ECB 2022 climate stress test: a sense of emergency but a long way to go

There is a common sense of urgency about climate-related risks, but policy actions to avoid unintended consequences or build consensus have their own timeframe. The European Central Bank's 2022 climate risk stress test performed on a representative sample of large European banks is a landmark achievement. This exercise matters from a credit standpoint because it informs on the resilience of European banks. The results are disappointing.

First, findings confirm that most European banks have not yet developed sufficiently robust risk management capabilities to measure, hence address, climate-related risks. Banks are making progress but the aggregated results and the contemplated timeframe to implement corrective actions question banks' current ability, but also their willingness to allocate sufficient resources to manage these risks.

Second, findings are not feeding into regulatory actions, despite the identification of significant short-comings vs regulatory expectations. This is because the climate stress test is only part of a set of policy actions. Other initiatives are ongoing and co-ordination is required. We note, for instance, that the EBA launched a consultation in May on the role of environmental risks in the prudential framework, discussing the possibility of incorporating those risks into the Pillar 1 prudential framework.

Third, due to the high level of data aggregation, findings are not feeding into individual banks' assessments in a transparent manner, which would have incentivised less advanced banks to make progress. This approach contrasts with the EU authorities' repeated call for action on identifying climate risk and the need to raise the bar, including on how market participants integrate ESG factors in their risk assessments. The high level of data aggregation was expected but it comes on top of all the other expressed limitations regarding the low reliability of aggregated results.

We see little analytical value in the main aggregated quantitative findings of the stress test which can be summarised as follows:

- *The share of interest income related to the 22 most GHG-emitting industries amounts to more than 60% of total non-financial corporate interest income on average for the banks in the sample*. It shows there is a long way to go to reduce emissions. But if at country level, banks' lending portfolios only mirror the financing needs of the local economy, the role assigned to banks as policy tool to accompany the transition needs to be better characterised.
- *Taken together, under a short-term, three-year disorderly transition risk scenario and the two physical risk scenarios (flood risk and drought and heat risk), the combined credit and market risk losses for the 41 banks providing projections would amount to around EUR70bn.* The ECB provides a contextual analysis of the result, including the fact that '*the exposures in the scope of this exercise only account for around one-third of the total exposures of the 41 banks*'.

Even at this early stage of data collection and strengthening of risk management capabilities, there are already grounds for credit differentiation among banks. The ECB highlighted that '*at least some of the banks were able to address the challenges in a satisfactory manner*'. The ECB expects to publish guidance on best practice in climate stress testing in the second half of the year which will be of great value for all stakeholders to inform their views and set the bar.

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The European Central Bank's 2022 climate stress test (CST) is available here:

https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.climate_stress_test_report.20220708~2e3cc0999f.en.pdf

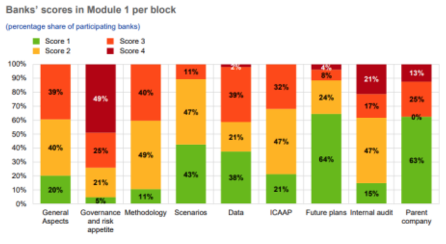
Appendix 1: banks' stress testing capabilities and action plans

(From the CST report)

Chart 4 provides a detailed indication of institutions' preparedness across the different dimensions of climate risk stress testing by showing the individual scores assigned to them (ranging from 1 to 4, with 1 being the best and 4 being the worst). Climate-related data availability is a challenging factor for many institutions, and it reportedly represents the key driver for the lack of a climate risk stress-testing framework (for 23% of the banks with no framework).

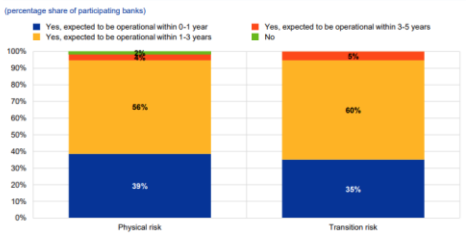
More than 50% of all banks that currently do not have a climate stress-testing framework in place indicate that they need at least one to three years to incorporate physical and/or transition climate risk into their stress-testing framework (Chart 5).

Chart 4
Preparedness across key components of climate risk stress-testing frameworks



Sources: Bank submissions and ECB calculations.

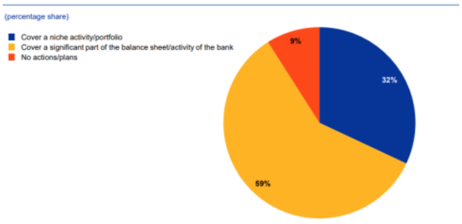
Chart 5
Time frame envisaged for implementing climate risk stress-testing frameworks



Sources: Bank submissions and ECB calculations.

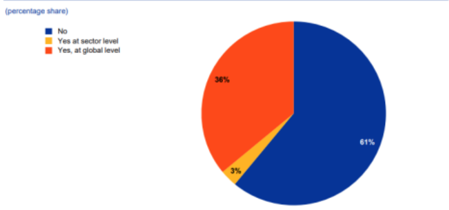
Institutions also had the opportunity to describe the actions they planned to take to mitigate transition risk and support the transition in relation to the corporate portfolio studied in the 2022 CST. The majority of banks (59%) described actions which cover a significant part of their corporate balance sheet, i.e. a significant number of economic activities (Chart 23). Nevertheless, for most of them (61%), information on future actions are not yet associated with concrete targets (Chart 24). For instance, some banks refer to overarching objectives (e.g. the Net Zero Banking Alliance) but associated key performance indicators (KPIs), while planned, are still to be established and connected in concrete terms with alignment on the required transition.

Chart 23
Magnitude of past and planned actions to mitigate transition risk and support transition in relation to the sectors studied in the CST 2022



Sources: Bank submissions and ECB calculations.

Chart 24
Information on green asset ratios or other KPIs for actions to mitigate transition risk and support transition in relation to the sectors studied in the CST 2022



Sources: Bank submissions and ECB calculations.

Appendix 2 : No immediate follow up action but focus on best practices

(From the CST report)

The ECB's 2022 climate stress test (2022 CST) will have no direct capital implications.

Given that the 2022 CST is essentially a learning exercise, stress test findings will be integrated into the SREP in a qualitative and non-mechanistic way.

Examples of best practices:

1. Banks that were able to engage with customers to retrieve climate-relevant counterparty-level data breakdowns.

2. Banks that have already integrated climate risk into their ICAAP supported by a good governance framework.

3. Banks that demonstrate proper climate risk credit modelling capabilities

4. Banks that appropriately allocated their income and exposures by sector/country and by emission intensity (with Scope 1 to 3 emissions included) using counterparty-level data.

5. While the general finding is that most banks still do not have clearly specified long-term strategies for dealing with the green transition, some banks have more elaborate plans which include concrete green transition targets and KPIs.

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