"Development of ESG markets and governance" Seventeenth Banking Sector Conference: Banking: Driving bold transformation

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This document roughly reflects the CNMV Vice-Chair's speech at the panel, although it may not correspond verbatim.

1. Governance. What is your approach to sustainability and its integration into governance issues, and how are you required to integrate ESG factors in your supervisees?

At the CNMV, we have a very broad scope of supervision, so I answer by differentiating between two areas that have different approaches:

On the one hand, entities providing investment services, such as the activity of investment fund management or financial advisers. On the other hand, all listed companies or issuers of securities.

Regarding the former, management companies, financial advisers or investment firms, the requirements have increased significantly, especially after the entry into force last year (March 2021) of the European Regulation (Disclosure Regulation or SFDR), which has had a galvanising effect on the sector and a boost for the development of sustainable investment. But also the obligations that will enter into force on 2 August.

Basically, managers (and financial market participants) have to report on:

Policy of integrating ESG or sustainability risks into their investment decision-making processes. That is, explain how the entity takes environmental, social and governance factors into account in addition to traditional criteria when making its investment decisions. It consists of integrating these risks in the same way as traditional risks such as liquidity or credit risks. And these policies have to be available to the end-investor: they have to be published on the website, information at entity level, and also in the documentation of a product (investment fund). In addition to reporting on the potential impact of risks on the fund's performance (where significant/material). That is, how risks can impact the fund's performance.

In addition, managers must also report on the analysis of adverse sustainability impacts[i]1 (or, if they choose not to consider them, explain why they are not taken into account). The focus here is on reporting how the investments made by the manager may impact on environmental, social or governance issues.

Thus, we have the (traditional EU) dual approach or principle of double materiality. For example, when investing in a coal-fired power company, the manager should take into account that this company may be domiciled in a country that plans to penalise carbon dioxide emissions by imposing a tax from 2025 onwards. That is, integrating ESG risks, integrating the risk of this tax and how it may affect the long-term performance of the asset. On the other hand, there is the consideration of the impact of this investment on ESG factors. That is, how does my investment in this company affect climate change, and you would still have this, even if there was no tax.

In the end, the aim of regulation is to order the development of the sustainable investment market, to ensure that ESG risks are integrated and that the investor has information and can decide what he/she prefers to do with it. It has its difficulties, no doubt, especially having all the necessary data, but the regulation clarifies the framework, gives comfort and thereby also offers new business opportunities, as well as of course contributing to the environmental objectives and the financing of the transition.

As regards the latter, ESG regulations also impact on listed companies. In this area the focus and requirements are mainly on transparency, information which we at the CNMV review annually and publish a report with recommendations.

I want to emphasise the importance of transparency and of having reliable, homogenous and comparable information. This is a market failure, as you are well aware. We have a problem of failure to incorporate or properly integrate the cost of externalities caused by individual activities on the environment and the surroundings. One of the consensus solutions among economists is to affect prices, for example by making use of environmental taxation. Another important action is precisely to address information-related market failures and to make it easier for investors and firms to have the necessary information, incorporating the time horizon dilemma.

2. How is the investment market and financing products developing, are there clear criteria for which IFs are sustainable and which are not, will the August 2022 deadline for incorporating investors' ESG preferences finally be postponed?

1 Known as PIAs, these are those incidences of investment advice and decisions that have negative effects on sustainability factors.

Simplistically, I would say we are not bad, but we could be better. We have a good collective investment industry: some 1,500 investment funds, in addition to investment companies, with more than 16 million unit-holders owning almost EUR 350 billion in assets under management. These are undoubtedly important figures that have been growing steadily in recent years.

Of these, the number of funds promoting or holding sustainable investments continues to grow. We are talking about some 200 investment funds (193 Article 8 funds, according to SFDR jargon, i.e., promoting sustainability aspects, and 11 Article 9 funds, i.e., with sustainable investments). In relative terms, it is about 23% of the assets. Compared to the EU, the figure is somewhat lower than the average, which is close to 30%, and far from what we see in some jurisdictions.

In addition, we should bear in mind that, as of next August, entities have to incorporate clients' sustainability preferences when first assessing or updating their suitability profile. And instruments that do not respect the client's individual preferences cannot be recommended to the client as instruments compatible with his preferences. This is a major challenge for the industry.

I realise that this is easy to say, but not so easy to do. The criteria for classification of funds are not entirely clear (some clarifications are still pending); there are level 1 regulatory obligations without all the developments on how to comply with these requirements; data are missing and the whole process is costly for entities, in particular for smaller ones; and we have to avoid dissemination of biased or unreliable information, which does not match the reality of the sustainability characteristics of the product or company in question.

I understand the industry's caution, but these challenges are common to all European jurisdictions and we cannot lag behind. In Spain, we also have the particularity that 43.5% of the funds sold in Spain are foreign funds or funds domiciled in another EU country.

I therefore encourage the industry to continue to develop this area of investment, in order to respond to the preferences of more environmentally conscious clients; but I encourage doing it correctly, without shortcuts, while maintaining confidence that the product is sustainable.

3. And in the context of sustainable emissions, is company reporting sufficient, how is the regulatory framework evolving, and are companies prepared to comply with the required reporting?

I would like to recognise, and I say this whenever I have the opportunity, that companies have improved notably in recent years in the quality of their reporting,

expanding the detail and explanations of the information on sustainability. This is despite the existing difficulties, which we can discuss later on.

This is a process in which there is no turning back. Listed companies and issuers are seeing an increasing and progressive increase in information and reporting requirements in the NFS, and they will continue to do so. Currently, all companies with more than 250 employees must publish a non-financial information statement (NFIS).

Among others, companies have to follow the double materiality approach:

- Companies should integrate and disclose how environmental and social aspects affect the entity's business and results (financial materiality).
- And how the company's activity impacts the environment in a broad sense (ESG materiality or inside-out perspective).

In addition, since the beginning of the year, companies have to publish information on what percentage of their business activities are environmentally sustainable activities[2]. That is, what percentage of their economic activity - based on annual total revenue, CapEx or OpEx - is eligible under the taxonomy to mitigate and adapt to climate change. In the case of banks or credit institutions, the so-called GRA, the data we are seeing for 2021 preliminary data ranges between 41 and 55%.

What is the difficulty of all this? We still need to make progress in homogenisation and have common standards. In this area, it is worth noting the proposal for a Sustainability Reporting Directive and the standards being developed in EFRAG, as well as the work on the international front (IFRS Foundation-ISSB).
Transparency is also important in the area of corporate governance. Not to mention the future regulation of the Due Diligence Directive on sustainability. As I said at the beginning: without information, without data, market participants cannot identify and quantify risks, nor incorporate them into prices and investment decisions. Transparency is one of the most important tools we have to discourage inappropriate behaviour and to encourage sustainable investments. And it answers precisely one of the questions I raised at the beginning, on how to address the challenge of sustainability.

4. Transition. Does everything have to be sustainable? How do we move forward?

We know where we want to get to (low carbon or emission neutral economy by 2050, and respectful of the UN sustainable goals), the question is how we do it, what measures we take and at what pace, as the transition is not without difficulties.

2 In relation to the 2021 financial year, companies with an obligation to draw up an NFS according to EU legislation (public interest companies with more than 500 employees) have to detail how and to what extent their activities are eligible and can be associated with environmentally sustainable activities.

It is about striking the right balance that will allow us to move forward in a decisive way, while achieving an orderly and just transition. It must take into account social and employment aspects, it must also address current inequalities, and it must make it easier for us to move together towards a low-carbon economy.

Hence the importance that the regulation and the different initiatives that we are adopting also incorporate the costs of this transformation, which we know will be quite heterogeneous, and that it takes into account the time that society needs to adapt and adjust its current structures, resources and procedures to the new requirements that these scenarios demand. And we need to finance this transition, which requires large volumes of resources, both public and private (some 250 trillion euros cumulatively over the next 30 years[3]). In the end, it is about finding that balance that allows society to move forward in a collective, public-private effort.

5. Let us look ahead to 2030. What will be the status of ESG integration in management?

The year 2030 is closer than it seems, but I sincerely hope that we are talking about something else, as I expect ESG aspects to be as integrated into day-to-day asset management as concepts such as liquidity or market risk are now. I am also confident that we will have been able to reduce ESG risks, thanks to the collective effort and the existence of companies that are increasingly aware of the effects of their activity on their environment; and I am also confident in our capacity for innovation, which will allow us to implement new technologies that make feasible solutions that are now only futuristic or ideas supported by paper.

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3 See "The Net Zero transition: what it would cost, what it could bring" McKinsey Global Institute, February 2022.