

The Central Bank of Chile and the introduction of ESG factors in the financial sector decisions

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1. ESG is too ample concept. On Governance (G) of corporations the Central Bank has nothing to say. The social goals of the Central Bank (S) are clearly defined by its legal charter: contribute to the stability of the currency and the normal operation of the financial system as a whole. As for the contribution to sustain the Environment (E) there are a few things to mention, beyond what we would expect from a “good citizen” in the actual operation of the Bank.
2. For the purpose of this panel I will concentrate just in Environmental factors linked to Climate Change and the possible roles of the Central Bank of Chile in this matter.
3. The Central Bank of Chile does not have a role in supervising individual financial institutions, as in other countries. Its legal mandate is limited to oversee the “normal operation of the payments system” something that might be affected by systemic failures in the financial system. In this role we have to work very closely in cooperation with the CMF and SP, the two most important financial supervisors.
4. In order to fulfill the other mandates of the Central Bank (price stability, macroeconomic statistics) we have to include ESG factors, as long as they have an impact in them, and always within the legal mandate of the Bank.
5. In other words, the Central Bank has limited power to promote the introduction of FSG factors in the financial sector decisions. Having said that, I believe we can still play a major role helping to provide relevant information about ESG risks and their economic impact to all actors involved in this process.

6. In assessing the impact of Environmental factors linked to Climate Change, we have to take into account three types of risks:
 - a. Physical risks originated in environmental changes (impact of droughts in farming or electric generation, for instance)
 - b. Transition risks originated in actions (policy or market participants reactions) to mitigate or adapt to environmental changes (Economic impact on power generation if a carbon tax is introduced, for instance)
 - c. Responsibility (Litigation) Risks due to perceived damages to individuals, communities or firms due to actions by companies (financial and non-financial) (pollution damages in specific places, damages due to losses of power or water due to climatic events, for instance)
7. The Central Bank of Chile has little or no mandate/capacity to estimate physical risks. However, as they might have significant impact on economic activities, it has to work in collaboration with other institutions to measure their economic impact. In this respect, there is an important role to “translate and connect” the physical statistics provided by the Ministry of the Environment with the National Accounts system. This is essential if we want government authorities and the private sector to be able to evaluate sectorial and macroeconomic impacts coming from environmental risks and related policy designs.
8. The policy decision-making by the Central Bank relies on the estimation of some key long-term variables (trend output, potential output, neutral interest rates) that might be affected by long-term environmental trends such as climate change, exhaustion of non-renewable natural resources, etc., as long as they could be reflected in the data in the relevant time horizon (10 - 20 years), and the models should be adapted to include these effects.
9. However, the most likely events with macroeconomic impacts within the time-horizon relevant for the Central Bank policy-making decisions are the actions by governments or market participants to mitigate climate change. The introduction of carbon taxes or other regulations, might have direct impact on prices and valuation of assets, affecting potential output, the output gap and short-term inflation. These type of

events are more amenable to be evaluated using standard macroeconomic models, with some adaptations. The existing models can be adapted to include these type of events, as long as we can identify measurable economic impacts, and the information they provide will be useful for our own monetary policy decisions.

10. In terms of the financial stability mandate of the Central Bank, we should work in close collaboration with sectorial supervisors. As they collect information from firms under their supervision, there should be a joint effort to try to identify activities and events that might have an impact beyond individual firms, compromising the health of systemic financial institutions (including financial infrastructures). Once we have that information, these risks could be monitored and eventually, included in specific stress tests, for instance. The bi-annual Financial Stability Report is the institutional channel to inform market participants and regulators about systemic financial risk and should be used to communicate these risks, once we are able to identify and measure them.
11. As you can see, we have a limited mandate on these issues, but given the lack of information about physical and transition risks, and their potential economic impact, there is a lot of work to do, mostly in collaboration with other institutions. The final product of our contribution will not be to produce specific regulation, but to provide useful economic information for policy makers, as well as for firms and consumers.