Ceres Ceres Accelerator for Sustainable Capital Markets

February 10, 2022

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland
baselcommittee@bis.org
Via File Upload

Re: Public consultation on Principles for the Effective Management and Supervision of Climate-related Financial Risks

Dear Basel Committee on Banking Supervision,

It is a pleasure to submit comments on behalf of Ceres and the Ceres Accelerator for Sustainable Capital Markets. Ceres is a nonprofit organization with over 30-years of working on climate change. The Accelerator works to transform the practices and policies that govern capital markets in order to reduce the worst financial impacts of the climate crisis. It spurs capital market influencers to act on climate change as a systemic financial risk—driving the large-scale behavior and systems change needed to achieve a just and sustainable future and a net-zero emissions economy.

Ceres works with leading global investors and companies. Our Investor Network is currently 217 investors that collectively manage over $49 trillion in assets. Ceres is a founding partner of the Net Zero Asset Managers Initiative and the Paris Aligned Investor Initiative, which includes investors focused on sustainable investments within their portfolios and other assets. Our Company Network includes approximately 60 of the largest global companies with whom we work on an in-depth basis on climate strategy and disclosure, among other issues.

We congratulate the Bank for International Settlements (BIS) and the Basel Committee on Banking Supervision (BCBS) for its fine work in enhancing international financial stability and for acting as the primary global standard setter for the prudential regulation of banks and for providing an effective forum for cooperation on banking supervisory matters. We also agree with the BCBS that the climate-related financial risks to the global banking system are only growing and that a set of internationally recognized principles are urgently required.

Below we provide our comments on your specific questions related to the proposed principles:

Q1. Has the Committee appropriately captured the necessary requirements for the effective management of climate-related financial risks and the related supervision? Are there any aspects that the Committee could consider further or that would benefit from additional guidance from the Committee?

- We applaud that the BCBS is now examining the extent to which climate-related financial risks can be addressed within the Basel Framework.

- Climate change risk permeates all aspects of the capital markets, much like cyber security risks and the coronavirus pandemic, posing grave threats to banks of all sizes and business models. We agree that many of the current regulatory tools available to international banking supervisors, including the Basel Framework, are flexible enough

- to accommodate and address both existing and emerging risks to the banking system, such as the transition and physical risks associated with climate change.

- Although your current consultation seeks to promote a principles-based approach to improving risk management and supervisory practices related to climate-related financial risk, we would encourage BCBS to also consider using a prescriptive approach (in addition to the principles) for certain of its proposed guidelines. We believe including a mix of both principles-based and prescriptive guidelines would still achieve BCBS's goal of providing a common baseline for internationally active banks and supervisors, while maintaining sufficient flexibility to account for evolving practices and accommodate a diverse range of banking systems.

- For example, among others, it would be reasonable to mandate compliance by banks and supervisors with Principle 1 ("understanding and assessing the potential impact of climate-related risk drivers"), Guideline 31 ("Banks should develop qualitative or quantitative metrics or indicators to assess, monitor, and report climate-related financial risks") and Principle 14 ("Supervisors should determine that banks can adequately identify, monitor and manage all material climate-related financial risks as part of their assessments of banks' risk appetite and risk management frameworks").

Q2. Do you have any comments on the individual principles and supporting commentary?

<u>Principle 1:</u> Banks should develop and implement a sound process for understanding and assessing the potential impact of climate-related risk drivers on their businesses and on the environments in which they operate. Banks should consider material climate-related financial risks that could manifest over various time horizons and incorporate these risks into their overall business strategies and risk management frameworks. [Reference principles: BCP 14, SRP 30, Corporate governance principles for banks]

- We support this principle.

- Ceres has published two recent reports on climate-related financial risks for banks—one on Transition Risk[1] and another on Physical Risk[2]—and we also recommend that banks immediately develop the capability to conduct stress-testing of their loan portfolios for climate risk. Without a formalized stress testing and / or scenario analysis regime, banks are likely running a higher quantum of enterprise risk (including climate risk factors) than they are aware of.

- Furthermore, we agree with the recent comments from U.S. Acting Comptroller Michael J. Hsu of the Office of the Comptroller of the Currency (OCC), that senior management and board involvement in all relevant stages of developing and implementing a sound process for understanding and assessing the potential impact of climate-related risk drivers is vitally important[3].

[1] Bateson, B. & Saccardi, D. (2020, October 19). Financing a Net-Zero Economy: Measuring and Addressing Climate Risk for Banks. *Ceres*. Retrieved from https://www.ceres.org/sites/default/files/reports/2020-10/Ceres%20Bank%20Risk%20Report%202020%20FINAL.pdf

[2] Bateson, B. & Saccardi, D. (2021, September 21). Financing a Net-Zero Economy: The Consequences of Physical Climate Risk for Banks. *Ceres*. Retrieved from https://www.ceres.org/sites/default/files/reports/2021-09/Ceres%20Financing%20a%20Net%20Zero%20Economy%20FINAL.pdf

[3] Hsu, Michael J. (2021, November 8). Five Climate Questions Every Bank Board Should Ask Retrieved from https://www.occ.gov/news-issuances/speeches/2021/pub-speech-2021-116.pdf?source=email

- Finally, as per our comment in Q1 above, we would recommend that BCBS consider making this guideline a requirement for international banks, and not a voluntary best practice.

Principle 2: The board and senior management should clearly assign climate-related responsibilities to members and committees and exercise effective oversight of climate-related financial risks. The board and senior management should identify responsibilities for climate-related risk management throughout the organizational structure. [Reference principles: BCP 14, SRP 30, Corporate governance principles for banks]

- We support this principle.

- In addition to clearly assigning climate-related responsibilities, Ceres also recommends that bank board members and senior management are selected from an inclusive pool of candidates reflecting the diversity of the communities that the financial institutions serve and that they have proven climate risk management competence and experience.

- To ensure that board members have access to climate and ESG training, and in support of principle 2, Ceres has partnered with Berkeley Law school to offer an online training program which pinpoints how corporate board members can embed ESG into their oversight role. We encourage all bank board of director members to participate in appropriate continuing education on these vital issues.

- Moreover, we are supportive of guideline 12 ("Banks should take material physical and transition risk drivers into consideration when developing and implementing their business strategies"). Ceres goes further in suggesting that banks should publicly disclose the material physical and transition risks they identify under this guideline, using the TCFD framework.

Principle 3: Banks should adopt appropriate policies, procedures and controls to be implemented across the entire organization to ensure effective management of climate-related financial risks. [Reference principles: BCP 14, SRP 30, Corporate governance principles for banks]

- We support this principle and the language contained in guideline 16. Furthermore, with reference to "...client onboarding and transaction assessment", Ceres recommends that banks factor the climate change-related transition, physical and reputational risks of their borrowers into capital, loan pricing and credit allocation decisions. We note that some international banks have already indicated support for this position. For example, in December 2021 Citi CEO Jane Fraser stated that Citi will start asking it's clients to measure emissions and that a borrower's climate impact will factor into lending and capital allocation decisions.

Principle 4: Banks should incorporate climate-related financial risks into their internal control frameworks across the three lines of defense to ensure sound, comprehensive and effective identification, measurement and mitigation of material climate-related financial risks. [Reference principles: BCP 26, SRP 20, SRP 30]

- We support this principle.

- We would like to add that banks will need to ensure that educational resources are made available to bank staff in order to ensure that material climate-related financial risks are embedded in policies, processes and controls across all relevant functions and business units.

Principle 5: Banks should identify and quantify climate-related financial risks and incorporate those assessed as material over relevant time horizons into their internal capital and liquidity adequacy assessment processes. [Reference principles: BCP 15, BCP 24, SRP 20, SRP 30]

- We support this principle.

- In our two recent reports on climate-related financial risks for banks (Transition Risk and Physical Risk reports) we make similar recommendations and believe that a climate stress testing regime should lead to adjustments to liquidity and capital adequacy assessment processes. In 2021, Ceres also provided testimony to the United States House of Representatives on the importance of climate stress tests as part of an effective bank capital adequacy regime.

- Additionally, as part of identifying and quantifying climate-related financial risks, Ceres believes that international banks should establish and disclose net zero plans which describe in detail how they plan to decarbonize their business activities and achieve net zero by no later than 2050. Furthermore, international banks should set interim decarbonization goals (for example, 2030 goals) and provide regular updates towards achieving them. Finally, all interim goals and 2050 net zero commitments should incorporate science-based targets, use credible climate scenarios and disclose decarbonization progress on a sector-by-sector basis.

Principle 6: Banks should identify, monitor and manage all climate-related financial risks that could materially impair their financial condition, including their capital resources and liquidity positions. Banks should ensure that their risk appetite and risk management frameworks consider all material climate-related financial risks to which they are exposed and establish a reliable approach to identifying, measuring, monitoring and managing those risks. [Reference principles: BCP 15, SRP 30]

- We support this principle.

- Furthermore, consistent with the U.S. Treasury Department's Financial Stability Oversight Council (FSOC) *Report on Climate-Related Financial Risk*, Ceres believes that consistent with "identifying, measuring, monitoring and managing those risks", banks should work with their clients to facilitate and enhance the provision of climate-related disclosures. Such borrower-level disclosures give banks, investors and market participants the climate-relevant information they need to make informed decisions. Not only will closing these data gaps help regulators and financial institutions better assess and manage climate-related risks, but we cannot see how they could satisfy principle 6 without such information.

- Finally, Ceres goes further than the FSOC report and would recommend that banks obtain scope 1, 2 and 3 emissions data from its borrowing clients as part of the process of properly identifying, measuring, monitoring and managing climate-relevant risks.

Principle 7: Risk data aggregation capabilities and internal risk reporting practices should account for climate-related financial risks. Banks should seek to ensure that their internal reporting systems are capable of monitoring material climate-related financial risks and producing timely information to ensure effective board and senior management decision-making. [Reference principles: BCP 15, SRP 30, Principles for effective risk data aggregation and risk reporting]

- We support this principle, as well as guidelines 28, 29, 30 and 31.

- In our two recent reports on climate-related financial risks for banks (Transition Risk and Physical Risk reports) we also recommend that banks must engage with their borrowing clients to obtain climate relevant data and close data gaps. Additionally, banks should update Know Your Customer (KYC) and onboarding processes and documentation to ensure the provision of all such borrower data in support of timely climate risk assessments. Finally, we recommend the use of the TCFD framework by borrowers and banks alike to ensure that public disclosure of climate relevant information is comparable across industries and geographies.

Principle 8: Banks should understand the impact of climate-related risk drivers on their credit risk profiles and ensure credit risk management systems and processes consider material climate-related financial risks. [Reference principles: BCP 17, BCP 19, SRP 20, Principles for the management of credit risk]

- We support this principle.

- Regarding guideline 33 (" Banks should also identify, measure, evaluate, monitor, report and manage the concentrations within and between risk types associated with climate-related financial risk... and monitor concentration of exposure to geographies and sectors with higher climate-related risk"), Ceres believes that it is important that international banks do so on a sector by sector basis, with consideration given to the unique transition risks (including legal and reputational) and physical risks inherent in each industry sector and client vertical.

- Regarding guideline 34 ("Banks should consider a range of risk mitigation options to control or minimize material climate-related credit risks"), in addition to the alternatives identified to reduce material climate-related credit risks, such as "adjusting credit underwriting criteria, deploying targeted client engagement, or imposing loan limitations or restrictions such as shorter-tenor lending, lower loan-to-value limits or discounted asset valuations", we would suggest that banks also consider complete withdrawal of lending activity from certain high GHG-emitting sectors as an additional risk mitigation option.

- Furthermore, when considering the use of carbon offset credits (or other similar carbon trading schemes) as part of risk mitigation strategies, Ceres recommends that the primary focus of banks should be on "absolute GHG reductions" through client engagement as opposed to "net GHG reductions" via financial engineering. As such GHG offset strategies should be used sparingly and only as a last resort. Ceres has produced a report, The Role of Natural Climate Solutions in Corporate Climate Commitments: A Brief for Investors to help banks and other end-users understand best practices when using this risk mitigation tool.

Principle 9: Banks should understand the impact of climate-related risk drivers on their market risk positions and ensure that market risk management systems and processes consider material climate-related financial risks. [Reference principles: BCP 22]

- We support this principle.

- Regarding guidelines 35, 36 and 37 we agree that "analysis of a sudden shock scenario could serve as a useful tool for better understanding and assessing the relevance of climate-related financial risks to a bank's trading book". We would go further and suggest that this shock scenario should not only consider mark-to-market losses but the absence of liquidity as well. Banks must develop the ability to assess if climate-related transition and physical risks will cause certain trading book assets to become "stranded". If so, banks should develop a plan to unwind such assets now, or set aside more capital against these potential "stranded assets".

<u>Principle 10:</u> Banks should understand the impact of climate-related risk drivers on their liquidity risk profiles and ensure that liquidity risk management systems and processes consider material climate-related financial risks. [Reference principles: BCP 24, Principles for sound liquidity risk management and supervision]

- We support this principle.

<u>Principle 11:</u> Banks should understand the impact of climate-related risk drivers on their operational risk and ensure that risk management systems and processes consider material climate-related risks. Banks should also understand the impact of climate-related risk drivers on other risks and put in place adequate measures to account for these risks where material. This includes climate-related risk drivers that might lead to increasing strategic, reputational, and regulatory compliance risk, as well as liability costs associated with climate-sensitive investments and businesses. [Reference principles: BCP 25, Principles for the sound management of operational risk, Principles for operational resilience, SRP 20, SRP 30]

- We support this principle.

- With regards to "climate-related risk drivers that might lead to increasing strategic, reputational, and regulatory compliance risk", banks should consider enhancing their internal monitoring and compliance surveillance system to account for greenwashing activity, especially in relation to the provision of products and services to bank clients.

- Ceres also recommends that banks involved in the trading of non-renewable commodities (including physical energy commodities and physical energy commodity derivatives) be required to disclose the impact of climate-related risk drivers on their operational risk around these products and services.

<u>Principle 12:</u> Where appropriate, banks should make use of scenario analysis, including stress testing, to assess the resilience of their business models and strategies to a range of plausible climate-related pathways and determine the impact of climate-related risk drivers on their overall risk profile. These analyses should consider physical and transition risks as drivers of credit, market, operational and liquidity risks over a range of relevant time horizons. [Reference principles: BCP 15, Stress testing principles]

- We support this principle.

- Ceres recommends that banks immediately develop the capability to conduct stress-testing of their loan portfolios for climate risk. Without a formalized stress testing and / or scenario analysis regime, banks are likely running a higher quantum of enterprise risk (including climate risk factors) than they are aware of.

- Additionally, as per our comment in Q1 above, Ceres recommends that BCBS consider making this guideline a requirement for international banks in the near future, and not a voluntary best practice.

- With regards to guideline 45 ("The field of climate scenario analysis is highly dynamic, and practices are expected to evolve rapidly, especially as climate science advances. Climate scenario models, frameworks and results should be subject to challenge and regular review by a range of internal and/or external experts and independent functions"), banks should be encouraged and incentivized to actively contribute to the development of this body of knowledge and the sharing of best practices and climate-relevant data, as appropriate.

Principle 13: Supervisors should determine that banks' incorporation of material climate-related financial risks into their business strategies, corporate governance and internal control frameworks is sound and comprehensive. [Reference principles: BCP 9, BCP 14, BCP 26, SRP 20]

- Ceres appreciates BCBS' focus on banks and bank supervisors as both have important roles to play in climate risk management. We support this principle, as well as guidelines 46, 47, 48 and 50.

- Additionally, in order to show leadership and convey credibility to the banks they supervise, Ceres recommends that bank supervisory organizations publicly declare that climate risk is a systemic risk to their financial system. (As you are no doubt aware, several central banks have already done so). We also recommend that all supervisors conduct and disseminate research, consult with other peer supervisors, academics and NGO climate risk specialists in order to enhance and expand their understanding of bank climate risk management. We believe that BCBS inclusion of some or all of these recommendations as guidelines or principles would enhance systemic safety and soundness around climate-related financial risks.

Principle 14: Supervisors should determine that banks can adequately identify, monitor and manage all material climate-related financial risks as part of their assessments of banks' risk appetite and risk management frameworks. [Reference principles: BCP 15, SRP 20, SRP 30]

- We support this principle, as well as guidelines 51 and 52.

- Additionally, as per our comment in Q1 above, we would recommend that BCBS consider making this principle a requirement for bank supervisors, and not a voluntary best practice. Furthermore, bank regulators should consider requiring banks, as noted earlier, to engage in supervisory climate stress testing and scenario analysis and that eventually the results of such exercises should be reflected in bank regulatory capital adequacy regimes.

Principle 15: Supervisors should determine that banks comprehensively identify and assess the impact of climate-related risk drivers on their risk profile and ensure that material climate-related financial risks are adequately considered in their management of credit, market, liquidity, operational, and other types of risk. Supervisors should determine that, where appropriate, banks apply climate scenario analysis. [Reference principles: BCP 17–25, Principles for sound liquidity risk management and supervision, Principles for the sound management of operational risk, Principles for operational resilience]

- We support this principle, as well as guidelines 53 and 54.

- Additionally, as per our comment in Q1 above, we would recommend that BCBS consider making this principle, along with guidelines 53 and 54, a requirement for bank supervisors, and not a voluntary best practice.

- Moreover, supervisors should incorporate climate-related risk drivers into existing bank supervisory frameworks (such as the CAMELS, RFI, LFI, RAS, and ROCA frameworks used by banking regulators in the United States).

Principle 16: In conducting supervisory assessments of supervised banks' management of climate-related financial risks, supervisors should utilize an appropriate range of techniques and tools and adopt adequate follow-up measures in case of material misalignment with supervisory expectations. [Reference principles: BCP 8, BCP 9, SRP 10, SRP 20]

- We support this principle, as well as guidelines 55 and 56.

Principle 17: Supervisors should ensure that they have adequate resources and capacity to effectively assess supervised banks' management of climate-related financial risks. [Reference principles: BCP 9]

- We support this principle, as well as guidelines 57, 58 and 59.

Principle 18: Supervisors should consider using climate-related risk scenario analysis, including stress testing, to identify relevant risk factors, size portfolio exposures, identify data gaps and inform the adequacy of risk management approaches. Where appropriate, supervisors should consider disclosing the findings of these exercises. [Reference principles: Stress testing principles]

- We support this principle.

- With regards to guidelines 62, bank regulators should be able to exhibit proven climate risk management competence and experience. The work of the Network for Greening the Financial System (NGFS) has been very helpful in sharing best practices across geographies. Ceres requests that BCBS encourage supervisors to support and collaborate with the NGFS. We also urge the BCBS to reference their work in the final version of the Principles for the Effective Management and Supervision of Climate-related Financial Risks.

- With regards to guidelines 63 and 64, while we agree with the statements regarding the current limitations and uncertainty around certain supervisory tools ("supervisors should recognize the limitations of their analyses when communicating their results or using them in supervisory assessment", "supervisors should take into account the level of uncertainty associated with scenarios when determining whether to disclose results"), we would caution against including language that could be interpreted as an excuse for inaction or delay. Uncertainty and data gaps are not excuses for inaction. To paraphrase Winston Churchill, banks and bank supervisors should not allow the pursuit of perfection to interfere with needed progress, when it comes to the monitoring and mitigation of climate-related financial risks.

Q3. How could the transmission of environmental risks to banks' risk profiles be taken into account when considering the potential application of these principles to broader environmental risks in the future? Which key aspects should be considered?

- We believe that the uniform adoption of these proposed BCBS principles would provide banks and international banking supervisors with sufficient tools to begin addressing the existing and emerging environmental risks to the banking system.

- The international regulatory regime has proven itself to be robust and flexible enough to meet the challenge of many recent perils. For example, through necessity and quick action, banks and regulators have been able to successfully navigate new threats to safety and soundness such as cyber security and the coronavirus pandemic.

- Thus when considering which aspects of these (and future) principles are “key” to tackling climate risk and other environmental threats, we would recommend that in addition to the appropriate technical elements, the principles guiding the international banking system are imbued with a sense of urgency, innovation and common purpose.

Once again, we congratulate the Bank for International Settlements (BIS) and the Basel Committee on Banking Supervision (BCBS) for its fine work in developing these Principles for the Effective Management and Supervision of Climate-related Financial Risks. Your leadership on this critical issue is deeply valued. We would be pleased to discuss any questions you may have on our feedback. In addition to the undersigned, you may also contact our in-house banking experts Blair Bateson, CFA (bateson@ceres.org) and Jim Scott, CFA (jscott@ceres.org) at your convenience.

Sincerely,

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CEO and President	Managing Director
Ceres Inc.	Ceres Accelerator for Sustainable Capital Markets