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Bank for International Settlements

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Basel, Switzerland

October 6, 2023

Re: Comments on the Core Principles for Effective Banking Supervision

We appreciate the opportunity to comment on the Basel Core Principles for Effective Banking Supervision ("BCBS"; "CPs"). E3G is an independent climate change think tank with a global outlook. We work on the frontier of the climate landscape, tackling the barriers and advancing the solutions to a safe climate. Our goal is to translate climate politics, economics and policies into action. E3G builds broad-based coalitions to deliver a safe climate, working closely with like-minded partners in government, politics, civil society, science, the media, public interest foundations and elsewhere to leverage change.

***Introduction: significance of the 2023 CPs consultation*.** It has been a decade since the CPs were formally updated. It is, therefore, reasonable to expect that these proposed revisions will be relied on for addressing climate-related financial risks for many years to come. This update is taking place as the G20, International Monetary Fund, G7, the Financial Stability Board ("FSB") and other international standard setters, or coordination forums, focus on additional climate-related financial reforms and initiatives. The BCBS noted in its **December 2022 Frequently Asked Questions** on Climate-related Financial Risks ("FAQs") that it was "…examining the extent to which climate-related financial risks can be addressed within the Basel Framework, identifying potential gaps in the current framework and considering possible measures to address them. This on-going work is holistic in nature, spanning regulation, supervision and disclosure."

Updates on the BCBS's work were included in the **FSB's July 2023 progress report**, and on **October 5, 2023**, the BCBS disclosed that it would soon publish a consultation on a Pillar 3 disclosure framework for banks' exposure to climate risk.

***Core policy messages**: The CPs should better reflect support for precautionary approaches to managing and mitigating climate-related financial risks, as well as mandating use and disclosure of transition plans.*

A precautionary approach is necessary considering the size and uncertainty of climate risk. The economic and financial impacts of climate change are outpacing financial authorities' current efforts to get ahead of climate related financial risks. This includes growing **insurance gaps** and the **increased severity and costs of physical climate-related risks**. Last month, **ECB Executive Board Member Isabel Schnabel** highlighted the importance of the "…incorporation of environmental considerations in the supervision of prudential risks." Climate-related and environmental risk "warrant special attention, owing to their size, global dimension and non-linearity, the irreversible nature of the damage they can cause, the resulting time criticality of action, as well as knowledge and data gaps," according to Schnabel.

These remarks highlight the financial sector's challenges in adequately assessing climate risks, warranting a **precautionary approach**. The CPs recognize that current prudential frameworks are intended, among other things, to assist supervisors' ability to take "*pre-emptive* action to address them [risks]." In addition, under CP 8 (Essential criteria 40-19 4& 5), supervisory analysis of system wide risks (including climate-related risks) should inform the need to *"proactively"* address serious threats to the banking system's stability (italics added).

Transition plans are the new norm. *The G20, IMF, G7, and the United Nations Secretary General have all called for the private sector to develop transition planning processes and procedures.* Transition plans disclosed across the economy can improve financial institutions' ability to both identify business opportunities and mitigate climate related financial risks. They also can provide supervisors and macro-prudential authorities with comparable information that can be used as a **supervisory tool**, as well as for **systemic risk assessment**.

This Spring, **G7 Finance** and **Climate and Energy Ministers** noted the importance of transition plans in their communiqués. The Network for the Greening of the Financial System ("NGFS"), the FSB, and the International Organizations of Securities Commission, ("IOSCO") have established working groups on transition plans. Also of note is the recent publication of the International Sustainability Standards Board's ("ISSB") sustainability and climate disclosure standards (that contain transition plan related elements; the United Kingdom's Transition Plan Taskforce ("UK TPT") has worked closely with the ISSB in developing its Disclosure Framework for best practice transition plans, which builds on and supplements the ISSB Standards.

Promulgation of the ISSB's standards, and other factors, have accelerated individual jurisdictions' consideration of transition plans as part of climate disclosure norms and standards: examples include the **EU**, **USA**, **Australia**, **Japan**, **Nigeria**, and **Singapore**. The **UK TPT**'s final sector-neutral Disclosure Framework and a suite of implementation guidance will be issued on Monday, October 9th, 2023. Later this year, the UK TPT will conduct a consultation on supporting sector-specific guidance for the banking sector and six other sectors. The **U.S. Treasury Department's** recent publication of Principles for Net-Zero Financing and Investment further highlights the importance of credible transition plans for the financial sector.

Transition plans should be required under the CPs, relying as much as possible on existing or emerging common approaches and baseline expectations. (Regulatory or policy fragmentation should be avoided in light of the significant work already accomplished in this area). Requiring transition plans' use and their disclosure would recognize that financial institutions can be both users (of corporate sector transition plans) and preparers (of their own transition plan and planning processes).With respect to the CPs and to climate-related risk, for example, it is difficult to imagine how a supervisor might make a determination that "the bank's board and senior management obtain sufficient information on and understand the nature and level of risk being taken by the bank and how this risk relates to adequate levels of capital and liquidity" in the absence of a transition plan and strategic transition planning processes. There's also growing interest in how financial institutions can gain an improved understanding of their climate risk exposure by using information available from other existing transition plans (e.g., sectoral transition plans, corporate firms' transition plans).

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Recommended improvements to CPs The consultation document describe the climate-related financial risk updates as 'targeted' changes with respect to financial-related climate risk, and the following CPs are cited as examples: CP 8 Supervisory approach; CP 10 Supervisory Reporting; CP 15 Risk management processes; and CP26 on internal control and audit. This 'targeted' approach is narrower than both the text and spirit of the **2022 BCBS Climate Risk Principles** ("CRPs"). They also could do more to address the "…concept of business bank model sustainability… reflecting the expectation that banks design and implement sound and forward-looking strategies that generate sustainable returns over time," an issue that has attracted attention in the insurance sector.

General comment The CPs do not sufficiently integrate adequate guidance for banks and supervisors to identify and manage climate-related financial risks. There is an absence of guidance on how banks can leverage the transition plans of their real economy clients and customers. Transition plan disclosures can be used to inform banks' assessments of their transition risks, as well as how to manage and mitigate them. Admittedly, striking the right balance between principle-based guidance and prescriptiveness is particularly challenging in addressing emerging risks, particularly climate change. We believe the modifications suggested below, however, will strike a more appropriate balance and ensure the CPs' relevance over time.

For example, more climate related "Essential criteria" and/or "Additional criteria" should be woven through certain CPs. For example, *CP15* on Risk management processes *explicitly states* that climate related financial risks could be material risk. The *footnote* to this section cites the CRP as a "Reference document" for this statement. Then, Essential criteria 40.34 (2)(d) specifically includes text citing to the importance of taking climate related financial risks into account.

This progression – explicit reference to climate-related risk embedded in the CP; followed by citation to the CRPs as a reference document, and incorporation into Essential criteria (or Additional Criteria) – should be similarly reflected elsewhere; it should also include guidance on the use of transition plans. In particular, we would like to see climate risk addressed in this fashion in the following: CP 8 Supervisory Approach; CP 9 Supervisory Techniques and Tools; CP 14 on Corporate Governance; CP 17 on Credit Risk; CP 19 on Concentration and large exposure limits; CP 22 on Market Risk; CP 24 on Liquidity Risk; and CP 25 on Operational risk.

Let's use CP 17 on Credit risk to illustrate:

CP 17 should be modified (see underlining) "The supervisor determines that banks have an adequate credit risk management process that considers their risk appetite, risk profile, market conditions, macroeconomic factors and forward-looking information. This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate credit risk (including counterparty credit risk) on a timely basis. <u>This includes the use and development of banks' transition plans, and how the bank has incorporated the use and analysis of available real economy transition plans when managing risk and planning its own transition.</u> The full credit life cycle is covered, including credit underwriting, credit evaluation and the ongoing management of the bank's loan and investment portfolios."

The Footnotes should be modified to include the principles for the effective management and supervision of climate-related financial risks 2022 CRP 8.

The Essential criteria (or Additional criteria) should be modified (see underlining): Laws, regulations or the supervisor require banks to have sound credit risk management processes, including climate transition plans, which provide a comprehensive bank-wide view of all credit risk exposures, including a robust methodology for the early identification and appropriate measurement of credit losses. The supervisor determines that the processes and use of client climate transition plans are consistent with the risk appetite, risk profile, systemic importance and capital strength included in the bank's transition plans, that they consider current and forward-looking market and macroeconomic factors, and that they result in prudent standards of underwriting, evaluation, administration, monitoring, measurement and control of credit risk.

Capital adequacy

The FAQ's provide some additional clarity on how climate related financial risks may be captured in Pillar 1, and notes that banks should add a 'margin of conservatism' in their estimates. Consideration, however, must continue to be given to a more robust response. It has been widely documented that climate-related financial risks are both deeply **underpriced**, and difficult to estimate. These risks could impact the financial system's resiliency, and its ability to support the real economy's transition to net zero. The U.S. Treasury issued a **report** on the increasing impacts of climate related expenses on households, particularly those of under-represented and underserved communities that can least afford it. Effective use of the precautionary policy response is critical to address gaps in the prudential framework's capacity to adequately address the matter of climate-related risk, and that are due to its specific nature, as noted above. We recommend it be incorporated in Pillar 1 of the Basel Framework. This implies upward adjustments to capital requirements for financing of activities such as fossil fuel expansion that are incompatible with international climate commitments and the imperatives of climate science and technological reality, including the use of adapted **capital risk weights**.

Secondly, **systemic risk capital buffers** could be used to address financial stability impacts of climate change. These buffers would come on top of other regulatory capital requirements. In Europe, for example, climate specific systemic risk buffers can be added to current national macroprudential frameworks; moreover, they can be tailored to cover sectors or specific institutions. The flexibility of such an approach promotes financial system resiliency, including by mitigating the build-up of risk (if imposed in a timely manner). An additional system-level measure could include adapting **concentration thresholds** or surcharges.

Improving use of transition plans and changing capital structures to better account for the underpricing of micro-and macroprudential climate-related risks through the CPs will make financing of sustainable economic activities and activities more attractive and support a more orderly and economically beneficial transition to a net zero economy.

Thank you for your consideration of these suggestions.

Sincerely,

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