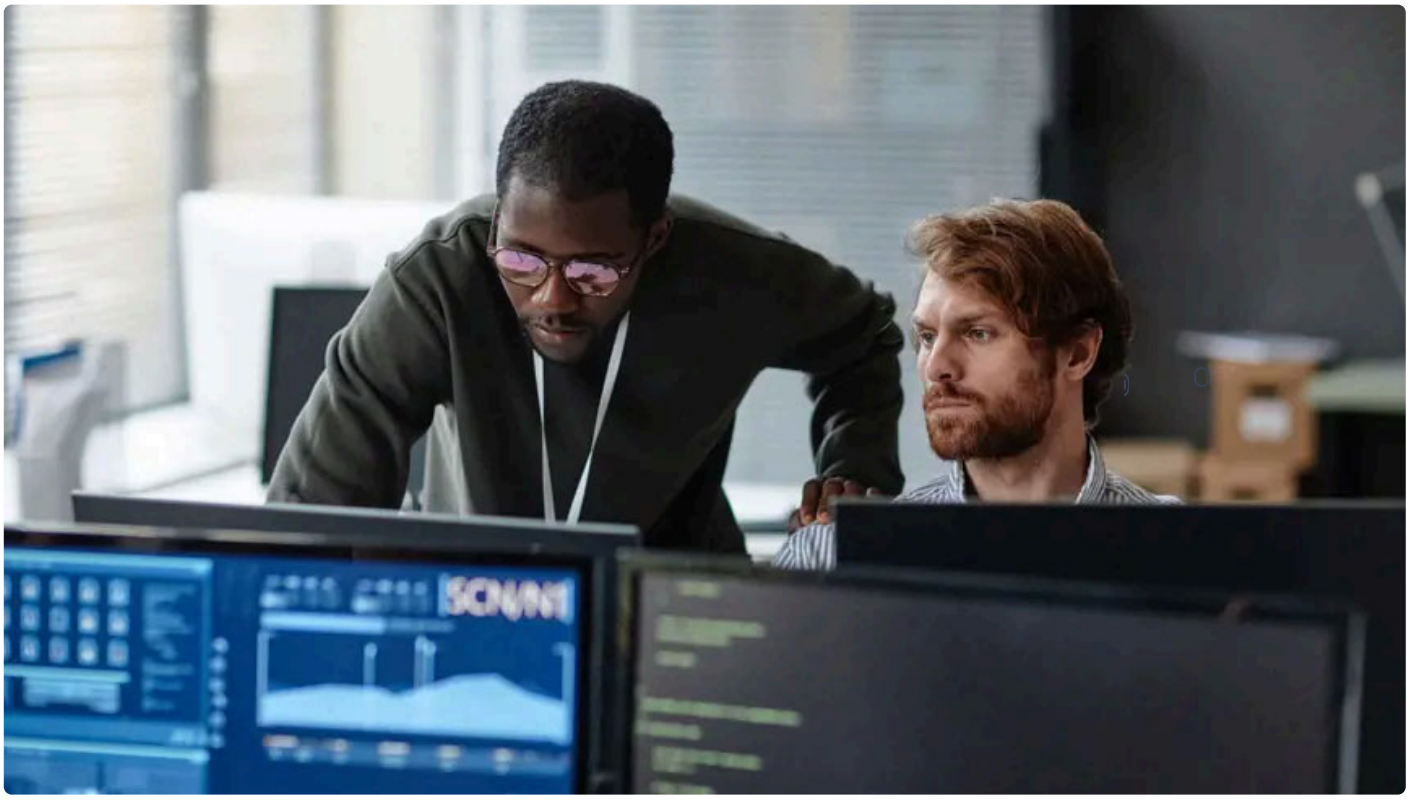
SPEECH

Risks to financial stability in autumn 2024

Read aloud

'Given the growing cyber risks, we must continue our work to reduce the probability of cyberattacks while simultaneously boosting our resilience against their potential impact.', said Olaf Sleijpen at the IIF International Accounting and Reporting Forum. He talked about the risks to financial stability caused by the rise in geopolitical tensions and geoeconomic fragmentation.

Published: 12 November 2024

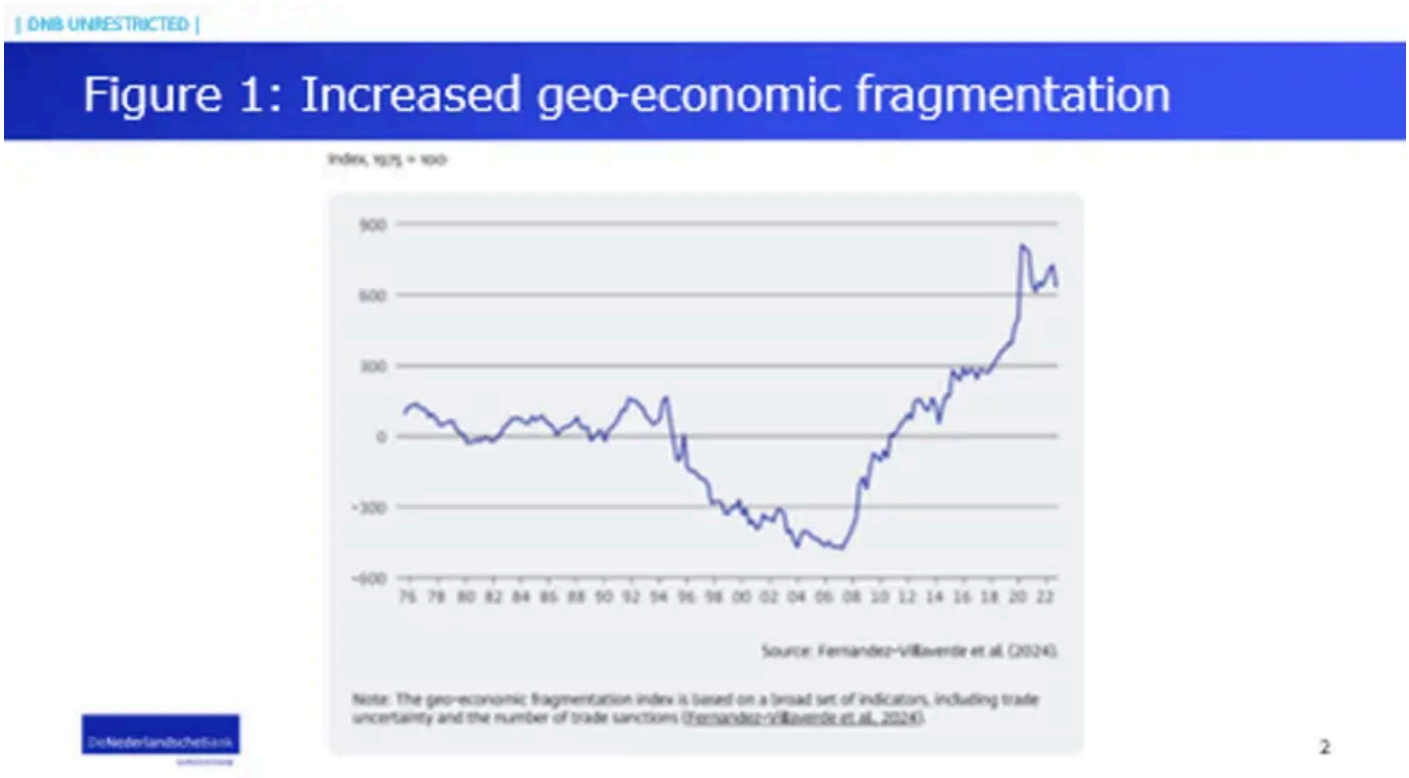


Good afternoon and thank you for the invitation. I asked specifically not to have to talk about accounting, given that I am not an expert in this important field. But, as a former member of the Basel Committee, I know enough about it to understand that regulation and accounting are crucial to keeping the banking industry safe and sound.

What I will do is take you through the most important risks to financial stability that we currently see as a central bank. Because I think this is very relevant to your field of work as well.

Now, the fun about analysing financial stability risks is that there's never a dull moment. Take last week for example. I cannot say I stayed up on election night, but obviously, the outcome of the US presidential election is an important factor for financial stability. And not only with regard to the new administration's economic policy, but perhaps even more, its foreign policy, in a world where geopolitical tensions have risen sharply.

Indeed, this surge in geopolitical tensions has fueled geo-economic fragmentation. Countries are clustering together in economic and political blocs, they are strengthening national security and curbing strategic economic risks, and we are seeing more and more trade restrictions. In response, firms around the world are rethinking their supply chains and are considering re-shoring, near-shoring or friend-shoring.



As you can see in this chart, the deglobalisation trend has been on-going ever since the global financial crisis. As an open economy with a large financial sector, the Netherlands is particularly sensitive to geo-economic fragmentation. But to some extent this also holds for the EU as a whole. The numbers show that even as a bloc, the EU economy is more open than,

for example, China and the US. EU trade with other countries is more than 40 percent of EU GDP. Europe has prospered as an open economic region, but is also more heavily exposed to the effects of geo-economic fragmentation.

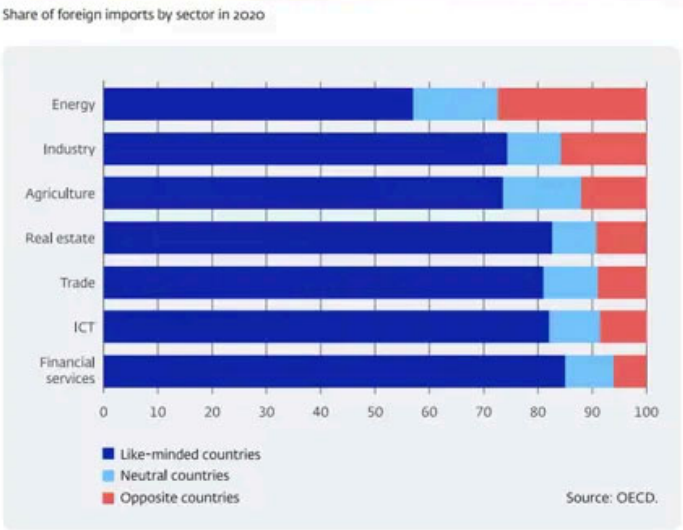
Both geopolitical tensions and geo-economic fragmentation can affect financial stability, and those effects can follow different channels. For instance, geopolitical tensions are associated with a higher number of cyberattacks worldwide. Also financial institutions are affected by geo-economic fragmentation through their lending and investment portfolio, the so-called real economy channel.

Let me cover these two channels a little bit more in depth, starting with the impact via the real economy. Trade restrictions hamper growth of the economy in general, but do not affect everyone to the same extent. For financial institutions the effect of fragmentation and tensions depends on their portfolio composition. Overall Dutch financial institutions have relatively few corporate loans and investments in countries that are geopolitically remote from the Netherlands. But they are more vulnerable to fragmentation through the value chains of the firms they lend to or invest in.

Financial institutions may also be indirectly affected by trade disruptions via corporates whose production depends on so-called opposing countries. Since 1995 imports such as commodities, services or components from these countries have increased fourfold to 12% in 2020.

| DNB UNRESTRICTED |

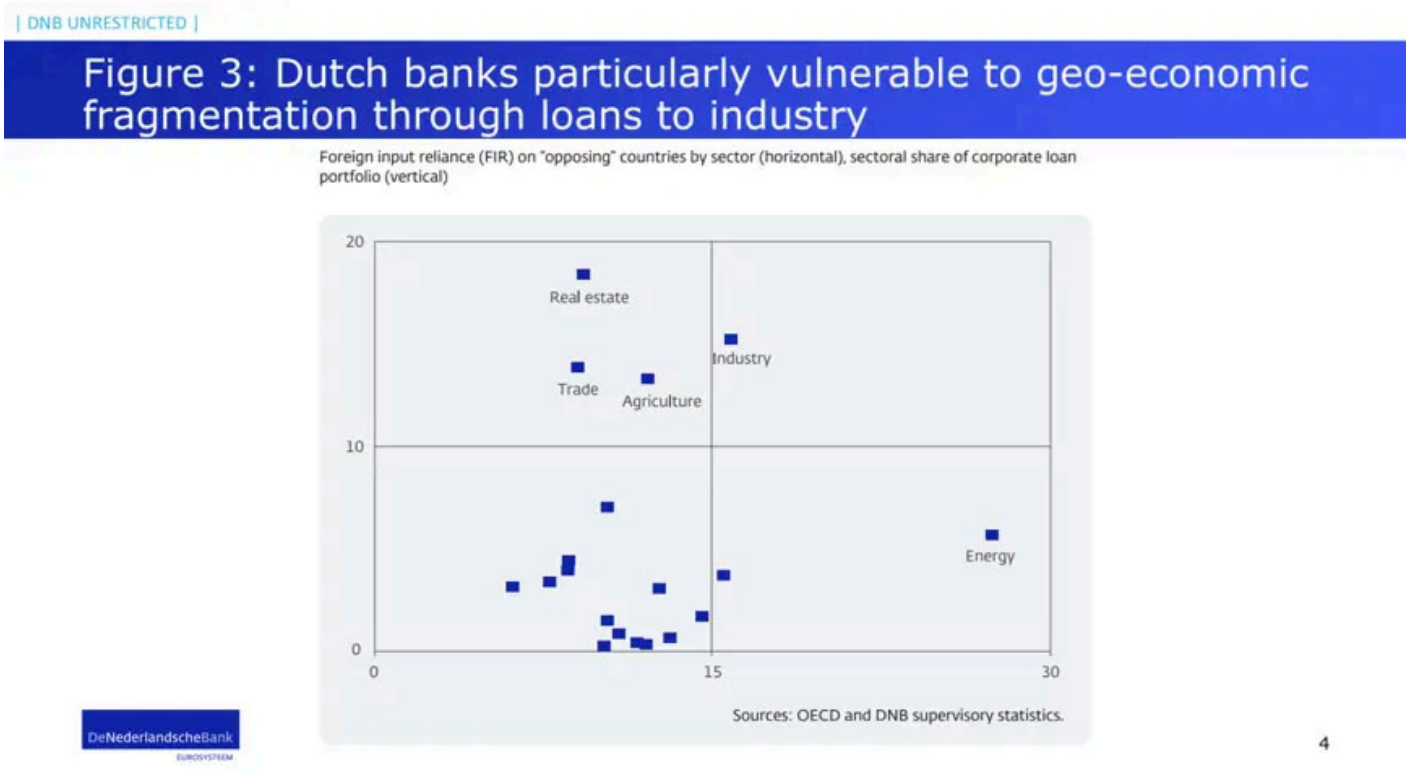
Figure 2: Dutch industrial sector vulnerable to geo-economic fragmentation



Notes: To map sensitivities to geopolitical tensions and fragmentation, we divided countries into three groups based on the way they voted on the UN resolution on the human rights situation in the temporarily occupied parts of Ukraine in 2023: "likeminded", "opposing" and "neutral" countries (Baba et al., 2023). The "neutral" group comprises countries that abstained or were absent at the time of the vote on this specific resolution. This division of countries into the three groups cannot be considered absolute, as it relates to a specific resolution.

As this graph shows, the industrial and construction sectors depend for a substantial share on foreign imports from such opposing countries. That makes these sectors vulnerable to trade restrictions between global regions. We saw this for example during the COVID-19 pandemic.

Combining this information about sectors with the corporate lending portfolio of banks, we see that the industrial sector depends relatively heavily on opposing countries and at the same time accounts for a relatively large share of banks' corporate loan portfolios. You can see that in this graph.



So when monitoring risks in the loan and investment portfolios, it is important that financial institutions look beyond the country in which a firm is based. They should also consider how vulnerable it may be through its value chains. This is because dependence on foreign imports may differ significantly between firms.

After touching on the real economy channel, let me now discuss another channel through which geopolitical tensions can impact financial stability, and that is the growing cyber risk.

Growing geopolitical tensions are accompanied by higher cyber risks. This was underscored in the recent warning issued by the National Cyber Security Centre in the Netherlands. The NCSC warns against the significant risk of cyber threats, including the growing presence of nation-state actors. This warning is already becoming a reality, as the recent hack of the Dutch National Police showed.

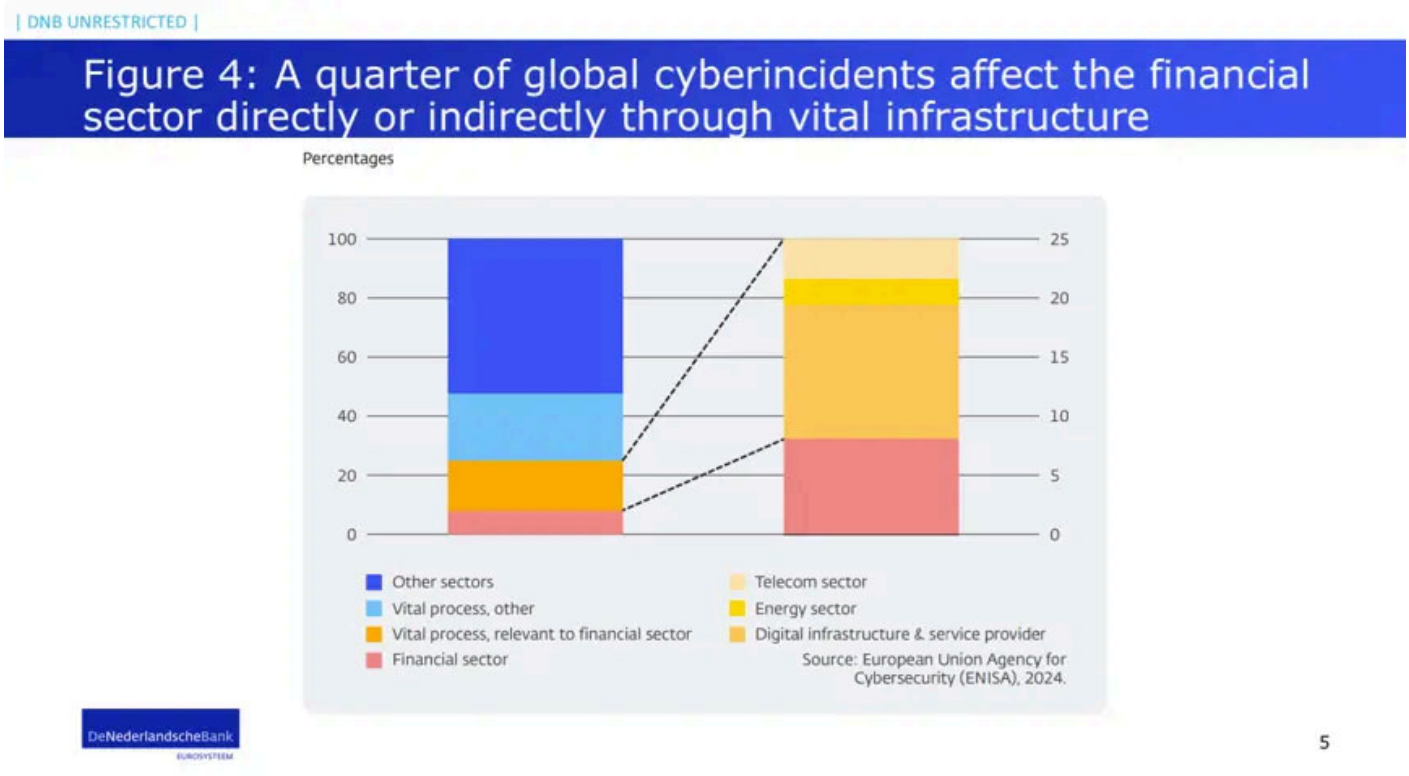
Now for the financial sector in particular I would like to reflect on three vulnerabilities that increase the risk of disruption to the financial system from a cyberattack.

First, the cyber landscape is becoming increasingly complex due to various developments, not the least of which is the rise of artificial intelligence. Arguably, AI offers many opportunities. For example it improves the operational efficiency or cyber security by detecting patterns and

anomalies that indicate cyberthreats in real time. But AI also enables more frequent and more sophisticated cyberattacks. For example, you may have heard how cyber attackers managed to steal 25 million US dollars from a foreign company by using AI face and voice impersonation software. They managed to trick a staff member into believing that the instructions were coming from the company's executive in a live video conference.

Second, there is a vulnerability related to outsourcing by financial institutions. To perform their core tasks, financial institutions outsource certain tasks or rely on the structure of third parties, such as cloud storage services or cybersecurity. As only a small group of parties provide these digital services, concentration risk arises. Given that the financial sector is traditionally highly concentrated in the Netherlands, this concentration risk from outsourcing is amplified here. Issues affecting a single service provider can thus hit multiple financial institutions, creating ripple effects throughout the system and society. A case in point is last summer's CrowdStrike incident. Although its cause was a programming error, it illustrates the risks of increasing concentration and digital dependencies.

Finally, processes that are vital for the Netherlands and the financial sector, such as telecommunications and energy supply, are strategic targets for cyber attackers. These dependencies increase the financial sector's vulnerability to cyberattacks.



For example, as you can see here, a quarter of all cyberattacks worldwide affect the financial sector directly or indirectly through a vital process on which the financial system depends. You can think of these dependencies on vital infrastructure as the blocks at the bottom of a tall Jenga tower. A complex system arises on top of the blocks in the foundation. And if you

remove one of these blocks, the entire system built on top may tremble or - in a worst case scenario - fail.

Given the growing cyber risks and known vulnerabilities, we must continue our work to reduce the probability of cyberattacks while simultaneously boosting our resilience against their potential impact.

Reducing the probability means solid and up-to-date operational risk management and policies. Stress tests and penetration tests are highly relevant in this regard, as they uncover weaknesses. The recent ECB stress test, for example, concluded that banks need to make improvements on several fronts, such as by assessing their reliance on critical third parties. Moreover, we must keep up with the rapid developments in the cyber threat landscape. Information exchange between financial institutions and across sectors is key in this respect. But also information exchange and co-operation between the financial sector and public authorities are key. Platforms, like the IIF, are invaluable for forging connections, sharing information and establishing working relationships.

Such connections can indeed prove very useful when push comes to shove, as you need to find each other in times of crisis. Next to having timely information available, having effective contingency measures in place is key to strengthening resilience in case of a successful cyberattack. Such crisis measures need to be regularly tested, but in order to act you need to know in detail what is happening. Adequate crisis management also requires all possible stakeholders in the outsourcing chain to be on the same page, so that they know what is expected of them. It is therefore of vital importance to hold regular drills with critical third parties. Also in this respect, public and private parties need to work together on system-wide cyber scenarios or stress tests to assess resilience and crisis response.

We live in a time where war has come close to our borders, and geo-economic fragmentation has become a new reality. Yet, even in this reality, policymakers can seek pragmatic solutions that minimise the economic costs of fragmentation. And remain committed to the functioning of the multilateral system that has brought us so many benefits. It is our role as members of the international financial community to keep conveying this message to national policymakers. And to keep working on cross-border challenges together.

Thank you for your attention. I am now available to answer your questions.

Discover related articles

Speech | Economy