



EUROPEAN CENTRAL BANK
EUROSYSTEM

ECB-PUBLIC

Christine LAGARDE
President

Mr Pascal Canfin
Member of the European Parliament
European Parliament
60, rue Wiertz
B-1047 Brussels

Frankfurt am Main, 3 February 2023

L/CL/23/6

Re: Your letter (QZ-033)

Honourable Member of the European Parliament, dear Mr Canfin,

Thank you for your letter, which was passed on to me by Ms Irene Tinagli, Chair of the Committee on Economic and Monetary Affairs, accompanied by a cover letter dated 3 November 2022.

In 2022, ECB Banking Supervision conducted its first supervisory climate stress test. Given the novelty of the exercise and the need for specific data and models to analyse climate-related risks, this stress test was a learning exercise for both banks and supervisors. It was designed as a means of gaining insights into banks' data issues and their progress in modelling climate-related credit risk. The stress test indeed found that, in a short-term disorderly scenario, losses for less energy-efficient houses are higher than losses for more energy-efficient houses¹, as you rightly point out.²

At the same time, in a broader context of addressing wider climate risk to the financial system relevant for financial stability, the European Central Bank (ECB) and the European Systemic Risk Board (ESRB) discussed in a report earlier this year high-level macroprudential policy options covering both the banking and non-bank

¹ See Chart 15 in "2022 climate risk stress test", ECB Banking Supervision, July 2022, available at: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.climate_stress_test_report.20220708~2e3cc0999f.en.pdf.

² The report also stresses that, in this short-term disorderly scenario, impairment losses are lower for mortgages than for the three types of corporate exposure analysed: secured by real estate within the scope of the Energy Performance Certificate (EPC), secured by real estate but outside the scope of the EPC and not secured by real estate.

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areas of the financial system, and considered a range of possible instruments that could be used to address wider climate risk.³ The report concluded that, while no macroprudential instruments appear readily available and fit for immediate purpose, some could be implemented with only limited adjustment. Other instruments could be developed by macroprudential authorities. One possible option would be borrower-based measures (BBMs), which place limits on individual borrowers' loan or debt amounts. BBMs are not harmonised by EU law and generally help mitigate macroprudential risks by ensuring minimum credit standards for new housing loans, for example. These measures could be developed and/or adjusted so that they could be applied to new mortgages to mitigate climate risks. The properties of these BBMs could reflect the extent to which mortgages are exposed to physical and transition risks in order to decrease households' overall vulnerability to these risks. For example, the maximum ratio between the loan amount and the value of the property used as collateral could be lowered when the property is in an area assessed as having high exposure to physical risks, such as extreme weather events.

The aforementioned ECB/ESRB report highlighted the potential drawbacks and unintended consequences of such measures, and more generally the interaction of macroprudential and public policies. These issues would need to be considered before any such measures could be put in place.

The issue you raise in your first question, namely the possible crowding out of the most vulnerable borrowers from the lending market, has been analysed by ECB staff in a similar context, albeit not for climate-related financial risks.⁴ In addition, cost-benefit frameworks are generally used to assess the effectiveness and potential consequences of BBMs⁵, comparing the benefit of risk mitigation with the cost of limiting credit and market access for more vulnerable borrowers. Such an analysis would need to be conducted in the context of addressing climate-related financial risks. The implications of positive incentives – such as public guarantee funds or discount rates – for loans for renovation would also need to be considered.

Finally, the ECB has been investigating how renovation loans could help reduce transition risk on banks' balance sheets, as you highlight in your third question. In a 2022 thematic review, ECB Banking Supervision observed how a small group of leading institutions has started to integrate climate-related risk metrics into collateral valuations, for instance, by taking into account the potential decrease in value of energy-inefficient houses⁶. Some banks reduce the rate of interest applied to mortgages over the course of their duration if the borrower upgrades the energy efficiency of the property, thereby acknowledging the relevance of energy

³ See "The macroprudential challenge of climate change", ESRB/ECB, Frankfurt am Main, July 2022, available at: https://www.esrb.europa.eu/pub/pdf/reports/esrb.ecb.climate_report202207~622b791878.en.pdf.

⁴ Georgescu and Vila Martin (2021) show a small negative welfare impact in terms of wealth inequality and a negligible impact on income inequality of BBMs. See Georgescu, O-M and Vila Martin, D., "Do macroprudential measures increase inequality? Evidence from the euro area household survey", *Working Paper Series*, ECB, Frankfurt am Main, June 2021, available at: <https://www.ecb.europa.eu/pub/pdf/scpwps/ecb.wp2567~92c5048dbb.en.pdf>.

⁵ See "The transmission and effectiveness of macroprudential policies for residential real estate", *Macroprudential Bulletin*, ECB, Frankfurt am Main, October 2022, available at: https://www.ecb.europa.eu/pub/financial-stability/macroprudential-bulletin/html/ecb.mpbu202210_3~b569204afa.en.html.

⁶ See "Walking the talk. Banks gearing up to manage risks from climate change and environmental degradation. Results of the 2022 thematic review on climate-related and environmental risks", ECB Banking Supervision, November 2022, available at: <https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.thematicreviewcerreport112022~2eb322a79c.en.pdf>.

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efficiency renovations as a risk mitigation tool.⁷ Furthermore, in the European Commission's proposal for the review of the Capital Requirements Regulation (CRR) of October 2021, an amendment was introduced to recognise that modifications that improve the energy efficiency of a building or housing unit should be considered as unequivocally increasing its value, thus acknowledging that energy efficiency renovations may mitigate transition risk. The ECB is of the view that improving energy efficiency and adapting to physical climate risks are crucial for the management of risks in banks' real estate lending.

As the ECB continues its work to identify and address the impact of climate change on the banking system and on financial stability, it will continue to publish key analytical and policy insights as they emerge. These will serve as inputs to discussions on how we can all contribute to tackling these profound challenges together.

Yours sincerely,

[signed]

Christine Lagarde

⁷ See "Good practices for climate-related and environmental risk management. Observations from the 2022 thematic review", ECB Banking Supervision, November 2022, available at: <https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.thematicreviewcercompendiumgoodpractices112022~b474fb8ed0.en.pdf>.

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