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Re: Feedback on BCBS Discussion Paper: The role of climate scenario analysis in strengthening the management and supervision of climate related financial risks, ISBN 978-92-9259-754-2 (April 16, 2024)

E3G welcomes this opportunity to comment on the Basel Committee for Banking Supervision 's (BCBS) Scenario Analysis Discussion paper. 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.

General Comments Climate-related financial risks, including financial stability risks, are diverse and the size of their impacts are not yet fully understood. The European Commission recently described why trying to understand the climate change's impact financial stability is so difficult: "Quantifying the impact of these climate risks on financial stability today is difficult for many reasons, including: (i) uncertainties about links between economic/financial indicators and climate, as they are mainly based on past data; (ii) the vast and variable time horizons involved; (iii) the unprecedented nature of the risks; (iv) the interconnections between financial sectors and the real economy; and (v) how risks could propagate throughout the system."[1] The BCBS discussion paper incorporates some lessons learned to regarding climate scenario and is a useful framework for gathering feedback that can inform much needed new policy development. We urge the BCBS prioritize efforts to *better incorporate climate science and adjust CSAs to take into account varying and longer time horizons.*

Q1: How does the role of CSA vary based on the objectives listed above, and are there other prudential objectives where CSA could be relevant?
Response: *Pillar 3 Objectives*: Using CSAs in transition planning, and the disclosures in transition plans (described more fully below), are a cost efficient and effective way to achieve Pillar 3 objectives. Transition plans are defined in the International Financial Reporting Standards as S2 defines a climate-related transition plan as "…an aspect of an entity's overall strategy that lays out the entity's targets, actions or resources for its transition towards a lower-carbon economy,

[1] **See** Report on the monitoring of climate-related risk to financial stability - European Commission (europa.eu)

including actions such as reducing its greenhouse gas emissions." [2] Transition plans have at their center a trajectory for reaching next zero, and views of risks and opportunities along the way. including actions such as reducing its greenhouse gas emissions." [3]

The ISSB recently took up the work of the United Kingdom's Transition Plan Task (TPT) Force. In the TPT Framework, transition plans can include: "… the extent to which it [an entity] has taken into account and aligned with any external requirements, commitments, science-based targets, transition pathways, roadmaps, or scenarios, which may include i.) national or international commitments made by governments ii.) any targets it is required to meet by law or regulation iii.) sectoral pathways, roadmaps, or other climate scenarios iv.) voluntary commitments (e.g., existing public commitments, organisational and industry standards, contractual relationships, codes of practices etc.)"[4]

In addition, TPT guidance on sectoral pathways for banks provides: "When disclosing any financial metrics and targets that it uses to drive and monitor progress towards enhancing its resilience and responding to the climate-related physical and transition risks and opportunities that arise from the transition, an entity may consider… the reporting of future financial impacts of climate-related physical risks under multiple climate scenarios.[5]

Basel Pillar 3 disclosure requirements are designed to provide appropriate information to enable market participants, and supervisors, to better assess banks' exposure and management of risks. To that end, Pillar 3 lays out a comprehensive set of public disclosure requirements that seek to provide market participants with sufficient information to assess an internationally active bank's material risks and capital adequacy. Information on financial institutions' exposures to climate and environmental risks and their corresponding strategies, internal governance and risk management processes – is currently absent from the Pillar 3 of the global prudential framework, despite this being critical to enforce market discipline and adequately support overall capital formation. Better tailored CSAs will enable stronger transition planning capacity for banks, and more relevant transition plan disclosures. Mandated disclosure of transition plans under Pillar 3 can improve assessment of banks' risk profiles and contribute to a better understanding of the potential gap between existing Pillar 1 risk assessments and what revised risk assessments under Pillar 1 could look like.

Use of CSAs in transition plans would support other prudential objectives, such as macro analysis. They would providing forward-looking information at the entity level that allows: 1) banks, insurance companies, & other financial institutions to provide targeted support to economic activities that support the transition, thereby contributing to lower physical risks down the line; and,

[2] Both the G7[2] and the G20 recognize the importance of transition plans. This year, the G20 Sustainable Finance Working Group (SFWG)[2] is expected to develop high level principles for transition plans. Transition plans promote alignment of public and private sector finance, as well as real economy actors and the financial sector, with Paris aligned goals.

[4] The TPT Disclosure Framework | Transition Plan Taskforce (transitiontaskforce.net)

[5] Note that this guidance may also be relevant to other financial market participants, including insurance companies.

2) provide prudential supervisors with an idea for where the transition is unfolding in a disorderly/disruptive manner (with possible consequences for macro-economic growth and stability).

The NGFS recently acknowledged the value of scenario analysis and transition planning in meeting micro prudential objectives, expressing an interest in pursuing the development of "…a guide for supervisory authorities on understanding and, where relevant, engaging with financial institutions' target setting from a micro-prudential perspective; and assessing the value of the interaction between scenario analysis and transition planning." [6]

CSAs that can take better account of interactions between transition risk and physical risks could be used for macro-prudential policy making. The European Central Bank recently noted that while there is a growing consensus on the systemic features of climate risks it is early days for potential solutions. One idea for consideration is "…future integration of firm level transition trajectories in the definition of transition risk exposures, e.g., by incorporating information from transition planning, could enhance the efficiency of a capital buffer for climate risks, further reducing the effects of negative side effects on transition finance."[7]

The NGFS also recently acknowledged the value of scenario analysis and transition planning in meeting micro prudential objectives, expressing an interest in pursuing the development of "…a guide for supervisory authorities on understanding and, where relevant, engaging with financial institutions' target setting from a micro-prudential perspective; and assessing the value of the interaction between scenario analysis and transition planning." [8]

The Basel Committee is in the process of finalizing its consultation on Pillar 3 climate-related disclosures. Integrating information about climate-related scenario analysis risks within the Pillar 3 framework would provide market participants with more decision useful quantitative and qualitative information. We urge the Basel Committee to consider our comments on the Pillar 3 consultation.[9]

Q2: What are the key challenges in the application of CSA and how can they be overcome? Response:

E3G requests that financial institutions and authorities prioritize CSA alignment with climate science and enhance CSA designs to take into account a variety of time horizons. *It is critical that climate science, and climate scientists be engaged early and actively in improving CSAs design and utility.* Economists struggle with translating big global climate models into useful projections of financial risk. This concern has been widely acknowledged. For example, most scenario analyses use models which are not equipped to deal with climate-related risks and, as a result, have predicted only a benign level of economic losses and benign effects on the financial sector. These models – known as dynamic stochastic general equilibrium models (DSGE) and integrated assessment

[6] See NGFS publishes a package of reports relating to Transition Plans | NGFS

[7] See **ecb.wp2943~1bf261835d.en.pdf (europa.eu)**

[8] See NGFS publishes a package of reports relating to Transition Plans | NGFS

[9] See **e3g.pdf (bis.org)**

models (IAMs) – rely on backward-looking data and are based on assumptions about general equilibrium in the economy be incompatible with climate-related impacts, which will be disruptive, unpredictable and permanent. Tipping points and feedback mechanisms (e.g. melting permafrost) could accelerate losses to levels far above those from recent financial crises. [10]

All supervisory climate scenario analyses use these models and, as a result, their estimates of the economic losses of climate change are clearly at odds with climate science, which incentivizes inaction. A major modelling flaw is the assumption that economic damages from climate change are a quadratic function of the warming level. Existing models ignore some of the most severe impacts of climate change. Notably, NGFS's recent estimate of climate losses excluded costs arising from extreme weather, sea-level rise, migration and conflict. Finally, information on financial institutions' exposures to climate and environmental risks and their corresponding strategies, internal governance and risk management processes – is also currently absent from the Pillar 3 of the global prudential framework, despite this being critical to enforce market discipline and adequately support overall capital adequacy.

The Bank of England (BOE) recently noted that "Macro climate scenarios generally project impacts over i) limited and ii) long time horizons. However, financial assets will have a broad range of maturities from months to years. End users may need to estimate effects at time horizons relevant to them and determine to what extent longer-term effects are relevant for the asset under consideration." This factor may also be increasingly of importance in looking at cross sector financial stability and contagion issues. Insurance companies, for example, may have short term (typically 1 year) exposures to physical risks, and/or longer-term exposures with respect to management of pension investments. Time horizon adjustments can be important for both micro and macro prudential stability.

Other adjustments could include: a) tipping points should now be treated as high impact, high uncertainty and increasingly likely events [11]; b) improving data availability and granularity, that could include improved data governance mechanisms, including public sponsorship[12]; and c) including both "top down" and "bottom up" approaches.

Q10. How could the effectiveness and efficiency of supervisory exercises be improved?
Response: Improved international collaboration on CSA design and supervisory approaches may make the exercises more effective and efficient than they are now, especially with respect to globally systemic financial institutions.[13] One reason is because current CSAs treat financial risk as exogenous. As a result, CSAs do not take into account how financial institutions (e.g., banks and insurance companies) can both create, and mitigate their own risks, as well as system wide risks.

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[11] See Climate Scorpion – the sting is in the tail (ifoa-prod.azurewebsites.net); the-emperor-s-new-climate-scenarios.pdf (actuaries.org.uk)

[12] See Panel discussion: climate scenarios grossly underestimate risk; a paradigm shift is urgently needed - Green Central Banking and Climate Services: The Business of Physical Risk by Madison Condon :: SSRN

Global cooperation would make for more effective design and use of CSAs globally systemic financial institutions.[14]

We thank you in advance for your consideration of these comments. We would welcome the opportunity to discuss them further, and/or participate in any related stakeholder outreach meetings that the BCBS conducts in connection with this discussion paper.

[14] See US block on Basel risks derailing global measures on climate risk - Green Central Banking**:** **"**The banking agencies' failure to address these risks is not just inconsistent with their legal mandates**.** It also runs counter to the… Biden administration's broader goals of driving clean energy investments. to achieve net zero by 2050. It's difficult to see this departure from the international consensus as anything other than capitulation to domestic political interests**.** If the US fails to get its act together, the best case scenario is that it will continue to lag its international counterparts in addressing what Treasury secretary Janet Yellen has described as "an existential threat" that "poses a tremendous risk to our country's financial stability". Worse still, the lack of US action could delay other jurisdictions… This should be a wake-up call for the US to stop obstructing the countries that are leading the way in our absence and reclaim a position of global leadership. Because as US banking agencies fiddle, the planet continues to burn. See also Explaining the Fed's climate test - E&E News by POLITICO (eenews.net).