Climate Bonds Initiative comments on the Basel Committee's draft Principles for the effective management and supervision of climate-related financial risks

General feedback on the Principles

Climate Bonds Initiative welcomes the Basel Committee's consultation on Principles for the effective management and supervision of climate-related financial risks.

We support the emphasis on integrating climate-related risk management into traditional financial risk management, but suggest the Principles draw more heavily on research that is already finding climate-related risks (CRFRs) material across the world,[1] and suggest that banks could begin the process of managing climate-related risks alongside the risk assessment methods laid out in the principles.

The principles are focused largely on the assessment of climate-related financial risks, suggesting full climate-related risk assessment be completed before incorporation on these risks into internal capital adequacy assessment processes (ICAAP) and internal liquidity adequacy assessment processes (ILAAP). We suggest that such actions should run concurrently.

The complexity of climate-related financial risk assessment means assessment and management should begin in parallel, so as to avoid a delayed response and manifestation of climate shocks on bank balance sheets.

We also welcome the Principles' scenario analysis position but suggest the Principles refer to the NGFS Climate Scenarios, so as to guide banks and regulators towards easily accessible granular data on transition pathways and climate impacts.[2]

The Principles closely match the TCFD recommendations and ask banks to set up internal governance, control frameworks, stress testing and disclosure We recommend they go further and feed the results of the stress tests on likely projected physical and transition risks, ideally from the NGFS scenarios, into the ICAAP frameworks of banks. Central banks and academics are exploring the idea of moving away from market neutrality.[3] This would require the Basel Committee to review its approach to developing risk weights and move away from using historical data to using forward looking weights derived from projected climate change and transition policy.

Comments on individual principles

We recommend the principles be strengthened to reflect the growing evidence of the risks posed by fossil fuel assets - stranding[4] and physical climate risks.

Internal control framework: Principle 4

Inclusion of CRFRs in the three lines of defence will help enable full capture of these risks. Quality and comprehensiveness of this data is crucial. Front-line staff reviewing credit applications need to ensure they use this opportunity to capture appropriate data to ensure physical and transition risks can be assessed.

This may include information on resilience against physical risks and the vulnerability of the project / asset to transition risk through its scope 1, 2 and 3 emissions. Company's transition and resilience strategies are also important to this assessment, particularly for those in carbon-intensive sectors. Including assessment of strategy and planning will enable forward-looking assessment of CRFRs at the micro level.

Capital and liquidity adequacy: Principle 5

Principle 5 states that banks should incorporate CRFRs over 'relevant time horizons' into their ILAAP and ICAAP.

Time horizons need to be extended beyond usual capital planning horizons, beyond the duration of the loan, to the lifetime of the asset itself – as climate-related risks may manifest after the loan has expired.

Risk management process and management monitoring & reporting: Principle 6 & 7

We believe these are excellent suggestions, and the banks should be transparent in reporting the overall findings of their risk management process.

Principle 5 suggests an iterative process of CRFR incorporation, beginning with capacity-building for risk analysis. However, CRFRs are already material on balance sheets across the world, and the capacity-building and risk analysis process (particularly in smaller banks) may take several years. Principle 6 should therefore be altered to suggest that risk management processes are begun concurrently with risk analysis, particularly for asset classes such as coal and fossil fuel exploration which are already showing devaluation.

Comprehensive management of market, liquidity, operational and other risks: Principle 9, 10 & 11

Principle 9 suggests the analysis of a sudden shock scenario to assess CRFRs' impact on the trading book. The principle should suggest use of the NGFS climate scenarios as the basis for this, as this will reduce the burden on banks of carrying out this analysis, therefore increasing the likelihood of their doing so. This would also promote coherency of analysis, better enabling comparison.

The scenario could also be used to assist with the assessment of liquidity and operational risks laid out in principle 10 and 11. Forward-looking scenario-based assessments will enable comprehensive management of these risks.

Scenario analysis: Principle 12

As outlined above, the Principles should make specific reference to agreed international climate scenarios such as the ones developed by NGFS, as these are designed to enable scenario analysis by financial institutions across the world and reduce the burden of such a process

Banks should also be encouraged to consider multiple scenarios with varying time horizons and trajectories. This will enable better identification of risks and quality of analysis.

Principles for Supervision

We endorse these principles, but they could be tilted to suggest a more pre-emptive approach to capital requirements, drawing on NGFS findings and central bank stress tests[5] that demonstrate the vulnerability of high carbon assets.

The expected path[6] of the transition will see largescale devaluation of fossil fuel assets and stranding of infrastructure and reserves. Therefore supervisors can act pre-emptively to safeguard their financial systems against the possible shocks of such occurrences by instating a higher capital requirement against high carbon assets.

Potential application of these principles to broader environmental risks

The issue of nature-related financial risks and disclosures is also very pressing.[7] Given market uncertainty over how to address these within the financial system, a similar set of principles for these would help banks incorporate biodiversity, deforestation and ecosystem services considerations into risk management processes.

About the Climate Bonds Initiative

The Climate Bonds Initiative is an investor-focused international organisation with a mission to mobilise debt capital markets for climate change solutions. Over the past ten years, Climate Bonds has been working with the financial sector and environmental experts on the development of a green debt market by 1. Tracking market developments and identifying trends; 2. Developing a Climate Bonds Standard and Certification Scheme as a tool to tag investments that are aligned with the Paris Agreement; and 3. Engaging with governments and regulators on how to grow sustainable finance markets. The green bond market has grown exponentially with approx. USD1tn issued so far. For more information visit: https://www.climatebonds.net/.

Contact

Please do not hesitate to contact Lily Burge (lily.burge@climatebonds.net) for further information on anything contained in this response or to discuss it further.

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[1] https://www.fitchratings.com/research/sovereigns/stranded-assets-long-term-risk-for-major-fossil-fuel-exporters-15-02-2021
[2] https://www.ngfs.net/ngfs-scenarios-portal/
[3] https://www.soas.ac.uk/economics/research/workingpapers/file155297.pdf
[4] https://www.fitchratings.com/research/sovereigns/stranded-assets-long-term-risk-for-major-fossil-fuel-exporters-15-02-2021
[5] https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op281~05a7735b1c.en.pdf
[6] https://www.unpri.org/inevitable-policy-response/the-inevitable-policy-response-2021-policy-forecasts/7344.article
[7] https://tnfd.global/publication/nature-in-scope/