EUROPEAN CENTRAL BANK

EUROSYSTEM

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Frankfurt am Main, 25 September 2020

L/CL/20/231

Re: Your letter (QZ-038)

Honourable Members of the European Parliament,

Thank you for your letter, which was passed on to me by Ms Irene Tinagli, Chair of the Committee on Economic and Monetary Affairs (ECON), accompanied by a cover letter dated 29 June 2020.

Climate change is an urgent and major challenge to which all stakeholders must respond and play their part. Within its mandate, the ECB is firmly committed to exploring every possible avenue through which it can contribute to mitigating climate change. To this end, we have already taken a number of concrete measures. Most recently, on 22 September the ECB decided that bonds with coupon structures linked to certain sustainability performance targets will become eligible as collateral for Eurosystem credit operations and also for Eurosystem outright purchases for monetary policy purposes, provided they comply with all other eligibility criteria[1]. The coupons must be linked to a performance target referring to one or more of the environmental objectives set out in the EU Taxonomy Regulation and/or to one or more of the United Nations Sustainable Development Goals relating to climate change or environmental degradation. This further broadens the universe of Eurosystem-eligible marketable assets and signals the Eurosystem’s support for innovation in the area of sustainable finance.

[1] See https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200922~482e4a5a90.en.html

For a comprehensive overview of all the steps already taken by the ECB, I would like to refer you to the ECB Annual Report 2019 where we dedicated a specific box to “The ECB and climate change” to describe the rationale behind our actions and the various facets of our contributions.[2] In the same vein, the ECB Annual Report on supervisory activities 2019, published in March 2020, contains a dedicated box on “Green finance” which provides an overview of current and planned supervisory measures in relation to banks' handling of climate-related and environmental risks.[3] I am committed to looking at all the implications in relation to our tasks and operations and, in line with our mandate, to making the necessary adjustments to tackle climate change.

The monetary policy strategy review, whose timeline has been extended owing to the coronavirus pandemic, will include an entire session dedicated exclusively to climate change. This will provide the opportunity to reflect sustainability issues in our monetary policy framework, including exploring the extent to which climate-related risks are understood and priced in by market participants, and how credit rating agencies incorporate such risks into their assessments. The ECB will continue to evaluate the implications for its own risk management, in particular through our collateral framework. In this context, and as highlighted recently in the Eurosystem reply to the European Commission's public consultations on the Renewed Sustainable Finance Strategy and the revision of the Non-Financial Reporting Directive[4], it is essential that existing data gaps are closed and that corporate data disclosure is made more consistent and accurate. This is a prerequisite for conducting an accurate analysis of the possible risks to which the ECB is exposed in the conduct of its monetary policy[5], as well as for any potential adjustment within the Eurosystem monetary policy implementation framework.

As I had the opportunity to discuss during my last monetary dialogue with the ECON Committee of the European Parliament on 8 June 2020[6], in line with the ECB's mandate, the immediate focus of our recent policies has been on addressing the acute economic and financial strains created by the pandemic. The core features of the asset purchase programme (APP) and the pandemic emergency purchase programme (PEPP) are designed in a broad and flexible manner to have the widest possible impact. This supports the programmes' effectiveness and helps mitigate distortions of specific market segments. The implementation of the APP and PEPP does not positively or negatively discriminate on the basis of environmental or any

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2 https://www.ecb.europa.eu/pub/annual/html/ar2019~c199d3633e.en.html

3 https://www.bankingsupervision.europa.eu/press/publications/annual-report/html/ssm.ar2019~4851adc406.en.html

4 https://www.ecb.europa.eu/pub/pdf/other/ecb.eurosystemreplyeuropeancommissionpublicconsultations_20200608~cf01a984aa.en.pdf

5 As explained on 8 June 2020 at my regular monetary dialogue with the ECON Committee, determining the possible environmental impact of the ECB's asset purchases based on backward-looking sectoral or firm-level data – as done in the analyses of the ECB purchases you refer to in your letter – can be misleading. Such analyses do not distinguish between the debt instruments that benefit from ECB asset purchases and the individual investments financed by the proceeds from issuing such debt instruments, nor do they capture any dynamics within firms over time. See also the ECB reply to letter QZ-052/2019, available at https://www.ecb.europa.eu/pub/pdf/other/ecb.mepletter191220_Tang_and_Gill~84f611ceb8.en.pdf

6 See transcript of the dialogue, available at https://www.ecb.europa.eu/press/key/date/2020/html/ecb.sp200608_transcript~43566d31cf.en.pdf

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other criteria. Nonetheless, under the corporate sector purchase programme (CSPP), the Eurosystem holds close to 20% of the CSPP-eligible green bond universe, the proceeds of which are used to finance projects with an environmental benefit. The more this market segment develops and grows, the more the Eurosystem will increase the share of green bonds that it holds. Ambitious progress on the EU sustainable finance agenda and on capital markets union will be essential to foster further growth of this market segment. Ultimately, this supports the private sector's growing efforts to adopt more energy-efficient technologies, reduce its carbon footprint and establish incentives to redirect activities toward renewable resources.

Regarding the prudential framework, it is important that banks account for climate-related and environmental risks given that they can have a substantial impact on the real economy. ECB Banking Supervision recently published a Guide on climate-related and environmental risks[7] explaining how it expects banks to safely and prudently manage and disclose these types of risks in a transparent manner under the current prudential framework. ECB Banking Supervision aims to raise industry awareness of climate-related and environmental risks and to advance the management of such risks. These risks can have a material impact on institutions and drive the existing categories of banking prudential risks, such as credit risk, operational risk, market risk and liquidity risk. ECB Banking Supervision drafted this Guide within the boundaries of applicable EU and national law. In its answer to two recent EU Commission consultations, it nevertheless stressed that more explicit and precise legal provisions on the management and disclosure of climate-related and environmental risks in the banking prudential framework may be considered by the EU legislators.[8] The European Banking Authority (EBA) has been given several mandates to assess how environmental, social, and governance risks can be incorporated into the three pillars of microprudential supervision. The ECB deems it necessary that the prudential framework remain risk-based. Changes in the capital treatment applied to certain assets presuppose that these assets demonstrate specific risk profiles. Further analysis is needed as a matter of priority, notably in the context of the EBA's mandate, to assess whether and how regulatory capital requirements should reflect sustainability considerations.

In your letter, you also mention the possibility of using macroprudential capital buffers. Macroprudential policies, including capital buffers, generally target material sources of systemic risk for the financial system, including those that are climate related. The ability to properly identify and assess those risks is, however, a key prerequisite for the application and potential extension of the current macroprudential policy toolbox to systemic risks related to climate change. Currently, ECB staff is working on the assessment of climate-related risks and are developing a monitoring framework for the euro area banking sector. This work faces major challenges, including, for example, the important issue of data gaps mentioned above. With these

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[7] https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/climate-related_risks/ssm.202005_draft_guide_on_climate-related_and_environmental_risks.en.pdf

[8] See footnote 3.

prerequisites in mind, an assessment of whether the current macroprudential framework is sufficient to address climate-related risks or would require additional measures could certainly be envisaged.[9]

When it comes to making sure that climate-related and environmental risks are duly taken into account by banks, stress testing represents an important analytical tool. Here, it is important to distinguish between several types of stress test exercise in which the ECB is involved and the different responsibilities the ECB has in each. The ECB – in its banking supervision function – is required by EU law to carry out stress tests on the institutions it supervises at least once a year.[10] Every two years, ECB Banking Supervision discharges this responsibility by participating in the EU-wide stress test that is conducted by the EBA.[11] In years when there is no EU-wide stress test, ECB Banking Supervision evaluates the impact of specific financial shocks on significant institutions under its direct supervision. The overall approach and features of these stress tests are developed in cooperation between the ECB and the national competent authorities participating in the Single Supervisory Mechanism, and approved by the ECB Supervisory Board. The next exercise of this kind is foreseen for 2022, the focus and approach of which have not yet been decided.

In addition to the prudential stress test exercises carried out by ECB Banking Supervision, ECB staff is working on climate-related issues with the entire membership of the European Systemic Risk Board (ESRB) and have finalised a forward-looking scenario analysis drawing on existing models and expertise to investigate the system-wide materiality of transition risks for banks' solvency and lending capacity. The results of this work were published recently in the ESRB Report entitled "Positively green: Measuring climate change risks to financial stability"[12]. In parallel, ECB staff is also working on a top-down climate-risk stress testing framework. While still based on a top-down approach, this framework will rely on highly granular information on banks' exposures and firms' emissions, with innovative modelling features capturing sensitivity to physical risk. Importantly, it will also feature trade-offs between the physical risks of climate change and the transition risks as we move towards a low-carbon economy. The first results of this broad exercise are expected to be ready in the first half of 2021.

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9 As identified by the European Systemic Risk Board (ESRB), possibilities for prudential instruments to mitigate systemic risk related to climate change include: (a) building systemic capital buffers; (b) regulatory loss absorbency requirements; (c) specific capital surcharges based on the carbon intensity of individual exposures; (d) large exposure limits. See ESRB (2016), "Too late, too sudden: Transition to a low-carbon economy and systemic risk", *Reports of the Advisory Scientific Committee*, No 6, February, available at https://www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_6_1602.pdf

10 See Article 100 of the Capital Requirements Directive, available at https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A32013L0036

11 For this exercise, the methodology, templates and overall assumptions are developed under the leadership of the EBA and approved at the level of the EBA Board of Supervisors, in which the ECB is a non-voting member. The baseline and adverse scenarios are developed by the ECB under instructions from the ESRB, taking into account guidance by the EBA. Final decisions on the overall narrative of the exercise and the scenario are taken by the EBA. For banks which are not included in the sample of the EU-wide exercise, the ECB conducts a separate stress test in parallel using the same template and methodology as for the EU-wide exercise, with adjustments to allow for a proportionate treatment reflecting the smaller size of the banks participating in the ECB exercise.

12 https://www.esrb.europa.eu/pub/pdf/reports/esrb.report200608_on_Positively_green_-_Measuring_climate_change_risks_to_financial_stability~d903a83690.en.pdf?c5d033aa3c648ca0623f5a2306931e26

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Yours sincerely,

[signed]

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