



**2022**

*Europe - U.S. Symposium on Building  
the Financial System of the 21<sup>st</sup>  
Century*





# **Sustainable Finance: Capital Markets and the Banking System**



## What is the nature of the climate challenge?

- Systemic risk
  - Predictions of catastrophic change to agriculture, habitability, extinctions
  - Could lead to widespread damages - wildfires, hurricanes, flooding
  - Massive stranded assets
  - Delayed response will make both climate change and eventual responses more severe
- Endemic condition
  - Large-scale change, but over the space of decades
  - We've seen large-scale gradual change before - industrial revolution
  - Technological change and investment will respond to changed incentives
  - Financial institutions will act in their own interests



## Approaches to addressing climate change

- Risk mitigation vs industrial policy
  - US focused on financial risk mitigation and “nudges”
  - EU looking to directed lending - green:brown ratios, mandates, etc.
  - Investment  $\neq$  innovation - which are called for?
  - Do governments need to insure transition risk?
- Where does prudential bank regulation fit with overall policies?
  - Challenges of forward-looking scenario analysis
  - Role of carbon markets, regulation, subsidized R&D and infrastructure
  - Is bank regulation a substitute or a complement?
- Widespread agreement on importance of disclosure and data
  - Are measures and metrics up to the task?
  - Challenges: greenwashing, arbitrary taxonomy definitions
  - Does disclosure change behavior? At what cost?
  - Do investors care? Scope 1, 2, 3



## Managing climate risk

- Will regulation just shift risk to less regulated entities?
  - From banks to markets
  - From public to private markets
  - Onshore to offshore
  - How far should we extend the regulatory perimeter?
- Climate and ESG classification considerations
  - Relationships between asset managers and credit rating agencies
  - Benchmarking and arbitrary definitions can lead to rapid movements of funds in and out of equities and debt markets
- Political risks
  - Is policy change the biggest risk?
  - Is the bigger danger underreaction or overreaction?



## International cooperation for sustainable finance

- Who should make standards?
  - Official actors - IOSCO, Basel Committee, FSB
  - Governments - EU, US, China, India?
  - Non-governmental - IFRS, SASB, Climate Action 100+
- Future of ISSB
  - Will it be incorporated into IFRS reporting standards?
  - Will it be widely accepted and implemented?
- EU as front-runner
  - Will the rest of the world follow?
  - US as alternative
  - Developing countries may have a veto
  - Fragmentation of standards likely



# **The Future of Capital Markets: Policy Issues in Primary and Secondary Markets**

## Are capital markets really resilient?

- Effective management of March 2020 crisis
  - Post-GFC regulations allowed banks to remain active participants
  - Some NBFIs contributed to liquidity
    - ETFs, pension funds, insurers
- Challenges to market liquidity and resilience
  - Ability of national regulators to manage global markets in question
  - Counterparty risk
  - Settlement uncertainties
  - Private markets
  - Must improve venue resilience



## Challenges to market liquidity

- Massive growth in public and private debt markets
- Supplemental leverage ratio
  - “Poster child for adverse effects of bank regulation on capital markets”
  - US gold-plating has effectively created 5% SLR
  - If it’s not reformed, could damage Treasuries markets
  - Does it make sense to apply SLR to former investment banks?
- Other regulatory issues
  - CCAR - does it require too much capital?
  - US GSIB surcharge methodology punishes capital market activity
  - Volcker Rule



## Potential causes of runs and liquidity freezes

- **Crypto**
  - Right now, links to the financial system are limited
  - Stablecoin as potential avenue for contagion to financial system
    - Asset-backed stablecoins as unregulated MMF
    - Algo stablecoins not connected but potentially dangerous
  - Can we keep these systems separate?
    - ECB seeks to exclude new players, while US seeks to incorporate in existing system
- **Private markets?**
  - Lack of visibility, rising leverage
  - How to understand links to public?
- **Commodities markets (LME nickel run)**



## Global issues

- Dash for dollar liquidity
  - Pandemic sparked dollar funding crunch, esp. for offshore holders
  - EMs are particularly endangered
  - Rising interest rates worsen dash and increase probability of solvency crises
- Role of the Fed
  - Global lender of last resort
  - Moral hazard and TBTF
    - Does each rescue sow the seeds of the next crisis?
  - Need more resilient liquidity mechanisms in global dollar market
    - FIMA reserve repo facility can help
  - How to tell if problem is liquidity or solvency?
- Political crisis?
  - Rising populism and resentment of financial and governmental actors
  - Difficulty of legislation is shifting policy to regulatory agencies



# UPCOMING EVENTS

2022

**China - U.S. Symposium**

*September 28-29, Virtual*

**Japan - U.S. Symposium**

*Dec 1-3, Washington, DC*

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