



**TOPICS:**

ESG Risk

**SOURCE:**

European Central Bank

## ECB: Simplifying Climate Change Adaptation for Banks in the EU

- This paper analyses how effectively the EU prudential regulatory framework integrates **climate change adaptation**, particularly physical risk management, **into banking supervision and disclosure**. The paper establishes that climate change adaptation is **a legal obligation in the EU**, embedded within the EU Taxonomy and broader sustainability framework.
- From a **financial stability** perspective, **physical climate risks** - such as floods, droughts, and wildfires - pose increasing macroeconomic and banking sector risks. Evidence shows these risks reduce credit supply, affect borrower creditworthiness and can increase sovereign and bank risk exposures. Despite this, **adaptation financing remains underdeveloped relative to mitigation**, creating a gap in resilience-building.
- The analysis focuses on EU **Level 3 prudential regulation**, particularly EBA guidelines and ECB supervisory expectations. While current rules require banks to incorporate ESG risks into governance, stress testing and capital assessment processes, **adaptation is not consistently embedded**.
- **Key deficiencies** include: a) Limited integration of physical risks into **stress testing and scenario analysis**, with inconsistent modelling approaches across institutions; b) **Transition plans** that insufficiently address physical hazards, exposure and vulnerability and rarely include explicit adaptation targets; c) Lack of recognition of **adaptation measures as risk mitigants**, particularly in loss-given-default (LGD) modelling.
- Regarding **transparency, Pillar III disclosure requirements** aim to enhance market discipline but remain incomplete. Current frameworks focus mainly on exposure metrics, with insufficient attention to **vulnerability and adaptation capacity** and apply proportionality rules that may exclude smaller yet highly exposed institutions.
- The paper concludes that a **holistic and harmonised approach** is required. This includes aligning climate scenarios across the EU, integrating adaptation into stress testing and transition planning and enhancing disclosures to reflect both exposure and vulnerability. Strengthening the EU Taxonomy's treatment of adaptation would further support the development of financial instruments and improve banks' capacity to manage physical climate risks effectively.

