

International Network for Sustainable Financial Policy Insights, Research and Exchange (INSPIRE)

First call for Research Proposals

A Comprehensive Call

Priority issues for research on central banks, supervision and greening the financial system

March 2019

Workstream 1 – Microprudential/Supervisory

1. Understanding the effectiveness of disclosure

The aim of this research package is to identify a) market failures and issues which can be addressed through enhanced disclosure and – conversely – b) the limits of disclosure-based financial supervision as a tool for market discipline with regards to climate change and other environmental challenges.

The strengths and limitations of different disclosure approaches – e.g. public vs supervisory disclosure – need to be assessed as well as the suitability of disclosure-based tools to manage different types of risk (e.g. climate risk vs other environmental risks). This is an area with extensive work underway, not least around the TCFD, and the aim would be to match experience with evidence and expectations about the likely impacts of disclosure on market behaviour.

2. Investigating the risk differentials of environmental factors

The aim of this research package is to stimulate further research which clarifies the relationships between environmental factors and the micro-prudential risks for banks, insurance firms and other asset managers/owners. Some insights are becoming available for listed markets such as equities and bonds, but, crucially, not yet for bank loans (apart from early results from China).

The focus here would be on the performance of assets with different environmental characteristics in current conditions – in other words with pervasive market and policy failures and externalities which mean that environmental factors are often not priced effectively. The research would explore how these might change in the future. The aim would be to respond to a simple question that has been so far hard to answer: do “green” properties of assets affect their risk profiles? If so, which properties are material for which asset classes, under which circumstances and to what degree? One way this could be done would be to gather the growing cohort of researchers working on risk differentials to share experience and communicate results to policymakers.

3. Looking beyond prudential regulation

The aim of this research stream will be to look beyond the current focus on prudential regulation in the green finance agenda to analyse the implications of climate change and other environmental challenges for other aspects of financial market regulations and supervision within the mandates of central banks and supervisors. This would build on emerging work undertaken in a number of countries. The research will seek to identify both potential challenges and solutions in the areas such as consumer protection, financial inclusion, financial conduct and market creation.

Workstream 2 – Macrofinancial

4. Modelling systemic climate-related financial risk

The aim of this research stream is to provide analysis on the quality of the models used to estimate systemic climate-related financial risk. What approaches are available? Are they sufficiently considering second round and network effects? How do these incorporate other environmental/social risks? What gaps remain?

Workstream 3 – Scaling up green finance

5. Setting out the implications of climate change for monetary policy

The aim of this research area is to unpack the implications of climate change and other environmental issues for monetary policy. It is clear that climate change will impact monetary policy, but these effects, the channels through which they materialise and over what timeframes, are not yet well-understood.

Questions that need further analysis include what are the links between climate change and inflation, interest rates and the conduct of monetary policy? How can climate factors be integrated into the risk models that underpin monetary policy operations – in particular the asset purchases and collateral frameworks of central banks?

How would a low-carbon, resilient, green economy be affected differently by monetary policy (e.g. through greater capital intensity compared with the current resource intensive model)? In turn, the potential effects of monetary policy responses on the real economy and the channels through which they propagate need to be understood as well.

Crosscutting Issues

6. Building a common language: understanding of the consequences of classification

To effectively allocate capital towards sustainable development, markets need clarity concerning the environmental attributes of financial assets and their underlying activities. Important work is underway to build a common language for specific green assets (eg bonds) and more systematically through the EU's extensive taxonomy process.

The aim of this research would be two-fold. The first goal would be to gather research expertise to explore the opportunities and risks of emerging green finance taxonomies.

What is the appropriate level of analysis and granularity for such taxonomies to be meaningful? To what extent do taxonomies provide effective guidance for investors and regulators? What is the role of policy-led taxonomies in comparison to market-led initiatives in sustainable finance? How do such taxonomies align with the growing momentum to integrate environmental risks into credit risk assessments and equity analysis?

The second goal would be to explore the development of an equivalent 'taxonomy' for activities, industries and sub-industries which cause high levels of environmental damage. At present, the policy and market agenda refers vaguely to 'brown' assets without definition in terms of either environmental attributes or financial performance. Developing such a damage-based approach to exposure could facilitate prudentially-based approaches to climate and other environmental risk-drivers. This could be done by highlighting assets where environmental damage leads to near-term materiality or 'shadow' materiality in terms of unpriced externalities (e.g. transition risk). Such a taxonomy could serve as crucial analytical tool to both manage environmental risk within the financial system as well as aid to channel capital flows into activities conducive to building environmentally sustainable economies.

7. Identifying a package of green finance crisis response measures

The aim of this research would be to identify robust green finance response measures that could be deployed rapidly in the context of market turbulence and future crises. This work comes in the context of the changing macro-context with slowing growth, rising rates and deleveraging which already appears to be impacting markets (such as green bonds).

The research would develop forward-looking options available to central bankers and others to respond to future financial crises in ways that are consistent with the strategic goal of greening the financial system. It would also explore how the toolkit of crisis management measures could be analysed with regard to their potential impacts on climate change. Importantly, the research would identify examples where response and stimulus measures may have had negative environmental impacts to help avoid 'unintended consequences' in terms of stimulus measures which entrench current unsustainable financing practices.

Details of projects awarded from INSPIRE's first and second calls for research can be found at <https://www.climateworks.org/report/building-the-analytical-foundations-for-greening-the-financial-system/>