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Regulation: Central Banks Should Consider Climate and Biodiversity Shocks When Stress Testing Financial Institutions

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Regulation



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Deputy Governor of the Banque de France, the French central bank, Sylvie Goulard, stated in a [speech](#) on October 24 that central banks need to take more aggressive action regarding nature-related risk. She posited that “monetary assessments of ecosystem services have many limitations,” in part because of their complexity and also because “shocks” in one sector can have significant impacts on other sectors. As a result, she proposed that “the best risk mitigation strategy is to do everything in our power, early enough, to ensure that we remain within planetary boundaries.” She proposed that central banks incorporate climate and biodiversity impacts into their decision-making as an aspect of their “non-monetary portfolios;” integrating nature-related concerns into central banks’ monetary operations, as the European Central Bank has begun to do for climate change, and implement nature-related stress testing exercises that address both climate and biodiversity shocks for banks and financial institutions to improve global financial stability.

Goulard concluded her speech by stating: “The task ahead looks like an uphill battle: academic economic departments, policy makers, central bankers and supervisors remain far behind the curve when it comes to acknowledging that our socioeconomic systems need to operate a radical transformation. We know that those who dare to question the status quo face strong pushback or even reputational risks for their careers. They may be considered ‘activists’ or ‘dreamers.’ However, we have no choice but to restore nature as much as possible, as quickly as possible and finance can play a role in this task. The magnitude of the change required makes it difficult but also promising. No generation on earth for the past 12,000 years had such a responsibility to keep the world alive.”

Taking the Temperature: Just as Blackrock’s CEO has stated that “climate risk is investment risk,” Goulard appears to be saying that nature risk is financial stability risk. What is more, she opines that governments and companies will be hard-pressed to

understand the full range of impacts resulting from climate-related biodiversity change. That, in turn, threatens the stability of global financial systems and the companies that operate within those systems. Financial regulators around the world, including in the U.S., have weighed in on climate-related issues confronting financial institutions, but less so specifically regarding biodiversity. For instance, the Federal Reserve Board recently announced that six of the largest U.S. banks “will participate in a pilot climate scenario analysis exercise designed to enhance the ability of supervisors and firms to measure and manage climate-related financial risks” (and that there would be no “capital or supervisory implications from the pilot”). We expect regulators increasingly to focus on nature-related climate change impacts as another aspect of risk to financial stability resulting from global warming.