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Opening address

Event on “The role of investors in the energy transition model”/Expansión

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Good morning. Thank you very much to the daily newspaper Expansión for kindly inviting me to open this event on the role of investors in the energy transition model.

Introduction

Combating climate change has been a recurrent objective of international institutions, since at least the United Nations Summit in Rio de Janeiro in 1992. This objective has become more defined and gained momentum since the 2015 Paris Agreement, and a deadline has also been set in the 2030 Agenda. In any event, it was the Paris Agreement that notably and explicitly acknowledged the important role of the financial system in efficiently channelling the funds needed to transform the economy into a more sustainable model.

We can affirm that the energy or ecological transition and, more specifically, the role finance can play in this transition, is becoming more visible and climbing up the agenda of international financial organisations. We could list various initiatives within the framework of the G20, the United Nations, the Financial Stability Board and the OECD, among others. Within the EU, mention should be made of the significance of the European Commission's action plan on sustainable finance, and in Spain, the Draft Bill on Climate Change affects us directly.

Specifically, in the central banking and banking supervision environment, I would mention the work by the Network for Greening the Financial Sector (NGFS). The Banco de España actively participates in this network, which has just published its second report, setting out best practices for boosting the role of the financial sector in complying with the Paris Agreement. The report is highly recommended, not only for being informative, but also, above all, because it is a call to action. The six recommendations of the report, addressed to central banks, supervisors, regulators and financial institutions, are an important starting point for beginning to act in coordination.

To use a colloquialism, you could say that sustainable finance is ‘in vogue’. Indeed, looking at my own agenda, since the middle of last month I have given four speeches on this matter: I opened an event on green finance organised by the Banco de España in conjunction with the Ministry for Ecological Transition, representatives from the banking sector and academics; I recently participated in the NGFS plenary meeting in Paris, where the report I mentioned earlier on sustainable finance was approved; I sat on a panel to discuss the role that central banks could potentially play as a driving force for the ecological transition; and, lastly, today, I have the honour of opening this event.

I believe that this build-up of events on sustainable finance is a good example of the growing attention being paid to this matter. Moreover, I believe that, in addition to sparking interest, the ecological transition towards a sustainable economic model is a need that, fortunately, is also being shared by an increasingly broad section of society. Although something of a cliché, we shouldn’t forget that what we do today will determine the type of world we live in tomorrow.

Clearly, the change in productive model is a matter of key importance. It has systemic implications and must therefore be carried out carefully and gradually if we are to avoid undesired economic and social consequences. The aim is to achieve what has come to be known as a fair transition, though we should not forget to harness the opportunities offered by this type of change.

In any event, it is clear that, to be successful, any transition must include far-reaching measures and instruments that affect virtually all economic agents, not just credit institutions. Proof of this is the diverse make-up of the roundtable scheduled for after I have finished speaking.

As such, the question arises of what the role of the financial system is in this process. I would like to highlight two points: (i) first, clearly any change affecting economic agents also directly affects banks, as suppliers of the credit needed to pursue economic activity; (ii) second, both institutions and investors can and should play an active role in this transition.

This second point, which is reflected, correctly in my opinion, in the title of this event, will be the main focus of my speech today. I will also refer to the role of the financial system as a potential catalyst for the ecological transition. Lastly, I will list the elements that I believe are still lacking to enable finance to act as a true driving force for change, including most notably the need to have a clear and functional taxonomy that can be used by all economic agents.

Role of banks and supervisors

As I mentioned, credit institutions' solvency may be affected by the ecological transition and, more specifically, by the materialisation of two types of risk: (i) on one hand, physical risks caused by the direct effects of climate change, such as the effects of droughts or floods; (ii) on the other, transition risks, i.e. the effect on bank borrowers of the measures aimed at sustainably transforming the economy.

Supervisors are required to monitor these risks and implement measures to encourage banks to asses, rate and mitigate these risks. These measures may vary in nature, including aspects such as:

- The gathering of detailed information on aspects such as the physical location of assets or the efficiency strategies of firms that receive financing;
- The implementation of stress tests based on different scenarios of ecological transition;
- The development of macroeconomic models in order to be able to assess the potential effect of certain transition scenarios on the economy; or
- The development, by banks, of risk models that envisage climate change.

It is worth asking where exactly we stand in relation to these measures. As I will later describe, we are still at an initial, somewhat incipient, stage where both the supervisor and supervised banks are raising the level of knowledge and awareness of this matter. Although significant progress has been made, we must admit that we are still constructing the governance structures and methodologies needed to tackle this challenge.

Qualitative measures

The matters currently under discussion at the NGFS notably include the Environmental Risk Assessment (ERA), which refers to the methods and practices used to quantify the environmental impact on the financial sector. These assessments have qualitative and quantitative elements.

Of the qualitative elements, I would first highlight governance. In this regard, it is crucial that as supervisors we establish a dialogue with banks to analyse how environmental risks are being treated. Clearly, the consideration of environmental risk is very new, and institutions that have already explicitly considered it have tended to include it within their social responsibility areas. Nevertheless, we must verify that banks are also incorporating it into their strategies and risk analyses and monitoring, and that the information generated internally reaches their board of directors.

Supervisory expectations in the short and medium term are that banks understand the implications of this risk and are capable of identifying and measuring it, always in a manner proportionate to their size and complexity. In this respect, they must be capable of assessing how it can affect their business model and of including it within their risk appetite framework. To this end, stress tests and hypothetical scenarios are expected to be used, given that, by definition, if they only use historical data, events that have not happened in the past, or at least since we have reliable records, cannot be captured. It is also important that this risk be analysed under the prism of a medium- and long-term horizon (one longer, in any event, than that commonly used when measuring financial risk).

Quantitative measures

The quantitative elements are aimed at measuring and reflecting the physical and transition risks that could affect bank borrowers. This quantitative assessment of environmental risk must be carried out within banks' risk models.

There are evidently challenges and methodological difficulties when including these factors in internal risk models, e.g. the time frame over which the effects of physical risk are observed may be much longer than that generally used in risk assessment. That said, I would point out that, although these elements are new, historically banks have been subject to this type of transition risk, even though it was possibly not referred to as such until now.

We can all think of examples of solvent, strong companies, many of them international leaders, that disappeared in a few short years as they were unable to adapt to a change in technology or consumer behaviour. Analysing the potential changes to the environment, in order to assess the possibility of business failure, is essential to assessing and managing risks in the financial system, regardless of whether the origin of such changes is technological, related to customer behaviour, regulatory or environmental.

In any event, let me stress that if banks identify these risks and properly quantify them in terms of price and capital needs, this would not only improve risk sensitivity and contribute to ensuring the stability of the financial system as a whole; moreover, banks would indirectly be acting as a driving force for change by helping financing reach those activities that most contribute to the sustainable transformation of the economy. They would also be discouraging the potentially most harmful activities, by having hitherto hidden environmental costs passed through to the price of financing.

Role of the supervisor

As regards the role of the supervisor, we also face significant challenges in quantifying these risks for the financial sector as a whole. For instance, we need to be able to assess the level of financial institutions' exposure to high-carbon emission activities, perform stress tests for the financial system overall and define scenarios and methodologies to be applied by banks individually. This is a new type of initiative, but the Single Supervisory Mechanism (SSM) itself has for the first time included climate change risks as an element to be addressed among its priorities for 2019.

To conduct this type of analysis centrally, it is imperative to have sufficiently detailed and disaggregated information on credit risks, for example by type of activity, sector or geographical location. The Banco de España has traditionally been a point of reference in terms of collecting credit information, having had a Central Credit Register (CIR) for decades, which has been widely used in supervisory, statistical and off-site monitoring work. Very recently, the Bank has been one of the few European authorities to complete the implementation of the SSM project known as "AnaCredit". AnaCredit enables a greater level of detail on exposures to firms to be obtained, providing for a more comprehensive and accurate analysis.

Also, as supervisors, we should move to develop models that envisage macroeconomic effects in the face of different ecological transition scenarios. The aim is to become familiar with the potential impacts of climate change on specific economic sectors, industries and even firms, and on more aggregate variables, such as growth and inflation. It is under this perspective that we must consider the measures that are conducive to a fair transition.

In any event, both banks and the supervisor evidently need to increase, or even on occasion begin to 'construct', the technical knowledge necessary to enable us all to understand and properly measure these risks. Furthermore, the integration of these risks into the supervisory culture should evolve in step with the increase in knowledge of these risks.

Role of investors

Returning to the title of this event, I would also like to refer to the role that investors can play in this ecological transition process. In the capital markets, some discrimination is being observed in the valuation of firms with a lower degree of exposure to climate change, although it is still limited.

Moreover, a certain proliferation of 'green bond' issuance has begun to be seen, even by the public sector, as we have recently seen with an issuance by the Official Credit Institute (ICO). In general, demand for these issues is much higher and their costs lower than in equivalent standard issues. Clearly, the appeal of green bonds to investors is a sign of the growing concern over the effects of climate change, but it should also reflect a lower underlying risk.

Logically, this discrimination in pricing traded financial instruments would enable us to estimate the 'financial' value of risks associated with climate change and, as with bank financing, it should act as a catalyst for change towards certain sustainable activities.

Taxonomy

Nevertheless, for the transmission mechanisms to function properly, whether it be through banks' risk assessments or the pricing differential for market issuance, a common "language" is needed that can be used by debt issuers and potential investors to consistently classify risk, enabling these markets to reach "critical mass", while enhancing transparency related to sustainable investments.

To achieve these goals, the initiatives developed within the European Commission are essential. As part of its action plan presented in May 2018, the Commission included three proposals for regulation:

1 Regulation on the establishment of a framework to facilitate sustainable investment;

2 Regulation on disclosures relating to sustainable investments and sustainability risks;

3 Regulation on low carbon benchmarks and positive carbon impact benchmarks.

The three regulations emphasise the need to endow this type of investment with greater transparency and consistency. However, of the three, the first is most notable, as it specifically establishes the creation of a ‘taxonomy’, i.e. a technically sound classification system that provides clarity as to what “ecological” or “sustainable” (green assets) is, in contrast to “polluting” assets (also known as brown assets).

Evidently, once this taxonomy were established, it would be possible to perform a much more consistent analysis of the risk differential between green and brown assets, whether measured in terms of default rate (solvency), price (financing spread required) or listing (green bonds). It would also facilitate the consolidated risk analysis by the supervisor, development of macroeconomic models to assess the effects in the medium and long term, and the consistency of stress tests.

Lastly, this risk taxonomy is evidently needed if clear and consistent information is to be provided to investors and to the general public, as will be required under the Spanish law on ecological transition for all listed companies.

Naturally, we need to understand that this taxonomy, or any other that may be proposed, cannot be perfect from day one. Certain categories will have to be adjusted, fine-tuned and modified as we gain a better understanding of the implications of and connections between certain activities. It is also true that establishing a single category of “green” activities is not the same as being able to classify all economic activities within a green-brown range. Consequently, the taxonomy initially proposed will be limited and will foreseeably become more ambitious as our knowledge progresses. However, for the sake of communication it is clearly much better to have a common language, even if it is limited and imperfect, than no language (common or otherwise), as is the case at present.

Role of central banks as investors

Central banks are also active investors in the financial markets, both in our monetary policy operations and in reserve portfolio management. In this respect, we need to acknowledge that, at present, environmental risks are not being included in most ratings of this portfolio, whether they be internal or prepared by rating agencies.

However, we are working to remedy this situation. In the framework of the Eurosystem, an in-depth review of risk assessment processes is under way, aiming to ensure that all relevant factors – such as environmental ones – are taken into account for prudent central bank portfolio management. I would also like to note that, like the ECB, we resolutely support the initiative that the European Securities and Markets Authority (ESMA), as the regulator of rating agencies, has recently launched with a view to establishing guidelines so that these agencies disclose the way in which they incorporate sustainability into their assessments.

Once again, I believe that it is clear that the development and consistent implementation of a common taxonomy would enable our efforts to result in a sounder and more robust rating methodology that is based on empirical evidence.

Conclusions

I wish to conclude by emphasising how important this challenge is, and the need to address it realistically but also ambitiously. The challenge posed by the transition to a more sustainable economy affects virtually all economic agents and sectors. But I believe that the financial sector unquestionably has much responsibility in this transition.

Financial authorities can and must, within the scope of our mandates, do all we can to properly assess, manage and mitigate the risks associated with climate change. I hope that the measures driven by Europe in this area will ultimately become an international benchmark and standard, so as to achieve a financial sector that actively and efficiently contributes to the sustainable transformation of our economy.

Looking at the current situation, I believe a large number of initiatives can be asserted to be "germinating" and others have even started to "bloom". That said, it is also true that much remains to be done before they bear fruit and the Paris agreement commitment was not as far back in time as it might seem.

Despite all these challenges and difficulties, I would like to end on a positive note. Verifiably, this process is moving at a surprisingly fast pace. It is worth recalling that the NGFS was created less than two years ago and that we still do not have national or European legislation in force relating to sustainable finance. However, the progress made in less than two years has been very significant and the preparedness of institutions and supervisors, which are not precisely quick to make such far-reaching changes, has increased considerably in this period.

I wish to highlight that changes in organisations usually occur after legislation is enacted; but in this case, both institutions and supervisors are acting before being explicitly required to do so by regulations.

As Victor Hugo said, nothing is more powerful than an idea whose time has come. I sincerely believe that the time of sustainable finance has just begun.

Thank you very much.