Environmental risk analysis (ERA) in the strategic asset allocation (SAA) of the international reserves (IRs) managed by central banks (CBs)

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Discussant: Diego Solórzano

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ERA in the SAA of the IRs managed by CBs

Motivation

International Reserves (IRs) serve a wide range of functions for CBs in emerging markets. Environmental risks are starting to be understood as sources of financial risks. The exposure of the IRs to environmental risks is important for CBs. In fact, the Network for Greening the Financial System (NGFS) was established among central banks (CBs) in 2017. Discussant: Solórzano (BoM)
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  CB, ERA, IR, SRI, SAA, SSA, NGFS, ESG, WEF, WWF, TIP, TPI, PRI, MPT, DCF, SWF, MVO, IO, O&G, DCF, BISIP, SDR, TCFD, MBRA, GFSG, DNS, ABS, MBS, MSCI, PACTA and many more.

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Research question:
How to consider environmental risk in the strategic asset allocation of international reserves.

Summary

Discussed in a lengthy but much needed literature review:
- Environmental risk analysis (ERA)
- IR management
- ERA as input on the SAA of the IRs

A multicriteria analytical framework:
- ERA is based on the analysis of scenarios of the environmental risk factors
- Think of physical and transitional risks
- Knock-on effects of the environmental risk factors on financial and systemic risks
- Use measures for assessing value and risk: VaR, OpVaR, etc.

The results from this analysis could be considered alongside IRs’ objectives and guidelines.

ERA would be the fourth investment pillar of IRs, alongside security, liquidity, and profitability.

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  - Discusses environmental risk analysis (ERA)
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- Multicriteria analytical (conceptual) framework
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  - The results from this analysis could be considered alongside IRs' objectives and guidelines.
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*Latin American Journal of Central Banking, Volume 2, Issue 1, 2021.*
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- UBS surveyed 30 IR managers,
  36% did not consider sustainability aspects in the IR investment process.
  32% had considered but not implemented any.
  5% had considered and allocated certain assets accordingly.
Points to highlight:

- Challenges ahead: “green bonds may not be eligible for the liquidity or working capital tranches of central banks reserve portfolios” - BIS Quarterly Review, 2019.
- BdF significantly modified its SAA as a result of its socially responsible investing (SRI) strategy.
- DNB signed the Principles of Responsible Investment (PRI).
- Swedish CB divested from bonds issued by the Canadian province of Alberta and the Australian states of Queensland and Western Australia due to their large climate footprint.

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This paper takes a step forward in the right direction. I look forward to see practical applications of ERA in macro models.
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