E3G

E3G'S COMMENTS ON THE BASEL COMMITTEE'S DRAFT PRINCIPLES FOR THE EFFECTIVE MANAGEMENT AND SUPERVISION OF CLIMATE-RELATED FINANCIAL RISKS

E3G welcomes the Basel Committee's decision to publish principles for the effective management and supervision of climate-related financial risks (CRFRs) as an important step towards harmonising supervisory approaches to CRFRs across jurisdictions. However, the draft principles fall short in a number of areas and could be strengthened.

Market-fixing versus precautionary policies

The principles embody a gradual, "market-fixing" approach to managing CRFRs (e.g., building up climate expertise within banks, developing risk management capabilities, conducting scenario analysis, disclosing exposure risk). Whilst useful, such measures are insufficient to mitigate the systemic risks posed by intensifying weather events (physical risks) and the regulatory and liability challenges posed by the transition from a carbon-based economy (transition risks).

Given that CRFRs are characterised by "radical uncertainty", whereby we may never have enough information to assess their probabilities, that climate science has already identified significant risks from certain financing activities (e.g stranded assets from fossil fuel activities)[1], and that some supervisors such as the ECB recognise the logic of acting early as the long-term costs of unchecked climate change will be much larger than the short-term costs of transition,[2] the Basel Committee principles should recommend precautionary policies to better build up banks' resilience to CRFRs. The Dutch Central Bank already supports such an approach at the ECB[3] whilst the White House has supported taking a "precautionary approach" in its Climate Risk Accountability Framework.[4]

[1] See IPCC (2021), **Sixth Assessment Report** and IEA (2021), **Net Zero by 2050, A Roadmap for the Global Energy Sector**

[2] S. Alogoskoufis, N. Dunz et al, **ECB economy-wide climate stress test: Methodology and results**, ECB Occasional Paper Series, No 281, September 2021.

[3] De Nederlandsche Bank (2021), **Climate-related Financial Disclosure**

[4] https://www.whitehouse.gov/wp-content/uploads/2021/10/Climate-Finance-Report.pdf

Such policies should include increasing capital requirements for investment with high climate-risk exposure, e.g fossil fuel activities. Increased capital requirements would be in line with the risk-based nature of prudential capital rules and would reflect the relative level of risk associated with the activity, i.e. capital increases for new fossil fuel activities should be higher than for existing activities. Capital regulations for banks and insurers already mandate higher capital charges for high risk exposures and in a similar vein, the Basel Committee is already considering increasing capital requirements for cryptocurrencies based on the risk they pose to financial stability.[5] The Basel Committee should thus use these principles to recognise fossil fuel exposures as high-risk and recommend precautionary actions accordingly. The Basel Committee should thus use these principles to recognise fossil fuel exposures as high-risk and recommend precautionary actions accordingly.

Recommendations for improvement

- The principles should be updated to explicitly endorse a precautionary rather than market-fixing approach to managing climate-related financial risks
- This should include recognising banks' fossil fuel exposures as high-risk and recommending commensurate capital requirement increases to build up banks' capital buffers and long-term resilience to climate shocks; principles 12-16 and 18 should be updated accordingly to recommend these as specific "follow-up actions" in order to build up the resilience of financial systems to climate risks and ensure an orderly transition as possible towards net-zero economies
- The Basel Committee should also publish a timeframe for implementation for the principles (e.g within 12 months of publication) with a monitoring function to encourage jurisdictional uptake
- The Basel Committee should also consider publishing a complementary set of principles on managing nature- and biodiversity-related financial risks

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