Steven Maijoor: On how climate-related and environmental risks affect banking and its prudential supervision

Speech by Mr Steven Maijoor, Executive Director of Supervision of the Netherlands Bank, at the Association for Financial Markets in Europe (AFME) European Sustainable Finance Conference, Amsterdam, 11 May 2022.

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Hello everyone. It is a pleasure to be here today.

The April 2022 report from the Intergovernmental Panel on Climate Change was unequivocal: the time for action is now. Without immediate and substantial emissions reductions across all sectors, it will no longer be possible to limit global warming to 1.5 degrees Celsius. We are at a crossroads and we need to take the right turn.

Regarding climate investments, the report found that the level of investment needed to limit global warming to 1.5 degrees should be three to six times higher than is currently the case. And that fossil fuel subsidies are still too high.

The current war on European soil is first and foremost a human tragedy. But it also makes painfully clear how dependent we are on fossil fuels. This adds to the urgency to reduce our dependence on fossil fuels.

Many, if not all of you, are fully aware of this. So today, there is no need for me to create a sense of urgency.

No, today, I want to create a sense of *action*.

I want to talk about our governments – about what they, as the primary actors, can do for the transition to a net-zero society.

And then I want to talk about you and me – the financial sector. About how climate-related and environmental risks, the C&E risks, affect the financial system. And about how supervisors and banks can respond, or better still, must respond, to these risks.

But first – our governments. The lion's share of the investment we need for the energy transition will have to be made by private parties. But our governments have an important kickstarting role to play. To accelerate and scale up climate investment, they should, first and foremost, adequately price carbon emissions. This is in line with the standard recipe for how to respond to externalities as explained in economics textbooks. Current pricing harms the business case for climate investment. We need to turn this around. To that end, carbon taxes must be raised and fossil fuel subsidies phased out.

Our governments should also support and promote the financing of innovative, sustainable investment. This could be done through subsidies, co-financing and guarantees. Any such government policies should, first, be consistent and reliable so that private investors have sufficient long-term certainty. And second, they must not jeopardize the stability of public finances.

Besides pricing and supporting, our governments have regulatory tools at hand. Through regulation, they could for example boost the private financing of innovations by promoting the market for equity finance. Equity financing is typically more conducive to innovation than debt financing.

In the same regulatory toolkit are reporting requirements, such as those on climate matters, and binding supervisory and risk standards. These requirements and standards could really incentivise established businesses to reduce carbon emissions.

If we want to succeed, *and we need to*, we need everyone to play their part.

So let me turn to us now – to you and me, to the banks amongst you, and supervisors.

Banks perform a crucial role in our societies. You play an important role in creating prosperity. And just like De Nederlandsche Bank wants to contribute to *sustainable* prosperity by safeguarding financial stability, you as bankers should also want to. I know many of you do.

As central bank, our primary responsibility is financial stability. As supervisor, we look after the solidity of the financial sector. This means that we look out for risks that are a potential threat to this stability or solidity.

Over the years, De Nederlandsche Bank has done extensive research on sustainability risks – mainly climate-related risks, and risks related to the loss of biodiversity.

And we have found that climate-related and environmental risks can be a threat to individual financial institutions, and so to global financial stability. For instance, when you finance companies that are directly exposed to C&E risks, *you*, in turn, are also exposed to financial risks.

Today, I want to talk to you about a few C&E risks that could have such an impact on your financial risks. When discussing C&E risks, we make a distinction between physical and transition risks. I will talk about these two first. After that, I will zoom in on three other important risks connected to climate risk: concentration risk, and reputational and litigation risks.

So first, physical risk. Think for instance about the risk of a flood in the western part of the Netherlands. This could increase a bank's credit risks following from damage to collateral, like houses and buildings. And this would then require a bank to draw on its capital reserves.

Second, transition risk. Transitioning to a net-zero society could lead to adjusted or new governmental policies, technological progress, or changes in market sentiment and market preferences. Governments, for example, could impose higher taxes on Green House Gas emissions. As a result, a company's revenue could decline, and with that, the company's creditworthiness and its ability to repay outstanding debts to banks.

To manage physical and transition risks, they need to be identified, measured and monitored. They need to be incorporated in your risk management frameworks.

I know many of you are aware of this. I know many of you have started thinking about how to provide finance for the transition as well as how to translate sustainability risks into your business operations. And I know that this complex transition demands a lot from you as banks.

The ECB and De Nederlandsche Bank, on their part, have progressively integrated C&E risks in their supervisory methods. The ECB, for instance, introduced supervisory expectations in its Guide of November 2020. This publication urged banks to analyse those risks and integrate them into their business model, governance, risk management and disclosure.

In the follow-up assessments of November 2021 and March 2022, results showed that banks have made some progress. However, significant gaps still remain, for example regarding banks' disclosures, as well as the substance of such disclosures.

About three out of four banks do not disclose whether climate-related and environmental risks are material to them. This shows that these institutions either are unaware of the potential impact of these risks on their balance sheets – or are aware of their impact, but do not transparently disclose it.

This year, together with the ECB climate stress tests, the Joint Supervisory Teams are conducting a thematic review on C&E risks. This means that those risks are part of the methodology for the Supervisory Review and Evaluation, and the ongoing supervisory dialogue. These conversations will most likely not be easy for banks that lag behind in terms of C&E risks.

With the introduction of various European disclosure requirements, such as the Corporate Sustainability Reporting Directive and the EBA Pillar 3 ESG reporting, little time remains for banks to close the disclosure gaps. And even more standards are currently being developed, such as those from the International Sustainability Standards Board.

Next to supervisory dialogues and disclosures, there is another important subject I need to talk to you about: the prudential framework. This framework is also looking at integrating climate-related and environmental risks.

Last week, the European Banking Authority, EBA, published a discussion paper on whether prudential treatment of exposures to environmental risks would be justified.

As far as De Nederlandsche Bank is concerned, given the global nature of C&E risks, we think that the prudential framework should ensure a minimum level of harmonisation and a level playing field across jurisdictions.

To achieve this, let's look at the current framework.

As a start, we should consider whether there is flexibility in the framework to respond to C&E risks. It is an undeniable fact that some elements in the framework are incapable of including information on these new risk factors. Take, for instance, the pre-set risk weights under the standard approach.

However – some elements in the framework *can* quantify and incorporate C&E risks whenever they materialize. Take, for instance, the internal model parameters like Probability of Default or Loss Given Default.

And some elements in the framework *are* already able to incorporate new information regarding climate-related risks. For example, before C&E risks materialize, External Credit Rating Agencies could take into account available and relevant information regarding environmental factors. They could use this information for the determination of external credit ratings that banks may use for their standard models. As current practices across Credit Rating Agencies differ, steps should be taken to improve consistency, comparability and reliability of the data underlying credit ratings as well as to improve the transparency of the rating methods.

But, even after explaining and refining the current framework, this would still not fully strengthen banks' resilience against C&E risks.

We see an increase in frequency and materiality of climate-related and environmental risks. And as a result, banks' exposures may be affected simultaneously through multiple channels.

That is why De Nederlandsche Bank is in favour of addressing *concentration* risk originating from C&E risks. This risk follows from shocks arising from *concentrated* exposures to physical or transition risk drivers.

What's new about this perspective on concentration risk is that seemingly unrelated counterparties may be subject to shocks arising from similar risks – physical risks due to location, or transition risks due to sectoral exposure.

To properly address concentration risks, the framework should be fundamentally changed. But introducing a new instrument would be even better. Currently, discussions on how to translate the theoretical insights on concentration risks into a practical instrument are on-going. One option that is being looked into is a quantitative concentration limit, either absolute or relative. This limit would then be subject to supervisory reporting, disclosure or an additional capital buffer. And in case of a breach of the limit, a range of supervisory measures could be considered, such as a mandatory notification in accordance with the Large Exposures framework or a deduction of the excess part of the concentrated position from the bank's capital.

If this concentration limit were to become part of the prudential framework, it could well be phased in to give you, banks, time to make the necessary adjustments.

I do want to stress, though, that our ideas on concentration limits are very much in the proposal phase. De Nederlandsche Bank is looking forward to comments on this proposal and to the results of any consultation rounds on the EBA discussion paper. These could in turn help us to improve the proposal.

So far, I have discussed climate and environmental changes as a source of prudential risks. However, some banks also consider these changes, and the related changing stakeholder preferences, as an opportunity to change their strategy and business model. For example, I find it promising to see that a number of banks are committing, themselves, to net-zero initiatives. Such as the banks that choose to align with the Paris Agreement by signing the Commitment Statement of the Net-Zero Banking Alliance.

Institutions that have signed this statement have 18 months to do a number of things. They need to identify operational and attributable Green House Gas emissions from their lending and investment portfolios. And then they need to set specific targets, for both 2030 and 2050, so that they can align with the trajectories towards net-zero in 2050 or earlier.

To achieve these targets, banks might need to adjust their business model and their range of products and services. Or they may need to adjust their decision-making process and thus adapt their governance structure and risk management procedures.

It is important that banks provide qualitative and quantitative disclosures to support their commitments. As mentioned earlier, the recent ECB assessment shows that banks do not fully meet ECB expectations on disclosure of C&E risks.

And this is where the final risks I want to mention today, occur. Reputational and litigation risks. These risks follow from an increased stakeholder awareness for a net-zero society. For instance, if stakeholders feel that a bank is not living up to its commitment, its reputation could be harmed. Activist measures or changes in consumption patterns could follow. The goal being, ultimately, to drive banks towards a more environmentally friendly business model.

Banks may also be exposed to an increasing litigation risk. If a bank, as a signatory to a climate commitment, does not live up to it, not only could its reputation be harmed, it could even be held liable, for example by NGOs.

And so not living up to a climate commitment, for instance by not providing sufficient qualitative or quantitative disclosures, may lead to reputational and litigation risks that could have financial consequences.

I'm wrapping up.

Today, in talking to you about the risks of global warming, I am not crying wolf. I, and many with me, know that the threat is real. That we need to act. That we need to make significant progress in the pathway to net-zero.

As a sort of shepherd of financial stability, I want to do what I can to protect our society against the wolf that is global warming. I want to do what I can within my mandate as supervisor.

But global warming knows no borders. Not between sectors. Not between countries. Global warming affects all of us. Everyone. Everywhere.

And so, we will only succeed if everyone, everywhere, does their part – governments, banks, and supervisors. If everyone, everywhere, within their respective mandates or from within their business operations, contributes to achieving our common goals – protecting lives and livelihoods.

So with that, comes a *different* cry. With that, comes a *rallying* cry. A cry to move from a sense of urgency to a sense of action in the fight against global warming.

I hope you are with me. Thank you.