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Submitted by email: consultatie@dnb.nl

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Subject: **NVB response to DNB consultation on Good Practice 'Integration of climate-related risk considerations into banks' risk management'**

Dear sir, madam,

On behalf the Dutch Banking Association (NVB), we would like to respond to the DNB consultation on the Good Practice *'Integration of climate-related risk considerations into banks' risk management'*. With great interest we have read the consultation and we are happy to provide feedback to the presented good practices and the more general topic of further integration of climate-related risk in banks' risk governance, risk management and disclosure. Our full response is attached to this letter.

We acknowledge that climate change is one of the biggest challenges of our time and that banks need to do their part in helping to shape a more sustainable society. Banks undertake initiatives that address climate impact *by* banks as well as climate impact *on* banks. There are numerous examples of such initiatives, such as the Principles for Responsible Banking and the Dutch Climate Commitment.

The consultation addresses climate change risk from a financial stability perspective, meaning the impact of climate risk *on* banks, and explores how climate risk could be integrated in banks' risk management. The NVB response will therefore also focus on banks' risk management.

Although practices and methodologies for climate risk are still in the early stages of development, banks recognize the urgency of taking action and are actively exploring how climate risk can be further integrated in their risk management. The consultation states correctly that the identification, assessment, management and monitoring of all important risks are at the heart of effective risk management. We agree that climate risk should be considered and challenged in risk management frameworks whilst taking materiality and proportionality into account. However, there are also still challenges in the development of methodologies for climate risk management which require further analysis and discussion.

We acknowledge the importance of this good practice consultation and we hope that our response will contribute to the further exploration and concretisation of climate risk management. Given the importance of climate change for society, we are looking forward to further dialogue with DNB, EBA and ECB on this topic.

Kind regards,

Eelco Dubbeling
Managing Director

Nederlandse Vereniging van Banken

Dutch Banking Association (NVB) response to the DNB consultation on Good Practices for the integration of Climate Risk in banks' risk management

Introduction
The NVB welcomes the Dutch Central Bank's (DNB) initiative to launch a public consultation on 'Good practices for the Integration of climate-related risk considerations into banks' risk management'. The consultation has the aim of collecting feedback on the clarity of the presented good practices and whether they provide helpful guidance for the further integration of climate related risks in banks' risk governance, risk management and disclosure.[1]

Climate risk management: challenges and dilemma's
The identification, assessment, management and monitoring of all important risks are at the heart of effective risk management. Therefore, we agree that climate risk should be considered by banks for inclusion in their risk management frameworks, taking materiality and proportionality into account. The non-binding guidance presented in the consultation document provides helpful examples on how climate risks can be visualised and discussed. Although banks are actively exploring how climate risks can further be integrated in risk management, practices and methodologies are still in the early stages of development and usage, and require further analysis of risk drivers. Therefore, this consultation comes at a time when banks are not yet ready to fully assess the effectiveness of the presented good practises. Considering this early phase, this response provides a starting point for further exploration and concretisation of climate risk management.

Scope of the consultation – impact climate risk "on banks" and "by banks"
The consultation addresses climate change risk from a financial stability perspective, meaning the impact of climate risk "*on* banks", and explores how climate risk could be integrated in banks' risk management. The NVB response will therefore only focus on this aspect of climate risk. However, there is also the topic of impact "*by* banks". There are many examples of initiatives on the impact of climate risks *on* banks as well as the impact *by* banks such as the Principles for Responsible Banking[2] and the Dutch Climate Commitment.[3] We are very aware of our role in shaping a more sustainable society. Banks acknowledge that climate change is one of the biggest challenges of our time and we are committed to reducing the impact of our own operations and helping clients reduce theirs.

Reflections: good practises on climate risk management
We have taken notice of the climate related risks drivers as discussed in the consultation, as well as the suggested good practises. In light of these examples, we would like to take the opportunity to provide some comments for further discussion.

Governance: the NVB supports the stance that risk governance arrangements are critical for effective risk management. However, risk governance is specific to the risk management framework of an individual bank. Therefore, we consider that the examples in the consultation are not intended to provide a full coverage of possible frameworks. The complexity lies in the choice of integrating climate risk in an existing risk governance, as climate-related events can be considered a driver of conventional risk types. Alternatively, a separate risk governance for climate can be created, which can take several forms. In both set-ups, climate policy and risk can be integrated into business strategy both in terms of management of these risks and for the identification of potential business opportunities.

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[1] https://www.dnb.nl/nieuws/dnb-nieuwsbrieven/nieuwsbrief-banken/nieuwsbrief-banken-december-2019/
[2] https://www.unepfi.org/publications/principles-for-responsible-banking/
[3] https://www.klimaatakkoord.nl/actueel/nieuws/2019/07/10/financiele-sector-ondertekent-klimaatakkoord

Short/long term risk: while it is widely recognized that continued emission of greenhouse gases will cause further warming of the planet and this warming could lead to damaging economic and social consequences, the exact timing and severity of physical effects are difficult to estimate. The large-scale and long-term nature of the problem makes it uniquely challenging, especially in the context of economic decision making. With regard to risk, the challenge particularly concerns the integration of long-term risk in the given short-term framework. There is no proven methodology to predict risks occurring over 20 years on the one hand, while on the other hand applying a stress testing horizon of 3 years. An example of a supervisor that is gaining experience in developing longer term risk methodologies is the Bank of England (BoE). They run a 30-year climate change stress as part of its 2021 exploratory scenario, potentially providing valuable insights. In sum, assessing climate change risks in the banking industry is a challenge considering there is no universally accepted approach and the industry is still learning how to assess these risks.

Data availability: one of the main concerns regarding climate risk is the lack of (historic) data. Inaccurate and incomplete data could result in incorrect assessments of climate risks and incorrect portfolio decisions.

- With regard to measurement, more availability of corporate and retail data will be a key factor for adequate banks' risk management, for the development of new financial products and for helping consumer and businesses to transition. It would be helpful if the data availability would be improved by policy makers providing more data to financial institutions.
- Concerning data and stress-testing, there is only a limited amount of statistical data available on which a stress test could be based. In addition, the data available for physical risk might have only partial predictive value. The reason for this is the large-scale and long-term nature of climate risk itself, but also the unpredictable nature of its occurrence. Unlike credit losses, which happen in a relatively predictable way, climate change occurrences do not take place in a normally distributed fashion. The statistical behaviour of climate risk is of a totally different nature, requiring new methodologies.

Climate Risk Mitigation poses dilemmas:

- For example, mortgages for properties in flood-prone areas might no longer be considered as part of a climate risk mitigation policy. However, there could be social considerations that would need to be weighted in such a decision, as it could affect housing prices in those areas and affect people that have been settled in such places.
- Another potentially relevant risk to be considered when mitigating climate risk is Business Risk (the impact of climate risk mitigation and portfolio decisions on the business model of the bank).

Interaction with other ESG risks: a challenge will be how to account for the interaction between climate change risks and other sustainability risks such as human rights, biodiversity loss and resource scarcity. For instance, a rising temperature due to climate change may lead to biodiversity loss which leads to credit risks for specific client groups. Or areas with already low biodiversity might be more affected by physical climate change. These risks should not be viewed in isolation, however at the same time it is very complex to conduct an integrated assessment at this stage. We expect our risk management practices in this area to be further developed as more data will become available and our understanding of the interaction of different types of risks improves.

Physical climate risk: in the consultation it is mentioned that 'long-term changing weather patterns' may reduce collateral values. This could be a true statement, but is not yet proven as there is no statistical data to estimate the impact on collateral values and there is no good notion of (long range) timelines. However, physical risk is expected to occur and eventually possibly at a scale that neither banks' capital, the stress testing methodology nor maybe even society can rightly estimate and potentially even sufficiently mitigate. It is a fundamental question how the financial sector could help to address this challenge. In our opinion it would be most sensible to focus efforts on those measures that will motivate parties to transition towards a more sustainable economy, helping to minimize future physical risk to the best extent possible. Stress-testing for transition risk can play a role in this.

Risk of sudden policy changes: this type of risk, when related to climate, may currently be the most material risk. We recognise that societal concerns regarding climate risks are taking the potential impact on people into account, next to the risks to the environment and biodiversity. Therefore, political risk related to climate change is significantly increasing in the shape of both action and inaction. Political risk plays out on a national level in The Netherlands, within the European Union, as well as internationally. The latter is important to establish an effective climate policy that will mitigate climate change globally, while also preventing regulatory arbitrage due to lower climate standards.

Disclosure

Regarding the collection and disclosure of climate-related information as mentioned in the consultation document, the NVB has the following comments.

- There are several useful guidelines such as Task Force on Climate-Related Financial Disclosures (TCFD)[4]. Although helpful in shaping global thinking on disclosure, we prefer one international standard that allows banks to be more easily compared to one another.
- There are some barriers to the broader implementation of the TCFD disclosure standards, including the availability of data. It would be helpful if DNB would place significant emphasis on data availability as part of its effort to enhance the understanding of climate risk. DNB could work on this with accounting firms, industry and wider stakeholders.
- It remains to be seen whether the inclusion of avoided emissions in disclosure will be effective as a good practice. Accounting for avoided emissions might encourage "creative" emissions accounting.
- It would be very helpful if DNB disclosed climate risks of its own portfolio and reported portfolio emissions. This would provide a meaningful example for all.
- It would be helpful if climate reporting and disclosure requirements were similar and proportional for all financial providers including other less and non-regulated financial providers (i.e. private equity) and fintechs. This would help to ensure a level playing field, might help to spur efficiency and quality in reporting, and further innovation in supply chain due diligence in accordance with OECD Guidelines for Multinational Enterprises and other leading standards.

Regulatory context

DNB published a Q&A[5], stating that following 3:17 Wft (article 74 CRD), material risks should be governed in a way consistent with sound risk management. In its capacity of prudential supervisor, DNB therefore expects banks to incorporate climate-related risks into their governance and risk management arrangements in line with the proportionality principle. The regulation also requires banks to have in place robust, effective and comprehensive strategies and procedures to ensure that the level, composition and division of its own equity capital are in accordance with the size and the nature of the risks it faces both in the short term and in the long term. In view of the long-term nature of climate-related risks, DNB considers this provision applicable with respect to climate-related risks. If climate-related risks are regarded as not material, for instance because an individual bank is not or could not be exposed to them, then an analysis describing why they do not impact its risk profile would be sufficient. Institutions are expected to be transparent about this in their reporting (e.g. in their ICAAP submission).

The NVB agrees that material risks must be taken into account, and climate risk should therefore be considered in bank risk assessment. The NVB acknowledges and appreciates that DNB has explicitly included the notions of proportionality and materiality assessment in the Q&A.

[4] https://www.fsb-tcfd.org/
[5] https://www.toezicht.dnb.nl/binaries/50-238048.pdf

In the future more detailed prudential regulation are expected. In this context, we would like to make the following comments:

- The NVB welcomes the EBA Sustainable Action Plan as an important opportunity for the integration of environmental, social and governance factors in the financial ecosystem, with a view to increasing the financing opportunities for low-carbon, energy- and resource-efficient activities.
- The EU designed a comprehensive ESG taxonomy including climate risks, which helps to create a common understanding and consistent use throughout the financial industry. Regulators and supervisors can play an important role in further defining the risk taxonomy. We would like to stress the importance of regular updates to the taxonomy. The risk is that the taxonomy regulation (the taxonomy) may not keep up with the technology developments, with the danger of even constraining rather than stimulating green financial innovation.
- There remains an uncomfortable fit between climate risk and the way the Basel framework has been set up. It will be a challenge to include transition climate risk in the PD's and LGD's of Basel Pillar 1. Climate risk is characterised by deep uncertainty and longer horizons, which is at odds with the standard approach to modelling financial risk by extrapolating historical data.
- Even more challenging will be the capturing of physical climate risk in Pillar 2 given the nature of these long-term, unpredictable events. The good practice indeed underlines that scenarios make assumptions on the time horizon, shocks and difference across regions. However, we run the risk of creating a false-truth by striving to create assessments into the future for events for which the pattern is unknown. This fundamentally unknown pattern distinguishes climate risk from the current Basel framework.

Looking forward to a continuous dialogue

The NVB considers this consultation as a start on the further exploration of integrating climate-related risk considerations into banks' risk management and prudential supervision. We are looking forward to a continuous dialogue with supervisors including DNB, EBA and ECB. We anticipate fruitful discussions on the measurement and management of climate risk, as well as on materiality assessment and proportionality.

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