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Climate-risk implications for the EU financial sector

Climate-risks are high on the agenda of the financial sector and its policymakers. As central bank and prudential supervisor, De Nederlandsche Bank (DNB) is committed to contribute to sustainable prosperity. We are convinced that sustainable economic growth is only possible when we avoid harmful effects on the environment.

DNB's sustainable finance strategy for its supervisory tasks focuses on integrating sustainability-related risks in our supervisory regulations, methodologies and examinations. In a broader context, and leveraging our role as central bank, DNB aims to fuel the public debate by contributing facts and insights about the energy transition and its effects on the economy.

DNB's approach on the integration of climate-related risks in our supervisory practice currently focuses on Data and disclosure, Risk management, and Governance and strategy – which follows the framework of the Taskforce on Climate-related Financial Disclosure.

Taking a look at where we are at integrating climate-related risks in the regulatory framework, notable good news is that the need for embedding (financial) risks related to climate change in the prudential regulatory framework is widely recognized. Encouraged by the expanding Network for Greening the Financial System, there's a growing number of standard setters and regulators taking a serious look at the effects climate change will have on our societies at large and how the risks stemming from these developments should be dealt with within the financial industry. However, amending a prudential framework typically requires quantitative evidence – which is, as of yet, lacking. Collecting such quantitative evidence is hampered by some specific characteristics of climate-related risks, which makes it challenging to adequately reflect their impact in a prudential regulatory framework.

First, whereas a forward-looking approach is key, there is an obvious uncertainty related to the size and timing of climate risks. Second, historical data are of very little use in making climate risk projections. Third, we lack expertise and experience in translating climate risks to financial institutions' financial risks. Furthermore, physical climate risks are subject to sizeable geographical differences, making it hard to generalize the impact of these risks. Fifth, there is a clear interrelation between climate-risks and other environmental risks (eg biodiversity loss), which may amplify their impact on financial risks. This interaction further complicates the design of risk differentials. Finally, the time horizon for climate-related risks tends to be longer than time horizons traditionally applied to prudential standards.

So, what is the way forward? Identifying and mitigating climate risks will require taking a fresh and perhaps non-traditional look at our regulatory toolkit. As the future is not in the data yet, it may be worthwhile exploring tools designed for non-cyclical and long-term events, such as concentration limits and/or targeted risk buffers, along with climate stress testing and scenario analysis.

Having said that, financial market players should not wait for all the regulations, conditions and perfect data sets to be in place before they can have impact. They, too, have a social responsibility to support a sustainable economy.