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Opening address

1st Conference on Sustainable Finances/ABANCA, Asociación de Emisores
Españoles and finReg360
Margarita Delgado
Deputy Governor

Good morning. Many thanks to ABANCA, Emisores Españoles and finReg360 for their kind invitation to me to open this first conference on sustainable finances.

The fact this is a first conference allows us to draw two conclusions. First, the relatively novel nature of this subject matter. And second, the clear intention of organising successive conferences, which means that sustainable finances are not a fleeting fad and are here to stay.

I concur fully with both conclusions.

Introduction

Just scanning the news this summer, we see that public opinion's concern over climate change is increasing. Fortunately, most citizens are progressively becoming aware of its importance.

The number of people convinced by the problem and its scale is on the rise, while the group of "climate sceptics" is shrinking. In a recent survey by the Real Instituto Elcano¹, 97% of Spaniards agree that climate change is a fact, and 92% believe we humans are chiefly responsible.

For 56% of respondents it is the biggest global threat, followed at some distance by armed conflict (only 20%).

Allow me to take this opportunity to point out a pair of obvious facts before someone else does. The first is that climate change is a global matter, in terms both of consequences and causes. Clearly, a potential rise in temperatures affects the planet as a whole. Evidently, too, atmospheric pollution does not halt when it reaches a border.

The second obvious fact is that while we face a global problem, temperature rises affect some countries in different ways than others. There are studies that show that global warming may prove economically and socially beneficial for the rich countries, especially colder ones such as Sweden and Norway, while adversely affecting poorer ones.²

The aspect of the problem also differs depending on distance from the sea. For the inhabitants of the Maldives, rising sea levels are an increasingly pressing problem given that more than 80% of their surface area is less than 1 metre above sea level, with 2.3 metres the maximum altitude in some of its 1,200 islands and atolls.

Focusing on continental Europe and analysing the type of climate in each region, we can see that Spain is one of the countries potentially most affected in Europe. Based on the report by ESPON Climate (2011)³, Spain is among the countries where the potential aggregate impact of climate change will be most acute.

Regrettably, in some regions of Spain there is a risk of endemic drought, which will affect agriculture and even tourism. The same report states that Spain is currently among the countries showing the least adaptability ahead of this change.

¹http://www.realinstitutoelcano.org/wps/portal/rielcano_es/contenido?WCM_GLOBAL_CONTEXT=/elcano/elcano_es/zonas_es/encuesta-espanoles-ante-cambio-climatico-sep-2019

² Global warming has increased global economic inequality - Noah S. Diffenbaugh and Marshall Burke <https://www.pnas.org/content/116/20/9808>

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In addition, we must not forget that Europe is a gateway to Africa. The African continent may be greatly affected by change, since the heat waves that cause crop production to collapse may trigger a humanitarian or migratory crisis.

That leads us to underscore the urgency of a response, which must necessarily be global given the scale of the problem.

Normally, when we talk about seeking global solutions for global problems, people usually agree. Such language makes everything seem remote. However, in this case citizens are clearly prepared for more specific action to be taken. For instance, 94% of the survey's respondents agree on devoting part of the State Budget to alleviating and offering compensation for the damage wreaked by heat waves, drought and fires.

Naturally, support drops when we talk about specific measures potentially affecting people's pockets. Support falls to 57% when the question is whether they would be prepared to pay more for road tax.

Individual responsibility also tends to be diluted; the percentages for people who believe that companies, governments or other countries are responsible for climate change stand at around 70%, while only 47% of men (compared with 61% for women, who are much more mindful of the problem) think that each of us is responsible.

Despite these nuances, we can conclude that people's degree of personal involvement is high. Indeed, it is so in those countries set to gain from global warming, such as Norway and Sweden. This awareness in countries where, on paper, temperature rises may prove beneficial, shows the degree of international commitment.

Banking and climate change

As I said, sustainable finances are a recent development. But, actually, combating climate change is not so recent, and has been a recurring goal of international institutions at least since the 1992 Rio de Janeiro United Nations Summit.

However, for a long time the financial sector's involvement in this battle has been very limited. Only very recently has climate risk begun to be a factor for consideration in certain banks' risk management, having been something that was only tangentially envisaged in their corporate social responsibility area. Of course, we should acknowledge that nor was it assessed by prudential supervision, being considered to be outside our remit.

This has now radically changed. Or perhaps I should say it is rapidly changing, given that the process is not complete. Banks, regulators and supervisors are incorporating the environmental dimension into the banking management and supervision framework. Two aspects should be considered here: why is this change occurring and how will it be carried out?

I believe the source of this change is to be found in the 2015 Paris agreement. Following this accord, the goal of combating climate change has become more specific and gained greater momentum, and a compliance timetable has moreover been set in the form of the United Nations 2030 agenda.

As is known, the ultimate objective of all these measures is to prevent a rise in average temperature of over 2°C from pre-industrial levels. This process should lead us towards a fully decarbonised society.

But, along with setting a specific goal and calendar, the Paris agreement acknowledges for the first time the importance of the financial system in efficiently channelling the resources needed to convert the economy to a sustainable model.

National and international action in relation to the ecological transition

Accordingly, the role finances may play in the ecological transition has also gained in visibility and importance on international financial agencies' agenda. There are a large number of initiatives, by the G 20, the United Nations, the Financial Stability Board and the OECD.

In the central banking arena, the work of the *Network for Greening the Financial System* (NGFS) undoubtedly stands out.

The NGFS is a network of supervisors and central banks created in December 2017. The Banco de España is an active participant. The brief history of the NGFS illustrates the exponential growth in the world of sustainable finances. Originally, the NGFS had 8 members. But today, less than two years after its creation, it has 46 fully fledged members and 9 observers, representing the five continents.

Further evidence of the significance of the NGFS's work is the Basel Committee (BCBS) 2019-2020 agenda, in which the intention of assessing the NGFS report published in April this year is included for the first time. The report includes six recommendations, aimed at central banks, supervisors, regulators and financial institutions, and best practices for promoting the role of the financial sector in fulfilling the Paris agreement.

Along with these international initiatives, within the EU it is worth highlighting the European Commission's plan of action for sustainable finances, to which I shall refer later, and Spain's draft Climate Change Bill, which will affect us directly.

The role of banks

The final goal of the Paris agreement, and the subsequent move to a decarbonised economy, entails the need for us to change our productive model. Almost by definition, a change in productive model has systemic implications; we must thus pursue this process carefully and gradually if we wish to avoid undesirable economic and social consequences.

The aim is to achieve what has been called a fair transition, paying due heed and offering support to those groups or regions most severely affected by this transition.

Clearly, in any event, any transition involving a change in productive model should include far-reaching measures and instruments that affect practically all economic agents. Indeed, we should consider how banks can contribute to this collective challenge. Ultimately, when we think of climate change, what springs to mind are particularly pollutant activities, among which banking is obviously not to be found.

The truth is that, despite being a "low issues" sector, banking has a crucial role to play in bringing about this transition. Moreover, investors are also destined to be key agents of change here.

The role of banking and of investors will in fact focus discussion on the two panels after my address. It is not my intention to "pre-empt" any debate, nor to detract any interest from the

discussions of the two panels. But I would like to highlight some ideas on the contribution of banking and investors.

On banks, I would like to underscore two factors. First, any change affecting economic agents will clearly also affect banks directly; it is thus essential to properly measure the risks arising from the transition to a more sustainable economic model. Secondly, I should stress that, in addition to measuring and controlling risks, both banks and investors can and should play an active role in this transition.

Risk measurement

Commencing with risk measurement and control, two types of risks can be distinguished in the transition process: (i) first, we have the so-called physical risks, caused by the direct effects of climate change, either because of a gradual rise in temperature or a greater frequency or severity of events such as storms, floods and natural catastrophes; (ii) then, the so-called transition risks, which refer to the effect that regulatory measures geared to sustainably transforming the economy, technological changes and changes in customer behaviour and preferences prompted by greater environmental awareness may have on certain bank borrowers.

Physical risks may emerge gradually, e.g. the progressive rise in sea level, or suddenly, in the form of one-off storms and floods. Transition risks may also be gradual, and have less of an impact, if the transition is progressive and planned; but they may also be abrupt, if policies are introduced belatedly. Moreover, both risks are clearly related: the greater the regulatory ambition in combating climate change, the greater the transition risk, but the lesser the physical risk, the other way round will matters stand.

Environmental risk has a nature of its own, although its impact materialises through “traditional” banking risks. To cite some examples, an insolvency caused by a change in customer behaviour concerning the use of a specific polluting technology will be treated as credit risk, while a significant loss in the market value of oil or of certain collaterals would be classified as market risk. Lastly, flood damage to own property would be considered as operational risk.

In any event, the measurement and quantification of physical and transition risks pose significant challenges. There are evident methodological difficulties when it comes to incorporating these factors into banks’ internal risk models. For instance, the horizon at which the effects of physical risk are observed may be much longer than that generally used in the assessment of credit risk, let alone of market risk.

Environmental transition risk, by its own definition, is not found in the historical record of events; therefore, it would be complicated to estimate and validate this risk “traditionally”, i.e. by looking at our past.

However, I should qualify this last statement. True, there is no record for this type of transition; but there is for other types. Banks have historically been subjected to transition risk, though they have possibly called it by another name.

If we look at the recent past, we can find numerous examples of solvent and strong companies, many of them international leaders, that have lost their leadership position or even disappeared over a short span of years through not having been able to adapt to a change in technology or in consumer behaviour.

One key conclusion today would be that the analysis of potential changes in the environment, for the purpose of assessing potential business failure, is pivotal to risk evaluation and management in the financial system, irrespective of whether this change is technological, customer behaviour-related, regulatory or environmental in origin.

Banks as a facilitator of productive model change

That leads me to the second key factor I referred to earlier. Along with measuring risks, banks should promote the change in productive model. This second factor is, in fact, a logical consequence of the first one.

The banking sector, through its risk analysis and evaluation work prior to granting financing, is known to act as an essential filter for the functioning of the economy. It allows the correct allocation of the financial resources available by discriminating between those projects highly likely to succeed and those not viable in the medium term. As unfortunately seen during the crisis, if the filter does not work properly or does so in an excessively relaxed way during the expansionary phase, the adverse social and economic consequences will increase during the crisis.

Likewise, if banks identify and quantify climate risks, passing them on to prices and capital, they become a “facilitator” of change, lowering the cost of financing for those activities that most contribute to the sustainable transformation of the economy while discouraging in turn the most pollutant activities.

Risk governance

As many of you know, I like to broach the matter of governance in my speeches. It is an essential aspect without which the proper control and prudent management of risks is impossible.

In this connection, I would highlight how important it is that supervisors enter into a dialogue with banks to analyse how environmental risks are being treated.

Many banks that already explicitly envisage this risk have tended to include it in their corporate social responsibility areas. We should ensure that banks are also incorporating it into their risk strategies, analysis and monitoring, and that the internally generated information reaches the Board itself.

The short and medium-term supervisory expectation would be that banks understand the consequences of this risk and are capable of identifying and measuring it, in proportion to its size and complexity.

Two aspects are worth mentioning: first, banks should be capable of evaluating how risk can affect their business model; second, they should integrate it into their risk appetite framework.

Role of investors

Let me move briefly onto the role that investors should also play as facilitators of this transition. In the economic news we read daily about the growing issuance of so-called “green bonds”, placed among investors with higher demand and generally at lower costs than equivalent standard issues.

The history of green bonds goes back to 2007, with the first issue by the European Investment Bank. A green bond must be used to finance projects directly related to sustainability, the preservation of natural resources and the transition to a low-carbon economy.

To be certified as green, the bond must comply with the *Green Bond Principles* (GBP) laid down by ICMA in 2014, whose fulfilment must be verified by an external assessor.

The market has been particularly active in recent years, especially since the publication of the GBP in 2014, with issues by financial and non-financial institutions alike, and also by Treasuries. As at June 2019, the outstanding volume of these instruments was \$630 billion.

Clearly, the attractiveness for investors of green bond issues is a sign of the growing concern over the effects of climate change; but it could also reflect lower underlying risk.

In any event, changes in attitude and public opinion's awareness of climate change, and its effect on the types of financial investment most demanded, is a factor that should also act as a catalyst for change towards more sustainable activities.

Taxonomy

However, for these markets to work properly and to enhance transparency, the initiatives launched by the European Commission are vital. The Commission, as part of its May 2018 action plan, included a proposal for three regulations bearing on the need to make these types of investment more transparent and uniform.

Specifically, the regulations refer to the disclosure of information, the setting of low-carbon reference indices and, lastly, the creation of a “taxonomy”, i.e. a technically sound classification system that provides clarity about what is “ecological” or “sustainable” (green activities) as opposed to “pollutant” (brown activities).

As mentioned, various “green” principles have been published, such as the GBP, which have enabled the initial development of the market. But there is still no commonly accepted taxonomy.⁴ A shared taxonomy is important for several reasons.

Firstly, it will allow us to conduct a much more consistent analysis of differences in non-performance, pricing and listing between green and brown assets.

Secondly, the taxonomy will provide for aggregate risk analysis by the supervisor, along with the development of macroeconomic models, which are needed to assess medium and long-term effects on the economy or for consistent stress-testing.

Lastly, a common taxonomy is needed to provide clear and uniform information to investors and to the public at large, as will be required of all listed companies under the Spanish law on ecological transition.

⁴ The *Green Bond Principles* are generally updated annually to reflect the latest market developments. There are other standards set by the *Climate Bond Initiative* and rating agencies have also devised criteria to assess the "greenness" of issues intended for specific projects. Some jurisdictions, such as China, have established their own standards.

Role of supervisors

So far, I have basically described a to-do list for banks, something I habitually do as the bank representatives present here will confirm. However, in this case we supervisors also have a fairly lengthy to-do list to deal with.

As I said earlier, the transition to a more sustainable economy has a potentially systemic dimension. Hence, as the micro- and macroprudential supervisor, we must be able to assess and quantify these risks, both for each individual bank and for the financial sector as a whole.

Among other tasks, we need to be able to evaluate financial institutions' exposures to high-carbon-emission activities, perform system-wide stress tests, and define scenarios and methodologies that banks must apply individually.

Evidently, as supervisors we are, like the banks, at an initial stage. Specifically, we are constructing methodologies and internal governance structures, and we are also promoting a cultural change in the supervisory model. Naturally, we are assessing reporting and data requirements as regards what we need to obtain to meet this challenge.

Regarding data, for any centralised analysis we need sufficiently detailed and disaggregated information based on the type of activity, sector or geographical location of the credit. In this respect, the Banco de España has for decades had its own Central Credit Register (CCR), which is widely used for supervisory, statistical and remote monitoring purposes; further, the recent launch of the SSM's 'Anacredit' project will provide greater detail on exposures to firms.

Notwithstanding, the information available will not suffice to cover all the objectives considered, although we are using it to conduct limited studies.

As regards methodologies, progress remains to be made on the development of models envisaging the macroeconomic effects in the face of different ecological transition scenarios. The aim is to ascertain the potential impacts of climate change on specific economic sectors, industries or even firms, and on more aggregate variables, such as growth and inflation. Naturally, as knowledge of these risks increases, so too must the integration of these risks into supervisory culture evolve.

Admittedly, we are at an initial stage. But we can see how this risk is explicitly being incorporated into our actions, albeit to varying degrees. By way of example, in 2018 the Dutch central bank conducted a stress test for its entire banking sector⁵ using an energy transition scenario; the Bank of England has recently announced it will use climate scenarios as part of its forthcoming stress tests; and the EBA⁶ is looking into the advisability of incorporating such scenarios.

Turning to our own Single Supervisory Mechanism, climate change-linked risks were included for the first time as a factor for consideration among the SSM's 2019 priorities.

⁵ https://www.dnb.nl/binaries/OS_Transition%20risk%20stress%20test%20versie_web_tcm46-379397.pdf

⁶ <https://eba.europa.eu/documents/10180/2647097/2019+EBA+POLICY+RESEARCH+WORKSHOP+-+Call+for+Papers.pdf>

Role of central banks as investors

Finally, a brief reference to the role of central banks as investors, both in respect of monetary policy and reserve management. While we have not yet incorporated environmental risk evaluation, we are working to remedy the situation.

The consideration of these criteria is quite novel, as is their application. Indeed very recently, on 26 September, we announced our participation in a fund launched by the Bank for International Settlements (BIS) investing wholly in green bonds. The aim with this type of initiative is to incorporate environmental sustainability goals into reserve management, in line with NGFS membership.

Further proof of how novel these initiatives are came yesterday evening, just in time for this conference. The NGFS published guidelines on the application of criteria entitled '*Sustainable and Responsible Investment*' (SRI) for central banks' own portfolios. The publication includes the findings of a survey of NGFS members and responds to the implementation of the second recommendation in the report published in April this year.

An intensive review of risk evaluation processes is under way in the Eurosystem to ensure that all relevant factors, such as environmental ones, are being taken into account for the prudent management of central bank-held portfolios. Evidently, a common taxonomy would contribute to the development of sound and more robust classification methodologies.

Conclusions

To conclude, I shall reiterate the global nature of the challenge facing us. The consequences of climate change affect everybody and the transition from our current productive model to another more sustainable one is incumbent upon us all: citizens, companies, governments and public authorities. However, I believe that both banks and financial authorities share a key responsibility here.

Despite methodological difficulties, the absence of a taxonomy and the lack of granularity in the data available, banks and supervisors alike should step up efforts to develop the methodologies, controls and governance structures enabling us to properly value, manage and mitigate climate change-related risks.

We must tackle this challenge realistically but, above all, with sufficient ambition to reach the Paris agreement goals. Under the numerous international initiatives seeking to adhere to this agreement, I believe those in Europe will be an international benchmark and I trust Spain will be at the forefront of this global commitment.

Thank you.