

“From mission to supervision”

Key note speech by Klaas Knot at the Bundesbank Symposium
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In his keynote speech, Klaas Knot outlines how the issue of ‘sustainability’ got on the DNB agenda, highlighting how and why sustainability is relevant for central banks, supervisors and the financial industry. Secondly, he gives an overview of the climate-risks in the Dutch financial sector. Third and finally, he sketches what this means for bank risk management and supervision.

Introduction

Dear herr Dombret, herr Otto, thank for your kind introduction, and thank you very much for having me. It's a great privilege for me to speak to you at this Symposium Banking Supervision in Dialogue.

Let me begin though by highlighting that if I would have told you 5 years ago that today at this very Symposium "Bankenaufsicht im Dialog", we would spend half the day discussing sustainability, not only would none of you have believed me, but most likely many of you would have taken me for a sort of tree hugger rather than a central banker.

And yet here we are today. It's a clear indication of the significant shift in thinking that has occurred in the financial sector and in the supervisory community over the past few years. Sustainability has become more and more part of mainstream finance, evidenced by so many initiatives and examples worldwide, of which the Sustainable Finance Action Plan, which the European Commission will publish tomorrow, is only just the latest.

At De Nederlandsche Bank, which is both the central bank and the supervisor of banks, pension funds and insurance companies, we have been active on the issue for a few years now. I can imagine though that many of you might be wondering why we have been active on this issue for a few years already. What happened there?

Today, in my speech 'From mission to supervision', I want to share with you precisely what happened. I will firstly share how this issue got on our agenda, highlighting how and why sustainability is relevant for central banks, supervisors and the financial industry. I will then turn to a thematic review of climate-risks in the Dutch financial sector that we did in 2017, which led to a publically available report, called Waterproof. As Andreas has already explained to you how and why our economies and financial sectors could be impacted by climate change and the energy transition, I will not bore you with repeating that. Instead, I would like to share with you the outcome of our thematic review on the risks we are seeing for the Dutch financial sector.

Third and finally, I will say a few things on what this means for bank risk management and supervision.

All in the hope that we all will walk away here with a better understanding of how sustainability can affect our different organizations. And convinced that it makes perfect sense to incorporate sustainability into our day-to-day operations.

I. Mission: Sustainability on the agenda of DNB

Let me begin by explaining how sustainability got onto the agenda of DNB, thereby also showing in the process why this issue fits the mandate of central bank and supervisor. You see, not too long ago, sustainability to us just meant we should ensure that our coffee cups were made out of sustainable paper, and that the coffee in those cups was fair trade. Sustainability was something we certainly thought that was important, but it was not something that concerned our core tasks or our strategy as an organization. (And I'm guessing we were not the only organization to think like this.)

That changed in 2011 though, when the newly appointed board of DNB concluded that probably this was the appropriate time to update the mission statement. We had to answer the question: **what is our Existenzberechtigung?** It's something I'm sure many of you have had to deal with as well, whether as a supervisor or as a commercial bank. Mind you, this happened in 2011, when we had just lived through the Global Financial Crisis. Europe was still in the midst of a sovereign debt crisis, and emergency measures were taken all around us. It had become clear to us, the new board, but also to many bankers and many economists we talked to, that a significant part of the economic prosperity that our societies had created in the early 2000s, had been based on excessive leverage. Our economies had seen too much credit growth, which was not adequately backed up by underlying strong economic and financial fundamentals of companies, households and even of governments. All of these developments were in the back of our mind when we had to come up with that new mission statement for DNB.

One obvious implication of all of this being at the back of our mind, was that safeguarding financial stability was to be a crucial part of this mission. Another implication was that we wanted to incorporate an element of the general good of the societies we serve, contributing to increases in living standards and prosperity of those we serve.

But there was something more, relating to all those crisis developments I just mentioned. Hadn't the crisis taught us that the prosperity we had created in the years before the financial crisis, had proven to not be durable in the long run? Put differently, **the prosperity had turned out to not be sustainable**. Because that's what sustainable means: durable in the long run.

And so, as we were walking down a foggy beach in Zandvoort, trying to come up with this new mission statement, we fortunately had the clarity of mind to add the word 'sustainable' before the word 'prosperity'. Our mission as central bank and supervisors became **"to safeguard financial stability and thus contribute to sustainable prosperity in the Netherlands."**

Now, of course, as we added the word 'sustainable' to our mission, our main thinking was in relation to the economic and financial crisis. Sustainable prosperity meant, for example, that banks should have sufficient buffers to absorb unexpected losses. But it soon became clear that the word sustainable could have broader implications.

After all, if the way in which prosperity is created today results in significant ecological damage that prevents future generations from obtaining similar or higher levels of prosperity, today's prosperity creation is not sustainable either. And as such, it runs counter to our mission.

Of course, having a mission is just the start. As I'm sure all of you know, any policy determined at the top needs to be embedded throughout the organization to be truly effective. Therefore our policy became **to incorporate relevant sustainability considerations in most of our core tasks**. Of course the extent to which sustainability can and should be incorporated, depends on each of the individual tasks that a central bank/supervisor may have.

And I'm sure that the extent to which sustainability can and should be incorporated for financial institutions, will not only depend on which type of institution you are - a bank, a pension fund or an insurer - but may also differ per institution as well.

For some of our own core tasks, it was quite practical. In our payments systems task, for example. We are probably one of the only central banks in the world where 70% of our bank notes are now made out of either fair trade or organic cotton, and our goal for 2019 is to reach 100%.

For other core tasks, it was more conceptual and theoretical. As part of our economic research and advisory function, we published an exploratory study called Time for Transition. In it, we identified the upcoming energy transition, as agreed upon by more than 190 countries in Paris in December 2015, as one of our economy's key long-term challenges. In the report we urged our government to pursue a plausible and practicable path towards a carbon-neutral economy, as such a long-term view enables households and businesses to gradually adjust their investments, preventing excessive misallocation.

And we also decided to take a closer look into climate risks for the Dutch financial sector as part of our supervisory mandate.

II. Risks: a thematic review of climate risks in the Dutch financial sector

Which brings me to the second part of this speech. What are the risks that we see as a supervisor in the Dutch financial sector? In 2017 we conducted a thematic review on this issue. In this review we took a deep dive into four topics:

- climate-related damages for the insurance industry
- risks for the financial sector from a potential flood
- risks from the financing of carbon intensive assets, so called 'brown finance'
- risks from the financing of assets and projects that are meant to contribute to the energy transition, so called 'green finance'.

Today I want to share with you some **key findings for banks**, regarding the risks for brown and green finance. In terms of brown finance, one of the things we wanted to do was get an understanding of the size of the risks. How big of a risk is the energy transition for our banking sector? As a first step, we wanted to measure how exposed our financial industry is to sectors that need significant reforms to become carbon neutral. Sectors such as fossil fuel producers, the utilities industry, heavy industry, agriculture and transportation.

This wasn't something that we could easily get from our supervisory data. Which is why we welcome the work that the Commission will do on developing a taxonomy for the sustainability of financial assets as part of their Sustainable Finance Action Plan.

For our research, however we had to develop our own template for our financial sector to fill out. We sent this template to the three biggest banks, covering around 70-80% of the market. What we found is that banks' balance sheet consist of around 11% of exposures to carbon intensive industries.

Not surprisingly, most of these exposures are through loans, which makes banks less sensitive to market fluctuations than for example pension funds. Moreover, most of these loans have maturities of less than five years, which should provide banks with sufficient scope to anticipate changes. Especially if the transition is more gradual in nature.

In one area however, we already see transition risks materializing, and that's in the real estate sector. The real estate sector plays an important role in carbon emissions and is therefore sensitive to the energy transition. In the EU, many, if not all, residential and commercial real estate have energy efficiency labels, ranging from A to G, with G being the least energy efficient building. The Dutch government has announced legislation that requires almost all offices in the Netherlands to have a minimum energy efficiency label of C by 2023. Any office that doesn't meet that requirement can no longer be used.

This affects banks in two ways. First, through loans to regular corporations, who use their own offices as collateral for their bank loans, and second, through loans to commercial real estate companies that lease offices as a business model. If some of these offices may no longer be used, or will need to be upgraded to meet the requirement, this could affect the value of the collateral or the ability of commercial real estate companies to pay back their loans.

So how big of an issue is this for our banks? Unfortunately, neither we nor our banks know the energy label distribution of the offices used as collateral for loans to regular corporations. For loans to commercial real estate companies, banks know of roughly 50% of those loans what the energy label distribution is. Of those loans where we did know the label distribution, we found that 46% of bank loans to commercial real estate companies in relation to offices, have an energy label lower than C. This is around 6bn worth of loans. All these loans, one could say, have elevated credit risks, which banks, one way or the other, will need to manage. Fortunately, we are seeing many banks react swiftly.

Banks are now demanding that any new loan or refinancing of existing loans in relation to those offices is dependent on the client meeting the energy-label requirement on time. This should ensure that banks will have limited exposures to offices that won't meet the deadline on time. For us, this national legislation is a prime example of how the energy transition will lead to risks in the financial sector.

We also looked at the risks of green finance, as I mentioned. **First there is the risk of a green bubble.** History shows us that many transitions are accompanied by a boom bust cycle, whether it's the dot-com bubble in the early 2000s, or the railway mania of the late 1900s. Whenever there's increasing demand, a hype, or new market opportunities and instruments, there's the risk of creating a new bubble. While we are still far away from a green bubble, institutions do tell us that green projects have become more and more expensive, as competition has increased with more and more institutions essentially bidding for the same projects.

A second risk we see is green washing. Do investors and consumers know what green is, when they're buying green? There are examples of a green bond being used to make a coal plant more sustainable. In itself, there is nothing wrong with that, or at least that's not for us to say, but what

is important is that purchasers of these bonds should be aware of this. Here, too, the work of the European Commission on a sustainable taxonomy as well as on standards for green bonds, will be most welcome.

Lastly, we are seeing an increased lobbying effort to lower capital requirements to stimulate green investments. Andreas has already touched upon this, so I won't repeat that, other than that we wholeheartedly agree: capital requirements should remain risk based. We are thus quite skeptical of the expected plans of the European Commission in relation to prudential requirements, even though they also acknowledge the risk based nature of capital requirements.

III. Supervision: Implications for bank risk management and supervision

So let me end with what this all means for bank risk management and supervision. The main conclusion is that banks, including those present today, will need to manage material climate-related risks. And that supervisors will need to supervise this.

This is of course easier said than done. If anyone in this room already knows how to exactly manage climate-related risks, please join us at the podium in a minute!

Two things are important to keep in mind here. One: **incorporating climate risks is greatly facilitated when governments impose clear and long term transition legislation**, which gives banks the ability to steer towards a set of well-defined goals. This is exactly what we are seeing with the energy efficiency requirements of Dutch offices.

Two, for many parts of our economies, unfortunately there is not yet any clear legislation that allows banks to anticipate such a set of well-defined goals. In those cases, banks would still do well to try and gauge how their business models and which parts of their balance sheets would be most strongly affected by the transition and which type of legislation or technological change might be expected in those sectors. It would then be prudent to **try to assess potential losses as a result**. Scenario analysis and stress testing would be a good tool for this.

Put differently, **institutions will need to take a more forward looking approach to incorporate climate related risks**. This process can fortunately be helped by implementing the recommendations of the FSB Taskforce on Climate-related Financial Disclosures. Implementing the recommendations means you will need to explain your governance, risk management and strategy on climate related issues. And you will need to explain which metrics and targets you use to prepare yourself on these issues. And all of this of course means you need to have a strategy, risk management and governance system on this issue. And that you subsequently need to have targets and metrics to measure your progress in these areas.

Fortunately we are seeing many financial institutions in the Netherlands and abroad experimenting with incorporating climate risk management. One Dutch bank for example, has incorporated the energy transition into its credit policies for loans to the utility industry. This bank will only finance utilities that have carbon reduction strategies, and the bank wants the average energy mix of the utility companies it finances, to be in line with the 2 degree scenarios from the International Energy Agency.

This is precisely the kind of thinking and attitude we need, to start incorporating climate risk considerations into investment decisions.

It won't be easy, and I'm sure it won't be perfect at first either, but we need to start somewhere. **How to precisely incorporate climate-related risks into banking supervision also remains an open question**. Here too, the same two points stand out.

One, when risks are already material, we can of course already assess them. If Dutch banks for example were ignoring the increased credit risk from the sustainability requirement for offices, you can be sure we would be in a serious supervisory dialogue as part of the Pillar 2 credit risk assessment. But that's of course just one very specific example, where there is specific transition legislation affecting only a small part of our economy. It's more challenging for the energy transition as a whole and for banks' balance sheets as a whole. How should supervisors assess

how well banks are incorporating climate-related risks there? Do we need to establish a separate risk category in the Supervisory Review and Evaluation Process as some European Parliament members are proposing? Or can and should we just incorporate it into the existing SREP-elements, such as for example credit risk?

We don't have all the answers yet, but we will continue to explore these questions in the years to come, and we hope you will join us.

One thing should be clear though: sustainability factors, and climate issues in particular, can affect the solidity of financial institutions, and therefore warrant the consideration of banks and supervisors alike. Fortunately, just a few months ago, central banks and supervisors from 8 jurisdictions, including Germany and the Netherlands, launched the Central Banks and Supervisors Network for Greening the Financial System. This Network aims to enhance the role of the financial system to manage risks and to mobilize capital in the transition to an environmentally more sustainable world. My colleague, Frank Elderson, was recently elected as the first chair of this Network. I am grateful and excited that DNB and the Bundesbank will work together in this Network to advance this issue in the international supervisory community.

Conclusion

Ladies and gentlemen. Today we went from mission to supervision. I hope that the transition that DNB underwent as an organization, where relevant sustainability-considerations have been incorporated into our core tasks, has inspired you or perhaps has even sounded familiar.

But I can also imagine that some of you might remain skeptical on the appropriateness of all this. Perhaps some are still wondering: are we really discussing sustainability today? For those I would like to share something my colleague Jan Sijbrand said to me recently:

"Klaas, when it comes to sustainability, we are being criticized from both sides: there are those who say we are operating beyond the boundaries of our mandate. But there are also those who say we are doing way too little."

"To me", he said, "That's a clear sign we're exactly on the track we should be."

And with that I would like to conclude for now.

Thank you.