

Cabinet News and Views

Informed analysis for the financial services industry



ESMA Launches Fifth Stress Test Exercise for Central Counterparties That Includes Climate-Related Risks



By **Sukhvir Basran**
Partner | Financial Services



By **Ludovica Veltri**
Associate | Capital Markets

On May 31, 2023, the European Securities and Markets Authority (“ESMA”) [published a final report](#) on the framework for the 5th ESMA Stress Test Exercise for Central Counterparties (“CCPs”). For the first time, climate risk has been included among the components of the test. In part, the inclusion of climate risk in the Stress Test evidences the regulator’s interest in evaluating the impact that the energy crisis and market disruption following the COVID-19 pandemic have had on CCPs, and how CCPs have responded to such events.

ESMA has been running such Stress Tests since 2016, and they represent part of its strategy to assess and evaluate the resilience of CCPs, which form a core element of the financial system in the EU, providing stability and mitigating financial risks. ESMA describes the Stress Tests as a key tool to strengthen the flexibility and resilience of the CCPs, in order to enhance and ensure the stability and effectiveness of the EU capital markets.

ESMA’s goal is to obtain an overview on how prepared CCPs are to tackle climate risks. For the 2023 Stress Test, fourteen CCPs authorized in the EU and two authorized in the UK are included in the exercise. The main components of the Stress Test are: (i) credit stress; (ii) concentration risk; (iii) liquidity stress; (iv) reverse stress; and (v) climate risk.

In order to assess CCPs’ response to climate risks challenges, the scenario presented in the Stress Test features, among other things, the transition to a carbon-neutral economy and the consequences of such transition. The study of the CCPs’ business models and their reaction to such changes will be carried out taking into account the long-term pillars of climate risk: (i) business model risk, *i.e.*, the risk to the profitability and stability of a CCPs’ business model; (ii) physical risk, *i.e.*,

the risk that an extreme weather event could have on the CCPs and its ecosystem, with consequences such as operational disruptions and market instability; and (iii) collateral replacement risk, *i.e.*, the risk that market participants might eventually need to replace assets provided as collateral following a negative evaluation of the eligibility of such assets.

Final Thoughts:

The decision by ESMA to include climate risk among the components of the Stress Test evidences how EU regulators are adapting their approach to the evaluation of resilience of CCPs to increasing climate challenges. In doing so, as also remarked by Verena Ross, Chair of ESMA, [in an interview](#), the additional innovative approach adopted by ESMA was that of assessing how climate risk can impact CCPs as a whole, rather than analyzing them individually, and to show how the various CCPs are interconnected.

(This article originally appeared in [Cadwalader Climate](#), a twice-weekly newsletter on the ESG market.)
