Getting the Finance Flowing: Colombia

Case Study 22. Greening Colombia's Financial System

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Context

Colombia's financial sector is exposed to climate risks, while also playing an increasingly important role in mobilizing finance for climate action. Climate change can affect the Colombian economy and destabilize its financial sector through the materialization of both *physical risks*, which emanate from natural disasters and global warming and can lead to economic costs and financial losses, and *transition risks*, which are associated with economic adjustment costs during the transition toward a greener, carbon-neutral economy. For example, the large-scale riverine floods of 2010 and 2011 led to combined damages of $7 billion (2 percent of GDP), which induced a significant increase in bank loan loss provisions (Reinders et al. 2021). The decarbonization plan in Colombia considers a 51 percent reduction of GHG emissions in 2030 compared with 2010; during that transition, banks may face write-offs on loans to polluting companies that face additional costs or cannot comply with regulations. At the same time, climate change represents an opportunity to mobilize new and greater resources for climate-resilient and low-carbon iinvestment (DNP 2022). In October 2021, Colombia became the first Latin American country to issue local currency green bonds on the domestic market, raising Col$750 billion (World Bank 2022k). Banks have also issued green bonds, and pension funds have invested in them.

Policy

Against this background, Colombia's financial supervisor, the Superintendencia Financiera de Colombia (SFC), with support from the World Bank, has initiated several high-impact activities to further green the Colombian financial sector. Following its membership of the Central Bank and Regulators Network for Greening the Financial System and the introduction of a climate action plan, SFC—with support from the World Bank and IFC—has initiated several key actions to green its financial sector, including a climate risk stress test, regulatory reforms for banks and investors, and a green taxonomy. These actions aim to stimulate private-sector investments for Colombia's ambitious climate targets, while also building resilience in the financial sector against the impacts of climate change and climate policy.

To build understanding in the financial sector of climate risks, SFC and the World Bank conducted a stress test to examine the impact of different climate scenarios on the banking sector. This first-of-its-kind exploration for an emerging market focused on the most relevant climate physical and transition risk scenarios for Colombia, such as large-scale flooding and introducing a carbon tax to decarbonize the economy. In the most severe forward-looking flooding scenarios, some banks would be affected by significant losses, with the results underlining the need for adaptation and resilience measures. The transition risk stress test assessed the impacts of decarbonization targets, including a scenario envisioning the late and abrupt introduction of a high carbon tax to support the 51 percent reduction in GHG emissions by 2030. While Colombia's credit exposure to highly CO_2-intensive sectors is moderate for the region, assessed impacts from transition scenarios are not trivial, with significant heterogeneity of impacts among banks and losses up to almost 3 percent of total assets. And while we should interpret results with caution, they point to the importance of Colombia's financial sector regulators incorporating these risks in their supervisory approach. Results also show that timely and coordinated mitigation policy can help smooth impacts on the banking sector.

Informed by the risk assessment, SFC has also introduced climate risk management guidelines for the banking sector and climate disclosure regulations for institutional investors. In alignment with global principles (Basel Committee 2022) and sound practices, SFC has presented guidelines for banks on how to further integrate climate risks in risk management, governance, and disclosure practices. It has also undertaken a set of activities to support the development of environmental, social, and governance (ESG) and climate risk disclosure regulations for institutional investors. This included developing ESG and climate risk reporting requirements for institutional investors, launched in 2021 (Centro de Estudios Regulatorios 2021a, 2021b). These guidelines and regulations will help banks and investors better integrate climate considerations into their operational frameworks, building a financial sector that is more resilient against climate shocks and that better aligns its investments with sustainable development.

In 2021, Colombia introduced a Green Taxonomy, which provides a classification of green economic activities and assets (Azizuddin 2022). By helping investors determine whether a project is green and aligned with Colombia's NDC to the Paris Agreement, the taxonomy can support growth of green-labeled products in the country's capital markets and banking sector, while also providing a framework to start measuring green finance flows. Its creation was supported by a large group of stakeholders, including various ministries, the National Planning Authority, SFC, and international initiatives such as the Green Bond Initiative and the Sustainable Banking and Finance Network. The World Bank also supported the development of Colombia's sustainable bond market, facilitating a second-party opinion on the Sovereign Green Bond Framework's alignment with the issuer's sustainable strategic priorities and climate-change commitments and goals.

Results and Impacts

These actions provide important building blocks for a more sustainable and greener financial system in Colombia. The strengthening of climate and environmental risk management practices not only supports the resilience of the financial sector against transition impacts but could also incentivize the reduction of carbon-intensive investments while increasing greener investments. A taxonomy—and subsequent green products that are issued using the taxonomy—is foundational in creating an enabling environment of public and private sector climate finance. Although the initiatives were first launched in 2020 and the impact on mobilizing funding for climate action remains to be assessed, the steps taken closely align with best practice from advanced markets, including examples from the EU (World Bank 2021i). SFC has clearly put some of the enabling pillars in place that will allow for further alignment of financial sector flows with decarbonization objectives and strengthen climate risk management and disclosure practices.

Following the establishment of the Sovereign Green Bond Framework, the inaugural sovereign green bonds issued on the local market in September 2021 raised Col$750 million, with a maturity of 10 years. The green bond secured a coupon of 7.56 percent, compared with 7.63 percent for a conventional bond with the same financial characteristics. Following support to develop a green bond issuance framework, the national development bank, Financiera de Desarrollo Nacional, issued the first tranche ($40 million) of a nine-year $116 million securitized bond in local currency to finance the renovation of the Transmilenio BRT buses. An official second-party opinion provider certified it as a green and social bond, and it was listed in the exchange and purchased mostly by local insurance companies, pension funds, and mutual funds.

Key Takeaways

This example, and the actions of SFC in particular, provide key learnings for other emerging markets and developing economies. First, while part of a broader picture, this case study underlines the central and systemic role that a financial sector regulator can play in greening the financial sector and the economy, not only through its direct microprudential (risk-based) mandate, but also by playing a catalyzing role in the development of key enablers for green finance markets and direct change by households and firms. Second, it underlines the importance of a clear strategy and vision to guide the work. And third, greening the financial system involves working with a large group of stakeholders. Ministries, financial sector regulators, financial sector institutions, firms, and academics all need to work together to assess climate impacts, design relevant tools, create climate regulations, socialize findings, and drive action across agencies and the financial sector.