

CLIMATE RISK AND SUSTAINABLE ECONOMY

The European Central Bank (ECB), in close cooperation with the national competent authorities and on the basis of a comprehensive assessment of the main risks and vulnerabilities of the supervised institutions, performs annual reviews of the SSM supervisory priorities, which reflect its strategy for the next three years.

In December 2023, the supervisory priorities for 2024-2026 were published; as in recent years, they highlight the need for credit institutions to continue working to resolve weaknesses related to the incorporation of climate and environmental risks into their risk management framework. This demonstrates European banking supervisors' commitment to play a major role in the fight against climate change and the transition to a more sustainable economy.

Given the priority nature of climate and environmental risks, numerous supervisory activities were developed in 2023, that will continue over the coming years, including most notably, in the case of significant institutions, the following:

- Specific monitoring of the weaknesses detected in the 2022 thematic review, which resulted in qualitative requirements being imposed on institutions with severe shortcomings in their materiality and business context assessment.
- On-site inspections on climate and environmental risks.
- Analysis of climate risk information that significant institutions published for the first time under Pillar 3 standards in the first half of 2023.
- Preparation and launch of the Fit-for-55 exercise, scenario analysis which aims to assess how public policies for the transition to a more decarbonised economy would affect the financial system (banking, securities and insurance).

For the less significant institutions, directly supervised by the Banco de España, an analysis of their progress in implementing the supervisory expectations on climate and environmental risk management that were published by the Banco de España in October 2020 was carried out by means of two questionnaires sent to all institutions. In parallel, there has been a progressive inclusion of the

considerations on these risks in the supervisory dialogue and recommendations issued under the SREP.

As regards these institutions, the Banco de España will intensify the specific monitoring of these recommendations through horizontal on-site reviews across a sample of institutions to verify, among other aspects, whether institutions integrate the risks arising from climate change and environmental degradation into their current risk management procedures, and whether they have implemented a comprehensive approach to the identification, assessment, monitoring and mitigation of these risks.

The importance of these supervisory activities is given by the weight of the most carbon-intensive sectors in the credit exposure and income of European banks, and by recent developments in climate and environmental risks, including most notably the following:

- on a global scale, greenhouse gas emissions continue to rise, causing global warming which leads to an increase in physical risks;
- transition risks are increasing, due to the delay in the adoption of policies and measures to meet climate objectives, together with the need to invest in low-emission technologies that, in many cases, are costly or not sufficiently developed; and
- society's level of awareness is growing and, therefore, there is greater demand for sustainable goods and services, and greater scrutiny of companies' and institutions' behaviour, which increases their operational and reputational risks.

For the proper integration of these risks into their practices, institutions face well-known challenges. These include, among other things, the limited availability of quality data to assess climate risks, the very nature of the risks and the high uncertainty as to their materialisation, which require a long-term approach, exceeding the usual periods used by institutions in their customary planning. Also, although progress is being made, the methodologies for estimating these risks still lack the necessary sophistication for proper assessment.

1 See "ECB Banking Supervision: supervisory priorities for 2024-2026".

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In this context, supervisors are playing a very active role, maintaining constant dialogue with institutions, publishing observed good practices and contributing to regulatory developments in this area.

It is important to note the significance of the transition plans that credit institutions will have to draw up. The fact that they will necessarily have to rely on the plans produced by their main counterparties will pose an additional challenge to those already mentioned. It is

essential that credit institutions maintain fluid communication with their customers to learn about their transition plans and the technological developments and investments needed to implement them. Channelling capital only to industries that can already be described as "sustainable" would make it practically unfeasible to achieve the European Union's climate targets. The ECB, in turn, will develop an approach for analysing these plans as part of its supervisory review and assessment process.