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EU: Climate transition risks alone are unlikely to threaten financial stability, according to 'Fit-for-55' climate stress test results

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Climate-related transition risks alone are unlikely to threaten the financial stability of the European Union but could lead to increased losses for financial institutions and disrupt the green transition, if combined with unexpected shocks to the financial system, according to the results of the one-off 'Fit-for-55' climate scenarios analysis, published on 19 November 2024.

Objectives

The European Supervisory Authorities (ESAs), together with the European Central Bank (ECB), conducted the test, requested by the European Commission in 2023, to assess the resilience of the financial sector to climate and macro financial shocks, while the 'Fit-for-55' package is concurrently being implemented in the EU.

Implications

The results show that first-round losses stemming from a potential 'Run-on-Brown' scenario have a limited impact on the financial system, indicating that perceived changes in climate risks would not be a concern for financial stability per se during the green transition. However, adverse macroeconomic developments could disrupt the evolving transition and substantially increase financial institutions' losses, thereby impairing their financing capacity.

This leads the supervisory authorities to call for a "*coordinated policy approach to financing the green transition*".

For the banking sector, the report reflects that while the sector is expected to be resilient enough to withstand the selected adverse shocks, the magnitude of the results highlight the need for banks to integrate climate risks into their risk management frameworks "as promptly and extensively as possible" – albeit there is a recognition that the purpose of this exercise is not to set micro- or macro-prudential requirements for financial institutions, but rather than the results will inform the work of the European Commission, the ESAs and the ECB.

As with all forward-looking projections, the outcomes are subject to inherent uncertainty – and the ESAs note that the assumptions that have been made mean that losses are likely to have been overestimated to some degree – the exercise has nevertheless provided valuable insights into key vulnerabilities, and they say will enable targeted future initiatives to monitor climate related risks.

Background

Methodology

The exercise involved subjecting banks, investment funds, occupational pension funds and insurers to three different scenarios that were developed by the European Systemic Risk Board (ESRB) over an eight-year time frame between 2023 and 2030 (unlike regular bank stress testing which covers a 3 year time horizon):

1. *Baseline Scenario*: Reflects the implementation of the Fit-for-55 package under economic conditions consistent with the European System of Central Banks' June 2023 forecasts, incorporating additional costs related to the green transition.

2. *First adverse scenario*: Focuses on 'Run-on-Brown' shocks, where carbon-intensive firms lose investor support, slowing their green transition efforts since 'brown' firms don't have the financing they need to green their activities.

3. *Second adverse scenario*: 'Run-on-Brown' shocks are amplified with macro-financial stress factors.

Findings

The results found that the 'Run on Brown' first adverse scenarios would have only a limited impact on the financial system (which indicates that perceived changes in climate risks would not be a concern for financial stability per se during the green transition), with estimated first-round losses between 5.2% and 6.7% of initial exposures per sector over the eight-year horizon. The most significant second-round losses occurred in the investment fund sector at 11.2% of starting point exposures.

However, under the amplified scenario where 'Run-on-Brown' shocks were coupled with macro stress factors, potential disruptions could substantially increase financial institutions' losses, thereby impairing their financing capacity, with the investment fund sector seeing the heaviest losses at 25%. According to the ESA's, investment funds suffer the worst losses as they are most exposed to market risk.

The results of the 'Fit-for-55' climate scenarios analysis is available here.

The joint press release is available here.