Climate change and the financial sector

AECA Conference

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Climate change and the financial sector

Broad consensus: If Climate Change is not tackled aggressively this decade, it may be too late

“Tragedy of the Horizon”
Mark Carney
Chair of the Financial Stability Board & Governor of Bank of England (2015)
Climate-related risks have become the top 5 risks

Climate change is real and will have major economic implications

The world is failing to stop the growth of CO₂ emissions, meaning that more radical changes are required.

Global warming projections according to different CO₂ emission scenarios

- **Baseline**: 4.1-4.8°C
- **Current Policies**: 3.0-3.4°C
- **Optimistic Policies**: 2.9°C
- **Pledges & Targets**: 2.6-2.9°C
- **2°C Consistent**: 1.5°C Consistent

Global Greenhouse gas emissions GtCO₂e/year

**Probable Impacts by 2100 of Rising World Temperature of 1.5°C**

- **Rising sea levels**: risk of permanently flooding small islands, low-lying coastal areas and deltas
  - 50 million people would be affected
- **Extreme weather events**: wildfires, cyclones,...
  - 2 times more frequent
- **Extreme heat waves and droughts**: loss of crops, impact on biodiversity and ecosystems
  - 400 million people could suffer droughts
  - 70% of coral reefs could disappear
  - One–fourth of all the plants and animals on Earth could become extinct
- **Impacts in human health, livelihoods, food security, water supply, ...**

Source: Intergovernmental Panel of Climate Change, 2018
Climate-related risks as a source of financial risk

Environment- and climate-related risks

**Transition risks**
- Policy and regulation
- Technology development
- Consumer preferences

**Physical risks**
- Chronic (e.g., temperature, precipitation, agricultural productivity, sea levels)
- Acute (e.g., heatwaves, floods, cyclones and wildfires)

Economic transmission channels

**Micro**
- Affecting individual businesses and households

**Businesses**
- Property damage and business disruption from severe weather
- Stranded assets and new capital expenditure due to transition
- Changing demand and costs
- Legal liability (from failure to mitigate or adapt)

**Households**
- Loss of income (from weather disruption and health impacts, labour market frictions)
- Property damage (from severe weather) or restrictions (from low-carbon policies) increasing costs and affecting valuations

**Macro**
- Aggregate impacts on the macroeconomy

- Capital depreciation and increased investment
- Shifts in prices (from structural changes, supply shocks)
- Productivity changes (from severe heat, diversion of investment to mitigation and adaptation, higher risk aversion)
- Labour market frictions (from physical and transition risks)
- Socioeconomic changes (from changing consumption patterns, migration, conflict)
- Other impacts on international trade, government revenues, fiscal space, output, interest rates and exchange rates.

Financial risks

**Credit risk**
- Defaults by businesses and households
- Collateral depreciation

**Market risk**
- Repricing of equities, fixed income, commodities etc.

**Underwriting risk**
- Increased insured losses
- Increased insurance gap

**Operational risk**
- Supply chain disruption
- Forced facility closure

**Liquidity risk**
- Increased demand for liquidity
- Refinancing risk

Source: NGFS, 2019
“About climate risk...because capital markets pull future risk forward, we will see changes in capital allocation more quickly than we see changes to the climate itself”

Larry Fink
Chairman & CEO BlackRock
January 2020
This massive shift will create winners and losers, and a huge surge in stranded assets

World reserves “usability” under a CO2 emissions pathway consistent with 1.5 degrees warming

According to Alliance Bernstein:

- Reaching the 1.5 degrees scenario of the Paris Agreement would imply that **84% of fossil fuels reserves might be stranded**. Oil sands and reserves with expected lives >10-20 years will become particularly risky.

- By 2050 close to 50% of global energy consumption will be **electricity**, up from less than 20% today. And 86% of it will come from **renewable sources** (up from 21% in 2016).

Source: Bernstein Climate Change and Decarbonization Greenbook - 2019

The financial impact of climate change will be anticipated by the market.
“Sustainability and climate change are probably the biggest business disruption humankind has ever faced”

Carlos Torres Vila
COP25. December 2019
Embedding climate into financial regulation
TCFD: a voluntary framework to promote a better disclosure for the capital markets (June 2017)

There is a need to refine & to homogenize disclosures

The voluntary recommendations are expected to become binding

It is positive that all companies (not only financial) can follow them

Nearly 1,500 organizations have expressed their support. Over 110 regulators and governmental entities from around the world support the TCFD, the NGFS among them
The Network for Greening the Financial System (NGFS) (2017)

A group of Central Banks and Supervisors willing, on a voluntary basis, to exchange experiences, share best practices, contribute to the development of environment and climate risk management in the financial sector, and to mobilize mainstream finance to support the transition toward a sustainable economy Plan Commission: main framework, coming renewed strategy

* 89 members and 13 observers. As of March 19th 2021 (Without Z. Snyder).

One comprehensive strategy | Three main objectives | Ten Actions

1. Reorienting capital towards sustainable investment
2. Mainstreaming Sustainability into Management
3. Fostering transparency and Long-termism

Actions

1. Establish EU Sustainable Taxonomy
2. Create Standards and Labels
3. Foster Investment in Sustainable Projects
4. Incorporate Sustainability in Investment Advice
5. Develop Sustainability Benchmarks
6. Integrate ESG in Ratings and Market Research
7. Clarify institutional investors and asset managers duties
8. Clarify institutional investors and asset managers duties
9. Strengthen Sustainability Disclosure & Accounting
10. Clarify institutional investors and asset managers duties


Renewed Sustainable Finance Strategy to be released in July 2021
EU taxonomy regulation

General activity-based approach

- Substantially contribute to at least one of the six environmental objectives as defined in the Regulation
- Do no significant harm to any of the other five environmental objectives as defined in the proposed Regulation
- Comply with minimum safeguards

Environmental objectives

- Climate change mitigation
- Climate change adaptation
- Sustainable and protection of water and marine resources;
- Transition to a circular economy
- Pollution prevention and control;
- Protection and restoration of biodiversity and ecosystems.

Other new developments: social taxonomy and “harmful activities”

Current version develops the 2 climate objectives. The other 4 objectives are being developed during 2021.
Corporate Disclosure

New Corporate Sustainability Reporting Directive (CSRD) in 2021

- Amplified scope: more than 50,000 entities
- Double materiality: enterprise value + social/environmental impact
- Including forward looking: targets & plans
- To be included in Annual reports
- Limited assurance (for the moment)

Towards a Sustainability Reporting Standard
Banking supervision: European Banking Authority (EBA) road map
Banking supervision: ECB supervisory expectations (2021)

1. **Business environment**: Comprehensive understanding of the impact of C&E risks in the S/M/L-term
2. **Business strategy**: Consideration of C&E risks to be integrated in the S/M/L-term

3. **Management body**: Effective oversight of C&E risk in development and roll out of business strategy, business objectives and risk management
4. **Risk appetite**: Inclusion of C&E risks in their appetite framework
5. **Organizational structure**: Assignment of responsibilities for C&E risks across organization in accordance with 3 Lines of Defense
6. **Reporting**: Aggregation and reporting of risk data reflecting exposure to C&E risks

7. **Risk management framework**: Incorporation of C&E risks as drivers of established risk categories into existing risk management framework including long-term monitoring
8. **Credit risk management**: Consideration of C&E risks at all stages of credit-granting process and portfolio monitoring
9. **Operational risk management**: Consideration of how climate-related events impact business continuity and influence reputational and/or liability risks
10. **Market risk management**: Monitoring the effect of C&E risks on current market risk positions and future investments and consideration in stress-testing scenarios
11. **Scenario analysis and stress testing**: Incorporation of C&E risks in baseline and adverse stress test scenarios
12. **Liquidity risk management**: Assessment of how C&E risks can cause net cash outflows or depletion of liquidity buffers; incorporation into liquidity risk management and liquidity buffer calibration (if relevant)

13. **Disclosure policies and procedures**: Publication of meaningful information and key metrics in line with the European Commission’s Guidelines on Non-Financial Reporting: Supplement on Reporting Climate-related information
### Spain: a focus on the financial sector

#### Draft Bill on Climate Change & Energy Transition
- Entities to embed climate-related risks* subject to the BdE’s supervision: an annual report as part of the information of prudential relevance (P3 of BIII):
  - i) assessing its financial impact for society
  - ii) considering transition risks
  - iii) measures to be adopted
- The AMCESFI** will coordinate a report jointly prepared by BdE, CNMV & DGSFP once every 2yrs

#### BdE
- Supervisory expectations on climate and environmental related risks to LSIs (BBVA is not subject to them. BBVA is directly supervised by the ECB: ECB expectations)
- Top-down climate Stress testing 2021: on transition risks and focused on credit risk

#### CNMV
- Its 2019 reports on Corporate Governance and remunerations (link) point the increasing relevance of climate-related risks

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* Integración del riesgo del cambio climático por entidades cuyos valores estén admitidos a negociación en mercados regulados, entidades de crédito, entidades aseguradoras y reaseguradoras y sociedades por razón de tamaño. ** Autoridad Macroprudencial Consejo de Estabilidad Financiera.
03.
Key practices by financial institutions
Mobilizing sustainable finance...

Market-driven standards in constant development

Sustainable debt issuance surpassing $700 bn in 2020

Sustainable investment see record inflows

Source: BloombergNEF
Note: nominal dollars
Integrating climate change in risk management...

**Risk Identification**

- **Example of sectors**
  - Oil & Gas
  - Agriculture
  - Healthcare

**Risk Assessment**

- **Impact on capital ratio**
  - Climate scenario 1
  - Climate scenario 2

**Risk Management Cycle**

- **Monitoring**
  - Key risk indicator: Concentration in CO2-intensive sectors (limit: 19, check point: 8)
  - Carbon emission footprint (limit: 250, check point: 225)

- **Risk Mitigation**
  - Ways to reduce exposure to material climate-related risks may include:
    - Diversifying portfolios by reducing exposure to specific sectors
    - Encouraging clients to transfer risk

- **Risk Avoidance**
  - Ways to avoid exposure to material climate-related risks may include:
    - Implementing an exclusion policy
    - Integrating climate risk indicators in lending criteria

**Risk reduction**

**Risk avoidance**

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**Risk appetite statement**

The risk appetite statement can guide the bank’s risk strategy. For instance, the bank can set limits at portfolio and individual client level.
Promoting sector frameworks to reshape the financial sector...

+220 signatories
+US$ 57 trillion in assets

+3000 signatories
+US$ 100 trillion AUM

+100 signatories
And with collective initiatives to align financial flows with the Paris Agreement and Net Zero economy

Glasgow Finance Alliance for Net Zero

Net-Zero Asset Owner Alliance

Net-Zero Banking Alliance [in progress]

Net-Zero Underwriting Alliance [in progress]

Net-Zero Asset Managers Initiative

United Nations-Convened

NET-ZERO BANKING ALLIANCE

43
Founding banks

28.5
US$ trillion in assets

23
Countries
Climate change at BBVA
Sustainability, at the core of BBVA's strategy

OUR PURPOSE

“To bring the age of opportunity to everyone”

A STRATEGIC PRIORITY

Helping our clients transition towards a sustainable future
Renewed push to sustainability in BBVA’s strategic plan

Creating opportunities for a greener and more inclusive future for all our stakeholders

Using our role to impact on our clients' behaviors inspired by selected SDGs

Incorporating climate change risks and opportunities in our strategy and business processes

Climate Change

- **ENERGY EFFICIENCY**: Technologies that reduce energy use
- **CIRCULAR ECONOMY**: Recycling, new materials, responsible use of natural resources
- **CO2 REDUCTION**: Renewables and other clean energy sources

Inclusive and sustainable social development

- **DIGITAL SOLUTIONS**: Provide financial services to unbanked population
- **INCLUSIVE INFRASTRUCTURES**: Basic services and affordable and sustainable transport
- **SUPPORT FOR ENTREPRENEURS AND UNEMPLOYMENT**: Economic growth and productive employment
**Specific KPIs defined to follow our progress**

**Mobilization**
Maximize sustainable finance business origination

**Portfolio alignment**
Adoption of the PACTA methodology with relevant metrics and targets to be defined in 2021

**Direct impacts**
Environmental footprint reduction and direct emissions offset
- **70%** RENEWABLE ENERGY USE BY 2025
- **68%** REDUCTION OF CO₂ EMISSIONS BY 2025 (VS 2015)

**Transparency**
Integration of sustainability related topics in the group’s corporate reporting, according to international standards

- **€100 Bn** FROM 2018 TO 2025
  BBVA’s 2025 Pledge

- **BBVA joins the net zero emission banking alliance promoted by UN**
“Every financial decision must take climate into account”

Mark Carney
UN Special Envoy for Finance & Climate Change
(2020)
thank you