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Asset Management

ECB's Stress Climate Test for Banks: Early Results Encouraging

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The European Central Bank (ECB) launched its first targeted climate stress test (CST) in July, covering 104 significant European banks, to test the banks' resilience to addressing and managing climate-related risks. However, the ECB stated the 2022 CST "should be seen as a joint learning exercise," and the test "is aimed at gaining an understanding of banks' climate risk stress-testing frameworks and their level of preparedness."

The ECB's CST results are a mixture of positives and negatives. Positive findings include banks' ability "to report comprehensive and innovative information on climate risk," and that climate-related losses will be "lower in an orderly transition scenario than after delayed action." Negative findings show that "banks do not yet sufficiently incorporate climate risk into their stress-testing frameworks and internal models" as well as that there are "many deficiencies, data gaps and inconsistencies across institutions."

This CST comprises three modules. Modules 1 assesses the capabilities of banks' own climate risk stress-testing. Module 2 assesses the sensitivity of banks' income to climate transition risks, and their exposure to carbon emission-intensive industries. **Although the majority of banks tested are at an early stage to integrate climate risk into their stress testing framework, they have started to increase efforts to improve climate-related and environmental risk management.** Module 3 is a bottom-up stress test on 41 of the largest banks, designed to provide projections of several stressful scenarios, under which "the combined credit and market risk losses would amount to around €70 billion." Though substantial, these estimated climate related losses will be incurred over the long run, and Spectrum believes they should be manageable. However, as the ECB has pointed out, that result may understate the actual transition risk, since it is a partial reflection of many potential hazardous scenarios.

In terms of the CST's direct capital impact on banks, this exercise will have "no quantitative effect" on banks' capital guidance. However, "the outcomes of the exercise will instead be incorporated into the annual SREP [Supervisory Review and Evaluation Process] assessment in a qualitative manner."

Spectrum views the CST as a first step in a long process of environmental risk modeling and supervisory analysis that should, over time, become a more important factor in banks' capital requirements and business processes. Banks will need to develop more comprehensive and long-term climate risk management strategies. In addition, bank regulators will need to issue new climate-related regulations and enhanced stress-testing models. These efforts should provide greater clarity on banks' climate-related risks, and facilitate inter-bank risk comparisons. **Spectrum believes this recent climate stress test by the ECB is a good starting point, but more work will be needed by all parties to better understand the dynamic risks of climate change.**

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