ClientEarth

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ClientEarth Consultation Response

Basel Committee on Banking Supervision Consultative Document:

Principles for the effective management and supervision of climate-related financial risks

ClientEarth is a charity that uses the power of the law to protect people and the planet. We are international lawyers finding practical solutions for the world's biggest environmental challenges. From our offices in London, Brussels, Warsaw, Berlin, Madrid and Beijing, we work on laws throughout their lifetime, from the earliest stages to implementation and enforcement.

1 Feedback

ClientEarth welcomes the BCBS's ongoing work on climate change (including its establishment of a Task Force on Climate-related Financial Risks in 2020) and the publication of the draft BCBS Guidelines which promote a principles-based approach to improving the management and supervision of climate-related risks. While we set out a number of specific comments on these Guidelines below, we also provide some broader recommendations as we would strongly encourage the BCBS to amend the Basel Framework itself as soon as possible to better address climate-related risks and impacts.

Question 1: 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?

As an overarching observation, ClientEarth notes that the principles focus predominantly on building expertise and capacity for the management and supervision of climate-related risks. They therefore risk failing to prevent climate risk accumulating in the financial system, and delay the effective management of these risks. It has been widely recognised that there are clear benefits to acting early on climate change, despite the inherent difficulties in accurately predicting and measuring forward-looking climate-related risks.[1] Where it is not yet possible to accurately measure climate risks and potential impacts, it is appropriate and necessary for prudential regulators to take a precautionary approach.[2]

Pillar 1 capital requirements

A necessary policy that is not referred to in the draft Guidance is the use of Pillar 1 capital measures to reflect the climate-related risks inherent in banks' fossil fuel exposures. This is a topic that a number of regulators have begun exploring,[3] and the BCBS's ability to set standards that would encourage and facilitate global harmonization would be highly valuable. This would help to ensure that such risks do not end up being shifted to banks in less regulated jurisdictions, which may not be as well equipped to cope with climate-related shocks to the financial system as others.

ClientEarth would **recommend the BCBS impose a significantly higher risk weight for any exposures which involve new exploration, expansion or development of fossil fuels and related infrastructure**, given that such exploration, expansion or development is incompatible with achieving the goals of the Paris Agreement (the Paris Goals).[4] We would propose a **risk weighting of 1250%**, to ensure that banks can absorb a full write-off of the exposures.[5]

The BCBS should also increase risk weights for existing fossil fuel exposures in light of their climate-related risks and impacts, but should prioritise the action above given the particularly high climate risks and impacts associated with new fossil fuel exposures.

Such regulation would improve banks' capital adequacy against climate-related losses and shocks, and drive behavioural change by disincentivising the continuation of financial flows to assets exacerbating

[1] See the comments from the NGFS in this regard: "*When balancing the need for robust and comprehensive data against the opportunity cost of inaction, central banks should be cognisant of the risk that acting early with imperfect information could be less costly than acting only once stronger data standards have emerged*": https://www.ngfs.net/sites/default/files/media/2021/06/17/ngfs_monetary_policy_operations_final.pdf
[2] See for example Chenet et al, 'Finance, Climate Change and Radical Uncertainty: Towards a precautionary approach to financial policy' (2021): https://www.sciencedirect.com/science/article/pii/S092180092100015X
[3] Such as the Bank of England: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/2021/october/climate-change-adaptation-report-2021.pdf?la=en&hash=FF4A0C618471462E10BC704D4AA58727EC8F8720
[4] See for example the IEA's Net Zero Roadmap, which specifies key milestones in its pathway to net zero, including that there should be no new unabated coal plants or new oil and gas fields approved for development from 2021 and no new coal mines or mine extensions from 2021: https://www.iea.org/reports/net-zero-by-2050 (page 20)
[5] For more detail setting out the content and rationale of this recommendation, see Finance Watch's report, 'Breaking the climate-finance doom loop' (8 June 2020), available at: https://www.finance-watch.org/publication/breaking-the-climate-finance-doom-loop/

climate change and undermining financial stability. It would acknowledge the 'double materiality' aspect of climate change, in both strengthening individual banks and the banking sector against climate-related risks, as well as helping to mitigate the impact that the banking sector is having on climate change. It would also help to correct the mispricing of climate-related risks and prevent the accumulation of assets which may (1) become stranded, thereby causing direct financial losses to the banks holding those exposures, or (2) contribute to exacerbating climate change, leading to the build-up of systemic risks in the financial system.

Importantly, it would be within each individual bank's control whether it will feel the consequences of this regulatory change, as it would only apply to banks that choose to continue financing activities that are clearly not aligned with the Paris Goals. Banks that implement policies to prohibit such financing would not have to hold additional capital.

The BCBS itself has already set a precedent for such an intervention through its Consultation Paper on the prudential treatment of cryptoasset exposures, where it proposed a 1250% risk weight for a certain group of cryptoassets as a "new conservative prudential treatment."[6] This ensures that banks hold risk-based capital at least equal in value to those cryptoasset exposures, i.e. capital sufficient to absorb a full write-off of the exposures without exposing depositors and other senior creditors of the banks to a loss. ClientEarth believes that a similar approach can and should be taken to new fossil fuel exposures which are incompatible with pathways aligned with the Paris Goals, based on best available science.

Pillar 3 disclosures

The BCBS should also introduce additional Pillar 3 measures to mandate the disclosure of greenhouse gas emissions per asset and asset category for on-balance sheet and off-balance sheet activities. This must include clients' Scope 3 emissions, at the very least for the sectors with the most significant climate impact. This would help to standardise the developing market practice currently being integrated into voluntary codes (such as the Task Force for Climate-related Financial Disclosures and the Net Zero Banking Alliance), provide the data necessary for banks to assess and manage the climate-related risks associated with their businesses, and allow banks to credibly plan how to decarbonize their portfolios and activities over time.

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

Principle 7, paragraph 29: the draft Guidelines suggest that banks should "<u>consider</u> actively engaging clients and counterparties and collecting additional data in order to develop a better understanding of their transition strategies and risk profiles." ClientEarth strongly recommends that the language be amended to reflect that banks "<u>should</u> actively engage clients and counterparties and collect additional data <u>including their Scope 1, 2 and 3 greenhouse gas emissions</u>…" Banks cannot credibly transition their businesses to net zero with short, medium and long-term emissions reductions targets without a comprehensive understanding of the emissions and transition pathways of their clients and counterparties.

Principle 8, paragraph 34: the draft Guidelines outline a range of climate-related credit risk mitigation options. One additional option ClientEarth would recommend that the BCBS include is that banks should

[6] https://www.bis.org/bcbs/publ/d519.pdf

set climate-related lending policies that would exclude lending for projects, or to companies involved in activities, that involve new exploration, expansion or development of fossil fuels.

Principle 11: the draft Guidelines state that banks should understand the impact of climate-related risk drivers on their operational and other risks, such as "strategic, reputational, regulatory and litigation or liability risk." In relation to climate litigation risk, we consider that it would be useful to outline in the Guidelines the various ways in which litigation risks can manifest themselves and impact a bank, even when litigation is not against the bank itself. This may include, for example, litigation against the bank's clients or counterparties on the basis of their climate impacts; against insurers, professional and legal advisors associated with clients' climate-damaging projects; or against other relevant parties such as governments and regulators that have approved such projects. Recent resources by the NGFS and the ECB on climate litigation could be usefully referenced.[7]

Principles 12, 15 and 18: the draft Guidelines promote the use of scenario analysis and stress tests. This is a welcome development and builds on the detailed work of the NGFS.[8] However, to date supervisors have not committed to adjusting capital requirements as a result of their findings.[9] The BCBS should consider revising these Principles to ensure that banks and their supervisors are not just exploring climate-related risks, but rather are taking action to ensure that banks will be resilient to climate-related risks and shocks by imposing additional capital requirements where necessary.

The draft Guidelines also state that "scenarios should cover a range of plausible pathways, as appropriate." We recommend that the BCBS include more detail on this, in particular that banks should be required at least to model scenarios based on assumptions of extreme warming (3°C or more), orderly transition limiting warming to under 1.5°C, and disorderly transition.

For further information please contact:

Joanne Etherton	**Jamie Sawyer**
Acting Head of Climate	Climate Finance Lawyer
jetherton@clientearth.org	jsawyer@clientearth.org
www.clientearth.org	www.clientearth.org

[7] https://www.ngfs.net/sites/default/files/medias/documents/climate_related_litigation.pdf and https://www.ecb.europa.eu/pub/pdf/scplps/ecb.lwp21~f7a250787a.en.pdf
[8] https://www.ngfs.net/sites/default/files/medias/documents/ngfs_guide_scenario_analysis_final.pdf and https://www.ngfs.net/ngfs-scenarios-portal/
[9] See for example the Bank of England's statement that its climate stress test "will not be used by the Bank to set capital requirements" (https://www.bankofengland.co.uk/stress-testing/2021/key-elements-2021-biennial-exploratory-scenario-financial-risks-climate-change) and the ECB's position that there will be "no direct capital impact on banks" from its climate stress test (https://www.bankingsupervision.europa.eu/press/pr/date/2022/html/ssm.pr220127~bd20df4d3a.en.html?utm_source=ecb_twitter&utm_campaign=220127_pr_climate_stress_test).

Brussels
60 Rue du Trône (3ème étage)
Box 11, Ixelles, 1050 Bruxelles
Belgique

Berlin
Albrechtstraße 22
10117 Berlin
Germany

Warsaw
ul. Mokotowska 33/35
00-560 Warszawa
Polska

Beijing
1950 Sunflower Tower
No. 37 Maizidianjie
Chaoyang District
Beijing 100026
China

London
Fieldworks
274 Richmond Road
Martello St. Entrance
E8 3QW
United Kingdom

Madrid
García de Paredes
76 duplicado
1º Dcha
28010 Madrid
Spain