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1 Why sustainability is important for regulators?

First, let me briefly recall **two of the key milestones** that underpin the implications of the climate change and sustainability issues for the financial sector:

- The **Paris Agreement**, signed in **2015**, which includes, among its **long-term objectives**, “making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development”, thus, highlighting for the first time, the relevant role of the financial sector in this matter and,
- The **Action Plan on financing sustainable growth** adopted by the **European Commission in March 2018**, which sets out the roadmap to boost the role of finance in achieving a well-performing economy, that is, to further connect finance with sustainability. In addition to reorienting capital flows towards a more sustainable economy, this Plan aimed at **mainstreaming sustainability in risk management**, for which achievement incorporating sustainability in prudential requirements was set as one of the key actions to be undertaken.

These two political initiatives made it already clear that the financial sector has an **important role to play** both in terms of **supporting the transition towards a climate neutral and sustainable economy**, and for **managing financial risks that this transition may entail** and stemming from other ESG factors. This is also explicitly recognized in the Commission’s Renewed Sustainable Finance Strategy (2021) and the CRD.

Therefore, **sustainability is a key element of the regulatory and supervisory agenda** given the implications of climate change and sustainability issues on the **financial stability**. The real economy will be impacted by the **physical damages** caused by climate change and also by the **transition** to a more sustainable model. As a consequence, **the financial sector will be exposed to these elements and hence, the regulators and supervisors need to assess the impact and react accordingly**.

Now, I will focus on the **supervisory approach** concerning climate change and sustainability issues. I would start by mentioning the set-up of the **NGFS Network of Central Banks and Supervisors for Greening the Financial System** in 2017. In its first Progress Report, published in October 2018, **the NGFS acknowledge that climate-related risks are a source of financial risk**, so that it is therefore within the **mandates of Central Banks and Supervisors to ensure the financial system is resilient to these risks**.

This key message was reiterated in the NGFS First Comprehensive Report, published in **April 2019**, accompanied with **six recommendations for supervisors**, among which, being all equally important, I would highlight the first one **“Integrating climate-related risks into financial stability monitoring and micro-supervision”**.

Ultimately, I would say that the **NGFS**, without being a standard setter nor a regulator, **has contributed to place the climate change related topics within the context of the financial system and is fostering supervisors to take actions in climate-related matters**.

From the banking supervision perspective, the **ECB** identified climate-related and environmental risks as a key risk driver in the **SSM Risk Map from 2019** onwards, so it is explicitly recognized that **transitioning to a low-carbon economy and physical damage** caused by climate change and environmental degradation **can have a significant impact on the real economy and the financial system**.

From a regulatory perspective the **EBA**, in its report on ESG risks management and supervision, published in June 2021 in response to a mandate given in CRD5, **concludes that ESG risks materialise through the traditional categories of financial risks** (credit risk, market risk, operational and reputational risks, liquidity and funding risks), defining ESG risks as “the risks of any negative financial impact on the institution stemming from the current or prospective impacts of ESG factors on its counterparties or invested assets”, **where ESG factors “are environmental, social or governance matters** that may have a positive or negative impact on the financial performance or solvency of an entity, sovereign or individual”. This definition of ESG risks is provided for in the CRR3 proposal, expected to be published soon.

To conclude, I would say that today there is a **clear global consensus that ESG risks are drivers of the traditional categories of financial risks to which institutions are exposed**. In addition, climate-related and environmental risks are expected to **become more prominent going forward**. Therefore, **the institutions should be able to properly and systematically identify, measure and manage ESG risks, taking a strategic, forward-looking and comprehensive approach**. Furthermore, prudential regulation (CRR and CRD) have already provided for specific requirements to credit institutions and competent authorities on ESG risks, which will be further elaborated through EBA Guidelines and standards. Then, we can admit without any doubt that sustainability issues have become a key topic that needs to be addressed by supervisory and regulatory authorities.

2 Why the role of Banks is so relevant in this matter?

First of all, I would like to stress that as we have mentioned in previous occasions, the **main responsibility relies on Governments**. They play the key role given that they have **powerful tools** to incentive the transition:

- a** Increasing green taxation and boosting public investment
- b** Setting environmental standards to enhance the regulation of economic activity.
- c** Providing economic agents with certainty and a stable operational framework.
- d** Deploying compensatory measures to mitigate adverse effects on the most vulnerable groups.

Having said that, we must also acknowledge that **Financial institutions also play a relevant role to support the transition**. In order to finance it, only public resources won't be enough, given the huge investments needed, so the role of the financial institutions and capital markets is crucial. Without the active involvement of the financial system, it will be impossible to efficiently **channel the large volume of funds needed** to develop new green technologies and to enable households and firms to adopt them across the board.

In order to adequately allocate resources in the most efficient way, it is important that we overcome two of the main challenges related to sustainability topics:

e Lack of data. It is essential that all stakeholders have **reliable, timely and accurate data** in order to make proper decisions. I refer to data stemming from companies and households. We are aware about the difficulties to gather all this information, specially from those companies that are not bound by the Corporate Sustainability Reporting Directive (**CSRD**). Even for those companies that will report under the requirements of the directive, it will be necessary to fine-tune the framework to provide data assurance. We cannot be complacent and we must use all resources at our disposal to gather sustainability data as using proxies when necessary.

f Data must be based on common international standards given that this is a global challenge that affects to all the economies. International organizations are already working on this, and the ISSB has already published 2 standards, but there is still a lot to do in order to have the complete regulation related to sustainability and to have the full framework. We need to speed up this process given that we are running out of time. The orderly transition has to start now.

g Transition plans. Although companies will be responsible for approving their own transition plans, financial institutions will also need to assess them when making financing decisions. They are not accountable for the reliability of them, but they will use them as additional input when granting loans. I would say that it is similar to financial statements. Banks are not responsible for the reliability of financial statements of the companies they finance, but they use them as input to gather information. **This is not about penalising brown industries and companies.** This would be against the green transition that we are pursuing. On the contrary, we must finance those *brown* sectors to transition into a more sustainable environment. All the information included in the transition plans will also contribute to elaborate their own transition plans.

Therefore, banks play a key role on this transition as institutions that **funnel all the necessary resources to the real economy in order to achieve the necessary transition.** They also play a key **role on gathering, assessing and promoting data disclosure necessary to make decisions aligned to the climate objectives.**

3 What are the main priorities for regulators and supervisors?

As already mentioned before, in **2019 the ECB identified, for the first time, the climate-related and environmental risks as key risks in the SSM Risk Map** and designed a roadmap pursuing the proper management of these risks by SSM banks. As you all know, the first relevant milestone of this roadmap was the publication, in **November 2020, of the ECB Guide on climate-related and environmental risks, setting out supervisory expectations** on how banks should integrate these risks into their business strategy, governance and risk management.

The Banco de España published the supervisory expectations in October 2020 applicable to the institutions under its remit.

Since the issuance of this Guide, the ECB has performed **several supervisory activities** to follow-up on the progress performed by banks for the implementation of the supervisory expectations. Among these activities, I would highlight the **Thematic Review**, as the most comprehensive assessment of banks' practices, and the **Climate Risk Stress Test**, as a joint learning exercise mainly focused on data collection, both conducted in **2022**.

In short, these exercises showed 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**. Based on its findings, the **ECB imposed qualitative requirements on several banks in the SREP, but without capital implications yet**. The ECB notified each bank individually of the results of its assessment, detailing the main shortcomings and setting specific deadlines to remedy them. In general, **the banks must comply in full with all of the supervisory expectations by the end of 2024**. The ECB has emphasized that the full toolkit of **supervisory measures** (including, enforcement actions) can be utilised where banks do not meet expectations. Accordingly, **the follow-up of findings and measures communicated to the banks will be one of the ECB supervisory priorities during the next 2 years**.

Additional potential **supervisory priorities regarding climate-related risks for 2023-2025** could be the **Assessment of banks' disclosures practices** (from the second half of 2023, the ECB will review whether the eligible banks fulfil the new standards- new ITS / Pillar 3 disclosure requirements) **or on site inspections** regarding mixed risks (e.g. integrating climate aspects in credit risk or IT missions).

Another point of attention is the reputational and litigation risks **that could arise from public transition objectives and / or net zero commitment**, e.g. via greenwashing claims, also leveraging on the outcome of the assessment on disclosure practices. **The first assessment, focused on GSIBs, is currently ongoing**. Moreover, the ECB will have to assess banks' transition plans as well as the other requirements to banks provided for in the upcoming CRR3 and CRD6.

Regarding the **integration of climate-related and environmental risks into the SREP**, the **ECB is following a sequential approach, in line with the EBA report and the prudential regulatory developments, and considering that C&E risks materialize through the existing financial risks, so that they are not a new risk category to be assessed as an additional SREP element**. Thus, in **2023 C&E risks have been explicitly included in the SSM SREP methodology, mainly, in business model** (specific STE on climate-related risks which improve the availability of quantitative data and a qualitative questionnaire) **and governance** (new questions on climate-related risks), together with a **light approach in credit risk**. **C&E risks will be further integrated in other SREP elements (risks to capital, ICAAP, etc.) in the coming years, also considering the future developments in the prudential regulation**.

Let me make one final note about the ECB approach on ESG risks. In line with the general approach followed by supervisors, regulators and standard-setters, the **ECB has first focused on climate risks, due to the fact that there is more scientific evidence and**

even conceptual definitions and more advanced regulatory developments (e.g. Taxonomy). But this does not mean that other environmental risks and social risks are not relevant for the supervisors. In fact, for example, **biodiversity loss and nature-related risks as well as social issues are gaining relevance** in the political and regulatory agenda (e.g. European Sustainability Reporting Standards, Corporate Sustainability Due Diligence Directive proposal). Likewise, the ECB is currently studying how much the euro area economy and financial sector are exposed to risks related to ecosystem services, having published a blog with the preliminary results of its research, according to which the **Europe's economy is highly dependent on ecosystem services and these risks can spread to the financial system.**

With regard to the **priorities for banking regulators**, I would elaborate a bit on the EBA works. The **EBA published its roadmap on Sustainable Finance 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.

As you know, the **first step was the development of the ITS on disclosures on ESG risks (i.e. Pillar 3)**, which has **already entered into force** and listed large institutions have published their first reports this year. The CRR3 proposal foresees broadening the scope of these disclosure requirements to small and non-complex institutions as well as mandate the EBA to integrate information on ESG risks in the supervisory reporting.

Regarding **Pillar 2, the EBA is currently working** on the mandates given in CRD6, in particular, the **Guidelines on the identification, measurement, management and monitoring of ESG risks**, which will also include requirements for institutions' transition plans and integration of ESG aspects in institutions' internal stress testing. These document will further elaborate of several aspects already addressed in the EBA Report on management and supervision of ESG risks, especially, the recommendations to institutions (i.e. integration of ESG considerations **in business strategy** -longer time horizon, limits, objectives, etc.-, risk management -RAF, policies, metrics, etc.- and **governance** ("tone from the top", control functions, internal capabilities, etc.).

With respect to **Pillar 1, the EBA plans to publish the final report on the role of environmental and social risks in the prudential framework** (mandated in article 501c of CRR) **by the end of this year**. This will further develop the content of the discussion paper published in May 2022, considering collected comments, the additional analysis of the Pillar 1 conducted by the EBA as well as BCBS developments in this regard.

Apart from the prudential rules, in response to European Commission requests, the **EBA is also working on other topics, such as: i) standards and labels, supporting definitions and methodologies for sustainable banking products (e.g. green loans) and; ii) greenwashing**, having published, in May 2023, the EBA Progress report on greenwashing monitoring and supervision, which includes a proposal of common high-level understanding of greenwashing, a quantitative analysis across all sectors, including banks and a description of the adverse impact on the institutions (e.g. reputational and operational risks).

I would finally mention the **'Fit for 55' package**, which includes a 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 EBA has already published the templates which will be under public consultation until 11 October.

As you can see, **sustainability considerations and ESG risks are placed in the centre of the priorities for supervisory and regulatory authorities** for the next years with the final goal of properly integrated them in the prudential frameworks, in order to ensure the resilience of the financial system to these risks.

4 What is the role of CSO (Chief Sustainability Officer)?

Firstly, let me say that we, as supervisors, **do not prescribe a specific structure or internal organization** within the credit institutions to deal with sustainability issues and, therefore, **we do not require institutions to necessarily create the position of Chief Sustainability Officer**.

However, as you all know, the ECB Guide includes supervisory expectations on how to integrate climate-related and environmental risks into the banks' internal governance arrangements. Specifically:

- The management body should explicitly **allocate roles and responsibilities** to its members and/or its sub-committees for climate-related and environmental risks. This is the so-called **"tone from the top"**. In doing so, institutions are free to consider assigning the responsibility for climate-related and environmental risks to a member of an existing committee or setting up a dedicated committee.
- The management body is responsible for ensuring that **climate-related and environmental risks are adequately embedded in the overall business strategy and risk management framework**, as well as for exercising **effective oversight** over the institutions' exposures and response to these risks.
- The assignment of the responsibilities on these risks within the organizational structure should be done in accordance with the **three lines of defense model**. These responsibilities should be duly **documented** in the relevant policies, procedures and controls.
- The functions involved in managing climate-related and environmental risks should have appropriate **human and financial resources**.

I would like to highlight that these ECB expectations are **aligned with the EBA recommendations on ESG risk management and the BCBS principles** for the effective management of climate-related financial risks.

Nowadays, it is clearly acknowledged that sustainability topics or ESG considerations are **transversal issues that need to be properly integrated across the whole organization**

and that are no longer matters to be only addressed from a corporate social responsibility perspective but from an **overall strategic and risk management perspective**.

Regarding institutions' practices, some banks may prefer to follow a more decentralized structure where roles and responsibilities are clearly defined within the existing committees and organizational structure, others may prefer to set up a specific committee that coordinates sustainability matters. Both are equally valid provided that the sustainability and ESG considerations are adequately integrated in the banks' internal governance, that is, meeting the supervisory expectations.

Of course, I see advantages in having a Chief Sustainability Officer (**CSO**) or equivalent role within the corporate structure, as a **visible head with the power and responsibility for creating a strong sustainability culture** within the organization as well as for **leading and coordinating sustainability-related topics**. Thus, the CSO could be a **catalyst or facilitator in the proper management** of ESG risks, helping the institution to comply with the supervisory expectations. In particular, the CSO:

- The CSO should be assigned a clear role and responsibilities for managing ESG risks and lead sustainability issues. I would expect the CSO to play a key role in coordinating all the departments of the organization to properly consider these matters in their activities and in ensuring the definition of responsibilities within the three lines of defense.
- The CSO should significantly contribute to reflect sustainability matters in the business strategy and objectives as well as in the risk appetite framework and risk management procedures. Likewise, the CSO should facilitate the management body to effectively oversight ESG risks.
- The CSO should promote a proper internal reporting of aggregated data on sustainability aspects and ESG risks with a view to enabling the management body and relevant sub-committees to make informed decisions.
- The CSO should also have responsibilities in relation to: i) building capacity and staff training; ii) relationships with external stakeholders and; iii) legal and regulatory compliance.

As a conclusion, I would say that, **although banks are not currently required to create the specific post of CSO, I think this could facilitate institutions to speed up their progress in the integration of sustainability issues** in their activities and procedures, provided that the roles and responsibilities of the CSO are properly defined by the management body and clearly communicated across the organization. Needless to say that the CSO should have adequate knowledge and skills as well as appropriate resources (financial and trained staff).

Annex. Main Challenges

We all know that assessing and measuring Climate Risks pose major challenges and difficulties for banks, among which, I would highlight the following:

The difficulty in obtaining **data of sufficient quality**, and the problems in interpreting these data from a financial standpoint. Banks were not used to collect climate-related data from its counterparties, since this information was generally not considered relevant from a financial perspective. Moreover, corporates did not provide robust and comprehensive set of climate-related information, with the exception on some large corporates under specific regulatory reporting requirements (e.g. EU NFRD¹). But, even in this case, the information was not detailed enough nor prepared under common standards. In addition, the availability and quality of climate data vary significantly across sectors. This problem of data gaps is more relevant in the case of SME and households, which represent a significant proportion of credit risk exposures of European banks, mainly focused on commercial activities.

To overcome these data challenges, I would like to point out, in the one hand, the efforts currently being made by banks: i) improvement of IT infrastructure; ii) data collection directly from clients or looking at their public disclosures (where available) and; iii) reliance on proxies (activity-based or asset-based data) using well known methodologies such as PCAF. On the other hand, the regulatory developments on disclosures (e.g. Corporate Sustainability Reporting Directive) are expected to help banks gather ESG-related data of their counterparties.

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 maximum 3-5 years, whereas climate risks need to be managed over a much longer time horizon of 10 to 20 years. In general, banks still lack methodological sophistication to capture climate risks in their risk assessment procedures, due to the unprecedented nature and high degree of uncertainty around the timing of these risks. In this respect, I would emphasize that some SSM banks have not even yet performed an adequate materiality assessment of climate risks, which is the first key step to properly assess them.

Regarding methodologies for evaluating climate risks, I would like to mention that it has been generally recognized that scenario analysis is a relevant tool given the characteristics of climate risks.

Finally, I cannot avoid mentioning the relevance that transition plans are gaining in the regulatory agenda, since it can serve as important risk management tools for banks as well as a relevant input for supervisors.

Lastly, it needs to be borne in mind that a proper understanding of climate risks calls for scientific knowledge that is often beyond banks' grasp. In general, banks still lack professional experience and human capital, so **capacity building** continues to be key for the proper assessment of climate risks. Banks are making efforts made to strengthen in-

¹ Non-financial Reporting Directive

house expertise (training) and decrease reliance on external sources. Some banks are also recruiting scientific experts.

From the **supervisory perspective**, I would say that we face the same challenges. Therefore, we are developing our own capabilities on climate-risks (e.g. dedicated resources, internal networks, training, etc.) and conducting supervisory actions (e.g. Climate Stress Test, targeted reviews CRE-RRE, on-site inspections, disclosure assessments, etc.), which have been a catalyst for building capability and identifying data and methodological gaps. From these exercises, we have published some identified good practices with the aim of helping banks to advance in these matters.

To conclude, I would highlight that collaboration between banks, regulators and supervisors should help to overcome these challenges.