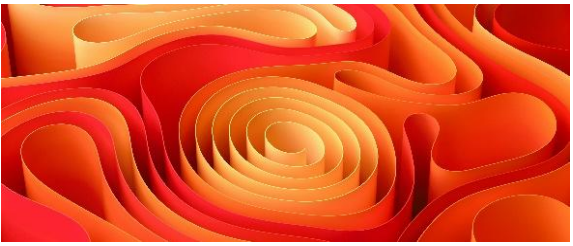
Pills

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TOPICS:

Climate risk

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ECB: Ensuring Resilience in the Face of Uncertainty

- The ECB's speech examines how financial institutions and supervisors should **strengthen risk management frameworks** to address growing uncertainty, particularly **climate and nature-related (C&N) risks**. It argues that **traditional, historically calibrated risk models are insufficient** to capture non-linear developments, interconnected shocks and potentially irreversible systemic changes.
- **Known Knowns: Measuring Identifiable Risks**. European banks have made substantial progress in identifying, quantifying and managing C&N risks through improved data, modelling and stress testing. However, significant vulnerabilities remain: Over 70% of significant banks' interest income continues to originate from carbon-intensive sectors; Risk assessments do not consistently cover all material portfolios, exposures and transmission channels; Historical data cannot adequately capture unprecedented environmental developments.
- **Known Unknowns: Strengthening Scenario Analysis**. Climate tipping points, compound physical events and ecosystem degradation create risks whose timing, magnitude and probabilities remain uncertain. The ECB emphasises that scenario analysis, particularly through the Network for Greening the Financial System (NGFS), should explore plausible adverse outcomes rather than predict future developments. However, existing models frequently underestimate feedback effects and extreme scenarios. Climate stress tests currently capture all bank-identified material risk drivers in only approximately 15% of cases. Banks should therefore expand scenario coverage, incorporate expert judgement and integrate findings into capital adequacy assessments and strategic decisions.
- **Unknown Unknowns: Building Institutional Resilience**. Radical uncertainty concerns developments whose potential outcomes and transmission mechanisms cannot yet be identified. The ECB advocates proactive resilience through adequate capital, liquidity, operational capacity and strategic flexibility. Additional priorities include strengthening underwriting, risk appetite frameworks, portfolio steering, insurance arrangements and prudential transition planning.
- **Broader Supervisory Implications**. The principles extend beyond environmental risks to geopolitical fragmentation, demographic shifts, artificial intelligence and quantum computing. These developments require forward-looking supervisory approaches, interdisciplinary cooperation and continuous reassessment of banks' business models.