

Klaas Knot: Main risks to the financial system

Introductory statement by Mr Klaas Knot, President of the Netherlands Bank, prior to the session with the Standing Parliamentary Committee for Finance, The Hague, 18 June 2024.

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I would like to thank the Chair and the members of the House of Representatives for their invitation. Together with my colleagues from CPB and the AFM, I would like to discuss with you the main risks to the financial system. I will do so on the basis of the DNB's Financial Stability Report, which has been sent to you.

I will start by outlining the overall macroeconomic picture before specifically addressing the risks of geopolitical tensions and the formation of blocs around the world (geoeconomic fragmentation), as well as the resilience of Dutch financial institutions. On both subjects I will highlight a number of recommendations for areas where national governments and parliamentarians, such as yourselves, have scope to further improve the financial system. Before moving on to these risks and recommendations, I will first look back briefly at the past year, because it has been an eventful year for the global financial system.

In the spring of 2023, the rapid transition from low to higher interest rates – in response rising inflation – exposed vulnerabilities in the financial sector. In the midst of this transition, a number of US regional banks and the systemic Swiss bank Credit Suisse encountered severe difficulties for different, unrelated reasons, leading to resolution, merger or acquisition. On my previous visit, I therefore drew a number of lessons from the failure of these banks.

Fortunately, a year on, the situation seems to have improved. Inflation has fallen substantially in both the Netherlands and the euro area. Dutch inflation, for example, fell to 2.7% in May 2024. This substantial fall in inflation and the improved inflation outlook in the euro area prompted the ECB to cut interest rates for the first time in early June. At the same time, Dutch economic growth is expected to pick up in the year ahead, spurring confidence in a "soft landing" for our economy. The Dutch financial sector has also proved resilient, partly due to the reforms following the financial crisis. Confidence in a soft landing for the economy is reflected among other things in historically high share prices and less tight financial conditions. As a result, the soft landing is initially good news for financial stability.

Looking ahead, however, there are risks to the economy and our financial system, with uncertainty being a central concern. First, inflation might start rising again, for example due to continued strong wage growth. It is therefore important to base further monetary decisions on incoming data rather than pre-empting future developments. At the same time, various factors, such as rising geopolitical tensions, are generating greater uncertainty, which could lead to financial market corrections and higher risks for financial institutions. High share prices make financial markets vulnerable to corrections and a downturn in sentiment. For instance, political uncertainty in France last week caused a correction in French government bonds, which also spread to bank shares in France. These corrections are taking place against the backdrop of geopolitical

tensions and geo-economic fragmentation. Price falls prompted by geopolitical tensions have so far been short-lived, but I do wonder whether investors are fully pricing in the risks of geopolitical tensions.

This is one of the reasons why I would like to focus particular attention on the risks of heightened tensions and geo-economic fragmentation. Geo-economic fragmentation is not new but is part of a gradual global shift. The fragmentation of the global economy into blocs has increased in recent years, leading to more trade restrictions and sanctions. At the same time, geopolitical tensions have increased. At first sight, Dutch financial institutions appear to have only limited sensitivity to geopolitical tensions given their small corporate loan and investment portfolios exposed to countries that are geopolitically remote from the Netherlands. Geo-economic fragmentation may nevertheless have an indirect impact on these portfolios, because Dutch firms also use imported goods in their production processes and trade restrictions disrupt these value chains. Geopolitical tensions also increase cyber risks worldwide and reduce the effectiveness of multilateral fora. For example, blocking and tensions hampers effective crisis response as during the COVID-19 pandemic, but also effectively tackling global challenges such as the energy transition.

As well as the need for greater awareness and analysis of these risks by financial institutions and policymakers, I also see scope for action by national governments. At a time when there is high external pressure from other regions of the world, a well-functioning European single market reduces Dutch dependence on other regions. As an open economy, the Netherlands has benefited from this more than other countries. After all, the European internal market acts as a cushion for shocks originating from outside Europe, thus providing economic security. In my view, this requires a European market that is as open as possible to market forces and competition. Further development both of the internal market and of the capital markets union and the banking union is necessary to achieve this. The European market offers scope for further integration, especially in the services sector. National governments have a vital role to play in driving progress and can draw on lessons from European banking supervision.

Given the heightened uncertainty, which is partly due to fragmentation, it is important that Dutch financial institutions remain resilient. Dutch banks, pension funds and insurers are in a good position, partly thanks to reforms following the financial crisis. In all sectors, the transition to higher interest rates has had a positive effect and prudential ratios are above the required levels. Although the transition to higher interest rates enabled banks to generate high profits in 2023, the higher rates may also negatively impact the quality of outstanding loans and investments. Higher interest rates and lower economic activity increase the probability of default among firms and households. So far, we have not seen this affecting banks, although the first signs of deterioration are visible. The credit quality of corporate loans secured on commercial real estate has deteriorated, partly because this market is under pressure. One solution to this is for banks to use part of their high earnings to set aside additional provisions. Insurers and pension funds are also now investing more in firms. Specifically, there has been growth in private equity investments and loans to high-risk firms, in other words private credit. Private credit broadens the range of credit available to firms and reduces their dependence on banks, which may contribute positively to the stability of the system. Private credit is attractive to investors because of the higher returns. But higher returns

are accompanied by risks, and the same applies to this shift in lending. Specifically in the case of private credit firms, risks additionally ensue from their inherently low transparency, given that they typically lack external credit ratings. Financial institutions must therefore maintain sound risk management and monitor potential interdependencies.

Given the heightened uncertainty, it is important to have an appropriate macroprudential toolkit for financial institutions in Europe. During the COVID-19 pandemic, we saw the value of banks having releasable capital buffers. At DNB, we have now introduced these additional capital buffers, but these lessons could be even more firmly embedded in the European toolkit, as recommended in the Ministry's study on the resilience of banks. More consistent use of instruments is also desirable for a more level playing field among European banks. In the case of non-banks, this macroprudential toolkit is still in its infancy, but pension funds, insurers and investment funds are now playing a greater role in the financial system. Improvements to the framework are therefore desirable, particularly for investment funds. This concludes my introduction.