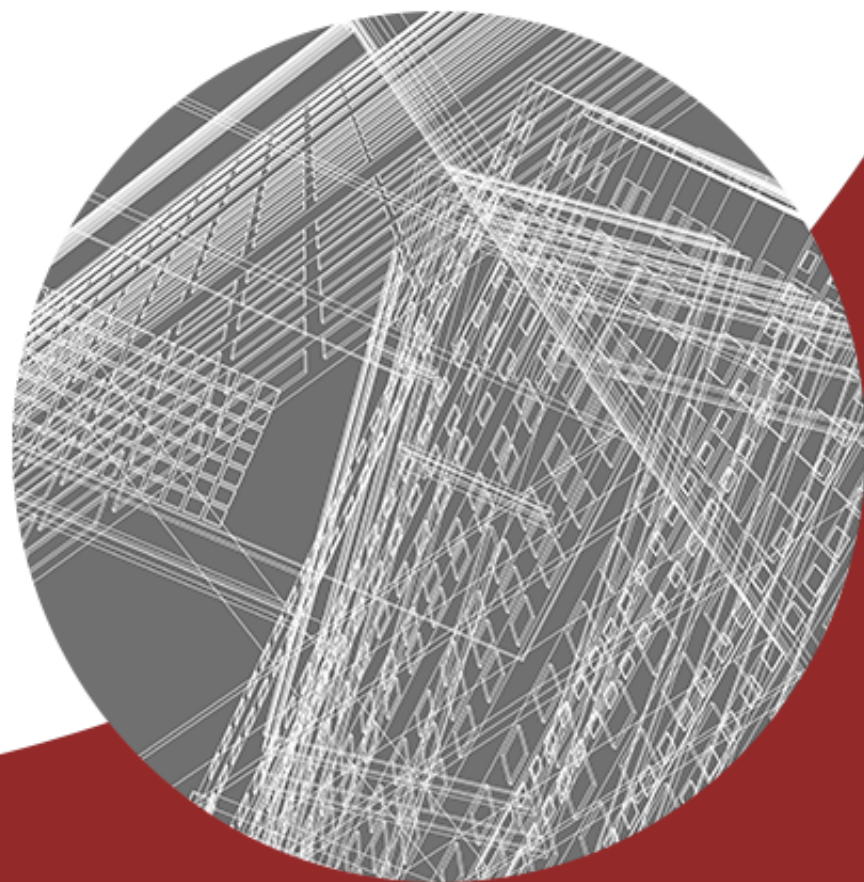


ONLINE EVENT

Launch of the C-ESG Risk Roundtable Collateral Workstream

Thursday, 11 January 2024

2:00 PM - 3:30 PM (CET)



Speakers



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Moderator



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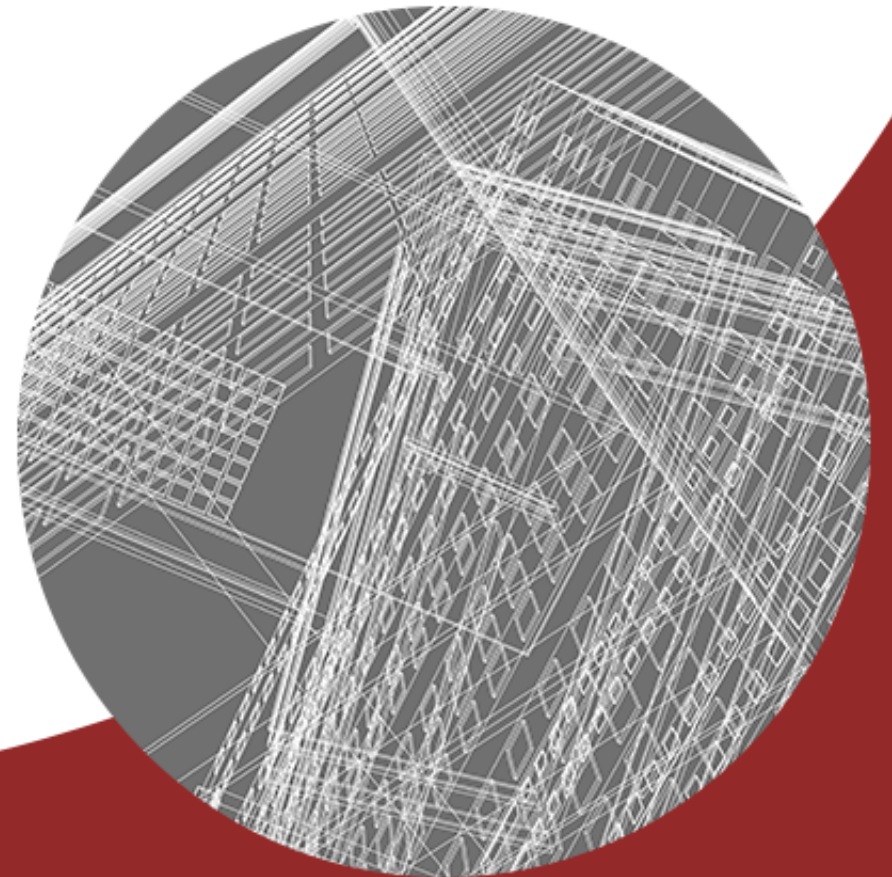
Senior Policy Adviser - Sustainable Finance,
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Report of the C-ESG Risk Roundtable Collateral Workstream

Presentation of the Report

**Monica López-Monís, Head of
Supervisory and Regulatory Relations,
Santander Group**

11 January 2024



Index

1 Overview CWS Report

- A. Objective and scope of this report**
- B. Scope of the Analysis**
- C. Key Conclusion**
- D. Analysis of Real Estate Collaterals**
- E. Conclusions and improvement levers**

A. Objective of the report



Objective

- This report is the **result of the collaborative work of the Collateral WS (CWS) members**, facilitated by Santander in its role as chair of the WS. The CWS journey was initiated in April 2023. A total of **11 participating banks** agreed on the objective of identifying the key challenges and feasible solutions in relation to collateral valuation and management to ensure that ESG risk drivers are incorporated in collateral valuation.
- **Key objectives** of the CWS:
 - identify common practices in collateral valuation, key sources of challenges in the regulatory and supervisory landscape, the different valuation standards and the gaps identified in their applicability, as well as the role of the different stakeholders in the integration of ESG risks in the valuation process (appraisers, insurance companies, etc.).
 - identify the main barriers encountered by banks in the collateral valuation process and to propose certain initiatives to improve valuation methodologies, data accuracy and a consistent approach to collateral valuation.

B. Scoping the report

- The CWS members agreed to focus this report on Real Estate (RE) collateral (both commercial and residential) and the integration of climate-related risks into its valuation.



The balance sheets' composition of the banks surveyed, the evolving regulatory landscape, the supervisory scrutiny and the momentum of the climate agenda in different jurisdictions, were key considerations in determining the scope of this report.

- *Considering the climate focus ⁽¹⁾, the relevance of real estate collaterals within the banks' balance sheets, the ECB expectation to give particular consideration to the physical locations and the energy efficiency of commercial and residential real estate, this report aims to:*

- 1. Provide an overview on how real estate collateral valuations are potentially affected by climate-related risks and;**
- 2. Identify gaps or shortcomings to be addressed, as well as the levers to pull to incorporate climate considerations into the collateral valuation process in a more homogeneous and consistent manner.**

⁽¹⁾ Note: physical risk considerations are not in the scope of this report since physical risk will be addressed in the report of the Physical Risk WS, which is expected to be issued later in 2024 and should be read in conjunction with this report.

C. Key conclusion of CWS discussion

As an overall conclusion of the CWS discussion, it can be stated:

- 1. Clear progress has been made towards the inclusion of climate considerations in institutions' business strategy, governance, risk management and collateral valuation.*
- 2. There is still room for improvement from a methodological development and pragmatic perspective to ensure a common and consistent approach.*
- 3. A homogeneous framework, together with increased transparency in the value chain of the collateral valuation process are the most critical aspects to improve a consistent integration of climate-related risks in collateral valuation.*

D. Analysis of real estate collaterals (1/6)

The report analyses different challenges regarding real state collateral including:

- 1. Regulatory and supervisory landscape*
- 2. Heterogeneity of valuation standards*
- 3. Role of the appraiser*
- 4. Insurance of Climate and Environmental Risks and its role on credit risk mitigation*

D. Analysis of real estate collaterals (2/6)

Challenges in the regulatory and supervisory landscape

- *High-level guidance regarding climate-related risks and collaterals' valuation, results in a non-homogeneous incorporation of climate considerations into collateral valuation*
- *The revised EPBD, pending to be formally adopted, intends residential and non-residential buildings to become more energy efficient and EPCs to become more comparable among geographies.*
- *For a comprehensive and coherent incorporation of climate-related risks into the RE collateral valuations: Further homogenization of EPC criteria is necessary; specific considerations need to be defined to ensure a common approach in collateral valuations standards; stringent requirements for appraisers to include EPC in the valuation report*
- *It would be critical that the ECB's expectations evolve in parallel, adjusting its pace and aligning its approach with the current and foreseeable regulatory tools*

D. Analysis of real estate collaterals (3/6)

Heterogeneity of valuation standards 1/2

- *The CWS mapped the valuation standards, specifically those mentioned by the EBA in its Guidelines on Loan Origination and Monitoring (International valuations standards, European Valuation standards, and the Royal Institution of Chartered Surveyors RedBook) and some challenges associated with their application*
- *The CWS members identified a need of defining homogeneous valuation methodologies at European level that could be reflected by national standards setters in the EU to allow all financial institutions to measure climate and environmental risks in a comparable way and to avoid market distortions due to different climate and environmental risk measurements among entities.*
- *For European banks that undertake financing activities collateralized by RE collaterals located outside of Europe, a certain level of interoperability among European and international valuation methodologies would ensure a comparable approach and a level playing field*

D. Analysis of real estate collaterals (4/6)

Heterogeneity of valuation standards (2/2)– Transition Risks

- *The CWS members gather in this section some suggestions to improve the incorporation of transition risk into collateral valuations*
- *Some of the measures agreed upon to improve the availability of EPC data: Including EPCs as a compulsory document for valuation reports, as per local appraisal regulations; and in the design of the database foreseen in the new EPBD draft, it would be necessary to include the immovable property unique ID, and the inclusion of the recommended cost-effective improvement value into the collateral valuation could help with the lack of homogeneous criteria.*
- *Suggestions to improve homogeneity would be, for instance, random audits to be performed to assure that certifiers properly follow the methodology set for EPCs, both for efficiency and retrofitting cost estimation*

D. Analysis of real estate collaterals (5/6)

Role of the Appraiser

- *According to the EU regulation the review of an immovable property collateral has to be carried out by a valuer who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process*
- *This task is typically performed by authorized appraisers on which financial institutions rely for the valuation process, although it is not necessarily a common practice in all markets*
- *The role of the appraisers and the applicable methodologies would benefit from a common approach and definition at a European level, although local specificity would continue nurturing the appraisal report.*
- *The result of incorporating climate-related risks into the valuation process, and the impact of climate and environmental factors on it, should be made available to financial institutions as part of the appraisal process without imposing an additional burden to the banking sector.*

D. Analysis of real estate collaterals (6/6)

Insurance of Climate and Environmental Risks and its role on credit risk mitigation

- *It was agreed that since the ECB best practices stated that “This assessment is used to integrate physical risks in the valuation of collateral for all new financing (unless sufficient insurance coverage is in place)”, greater clarity would be needed to understand in practice what ‘sufficient insurance coverage’ would mean.*
- *Article 208(5) CRR requires institutions to hold adequate insurance against the risk of damage to the immovable property and have in place procedures to monitor the adequacy of the insurance.*
- *According to ‘Expectation 7’ in the ECB guide on climate-related financial risks, institutions are expected to incorporate climate-related and environmental risks and to identify and quantify these risks within their overall process of ensuring capital adequacy. In line with this expectation, the insurance of climate-related risks as a mitigating factor would be a time-sensitive issue and it would therefore need to be clarified how the financial institution can ensure that this insurance is maintained on an ongoing basis.*
 - *Regarding the use of sufficient insurance coverage to mitigate physical risks, its analysis will be addressed in the specific WS devoted to Physical Risk.*

E. Conclusions & Improvement levers

Although definite progress has been made towards the inclusion of climate-related considerations into the RE collateral valuation, there is still room for improvement from a methodological and pragmatical perspective as portrayed by the following:

Improvement levers

1. Real Estate Collateral Framework

- **Need for a coherent and feasible regulatory framework.** Amendments to guaranteeing a comprehensive and coherent incorporation of climate-related risks into the RE collateral valuations, should be undertaken at different levels (EPCs homogeneous criteria; common approach in collateral valuations standards; and more stringent requirements for appraisers to include EPC in the valuation report).
- **Creating a European public source of providers of information to be used in the valuation process would be a valuable tool to achieve a coherent playing field.** The more data is collected the more accurate the statistic will be. Hence, valuations based on this data should result in consistent and coherent outcomes).
- **A minimum requirement standard with regard to the content of the valuation report needs to be set.** Including the EPC in the appraisal report is key to enhance the EPC availability across the EU.

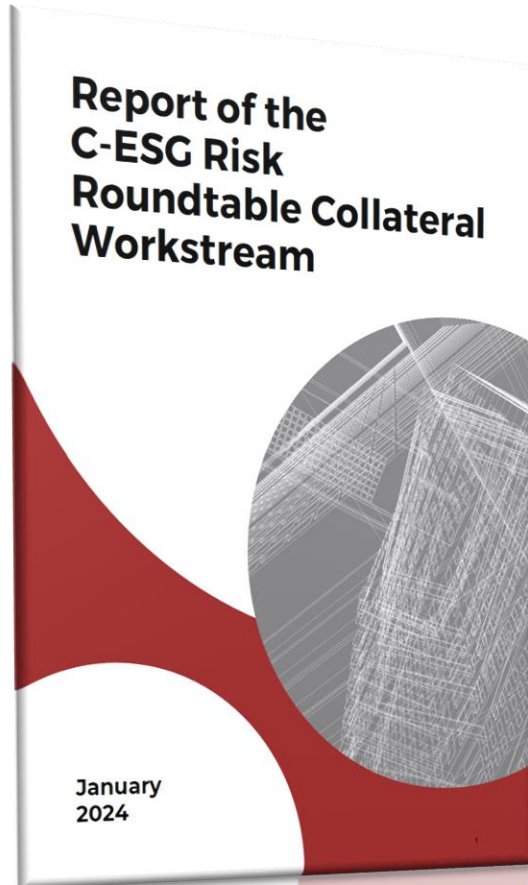
2. Transition tools: EPC enhancements

- **Further homogenization of EPC levels.** Although proposed measures in the EPBD provide a clearer definition of EPC levels, the current room for improvement in enhancing comparability among countries would be mitigated once the EPBD is transposed.
- **Need of reinforcing control systems over the EPC providers** (audit of EPC providers) would ensure that their approach is consistent and compliant with common standards.
- **Need to have homogeneous public EPC databases** with sufficient collateral identification quality that allow periodic energy efficiency update of the whole collateral stock.

3. Role of Insurance

- **The role of insurance in the collateral valuation process needs to be further clarified in two ways:**
 1. defining when sufficient insurance coverage is in place to mitigate climate-related risks, and
 2. developing tools to ensure that this sufficient mitigation is in place throughout the life of the collateralised exposure.

THANK YOU FOR JOINING US!



The recording of this event will be available tomorrow!

THE REPORT IS NOW AVAILABLE!