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ECB Stress Test: Bank's Credit Risk Doubles by 2030 under Slower Climate Transition

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In September 2023, the European Central Bank ("ECB") published its second economy-wide stress test, shedding light on the credit risks that European banks may face as a result of the ongoing climate transition. The test analyzed the resilience of banks, firms and households to three transition scenarios, which differ in terms of timing and ambition:

- an "accelerated transition," which frontloads green policies and investments, leading to a reduction in emissions while limiting global temperature increases to 1.5°C by 2030 in line with the goals of the Paris Agreement;

- a "late-push transition," which continues on the current path whilst the "real" transition begins around 2026 with a weaker economy but achieves emissions reductions similar to the accelerated scenario; and

- a "delayed transition," which is compatible with a temperature increase of around 2.5°C by the end of the century, but is not sufficiently ambitious to reach the Paris Agreement goals by 2030.

"The results show that – all other things being equal – the earlier the transition happens, the smaller the financial risk, and consequently the less policy support is required to mitigate the costs." The accelerated scenario assumes a significant increase in energy costs in the near term, rising to €2 trillion by 2025, however, the ECB found that the "accelerated" transition scenario resulted in the lowest long-term financial physical risk.

One of the key findings of the stress test indicates that banks' credit risk could increase by more than 100% by 2030 under the late-push scenario. Banks' loan portfolios could become more vulnerable and in response to the heightened credit risk, banks will likely need to reassess their lending practices, which may involve adopting more stringent criteria for evaluating potential borrowers, particularly those operating in high carbon-intensive sectors.

In addition to the difficulty in accessing financing for corporations that are slow to adopt sustainable practices, the stress test results further identified mining, manufacturing, and utility industries as amongst the most severely impacted industries regardless of the scenario given their reliance on brown energy sources. These sectors face higher energy expenses and require substantial investments in carbon mitigation and renewable energy. It was further reported that the reduction in the revenues of brown energy suppliers due to the transition would be substantially larger under the accelerated and late-push transition scenarios.

The ECB's findings underscore the growing calls for corporations to transition to greener business models. Companies are being urged to enhance their risk management and disclosure practices in the transition, while banks are encouraged to embrace sustainable finance including offering green loans, investing in renewable energy projects, and actively supporting environmentally conscious businesses.

Final Thoughts

The ECB's climate stress test highlights that the choice of transition scenario, timing of the transition, and level of investment could significantly impact long-term economic and financial outcomes. The ECB's research also emphasizes the need for coordinated efforts to mitigate climate risks, support businesses and households during the transition, and ensure the resilience of the financial sector. As financial institutions plan this transition, they will also need to consider how to disclose their transition strategy. As we have previously covered, the ECB has provided guidance on such disclosures in its 2022 assessment of climate-related and environmental risk disclosures of EU-based banks, its joint statement on climate disclosure for structured finance products, and its own climate-related financial disclosures.

(This article originally appeared in Cadwalader Climate, a weekly newsletter on the ESG market.)