current one has no incentive to fix. Once climate change becomes a clear and present danger, it could be too late to stabilize, as global temperature rises.

The FSB was an early mover in recognizing the risks of climate change for the financial sector. In 2015, in response to a call from G20 leaders, it established the Task Force for Climate-related Disclosures (TCFD) to develop recommendations for voluntary disclosures of material, decision-useful, climate-related financial risks. Today, the TCFD is the gold standard for such reporting and the basis for newly announced mandatory reporting regimes around the world, including in the United Kingdom, the European Union, and New Zealand.

In November, the FSB's report on the *Implications of Climate Change for Financial Stability* provided an important contribution in furthering the discourse on climate-related financial risks. Indeed, this work highlights the considerable variation in how financial institutions and their supervising authorities are addressing climate-related risks and the need for more urgent action.

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With the climate ambition of countries around the world dramatically increasing, climate transition risk is moving from concept to reality. The FSB should use the run-up to COP26 next year to focus on delivering globally consistent standards for climate-related reporting, building climate risk management capabilities in the financial sector, and developing consensus on forward-looking metrics for net zero transition in the financial sector. These building blocks will minimize transition risks, build resilience, and promote financial stability as the world tackles this fundamental challenge.

PRIORITY 1: Create consensus around and embed a globally consistent framework for climate-related reporting

Following on from the success of the TCFD, the FSB is well placed to support further integration of its recommendations into more established disclosure frameworks. The time has come to move from voluntary, market-led disclosure to establishing pathways to mandatory climate disclosure for the largest companies in the largest jurisdictions.

The FSB can help ensure that there is no divergence between competing standards and that the international community can agree on minimum baseline standards, which can be adapted for local jurisdictions. This coordination is especially important, as it will help make any disclosures decision-useful and comparable for users of the information and efficient for companies who disclose the information.

The International Financial Reporting Standards (IFRS) Foundation is a mechanism by which to achieve this. Its role in overseeing the International Accounting Standards Board (IASB) and accountancy standards, as well as the depth of its existing standards in over 140 countries, ensures that it is well placed to take the TCFD recommendations forward in a manner that can achieve global consensus.

ACTIONABLE TO-DO LIST:

The FSB should consider:

- Endorsing the IFRS Foundation's proposal to establish climate-related disclosure standards through a new Sustainability Standards Board under the Foundation's remit, via the FSB's upcoming public statement on the TCFD.
- Publishing a statement to encourage jurisdictions to use the TCFD as the basis for setting domestic requirements on climate disclosure.
- Publishing a report for the G20 based on the Italian Presidency's request for the FSB to work with other financial sector bodies to "explore ways to promote globally comparable, high-quality, and auditable standards of disclosure in sustainability reporting based on the TCFD recommendations, as well as a better alignment of the climate-related financial disclosure frameworks at the global level, so as to enhance coordination of relevant regulatory and supervisory approaches."

PRIORITY 2: Improve climate risk measurement and management

The effects of climate change are already being felt through two channels: physical risks and transition risks.

Physical risks arise from damage to property, land, and infrastructure from catastrophic weather–related events such as heat waves, hurricanes, floods, and rising sea level. Over the last three decades, the number of extreme weather events tripled. Inflation-adjusted

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insurance losses increased fivefold. Uninsured losses from extreme weather increased seven-fold over the same period.

These physical risks can affect the banking sector as well. For example, extreme weather events can cause significant losses for homeowners, reducing their ability to repay their loans and damaging the value of their property. The average annual loss on residential mortgages in the United Kingdom from flood risk is expected to more than double by 2050 in a 4°C world. Smaller lenders with geographic concentrations would be more at risk.

Transition risks arise from changes in climate policy, technology, and market sentiment as the world adjusts to a net-zero economy. These risks will affect every sector. Depending on the speed and predictability of the adjustment, banks may find themselves with large, unexpected losses through credit exposures to companies that are not viable in a net-zero economy, leading to stranded assets, reduced earnings, and business disruption. More than 100 oil and gas companies in North America filed for bankruptcy this year. And the world's largest listed oil companies collectively wiped out almost $90 billion from the value of their oil and gas assets in the last nine months.

Managing climate-related financial risks requires that disclosure go beyond the static (a company's carbon footprint today) to the strategic (their plans to manage down their emissions). Risk management means assessing such forward-looking disclosures to judge the resilience of firms' strategies to the transition.

The financial stability risks from climate change are still not being adequately identified, addressed, or priced. This leaves the financial system vulnerable to climate change and the necessary transition of the global economy to net zero. The scale and threat of the challenge here calls for an ambitious program of work, with the FSB well placed to galvanize action among international and national authorities.

ACTIONABLE TO-DO LIST:

The FSB should consider:

- Integrating climate risks into its guidance and frameworks. Publishing guidance on addressing climate risks for financial institutions would help meet the urgent need to raise expectations globally for risk assessment and encourage the necessary investment in the financial system's collective capability.
- Identifying new areas, tools, and frameworks to embed climate considerations in the global financial system.
- Catalyzing agreement among G20 regulators to set expectations on firms' climate risk management and stress test their systems against different climate outcomes set out in the reference scenarios published by the Network for Greening the Financial System (NGFS), a group of nearly 80 central banks and supervisors committed to addressing these risks.
- Joining other international standard setters as an observer on the NGFS.
- Endorsing the use of the NGFS scenarios as a way for companies and financial institutions across the economy to assess their resilience.

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PRIORITY 3: Develop the metrics for the financial sector to disclose its alignment with net zero

The financial community needs to measure and disclose how its activity is aligned to net zero. Banks will need to disclose how their lending aligns with net-zero goals. And investors should be disclosing how closely their portfolios are aligned with the transition to net zero.

In recent months, some of the world's largest global banks committed to net zero by 2050 on a *scope three* basis, which means bringing all their financed emissions in line with net zero. They now need to work out a robust measurement framework and disclose the results.

Some of the world's largest and most influential investors are making this commitment. The members of the Net Zero Asset Owner Alliance, with over $5 trillion in assets under management, have committed to manage down their carbon footprints by up to 29%, preferably on a scope three basis (including direct and all indirect emissions), by 2025 and to be at net zero by 2050. This metrics-based approach will likely become increasingly common. The recently launched Net Zero Asset Managers Initiative, representing $9 trillion in assets under management, also committed to working with clients to achieve target-based net-zero goals by 2050. And Climate Action 100+—a group of over 500 institutional investors controlling almost $50 trillion of assets—recently demanded that the world's 161 highest-emitting companies (representing 80% of industrial emissions) publish strategies to reach net zero by 2050.

Investors will need to agree how best to demonstrate how clients' investments are aligned to climate targets. One of the most important tasks over the next 12 months will be to determine the best approaches for managing transition risks and opportunities. Any measure of alignment to net zero needs to be:

- forward looking, giving appropriate credit to efforts by companies to decarbonize
- anchored in real-world climate targets
- dynamic, to show progress over time and accommodate new technologies.

These criteria encourage engagement with companies across the economy that are seeking to decarbonize. Existing climate-related metrics serve useful roles, but they are not best suited to measuring a whole-economy transition. Carbon footprints and CO_2 emissions per dollar invested are not forward looking. Environmental, social, and corporate governance (ESG) metrics are inconsistent and poorly correlated, and their "E" is not benchmarked to net zero. And taxonomies, while useful for measuring the percentage of assets invested in certain activities, capture only a small proportion of business activity, cannot chart progress through the 50 shades of green, and are not yet dynamic enough to account for new technology developments.

There are, however, ways to measure alignment, including:

- the percentage of assets that are net zero–aligned ("Paris aligned")
- transition progress versus scientifically determined transition pathways by sector
- calculations of a "degree warming metric" to assess the quality of transition plans relative to the Paris goals in a given portfolio.

The challenge for the industry is to work on a framework that will help it measure alignment and to disclose this information to people whose money they manage.

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ACTIONABLE TO-DO LIST:

The FSB should consider:

- Charging the TCFD with including forward-looking metrics for investors and banks in their recommendations framework.
- Taking stock of the landscape of how banks and investors are measuring the alignment of their lending and investments and providing guidance on those that are particularly relevant to mitigating risks to financial stability.
- Identifying the data gaps that exist to accurately measure alignment of lending and investment with the transition.

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