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Central banks' role in the supervision of ESG risks

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Good afternoon everyone, and good morning to those of you on the other side of the Atlantic. I wish to begin by thanking Financial Mercosur for inviting me to take part in this Sustainability seminar.

Firstly, I wish to highlight that the very fact of holding a sustainability seminar is clear proof of the importance of sustainability for organisations.

As you all know, ESG stands for Environmental, Social and Governance criteria. I intend to review each of these areas, and their implications for financial institutions and banking supervision, separately. I will start with the environment.

Environment

The signing, in 2015, of the Paris Agreement and the United Nations' 2030 Agenda for Sustainable Development underlined once again the urgent need for action to halt global warming and achieve a carbon neutral economy. This time it seems the message has finally caught on, and international organisations, governments and many businesses are now designing changes in their processes to meet these commitments.

Clearly, financial institutions are not immune to these developments. The financial system plays a key role in channelling funds through to the real economy, and any economic disruption will affect the stability of the financial system and vice versa. Climate risks – both physical and transition risks – are undoubtedly a new consideration that we must bear in mind.

Physical risks arise from the increase in extreme weather events or long-term climate change impacts. A recent study published by the European Central Bank (ECB) indicated that more than 60% of Spanish firms were exposed to such physical risks (specifically, droughts and wildfires are the two most likely events in southern Europe).

Transition risks derive from the transformation of the real economy towards more sustainable production models in accordance with the regulatory changes at each time. The same ECB study indicates that approximately 30% of Spanish firms are exposed to energy transition risk owing to their high carbon emissions.

My intention, with these figures, is to contextualise the importance of this risk for the management of financial institutions, given that materialisation of the risk could have serious consequences for financial stability on account of its interconnection with the real economy.

As supervisors we have observed that banks are making efforts to include climate risk in their internal management. Indeed, some banks have established climate risk board committees and have appointed executive directors in charge of climate risk and sustainability matters. In addition, not only are they becoming aware of the problem, and addressing it from the governance standpoint, which is key, but they are also incorporating specific climate-related metrics into their risk appetite. They are also gradually including environmental criteria as one of the considerations to be taken into account in lending policies.

Yet it is not all plain sailing. The absence of a global taxonomy that establishes clear definitions at the international level, and above all the lack of reliable data, are two of the challenges that we – banks and supervisors – face when it comes to managing this new risk. In 2020 an EU Regulation[1] was published which establishes the criteria to determine whether an economic activity qualifies as environmentally sustainable, to determine the degree of environmental sustainability of exposures.

This Regulation is a first step towards the introduction of clearer criteria in the environmental sphere, but the implementing regulations – which the European Commission is currently working on – are still pending. For example, which activities may be classified as environmentally neutral and which will be classified as brown or harmful from an environmental standpoint is still to be defined, as are the consequences of this classification.

I must also mention the climate risk stress test exercise to be carried out on European banks in 2022. The exercise aims to verify banks' capacity to assess climate risks, understand climate risk stress tests that banks may have designed internally, identify vulnerabilities, assess the inclusion of climate risks in management, provide guidelines and enhance data availability. It will include profitability metrics and exposures to sectors affected by climate risks, to draw comparisons between banks. Naturally, it will also include different scenarios that cover both the transition risk and physical risks.

The purpose of this exercise – which is the first of its kind – is to acquire experience and knowledge of climate risk management, to help define future methodologies for supervision of climate risk.

However, designing this stress test is not the only environmental risk-related work being carried out by central banks.

We have issued guidelines on supervisory expectations in this sphere. These guidelines are not binding on banks, but they provide clarity on what we, as supervisors, expect from them in terms of climate risk definition and management. In 2020 the Banco de España published guidelines for less significant institutions and the ECB for significant institutions. The degree of financial institutions' incorporation and assimilation of these guidelines will be analysed in 2022.

I believe, therefore, that in our role of supervisory authorities, we central banks have the necessary tools to monitor these risks and include them in bank management. Looking forward, however, a learning process remains in which cooperation between supervisors and banks is essential. International cooperation is equally essential to address this global risk. As evidence of the work still ahead at the regulatory level, both the European Banking Authority (EBA) and the Basel Committee on Banking Supervision (BCBS) are analysing how environmental risks could be more explicitly included in the Basel prudential framework.

In addition, beyond central banks' supervisory functions, I now wish to mention the commitment assumed in the framework of the Eurosystem, in February of this year, on

1 Regulation (EU) 2020/852.

sustainable investments in euro-denominated non-monetary policy portfolios. In July the Banco de España signed up to this commitment, to apply it to its own portfolios.

Also in July, the ECB presented its plan to include climate change considerations in its new monetary policy strategy, in the areas of disclosure, risk assessment, the collateral framework and corporate sector asset purchases. Specifically, the ECB is to introduce disclosure requirements for private sector assets as a new eligibility criterion for collateral and asset purchases. The ECB will also consider relevant climate change risks when reviewing the valuation and risk control frameworks for assets mobilised as collateral by counterparties for Eurosystem credit operations.

Lastly, I wish to mention the draft legislative proposal for the definition of a green bond standard, published by the European Commission in July. This initiative aims to protect investors and issuers and thus prevent greenwashing.

Now, continuing with the ESG criteria, I will move on to the Social issues.

Social

All economic activity has an effect on society. When making their decisions to consume products or services, consumers increasingly analyse the impact that businesses have on their surroundings, focusing on the social consequences of business activity in their area of operation.

Financial institutions are not immune to this trend and have been criticised in recent years, following the great financial crisis, for behaviour that was not always sufficiently clear and transparent. This has had a major impact on bank reputations.

In a setting in which, as a result of digitalisation and the entry of new competitors, bank customer loyalty has decreased, good care needs to be taken of banks' reputations, to ensure the continuation of the business model and, therefore, of banks' sustainability. Nowadays it is easy for customers to change banks and this means that a sound reputation is a valuable asset.

I believe that banks have learnt from their past mistakes and have strengthened their procedures, to ensure that they are in strict compliance, at all times, with conduct regulations, which are essential in their relationships with customers.

But I do not wish to refer only to regulatory compliance, which I firmly believe is essential and indispensable for all economic activity. We have also observed that banks are now including other social considerations in their performance appraisals and setting of strategic objectives. For example, customer satisfaction metrics. Banks are aware of the importance of these considerations and are including them accordingly.

Central banks are also aware of their importance. Proof of this is that we analyse reputational risk as part of our regular analysis of operational risk in our annual supervisory process. Reputational risk is not a financial risk, but it can materialise through financial risks and can have a severe impact on a bank's business and viability.

As supervisors, we must ensure that banks have the means at their disposal to guarantee regulatory compliance and thus reduce the risk of any reputational impact.

Moreover, financial institutions – like all other organisations – must analyse the social impact of their activity beyond the direct customer-bank relationship. Social considerations are difficult to quantify, but it seems clear that social goals must be based on existing international rules and standards, such as the Declaration of Human Rights. As intermediaries, financial institutions hold a privileged position which enables them to finance social investment such as access to housing or other basic services.

In this respect, the definition of a social taxonomy is still much less developed than the environmental taxonomy I referred to earlier. It will still be some time before social considerations are fully integrated into banks' management and, therefore, before supervisory functions are tailored to these changes.

For the time being, the main tool at our disposal for the correct pursuit of financial activity, compliant with all existing regulations, is governance. This takes me to the third ESG criterion.

Governance

Robust governance is the key to sound bank management. Sustainable business is not possible without a well-designed governance framework that allows strategic decisions to be made in an appropriate manner. Governance hinges on three main pillars.

First, there must be a clear and well-designed organisational structure, including governing bodies and committees with clear functions, whose membership is in keeping with the bank's profile and which are entrusted with establishing a sustainable business strategy. In this respect, the professional profiles of the members of the governing bodies must be diverse and must cover the entire spectrum of risks that banks face, including, for example, climate risk.

Second, these governing bodies must establish banks' risk appetites in keeping with the level of risk they are prepared to assume, and must manage banks in such a way that they comply at all times with the parameters defined. In this respect, as I mentioned earlier, banks are now incorporating metrics on climate risks and social considerations.

Third, this risk appetite must be communicated internally throughout the organisations, so that it becomes part of their culture and is taken as a guideline in their everyday activity.

At this point I wish to underline that governance has always been a fundamental pillar of banking supervision because, as I have said, sound governance is essential for the correct operation and management of a bank. As supervisors not only do we focus on the suitability of banks' management teams (what we call fit and proper assessment), but we also analyse the composition and reporting lines of their governing bodies and we monitor that there is in-depth debate on each of the matters submitted to them. Only in this way can sound decisions be made.

Review of governance has always been, and continues to be, a supervisory priority, given that it acts as a line of defence against the risks that banks assume in the pursuit of their activity.

Conclusion

To sum up, we central banks have a very important role to play in designing the supervisory processes for ESG risks. For some, such as environmental risks, there is still a learning process ahead of us, to establish uniform definitions, appropriate metrics and supervisory methodologies. In other areas, such as governance, supervision is more consolidated and mature. In this case, all that remains pending is to analyse how to include the newest issues, such as climate and social considerations, and how their inclusion will affect governance.

In the short term, we central banks will foreseeably be concentrating on supervising how these risks are included in banks' strategies, as part of our analysis of their business models and governance. In the longer term, as more data become available on these risks and tools are developed to quantify their financial impact, supervision will extend to capital and liquidity risks and to internal capital and liquidity adequacy assessment in the supervisory review and evaluation process (SREP).

Accordingly, as central banks we have the responsibility to scrutinise how these new risks are being correctly incorporated into all aspects of bank management, how they are permeating through the organisation and how they are included in loan pricing. As I have said, there are indeed various aspects that remain to be defined, especially relating to climate risk and social considerations, but I am certain that we are on the right track.

Thank you.