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Towards the promotion of a virtuous circle of Sustainable Finance in the EU. Will Europe drive the global agenda setting?

ELEC. The EU banking industry: a guide on sustainable finance - ESG

Madrid

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Good morning.

Let me begin by thanking ELEC (European League for Economic Cooperation), for inviting me to give the opening speech of the second roundtable of this session.

Since the Paris Agreement in 2015 the concern for climate change has reached another dimension. The agreement covers climate change mitigation and adaptation, as well as financing commitments, setting a new goal to guide all signatory nations, "to keep the rise of global temperature in this century well below 2° degrees Celsius, and preferably limit the increase to 1.5 degrees".

Besides, climate change has a global dimension, and therefore should be addressed globally, in a coordinated manner. Europe is leading this process from the beginning. In this vein, the EU aims to be climate-neutral by 2050, meaning net zero greenhouse gas emissions for EU countries as a whole.

As you are aware, sustainable finance has been in the EU agenda for some years now. As a first key milestone, I would highlight the **Action Plan on financing sustainable growth** issued by the European Commission in **March 2018**. It sets out the roadmap to boost the role of finance in achieving a well-performing economy, that is, to further connect finance with sustainability. This strategy involves all relevant actors in the financial system and aimed at: (i) first, reorienting capital flows towards a more sustainable economy; (ii) second, mainstreaming sustainability in risk management and; (iii) third, fostering transparency and long-termism in financial and economic activity.

This Action Plan included ten key actions for achieving these three objectives. Among these actions, I would like to highlight the following:

- Establishing an EU classification system for sustainable activities.
- Creating EU standards and labels for green financial products, including an EU green bond standard.
- Incorporating sustainability in prudential requirements.
- Enhancing transparency in corporate sustainability reporting.
- Fostering sustainable corporate governance and attenuating short-termism in capital markets.

Additionally, in **December 2019**, the European Commission presented the **European Green Deal**. This initiative, for which the Commission has pledged to mobilise at least €1 trillion in sustainable investments over the next decade, aims at making Europe the first climate-neutral continent by 2050, while also creating an inclusive economy, improving people's health and quality of life, and taking care of the environment.

The European Green Deal tackles climate change in all sectors of the economy, but makes emphasis on transport, industry and agriculture. Although these efforts involve mainly the real economy, they require a huge volume of financial resources coming from public and private investments. Therefore, financial institutions and markets should play a key role in mobilizing capital flows towards green and sustainable projects.

In July 2021, the European Commission adopted the **'Fit for 55' package**, as part of the European Green Deal, with the aim of adapting existing climate and energy legislation to meet the EU objective of a minimum of 55 % reduction in greenhouse gas (GHG) emissions by 2030. Overall, the package covers a range of policy areas and economic sectors: climate, energy and fuels, transport, buildings, land use and forestry. The chosen policy mix is a careful balance between pricing, targets, standards and support measures.

Simultaneously, the European Commission published also its **Strategy for Financing the Transition to a Sustainable Economy** with a broader scope than the 2018 Sustainable Finance Action Plan. It is based around four main topics: (i) financing the transition to sustainability; (ii) inclusiveness; (iii) financial sector resilience and contribution and; (iv) global ambition (fostering of international consensus on sustainable finance).

In this context, from a financial sector perspective, I would outline the request for a one-off scenario analysis exercise to be conducted jointly by the European Supervisory Authorities, the ECB and the ESRB. These authorities will assess the extent to which early climate risk related shocks could already generate significant stress for the financial system as a whole in the period up to 2030, taking into account contagion and second-round effects.

The initiatives described above demonstrate the **EU´s leadership** on environmental issues, both in terms of timing and in terms of the volume of resources committed. Just to compare with similar initiatives in other geographic areas, we can refer to the **US Inflation Reduction Act of 2022**. This project, announced almost 3 years later than the European Green Deal, is also less ambitious in terms of allocated funds ($369 Bn). This plan would essentially boost the US' competitiveness and businesses. The related budget includes tax credits and other financial incentives for the production of electric vehicles, renewable energy, sustainable aviation fuel, and hydrogen.

The concerns that these incentives for US manufacturing of clean technologies would disadvantage European industries were responded by a new European regulation, the **Net-Zero Industry Act**, that came out in **March 2023**. This legislative proposal sets a goal for the EU to domestically produce at least 40% of the technology it needs to achieve its climate and energy targets by 2030.

We will see the implications of both acts in terms of potential reallocation of industrial projects from one region to the other, sustainable projects to be developed in Europe, thus, to be potentially financed by European banks, and, the potential impact on banks' transition towards a net zero economy.

Completed legislative initiatives

I would like to continue by briefly mentioning some of the most relevant **EU's legislative initiatives** completed so far supporting the EU's sustainable agenda.

Let me begin with the **Taxonomy Regulation,** published in **June 2020,** which is a cornerstone of the EU's sustainable finance framework and an important market transparency tool. The EU taxonomy allows financial and non-financial companies to share a common definition of economic activities that can be considered environmentally sustainable. It is vital to be able to direct investments towards projects and activities that make it possible to meet the EU's climate and energy targets for 2030 and reach the objectives of the European Green Deal.

In this way, it plays an important role, helping the EU scale up sustainable investment, by creating security for investors, protecting private investors from greenwashing, helping companies become more climate-friendly, and mitigating market fragmentation.

In **November 2022**, the EU adopted the **Corporate Sustainability Reporting Directive (CSRD)**. The CSRD entails a dramatic increase in the number of companies subject to the EU sustainability reporting requirements, around 50,000 compared with 11,700 under the former Non-Financial Reporting Directive. This new Directive also strengthens the reporting requirements with the long-term goal of aligning sustainability reporting with financial reporting.

Under the double materiality perspective, this Directive will: i) ensure that investors and other stakeholders have access to the information they need to assess investment risks arising from climate change and other sustainability issues and; ii) and, at the same time, create a culture of transparency about the impact of companies on people and environment. Finally, the sustainability information should be reported under a common standard to be developed by EFRAG and will be assured by independent third parties.

Also in relation to disclosures, the **European Banking Authority (EBA)** published in **January 2022** its implementing technical standards (ITS) on **Pillar 3 disclosures on Environmental, Social and Governance** (**ESG) risks**. These standards, applicable to listed large institutions, put forward comparable disclosures to show how climate change may exacerbate other risks within institutions' balance sheets, how institutions are mitigating those risks, and their ratios, including the Green Asset Ratio. This has been the first step to integrate sustainability in the prudential requirements.

Ongoing legislative initiatives

Regarding the **ongoing regulatory initiatives**, I would like to focus on the following:

1) **In October 2021**, the European Commission adopted a review of the EU banking rules (the **Capital Requirements Regulation and the Capital Requirements Directive**), which is now entering its final stages under the trialogue discussion. The new rules will require banks to systematically identify, disclose and manage ESG risks as part of their risk management.

Among the ESG-related provisions, I would highlight: i) the introduction of the definition of ESG risks; ii) the expansion of the disclosure requirements on ESG risks to small and non-complex institutions (with proportionality); iii) the incorporation of ESG risks in the supervisory reporting; iv) the integration of ESG risks in the institutions' strategies, risk management policies and procedures (including the development of transition plans) and competent authorities' assessment on this integration; v) the explicit mention of the ESG risks in SREP and supervisory measures and; vi) the acceleration of the EU's assessment of whether further changes related to environmental and social issues in the capital framework are justified.

2) In **February 2022**, the Commission adopted a proposal for a **Directive on corporate sustainability due diligence**. This Directive will introduce requirements for companies to identify and prevent or mitigate the actual and potential impacts of their activities on the environment and on human rights abuses. It will oblige them to conduct due diligence not just on their own operations, but also on the activities of their subsidiaries and other entities in their value chains, with which they have direct and indirect established business relationships. They would need to develop and implement 'prevention action plans', obtain contractual assurances from their direct business partners that they will comply with the plans, and subsequently verify compliance. This Directive establishes not only a corporate due diligence duty but also duties for the directors of the EU companies covered. This would apply directly to around 13,000 EU large limited companies and 4,000 non-EU companies operating in the EU.

3) **On February 2023**, the Council and Parliament announced that they had reached a provisional agreement on the creation of **European Green Bonds Regulation**. This Regulation aims to facilitate the further development of the European market for green bonds that will help meet the EU's climate and environmental objectives as well as to reduce the risk of "greenwashing" by setting high standards for the issuance of green bonds.

   Some key features of this agreement are: i) the EuGB will remain of voluntary nature with its uniform requirements applying to issuer of bonds that wish to use the designation "EuGB"; ii) issuers of EuGBs would need to ensure that at least 85% of the funds raised by the bonds are allocated to economic activities that align with the EU Taxonomy; iii) all issuers choosing to use the EuGB standard when marketing a green bond will not only be required to disclose much information about the use of proceeds, but also show how those investments feed into the transition plans of the company as a whole; iv) the Regulation establishes a registration system and supervisory framework for external reviewers of European green bonds and; v) the national competent authorities of the home member state designated shall supervise that issuers comply with their obligations under the new standard.

EBA and BCBS

Regarding the banking industry, let me just briefly mention that, , the EBA has an important role in supporting the European banking sector towards the objectives of transitioning to a more sustainable economy and mitigating risks stemming from climate change and broader ESG factors. It published its **roadmap in December 2022, according to which the EBA will continue delivering on mandates for the progressive incorporation of ESG considerations** into the three pillars of prudential regulation (regulation, supervision and disclosure) and those stemming from the Commission's action plan and renewed Sustainable Finance Strategy.

Along the same lines, the **Basel Committee** has incorporated climate-related financial risks into its work programme, taking a holistic approach to their assessment and again considering the three pillars of the prudential framework (regulation, supervision and disclosure). I would highlight its principles for the effective management and supervision of climate-related financial risks, issued in June 2022, aiming to promote a principles-based approach to improving both banks' risk management and supervisors' practices related to climate-related financial risks. These principles are closely aligned with the supervisory expectations covered in the ECB Guide on climate-related and environmental risks and with the recommendations included in the EBA Report on management and supervision of ESG risks, showing the influence by the European authorities. In addition, the BCBS plans to publish a consultation paper on the disclosure of climate-related financial risks.

Supervisory activities and progress up to now

So far, I have described some of the main EU regulatory initiatives since the publication of the EU Action Plan on Sustainable Finance in 2018, which I see as the matters on which this roundtable should focus on. Now, let me say a few words from the perspective of the banking supervisory authority, since we are **responsible for ensuring that banks comply with the applicable regulations**.

From the supervisory standpoint, I would like to give you an overview of the main activities that we have carried out over the last year.

In a bid to spur banks into incorporating climate risks into their operations and day-to-day reality as soon as possible, the Single Supervisory Mechanism (SSM) stepped up its supervisory activities in 2022. Thus, it conducted a climate risk stress test and a thematic review on climate-related risks, began to reflect on how to integrate climate risks into the SREP (Supervisory Review and Evaluation Process), and drove improvements to climate risk disclosures.

We have found that banks have made some progress:

- There has been a slight improvement in the quality of the climate-risk related data available to banks. We would expect that availability and quality of data will improve following the enter into force of the regulations on disclosures previously mentioned (e.g. CSRD).

- There is greater recognition of the importance of physical and transition risks for banks.

- Progress has also been made in terms of the institutional architecture for addressing climate-related risks. More than 85% of the banks have basic practices in most of the areas covered by the ECB expectations.

- Compared with 2021, the basic information disclosed by the banks in the different categories has increased substantially in 2022. Moreover, nearly all banks now report how their Board oversees such risks, and over 90% provide basic descriptions on how they identify, assess and manage them.

However, we have found that banks are not yet properly managing climate-related and environmental risks and that, although improvements and some good practices have been identified, there is much still to be done. Also, in general, it appears that the banks are not sufficiently prepared to comply with the climate-related and environmental disclosure requirements. This shortcoming is particularly concerning for the SIs, which are included within the scope of application of the EBA's Implementing Technical Standards (ITS) and are therefore obliged to disclose information referring to 31 December 2022 by the end of this month.

Challenges and difficulties

We are aware that identifying, measuring and managing climate risks continue to pose major challenges and difficulties for banks, including:

- The difficulty in obtaining data of sufficient quality, and the problems in interpreting these data from a financial perspective. Banks generally still lack methodological sophistication and sufficiently forward-looking and granular information on climate risks.

- Also, the forward-looking nature of these risks makes it very difficult for banks to include them in their risk management frameworks, as these frameworks normally consider the medium term and a time horizon of three years, whereas the climate related risks need to be managed over a much longer time horizon of 10 to 20 years.

- Furthermore, when developing and reviewing transition plans, banks have to base themselves on their counterparties' transition plans which, broadly speaking, are not yet very developed.

  As supervisors, we expect that in the transition plans that they will have to draw up under the Corporate Sustainability Reporting Directive (CSRD), banks will clearly set out their transition strategies, with concrete objectives, interim deadlines for the different phases, and details of all of the risks associated with the implementation of each strategy.

- It also needs to be borne in mind that a proper understanding of climate risks calls for scientific knowledge that is often beyond our grasp.

- Lastly, we should not disregard that the higher pressure from the society (consumer preferences) could accelerate the impact of climate considerations on the institutions' activities and reputation (e.g. litigation, claims, etc.).

I would like to finish by noting that, while we are conscious of the current difficulties in prudently managing the climate and environmental risks, we believe that we must continue working hard together, to overcome these obstacles. Europe must keep its leadership in sustainable finance and be a major player in the fight against climate change, for which it is vital to adequately and timely progressing in the actions foreseen in the EU Plan and Strategy on sustainable finance.

Many thanks.