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Central Banks and Supervisors Network for Greening the Financial System

From: NGFS Secretariat
To: UNFCCC SCF

Achieving ways to achieve Article 2, paragraph 1(c), of the Paris Agreement, including options for approaches and guidelines for implementation

Submission to UNFCCC SCF consultation (FCCC/PA/CMA/2022/L.9, para. 4)

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The UNFCCC Standing Committee on Finance has been requested at COP28 (14/CMA.4, paragraph 68) to work on enhancing the understanding of the scope of Article 2, paragraph 1(c), of the Paris Agreement. To this end, it has initiated a dialogue with relevant organisations and stakeholders on:

- *ways to achieve Article 2, paragraph 1(c), of the Paris Agreement;*
- *options for approaches and guidelines for implementation.*

This submission has been prepared by the NGFS Secretariat with a view of providing insights into the on-going work in the central banking and financial supervisory community that is relevant for progressing toward "making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development."

1. Paris Agreement Art. 2.1(c)

At COP21 (Paris, 2021), UNFCCC parties set out three objectives in the Paris Agreement. Parties committed to "[hold] the increase in the global average temperature to well below 2 °C […] and [pursue] efforts to limit the temperature increase to 1.5 °C", to "adapt to the adverse impacts of climate change and foster climate resilience and low greenhouse gas [GHG] emissions development" and to "[make] finance flows consistent with a pathway towards low [GHG] and climate-resilient development."

The latter objective (**finance objective**) is also referred to **"aligning" financial flows with** the two former objectives which are directly related to mitigation of and adaptation to climate change (**climate objectives**).

The **scope** of this alignment can **vary depending on the perspective of the stakeholders**. For example and for the sake of illustration, one can distinguish:

- **Climate and development finance alignment**: some would refer to climate finance and sometimes broader development finance (i.e. public resources committed to a development objective and resources mobilised by the public sector that contribute to a development objective). In this respect, it is understood as "publicly sponsored" financing provided to support the net zero transition of developing economies and their adaptation to climate change;
- **Public finance alignment**: the alignment objective can also address the consistency of public finances with the dual need to transition toward a net zero GHG emission economy and to increase the resiliency of the economy to climate shocks;

- **Broad financial system alignment**: most have understood the call for a stronger alignment well beyond this traditional focus to encompasses private as well as public financial flows and calls not only for increasing finance flows to support low emission technologies and climate resilience, but also for phasing out the financing of investment inconsistent with the climate objectives of the Paris Agreement.

Each of these approaches has merits on its own and should be pursued in order to achieve the climate objectives of the Paris Agreement.

It should be noted that **these various understandings are related** and can be understood as a series of **concentric scopes**, staring from public climate and development finance and the private resources it mobilises to public finance in general and, eventually, to the financial system and all the financial flows it supports.

From the perspective of central banks and financial supervisors, Art. 2.1(c) would, in general, be understood as a **broad objective** to ensure the consistency of financial flows with climate change mitigation and adaptation objectives stemming from the Paris Agreement.

2. Relevance of the Paris Agreement Art. 2.1(c) to the NGFS

The **Network for Greening the Financial System** (NGFS) was set up in **December 2017** by 8 central banks and supervisors.

Following the COP21, official sector and private-led initiatives (e.g. G20 Green Finance Study Group and the FSB Task Force on Climate-Related Financial Disclosures) had raised the **awareness** about climate related financial risks and the need to scale up of green financing. Accordingly, financial institutions were encouraged to conduct environmental risk analysis and to improve environment- and climate-related information disclosure. However, the **actual implementation** of such intuition and intentions proved challenging given the novelty of such work.

In such context, the founding Members of the NGFS initiated a **collaboration** "as a group of […] authorities willing, on a voluntary basis, to exchange experiences, share best practices, contribute to the development of environment and climate risk management in the financial sector, and to mobilise mainstream finance to support the transition toward a sustainable economy."[1]

The Network sought to "**strengthen the global response required to meet the goals of the Paris Agreement**" and to "**enhance the role of the financial system** to manage risks and to mobilise capital for green and low-carbon investments in the broader context of **environmentally sustainable development**."[2]

More than five years later, the NGFS brings together **125 Members and 19 Observers** from **all continents**. They operates in jurisdictions that, together account for almost **90% of global GDP and of GHG emissions** and are collectively responsible for the supervision of **all the global systemically important banks** and **80% of internationally active insurance groups**.[3]

From the onset, the NGFS understood its work as a contribution to Art. 2.1(c) as it explicitly mentioned its ambition to contribute to meeting the goals of the Paris Agreement by ensuring that the financial system would play its role in managing risks and mobilising capital toward an environmentally sustainable development.

[1] Art. 1 of the NGFS Charter (see also 2017 Joint statement by the Founding Members)

[2] Joint statement by the Founding Members of the Central Banks and Supervisors Network for Greening the Financial System

[3] NGFS Annual Report 2022

3. NGFS contribution to the Paris Agreement Art. 2.1(c)

The NGFS formally recognised the **significance of climate related financial risk** in its 2019 comprehensive report[4] and **the need for central banks and supervisors to take climate change and the transition dynamics into account in pursuing their core (monetary and financial stability) mandates**. While emphasizing the diversity of the mandates and circumstances of its Members, the NGFS considers that central banks and supervisors recognising climate related financial risks (more generally, the macroeconomic dimension of climate change and the net zero transition) and accounting for them in their decisions contributes to **advancing the consistency of financial flows with the climate objectives of the Paris Agreement**.

In practise, central banks and supervisors can:

- **Integrate climate-related risks into financial stability monitoring and micro-supervision**. To this end, the NGFS has identifies best practices in the supervision of these risks[5] and developed climate macrofinancial scenarios in order to enable climate stress tests/climate scenario analysis[6];
- **Integrate climate related developments into monetary policy**. This encompasses both taking into consideration climate related developments into monetary decisions[7] as well as adjusting monetary policy operations to climate related risks[8]; more generally,
- **Integrate climate related consideration into the management of their non-monetary policy portfolios**. Albeit sometimes framed in a specific legal and/or operational context, this approach would be broadly similar to the approach of a (private sector) institutional investor.

In 2021, at COP26, the NGFS and its Members took a further commitment to advance this agenda and develop their own climate action accordingly while contributing to the (quantitative and qualitative) strengthening of the wider momentum in the financial sector.[9]

Recognising and accounting for climate related financial risks in their strategy as well as their day-to-day financial operations and dealings with the financial sector, central banks and supervisors are **directly and indirectly fostering a capital allocation which is more favourable to the transition toward net zero and climate resilient economies**. When climate risks are identified, assessed and recognised, the real value of "climate friendly" financial flows is better recognised while a clearer evaluation of the detrimental implications of "climate inconsistent" financial flows leads to a curtailing of the funding of the associated activities. As such, progress (including both regulatory initiatives and enhanced practicises) toward an effective micro and macroprudential supervision of climate related risks is contributing to the achievement of Art. 2.1(c) of the Paris Agreement.

More generally, accounting for climate change in the pursuit their core mandates (monetary policy contributing to macroeconomic stability, financial stability) is **facilitating the net zero transition to the extent macrofinancial stability is a precondition to efficient long term investment decisions** by firms and financial institutions of the sort required by the transition.

The involvement of central banks in **financial markets** and their interactions with the **financial system** also enable central banks to contribute to **promoting sustainable finance** more broadly (including the

[4] A call for action: Climate change as a source of financial risk
[5] NGFS Guide for supervisors: Integrating climate-related and environmental risks into prudential supervision (May 2020), see also the Progress report on the NGFS Guide for supervisors (October 2021).
[6] 3rd vintage of the NGFS Scenarios (September 2022), see also NGFS Guide to climate scenario analysis for central banks and supervisors (June 2020).
[7] Climate Change and Monetary Policy Initial takeaways (June 2020).
[8] Adapting central bank operations to a hotter world: Reviewing some options (March 2021).
[9] NGFS Glasgow Declaration: Committed to action (November 2021).

development of dedicated financial instruments or transactions, thereby also **supporting the momentum of proactive financial institutions**.

Finally, recognising the importance of **cross border capital flows** to finance the transition of a number of economies, especially among emerging markets and developing economies, the NGFS is also currently seeking to **foster a more effective mobilisation** of private capital through a more efficient use of public resources through a **scaling up of blended finance**.

While the NGFS promotes climate action by central banks and supervisors, supports the development and implementation of sustainable finance strategy and encourages climate action by financial institutions, it is also **adamant that these actions are a complement to climate policies** rather than a substitute to such policies. In particular, if a climate conscious private financial sector can facilitate, accelerate and even, under certain circumstances, catalyse the transition, it can **neither substitute for firms and households** in their investment and consumption decisions **nor compensate for gaps in climate policies** that fail to amend the economics of transition decisions relative to current trends that still implicitly if not explicitly favour GHG emissions.

4. Assessing progress toward achieving Art. 2.1(c) of the Paris Agreement

In light of the above and in addition to actions contributing to an increase in actual financial flows toward transition investments, progress toward achieving Art. 2.1(c) of the Paris Agreement entails setting up the appropriate **financial regulatory framework** and implementing effective **practices** which would enable a **scaling up of climate finance** accompanied by a **phasing out of "climate inconsistent" financial flows**.

Against this background, any assessment of such progress should combine **quantitative measures** at global, cross border and jurisdiction levels in order to track the scaling up (respectively, phasing out) of finance flows toward the transition and the implementation of the Paris Agreement through the rolling out of ambitious NDCs and the associated private and public assessment (respectively, divestment from assets inconsistent with the climate objectives of the Paris Agreement) and more **qualitative measures/measures seizing progress in the implementation of financial policies and the operationalisation of regulatory framework and practices** conducive of an improvement in the consistency of the capital allocation with the climate objectives of the Paris Agreement.

The NGFS is currently considering these issues in order to better assess **progress toward the "greening of the financial system**."