SPECTRUM
Asset Management

ECB's Second Stress Climate Test

Regulation Driven Green Transition

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The European Central Bank (ECB) released its second economy-wide climate stress test (CST) in September, testing the resilience of companies, households and the financial system. The second test has upgraded several features based on the first CST (**see Spectrum's earlier report)**, which includes using the new scenarios of the Network for Greening the Financial System and new climate risk models that integrate the recent European energy crisis.

The test assesses the impact of three scenarios on the real economy and the financial system within a short-to medium term horizon (2023-2030). For example, through using granular datasets on firms' geographical location and greenhouse gas emissions, the test helps to identify the transition and physical risks that firms would face.

- **Scenario 1,** "the accelerated transition", which is an immediate start of a green transition, would potentially allow the euro area to achieve the 1.5 degrees target by the end of the century through emissions reductions by 2030
- **Scenario 2,** "the late-push transition", a green transition, which remains on the current path and doesn't "speed up" until 2026, would achieve a similar 1.5 degrees target through strong policy support but with higher costs
- **Scenario 3,** "the delayed transition", also accelerating in 2026, would have a smoother and less costly transition, but it would result in a 2.5 degrees temperature rise by the end of the century

The result of the ECB's CST framework shows that the accelerated transition scenario which acts immediately and decisively would be the most beneficial for the firms, households and the financial system. It would help to limit the impact of climate change and reduce energy costs, and thus lower financial risks.

For firms, credit risk would increase the most under the late-push scenario, especially those transition-vulnerable firms, such as electricity, mining and manufacturing sectors. For households, the costly transition due to the regulation on energy efficiency may adversely impact the net worth of homeowners and the collateral value of their homes, and potentially their solvency. Thus, the transition risk could have consequent spillover effects on the financial sector. For banks, their loan portfolios are exposed to transition risk with a substantial portion of lending to energy-intensive sectors and "an accelerated transition would lead to the best trade-off between credit and transition risks".

Although the latter two scenarios would generate higher risks, **"absolute losses on corporate bond portfolios would be limited**". For non-bank financial institutions, the "estimated market risk impact on the corporate bond portfolios of pension funds and insurance corporations would be notably higher than the impact for investment funds" due to the relative size of their exposures to the highly affected sectors, *e.g.,* electricity, gas and steam.

The CST reflects a continuation of the European Union's green transition driven by regulation across sectors. The accelerated transition scenario will help the most vulnerable firms to mitigate costs and financial risks. **Spectrum views the impact of physical climate and transition risks to be manageable for the euro area financial institutions in which it invests.**

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