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Sustainable finance developments and regulation in the national and international sphere

“Economic policy and sustainable finance: a new approach”. Seminar at the Rey Juan Carlos University.

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Good morning everyone. First, I would like to thank the education community, in particular the Rey Juan Carlos University and, specifically, the Faculty of Law and Social Sciences, for giving me the opportunity to participate in this international seminar on finance and sustainability.

This is undoubtedly a topical issue which, I am convinced, will leave its mark on the course and transformation of the financial sector in the coming years.

As the economy adapts to a more sustainable model, not just environmentally but also socially, we will also see a shift in the financial sector. We cannot overlook the close ties between the real economy and the financial sector, which channels and distributes funds.

The current regulatory agenda for sustainable finance is highly ambitious. Today, in this forum, I will review the main regulatory and other developments that have taken place and, especially, those that are still in the pipeline. I will focus on those particularly affecting the Banco de España's activity as prudential supervisor and central bank. Climate risks are relevant for the Banco de España because of their potential implications for financial stability through their impact on inflation, potential economic growth and monetary policy transmission. Prudential regulation is one of the tools at our disposal to try to mitigate these risks and smooth the transition to a more sustainable economic model.

In order to achieve this transition, it is not only necessary to adapt regulation, but also to provide it with funds. There are various estimates but, according to the European Commission's own calculations,¹ €1 trillion of public and private funds will need to be mobilised over the next decade. To put this figure into context, I would like to recall that Spanish GDP in 2020 was €1.1 trillion. An additional annual investment of €260 billion would be needed to achieve carbon neutrality by 2050.

My address will be structured according to the different regulatory tiers: national, European and international, starting with the latter.

International regulation

One of the most active fora in the international arena is the **NGFS** (Network for Greening the Financial System), comprising 100 members, mainly central banks and supervisors, together with 16 observers such as the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS). This forum, whose aim is to promote the role of the financial system in the shift to a more sustainable economy and to mobilise capital towards "greener" projects, is pursuing several work streams:

- a) The first assesses the extent to which supervisors are making progress in integrating climate and environmental risks into their supervisory frameworks and their activities. It also studies the risk gap between green assets and other assets. This last point is key to confirming whether or not investing in more sustainable assets intrinsically entails a lower risk and thus to assigning prudential measures commensurate with that risk.

¹ <https://www.europarl.europa.eu/news/en/headlines/society/20200109STO69927/europe-s-one-trillion-climate-finance-plan>

- b) A second work stream focuses on developing and updating both the transition and the physical risk climate scenarios to be used both by supervisors and central banks and by institutions in stress testing vis-à-vis these risks.
- c) The third work stream deals with green finance, and studies the inclusion of sustainable and responsible investment (SRI) criteria in central banks' portfolios and in monetary policy management. I will elaborate on this later.
- d) The fourth and last work stream crucially aims to identify the missing data needed to improve the assessment of climate change-related risks in the financial system. As I have pointed out on numerous occasions, the absence of data with sufficient detail and historical depth is one of the main obstacles for both enterprises and supervisors in measuring and managing climate risk.

Another key international organisation on the regulatory and prudential banking supervision front is the **Basel Committee on Banking Supervision**. This global committee is responsible for issuing international standards on prudential banking supervision. It also promotes cooperation on supervisory matters to improve banks' regulation, supervision and practices in order to strengthen financial stability.

This Committee, which has created a specific task force on climate risk, has published two reports that I would like to draw your attention to.

The first one refers to climate-related risk factors and their transmission channels. The paper explores how these risk factors affect the banking system through micro and macroeconomic impacts.

The second report addresses the methodologies for measuring climate-related financial risks. It also stresses the need to have more data to address the management of these risks.

The most important finding of these two reports is that traditional risk categories (credit, market, liquidity and operational) can be used to capture climate risk, but it is still necessary to determine how these risks are impacted by gathering more and better data.

Lastly, I would like to mention the ongoing work by the Basel Committee to analyse to what extent climate risks can be addressed by the banking prudential framework through regulation, supervision and market disclosure. The Committee has recently acknowledged the importance of establishing global standards to improve the consistency, comparability and reliability of sustainability-related information. That is why it has welcomed the initiative of the IFRS (International Financial Reporting Standards) Foundation to create the International Sustainability Standards Board (ISSB) for this purpose.

Additionally, the Basel Committee emphasises the need for supervisors to guarantee that both the financial system as a whole and the individual banks are prepared to identify, measure and mitigate climate risks.²

I will now turn to the regulatory initiatives at the European level.

²<https://www.bde.es/f/webbde/GAP/Secciones/SalaPrensa/IntervencionesPublicas/Gobernador/Arc/Fic/hdc040621en.pdf>

European Union regulation

The European Union is putting in place a European sustainable finance framework whose main aim is to enable the channelling of public and, especially, private capital into sustainable investment.

There are two key elements in this European framework. First, the sustainable finance **action plan** that the **European Commission** published in **March 2018**, which has been the basis for a significant number of legislative and non-legislative initiatives in this area. Second, the **renewed sustainable finance strategy**³ that the Commission published in **June 2021** as a complement to the 2018 action plan and as a logical consequence of the developments in sustainability since its publication.

Of all the initiatives based on the two aforementioned documents (the action plan and the renewed strategy), I will refer to those that are particularly relevant for the financial system and the Banco de España, i.e. the Taxonomy Regulation, the Proposal for a Corporate Sustainability Reporting Directive and the Green Bond Regulation. I will conclude this part of my address by discussing in more detail the changes to the banking prudential framework.

Because of its importance, I will start with the Regulation on the establishment of a framework to facilitate sustainable investment or **Taxonomy Regulation** (Regulation (EU) 2020/852). It is essential to establish, not just at the European level, but globally, a common set of definitions for all economic agents, be they banks or enterprises, as this is a global problem that cannot be tackled from a local standpoint. This Regulation sets six environmental objectives: (i) climate change mitigation; (ii) climate change adaptation; (iii) the sustainable use and protection of water and marine resources; (iv) the transition to a circular economy; (v) pollution prevention and control; and (vi) the protection and restoration of biodiversity and ecosystems. In order for an economic activity to qualify as Taxonomy-aligned, in addition to contributing to one of the above objectives, it must not significantly harm the rest and must be carried out in compliance with minimum social safeguards. This Regulation is key. It provides the basis for all sustainability regulation. As I said, the European Commission is still working on the implementation of this taxonomy, including covering – for climate change objectives (i) and (ii) – the economic activities that it has not yet addressed, such as agriculture and certain more controversial energy sectors, such as nuclear energy and natural gas. Furthermore, it has yet to set out the technical criteria for classifying economic activities as sustainable on the basis of the other objectives.

In addition, work is under way to extend this environmental taxonomy to so-called “brown” and “neutral” activities, but this work is still at a very early stage.

Second, I would like to mention the **Proposal for a Corporate Sustainability Reporting Directive (CSRD)**, which amends the non-financial reporting directive (NFRD). It will make substantial and much-needed improvements to sustainability reporting obligations, which should contribute to better allocating funding via an adjustment in asset prices. A clear example is the extension of the NFRD’s scope to all large companies, whether listed or not, and to all listed companies, including SMEs (with the exception of listed micro-enterprises).

Third, I must also highlight the proposal for a **green bond standard**, issued in July 2021. This proposal will create a voluntary high quality standard for all issuers (private and

³ https://ec.europa.eu/commission/presscorner/detail/en/ip_21_3405

sovereign) with the aim of contributing to financing sustainable investments. Having a European green bond standard will incentivise the creation of a common framework consistent with the Union's climate change mitigation and adaptation objectives. These are two of the environmental objectives of the aforementioned European Taxonomy Regulation. Linking these standards to the Taxonomy Regulation is essential to ensure that sustainable economic activities are adequately funded through the issuance of debt instruments. Here I would also like to mention the importance of these standards in avoiding what is known as "greenwashing", i.e. the process of classifying certain activities as environmentally sustainable when in fact they are not. It is common knowledge that ESG security issuance is becoming increasingly important. Several weeks ago, it was reported that 14.4% of the total assets of Spanish funds are deposited in ESG funds, that the sustainable debt placed up to June exceeded the total debt issued in 2020 and that 40% of Spanish investors consider that ESG criteria are "key" to their investment approach, above the global average. This highlights the importance of having a clear definition of what a green bond is. European standards are key for this.

At this point I would like to make a brief digression on green issuance. In July 2021 the European Central Bank presented its strategy to incorporate climate considerations into its monetary policy framework and, specifically, into the areas of disclosure, risk assessment, the collateral framework and corporate sector asset purchases. In February 2021 the Banco de España subscribed to the decision adopted by the Eurosystem to establish a common stance for climate change-related sustainable investment in non-monetary policy, euro-denominated portfolios. By 2019 the Banco de España had already decided to add sustainability and responsibility criteria to its investment policy in respect of its own portfolios.

Continuing the review of European regulation in the **prudential realm**, I must highlight the initiatives undertaken by the European Banking Authority (EBA) and the European Commission.

- 1) First, the European Banking Authority was mandated with analysing how to **incorporate ESG risks into the three pillars** of the banking regulation of the Basel Accords.

Pillar 1 refers to capital requirements and includes and defines the solvency ratio. The EBA is determining whether a specific prudential treatment for exposures related to assets or activities linked to environmental or social objectives would be warranted. This work is still at a very early stage. Moreover, ongoing analysis not only focuses on the solvency ratio, but also includes other measures within the scope of Pillar 1, such as the large exposures framework, the leverage ratio, liquidity, etc.

With regard to Pillar 2, the EBA is assessing the possible inclusion of environmental, social and governance (ESG) risks in the supervisory review and evaluation process. This process, commonly known as the SREP, shows where each institution stands in terms of capital requirements and the way it deals with risks. The SREP concludes with a decision setting key objectives to address the identified issues. In June 2021, the EBA published a report⁴ making a series of recommendations to institutions and supervisors on integrating ESG risks into business and governance strategies and risk management.

⁴ <https://www.eba.europa.eu/eba-publishes-its-report-management-and-supervision-esg-risks-credit-institutions-and-investment>

Most importantly, the report establishes standard definitions relating to ESG risks and their transmission channels and identifies appropriate methodologies for measuring them. It sets out how institutions should manage ESG risks and recommends integrating them into their business strategies, internal governance structures and risk management systems. It also outlines how these risks should be supervised under a principle of proportionality and assessing the long-term resilience of institutions' strategies.

Pillar 3 deals with the information to be reported by institutions and is related to market discipline. In this regard, in March 2021 the EBA published a draft implementing technical standard⁵ (ITS) on disclosures on ESG risks, both in quantitative and qualitative terms. The purpose of this ITS is to provide the market with comparable and quantitative information on the physical and transition risks to which credit institutions are exposed. Credit institutions will also have to report their green investments to the market through the so-called GAR (green asset ratio), which provides information on which part of the exposures of financial institutions contribute to achieving the climate change mitigation and adaptation objectives as defined in the Taxonomy Regulation. Initially, only significant credit institutions having issued listed securities would be subject to this disclosure requirement. But, as I said, this standard is still at the consultation stage.

- 2) As for the **Commission's** initiatives in the prudential realm, I would like to highlight the banking package published at end-October. This package goes a step further by explicitly including sustainability – in line with the EBA's work – in prudential banking regulation (basically in the regulation and directive on prudential requirements), with the aim of ensuring better management of ESG risks by credit institutions. It has also extended to all credit institutions, bearing in mind the principle of proportionality, the ESG disclosure requirements I mentioned earlier. Finally, I would like to mention that the Commission's proposal does not address one of the most controversial issues: the possibility of adjusting Pillar 1 capital requirements on the basis of green/brown assets. This idea is still being explored by the Commission, which does not wish to take a stance until it has the analysis and results of the work that both the EBA and the BCBS are conducting in this respect.

Allow me to digress once again from this review of sustainability regulation for a brief reflection. So far, I have referred almost exclusively to environmental aspects, but for an economy to be sustainable, it must also be so from a social point of view. All organisations, enterprises and public institutions have an impact on society wherever they operate. This social aspect must also be defined and regulated in the same way as the environmental aspect is.

Unfortunately, I cannot elaborate much on this because this regulatory development is still very much in its infancy. We have yet to establish a social taxonomy similar to the existing environmental taxonomy. It would be desirable for the Commission to make a legislative proposal along these lines over the course of next year, but it is still too early to know if this will be possible. For the time being, I can only confirm that work is under way to define what

⁵ <https://www.eba.europa.eu/calendar/consultation-draft-its-pillar-disclosures-esg-risk>

is meant by “social investment” and what the social objectives are. Perhaps in few years’ time we will have a clearer framework for social sustainability.

We now leave behind the work of the European regulators to briefly mention the actions taken by the **European Central Bank**.

In November last year, the ECB published a guide on climate-related and environmental risks which outlines how credit institutions are expected by supervisors to manage these risks prudently and the mechanisms for communicating them transparently. These guidelines are aimed at significant institutions supervised by the European Central Bank. Similarly, in October 2020 the Banco de España published expectations along these same lines aimed at less significant institutions, as the body ultimately responsible for their supervision. Compliance and adherence to these guidelines will be reviewed over the coming year, although we have already analysed institutions’ self-assessment exercise in relation to their compliance with these expectations. No bank is yet fully aligned with these guidelines, but we have seen good practices across all geographical areas and types of institutions, so there is some optimism about their compliance in the future.

In addition, as I pointed out earlier, in July 2021 the European Central Bank presented its plan to include climate-change considerations in its monetary policy strategy. In this new strategy, climate aspects are included in four areas: disclosures, risk assessment, the collateral framework and corporate sector asset purchases. Specifically, the ECB will introduce disclosure requirements on private sector assets as a new criterion in order to be eligible as collateral or for asset purchases. It will also take into account the relevant climate risks when revising the assessment and risk control frameworks for the collateral pledged by counterparties in Eurosystem credit operations.

Among the ECB’s actions, I must underline the two stress test exercises. The results of the first exercise, with a top-down approach, were published recently. The second exercise (bottom-up) will be conducted next year on the institutions it supervises. The first exercise tested the impact of climate change on over four million companies worldwide and 1,600 euro area banks under three different climate scenarios.⁶ It concluded that there are clear advantages to taking early action against climate change.

To conclude, I would like to review the legislative initiatives at the national level.

Spain

I would like to start with Climate Change and Energy Transition Law 7/2021. The provisions of this law stipulate that credit institutions must prepare an annual report as part of the Pillar 3 report. They must include in this report an assessment of the financial impact on society of climate change risks arising from their exposure to climate change. The report should therefore include the risks posed by the transition to a sustainable economy and the measures adopted to address these risks. As of 2023, they must also publish specific decarbonisation targets for their loan and investment portfolios, in line with the Paris Agreement. The content of this report will be determined by an implementing regulation within two years of the passing of the law, and will in any case include the following aspects:

⁶ <https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op281-05a7735b1c.en.pdf>

- a) The governance of the institution in relation to the identification, assessment and management of climate risks.
- b) The strategy approved to adapt to climate change and mitigate the attendant risks.
- c) The impacts that the risks and opportunities associated with climate change might have on the organisation's activities, strategy and financial planning.
- d) The climate risk identification, assessment, control and management processes and how they are integrated into institutions' global business risk analysis and global risk management.
- e) Lastly, the metrics, scenarios and targets used to assess and manage the relevant risks and opportunities associated with climate change.

As you can see, the objectives to be covered are very ambitious. We will have to wait for them to be detailed in the upcoming implementing regulation, which is already under way.⁷

Moreover, this law also sets out requirements for the authorities, as it states that the Banco de España, the National Securities Market Commission and the Directorate General of Insurance and Pension Funds, within their respective remits, will jointly draw up, every two years, a report on the degree of alignment with the climate goals of the Paris Agreement and EU regulations. This report will be based on future scenarios and will assess the risks that climate change may pose to the Spanish financial system. It will also detail the policies to combat it and will be coordinated by the Spanish macroprudential authority (AMCESFI).

Conclusion

As you have heard, we are witnessing a regulatory whirlwind of activity around sustainability on all fronts. All actors, international, European and, of course, national, are immersed in a process of defining regulations to build an economic and, therefore, financial future that is sustainable in all respects to tackle the enormous challenge of adapting to the new climate context.

I would like to highlight the leading role that the European Union has taken on, without losing sight of the importance of coordination at the global level, as climate change is a global problem and a lack of coordination could lead to a fragmentation of regulatory frameworks and to the absence of a level playing field.

Meanwhile, from the prudential supervision standpoint and by way of a summary, I would like to point out that, initially, efforts have focused on improving the management of these risks by institutions (Pillar 2) and their disclosure to third parties (Pillar 3). The need to adjust Pillar 1 to reflect these new risks is still under discussion. However, all the measures already adopted should result in a better allocation of bank financing to more sustainable projects, thus contributing to mitigating climate change.

I hope that this speech has illustrated the commitment of all regulators to work towards the creation of a regulatory framework that will underpin this sustainable economy.

⁷ The Treasury has just launched a consultation to determine the content of this legislative act.

However, I would like to stress that the shift to this sustainable economy is primarily and without a doubt the responsibility of governments, whose policies and decisions must guide the change of economic model. It is true that financial institutions play a leading role in channelling funds among economic actors, but they are just one of the players, along with the rest of society. Institutions are responsible for identifying, measuring and incorporating climate risk into their usual risk management, but the true drivers of change will be governments with their policies and, naturally, citizens with their actions.

Thank you.