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The Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

By electronic upload:
https://www.bis.org/bcbs/commentupload.htm?cdpath=/bcbs/publ/d530.htm

Dear Sir or Madam

Deloitte LLP (Deloitte UK) is pleased to respond to the BCBS's Consultative Document on *Principles for the effective management and supervision of climate-related financial risks*, issued for comment November 2021 ("the CD"). Our response draws upon insight from Deloitte colleagues across a range of fields and geographies.

We strongly supported the BCBS's decision to establish a high-level Task Force on Climate-related Financial Risks as the safety and soundness of individual banking institutions and the broader implications for the banking system will be materially impacted by the response of banks and regulators to climate risks. We have followed with interest the BCBS's publication of analytical reports on *Climate-related risk drivers and their transmission channels* and *Climate-related financial risks – measurement and methodologies* and we welcome their examination of how to address these within the Basel Framework.

We support the principles set out in the CD and are of the opinion they meet the stated goal of supporting a principles-based approach to improving risk management and supervisory practices. However, we have identified four main considerations that the BCBS paper may wish to include, namely:

(i) Risk Culture / Organisational Culture;

(ii) Liability Risk;

(iii) A more formal definition of "long-term"; and

(iv) Acknowledgement of the learning process upon which banks have embarked.

It is our view that further enhancing the Principles to cover these areas could provide an improved approach to risk management.

Appropriate risk cultures within organisations are critical to climate risk management, we would welcome enhancement of the CD to cover the Principles required to incentivise the right long-term risk management behaviours and clarifying expectations regarding the board of directors' responsibilities with respect to these issues. We would also welcome more prescriptive wording to ensure that climate-related financial risks are considered as part of a bank's business strategy and that those in board and management positions have the correct competence and knowledge in the field of climate-related risks.

We would welcome a definition of liability risk as many supervisors have added this to physical and transition risks. The legal risks to firms that participate in greenwashing are substantial and it would be helpful if the Principles considered these in more detail.

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The Principles omit a definition of "long-term" which is important as each bank may define "long-term" differently. Net zero targets often adopt a 2050 which suggested a definition of 25-30 years. However, when considering international regulatory definitions of time horizons for regulatory submissions, international banks active in different countries may face conflicting definitions and expectations – which could add extra cost and complexity, to the detriment of regulators' intentions.

Our final overarching observation concerns the acknowledgment of the learning process. Banks, supervisors and wider stakeholders will likely face future amendments to strategic approaches. Consideration of this in the Principles with an explanation on adaption of future developments would be welcomed.

Our responses to the specific questions raised in the CD are in the Appendix to this letter. Please do not hesitate to contact us if you would like to discuss any of the issues raised in the course of our response.

Yours sincerely,

Thomas Spellman
Deloitte LLP

Appendix

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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?

We support the Principles set out in the Consultation Paper. However, we think it would be helpful if the principles covered a number of other considerations, as set out below.

1. Risk/organisational culture: Culture and purpose are important in relation to climate risk management and we suggest that the Principles recognise this and make it clear that the responsibility for setting the right culture and for incentivising the right long-term behaviours rests with a bank's Board of Directors.

2. Liability risk is not defined: Many supervisors have added liability risks to physical and transition risks in their guidance on climate-related risks. The risks of legal action against companies that either succumb to greenwashing or fail to adequately disclose the risks arising from climate change are substantial and increasingly evident. It would be helpful if the Principles considered liability risk in more detail.

3. Definition of "long-term": There is currently no explanation or definition of how many years constitute "long-term" for the purposes of the Principles. This is important as each bank may define "long-term" differently. The net-zero target adopted by many corporates and countries is 2050 which in turn suggests that "long-term" should be at least 25-30 years. The absence of a definition of "long term" will likely mean that international banks active in different countries will face different regulatory definitions of time horizons for, in relation to, for example, scenario analysis and stress testing. These differences will add unnecessarily to cost and complexity while risking inconsistent application.

4. Acknowledgement of the learning process: We are aware that this is a learning process for all banks, supervisors and wider stakeholders and that future amendments to strategic approaches and regulatory requirements are likely. It would be helpful for the Principles to acknowledge this and explain how the BCBS will adapt them to take account of future developments (e.g., evolution of approach to stress testing, scenario analysis or physical risk assessments).

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Question 2

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

In our responses below, we have set out our comments by theme and Principle, citing particular paragraphs where relevant.

Corporate Governance

Principles 1, 2 and 3

We very much welcome the emphasis on corporate governance. In our view, a holistic approach is essential, connecting board strategy, net-zero plans and risk appetite with the underlying risk management and control frameworks that drive decisions on how the balance sheet is used, e.g., credit assessments and lending criteria.

Paragraph 13 states that: "Responsibilities for managing climate-related financial risks should be clearly assigned to board members and committees to ensure material climate-related financial risks are appropriately considered as part of the bank's business strategy and risk management framework."
We would welcome more prescriptive wording to help guide supervisors as to what "appropriately considered" means in this context. For example, how should banks embed climate risk appetite into first line decision making? And how can stress testing and sensitivity analysis be used to aid decision making as they evolve?

Paragraph 14 highlights the need for board and senior management competence and knowledge in the field of climate-related risk. We agree and have found that internal workshops, training sessions and external collaborations are all effective in terms of sharing insight and developing strategies.
However, terminology such as "adequate understanding" and "appropriate skills and experience" might risk downplaying the extent of upskilling that will be needed. Climate risk management is a relatively new discipline, without access to a large pool of experienced talent; hence, it will require a lot of "learning on the job". This implies the need for agile skills, teaming, and a willingness to collaborate and learn from mistakes.

Internal control frameworks

Principle 4

We welcome the provision of examples which can help further understanding of the spirit of the Principle. Additional examples throughout the paper would be valuable. For example, **paragraph 18**, references the role undertaken by the first line of defence, and the example relates predominantly to credit risk assessments. We would encourage expanding the examples to include other first line control responsibilities, such as operational risks, and new product or business approval processes as well as consideration of potential liability and reputation risks.

We further note that **paragraph 20** currently states that "the internal audit function, should carry out regular reviews of the overall internal control framework and systems". We suggest adding "and testing" after "reviews" to reflect the importance of performing detailed testing to assess whether the internal controls have worked.

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Capital and liquidity adequacy

Principle 5

Paragraph 23 refers to the "identification of the climate-related risk drivers that may materially impair the firm's financial condition". This guidance would benefit from explicit reference to the performance of a climate risk materiality assessment in advance of the Internal Capital Adequacy Assessment Process (ICAAP), as one example of a specific action that supports the ICAAP analysis.

The commentary in Principle 5 focuses on the identification and assessment of climate-related financial risks through the ICAAP and Internal Liquidity Adequacy Assessment Process (ILAAP). We would also suggest that this Principle recognise the emerging regulatory expectation (at least in some BCBS member countries) that banks should hold capital against any material climate-related financial risks.

Risk management process

Principle 6

We agree with the inclusion of a focus on risk management process. However, we would welcome some additional guidance in the areas set out below.

With respect to **paragraph 24**, we would welcome a clearer link between the strategic objectives of the firm, its risk appetite. and the material climate-related risks (both financial and non-financial) to which the firm is exposed. The strategic link is particularly important as it will help define how the firm manages the risks related to climate change and/or the opportunities that arise from the transition to net-zero.

This could be achieved by including a reference as to how climate risk may be incorporated as a risk type into existing risk management frameworks. For example, climate risk can be incorporated as a risk driver in existing risk categories or treated as a standalone risk type or, as we have seen in some cases, both.

We acknowledge that the Committee is currently assessing the existing Basel capital framework to ensure that is appropriately designed to address climate-related financial risks, including the disclosure requirements. We would encourage the outputs of this work to include specific guidance on the disclosure requirements for climate-related financial risks and that any guidance or updates to the framework align closely to the objectives of the disclosures required under TCFD.

Management monitoring and reporting

Principle 7

We consider that Principle 7 might usefully acknowledge some of the current and pervasive limitations that exist in the performance of robust assessments and monitoring of climate-related financial risks, and how other regulatory initiatives (such as TCFD) are seeking to address them.

Many firms report that it is hard to get data and there are many sources with conflicting information. While companies typically have built an infrastructure around financial data, they often lack similar infrastructure with respect to around climate-related data – which is why further guidance from the BCBS could be beneficial (for example, what quality threshold should firms aspire to so as to avoid the risk of misstatements?). Sourcing quality data for non-disclosure purposes is also a challenge that firms are reporting. Data will be required for regulatory reporting outside of disclosures but also prudential, MIS and internal reporting, we would encourage the BCBS to produce further guidance covering these areas.

Firms will need to develop their climate data capabilities over time and it may be that distinct phases are needed, perhaps with distinct principles. Examples of these issues are data availability and consistency (see **paragraph 31**) and the widespread reliance on proxies.
Moreover, our experience has shown that a bank cannot easily develop a Key Risk Indicator (KRI) that quantifies its own risk to systemic climate collapse, given that the risk grows or decreases depending on the actions and reactions of the wider financial services ecosystem. We also see a danger in adopting an approach around monitoring and reporting which only seeks to measure the impact of the external environment on the bank's risk profile – since this potentially excludes the impact of the bank's activities on the external environment. We would argue that all financial institutions have a role to play in creating the data needed to assess systemic environmental risks. This is not purely to contribute to the solution to a common problem. Banks that fail to measure their own climate impact may be unaware of the threat of their activities to their long-term enterprise value.

Comprehensive management of credit risk

Principle 8

While we welcome the explicit focus on management of credit risks and the guidance on incorporation of climate-related financial risks into credit policies and processes, we would suggest adding guidance on how banks can incorporate climate-related financial risks in their methodologies for calculating Probability of Default and Loss Given Default. We also believe that regulatory credit estimates should be tested for robustness against climate risk; this should include parameters based on through-the-cycle and downturn methodologies.

We have specific comments on the following three paragraphs:

- **Paragraph 32**: Additional commentary on the management of and connection to counterparty credit risk would improve consistent application.
- **Paragraph 33**: Further guidance would be useful on whether climate-related risks (in this case linked directly to concentration risk) should be considered separately for physical and transition risk, or in combination. If the latter, perspectives or comments on weighting schemes or methodologies could be provided.
- **Paragraph 34**: Reference could be made to other risk mitigation options e.g., consideration in the collateral valuation and/or pricing process. We would encourage regulatory review into the adequacy of credit provisioning for long-dated lending.

Comprehensive management of market, liquidity, operational and other risks

Principles 9, 10 and 11

With respect to **paragraph 37**, it would be beneficial to include reference to a physical risk example, in addition to the transition risk example already provided, due to the relevance for market risk (e.g., commodity price shocks following weather events).

Further to our comment on time horizons, liquidity planning horizons are typically even shorter than those for capital. We therefore believe that further work and guidance on how climate risks should be incorporated into the calibration of liquidity buffers (see **paragraph 38**), in view of the long time horizons over which they might materialise, will be important to consistent implementation.

Some of the climate-related risk drivers, for example extreme weather events linked to climate change, may be thought of as "tail events" – low probability but potentially high impact events. These have traditionally

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been harder to incorporate within risk management frameworks and therefore we believe this is another area where additional guidance would be useful in the future (see **paragraph 39**).

Scenario analysis

Principle 12

We see benefit in providing specific guidance on scenario use and best practices. For example, using industry standard scenario paths from the Network for Greening the Financial System (NGFS), balance sheet assumption recommendations, including the current regulatory focus on static balance sheets as a starting point and a dynamic one to evaluate the impact of specific strategies.

Banks also need to think about which granularity assumptions to use for scenario projections and which are suitable for the climatic peril being analysed. For instance, when applying climate change allowances for flood, using catchment areas might be more appropriate.

With respect to **paragraph 43**, further clarifications around scenario complexity and granularity would be beneficial, as these differ by portfolio composition. Following on from our previous comments, additional examples would be helpful (e.g., different expectations for lenders versus credit traders).

Prudential regulatory and supervisory requirements for banks

Principles 13, 14 and 15

We have no comments on this section.

Responsibilities, powers and functions of supervisors

Principles 16, 17 and 18

We have no specific comments on this section. However, we would emphasise that regulators and supervisors across the world are developing new approaches at pace. For example, we anticipate that the standards under development by the ISSB will need to be adopted by firms. Such standards will need to be supplemented by regulation around the world, together with associated regulator enforcement and monitoring, corporate governance and controls, assurance, and training. Fragmentation or misalignment of standards or standards that are not robust and do not follow a due process pose a risk to the successful regulation of the financial system as a whole.

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Question 3

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?

Primarily, we believe that it is not appropriate to separate climate from broader environmental risks, as in practice the two can be closely linked. For this reason, when seeking to address climate risk, banks need to be mindful of the potential knock-on impacts on other environmental risks, such as biodiversity or wider risks to particular groups or communities.

However, it is acknowledged that scenario and stress testing frameworks are more aligned to climate risk, with carbon elasticity models being used to evaluate the financial impact on companies, yet for wider Environment, Social or Governance risks there is no obvious single factor that can be stressed or modelled to evaluate the impact on the wider portfolio.