Joachim Wuermeling: A new world ahead. What do sustainable finance and digitalisation mean for supervision?

Keynote speech by Prof Joachim Wuermeling, Member of the Executive Board of the Deutsche Bundesbank, at the occasion of the European Supervisor Education Initiative (ESE) conference, Munich, 17 October 2019.

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1 Introduction

Ladies and gentlemen,

Sustainability and digitalisation are two megatrends of our time, and they are both highly relevant for the financial sector. They have been the showcase topics of many financial sector conferences already. But this here is a very specific conference – one by and for supervisors, designed to advance their knowledge.

2 Why to combine sustainable finance and digitalisation in one conference

Let us look at a major challenge for supervisors in the realm of sustainable finance: The analysis of climate-related risks and the quest for appropriate analytical methods. We know by now that our traditional and tested backward-looking approach is not up to the task; we need a forward-looking perspective. The task is complicated by the fact that climate-related risks tend to be long-term risks by nature. How can we tackle them? Can we make banks undergo a climate-related stress test? Is it even possible to go beyond our traditional horizon of three to five years without sacrificing too much accuracy?

I am not aiming for an answer here. My point is that when faced with these challenges, we struggle to tackle them using only our traditional methods.

Regarding the digitalisation of banks and the entire financial sector, we are making similar observations. You see, digitalisation extends far beyond digitising traditional businesses and processes – it has led to transformation of finance, and in some cases even disruption. It comes as no surprise that supervisors might feel insecure when applying the supervisory toolkit to innovative businesses.

Just as a random example, supervisors might be confronted with a financial institution whose mid-term goal is not to earn profits, but to grow as quickly as possible. This kind of strategy might be sensible in the age of platform-based companies fighting for market supremacy, take e.g. Libra. If business is all about “the winner takes it all”, this alters not only economics, but also raises the question about the focus of supervision.

Of course, solvency and liquidity ratios remain at the core of our interest. But the next question is, how do we deal with all the new issues of a company growing at high speed – e.g. its long-term profitability or also its risk management keeping pace with expanding business? Does it suffice to confront bank managers with those issues at the annual regulatory meeting? Are targeted on-site inspections the best way forward? Existing supervisory standards do set the right framework, but supervisors might need clearer guidance in order to exert the necessary amount of pressure on the supervised entity.

3 Where do we stand?

So where do we stand today?

Although sustainable finance is no longer an entirely new topic, it is still difficult to grasp. At the same time, we are clearly moving beyond great political speeches.

To supervisors, tackling sustainable finance means tackling environmental, social and governance ("ESG") risks; here, we have so far mostly but not exclusively focused on climate-related risks.

Much of the pioneering work at the international level is being done by the members of the Network for Greening the Financial System (NGFS). Compared to about one and a half years ago, when the newly founded NGFS entered into its productive phase, we have certainly made good progress.

We have built a broad consensus that ESG risks, in particular climate-related risks, are financial risks.

And we have started analysing regulatory implications and setting supervisory expectations.

But we are still in the process of developing an understanding of the channels through which these risks could materialise, from both the micro- and macroprudential perspectives. Unlike other risk factors, the way climate change-related developments including policy measures will impact the macro economy is not well understood. Our current activities could be considered as "sensitivity analyses" exploring potential vulnerabilities of the financial system under different assumptions. Of course, the objective of the global efforts on the part of central banks and supervisors is to add stress tests or scenario analyses to our toolbox.

Therefore, the CRR II and CRD V contain not only new disclosure provisions but also mandates for the European Banking Authority (EBA) to examine the integration of ESG risks into pillar 1 and pillar 2. Work on pillar 2 has already started and is being conducted jointly by the EBA and National Competent Authorities (NCAs) in the EBA Sustainable Finance Network. Here in Germany, a guidance note on the treatment of sustainability risks by financial institutions drafted by BaFin is currently up for public consultation. Other countries have already published supervisory statements.

But: If you were to randomly pick a local supervisor and ask them about the role of ESG risks in day to day supervision, you would find climate-related risk relatively absent thus far. Overall, we are currently only beginning to move from theory to practice. And this is where the real challenge lies.

There are several areas where progress is needed, the most pressing of which is risk management. We have recently surveyed all German LSIs and asked them to what extent they are taking into account climate-related risks in their risk management and what they are planning for the near future.

The good news is: Around one-third have integrated climate-related risks into their risk assessment, at least in part. The not so good news: Around two-thirds have not integrated climate-related risks at all. Of these, only a third are planning to do so in the future.

Our findings are consistent with surveys among SIs conducted by the SSM, EBA, and the NGFS.

Clearly, the integration of ESG or even only climate-related risks into banks' risk management is still in its early stages. This will have to change soon if we bear in mind the work on regulatory standards in the EU and BaFin's guidance note on ESG risks that is expected to be finalised before the end of the year, but more importantly because climate-related risks are relevant.

This has been a short fly-over over the progress made so far regarding sustainable finance. How about digitalisation of the financial sector and supervisory challenges?

Digitalisation is not that new anymore; it has now diffused into various niche topics and existing supervisory compartments – e.g. cyber and IT security; third parties and open banking; business model analysis; regulatory perimeter (esp. regarding FinTechs and BigTechs). Also, the prudential and supervisory treatment of crypto tokens has become a separate realm – with many connections to traditional segments such as operational risk or prudential requirements.

We have achieved significant progress in updating and concretising our standards, e.g. regarding IT-related expectations or also regarding outsourcing activities.

However, within most of those topics, fundamental questions remain. For example, should we directly supervise third parties such as cloud service providers? And how do we deal with IT becoming more and more crucial to the functioning of the financial sector? We do exert pressure on banks to remedy their gaps in IT risk management – but when it comes to regulatory action, the "traditional" focus of banking supervision, namely solvency and liquidity, is what counts. Is this logic still valid in the digital age?

Summing up, we are witnessing significant advances in both topics, but their practical design is not yet decided.

4 What are common strategic challenges?

Now the question is: What are underlying structural causes (if any) for that? And how should we best deal with these grounds in order to move forward quickly and successfully? I will confine myself to three aspects that I find particularly important.

First, both topics are per se very complex already, consuming time and energy in daily supervision and beyond.

The NGFS nicely summed up the reasons for complexity: "Assessing the impact of climate change can be challenging due to the uncertainties associated with the course of climate change itself, the breadth and complexity of transmission channels, first and second round effects as well as the need to consider, in aggregate, some combination of both physical and transition risks." Therefore, analysing how exactly they would influence a particular bank's balance sheet, let alone the entire financial system, is a very complex endeavour.

The same holds for digital innovations. Have you had the chance to read through an outsourcing agreement? Today, banks tend to have multiple of such outsourcing relationships, and the share of processes outsourced to third party vendors is still increasing – especially due to digitalisation. For a supervisor, keeping up to date regarding outsourced processes may thus become a challenge in itself.

Second and adding to the complexity, both topics require new expertise.

To develop a climate stress test, we first need to understand the different scenarios of global warming and how weather and climate phenomena would develop under them. Assuming a given set of socioeconomic drivers, technologies and policies, we then need to translate climate-related risks and mitigation pathways for finance risk assessments, ideally at the asset level.

The same holds for digital innovations. For example, there is no one-size-fits-all supervisory response for all types of crypto tokens; each individual case must be assessed on its own merits. This in turn requires going into the nitty-gritty of the business case and understanding its technological features along with its legal classification.

Third, they are horizontal topics that don't easily fit into the organisational structure of supervisory institutions. That makes grasping the topics in their entirety and treating them consistently difficult. The FinTech hubs and sustainable finance networks we are seeing emerge within supervisory institutions are an attempt to overcome this challenge.

If our organisational structures do not fit and, more broadly, our supervisory structure doesn’t fit, then we should not hesitate to adjust to the new realities. We must pinpoint where and how exactly we must adapt.

And that’s the task I want to define for today and tomorrow.

How do we deal with a lack of expertise in certain fields? Do we create it from within? Do we acquire it from without?

How do we deal with the complexity and the horizontal nature of the topics?

How can we improve cooperation between different departments internally, cooperation between each other and cooperation with other players like academia, NGOs, etc.?

These are the questions I invite you to ponder over the coming two days.

5 Conclusion

Ladies and gentlemen,

Sustainable finance and digitalisation pose unprecedented challenges for supervisors. In some areas, they have exposed the limits of our current approach to supervision. And they are forcing us to adapt.

I have sketched some of the strategic challenges that follow, but I have not provided a solution. That is what I am inviting you to think about during the conference.

And in case you might get lost in details, remember that our anchor point is quite simple: to maintain our ability to perform solid supervision under new circumstances.

Thank you for your attention.