SPEECH

Working together for climate neutrality: what role do stable banks play?

Speech by Claudia Buch, Chair of the Supervisory Board of the ECB, at ‘’the Week of the Environment”

Berlin, 4 June 2024

Thank you very much for inviting me to the opening of the seventh Week of the Environment. I am delighted to talk today about the significance of climate-related and environmental risks for the stability of the economy and the financial system – a very important topic for us at the European Central Bank.

Because climate change and nature degradation are everywhere. They are palpable, hold major risks and cause massive damage to the economy. Not just in the distant future but here and now, right on our doorstep.

Floods, droughts and heatwaves have already caused considerable financial damage in the Europe.[1] Studies show that, if nothing is done, global heating in the period up to 2050 could lead to a loss in global economic output of several percentage points per year.[2] The loss of biodiversity would also have considerable economic costs.[3]

We need to protect our climate and environment *today* if we are to live in a secure and stable world *tomorrow*. Climate protection and biodiversity are a necessity if people and firms are to be able to plan with confidence for their future – without worrying that their livelihoods and businesses are endangered.

Climate-related and environmental risks also affect the banking sector.

Because banks are an important bridge to the future. Their loans reflect the economic structures of the past – for example loans made to companies with high carbon dioxide emissions. Banks can at the same time help to shape the future by making new loans, for example to producers of renewable energy. Such financing is important, as by 2030 carbon dioxide emissions in Europe have to be cut by 55%.[4] That will require investment.

Banks cannot provide this financing alone, as the investments are often long-term and risky, and also require capital market financing. But banks certainly play an important role in the financing of the green transition.

Why is the European Central Bank (ECB) interested in climate-related and environmental risks? Climate and environmental policy are not the role of a central bank. They must be shaped by elected parliaments. [5]

But the ECB has to consider the effects of climate change and climate policy when carrying out its mandates.

The ECB’s monetary policy mandate is affected by the overall economic impact of climate change.

But the ECB has another important role alongside monetary policy: it supervises the major banks in the euro area. This year we are celebrating the tenth anniversary of the banking union in Europe – with banking supervision under one roof at the ECB as a central pillar.

Banking union was a response to crises. The global financial crisis and the European debt crisis showed that financial sector risks don’t stop at international borders.

The risks arising from climate change and nature degradation are also global. They affect all countries, they affect all banks. For several years now, European banking supervision has therefore been working intensively on climate-related and environmental risks.

These are physical risks such as floods, wildfires or storms. Extreme weather events can reduce the value of property and thus the collateral held by banks for loans. Credit risk increases.

Climate change also entails transition risks. If the carbon price rises, then costs initially also rise for companies with high carbon dioxide emissions. This is intended, to steer behaviour. But in the meantime loan defaults may increase.

That means that banks have to assess how climate-related and environmental risks affect their balance sheets. As with any other type of risk, they must first identify and then manage these risks well. They must have enough capital to absorb potential losses. In other words, they need to be resilient.

With good risk management and sufficient resilience, banks can make a key contribution to a more sustainable economy. They must work closely with their customers and provide financing so that firms can realign their supply chains and production.

How much are banks affected by climate-related and environmental risks?

In 2019 we asked European banks about climate-related risks for the first time, with somewhat sobering results. For many banks, climate-related risks were a relatively new topic. Data needed to measure the risks weren’t available. Plans for managing climate-related risks were lacking.

In 2020 ECB Banking Supervision therefore developed a guide to dealing with climate-related and environmental risks.[6] The intention is not to steer bank lending or generally prevent loans from being made to carbon-intensive companies. The important thing for us is that banks manage their climate-related and environmental risks well.

In 2022 we conducted a thematic review[7] on climate-related and environmental risks and a climate risk stress test. The result showed that a high proportion of banks’ interest income comes from loans to carbon-intensive sectors.[8] We are working closely with the banks to improve the management of the risks this entails.

The situation has now improved considerably. Almost all banks see climate-related and environmental risks as material financial risks and are adjusting their risk management step by step.[9] For this the banks are dependent on information from their customers – the forthcoming application of corporate sustainability reporting will provide banks with more reliable and comparable data. [10]

That's good news – but a great deal more work lies ahead. Banks need, for example, to further integrate climate-related and environmental risks into their strategic planning and stress tests. If they don't meet our supervisory expectations,[11] we can take applicable measures, for example by requiring better risk management or higher capital.

Good risk management at banks and strong banking supervision thus support climate and environmental policy – but they are not a substitute for it. They are important components in the way our society deals with climate-related and environmental risks. Today's event is about working together for climate neutrality ("Zusammen für Klimaneutralität"). For me, this means that: we have a strong consensus in our society on climate-related and environmental objectives. Over the next two decades, we want to move step by step to climate neutrality.

There are many ways to reach this goal. Adjustments in the relative prices of carbon dioxide are an important tool for making it more expensive to act in ways that harm the climate. But regulatory measures and social policies are also needed to ensure that vulnerable groups are not burdened more than necessary by changes in relative prices for CO_2.

The best combination of these measures must be discussed across society and then decided at the political level.

These decisions on climate and environmental policy form the basis for our work.

Banking supervision and regulation do not have climate policy objectives. But they do establish the framework within which banks must properly measure and assess climate-related and environmental risks, and build resilience. That creates transparency and stability at a time when the climate crisis is demanding a major transformation of European economies.

Stable banks are a key bridge on the road to a more sustainable future.

1.

In Slovenia, very heavy rain last year caused damage equivalent to 16% of GDP. In the Emilia-Romagna region of northern Italy floods produced €9 billion of damage. See European Environment Agency (2024), "European climate risk assessment", *EEA Report*, No 01/2024; and Hancock, A. (2024), "EU warned of rising risk of systemic financial shocks from continent warming", *Financial Times*, 11 March.

2.

See Bennett, P. (2023), "Climate change is costing the world $16 million per hour: study", World Economic Forum and EcoWatch, October 12; Aerts, S., Spaggiari, M. and Stracca, L. (2023), "Climate scenarios:

procrastination comes at high cost", *The ECB Blog*, ECB, 4 December; Sustainability Insights Research: Lost GDP: Potential Impacts of Physical Climate Risks on the website of S&P Global; and estimates in European Environment Agency (2023), "Economic losses from weather- and climate-related extremes in Europe", 6 October.

3.

See Ranger, N. et al. (2023), "The Green Scorpion: the Macro-Criticality of Nature for Finance – Foundations for scenario-based analysis of complex and cascading nature-related financial risks", *NGFS Occasional Paper*, 13 December; and Torkington, S. (2023), "50% of the global economy is under threat from biodiversity loss", World Economic Forum, February 7.

4.

In the EU the Paris Agreement has been transposed into the binding European Climate Law, which requires climate neutrality by 2050. The commitment to reduce emissions by 55% by 2030 is further reinforced by the EU's "Fit for 55" strategy.

5.

Elderson, F. (2023), "Policymakers as policy takers – accounting for climate-related and environmental factors in banking supervision and monetary policy", speech at the Peterson Institute for International Economics, 21 April.

6.

ECB (2020), *Guide on climate-related and environmental risks*, November.

7.

The aim of the thematic review was to assess whether banks adequately recognise, quantify and manage climate-related and environmental risks. See ECB (2022), *Walking the talk – Banks gearing up to manage risks from climate change and environmental degradation*, November.

8.

See ECB (2022), *2022 climate risk stress test*, July; and ECB (2022), *ECB report on good practices for climate stress testing*, December.

9.

Elderson. F. (2024), "You have to know your risks to manage them – banks' materiality assessments as a crucial precondition for managing climate and environmental risks", *The Supervision Blog*, ECB, 8 May.

10.

Sustainable finance legislation such as the EU Taxonomy Regulation or the Corporate Sustainability Reporting Directive (CSRD) play a decisive role in the disclosure of information on sustainability.

11.

See Elderson. F. (2024), “Making banks resilient to climate and environmental risks – good practices to overcome the remaining stumbling blocks”, speech at the 331st European Banking Federation Executive Committee meeting, 14 March; and Elderson, F. (2024), “You have to know your risks to manage them – banks’ materiality assessments as a crucial precondition for managing climate and environmental risks”, *The Supervision Blog*, ECB, 8 May.