7 July 2022

Dear Finance Ministers, Members of the Economic and Monetary Affairs Committee of the European Parliament, Dear Financial Counsellors and Attachés of the Council of the EU,

We are writing to you on behalf of the above signatories **to call for** the adoption of a holistic set of rules to ensure banks and insurers identify, manage and mitigate climate-related financial risks. **Mandatory transition plans and targets should be part of the requirements and should be integrated into bank and insurance risk management processes, governance and subject to supervisory scrutiny**. Recognising the many voluntary initiatives and efforts made by financial institutions to manage their transition risks and impacts on climate, regulators should ensure accountability, as well as robustness and comparability of the reported efforts and progress made. Transition plans should be **complemented by robust capital requirements** to cover potential future losses, in particular resulting from the financing of fossil fuels.

The requirements should be **included in amendments** to the **Solvency II Directive, Capital Requirements Regulation and Capital Requirements Directive**, as part of their ongoing reviews.

Financial institutions have an important role to play in supporting transition by channelling financing to transformative and sustainable activities. With its risk-based approach, the EU prudential regulatory framework for financial institutions needs targeted upgrades to ensure climate-related financial risks are dealt with, also in the medium and long term, preventing a bail-out using public budgets. By integrating requirements for transition-planning and the related stewardship role, financial institutions can both mitigate risks and play a role of channelling financing at the same time.

The time to act is now

Climate change is causing enormous damage from catastrophic events, which trigger environmental degradation, biodiversity loss, food insecurity, conflicts, mass displacement and migration. This has an increasingly destabilising impact on our economies and financial system.

The longer the European Union waits, the higher the chances are that it will also face **a financial crisis induced by the climate crisis** - either due to extreme weather events disrupting the economy or due to an abrupt and disorderly transition. We cannot afford **another financial crisis on top of the other challenges** we are already facing - a climate crisis, recovery from the economic hit from the Covid-19 pandemic, an increasing debt crisis in developing countries, the Russian war in Ukraine and related inflation.

Someone will have to **pay the cost - and policymakers get to decide whether the size of it is manageable or overwhelming**. As it stands, this cost looks like it will be on public budgets and taxpayers, as the financial sector is successfully delaying the inevitable transition to a more sustainable economy and building up of adequate capital buffers to absorb upcoming losses. Billions of dollars in profit have been spent by financial institutions on dividends and share buy backs rather than on engaging with their clients, transitioning business models and financing a just energy transition.

Mandatory transition plans to manage transition risks

Transition plans can and should be used as a risk management tool[1] provided that transparency, comparability and robustness of these plans is ensured. Supervised stewardship and engagement implemented as part of the transition plans will help reduce the exposure of individual banks and insurers to **transition risk** by **reducing their exposure to stranding of certain assets**. This will also help reduce the negative environmental impact of unabated climate change and therefore, contribute to addressing the systemic risk of disruption. Divestment or withdrawal of financing or insurance coverage is an option for banks and insurers, but would only eliminate individual institutions' transition risk, not necessarily systemic risk, as financing could migrate to entities[2] that are currently less regulated.

We need mandatory sustainability targets that deliver, as voluntary initiatives alone have been proven ineffective. These targets must be aligned with the EU commitments, in particular on climate neutrality, and supported by implementing transition plans that are supervised by the EU and national competent authorities. Financial institutions should put in place appropriate **governance structures** and ensure **involvement of directors**. The Solvency II Directive, Capital Requirements Regulation and Capital Requirements Directive should be amended to incorporate these requirements and ensure that financial institutions manage their risks, deliver on their sustainability targets and take on their stewardship role with clients, which creates the **win-win scenario** of effectively managing risk and contributing to the orderly transition to a sustainable economy. Prudential rules should leverage on and be coherent with obligations of the EU **Corporate Sustainability Reporting Directive** and **Corporate Sustainability Due Diligence Directive**.

Capital requirements to cover future losses

EU prudential regulation should be internally coherent in addressing climate-related financial risks. This means that capital requirements should reflect these risks, where

1 PRA *Climate Change Adaptation report* 2021, 28 October 2021

2 Finance Watch, "*The problem lies in the net: How finance can contribute to making the world reach its greenhouse gas net-zero target*", June 2022.

evidence is clear. Since climate-related risks are forward-looking, non-linear and highly uncertain, academic experts, regulators, supervisors and financial institutions alike recognise that measuring these risks with any degree of precision is currently out of reach. **By the time historical data is available, it will be too late**. Financial institutions will have to deal with major climate-related losses facilitated, among others, by their own activities.

Given this context, EU policy-makers should not use the undoubtedly useful exploratory analysis undertaken by supervisors as an excuse to delay regulatory action on climate risk. Climate scenario analyses remain subject to significant constraints and limitations and a lot of work still needs to be done for these to deliver comprehensive conclusions[3]. **In the meantime, legislative amendments are needed to adjust the treatment of fossil fuel exposures, as a starting point to addressing climate-related financial risks**[4]. Transition and physical risks associated with these specific exposures are clearly identifiable - the risks of stranding in particular have been quantified in academic research. Work must continue to identify other sectors and activities that are particularly exposed to climate-related financial risks, including in the upcoming EIOPA and EBA reports on prudential capital requirements.

You will find attached to this letter supporting analysis and publications that make the case for upgrading the existing rules.

If you seek to take action with us, please do not hesitate to get in contact should you wish to discuss the issues further.

Kind regards,

Bank Track
Bürgerbewegung Finanzwende
E3G
Facing Finance
Fair Finance International
Fair Finance Sweden
Finance Watch
Frank Bold
International Service for Human Rights
Milieudefensie
Reclaim Finance
ShareAction
Urgewald
WWF European Policy Office

3 See for example: N.Stern, J. Stiglitz, C. Taylor,. *The Economics of Immense Risk, Urgent Action and Radical Change: Towards New Approaches to the Economics of Climate Change*, February 2022; "N.A. Ranger, O. Mahul, I. Monasterolo, *Assessing Financial Risks from Physical Climate Shocks : A Framework for Scenario Generation*, February 2022.

4 Finance Watch, "*Breaking the climate finance doom loop*", June 2020; Finance Watch, "*Insuring the Uninsurable*", July 2021; Finance Watch, A silver bullet against green swans, November 2021.

Annex - List of supporting analysis and publications

Finance Watch, "*Breaking the climate finance doom loop*", June 2020;

Finance Watch, "*Insuring the Uninsurable*", July 2021;

Finance Watch, A silver bullet against green swans, November 2021.

Finance Watch, "*The problem lies in the net: How finance can contribute to making the world reach its greenhouse gas net-zero target*", June 2022

ShareAction, *Going Beyond Insurers' Voluntary Initiatives*, June 2022

ShareAction, *Oil & gas expansion A lose-lose bet for banks and their investors*, February 2022 (press release '*Net zero' banks continue to finance oil & gas expansion, ignoring climate science*)

ShareAction, *Insuring Disaster: How the EU can improve the insurance framework Solvency II*, August 2021

ShareAction, *Countdown to COP26: An analysis of the climate and biodiversity practices of Europe's largest banks*, September 2021 (press release *New research puts big banks' sustainability claims in doubt*)