Fundación "La Caixa" – Circulo Financiero

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Financing transition to sustainability? What is the role of banking regulation?

Introduction

Thank you for inviting me. It's my pleasure to speak here at the Fundación "La Caixa", Circulo Financiero.

Climate change is one of the most pressing issues of our generation and future generations to come. As many of you are well aware, international efforts, under the United Nations (UN) Climate Change Conferences, started in mid-90s leading to the recognition of climate change as a global emergency. Today, it is recognised that climate change is a global emergency that goes beyond national borders and it is an issue that requires international cooperation and coordinated solutions at all levels.

It was in 2015, during UN Climate Change Conference of Parties (COP21), that the international efforts resulted in a concrete set of objectives under the so-called Paris agreement. Today 193 States plus the European Union signed this legally binding international treaty. The signatory States and the European Union (EU) are committed to reduce their greenhouse gas emissions to limit the global temperature rise to well below 2 degree Celsius, and prepare ambitious action plans to reach targeted climate objectives. More recently, the 2022 UN Climate Change Conference (COP27) reminded us to move from targets to climate action as we must work "*together for implementation*".

Today, it is encouraging to see that climate change and sustainability is no longer a subject that concerns scientists and activists only. Now, it is also a top priority in the policy agenda.

The European Union and its Member States have pledged to become the first climate-neutral economy and society by 2050. In the pursuit of its ambitions and to fulfil its commitment as one of the signatories of the Paris agreement, the EU adopted the European Green Deal in 2020 and then the European Climate Law in 2021. This Law introduces concrete targets and the necessary framework to cut greenhouse gas emissions in the EU – that is by at least 55% by 2030 – and then reach climate neutrality.

The European Union sets the bar high and invites a systemic change in the way we live and in the way our economies operate. Let me emphasise this point and remind you what the EU Climate Law states: "*the transition to climate neutrality requires changes across the entire policy spectrum and a collective effort of all sectors of the economy and society […] all relevant Union legislation and policies need to be consistent with, and contribute to, the fulfilment of the climate-neutrality objective while respecting a level playing field […]*".

We started seeing the first steps of these changes in the policy spectrum already. In many sectors from housing to energy, from agriculture to finance, the EU is taking action to reform our society and our economy in the path to climate-neutrality.

Certainly, climate change is only one aspect of the wider environmental, social and governance (ESG) factors. We should not overlook other factors and risks that our society and economy is going to face in years to come. Other environmental factors such as dependence on biodiversity, social factors such as human rights, health and working conditions, and governance factors such as executive leadership are driving societal relations and monetary impact in the real economy. As a result, ESG factors are changing the risk picture for the financial sector too, calling for assertive actions by all stakeholders.

Role of the financial sector and banking regulation

Now, let me tell you what role the banking regulation and the EBA are going to assume to contribute to the needed transition to a low carbon, more resource efficient and sustainable economy, and a more inclusive society.

The financial sector has an important role to play, both in terms of financing the transition to sustainability given their unique position in intermediating capital flows through their lending and investment, and for managing financial risks stemming from ESG factors.

A robust banking sector will be fundamental in supporting an orderly transition because only a robust and orderly functioning banking sector can provide the needed private funds for the transition. And when it comes to the banking regulation, I will argue that its primary role remains the same; to continue providing the right framework to maintain financial stability and to safeguard the integrity, efficiency and orderly functioning of the banking sector.

EBA's agenda on sustainable finance

With this objective in mind the EBA published its first action plan on sustainable finance back in 2019. Risk management and transparency was our initial focus. We started investigating and identified banks' exposure to ESG risks as key risk drivers in the banking system. We also tried to understand how banks take (or not) the necessary measures to identify and mitigate such risks. Accordingly, we built regulatory expectations for banks to integrate ESG considerations in their risk management. The EBA documented its findings and regulatory expectations in its report on management and supervision of ESG risks in 2021. The report provided common definitions of ESG risks, identified evaluation methods that are needed for effective risk management, and recommended integrating ESG risks into business strategies, governance and risk management as well as in the supervision. In parallel, in 2020 we started our regulatory work in banks' Pillar 3 public disclosures and conducted an EU-wide pilot exercise on climate risk.

Since the publication of that first action plan the EBA's policy agenda on sustainable finance grew significantly, in parallel with the policy developments at the EU and international level. Through various mandates, the EBA is requested to take concrete actions in a wider set of policy areas in a now more mature framework for sustainable finance.

As a response to these developments and as a continuation of its first action plan, the EBA recently, in December 2022, published its new roadmap on sustainable finance. In the remainder of my intervention today I am going to discuss the key elements of this roadmap and explain how the regulatory action can support the EU banking sector in its path to sustainability.

Incorporating ESG risks in banking framework

The roadmap outlines the EBA's key objectives and timeline for delivering mandates in the area of sustainable finance and ESG risks over the next three years.

As I argued earlier, the EBA's work in this area is closely linked with the broader objective of contributing to the short-, medium- and long-term stability, resilience and orderly functioning of the financial system.

To this end, the EBA will analyse how ESG risks are embedded in the current prudential regulation, and how institutions and competent authorities address these risks. The EBA will assist institutions and supervisors in embedding ESG risks in their activities through three key angles:

i) anchoring ESG risks in the relevant regulations,

ii) providing guidance on risk management and supervisory practices, and

iii) carrying out risk analysis and monitoring exercises, including climate stress tests.

As the regulatory agency of the EU for the banking sector, the EBA recognises that while addressing ESG challenges necessitates the implementation of a range of public policies, the primary role of the prudential framework is to ensure a stable and resilient financial sector that will be able to provide the adequate financing for the required economic and social transition.

In executing this roadmap and delivering mandates on ESG, the EBA will pay particular attention to the following three elements:

i) ensuring continued resilience of the EU banking sector against the risks,

ii) appropriately applying the principle of proportionality, and

iii) supporting the solid and consistent implementation of the EU and international agenda on sustainable finance.

We will address the ESG-related topics in a comprehensive and sequential manner by progressively updating and enhancing all relevant parts of the supervisory and regulatory framework. The EBA’s work on ESG risks will primarily cover the three pillars of the banking framework: transparency and market discipline, supervision, and prudential treatment of exposures.

Recently, the European Commission adopted the EBA’s **Pillar 3 disclosure requirements** on ESG risks. This regulation is of paramount importance; to be able to develop methodologies to manage risks, we first need to get the right data and information on how to assess these risks.

Banks should understand the risks they are facing, as well as the environmental and social impact of their activities, such as their financed greenhouse gas emissions, and make them publicly available. In these disclosure standards, information on carbon related exposures, financed GHG emissions and alignment metrics or assets in geographies exposed to climate-change events is combined with information on mitigating actions, such as the Green Asset Ratio (GAR).

Transparency and market discipline is a necessary condition for financial market participants to understand the risks associated with banking activities and investment, and to channel capital flows to sustainable economic activities. These requirements for banks, together with other disclosures by financial entities and by non-financial corporations, will certainly increase data availability and quality, which at the moment is still a significant challenge.

Going forward, the EBA will continue developing and enhancing disclosure requirements and promoting high levels of transparency.

This brings me to the second area in the EBA’s roadmap on sustainable finance, that is the **management and supervision of ESG risks**. Data is of paramount importance not only for transparency but also for banks’ ESG risk management.

Banks need to build their capabilities to withstand ESG risks. I mentioned before that the EBA recommends financial institutions to integrate ESG risks into business strategies, governance and risk management. To this end, we welcome the legislative proposal providing more explicit requirements in that area and giving the EBA mandate to guide banks in the integration of ESG risks in their risk management.

Depending on the final outcome of the legislative review of the banking package, the EBA is going to deliver its guidelines on banks' ESG risk management covering also their transition plans to sustainable economy. Furthermore, these risks should also be part of regular supervision being performed by supervisory authorities. In parallel to the guidelines on banks' risk management, the EBA is also planning to integrate gradually and proportionately ESG risk considerations in its guidance on the Supervisory Review and Evaluation Process (SREP).

One area of particular focus is testing the robustness of the financial sector, and in particular banks, to various situations of stress arising from environmental challenges. Many authorities have already conducted exploratory exercises on climate related risks, primarily aimed at learning and exploring different approaches and potential challenges. The measurement of environmental risks remains a challenge, also because of their forward-looking nature and uncertainty around future events and their impacts.

In this context, in addition to the initiatives that I have just described, we are also going to continue working to embed ESG considerations into our **risk analysis and stress testing**. Building on the experience we gained in the pilot exercise back in 2020 - 2021, as well as other similar exercises performed by other authorities, the EBA is preparing a more comprehensive pan-European climate stress testing. These tools should contribute to better understanding of climate risk by institutions and supervisors, allowing development of better strategies and mitigating actions. We also expect the EBA to receive mandates to develop guidelines for banks and supervisory authorities on how to perform ESG stress testing.

The third element in EBA's ESG agenda is the prudential regulation. The EBA is currently working on the assessment of whether current **prudential treatment of exposures subject to environmental and social risks** is adequate. Last year in May we published a discussion paper on this topic, on which feedback from stakeholders has been sought. The feedback received will feed into the formulation of policy recommendations in a final report on whether a dedicated prudential treatment of assets and activities associated with environmental and social objectives/impacts would be justified.

In this context it is crucially important to look at the allocation of capital to specific exposures to ensure that the framework continues to reflect the risk of exposures accurately. It is equally important to investigate how much of the ESG related risks are already directly or indirectly captured by the existing prudential framework and what additional risk remains unaccounted for.

I emphasise once again that the prudential framework exists to ensure that banks are adequately capitalised against the risks they are facing. In the end, a strong and resilient banking sector that adequately assess the risks and is able to properly channel the needed funds is crucial to allow financing the transition to sustainable economy. That is also the overall aim of the EBA work in this area.

Finally, the roadmap explains the EBA's future work on **supervisory reporting.** The EBA will soon start developing supervisory reporting framework on ESG risks. This framework will build on the already existing Pillar 3 disclosure requirements. Supervisory reporting will provide a key tool and source of information for the regulators and the supervisors to identify and assess ESG risks in the banking sector.

New areas of focus in sustainable finance

Up to now, I explained how the EBA's agenda assesses and incorporates ESG risks in various aspects of the existing regulation. In addition to these initiatives, the EBA's agenda covers a number of new policy areas. The objective of these new policy areas is to support the development of the sustainable finance framework and facilitate the orderly transition to a sustainable economy.

The EBA is going to continue its work in the area of **standards and labels**. The work to date included the EBA report on sustainable securitisation, and the EBA's preliminary considerations on the use of ESG-related proceeds bonds for own funds and eligible liabilities instruments.

This year we are going to deliver our advice to the European Commission on definition and possible supporting tools for green loans and green mortgages to households and SME borrowers. This is another important piece of work as indeed, retail and SME borrowers play a significant role in transforming the economy by accessing sustainable finance. For example, green loans can help households and SMEs improve the energy performance of their buildings or switch to zero emission vehicles. To this end, it is important to create a framework that includes all market participants and facilitate green lending in all segments of the markets.

Finally, the recent proliferation of banking products which describe themselves as sustainable or environmentally conscious raise the risk of **greenwashing**. The policy makers and the regulatory community have become increasing concerned about this risk.

The EBA will continue supporting the European Commission in the fight against greenwashing. As the first step the EBA, in cooperation with other European Supervisory Authorities, are going to deliver its advice to the European Commission to help define and identify greenwashing and to evaluate greenwashing risks in the banking sector. Based on the advice, the European Commission will determine whether the regulatory framework including the supervisory legal mandates, powers, capabilities, and obligations are fit for purpose, and consider potential amendments to the EU single rulebook.

Conclusion

Sustainability considerations are becoming a key element in the way banks operate. As transition to a sustainable economy is a long-term commitment and offers challenges and opportunities, the regulatory agenda will support the market players in this journey.

It was my intention today to discuss how sustainable finance and ESG considerations are integrated in EBA's policy agenda, and how this policy agenda is designed to support the banking sector in the transition.

The primary role of the regulation and the EBA remains the same: it is to maintain the resilience and orderly functioning of the EU banking sector. In order to achieve that objective, the changes in the economies, societies and risk dimensions cannot be overlooked. Therefore, the EBA will continue delivering under its sustainable finance agenda to support an orderly transition.

Thank you very much for your attention.