Ms Ursula von der Leyen
President of the European Commission
European Commission
Rue de la Loi / Wetstraat 200
1049 Brussels

Letter also sent to:

Valdis Dombrovskis, European Commission Executive Vice-President,
Mairead McGuinness, Commissioner for Financial Services, Financial Stability and Capital Markets Union,
João Leão, Chair of the ECOFIN Council,
Irene Tinagli, Chair of the European Parliament ECON Committee.

Brussels, 4th May 2021

Subject: Prudential regulation needs an upgrade of capital requirements to break the climate-finance doom loop

Dear President von der Leyen,

Climate change presents the most pressing challenge of our time as we are faced with a global crisis that impacts society and economic life at every level.

In a "tragedy of the horizons" context, financial institutions must transition swiftly to a sustainable model given their essential role in a functioning economy. Yet, financial institutions feed a vicious circle, enabling climate change by financing fossil fuel related activities despite the now universal recognition that climate change poses a major threat to financial stability.

We must address this climate-finance doom loop urgently: we cannot afford another financial crisis while we are fighting a climate crisis and recovering from the economic hit from the current pandemic. The potential cost of delaying action grows every day: the longer the European Union waits, the higher the chances mount that it will face a financial crisis induced by the climate crisis. Time is running short, as 10 to 15 years remain before the planet's carbon budget is exhausted. People should not have to live with the threat of another financial sector bail-out.

With its risk-based approach, the EU prudential regulatory framework for financial institutions only needs to amend the capital requirements applied to fossil fuel exposures. This can be done by aligning them with basic risk management principles and ensuring that the Capital Requirements Regulation (CRR) and Solvency II (SII) are internally coherent, i.e. treat comparable risks in a comparable manner, which proves not the case today for fossil fuel exposures.

Financial institutions face a formidable trio of climate change-related risk types: physical, transition and disruption – the most significant among them. Like the other two, disruption risk, i.e. the risk that the economy and, subsequently, the financial system face disruption due to climate change, cannot be assessed based on historical data given its forward-looking nature and utter uncertainty of its materialisation. The only certainty is that it will hamper the functioning of our society and economy. The financial system will inevitably be destabilised, a scenario similar to what happened during the current Covid-19 crisis, only compounded given the much bigger impact of climate change on humankind.

At supervisory level, scenario-based analyses conducted so far to test the resilience of financial institutions to climate change ignore disruption risk. Instead, supervisors rely on less-weighty transition risk and barely consider physical risk. Importantly, none of those exercises lead to an evaluation of possible capital shortfalls of financial institutions. This is due to the impossibility, recognised by all participating parties – banks, insurance companies and supervisors alike – to measure with any degree of precision what is fundamentally a radically uncertain situation. If the direction of travel appears certain, its measurement is, and will remain, an illusion until it becomes too late[1].

Given this context, EU policy-makers should not use the analysis work undertaken by supervisors as an excuse to delay action. The imminent reviews of the Capital Requirements Regulation (CRR) and Solvency II (SII) give them the chance to break the climate-finance doom loop. You will find attached to this letter the amendment proposals that, in our view, would enable you to reach that objective. As you will notice, they constitute a simple evolution, and by no means a revolution, of existing rules.

Finance Watch's approach to this subject[2] garners broad-based support. It has been recognised by a panel of 50 banks, NGOs, academics, regulators and investors from the United States, Canada, European Union and United Kingdom as the top-ranked policy proposal at the nexus of finance and climate change. In a report published on 13 April[3], the international panel coordinated by the Climate Safe Lending Network in partnership with UNEP FI, identified the proposal by Finance Watch as the most impactful feasible solution to tackle the link between climate change and financial instability.

Given your mandate under Article 191 TFEU to combat climate change and take preventive action in the case of risk, we urge you to act now and bring a now-internationally recognised solution to a problem threatening our society.

We look forward to your coming action and remain at your disposal should you wish to discuss the issue further.

Best regards,

Benoît Lallemand
Secretary General

Thierry Philipponnat
Head of Research and Advocacy

Attached: Amendments proposal from Finance Watch to the Capital Requirements Regulation (CRR) and Solvency II (SII).

1 The green swan, BIS, January 2020

2 Breaking the climate-finance doom loop, Finance Watch, June 2020

3 Financial Stability in a Planetary Emergency, Climate Safe Lending Network, April 2021