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The ECB – Monetary Policy and Financial Stability Implications of Climate Change

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The ECB is including climate change considerations in its monetary policy, including banking supervision, financial stability, economic analysis, statistical data and corporate sustainability. With this commitment, the ECB aims to make a real difference in three ways: (1) by managing and mitigating the financial risk of climate change and assessing its economic impact, (2) by promoting sustainable finance to support an orderly transition towards a low-carbon economy and (3) by sharing their expertise to help foster wider changes in economic behaviour.

ECB's monetary policy operations regarding climate change

The long-term goal is to make sure that all the ECB's monetary policy actions are aligned with the objectives of the Paris Agreement. This means greening its stock of bond holdings, including public sector bonds, as well as their lending operations and collateral framework. Restoring price stability through an appropriate monetary policy today will benefit society over the longer run and will facilitate the transition to a greener economy.

The following concrete measures have been decided:

- **Corporate bond holdings:**
  As the ECB aims to decarbonise its corporate holdings it will tilt these holdings towards issuers with better climate performance to align with the Paris Agreement goals. Better climate performance will be measured with reference to lower greenhouse gas emissions, more ambitious carbon reduction targets and better climate-related disclosures.
- **Collateral framework:**
  By introducing a new limits regime the Eurosystem aims to reduce climate-related financial risks in Eurosystem credit operations. The share of assets issued by entities with a high carbon footprint that can be pledged as collateral by individual counterparties will be limited when borrowing from the Eurosystem. At first, the Eurosystem will apply such limits only to marketable debt instruments issued by companies outside the financial sector (non-financial corporations). The measure is expected to apply before the end of 2024 provided that the necessary technical preconditions are in place. Additionally, the Eurosystem will, as of this year, consider climate change risks when reviewing haircuts applied to corporate bonds used as collateral.
- **Climate-related disclosure requirements for collateral:**
  In order to improve disclosures and generate better data for financial institutions, investors and civil society the Eurosystem will only accept marketable assets and credit claims as collateral from companies and debtors that comply with the Corporate Sustainability Reporting Directive (CSRD) once the directive is fully implemented (expected to apply as of 2026). This requirement will apply to all companies within the scope of the CSRD. In addition, to ensure a proper assessment of climate-related financial risks for assets outside the scope of CSRD, such as asset-backed securities and covered bonds, the Eurosystem supports better and harmonised disclosures of climate-related data for them and engages closely with the relevant authorities to make this happen.
- **Risk assessment and management:**
  The Eurosystem will further enhance its risk assessment tools and capabilities to better include climate-related risks. For example, the Eurosystem will urge rating agencies to be more transparent

about how they incorporate climate risks into their ratings and to be more ambitious in their disclosure requirements on climate risks. Additionally, the Eurosystem agreed on a set of common minimum standards for how national central banks' in-house credit assessment systems should include climate-related risks in their ratings. These standards will enter into force by the end of 2024.

These measures aim to reduce financial risk related to climate change on the Eurosystem's balance sheet, encourage transparency, and support the green transition of the economy. Regularly review is required to check that these measures are fit for purpose and aligned with the objectives of the Paris Agreement and the EU's climate neutrality objectives.

The decisions described above are part of the climate action plan announced in July 2021. The ECB's work is progressing as outlined in the climate roadmap, and may have to be aligned if and when the timetable in EU legislation changes.

Financial Stability and Supervision - ECB

The ECB has intensified quantitative work towards incorporating climate-related risks into financial stability agenda. The work incorporates estimating financial system exposures to climate-related risks, upgrading banking sector scenario analysis and monitoring developments green transition financing.

The conclusions from its work so far are:

- Somewhat concentrated bank exposures to physical and transition risks;
- A prevalence of exposures at more vulnerable banks and in specific regions;
- Potential for risk mitigation; and
- Strong inter-temporal dependency conditioning the interaction of transition and physical risks.

The ECB has also flagged that, while investor interest in "green finance" continues to grow, there are concerns around potential greenwashing. Enhanced disclosures would benefit risk assessment and the allocation of finance to support the orderly transition. It is seeking for banks to include forward-looking emission targets, better data and risk assessment frameworks that incorporate transition risk.

ECB Bank Climate Risk Stress Test - 2022

While there were data and methodological limitations in the ECB 2022 bank climate-risk stress tests, the central bank also appreciated some progress in integrating climate risks into their risk management policies and strategic objectives. Only about 40% of the test participants had well-integrated climate stress-testing frameworks when evaluating risk and about 80% did not consider climate risks when granting loans. The ECB scored close to half of the banks at '4' for governance and risk appetite under their climate stress-testing framework preparedness, its weakest score.

Only 41 of the 104 EU banks that participated in the stress tests performed a more thorough bottom-up stress test and estimated credit and market risk losses were EUR70 billion in total under the short-term scenarios incorporating transition and physical risks. This appears smaller than estimated losses of GBP44 billion for eight large UK banking groups during the first five years of the toughest scenario in the Bank of England's 2021 climate stress test. However, exposures that were stressed represented only about one-third of the total exposures of participating banks. The test was focused on the sectors most vulnerable to climate risks.

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Given existing data gaps, in the future, stress tests will include less-benign macroeconomic assumptions and more science-based data and carbon-pricing estimates. For the exercise, only 20%-30% of the data for the greenhouse gas (GHG) emissions of counterparties were based on actual figures.

None of the supervisory climate tests to date – in France, Hong Kong, Canada, the UK and the EU – will be used to set Pillar 1 minimum capital requirements the data and methodological limitations. Pilot testing was designed as a learning experience.

What are central banks doing with this data?

- The ECB will consider the qualitative findings from its 2022 stress test, combined with its ongoing review of how banks incorporate climate and environmental risks into their strategies, governance and risk management when conducting its 2022 supervisory review and evaluation process.
- The ECB's stress test also demonstrated that bank lending books remain tilted towards high-emission corporate sectors. Participating banks received more than 60% of their interest income in 2021 from corporate customers operating in 22 high GHG-emitting sectors.
- The 2021 Bank of England stress test results will be used to inform future work on regulatory capital requirements. It is assessing the links between climate change and capital adequacy.
- The Hong Kong Monetary Authority has stated that the capital adequacy of tested domestic systemically important banks would, on average, decline by 3pp over a five-year horizon under its disorderly climate transition scenario.
- In September 2022, the Federal Reserve announced in a pilot exercise to analyze the effects of climate change on bank businesses and exposures under various scenarios. It is scheduled to take place in September 2022 and will include the six large U.S. banks (Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, and Wells Fargo). This is an important step forward for climate risk on the regulatory agenda. No capital or supervisory implications are not expected and visualizes this more as a pilot "scenario analysis".
- Scenarios are expected to address:
    - the physical risks from greater frequency and severity of weather events
    - the risks of transition to a clean economy, including the adoption of carbon pricing.
- Aggregate findings and insights of the exercise will not likely be available until 2024 and could be used to tailor future regulation, although firm-specific results will not be disclosed.

Useful Information:

https://www.ecb.europa.eu/pub/economic-bulletin/focus/2022/html/ecb.ebbox202206_06~d7f88f706f.en.html