2.6 BCB's participation in the global sustainability and socio-environmental agenda

BCB directs its actions to reduce risks and mitigate the impact, occurred or expected, of shocks on the economy and the financial system, in order to fulfill its mission of ensuring price stability and ensuring the soundness and efficiency of the SFN. In this sense, the socio-environmental risk (RSA) can impact BCB's objectives. Materializing these risks can bring significant damage to the financial system. Climate shocks – fires, droughts, floods, extreme temperatures – affect relative prices in the economy and therefore can have impacts on monetary policy decisions. These same extreme events jeopardize the SFN, which can alter the demand for currency, values of physical goods and collateral, in addition to bringing high financial costs to society as a whole.

The formulation of BCB policies considers the socio-environmental risk and the impact of extreme events on the economy and financial system. In fact, the financial system in Brazil is one of the forerunners in the sustainability agenda, with a long history of initiatives to foster green or sustainable finance and mitigate social and environmental risks.

In the last two decades, BCB has been expanding its regulatory and supervisory framework, with the objective of developing best corporate governance practices for the assessment and management of social and climate-related risks and, consequently, fostering a greener or more sustainable financial sector in Brazil.

Climate change and other socio-environmental issues impact advanced, emerging and developing economies and therefore require coordinated global action. In this sense, the BCB has been actively engaged in several international forums to continue inserting in its regulation and supervision the approach of these risks in the SFN.

Recently, on September 8, 2020, BCB launched the Sustainability dimension in the Agenda BC#, which aims to promote sustainable finance, fostering the proper management of socio-environmental and climate risks in the SFN, as well as integrating sustainable variables into the BCB's decision-making process.
2.6.1 History of BCB’s performance in socio-environmental issues

BCB has been actively working on the socio-environmental agenda since the late 2000s. During that period, the CMN published regulations requiring FIs to verify compliance with environmental legislation as one of the conditions to provide credit for rural and agro-industrial activities. The legislation aims to protect some of Brazil’s biomes and foster low-carbon agriculture.151

In 2014, the CMN issued a resolution on Social and Environmental Responsibility, which established the foundation and principles for social and environmental practices to be followed by the FIs. Under this Resolution, the FIs are obliged to implement a Social and Environmental Responsibility Policy (PRSA), proportional to their exposure to the RSA, based on the nature of their services and activities, which also establishes how the management of the RSA will be performed.152

In 2016, in order to support the preparation of the Supervisory Action Plan (PAS), the BCB implemented the first version of its Socio-environmental Risk Matrix, considering both the socio-environmental risk incurred by the FIs and the adequacy of its risk management action plan.

In 2017, the BCB established requirements for an integrated risk management approach for FIs, which should consider the RSA. Under this integrated approach, FIs must identify, measure, evaluate, monitor, report and mitigate financial risks, including socio-environmental ones. They should also implement risk management structure and governance for risk mitigation, including the socio-environmental risk and, if considered relevant, climate-related risks.153

Additionally, larger FIs are obliged to consider the socio-environmental risk in their Internal Capital Adequacy Assessment Process (ICAAP), with the mandatory disclosure of any exposure to the RSA in the risk assessment process of the FIs and in their capital adequacy calculations.154

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152 CMN Resolution 4,327, 25 April 2014.


154 Circular BCB 3,547, of July 7, 2011.
From 2020, the Supervision included the evaluation of the RSA in the SRC (Risk Assessment System and Controls). The SRC is continuously conducted and is composed of a set of structured criteria and procedures, which allow the Supervisor to consolidate and keep up-to-date its knowledge about the risk profile of banking institutions, as well as to identify in a timely manner the situations that present the greatest risk.

It is also noteworthy, a joint initiative with the Ministry of Economy, involving the FiBraS Project, sponsored by the German Society for International Cooperation (GIZ), with the objective of expanding the sustainable finance market in Brazil and improving the surveillance of the socio-environmental risk associated with the FIs. The project should contribute to improving procedures for supervising social and environmental risks and risks related to climate change.

### 2.6.2 Inclusion of the “Sustainability” dimension in the Agenda BC#

Concern for sustainable development and social and environmental risks has grown among the entities of the global financial system. Specifically in the financial market and capital market, the absence of policy debate and the implementation of measures aimed at social, climatic and environmental risks can result in financial losses arising from the materialisation of these risks.

In this context, the “Sustainability” dimension was included in the Agenda BC#, with three main objectives: (i) promoting sustainable finance within the SFN; (ii) improve the social, environmental and climate risk management rules applicable to FIs; and (iii) incorporate variables associated with sustainability in the work and decision-making processes in the BCB.

The Agenda BC#, created in 2019 from the reformulation of the project initiated in 2016 by the BC+ Agenda, defines BCB’s strategic line of action. In its original conception, four dimensions were established (Inclusion, Competitiveness, Transparency and Education) to guide the BCB’s performance.

The inclusion of this new dimension in the Agenda BC#, as a new pillar, stems from the impacts of extreme weather events such as fires, droughts and floods on the main economic variables, as well as from the growing relevance of the theme to society.
This new reality potentially affects relative prices in the economy and consequently impacts economic policy decisions. This impact reaches not only the market value of financial assets and the ability to pay economic agents, but also the values of physical and collateral assets, with repercussions on the stability of the SFN.

The environmental issue, which was already the focus of relevant debate on the international agenda, gained significant momentum after the Covid-19 pandemic. Promoting a sustainable and inclusive recovery is now a key part of the agenda and policy advice criteria of key international forums such as the International Monetary Fund (IMF), the Organisation for Economic Cooperation and Development (OECD), central banks, FBS and G-20. In some of these, as in the IMF special case, the decision to integrate the topic of mitigation and adaptation to climate change into the process of regular surveillance of the economies of the countries will already be the result of evaluation from 2020.

In the future, new modules of the Financial Sector Assessment Program (FSAP) are also expected to be dedicated to sustainability, with a special focus on issues related to stress tests and data generation on climate change.

In this sense, the launch of the new dimension of the Agenda BC# seeks to respond to structural changes in the economy in the face of the emergence of climate and socio-environmental risks, integrating sustainable variables in the BCB decision-making process.

The new dimension establishes a comprehensive but not exhaustive set of measures applicable to both FIs and BCB itself in initiatives listed below:

- **Social and Environmental Responsibility of BCB itself**
  - Promoting a culture of sustainability
  - Inclusion of the theme in the Museum of Economics
  - Reduction of environmental impact on the processes of the circulating environment
  - Review of the BCB’s Social and Environmental Responsibility Policy
» Implementation of the recommendations of the Task Force on Climate related Financial Disclosures (TCFD)

» Improvement of integrated risk management, including socio-environmental issues in all BCB decision-making processes

• Partnerships

» BCB's entry into the Network for Greening the Financial System (NGFS)

» Signing of the Memorandum of Understanding with the CBI

• Policies

» Creation of a sustainable liquidity financial line

» Inclusion of sustainability criteria in the administration of international reserves

• Supervision

» Structuring and expansion of the collection of information on social and environmental risks

» Monitoring climate risks and conducting stress tests

• Prudential and procedural regulation

» Management of social and environmental risks by FIs - Improvement of regulation (CMN Resolution 4,327, of April 25, 2014)

» Expanding transparency based on TCFD recommendations

» Creation of the Green Bureau of Rural Credit

» Establishment of incentives for green rural credit

2.6.3 Cooperation actions for social and environmental sustainability

It is worth highlighting the growing interaction of BCB with other central banks and international organizations in the proposition of regulatory guidelines related to socio-environmental and climate risks, as well as the frequent
dialogue with the institutions of the SFN, with a view to monitoring the evolution of the theme and conducting its performance as a regulatory and supervisory body.

Among BCB’s most recent actions associated with the theme is the partnership established with CBI, an international non-profit organization that promotes investments in projects and assets needed to transition to a low-carbon and climate-resilient economy to facilitate the exchange of sustainability information.

Another important action was the entry into NGFS, a network established in 2017 by representatives of eight central banks and supervisory bodies. Since then, the network has expanded and – by July 2020 it already had 69 members and 13 observers from five continents.\(^{155}\)

NGFS discloses non-binding recommendations, with the aim of assisting central banks and supervisors in monitoring and supervising environmental risks and climate-related risks, as well as inspiring them to take the necessary measures to promote a financial system focused on sustainability.

As next steps, based on the experiences so far, NGFS plans to work on the following issues:

- continuity of the identification of best practices to assist central banks and supervisors, as well as relevant stakeholders, in assessing and mitigating climate-related risks and environmental risks;

- metrics to assist supervisors in assessing climate-related risks and environmental risks;

- transmission channels through which environmental risks materialize as a source of financial risk;

- classification system for economic activities (taxonomy); and

- development of new lines of work in the fields of research and data generation, to cover gaps already identified in the area.

The work at NGFS is part of a series of actions in which BCB is involved. Over the past few years, experts at the institution have participated, as regular or invited members, in several other discussion and cooperation

forums on green finance, sustainable finance and climate risks, such as those listed below:

- **Task Force on Climate-related Financial Risks (TFCR) of the Basel Committee on Banking Supervision (BCBS)**

  Established in January 2020 under the BCBS, known as the “Basel Committee”, TFCR is a group dedicated to the subject of climate-related financial risks. His work consists of a gradual and sequential approach, with an initial focus on the analytical aspects related to the measurement of climate risk in financial systems, as well as the exchange of information in banking supervision approaches. The BCB is supporter of the group.

  Among the group’s products, we highlight the publication of the report “Climate-related financial risks: a survey on current initiatives”, which includes research on regulatory and supervisory practices currently adopted by its members in relation to the financial risks associated with climate.

- **Financial Innovation Laboratory (LAB) - Working Group (WG) Green Finance**

  LAB serves as a forum for the interaction of institutions in various sectors. It was launched in 2017 by the Brazilian Development Association (ABDE), the Inter-American Development Bank (IDB) and the Brazilian Securities and Exchange Commission (CVM), with support from GIZ. The Green Finance Work Group brings together more than 90 institutions, including government, private sector and civil society. The objective of the work group is to strengthen sustainable finances in the financial and capital markets in Brazil.

- **G20 Sustainable Finance Study Group**

  Established in 2016 under the name Green Finance Study Group (GFSG), this forum had its scope expanded in 2018 and became the Sustainable Finance Study Group. Based on the experiences of member countries, the group seeks to develop measures to improve the financial system’s capacity to mobilize private capital for sustainable activities, that is, with positive environmental, social and economic impacts.
Sustainable Banking Network

The Sustainable Banking Network (SBN) is a network of financial regulators and banking associations from 38 emerging countries who are voluntarily committed to advancing the theme of sustainable finance, aligned with international best practices. Created by the International Finance Corporation (IFC), an integral institution of the World Bank Group, the network fosters learning among its participants and supports countries in the development of public policies and initiatives focused on sustainable finance. BCB has been a member of the network since its founding in 2012.

2.6.4 Identification of the exposure of institutions to RSA for supervisory purposes

In order to improve supervisory practices focused on sustainability, BCB has also advanced in the development of a methodology for identifying the RSA, which includes a classification system (taxonomy) of exposures to that risk. The BCB uses this taxonomy, for example, in the Risk Matrix that subsidizes the annual preparation of its PAS, in order to direct BCB’s supervisory actions on the subject.

The Risk Matrix consists of two dimensions: (i) the adequacy of the management of the socio-environmental risk, by the FIs; and (ii) the relevance of their credit exposures to the socio-environmental risk. The latter is evaluated considering the sectors of economic activity of customers and the socio-environmental damage that they may eventually cause (pollution, child labor, slave labor and environmental disasters, among others) or suffer, leading, consequently, to financial losses in institutions.

As provided in Resolution 4,327 of April 25, 2014, the socio-environmental risk is defined as the possibility of losses of FIs resulting from socio-environmental damage. The RSA permeates several risks, such as credit, market, legal and image risk, among others. For example, the occurrence of socio-environmental damage can affect a customer’s ability to pay, leading to credit losses from the institution that financed it. If this socio-environmental damage was caused by the client himself, we could also potentially have image risk and legal risk from the financial institution.
It is important to highlight that the fact that an institution grants credit to a particular client exposed to the RSA does not mean that this client is necessarily generating socio-environmental damages. Such client can efficiently mitigate the risks of causing socio-environmental damage, or even be exposed to the financial consequences arising from socio-environmental damage not caused by it.

The main objective of Resolution 4,327 of April 25, 2014, is to induce the FIs to include the evaluation of the RSA in its management and in its decision-making process, aligned with its PRSA. According to the World Bank, by implementing a Socio-environmental Management System, a financial institution can improve its understanding of the socio-environmental risk associated with each transaction, which can even be included in the decision-making process of proceeding or not with the operation.

The RSA measurement methodology, currently used in BCB, is based on the risk categories and subcategories presented in studies by the International Finance Corporation (IFC) of the World Bank (Table 1). The IFC evaluated, for 29 sectors of economic activity, the risk they present in these subcategories, and their risk consolidated to the RSA. By the association of the CNAE codes156 of the clients that make up the Total Credit Responsibility157 of the FIs to these 29 sectors of economic activity, the level of the socio-environmental risk proposed by the IFC is identified for each operation of each client. The exposure of each institution subject to the RSA is the sum of the Total Credit Responsibility of clients who are related to economic sectors that present a medium or high classification of socio-environmental risk.158

The BCB has been studying ways to improve this methodology, in particular, seeking to:

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Table 1 – Categorization of social and environmental risks

<table>
<thead>
<tr>
<th>Exhibition category</th>
<th>Subcategory</th>
</tr>
</thead>
<tbody>
<tr>
<td>Environmental</td>
<td>Energy</td>
</tr>
<tr>
<td></td>
<td>Water use</td>
</tr>
<tr>
<td></td>
<td>Water pollution</td>
</tr>
<tr>
<td></td>
<td>Waste</td>
</tr>
<tr>
<td></td>
<td>Air pollution</td>
</tr>
<tr>
<td></td>
<td>Damage to ecosystems</td>
</tr>
<tr>
<td></td>
<td>Disaster risk</td>
</tr>
<tr>
<td></td>
<td>Soil contamination</td>
</tr>
<tr>
<td>Social</td>
<td>Health and safety at work</td>
</tr>
</tbody>
</table>

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156 BCB uses the codes CNAEs (National Classification of Economic Activities) up to the seventh level (about 1300 CNAEs).
157 The Total Credit Responsibility of each financial institution is obtained in the Credit Information System (SCR) of the BCB, and considers the operations contracted from 2015, that is, in the last 5 years. The exposures used to calculate the total liability are: the active credit portfolio (installments due and overdue installments), the co-obligations assumed and the guarantees provided.
158 IFC references (International Finance Corporation – World Bank Group) to the degree of exposure of each of the 29 sectors of economic activity can be found on the site https://firstforsustainability.org/risk-management/risk-by-industry-sector
• the inclusion of additional subcategories, particularly regarding risks of social damage;

• improving the way of assessing the degree of risk exposure in each of the subcategories;

• the use of more complex forms of mapping of the risk of each subcategory, due to limitations of the CNAE. For example, there is a single CNAE code for electricity generation. However, the socio-environmental risk profile of each type of generation (wind, hydroelectric, thermoelectric, solar, etc.) is quite different from each other; and

• the inclusion of information related to customer compliance in relation to socio-environmental norms and regulations.