Nederlandse Vereniging van Banken

POSITION PAPER
On the Prudential Treatment of Climate-Related Assets

Introduction

In this position paper, the Dutch banking sector, represented by the Dutch Banking Association (Nederlandse Vereniging van Banken, NVB), shares its views on the desirability of various proposed prudential measures intended to contribute to the management of climate-related financial risks in the financial sector. It concerns, inter alia, the question whether a specific treatment for climate-related ('green' and 'brown') assets in the capital requirements can be justified from a risk perspective. Other aspects of sustainability, such as social concerns or environmental concerns other than climate change, are not taken into consideration in this memorandum. I

Key messages

- Prudential requirements are not considered to be the most important factor in the decision to finance 'green' or other assets. There are more effective ways to stimulate the transition to a carbon-neutral economy, such as carbon pricing.
- Even so, the NVB argues that prudential regulation can play a role in mainstreaming of climate risk management in the European financial sector.
- Climate stress testing and reporting requirements are the most effective instruments within the current prudential framework.
- The NVB is not in favour of specific capital requirements for green or brown asset classes, unless these are truly risk-based.

What are green and brown assets?

There are various definitions of 'green' and 'brown' assets in use. In general, in the debate about 'green assets' green is used to refer to all economic activities that combat climate change or mitigate its consequences. The definition of brown sometimes only includes activities that clearly contribute to climate change, but sometimes is seen to include all activities that do not demonstrably contribute to combating climate change (and that could be regarded as 'neutral' by others). The European Commission has proposed forming a taxonomy to define what assets can be considered environmentally sustainable, but this has not yet been realised.[1] Where this memorandum refers to green or brown assets, it should therefore be kept in mind that, at present, this could include various types of financing.

Capital requirements and financing of green assets

The NVB recognizes the importance of integrating climate risk in the risk assessments of financial institutions as climate change may have a range of detrimental effects on financial stability, mostly summarized as risks relating to changes in our physical environment and risks relating to changes in the economy.[2] Dutch banks have taken action already and have developed methodologies to measure and decrease the carbon impact of their financing activities.[3]

[1] The EU Action Plan Sustainable Finance refers to a uniform taxonomy for sustainable financing (source: http://europa.eu/rapid/press-release_IP-18-1404_en.htm). This will be drawn up soon. The banks wish to see that the existing definitions (for example of the Climate Bonds Initiative) are followed as much as possible.
[2] For more information managing on fysical and transition risk in the banking sector, see: http://www.unepfi.org/banking/tcfd/.
[3] See for example the NVB Climate Statement and the Spitsbergen Ambition.

Gustav Mahlerplein 29-35 • 1082 MS Amsterdam • +31(0)20 55 02 888 www.nvb.nl

September 2018

However, the NVB believes that capital requirements are only one of many factors that influence the decision to finance activities that diminish or mitigate climate change. Other factors, such as the business case for these activities, largely influenced by the cost of carbon emissions, are more important. Carbon pricing is therefore still considered to be the most effective way of stimulating climate-friendly economic activities.

Besides, NVB is convinced that capital requirements should always be based on the risk profile of targeted asset classes. Dutch banks generally do not expect green projects to be less risky from a financial perspective, even if they do mitigate risks to society associated with climate change. Therefore, the NVB is not in favour of the introduction of a Green Support Factor (GSF) as was proposed by various parties: a reduction to the capital requirement of certain assets, without proper research into the risk profile of these assets.[4] Overall, it is not desirable to artificially alter the risk profile of assets by the introduction of exceptions to capital requirements.

The NVB further notes that the time horizon of Pillar 1 capital requirements is one year. Considering that climate-related financial risks will, in general, probably manifest themselves in the somewhat longer term, capital requirements do not seem to be the best fitting instrument to contribute to the effective management of these risks. Moreover, we not are in favour of a measure of a general nature that would apply to all banks, but for measures that are more institution specific. In line with our position on a Green Supporting Factor, the NVB would also not support a Brown Penalising Factor (BPF) unless it is based upon a clear definition and proper information on the risk profile of targeted assets.

Alternative measures within the prudential framework

The NVB would like to promote further mainstreaming of climate risk management in the European financial sector and believes that prudential regulation can play a role. Even if we agree with the European Supervisory Authorities' (ESA) Joint Committee that knowledge about the impact of these risks on the financial sector is still relatively limited[5], we welcome the European Commission's proposal to make supervision on climate risk part of the ESAs' duties.[6] The NVB envisages the following ways in which this can be implemented effectively:

- Tailor-made stress testing; Dutch banks believe that climate stress tests are a sensible way of increasing the awareness and improving the management of climate risks by financial institutions. Financial institutions would have to determine the most relevant climate stress test themselves, and assess the vulnerability of their balance sheets and the effects on its financial resilience. Climate stress testing could become part of the internal capital adequacy assessment process (ICAAP).
- Disclosure requirements; The importance of transparency about climate risks that have been identified is also acknowledged. The NVB is therefore in favour of disclosure requirements under Pillar 3 with respect to climate risks. However, it is important here that a reasonable lead-time be observed considering the many data problems that still exist.

More information

Hubert Schokker
Advisor Supervisory affairs

Sharon van Ede
Sustainability Advisor

[4] Most proposals for a GSF argue a reduction of 25%, seemingly inspired by the current SME supporting factor.
[5] Source: https://esas-joint-committee.europa.eu/Publications/Reports/Joint%20Committee%20Risk%20Report.pdf.
[6] Source: EU Action Plan Sustainable Finance, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0097.