Klaas Knot: On financing the energy transition

Speech (virtually) by Mr Klaas Knot, President of the Netherlands Bank, at the Forum Analysis, Milan, 8 July 2021.

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It is a pleasure to be back in Milan – even if it is only virtually.

About 35 kilometres south of Milan lies the city of Pavia. Twenty years ago, I studied there for a semester – so I have very fond memories of that city.

One of the most famous people that ever lived in Pavia is Alessandro Volta. In 1799, he invented the battery. This invention would soon lead to the development of the first electric motor – a machine that, in its current form, plays an important role in the transition to a net-zero society.

This transition will be hard to achieve. But it is what we will need to do – because climate change is a major threat to societies and economies all over the world, and to the stability of the entire financial system.

Currently, however, we are still far from achieving the ambitions set out in the Paris Climate Agreement.

If we want to achieve these ambitions, we will need large-scale investments in sustainable energy services, in agriculture, in manufacturing, and so on. And these investments will need to be accompanied by increased efforts to reduce greenhouse gas emissions.

The lion's share of these investments will have to come from the private sector.

But when we look at financing flows, whether in capital markets or bank finance, we see they are mostly directed towards large and often carbon-intensive companies – companies perceived as having low credit risk.

The energy transition, however, hinges on successful technological innovations.

According to a recent report by the International Energy Agency , and I quote: "*most of the global reductions in CO2 emissions between now and 2030 in the net zero pathway come from technologies readily available today. But in 2050, almost half the reductions come from technologies that are currently only at the demonstration or prototype phase.*"

Early on, these innovative technologies are often less competitive than fossil alternatives. This makes banks more hesitant to finance these higher risk activities. And innovative start-ups are often too small to attract capital market financing.

So currently, innovation investment is best aligned with the risk appetite of private equity firms. But they do not have a large presence around the world.

So this is where governments come in.

The bulk of the much needed investments will *indeed* have to come from the private sector – but there is a loud and clear *sine qua non*. And that is that governments create *investment* conditions that improve the business case for climate investments.

They need to do this for both companies in need of green finance and investors providing green finance. If demand and supply grow in the same pace we reduce the risk of a green bubble once the private sector increases its green investments. And to reduce the risk of greenwashing, we need international standards such as a taxonomy.

Our governments' broad mandates allow them to create favourable conditions for green investments – and so they should act upon it.

Meanwhile, of course, central banks should do what they can within their mandates and continue to work on favourable *financing* conditions.

But I want to stress that, given their broader mandate, our governments are the primary actors in greening our economies.

I will now elaborate on three ways governments could step up their efforts. After that, I will talk about the role of supervisors and central banks in greening our economies.

So first – governments need to address the issue of under-priced carbon emissions. This will improve the business case for climate investments.

With the Emissions Trading System, the ETS, European leaders have a powerful tool to do this and achieve the target of reducing net EU greenhouse gas emissions by 55 percent by 2030.

Second – investment uncertainty, which is usually high for innovative green investments, needs to be reduced. And governments could contribute to this with a consistent and reliable policy mix of subsidies, co-financing and guarantees. A good example are offshore wind farms in the Netherlands: minimum price guarantees helped the industry scale-up, after which costs fell sharply.

The European Commission can stimulate public-private partnerships by simplifying government support rules. They can also do so by granting exemptions for the co-financing of climate investment by governments.

Third – corporate reporting of sustainability data must improve, in terms of quality, comparability and consistency. And this credible and comparable information should be readily available for all market participants, shareholders and other stakeholders across the world.

That is why I encourage authorities to support the IFRS Foundation in developing a global baseline standard. One that is, *first*, compatible with regional and national disclosure frameworks that may be more far-reaching; and *two*, builds upon the recommendations of the Task Force on Climate-related Disclosures.

Until the IFRS reporting standards have been developed, it is important we avoid fragmentation. We need to ensure that national and regional requirements currently being put in place, can easily dovetail with the new global standards later on.

Let me now talk about what supervisors could do to encourage climate investments.

Supervisors expect financial institutions to manage their climate-related risks.

This calls for a more forward-looking approach from financial institutions and supervisors – with stress tests and scenario-analyses becoming an integral part of the regular toolkit.

And this requires financial institutions to take material sustainability risks into account – which means measuring, assessing and controlling these risks as part of their regular risk management processes.

The Dutch financial sector is increasingly aware of climate risks and is taking steps to mitigate them. For example, many financial institutions are working on identifying which carbon-intensive sectors they are exposed to. The Dutch financial sector has also committed to reporting on the climate impact of its financing and investment, and to reduce its impact.

Supervisory authorities, like De Nederlandsche Bank, also need to investigate where and how climate-related risks can be further integrated in the applicable prudential frameworks for banks and other financial institutions. They need to do this to ensure the soundness of financial institutions.

Furthermore, climate risks should be adequately reflected in prudential regulations, with adjustments to the framework where necessary. That is why I welcome the work of the European Banking Authority and the Basel Committee in this area. The uncertainties surrounding climate-related risks make them harder to quantify, but this certainly does not mean we can afford to ignore them. Prudential regulation is aimed at ensuring financial institutions can absorb unexpected losses – and this should include losses related to climate change.

In our *macroprudential* supervision, we have designed a climate stress test. And in the future, we aim to integrate climate-related risks in our regular macroprudential supervision.

Last but not least, let me now turn to what role central banks can play in greening our economies.

The primary objective of the ECB is price stability. And we know that climate change in itself can cause adverse demand and supply shocks, and that these shocks cause higher inflation volatility.

Governments' transition policies may also lead to more inflation volatility. The most effective measure for greening the economy is adequate pricing of carbon emissions. Doing this will lead to relative price changes and the reallocation of resources across sectors. The greater the delay in implementing such government policies, the more abrupt the transition will be. This raises the risk of stranded assets on balance sheets and shock-induced revaluations of financial sector exposures.

Whether transition measures are direct or indirect, all the possible, likely, or actual effects of climate change will be reflected in pricing measures. And this affects price stability. So you can easily see that climate change falls within the monetary policy horizon.

The secondary objective of the ECB implies that it shall support the general economic policies of the EU, provided it does not interfere with the primary objective. And with the Green Deal, the EU has an ambitious climate agenda. The ECB is considering how best to take account of climate change in its current monetary policy strategy review.

In addition to the primary and secondary objective, the ECB needs to integrate risks related to climate change in its own risk management framework. We know that climate-related risks are a source of financial risk. And since we expect financial institutions to manage their climate-related risks, the ECB should lead by example.

And finally – central banks should be transparent about the climate risks on their own balance sheets. And they should ensure that their own reserves are aligned with international sustainability goals and Corporate Social Responsibility standards.

At De Nederlandsche Bank, we are currently exploring whether we can align the equity portion of our own-account portfolio with the agreements set out in the Paris Climate Agreement. And we will start identifying the physical climate risks of our investment portfolios, such as the impact of increasing drought and extreme weather conditions on our investments.

By setting a good example, central banks can advocate transparency on climate risks in financial markets. This is, for instance, why De Nederlandsche Bank added a climate annex to its annual report this year, fully in line with the recommendations of the Task Force on Climate-Related Financial Disclosures, the TCFD.

Dear all, today I have spoken to you about the role that governments, supervisors and central banks can play in greening our economies. But I would like to stress that none of them operate in isolation. Collaboration and coordination between the different stakeholders, including these three parties, but also international organisations like the FSB and the G20, and the financial sector itself, will be paramount in the transition to a net-zero society.

Let me conclude.

Exactly one hundred years after Alessandro Volta invented the battery, the first car reached a speed of over one hundred kilometres an hour.

This was in 1899. It was a Belgian car. And that car was electric.

This electric car even had a name. It was called *La Jamais Contente*. The *Never Satisfied* in English. Or *La Mai Felice* in Italian.

Regarding the energy transition, we have been satisfied with *too little for too long*.

We need immediate, decisive and greater action.

And we need this from everyone – each within their own mandate, everyone contributing their own expertise.

All of us, to use a famous 'Italian' expression, will need to do 'whatever it takes'.