

Focus on: Credits

11 July 2022



European banks: Climate risk stress test highlights need for further action



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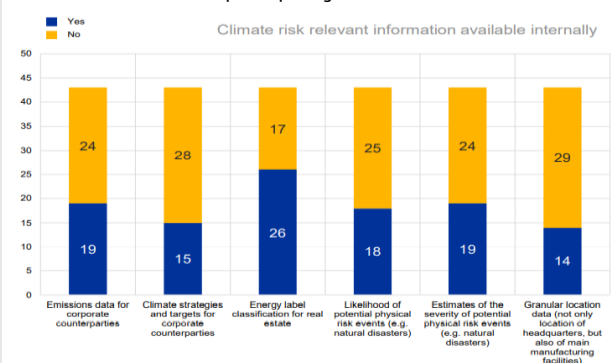
Last Friday saw the ECB banking supervision publish the [results of this year's supervisory stress test](#), the focus of which was on how institutions are addressing the risks associated with climate change. Overall, it would appear that the majority of banks still have considerable deficiencies in implementing climate risk stress tests, despite the supervisors in their final report acknowledging that they have made significant progress in this area.

For instance, close to 60 % of banks included in the stress test do not yet have a climate risk stress-testing framework

in place. Even for those whose stress-testing frameworks did include climate risks, there were considerable shortcomings. For example, the supervisors pointed out a lack of organisational independence between the development and validation processes of climate risk stress-testing frameworks. What is more, in many cases the results of the stress tests were not incorporated into banks' business strategies. They found that climate-related data was often not available at all or only partially available as an input. Only 20 % considered climate risk as a variable when granting loans. Supervisors concluded that enhancing data availability and improving the models for assessing climate risks were foremost on the list of outstanding issues to be addressed.

Scarcity of underlying data

Number of answers from participating banks



Sources: ECB Banking Supervision, Helaba Research & Advisory

Regulators have long identified **climate change as a source of financial risk**. The following figure from the ECB's report clearly illustrates the importance of this issue: around 65 %¹ of interest income that banks earn from non-financial corporate customers stems from greenhouse gas-intensive industries. However, this number is largely based on estimates due to existing data gaps.

The stress test also revealed that, of a sample of 41 large banks examined, credit and market losses of up to EUR 70 billion could be incurred in an extreme weather event scenario. While at first this seems to be easily manageable in view of the high capital buffers within the industry, the ECB banking supervision itself notes in its commentary that this amount significantly understates the actual climate-related risk. In particular, it justifies this with a lack of available data and the fact that second-round effects were not included. Additionally, the scope of this exercise only accounted for around one-third of the total exposures of the 41 banks. Our own analysis suggests that green transition costs for the industry will be much higher. In addition to the immediate costs for the banks themselves and their customers resulting from physical and transition risks, there will also be high regulatory and bureaucratic costs as well as reputational risks.

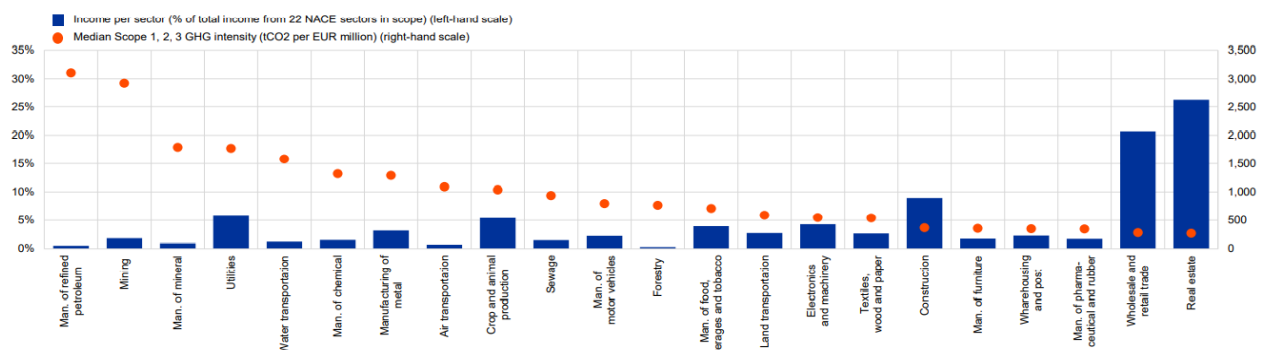
¹ median

As far as we are aware, this first bank climate risk stress test is a learning exercise for both the institutions and the banking supervision. The objective was to gain a better understanding of the weaknesses, modelling processes and challenges faced by banks in addressing climate-related risks. It is part of the ECB's wider climate roadmap to identify and manage climate-related risks. (For more about the green transition, see our publication "[European banks: Activities becoming ever greener](#)" of 27 April 2022).

The stress test exercise began on 27 January 2022 and involved a total of 104 significant banks. Banks were asked, in particular, about their climate stress-testing capabilities and reliance on carbon-emitting sectors. The results of this stress test will feed into the Supervisory Review and Evaluation Process (SREP) from a qualitative point of view, but there will be no direct impact on capital through the Pillar 2 guidance for the time being. The banking supervision expects the participating institutions to take action based on their respective findings and will publish a set of best practices in the final quarter of 2022. **We would welcome it** if the various banks were to publish comments on their own individual results.

Key takeaways: In our view, the results of the climate risk stress test do not contain any major surprises. They once again highlight the crucial role that banks play in the transition to a zero-carbon economy. This poses enormous challenges and risks, but also offers tremendous potential for new business. The industry is still in the very early stages of identifying and managing the risks associated with climate change, especially in quantitative terms. In view of a lack of historical time series, the scarcity of data to feed into models presents a very significant problem. In 2022, the main task for institutions and supervisors alike will be to improve their understanding of climate-related risks and to develop best practices. In the medium term, this could result in higher capital requirements if the assertion that climate-related risks are a source of financial risks proves to be correct.

Major proportion of income from greenhouse gas-intensive industries



Sources: EZB Banking Supervision, Helaba Research & Advisory



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