Basel Committee on Banking Supervision: Disclosure of climate-related financial risks

Dear Sir/ Madam,

Many thanks for the opportunity to comment on the BCBS consultative document on the disclosure of climate-related financial risks.

I work for Environmental Defense Fund, a global NGO operating in the US, Europe, China and India. We aim to deliver game-changing solutions that have a real impact for people around the globe.

Overarching comments

Environmental Defense Fund welcomes the publication of the Pillar 3 disclosure framework for climate-related financial risk and sees this as foundational to delivering a safe and sound global banking system. Climate-related risks are far-reaching and differ from other risks to financial stability. It is therefore important that the Pillar 3 disclosure framework for banks recognizes these risks and allows market participants, supervisors and policymakers to assess and compare the size of those risks and their potential threat to the banking sector. Given the global and interconnected nature of the banking system, it is important that this is done in a way that is globally comparable.

We welcome the disclosure framework set out and think that it will make a material difference to the ability of market participants, regulators and others to compare the risks that climate change poses to banks across jurisdictions.

I have summarised our main comments below. More detailed responses to specific questions are in the Appendix.

Overall

- Disclosures should cover the trading book as well as the banking book given the important ways in which climate-related financial risk can affect the trading book (e.g. through changes in the value of financial instruments caused by commodity price fluctuations).

Qualitative disclosures

- Qualitative disclosures should include climate-related targets and metrics.
- Disclosures should consider resilience as well as risk. For example, an explanation of how adaptation and resilience provide potential mitigation for exposures in vulnerable geographies could be set out in the Qualitative statement. This would help reduce the risk of unintended second order effects in which financing is withdrawn from potentially vulnerable geographies that have adaptation or resiliency measures in place.
- Scenario analysis disclosures should include an explanation of whether – and if so how – the results of the scenario analysis feed into strategy and risk management (including pricing).
- Disclosure of transition plans and transition risk intensity metrics should be mandatory rather than subject to national discretion – reflecting that the nature of climate-related financial risk requires forward looking analysis and assessment.

Quantitative disclosures

- Financed emissions are a reasonable proxy for transition risk; however, the BCBS should also request that banks provide exposures with time horizons of less than 5 years.
- Facilitated emissions should be subject to mandatory disclosure. Capital markets and financial advisory activities are core to many banks' business models.
- BCBS should not specify which methodology banks use to calculate financed and facilitated emissions. As EDF set out in its report Carbon Conundrum, climate accounting standards for banks and other lenders are still evolving resulting in a patchwork of data disclosures with sometimes incomplete and misleading results. Further, PCAF methodology allows significant room for interpretation and banks do not always disclosure their methodological choices. Instead, we recommend that the BCBS asks banks to disclose which methodology they are using to calculate their financed and facilitated emissions.
- We also note that methodologies for calculating financed emissions will continue to evolve as the measurement of emissions improves. For example, the development of satellite technology is an important step in measuring and tracking emissions in a more accurate way. Environmental Defense Fund has just launched MethaneSat to track methane emission rates and locations globally and show how those emissions are changing over time. We anticipate that MethaneSat will show that methane emissions in oil & gas fields are currently under-reported.[1]

Additionally, we encourage the BCBS to consider how environmental risks more broadly – in particular **nature and biodiversity risks** – will impact on the safety and soundness of individual banks and on financial stability more broadly. For example, in March 2022 the Network for Greening the Financial System stated that "*nature-related risks, including those associated with biodiversity loss, could have significant macroeconomic implications, and that failure to account for, mitigate, and adapt to these implications is a source of risks relevant for financial stability*." We call on the BCBS to publish principles on nature-related financial risk and to incorporate nature-related financial risk into the Pillar 3 disclosure framework.

Finally, we encourage Basel to update its core principles for effective banking supervision to include supervisory review and consideration of the Pillar 3 disclosures on climate-related financial risk so as to ensure that these are properly scrutinized by national supervisory authorities.

If it would be helpful to discuss our comments, please do reach out me: nharrison@edf.org.

Best,

Nicki Harrison

[1] For further information on how MethaneSat may be used by the financial community please see here: PowerPoint Presentation (edf.org)

APPENDIX – DETAILLED COMMENTS

5.1 General

Q1. What would be the benefits of a Pillar 3 disclosure framework for climate-related financial risks in terms of promoting comparability of banks' risk profiles within and across jurisdictions and promoting market discipline? What other benefits have been identified?

Disclosure requirements provide the foundation of a safe and sound banking system. Currently pillar 3 disclosures do not specifically address climate-related financial risk. The nature of climate-related financial risk is very different to other risk drivers in that it is systemic and its impact is likely to be correlated, non-linear, irreversible and subject to tipping points and the risk is likely to grow over time. It is therefore important to integrate disclosures that capture the particular nature of climate-related financial risk within pillar 3 disclosures.

By mandating the disclosure of climate-related financial risk within the pillar 3 disclosure framework, Basel will create internationally comparable disclosure requirements. This will reduce information asymmetry and promote comparability across jurisdictions.

Global comparability across jurisdictions is particularly important given the global nature of the international banking system and the role that the banking system needs to play in aligning financial flows to the Paris agreement. Internationally comparable disclosures will make it easier for market participants, supervisors and policymakers to assess and compare the size of the risks arising from climate change for banks and the mitigation measures that banks are taking to address. This would support financial stability.

Q2. What are the risks of a Pillar 3 disclosure framework for climate-related financial risks not being introduced?

Climate change is a global collective action problem. The earlier we make meaningful adjustments to our emissions path, the more orderly the transition will be and the lower the physical risks that we collectively face. Conversely, delays are more likely to lead to higher physical risks and potentially an abrupt and disorderly transition. It will be critical for policymakers, supervisors, market participants and the public to be able to assess both the risks to the banking system of potential future trajectories for physical and transition risk, as well as risks to individual banks. Without globally comparable disclosures, assessments of how both the banking system and individual banks are faring will be challenging.

Q3. Would the Pillar 3 framework for climate-related financial risks help market participants understand the climate-related financial risk exposures of banks and how banks are managing these risks?

Yes. Whilst other disclosure frameworks will provide a strong global baseline for disclosures for all corporates, it is important that this is supplemented by disclosures that draw out the unique way in which climate-related financial risks might impact the banking sector.

Q4. Would the Pillar 3 framework for climate-related financial risks be sufficiently interoperable with the requirements of other standard-setting bodies? If not, how could this best be achieved?

It is important that the Pillar 3 framework for climate-related financial risks is interoperable with best practice. We welcome that the BCBS is seeking to ensure that the bank-specific Pillar 3 disclosure requirements are complementary to the ISSB framework. The Qualitative Strategy could also be aligned with the frameworks set out by the UK's Transition Plan Taskforce and GFANZ.

Q5. Would there be any unintended consequences of a Pillar 3 framework for climate-related financial risks? If so, how could these be overcome?

The approach of allocating exposures to sectors and geographical locations subject to climate-related financial risks appears generally sensible; however, adaptation and resilience are important potential mitigants to physical risk exposures in particular geographies. The Qualitative statement should capture how adaptation efforts protect exposures in particular geographies. This would help reduce the risk of unintended second order effects in which financing is withdrawn from potentially vulnerable geographies that have adaptation or resiliency measures in place.

Q6. What are your views on potentially extending a Pillar 3 framework for climate-related financial risks to the trading book?

As noted by the European Banking Authority and others there are many ways in which climate-related financial risk can affect the trading book and, as such, pillar 3 disclosures should also cover the trading book.[2] For example, the transition to a low carbon economy can impact commodity markets, especially fossil fuels. Physical risks emerging from climate change can cause market price fluctuations, such as more frequent and severe extreme weather events causing losses in equities due to the destruction of a firms' assets or capacity to produce.

Further, given general pillar 3 disclosure requirements cover the trading book it would be inconsistent if climate-related financial risk disclosures did not.

Q7. What are your views on the proposed methodology of allocating exposures to sectors and geographical locations subject to climate-related financial risks?

The approach of allocating exposures to sectors and geographical locations subject to climate-related financial risks appears generally sensible; however, adaptation and resilience are important potential mitigants to physical risk exposures in particular geographies. The Qualitative statement should capture how adaptation efforts protect exposures in particular geographies. This would help reduce the risk of unintended second order effects in which financing is withdrawn from potentially vulnerable geographies that have adaptation or resiliency measures in place.

Q8. What are your views on which elements should be made subject to national discretion and which should be mandatory? Why?

As much of the Pillar 3 climate-related financial risk disclosure framework as possible should be mandatory. Introducing national discretion weakens global comparability and thereby increases risks to safety and soundness. In particular, the disclosure of transition plans should be

[2] On the role of environmental risk in the prudential framework (europa.eu)

mandatory reflecting that the nature of climate risks requires forward-looking analysis and assessment.

Q10. Would the qualitative and quantitative requirements under consideration need to be assured in order to be meaningful? If so, what challenges are foreseen?

The standard of assurance should be the same for climate-related financial risks as for regular pillar 3 disclosures. Whilst there should be no obligation to have these disclosures audited, these must, at a minimum, be subject to the same level of internal review and control as the qualitative information provided by banks in their financial reports.

5.2 Qualitative disclosure requirements

Q11. What are the benefits of the proposed qualitative Pillar 3 climate-related financial risk disclosure requirements?

Qualitative information on banks' governance, strategy, risk management and concentration risk management in relation to climate-related financial risks are all vital elements of banks' approaches to climate-related financial risk management. Creating a consistent set of global disclosure standards will allow market participants to assess how individual banks are managing and mitigating climate-related financial risk and what this means for the financial system as a whole. This should in turn incentivize both banks and financial supervisors to improve the quality of climate-related financial risk management.

Q12. Should the proposed qualitative Pillar 3 climate-related financial risk disclosure requirements be on a mandatory basis to facilitate comparability across banks?

Given the importance of these qualitative elements for forming a view on how banks are managing their climate-related financial risks, we think it is important that these disclosures are mandatory.

Q13. What key challenges would exist for preparers or users of the proposed qualitative Pillar 3 climate-related financial risk disclosure requirements? How could these be overcome?

Whilst banks may challenge the lack of data and relatively immature methodologies, we don't think that this should prevent preparers from developing the disclosures on a best endeavors basis whilst continuing to build data collection capacity and to improve methodologies.

Digital tagging of the data would help users with analyzing the data. Digital tagging could follow a similar model to the European Union's digital ESRS XBRL Taxonomy. This is designed for undertakings to tag their sustainable statements in a structured, machine-readable data format, which enables users of European Sustainability Reporting Standards disclosures to analyse the information avoiding manual and error-prone transformation from a PDF or printed document.

Q14. What additional qualitative Pillar 3 climate-related financial risk disclosure requirements should the Committee consider?

The BCBS should incorporate any climate-related targets and milestones that the bank has set into the disclosure framework. For example, aligned to the UK's Transition Planning Taskforce framework this could include any short-, medium- and long-term targets and milestones a bank has set to measure progress, including how short-, medium-, and long-term are defined in the context of transition planning.

Scenario analysis disclosures should include an explanation of whether – and if so how – the results of the scenario analysis feed into strategy and risk management (including pricing). This will give market participants a sense of whether the climate-risk scenarios used by banks are having an impact on the pricing of risk at the bank.

<u>Q15. How could the proposed qualitative Pillar 3 climate-related financial risk disclosure requirements be enhanced or modified to provide more meaningful and comparable information?</u>

Qualitative pillar 3 disclosures should be consistent with global best practice disclosure standards. For example, in relation to Strategy this could be made consistent with the outcomes of the Transition Plan guidance set out by the UK's Transition Plan Taskforce and GFANZ.

As per Q5, the Qualitative statement should capture how adaptation efforts protect exposures in particular geographies. This would help reduce the risk of unintended second order effects in which financing is withdrawn from potentially vulnerable geographies that have adaptation or resiliency measures in place.

5.3 Quantitative disclosure requirements

General

<u>Q17. What are the benefits of the proposed quantitative Pillar 3 climate-related financial risk disclosure requirements?</u>

Creating a consistent set of global disclosure standards will allow market participants to assess how individual banks are managing and mitigating climate-related financial risk and what this means for the financial system as a whole. This should in turn incentivize both banks and financial supervisors to improve the quality of climate-related financial risk management.

<u>Q18. Should the proposed quantitative Pillar 3 climate-related financial risk disclosure requirements be on a mandatory basis to facilitate comparability across banks?</u>

As much of the Pillar 3 climate-related financial risk disclosure framework as possible should be mandatory. Introducing national discretion weakens global comparability and thereby increases risks to safety and soundness.

Transition risk: exposures and financed emissions by sector

<u>Q24. Would exposures and financed emissions by sector be a useful metric for assessing banks' exposure to transition risk?</u>

Financed emissions are currently being used as a credible indicator for transition impact on financial risk – especially when considered alongside transition plans. The inclusion of both on- and off-balance sheet items is welcome. To further strengthen the understanding of risk exposures, the BCBS should also consider addressing exposures with time horizons of less than 5 years to reflect that transition risk can occur in the nearer term.

At the sector level, methodologies for calculating financed emissions will continue to evolve. For example, the development of satellite technology is an important step in measuring and tracking emissions in a more accurate way. Environmental Defense Fund has just launched MethaneSat to track methane emission rates and locations globally and show how those emissions are changing over time. This will initially be targeted at the oil & gas industry and later could expand to cover the agriculture sector: PowerPoint Presentation (edf.org)

Assessing banks' exposures to transition risk by sector is very important. We note that the BCBS has produced a specific template on how reporting requirements could apply to real estate. We would welcome similar templates for other critical real economy sectors (what counts as critical will differ by jurisdiction).

Q27. What additional transition risk disclosure requirements should the Committee consider?

The BCBS should also request that banks provide exposures with time horizons of less than 5 years reflecting that transition risk could occur in the nearer term.

Q29. Would it be useful to require disclosure of the specific methodology (such as Partnership for Carbon Accounting Financials (PCAF)) used in calculating financed emissions?

We welcome that the Pillar 3 disclosures covers both financed and facilitated emissions as these are both important components in the management of climate risk. We do not think that Basel should specify which methodology banks use to calculate financed and facilitated emissions. As EDF set out in its report Carbon Conundrum, climate accounting standards for banks and other lenders are still evolving resulting in a patchwork of data disclosures with sometimes incomplete and misleading results. Even when lenders use the PCAF methodology, the methodology allows for significant variation and banks do not always disclose their methodological choices. Instead, we recommend that Basel ask banks to disclose which methodology they are using to calculate their financed and facilitated emissions.

We also note that PCAF itself is an industry-led body, which has come under some criticism from NGOs and others – particularly for its work on facilitated emissions: https://www.ft.com/content/ca549b24-ece5-46c2-85fb-5fe1aa24d296

Templates

Q48. Would the potential structure and design of the templates pose any challenges for preparers or users of Pillar 3 climate-related financial risk disclosure requirements? How could those be overcome?

Digital tagging of the data would help users with analysing the data. Digital tagging could follow a similar model to the European Union's digital ESRS XBRL Taxonomy. This is designed for undertakings to tag their sustainable statements in a structured, machine-readable data format, which enables users of European Sustainability Reporting Standards disclosures to analyse the information avoiding manual and error-prone transformation from a PDF or printed document.

5.4 Quantitative disclosure requirements subject to jurisdictional discretion

Q49. What are the benefits of the proposed quantitative Pillar 3 climate-related financial risk disclosure requirements subject to jurisdictional discretion?

It is important that facilitated emissions metrics are disclosed globally and not just subject to jurisdictional discretion given the contribution that facilitated activities can make to bank profitability and therefore to bank safety and soundness.

Q51. What are your views on the feasibility, meaningfulness and practicality of banks' disclosure of facilitated emissions?

It is essential that facilitated emissions are disclosed. Capital markets and financial advisory activities are core to many banks' business models. These activities are also vulnerable to climate-related financial risk (e.g. Ceres has set out the implications of derivatives for climate-related financial risk[3]).

Given methodologies for disclosing facilitated emissions are still in their infancy, we would advocate disclosing on a best endeavors basis whilst supporting the continued development of industry-standard methodologies.

5.6 Liquidity risk

Q54. What are your views on the Committee exploring disclosure requirements for the impacts of climate-related financial risks on deposits/funding and liabilities?

At a minimum, the BCBS should ask banks to provide qualitative information on the tools that they use to identify and manage the impact of climate-related risks on liquidity. This would allow market participants to compare how institutions were managing the potential liquidity risk posed by climate-related risk drivers.

About us: ***Environmental Defense Fund (EDF)*** *addresses the world's most urgent environmental challenges by applying our science, economic and innovation expertise. We match these efforts with a commitment to ensuring that our work protects the rights of all people to have clean air and water, and a healthy environment – including those most vulnerable to climate change and other environmental threats.* Environmental Defense Fund - Building a vital Earth for everyone (edf.org)

[3] https://www.ceres.org/sites/default/files/reports/2022-09/Ceres%20Derivatives%20and%20Bank%20Climate%20Risk%20Report%202022_0.pdf