

## BANCO DE ESPAÑA SUPERVISORY EXPECTATIONS ON CLIMATE CHANGE AND ENVIRONMENTAL RISK, AND THE ECB GUIDE

Climate change and environmental degradation represent a global concern that has prompted initiatives in various fields. These reflect the need for measures geared towards achieving the demanding global warming reduction targets.

New risk factors are emerging as a result of the measures introduced to transition to an environmentally friendly low-carbon economy, along with the physical risks deriving from climate change and environmental events. These are having an impact on financial risks, which has attracted the attention of supervisors and central banks. Both are therefore adding to their work agendas analysis of the financial risks associated with climate change and environmental degradation.

The Banco de España and the European Central Bank (ECB) have been party to the debates surrounding the energy transition and its implications for credit institutions in the euro area. In this regard, and besides their participation in a number of international fora and bodies, they have implemented public initiatives in the interest of raising the banking sector's awareness and readiness.

One good example of these initiatives is the publication of the Banco de España supervisory expectations document on risks posed by climate change and environmental degradation, and the ECB guide on climate-related and environmental risks. Both documents recognise climate-related and environmental risks as sources of financial risk; institutions must therefore begin to factor these into their oversight of the traditional banking risks (credit risk, market risk, liquidity risks and operational risk). While these expectations are not binding for the institutions, they do provide guidance on how to incorporate and approach climate-related and environmental risks in the following aspects:

- i) Business model and strategy: institutions are expected to incorporate those risks that may be material in both the short and long term.

- ii) Governance: ultimate responsibility for integrating these risks in the overall strategy, and for establishing the necessary mechanisms to review these arrangements, is expected to lie with the board of directors.
- iii) Risk management: institutions are expected to consider the risks posed by climate change and environmental degradation seamlessly within its existing risk management procedures and to adopt a comprehensive approach to their identification, assessment, monitoring and mitigation.
- iv) Disclosures: institutions are expected to publish material information on significant events, taking into account their characteristics and, in particular, their time horizons.

The ECB guide is directly applicable to significant institutions and recommends that national competent authorities apply the guide in a proportionate manner in their supervision of less significant institutions (LSIs), whereas the Banco de España supervisory expectations are addressed to the LSIs under its supervision.

Although the two documents differ in the degree of detail of the expectations, both envisage the institutions applying the expectations based on the materiality of their exposure to climate-related and environmental risks, which is not necessarily linked to their size.

Both the Banco de España and the ECB are aware of the novel nature of this subject matter and the considerable uncertainty regarding the materialisation of these risks, along with the challenges relating to methodology and the availability of information that institutions face when identifying and measuring such risks. They are therefore of the view that the institutions need time; accordingly, they do not expect all of the expectations set out in these documents to be implemented immediately, and instead will assess their gradual deployment as part of the supervisory dialogue.