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ECB Climate Change Stress Test

Six key learnings for financial institutions to consider as they prepare for the regulatory climate stress test in 2022

In November 2020, the European Central Bank (ECB) issued guidelines on climate related and environmental risks, setting the regulatory expectation that financial institutions will embed climate change, as any other risk, into their decision making and risk management processes. The ECB has also announced a stress test for H1 2022 focussed on the exposure of the European financial institutions to climate change and their readiness to address it.

Further guidance for the ECB stress test is to be issued later this year, but the general expectation is that financial institutions will need to perform both a short term and long term (30 years) climate change impact analysis on their corporate and residential credit portfolios and trading book based on physical risk and transition risk scenarios to be provided by the ECB. This credit risk analysis is expected to be sector specific for identified carbon intensive industries and will include some level of review of the largest exposures per sector at counterparty level. The timelines for submission of the initial and final results of the analysis are expected to be Q1 and Q2 2022, leaving little time for financial institutions to prepare.

Learnings from the Bank of England's 2021 climate stress test

The Bank of England is just concluding its in-depth stress test focused on climate change, the CBES. Many of the same factors are at work and will no doubt inform the ECB approach. Baringa has partnered with 10 of the 18 CBES participants in providing them end-to-end support to complete this exercise.

Based on this experience, we have distilled six key learnings for financial institutions to consider as they prepare for the ECB climate stress test next year:

1. Start now

It will take time to build up to running a full scenario analysis at scale. As we have done with many of our clients, we recommend starting with a small-scale pilot to support developing your data sourcing strategy, progressing to a full-scale dry run to enable you to test and refine your implementation ahead of the final 'live' run. As it's already September, time is already running short.

2. Use the ECB stress test to accelerate your strategic climate scenario analysis solution...

Do not see the ECB stress test as a one-off exercise, but use it to build capability and to progress the implementation of climate risk management into the organisation. Taking this approach has enabled many of our clients to keep up with the climate change progress being made by competitors and the growing pressure from shareholders to manage climate risk and temperature alignment.

3. ...and to accelerate your climate data sourcing strategy

Climate change scenario analysis requires a lot of granular counterparty-specific data not commonly held by banks. Filling these data gaps requires a strategy for addressing data gaps, e.g. counterparty engagement, use of third party data providers, and implementing proxies for residual counterparts. We have found that addressing the data gap on unlisted counterparties is a large part of the effort, usually taking far longer than expected – especially as 75% of the counterparties in a typical corporate banking portfolio are unlisted.

4. Engage key stakeholders across the organisation early

This exercise is an opportunity to accelerate the high-quality dialogue and capability building around climate risk and net zero, across a wide range of stakeholders (including Risk, Finance, Front Office, Sustainability and Technology). By running Climate Change Education and Scenario Outcome Review sessions with Executive Teams, Sector Leadership teams and Risk Boards/Committees at our clients, we have helped build understanding of the drivers of climate change and the specific impact on portfolios, sectors, geographies, counterparties and assets classes.

5. Clearly articulate the strategic value of climate scenario analysis with all stakeholders

30-year scenarios are inherently exposed to significant model risk, and the outputs should not be interpreted as predictions. However, many of our clients have found that climate scenario analysis can be a very powerful technique for creating material separation between the potential 'winners' and 'losers' from climate change, and therefore for identifying concentrations of risk in a portfolio, identifying potential opportunities, and informing portfolio strategy. The real value of granular and sector and counterparty –specific outputs will be to provide you with *actionable* insights, which you can use to drive your business strategy and portfolio decision making.

6. Allocate significant time and resource to the qualitative components of the exercise

The stress test should stimulate the development and embedding of new risk management capabilities within firms' business-as-usual processes. We have helped our clients use the scenario analysis outputs to accelerate their thinking on how to embed climate risk in their enterprise risk management framework: e.g. portfolio reporting, Board Risk Committee engagement, annual credit reviews, and risk appetite. Using scenario analysis results to inform your climate risk framework development will not only accelerate your strategic embedding, but also strengthen your response to the qualitative questionnaire from the ECB.

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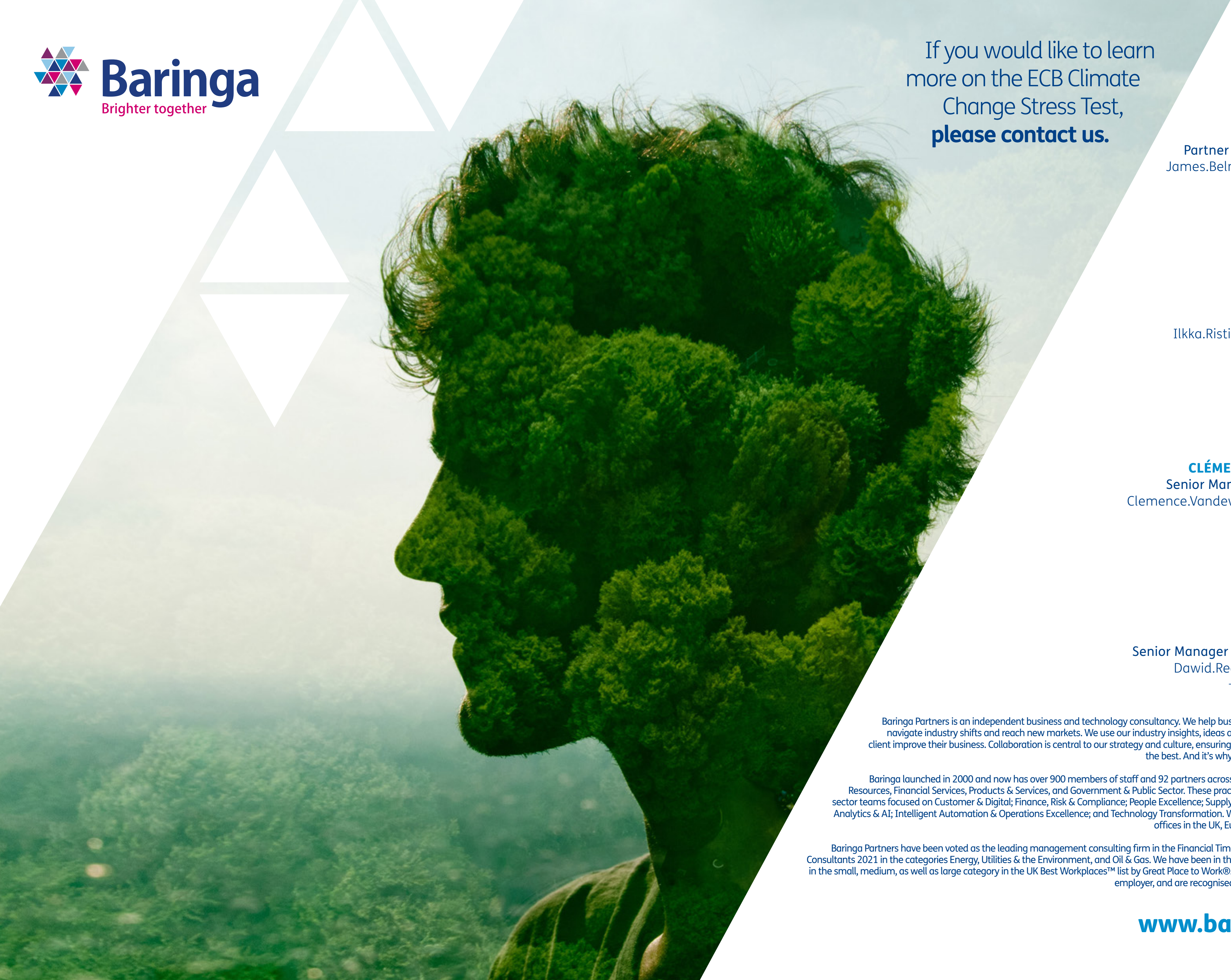

If you would like to learn more on the ECB Climate Change Stress Test, **please contact us.**

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