



EUROPEAN COMMISSION

DIRECTORATE-GENERAL FOR FINANCIAL STABILITY, FINANCIAL SERVICES AND CAPITAL
MARKETS UNION

The Director-General

Brussels

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Subject: Assessment of the financial system's resilience to stress in the transition to the EU's 2030 goals for the reduction of greenhouse gas emissions

Dear Chairs,

In the *Strategy for Financing the Transition to a Sustainable Economy* of July 2021, the Commission laid out its plans for ensuring the resilience of the financial sector to climate risks and an orderly transition towards the EU's climate targets of reaching carbon neutrality by 2050 and reducing greenhouse gas emissions by at least 55% by 2030 compared to 1990 levels.

To ensure financial stability and to enable the financial sector to play its role in financing the transition, we need to be aware of any potential vulnerabilities in the financial sector and of how stress in the financial system could affect the transition to the 2030 goals.

As detailed in the annex to the strategy, I would like to invite you to conduct a one-off climate risk scenario analysis to assess, in cooperation with the ECB and the ESRB, the resilience of our financial system on the way to the EU's targets for 2030. This one-off exercise should go beyond the usual climate stress tests, as a cross-sectoral exercise looking also at contagion and second-round effects, thereby giving us a better understanding of the vulnerabilities in the financial system. As part of this work, we would also appreciate any insights into the financial system's capacity to support green investments under stress.

More details on the exercise are available in the attached document which has benefited from extensive exploratory discussions with your staff at a technical level. Nevertheless, many

aspects will have to be further clarified, and this should be done in a joint team. My staff will be happy to provide any clarifications that may be needed.

While I fully understand that it will take some time to carry out such a complex task, it will be important to have any policy-relevant conclusions not later than Q1 2025, in order to provide input into the work of the new Commission.

This will be a collaborative effort. I would therefore like to thank you in advance for your organisations' engagement in this work.

Yours sincerely,

Electronically signed

John BERRIGAN

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Enclosure: Request for a one-off stress-testing exercise

c.c.: Mr Luis de Guindos, Vice-President of the ECB
Mr Andrea Enria, Chair of the Supervisory Board, ECB
Mr Francesco Mazzaferro, Head of Secretariat, ESRB

Request for a one-off scenario analysis exercise to be conducted jointly by the European Supervisory Authorities, the ECB and the ESRB in accordance with the Communication from the Commission of 6 July 2021 “Strategy for Financing the Transition to a Sustainable Economy”

1. CONTEXT AND PURPOSE

Under the European Green Deal, all 27 EU Member States committed to turning the EU into the first climate-neutral continent by 2050 and pledged to reduce emissions by at least 55% by 2030, compared to 1990 levels.

The European Commission estimated that the EU will need EUR 350 billion in additional investment per year over this decade to meet its 2030 emission reduction target in energy systems alone. ⁽¹⁾

Such a level of investment cannot be achieved just by public spending. The EU has therefore developed a sustainable finance framework that aims to channel private financial flows into sustainable economic activities. Such capital flows into sustainable investments will be monitored by the Commission, assisted by the Platform on Sustainable Finance. ⁽²⁾ Moreover, the Commission committed to assist Member States in assessing the investment gap and measuring the progress made by their financial sectors to align with the EU’s climate and environmental goals. ⁽³⁾

There is very little time to achieve the goals set for 2030, and the transition towards these goals could be derailed by adverse developments in the financial sector. Therefore, it is important to not only monitor progress, but also to anticipate shocks to the financial system that could jeopardise the viability of financial institutions or the financial system as a whole, or the EU’s ability to achieve its climate and environmental goals, and to be ready to react swiftly to any such adverse shocks.

⁽¹⁾ See Communication from the Commission “Strategy for Financing the Transition to a Sustainable Economy” COM(2021)390 final of 6 July 2021, <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021DC0390>

⁽²⁾ https://finance.ec.europa.eu/sustainable-finance/overview-sustainable-finance/platform-sustainable-finance_en

⁽³⁾ See action 5(b) in the annex to COM(2021)390 final.

Such adverse shocks may be climate-related and materialise in the form of transition risks (the impact of a switch to a more sustainable economy on financial assets) or through the impact that the anticipation of increasing physical risks may have on asset valuations. Major efforts are now being undertaken to monitor and address potential systemic risks stemming from sustainability challenges.

As announced in its Communication “Strategy for Financing the Transition to a Sustainable Economy”⁽⁴⁾, the Commission invites the European Supervisory Authorities (ESAs), the European Central Bank (ECB) and the European Systemic Risk Board (ESRB) to cooperate in a one-off exercise that should assess the resilience of the financial sector in line with the Fit-for-55 package.⁽⁵⁾

The Commission would welcome an assessment of the extent to which early climate-risk related shocks could already generate significant stress for the financial system as a whole in the period up to 2030, taking into account contagion and second-round effects.

While it will be useful to get a better understanding of how vulnerable our financial system may already be in the near term to climate-risk related shocks, we cannot assume that such shocks will only occur in a benign macrofinancial environment. It would therefore be desirable to simulate also the materialisation of climate-risk related shocks in an adverse macrofinancial scenario, possibly by combining a climate shock scenario and (elements of) adverse scenarios used in regular stress-testing exercises.

2. SCENARIOS TO BE CONSIDERED

The Commission invites the addressees of this request to develop severe but plausible scenarios that could affect the financial system as a whole over the period up to 2030.

One scenario should focus on climate-change related risks that could already materialise in the near term, most likely in the form of asset price corrections triggered by a sudden reassessment of transition or physical risks⁽⁶⁾.

A second scenario could combine such climate-change related risks with other stress factors, as far as possible consistent with scenarios for regular stress-testing exercises.

The adverse scenario(s) should be developed by the ESRB’s Task Force on Stress Testing to ensure consistency across sectors and synergies with the scenarios used in other stress tests. The adverse scenario(s) should be compared to a baseline scenario in which the implementation of the Fit-for-55 package is progressing as planned and within the economic environment as forecast at the launch of the one-off exercise.

⁽⁴⁾ See footnote 1.

⁽⁵⁾ https://commission.europa.eu/strategy-and-policy/priorities-2019-2024/european-green-deal/delivering-european-green-deal_en

⁽⁶⁾ Such a reassessment of physical risks seems a more plausible assumption than the sudden and simultaneous materialisation of a number of physical risks as a trigger of an adverse scenario whose effects on the financial system are to be modelled in this exercise.

3. MODELLING AND OUTPUTS

The one-off exercise should focus on the EU financial system as a whole. It should assess its resilience until 2030. This will require modelling contagion and second-round effects across firms and sub-sectors of the financial system.

It will be for the addressees of this request to determine an appropriate time horizon for the exercise, depending on how long it takes for the initial shocks to develop their full impact on the financial system.

While the exercise should cover all relevant sectors of the financial system and should be EU-wide, the exercise should rely, to the extent possible, on available data collected by the ESAs/ECB in order to ensure feasibility and to limit the burden for financial institutions related to data needs by using a top-down approach.

As the purpose of this exercise is not to set micro- or macro-prudential requirements for financial institutions, the exercise should not limit itself to estimating capital losses and shortfalls in financial institutions. The results in terms of capital losses/adequacy should then feed into a modelling process indicating how shocks and their possible amplification through contagion and second-round effects could affect the overall availability of capital and economic activity.

Results should be as differentiated (notably by countries, types of financial institutions, economic sectors) as possible so that they can be used by policymakers to better understand how climate-related shocks can affect the financial system in the period up to 2030.

The results could feed into subsequent supervisory or monitoring programmes of the ESAs and the ECB, where the exercise identifies specific vulnerabilities in the financial system such as concentration or contagion risks. Where appropriate, supervisory authorities may provide feedback on issues identified in this exercise to their supervised entities.

Following on from this work, the Commission would welcome any insights on the degree to which climate risks could impair the EU's financial system's capacity to channel private investments into the real economy as part of its transition to the goals set for 2030.

4. ORGANISATIONAL ASPECTS

The addressees of this request should carry out this exercise in close cooperation with each other to ensure a high degree of consistency of the sectoral work to be carried out by the ESAs and a realistic modelling of system-wide contagion and second-round effects.

The Commission services stand ready to support the work on this one-off exercise, notably to clarify any issues as regards the expected deliverables and to ensure that this exercise fits in well with other work streams, in particular the monitoring financial sector stability and of capital flows into a sustainable economy.

5. TIMING AND FINAL DELIVERABLES

The Commission would welcome receiving results from this exercise ideally by the end of 2024 and in any case not later than Q1 2025, in order to provide input to the work of the new Commission. The exercise should therefore be launched as soon as possible and could be based on end-2022 balance sheet data.

The team in charge of conducting the exercise should develop a detailed roadmap and timetable and report on progress to the governing bodies of the addressees and the Commission at key moments, and in particular when the scenarios are to be validated, the sectoral work is completed and fed into the cross-sectoral modelling and at the beginning of the phase in which all elements will be integrated into the final report.

The final deliverable should be an integrated single report combining sectoral work conducted in a consistent manner and the cross-sectoral modelling.