Submission to the Reserve Bank of New Zealand Te Pūtea Matua

February 2023

CENTRE FOR
Sustainable Finance
TOITŪ TAHUA

"As the financial system is truly global, any efforts to 'modify the engine' require collaboration and leadership across countries, and between the public and private sector. Importantly, these modifications to the financial system require some leaders to take the first steps."

— RBNZ Governor Adrian Orr, Climate Changed address, September 2022

"The biggest activity of the Reserve Bank on Climate Change is our financial stability work – how the banks identify and price risks and work with communities on the way through...[recent events are] a reminder and sense of urgency that climate change is really important to our resilience and stability"

— RBNZ Governor Adrian Orr, 22 February 2023

The following is a response to the Reserve Bank of New Zealand I Te Pūtea Matua (RBNZ) consultation paper titled 'Risk Weights: Omnibus Consultation Paper' published in September 2022.

This is a non-technical submission concerned with the broader issue of risk weights in the context of climate and sustainability-related financial risks, and therefore does not directly respond to the questions in the current consultation paper.

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Introduction

The Centre for Sustainable Finance: Toitū Tahua (the Centre) is an independently governed charitable trust established in 2021 to accelerate progress toward an equitable, inclusive and sustainable financial system. In short, we are working toward a financial system which supports the New Zealand economy to operate within social and planetary boundaries.

Established by major financial institutions, Crown entities and strategic philanthropists, the Centre follows a model pursued successfully in other jurisdictions such as the UK, Canada, Europe, Australia and Singapore.

The Centre seeks to clarify the role of private capital in achieving New Zealand's commitments under the Paris Agreement, which includes "making sure that financial flows support the development of low-carbon and climate-resilient economies". Importantly, we take sustainable finance to include broader considerations of sustainable development, including iwi & Māori access to capital, nature and biodiversity, financial inclusion and equitable access to financial services.

The role of the Reserve Bank is to act as kaitiaki of the financial system, guarding the prudential soundness of New Zealand's entities and the system as a whole. The message from RBNZ is clear: climate change poses a direct challenge to financial stability.

The Centre commends this message, along with the Reserve Bank's ongoing involvement in the Network for Greening the Financial System, and the three pillars of its 2018 climate strategy.

1. Monitoring and managing our impact on climate
2. Understanding and incorporating the impact of climate change on our core functions
3. Providing leadership as an institution

The third strategic pillar, leadership, is the basis of this submission.

The Centre urges RBNZ to continue with its climate change leadership by consulting, engaging and providing further clarity to the financial sector on the matter of climate and sustainability factors, and the influence these have on the risk profile of lending made by the financial sector to support Aotearoa New Zealand's transition to a low carbon economy.

Rationale for Action

The evolution in the understanding of climate risks and financial impacts is rapidly becoming apparent on a global scale.

The unforeseen impact of Cyclone Gabrielle and the Auckland floods have brought into stark focus the physical and transition risks faced by New Zealanders, and businesses, of extreme weather and climate-related events here at home. We note the Reserve Bank's leadership in encouraging banks to understand and model these risks in order to ensure the resilience of the New Zealand financial sector.

The March 2022 IPCC report into climate change adaptation, impacts and vulnerability, made clear that Aotearoa New Zealand, with the rest of the world, has a brief and closing window of opportunity to secure a liveable future through climate change mitigation and adaptation. The IPCC has also reminded us that adaptation without mitigation is an insufficient response.

The latest UNEP Emissions Gap report, released October 2022, highlighted that current commitments put humanity on a 2.4C-2.6C trajectory by the end of the century. UNEP Executive Director Inger Andersen observed, "We had our chance to make incremental changes, but that time is over. Only a root-and-branch transformation of our economies and societies can save us from accelerating climate disaster."

Keeping within 1.5 degrees will require reaching peak emissions in 2025. New Zealand scientists proposed that the required steep emission cuts and adaptive responses will take unprecedented, genuine collaboration between central and local governments, the private sector, indigenous peoples, and all communities.

Leadership

Financing the transition to a resilient low emissions economy is an unprecedented undertaking.

By some estimates, $34 billion of additional investment is needed across key areas of the NZ economy by 2035. On top of these domestic costs, the Treasury estimates that meeting the international commitments under the Paris Agreement through our Nationally Determined Contributions could require up to $12.8 billion in offshore carbon credit purchases by 2030. And as just one signal of adaptation costs, with 60cm of sea level rise, 94,000 buildings worth $26 billion are estimated to be exposed to coastal flooding.

The requirement for funding and investment to support both the adaptation and mitigation response, as well as the cost of transitioning to a low carbon economy, is clear.

Mobilising capital at the requisite pace and scale demands boldness in the face of uncertainty from New Zealand's private and public sector leaders and institutions.

We understand the Reserve Bank's expectations of banks in responding to climate risk and the capital that may be required to mitigate for those risks. We note that banks accredited by the Reserve Bank to use the internal models-based approach to calculate risk-weighted assets, in particular, have a degree of flexibility. Nonetheless, there are practical and timescale challenges that need to be addressed. The development, review and approval of internal models requires significant ongoing commitment on both sides of the equation — from submitting banks and RBNZ.

Despite significant progress in climate disclosures and voluntary Net Zero by 2050 pledges by major financial institutions, the financial sector still faces many challenges in assessing climate- and sustainability-related risks. Using a traditional approach, financial models would require significant amounts of historic performance data and projected impacts to understand the likely forward-looking, long-term, non-linear impacts of climate change. There are many uncertainties around the precise impact of climate change on the financial system and there remain persistent gaps in nationally available sustainability data and national physical risk data.

In consultation with the private sector, there is an opportunity for RBNZ to positively influence the flow of capital into sectors of the economy and projects that will accelerate the transition to a low emissions economy and the required adaptations.

While acknowledging the need for higher risk lending to attract greater capital (such as that which is long dated and linked to fossil fuels industry), lending that can be shown to have a positive impact on New Zealand's climate adaptation or transition (such as solar or wind farm developments) should receive favourable risk weighted asset treatment, reflecting the anticipated long-term favourable risk profile of these investments and the critical role they will play for our country.

There is evolving international discourse around the intersection of climate-related risk and financial system stability. Evidence and expectations will inevitably evolve through the Basel Committee. We submit that New Zealand should be aligned with but not constrained by G20 processes, and waiting for international examples is not a reason to stall leadership, collaboration and progress at home.

The Reserve Bank has undertaken significant work with the banking sector to lift capital levels to globally leading levels, reflecting the fairly unique nature of the New Zealand economy and financial system. This puts New Zealand in a strong position to innovate and lead through continued dialogue and close collaboration between RBNZ and the financial sector.

In summary

RBNZ is uniquely positioned to lead and enable the alignment of the Aotearoa New Zealand economy with a low emissions future.

- The Centre is working toward a financial system which supports the New Zealand economy to operate within social and planetary boundaries.
- The role of the Reserve Bank is to act as kaitiaki of the financial system, guarding the prudential soundness of New Zealand's entities and the system as a whole. RBNZ is uniquely positioned to lead and enable an orderly transition to a low emissions economy.
- The required steep emission cuts and adaptive responses will take unprecedented, genuine collaboration between central and local governments, the private sector, indigenous peoples, and all communities.
- Climate change is causing enormous damage from catastrophic events, which are having a destabilising impact on our economy.
- Banks and insurers have a role to play in managing and mitigating climate-related financial risks, as does prudential regulation, however there are many challenges in assessing climate and sustainability risks.
- Capital requirements and risk weights should reflect climate-related risks. This will require new ways of thinking but is of the utmost importance.
- Further dialogue and consultation is needed to understand, appreciate and address the practical barriers currently preventing the adjustment of internal risk models.
- Climate-related financial risks are a priority, with broader sustainable development considerations such as iwi & Māori access to capital, nature, and biodiversity being core considerations for further consultation.
- New Zealand is in a strong position to innovate and lead on prudential regulation that responds to the unprecedented challenge of funding and financing the transition to net zero by 2050.

Appendix

Desktop scan of related developments from Central Banks:

European Central Bank (ECB): The ECB's targeted longer-term refinancing operations (TLTROs) provide banks with long-term funding at low interest rates. In June 2022, ECB President Christine Lagarde listed among her top four hopes for 2023 the introduction of a green targeted lending facility, though the ECB board has also acknowledged the practical difficulties of implementing such a mechanism due to competing definitions and disclosure standards. In July 2022, the bank's Governing Council decided to consider climate change risks when reviewing haircuts in its risk control framework for collateralised credit operations. The bank's bond-purchase schemes have been 'tilted' away from firms with high carbon emissions, in favour of more climate-friendly companies and industries.

Bank of Canada: In a Bank of Canada pilot, six financial institutions trialled using climate transition scenarios to explore new methodologies to support climate-related financial risk assessments. Pilot results showed the Canadian economy as a whole will undergo significant structural changes as the world transitions to net zero, and that substantial restructuring in many sectors may be required to meet climate targets. The pilot also highlighted the important role for investment in innovation—for example, to scale up renewable energy technologies.

People's Bank of China (PBOC): PBOC uses the dual-pillar framework of "macro-prudential policy + monetary policy" to promote the growth of green finance. Banks are rewarded for their performance on green credit through higher scores. PBOC can accept green loans and bonds as collateral, to grant banks increased access to PBOC's Short-term Standing and Medium-term Lending Facilities.

RBNZ submission to the C2022 Sustainable Finance Progress Report

Monitor systemic climate risks.

a) The RBNZ sets expectations for banks and insurers to assess firm-specific climate and environmental risks through introduction of stress testing which incorporates climate-risk, longer time horizons, and multiple scenarios; encourage developing novel modelling approaches and that RBNZ uses similar approaches to assess its own balance sheet risk.

b) The RBNZ sets expectations for incorporating climate risk assessment into bank and insurer risk management practices and disclosures, following the Government's proposed mandatory climate-risk (TCFD) reporting regime, which will apply to all registered banks and licensed insurers.

Progress

***Update provided by the RBNZ*: RBNZ stress testing**

RBNZ is working to better understand the impacts of climate change on the stability and resilience of the financial system. RBNZ began incorporating climate-related risks into its stress testing of entities in 2021 for both banks and insurers, and in 2022 it undertook a series of sensitivities examining risks to large banks' systemically important loan exposures. Those exercises are informing the RBNZ's climate scenario stress test in 2023, which is currently in development.

2023 will also see RBNZ consult on climate-related risk management guidance for its regulated entities, and a survey to assess the challenges and successes of the industry in understanding, managing, and disclosing climate-related risks as part of increasing engagement on climate change with the sector.

RBNZ also notes that given its role and remit, a more appropriate wording of b) above would be: *The RBNZ sets expectations for incorporating climate-related risk assessment into bank and insurer risk management frameworks, and fully incorporates climate-related risks into its own supervisory framework.*

Reflect long-term risk in capital adequacy requirements.

a) Researchers and the RBNZ investigate the relationship between sustainable lending practices and longer-term risk reduction. If needed, the RBNZ should consider: encouraging industry to build any new evidence into their internal risk models; the issuance of new guidance; and alignment with international capital adequacy recommendations should explicit changes be required.

Progress

Update provided by the RBNZ: RBNZ is monitoring international capital adequacy recommendations. RBNZ is also encouraging entities to incorporate climate-related risks into their internal capital adequacy processes.

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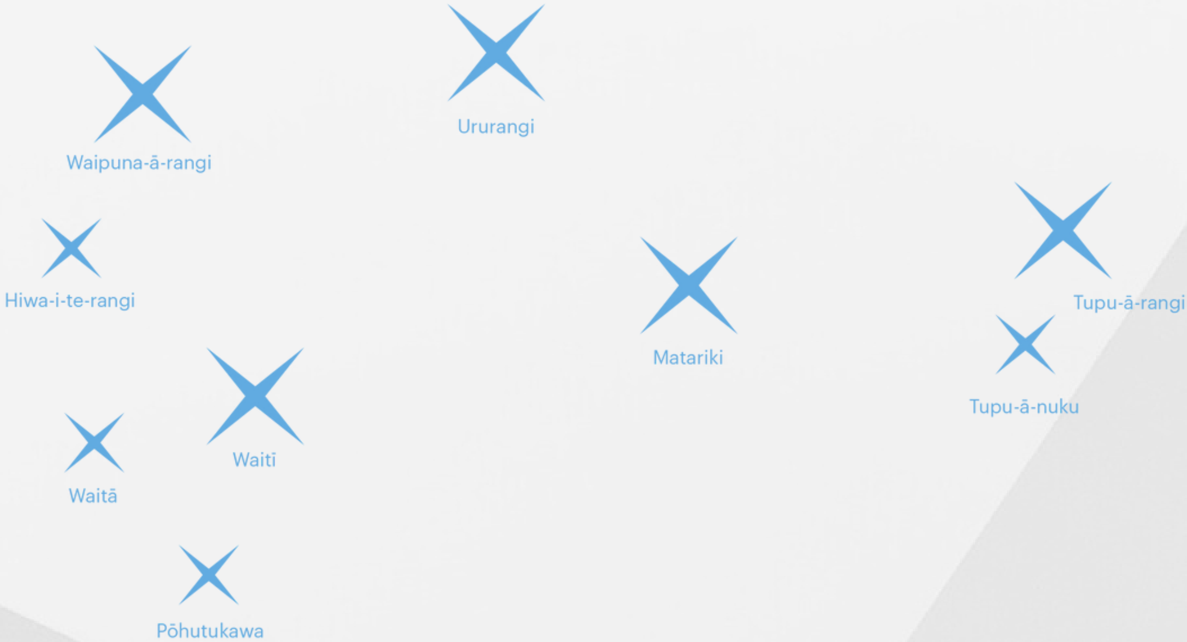

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