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EUROSYSTEEM

We all play a vital role

Keynote speech by Frank Elderson at the International Capital Markets Conference, Frankfurt, 30 August 2019

In his keynote speech on the International Capital Markets Conference, Frank Elderson states that unprecedented changes to our economy are necessary and it should be clear that ignoring climate-related issues, is far riskier than facing up to them. It requires urgent action to limit the damage as much as possible. And it takes collective action to avoid these irreversible tipping points, actions from central banks, financial institutions and governments.

When I walked out of my hotel this morning, the usual line of taxis was waiting for me. Most were of a particular, well-known brand in Germany. The first in line however, happened to be a Tesla. I was thrilled to be driven in an emission-free fashion to this Conference on Climate Change. I told the driver. He loved the idea as well and explicitly asked me to pass on a message to all of you. I promised him I would do so.

Currently, so my taxi driver told me, in the entire city of Frankfurt there are four fast-charging stations available. (Fast, by the way, means one hour and thirty minutes…) There are considerably more slow charging stations, but charging there takes five to six hours and they are hence not of use for a taxi driver. Of the four fast ones, often one or more are broken or otherwise not available because fossil cars are parked in front of them. My taxi driver happened to be an optimist: his clients love the zero-emission ride he offers them. He knows that he is part of the future. But he wants that future to start now. He knows that requires investments. And he knows that I am now addressing a room full of people who can make that possible. Who can also choose to become part of the future and can grab the myriad of opportunities that future grants us. Just like he does.

If you say that bankers make our world a better place, perhaps not everyone would immediately agree with you. Especially these days! But history illustrates that the banking industry has played a crucial role in guiding the changes that shape our future. For the better.

Take our hosts, KfW Bankengruppe. Founded with start-up capital from the Marshall Plan, KfW played a key role in post-war reconstruction efforts. It must have been a daunting challenge – getting the German economy back on its feet after the devastation of war. But that is exactly what it achieved. And more. Through a spirit of cooperation, through a willingness to take on massive responsibility and through ensuring funds were channeled to where they needed to go, ultimately, paving the way for the country to recover and emerge as one of the world's leading industrial states.

Today another wind of change is blowing. And though the challenges we face today are equally daunting, I am certain that once more we can overcome them. And that once again we will show to the world that the financial sector can be a force for good.

We've come a long way. In 1992, the leaders of the world took a first step by signing the UN convention on climate change. That is over a quarter of a century ago. 25 years in which many more steps have been taken, leading up to the Paris Agreement of 2015. The good news is that momentum is building. And not a moment too soon. In 1992, there was little consensus on the catastrophic effects of rising temperatures. We did not yet know that in 2017, air pollution would cause the deaths of almost 5 million people. We did not yet know that in 2018, 62 million people would be affected by extreme weather events and over 2 million would be displaced because of it. And we did not know that by now, we would be risking our homes, our jobs and eventually even our lives if we don't drastically change how we live.

World leaders took the first step in acknowledging climate-related risks. And it seems that investors and financial institutions are now on the same page. In 1992, the words "climate change" popped up in only 69 Bloomberg articles. By comparison: last year, it appeared in over 22,000 Bloomberg articles. Also, in 1992, seminars like this didn't cover climate-related issues. This is of course not only true for climate change: "low interest rates" weren't really a hot topic then either: with the German Bund yield at 8%. But the difference between these two subjects is that interest rates go up and down over time, while the temperature keeps rising.

The world has already warmed by about 1 degree Celsius since pre-industrial times, due to human activity. Drastic efforts are needed to reduce carbon emissions now. Otherwise, it is likely we will pass irreversible tipping points in just 12 years. As the IPCC puts it, in their report: "There is a significant risk of crossing critical thresholds and even triggering tipping points as warming goes from 1.5 degrees to 2 degrees Celsius." So waiting for climate change to become less of a "hot" topic is not an option. It will only get hotter. Inaction is simply not an option.

I must admit, in view of the findings of the IPCC and others, I was a bit surprised when I saw the topic of the next panel discussion: "Climate-related aspects in investment portfolios: nice-to-have or compelling necessity?" For me, the question has long been answered and the answer is compellingly clear.

At this point, and given all the extensive scientific evidence, it is clear that climate change poses risks beyond anything seen in the modern age. It is clear that we need to make unprecedented changes to our economy and it should be clear that ignoring climate-related issues, is far riskier than facing up to them. So we should not discuss if, but how we respond to climate change. It requires urgent action to limit the damage as much as possible. And it takes collective action to avoid these irreversible tipping points.

Today, I would like to focus on what central banks, financial institutions and governments can do.

Role of central banks and supervisors

Central banks and supervisors are working together to produce a collective response to climate change. But our collective journey together started much later than 1992. Last year, De Nederlandsche Bank hosted the first ever international climate conference for prudential supervisors. This conference was organized by the newly-formed Central banks' and supervisors' Network for Greening the Financial System. The NGFS. The NGFS was founded on the initiative of the Banque de France. And I have the privilege to be the first chair of this network. At the conference we came to the conclusion that climate change is a source of financial risk. And one that is squarely within our mandate. This was still unthinkable in 1992, but now, this is a widely-shared conviction.

The Network has grown significantly. From the original eight founding members, today, the NGFS brings together 42 central banks and supervisors and eight observers, representing five continents, representing half of global greenhouse gas emissions, responsible for supervising three quarters of the global systemically important banks and two thirds of systematically important insurers.

The conference was the first milestone for the network. This year, the NGFS reached its second milestone: a report with six recommendations on how central banks and supervisors should contribute to Paris. In short: central banks can play a catalyzing role in promoting responsible financial markets. As investors, they can strive to make the economy more sustainable by managing the environmental risks of their own reserves. De Nederlandsche Bank has, for example, signed the Principles for Responsible Investment. In the financial sector, we would be considered laggards, as this is already standard industry practice. But in the central banking community, we were the first ever to sign the PRI. The direct effects of our action may be limited, given the size of our investment portfolio, which is 19 billion euros, and given the composition, which is mostly government bonds. But we hope that others will follow, and collectively, the impact will be larger. And apart from the absolute number, we as central banks exert influence by leading by example.

The starting point for supervisors is the risk perspective. As I said before, climate change and the transition towards a carbon-neutral economy are sources of financial risk. The financial sector is particularly exposed to physical risks and transition risks. Physical risks refer to the damage of the catastrophic effects of climate change. Assets may by ravaged by climate calamities. And the whole economy may be affected indirectly through weaker growth and lower asset returns.

These risks are not just in the distant future. 2017 and 2018 were already the costliest years on record in terms of weather-related disasters. Here in Germany, the hot summer of 2018 caused the closure of parts of the Rhine to commercial shipping, for the first time in living memory. The closure of this vital waterway shaved 0.2% off Germany's gross domestic product. Shipping restrictions were again in place this year following the record temperatures. So it looks like climate-related disruption is here to stay.

Even if you are skeptical about climate change or its causes, there is no escaping climate regulation. The risks of stranded assets are very real. This is what we refer to as the transition risk. Financial institutions have significant exposures to companies that emit high levels of CO_2. Pension funds and banks, in particular, are vulnerable to their carbon intensive assets suffering a sudden loss in value. Here again, risks are already unfolding. A good example is Dutch legislation in the real estate sector. From 2023 onwards, office properties in the Netherlands will be required to have an energy efficiency label of at least C, resulting in stranded assets, in the form of those offices with an energy label lower than C.

The NGFS report calls for the integration of these climate-related financial risks into day-to-day supervisory work, financial stability monitoring and board risk management. The report was the second milestone of the Network. And we expect more milestones to come soon. At the moment we are working on more technical documents, for example a handbook for supervisors on how to supervise climate-related risk. A handbook for central banks on responsible investing. And a good practices guide for financial institutions on conducting environmental risk analyses.

So central banks and supervisors are in the process of incorporating a new risk driver. Luckily, we already have a track record in this respect. Once upon a time, no supervisor ever thought about cybercrime, but now we all do. This required no change in our legal mandate. It simply required the realization that cyber risk is a material risk for financial institutions. Likewise, central; banks and supervisors don’t need a change in their legal mandate to deal with climate change. It simply required the realization that climate change leads to material risks for financial institutions and financial stability.

Role of the financial institutions and investors
As I said, it takes collective action to avoid irreversible tipping points of global warming. Which brings me to what you in the financial sector can do. To begin with, institutions must assess their organization’s exposure to climate risk. This is the first step and the absolute bare minimum of what they must do. Given the rising costs of extreme weather events, no institution can afford to continue to originate loans and invest using old risk identification processes.

Institutions must recalibrate and adapt their processes to properly reflect risks. Otherwise, markets and supervisors will do that for them. Building forward looking models is difficult, but developments in this field are progressing fast. And when I say forward looking models, I mean techniques such as scenario planning and climate stress testing. Also, we need to accept that our risk analysis won’t be perfect from the start. If we wait with managing climate related risks until we have precisely quantified it, we will be too late.

This is not only true for climate-related risks. It also holds for broader environmental and social challenges. Water scarcity is a source of financial risk. Diminishing biodiversity is a source of financial risk. Human rights controversies are a source of financial risk.

Basically, if you want to know the early warning indicators for future policy (and therefore for upcoming transition risks and stranded assets), just look at the UN’s Sustainable Development Goals. These will give you an idea of what activities may be subsidized, forbidden or downgraded. Between 2009 and 2015, for example, Moody’s cut the average credit rating of European power utilities by three notches, partly because of environmental risk. Next year in Beijing, an international Biodiversity Treaty will be signed. So, integrating ESG factors is no longer just for do-gooders. It is now a key risk management tool.

After you’ve assessed these vulnerabilities, you need to disclose them too. Because you don’t want to surprise markets with risks that suddenly materialize. I guess I don’t need to tell you that when markets reprice a company’s risk, they do so in a hurry. Companies are already increasing their transparency. Over 800 organizations support the voluntary disclosures of the TCFD, including the world’s largest banks, asset managers and pension funds, responsible for assets of $118 trillion. And what’s more, as from 2020 all PRI signatories will have the obligation to report TCFD aligned indicators. Whether or not they will also publicly report their TCFD score, is their own choice.

So, more and more financial institutions are taking steps to evaluate and disclose the threat of climate change. But applying risk management instruments does not necessarily in itself contribute to sustainable development and the energy transition. A bank could for example implement the TCFD but not invest a penny in the sustainable transition. For that very reason, even though I am a central banker and supervisor, I must say that it’s not just about mitigating risks. There are opportunities too. hink about the great demand for renewable energy and new infrastructure, creating new investment opportunities in a low yield environment. Think about the massive supply of green, social and sustainable bonds, giving financial institutions the opportunity to broaden their investment base. Think about the fees you can collect, by actively managing portfolios with the climate in mind.

But investing and lending with the climate in mind isn’t yet standard industry practice. We have seen fine examples in the financial sector from forerunners. For example, our host KfW is supporting countries in converting their energy systems in a sustainable manner.

But the real economy cannot shift fast enough to meet the Paris Agreement without help from the entire financial sector. The transition to a low-carbon economy requires tremendous amounts of investment. Wind farms have to be built. Households need to be made more energy efficient. And we need to start using cleaner vehicles.

So we still have a long way to go: Fossil fuels are still Europe's dominant source of energy. The European Commission estimates that to achieve the Paris targets, we have to fill an investment gap estimated at € 180 billion per year. This sounds massive, but it is only slightly more than 1% of our combined GDP. Government and corporate investment already adds up to a multiple of this amount. So it should not be difficult to mobilize these funds.

And it might even make good business sense to do so. It sounds counterintuitive, but investing with the climate in mind is hot. To keep a competitive edge, financial institutions need to adjust their business model on time. So they can seize these opportunities. You don't want to miss the boat. especially now that sea levels keep rising.

Role of governments

As I said, the real economy cannot shift fast enough without help from the financial sector. But in turn, the financial sector cannot act fast enough without help from governments. Therefore, at the same time, governments should clearly plot a route of safe passage to a zero-emission economy. This route must include unambiguous and long-term legislation. The sooner governments create clarity as to how they will tackle and adapt to climate change, the better it is for financial stability. And the better financial institutions can adapt their strategy going forward.

An effective carbon tax would, for example, address the problem at its root, by functioning as a direct incentive for corporations to reduce their footprint. Now, tax levies on carbon emissions vary widely across countries. From € 6 per tonne of carbon dioxide in China to € 112 in Sweden. Carbon pricing policies should be better coordinated on an international level, and should address carbon leakage and competitiveness effects.

Governments were among the first to demand action on global warming in 1992. Many of them did. And they should stay ahead of the curve when it comes to taking and coordinating climate action. But in the end, we all play a vital role in tackling climate change. I believe that the momentum for climate action is now unstoppable, that the pace of change is accelerating and that even the laggards will have to jump on board sooner rather than later.

After all: unsustainable means that it cannot be sustained. In other words: what is unsustainable will disappear. Investing in what disappears, rarely is a sound strategy.

Three quarters of a century ago, the KfW Bankengruppe helped the German economy to emerge from the ashes of war. Now we must transform the world economy to become stable. Now we must transform our way of life to become sustainable. This transition needs the sustained effort of us all. Of governments. Of firms. Of financial institutions. Of central banks and supervisors. Because if the world is to be set on a truly sustainable footing, all finance shall become sustainable as well. Because ultimately, outside sustainable finance, there shall be no finance.

Thank you.