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Sustainability policy and its impact on the banking sector

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Greening monetary policy

Integration of environmental sustainability considerations into monetary policy

Goal: to align monetary policy with environmental objectives

-> assess the impact of climate change on the economy and financial system

-> incorporate climate considerations into policy framework

-> support the efforts of governments in achieving carbon emission reduction goals

Greening monetary policy

Integration of environmental sustainability considerations into monetary policy

ECB's strategy review: action plan to include climate change considerations in monetary policy strategy (July 2021)

-> Incorporating climate change considerations in monetary policy assessments and into the operations

- improving the availability and quality of climate data
- enhancing macroeconomic models, scenario analyses and risk assessment

! Goal: implementation of action plan in line with progress on EU initiatives in the field of environmental sustainability disclosure and reporting

“The primary objective of the European System of Central Banks (hereinafter referred to as "the ESCB") shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union.”

Source: Treaty on the Functioning of the European Union, Article 127 (1)

-> Climate change induces direct and indirect effects on inflation

"It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment."

Source: Treaty on European Union, Article 3 (3)

-> supporting climate change-related policies squares with the mandate, the challenges faced surpass the central bank's abilities and policy tools

Central banks' interest in climate change

included in policy mandate

risks to price and financial stability

balance sheet risks

Risks to price and financial stability

Different types of risks

Physical risks

-> financial losses related to physical damage resulting from adverse weather- and climate-related events

-> especially given expected increased frequency and intensity combined with fewer options to diversify geographically

Transition risks

-> losses associated with shift towards low-carbon economy (shift in consumer preferences, business practices, policy changes)

-> declining revenues and losses in asset values

Liability risks

-> climate-related litigation, increasingly oriented to corporates

Risks to price and financial stability

Different types of risks

Physical risks

Transition risks

Liability risks

On top: climate insurance protection gap

"In the EU, only a quarter of losses caused by climate-related catastrophes are insured, giving rise to additional risks to the macroeconomy, financial stability and public finances."

Isabel Schnabel, Frankfurt am Main, 5 September 2023 link

Risks to price and financial stability

Different types of risks

Physical risks

Transition risks

Liability risks

On top: heterogeneous socioeconomic impacts

"Climate changes can deplete resources or cause damages that can lead to an increase in violent conflicts, substantial relocation of households or mass migration"

Bank for International Settlements, April 2021, link

Risks to price and financial stability

Different types of risks

Physical risks

Transition risks

Liability risks

Note: Transition and physical risks are two sides of the same coin

Risks to price and financial stability

Different types of risks

Physical risks

Transition risks

Liability risks

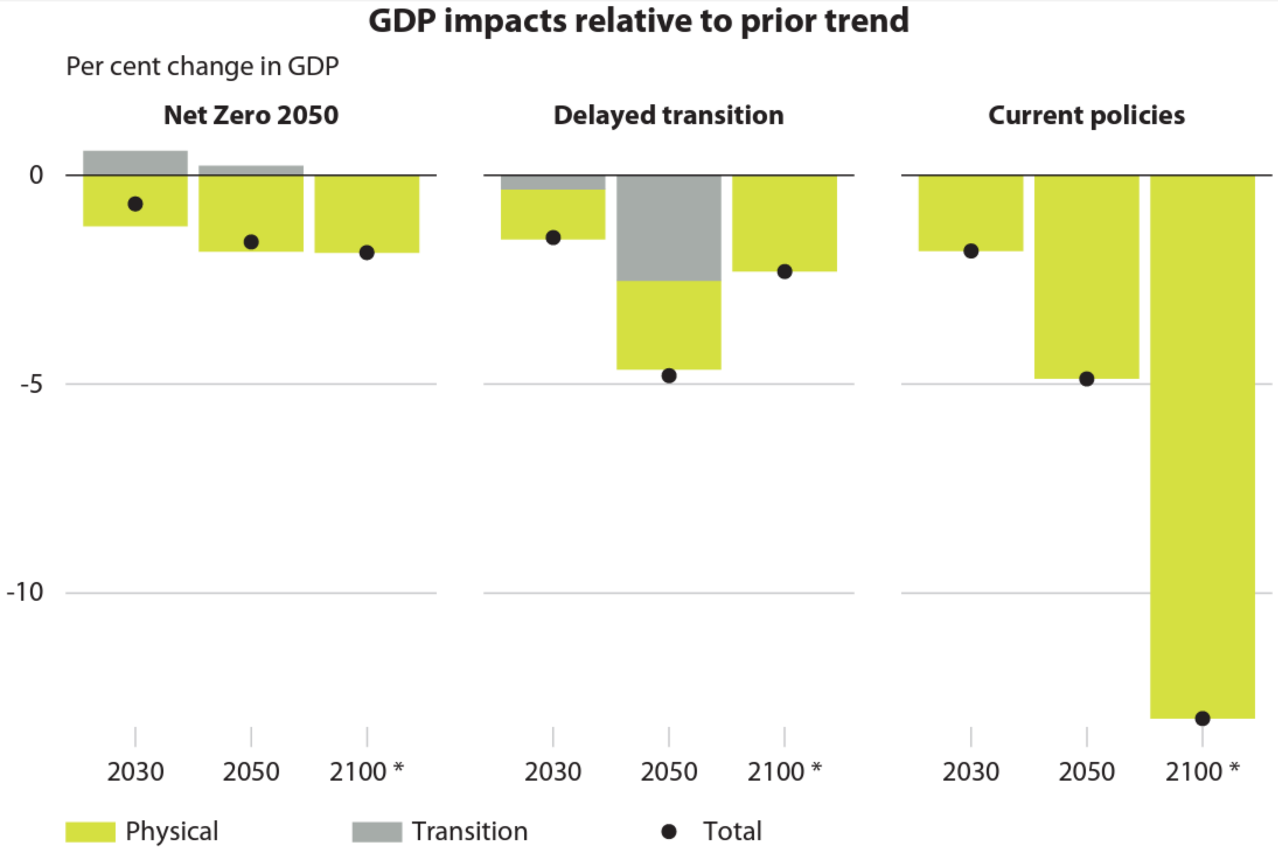
=> require supervisory attention

- size of risks: existential threat
- critical timing: often irreversible consequences, tipping points
- knowledge and data gaps

Risks to price and financial stability

Supervisory attention

size of risks: existential threat

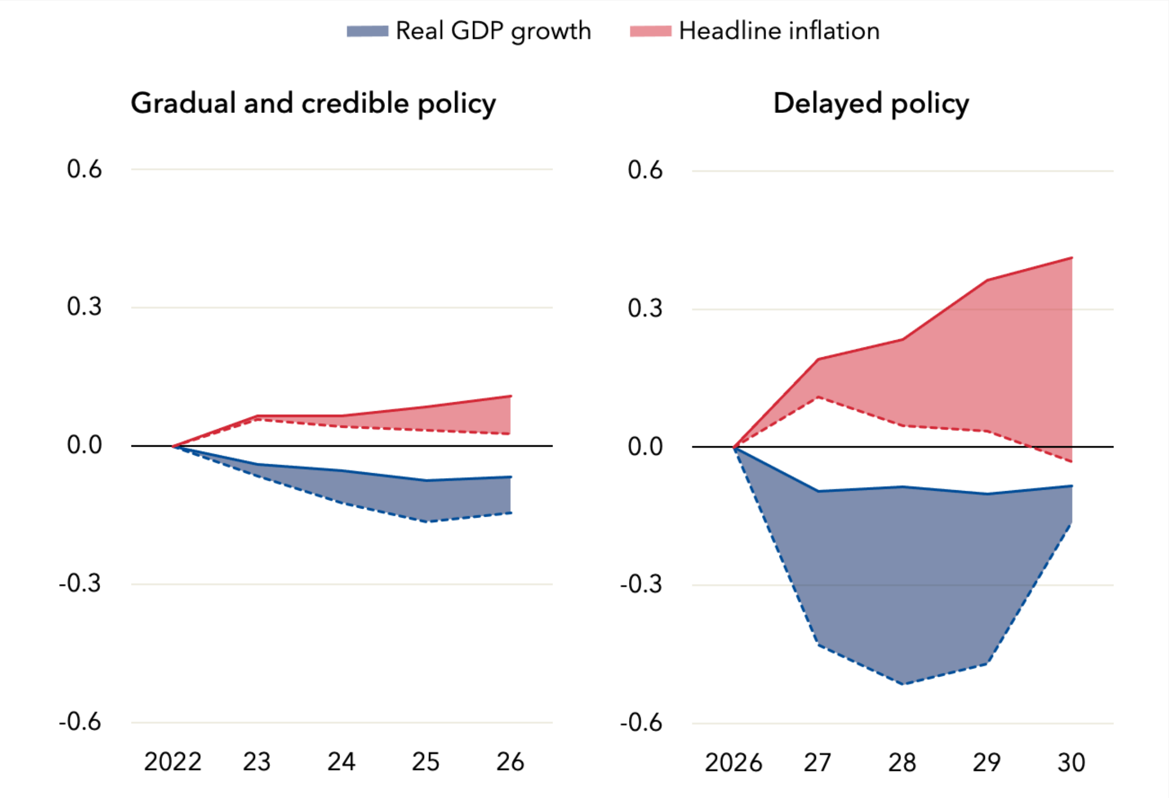


Source: NGFS, Climate scenarios for central banks and supervisors June 2021

Risks to price and financial stability

Supervisory attention

critical timing: often irreversible consequences



Source: IMF

Risks to price and financial stability

Supervisory attention

knowledge and data gaps

"When you can measure what you are speaking about, and express it in numbers, you know something about it" - William Thomson Kelvin, May 1883 (link)

-> Different dimensions:

- more detailed and timely official climate indicators
- more detailed and timely socioeconomic indicators
- enrichment of climate scenarios

related: corporate climate change disclosure (Corporate Sustainability Reporting Directive [CSRD], Sustainable Finance Disclosure Regulation [SFDR])

Risks to price and financial stability

Potential impact on prices

Direct impact on inflation evolutions

-> more frequent and more severe adverse climate events leading to more volatile

-> especially in longer run, potentially more persistent effects on prices and wages

-> mitigation policies impacting relative prices (e.g., carbon pricing)

Less effective transmission of monetary policy

-> knock-on effects for the real economy of impacted financial institutions and malfunctioning of financial markets

Less policy space

-> climate change triggering further declines in equilibrium interest rates

Risks to price and financial stability

Potential impact on financial stability

Impact on traditional risk categories

-> credit risk

-> market risk

-> liquidity risk

-> operational risk

=> impacting individual financial institutions

Especially for banks with portfolios concentrated in certain economic sectors and specific geographical areas

=> creating broader financial stability implications

=> major source of systemic risk

Concrete ECB actions

publication of climate-related indicators

adjusting monetary policy operations

banking supervision

Supervisory expectations

Climate stress tests

Supervisory expectations

relating to risk management and disclosure

Publication supervisory expectations: November 2020

-> Expectations for how banks should integrate climate-related and environmental (C&E) risks into their business strategy, governance and risk management link

- disclosure of C&E risks under the existing prudential framework
- enhance the industry's awareness and preparedness

Supervisory dialogue since 2021

-> Required self-assessment of banks' current practices relative to Guide's expectations

Thematic review 2022

-> Detailed analysis of institutions' C&E risk strategies, governance and risk management frameworks and processes

-> Identification of good practices originating from institutions varying in business models and size

Supervisory expectations

relating to risk management and disclosure

Prior report on climate-related and environmental risk disclosure

-> providing a snapshot of the existence of disclosures of C&E risks in the SSM countries

-> reference year 2019

-> offering overview of observed practices and areas for improvement

! Observation of positive trend in climate-related disclosure but “virtually none of the analyzed institutions would meet a minimum level of disclosures consistent with the Guide”

Supervisory expectations

relating to risk management and disclosure

Publication supervisory expectations: November 2020

Governance	Strategy	Risk management	Metrics and targets
Disclose the organisation's governance around climate-related risks and opportunities.	Disclose the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy and financial planning, where such information is material.	Disclose how the organisation identifies, assesses and manages climate-related risks.	Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities, where such information is material.

Source: ECB

Supervisory expectations

relating to risk management and disclosure

Supervisory dialogue since 2021

-> guide not binding but basis for “supervisory dialogue”

-> banks inform the ECB of divergences of their practices from the expectations

-> acknowledgement of evolving nature of tools and methods

-> divergences are expected to be addressed

Supervisory expectations

relating to risk management and disclosure

Thematic review 2022

-> sharing observations and good practices

-> staggered deadlines for banks

- institution-specific
- by March 2023: categorization of C&E risks and full assessment of their impact on the bank's activities
- by end 2023: include C&E risks in the bank's governance, strategy and risk management
- by end 2024: full alignment with Guide's supervisory expectations on C&E risks
- enforcement actions will be taken when needed

Climate stress tests

Assessing the resilience under different climate-specific scenarios

Since Global Financial Crisis, stress tests have become a vital part of the supervisory and financial stability toolkit

-> capturing the interplay between all the institutions and markets in the financial system

Specific angle of economy-wide climate stress tests

-> resilience of NFCs and euro area banks to transition and physical risk

-> taking account of interaction of risks

-> under different scenarios of future climate policies

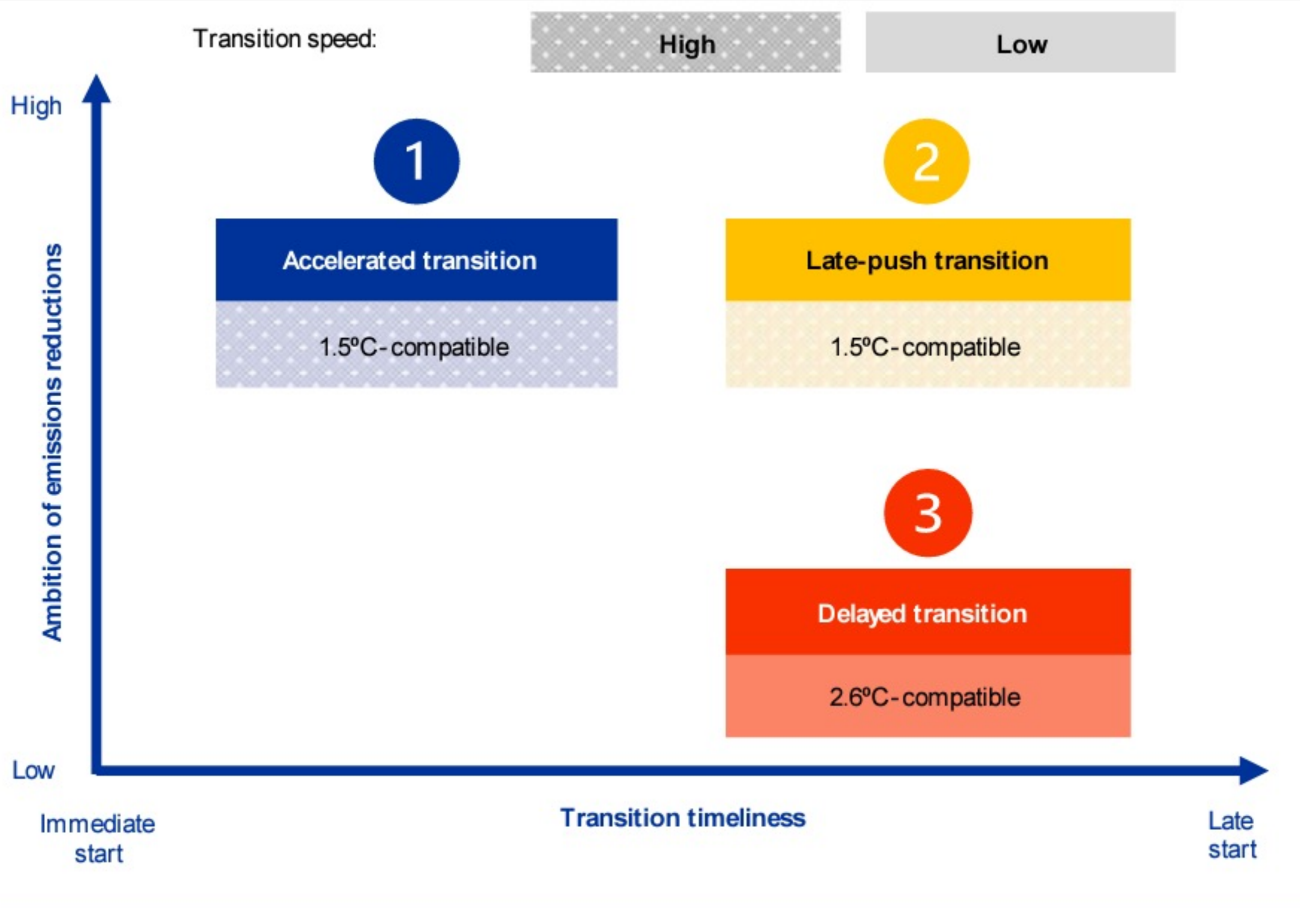
-> picking up both direct and indirect effects on NFCs and banks

=> allowing to capture future costs and benefits from climate policies

Climate stress tests

Assessing the resilience under different climate-specific scenarios

Different scenarios:



Source: ECB

Climate stress tests

Potential impact on financial stability

Stress test 2021

-> early adoption of climate policies pays off

-> physical risks dominant in terms of generated bank losses

-> geographical and sectoral concentration

Stress test 2022

-> confirming importance of timing climate policies

-> pointing in addition to the impact of policy ambition

-> indicating increased bank provisioning needs in short to medium run and long-term financial stability

! Not yet covered in framework: feedback loops between the financial system and the real economy, interaction of risks inside the financial system and across financial sectors

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In conclusion:

- **steps taken concerning supervision on C&E risks disclosure**
- **advances in assessment of financial sector resilience**
- **much more to be expected**