Green Horizon Summit

The Pivotal Role of Finance

Christine Lagarde, ECB President

Thank you so much. And good morning, I would like to thank the City of London, the Green Institute for Finance, or the Green Finance Institute, and indeed the World Economic Forum. Mark, I would like to just pay tribute to your leadership to the excellent introduction that you have outlined for us. And I feel like resting my case, because in many ways, I will simply compliment many of the points that you have made in a very modest way from my end. The economic challenges of the climate transition are phenomenal. And often I asked myself, what is the cause? Survival? And I asked myself, who is responsible? All? And then I asked myself, how much does it cost? A lot, but nothing that we cannot afford, because the cause is our survival.

Now, of course, as we all know, a global and accurate price on emissions that would reflect the true underlying climatic and economic externality remains vital to provide the right incentives. But short of that, which I hope will come and not at around two to $5 per tonne, financial markets and institutions can provide powerful and complimentary impetus for change. It is crucial that funds be channelled correctly to underpin and accelerate an orderly transition. Just to give you an idea about the magnitude we're talking about, in the European Union only, an additional 470 billion euros would be needed annually. To that end, the two priorities that I would like to talk about today fall in under the headline of information, which Mark has talked about quite a lot, and innovation. More information is indeed essential for financial market participants to understand the link between underlying economic activity, and its environmental impact. And financial support is indeed vital for the many innovations that are necessary for the transition.

So let's talk about information first. At the moment, information on the sustainability of financial products when available, is at best inconsistent, largely incompatible, and at times unreliable. And that means that climate risks are not adequately priced, posing challenges for financial stability. This is what I would call the pricing gap. We have in Europe, recent stress tests that were carried out carried out by the Dutch National Bank and the ESRB. And they point to marked impairments for banks and other financial institutions should a disorderly transition occur. So we're not quite ready.

Disclosures of climate related information using standardised and commonly agreed definitions, combined with improved data quality can help bridge that pricing gap that I just mentioned. One prominent example is the framework that was developed by the Task Force on climate related financial disclosures that gave birth to the TCFD. Now in addition to the 60 countries mentioned by Mark around 1500 entities have now endorsed TCFD recommendations, representing a combined market capitalization of $12.6 trillion. And the supporting financial firms being responsible for assets of nearly $150 trillion. In the European Union reporting is covered by something that we call the NFRD which is the non financial reporting directive. But believe it or not, climate change information remains optional, in part, because the financial impact is still not well understood. Yet while TCFD and the NFRD are the reference frameworks, there are plenty of other disclosure and reporting frameworks. And we are talking about dozens and dozens of them. And it multiplies requirements and increases reporting costs. So harmonisation efforts are crucial to ensure a proper disclosure of climate related information. Actually, a review of the NFRD at the European level is currently ongoing and the ECB will participate in that. We need a leap forward in reaching common technical reporting standards and increased data availability at a granular level including, as mentioned by Mark, adopting forward looking and dynamic climate indicators. In that regard, I'm really happy that the European taxonomy regulation that entered into force on July the 12th this year, marks an important milestone. More to be done, but it's a good one, because it enables a consistent way to classify green activities. More to be done because it needs to be matched by a widely accepted and applied taxonomy of carbon intensive activities. Such moves would permit both lower reporting costs for firms and greater ability for financial markets to correctly analyse and price risks.

Moreover, it is essential that climate risks are included consistently and transparently into credit ratings if all investors are to incorporate such risks fully into the investment decisions, rating up well, the recent initiatives by credit rating agencies are certainly moving in the right direction, but still far too short of what is required. Making further progress may involve recognising the obstacles they face, including insufficient information on climate exposures of rated entities. In this regard, more and better disclosures would support rating agencies in the effort. The Euro system and the ECB at the centre, by the way, all members of the NGFS, has advocated for mandatory disclosures of climate related risks from a far greater number of companies, including non listed entities. Climate change, and its impact on monetary policy will be reviewed in depth as part of the ECB's ongoing strategy review. And interestingly enough, this exercise will be completed around the time when the new taxonomy regulation comes into effect in January 2022. More about that later.

But achieving a successful transition to a carbon neutral world requires more than just understanding the risks. It involves the wholesale transformation of the economy. Or as Lord Mayor said, we don't need to talk about the green economy, one day, we only talk about the economy. We don't talk about green finance, we talk about finance. Innovation, which is what I want to talk about now, is needed to reduce energy intensity, to boost the effectiveness of renewable energy sources, and to scale up capacity for carbon capture and removal. There is a substantial role for the financial sector to play in fueling and accelerating the development of new firms and new sources of growth. By the way, and this is not incidental, this is critically important, in that way, if we can manage that properly. people employed currently in sunset industries can then transition to new, sustainable jobs. That will become even more apparent and more urgent, as we're going through this pandemic at the moment.

Let me say a few words about the European Union. Because it has been at the forefront of the push for green finance. Europe is already the biggest region of issuance of green bonds, and accounts for 48% of the outstanding volume and nearly half of green bonds today in the world are denominated in Euros. The outstanding amount of green bonds issued by Euro area residents has grown tenfold since 2015. And obviously, the issuance by the European Commission on behalf of Europe, under the recovery and resilience fund will push those numbers up. And green bonds may not be enough by themselves. Funding innovation needs to come from all market segments. Indeed, recent analysis suggests that an economy's carbon footprint shrinks faster when it receives a higher proportion of its funding from equity investors. For those of you interested the ECB just recently published that piece of research. This highlights the potentially supportive role that investment funds with ESG mandates can play. Such funds have grown globally by 70% since 2015, and 57% of them are actually domiciled in the euro area. Yet, and I come to the funding gap here, financing through equity traded on public markets remains relatively uncommon in the Euro area, as does venture capital. The EU needs to close that gap too, and be at the forefront of innovation in green equity financing, which involves fostering deep and liquid capital markets across Europe. Completing the capital markets union to green capital markets union is therefore a vital plank in financing the green transition in the EU.

So let me conclude. Climate change is happening such a truism, but it needs to be repeated over and over. Whether transition to a carbon neutral economy takes place in an orderly fashion, or in a disorderly one. There will be impacts on the financial system. But we should keep in mind that the consequences will be considerably worse if the transition is disorderly. And we should also keep in mind that finance can and must play a key role in fueling and accelerating an orderly transition. Financial institutions need to provide more complete disclosures of their climate exposures. And as a result, demand the same from their counterparties. And financial markets need to play a substantial role in accelerating the development of new firms and new sources of sustainable growth by supporting innovation and financing it. We at the ECB and throughout the Euro system will be active participants and we are on that caravan that you talked about Mark. Thank you.