# Navigating the permacrisis: The role of financial institutions in addressing climate challenges



The world is increasingly grappling with a phenomenon described as a 'permacrisis', where multiple crises, including climate change, political instability, and unprecedented disasters, converge and exacerbate each other. This trend is evidenced by devastating natural events such as the recent wildfires in California, which underscore the urgent need for comprehensive policy solutions to address climate-related challenges.

Recent discussions at the Green Swan 2024 conference have highlighted the significant risks climate change poses to financial markets, with experts suggesting that the financial sector is largely ill-prepared for the potential fallout. The European Union (EU) has endeavoured to implement pioneering financial legislation aimed at mitigating these risks. However, concerns remain about the capability of the European Central Bank (ECB) to navigate what the Bank of International Settlements has characterised as the ‘green swan’, involving a financial crisis that could arise from a sudden shift away from fossil fuels.

The EU's ambitious targets, as prescribed by the European Climate Law, stipulate that the region must achieve net-zero greenhouse gas emissions by 2050. Achieving this goal necessitates significant transformations across all sectors of the EU economy, including those that financial institutions support. Experts caution that this transition could lead to financial instability, with potential losses amounting to approximately 19% of global GDP by 2050 if proactive measures are not taken. Conversely, successfully limiting global warming to 2°C could mitigate this figure to a mere sixth of the anticipated total.

To maintain financial stability amid these sweeping changes, central banks face challenging decisions that could involve trade-offs such as stunted growth, increased inflation, or rising unemployment. Research presented at the conference delineates how cutting carbon emissions may initially lead to productivity losses and a complicated reorganisation of production processes, further complicating the roles of central banks in managing inflation and unemployment rates. In this context, tighter monetary policies may inadvertently hinder innovation within the green sector.

Further measures have been proposed to bolster green investments through targeted credit policies and subsidies, which may help to balance inflation management while fostering a successful transition. However, experts argue these measures may be insufficient to avert a financial crisis. The successful execution of the EU’s Green Deal, aimed at steering the continent towards sustainability, may require even more unorthodox policy interventions.

A 2024 ECB report has raised alarms about the climate risks embedded in European banks' portfolios, particularly concerning assets associated with fossil fuels. The ECB survey revealed that a considerable proportion of euro area loans diverged significantly from the objectives set in the Paris Agreement. A recent stress test conducted by the ECB indicated that while the financial system could remain intact under optimistic scenarios, uncertainties could lead to significant losses.

In scenarios worse than the baseline, such as a 'run on brown'—a sudden withdrawal of investments in environmentally unfriendly companies amid an economic downturn—the repercussions could mirror those experienced during the last financial crisis. Experts warn that it would only take a triggering event to unleash a contagion that jeopardises the entire financial system.

In light of these challenges, the discourse surrounding potential regulatory responses has intensified. Suggestions have included the establishment of a 'climate bad bank', a public-private partnership designed to acquire and wind down non-performing fossil fuel assets and redirect investments towards sustainable industries. Drawing from historical precedents, bad banks have previously been utilised in Europe to shield financial systems from toxic assets, and a climate-focused iteration aims to address imminent transition risks while supporting decarbonisation efforts.

Creating such a bank would necessitate collaboration between public entities, like the European Investment Bank and the European Stability Mechanism, and private investors, given that the scale of investment required for a successful transition significantly exceeds what the public sector can provide alone. Establishing a well-structured partnership could help ensure an orderly transition away from fossil fuels while recycling capital into promising green sectors.

The success of climate initiatives hinges on substantial investment, making the establishment of a climate bad bank a potential solution that could navigate the complexities of the transition. However, the political will to adopt such measures remains a critical factor in determining the path forward in addressing climate challenges effectively.

Source: [Noah Wire Services](https://www.noahwire.com)

## References

* <https://www.eea.europa.eu/publications/european-climate-law> - This URL supports the claim about the European Union's ambitious targets to achieve net-zero greenhouse gas emissions by 2050, as stipulated by the European Climate Law. It provides details on the EU's climate goals and strategies for achieving them.
* <https://www.bankofengland.co.uk/-/media/boe/files/speech/2023/financial-stability-and-climate-change.pdf> - This URL corroborates the discussion on financial risks associated with climate change and the need for central banks to manage these risks effectively. It highlights the challenges faced by financial institutions in addressing climate-related financial stability issues.
* <https://www.ecb.europa.eu/pub/pdf/other/ecb.climatechangeandbanking2024~b0a3c0a3c9.en.pdf> - This URL supports the information about the European Central Bank's concerns regarding climate risks in European banks' portfolios. It provides insights into the ECB's assessments and stress tests related to climate-related financial risks.
* <https://www.bis.org/publ/qtrpdf/r_qt2309.htm> - This URL from the Bank of International Settlements discusses the concept of a 'green swan' event, which refers to a sudden shift away from fossil fuels potentially leading to a financial crisis. It aligns with the article's mention of the 'green swan' as a risk factor in financial markets.
* <https://www.eib.org/en/press/all/2023-12-eib-group-climate-action-plan> - This URL supports the discussion on the role of public entities like the European Investment Bank in supporting climate initiatives and green investments. It highlights the EIB's commitment to climate action and sustainable development.