FEDERACION LATINOAMERICANA DE BANCOS

A response by the Federation of Latin American Banks – FELABAN to the Basel Committee on Banking Supervision's consultative document on:

# *Principles for the effective management and supervision of climate-related financial risks*

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Dear Basel Committee on Banking Supervision members:

The Federation of Latin American Banks - FELABAN acknowledges the Basel Committee on Banking Supervision (hereinafter *the Committee)* for the opportunity to discuss the proposals included in the consultative document "*Principles for the effective management and supervision of climate-related financial risks*", published on November 2021.

As expectations on ESG matters from the financial system in general, and from banks in particular, has seen a steady growth over the last years in our region, so do have their interest in proper climate risk management. Latin American banks are aware that climate-related financial risks will have more probability of occurrence, will be more severe and will cause greater financial impact; thus, appropriate supervisory methodologies on this regard will always be welcome.

FELABAN analyzed and discussed its content with the Banking Associations we represent, as well as with our Latin American Committee on Risks, and the outcome is this response, which highlights our comments and views on this initiative. We believe it will be a useful point of reference when considering best regulatory and supervisory practices for climate-related financial risks, from the point of view of the Latin American banking sector.

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## 1. Overall comments

Climate change effects on banks' risk management policies can significantly differ depending on attributes such as location, level of exposure and risk appetite, amongst others.

As climate-related financial risks are increasingly important, recommendations integrated with the Basel framework become more useful. However, it is essential to realize that each location in the world is different, with diverse needs and challenges. Therefore, it is important to "tropicalize" measures and recommendations to each region of the world, or general measures that can be applied in each country, instead issuing general recommendations that may not fully apply to a given jurisdiction in a given point of time.

Similarly, we suggest to clarify how these principles would converge with other initiatives that also address climate risk analysis and management (such as the TCDF, Equator Principles), in order to avoid regulatory fragmentation.

Regarding climate-related risks with significant impact on business continuity, we suggest to specify which external events should a bank adapt to their management systems and policies. Even though banks are able to identify climate risks and assign probabilities of occurrence to specific events, its should be kept in mind that there is a limited scope (and control) over the causes and controls to be implemented in order to mitigate those external events.

Separately, we observed the consultative document references 4 climate-related risks: physical, transition, reputational and regulatory. We kindly request to further clarify if reputational and regulatory risks are embedded within transition risks, as these two risks are explicitly stated only twice throughout the whole document (particularly, in Principle 11).

Last, but not least, should the Committee deem appropriate setting minimum standards on climate-related financial risks, we kindly suggest 1) to consider climate risk regulatory and supervisory guidelines commensurate with the size, complexity, location, business activities and economic cycles, amongst other factors; 2) to include a gradual implementation plan for each of the principles stated in the document ; and 3) to specify a reasonable timeline or deadline date to this end, so that banks can incorporate these affairs within their long-term risk and corporate governance strategy.

2. **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 consider that, on broad terms, the necessary requirements for the effective management of climate-related financial risks and related supervision have been adequately captured (roles, responsibilities, identification, evaluation, monitoring and risk management policies, as well as corporate governance).

We recognize the value of freedom for the industry to implement the principles; however, their interpretation will have a gradual impact as both climate change and climate risk management evolves and matures. In this sense, it will be necessary to follow the existing international methodologies and parameters so that the regional supervisors can reach a common understanding.

On the other hand, regarding the impact on solvency indicators, and despite the need of "tropicalizing" potential supervisory methodologies and policies on this regard, we consider the Committee should address and define a standard model. Otherwise, banks could develop their own internal models, leading to regulatory fragmentation.

We recommend the Committee to follow closely availability and sources of climate data. Given that climate-related data is relatively new in Latin America's financial sector, there is still much to learn in this regard – especially for small banks. Therefore, we suggest that any climate risk standard should be issued according to the "depth" of historical climate data time series – be it public or captured from client's data.

Lastly, and before issuing regulations on climate risk management, we consider the Committee might consider sharing business cases or best practices on scenario analysis, climate risk measuring and mitigation, and climate risk modelling (for example), so that banks can get a better sense of the regulatory and supervisory expectations in this regard.

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

Principle 1. We highlight that the Proposal would not require any particular governance structure to meet these expectations. If banks have already implemented a management system, this should be reviewed in order to analyze whether adjustments or adaptations need to be made. In some cases, a new management system might be needed.

However, we believe that the Committee should carefully distinguish the roles and responsibilities assigned to the board from those assigned to the Senior management. In particular, we believe it would be useful to clarify the following sentence in paragraph 12: ‘The board and senior management should be involved in all relevant stages of the process’ by adding at the end ‘according to their respective roles’; also, we suggest replacing the word “process” by “policies or rules”.

Also, as acknowledged by the Basel Committee, climate risk is not a new, standalone category of risk. All ESG factors can positively or negatively impact the current risk categories. The text should be clarified accordingly to avoid possible misinterpretation. The wording ‘risk driver’ could be replaced by ‘factor’.

Principle 2. Similarly, we believe that the Committee should carefully distinguish the roles and responsibilities assigned to the board from those assigned to the Senior management. In particular, we suggest the following wording change in Principle 2 itself to avoid any ambiguity: ‘According to their respective roles, the board or the senior management should identify responsibilities for climate-related risk management throughout the organizational structure.’ Given that some changes in the bank system could be applied to implement a new climate-risk management, it will be crucial to have the commitment of banks’ key personnel.

Similarly, there should be an explanation of what is deemed as “adequate understanding…” (*Banks should ensure that the board and senior management have an adequate understanding of climate-related financial risks*), in order to avoid misinterpretations (exact skills/knowledge to guarantee, frequency of training, etc).

Principle 3. Similar to our previous point, explanation of what is deemed as appropriate when talking about *policies, procedures and controls to be implemented across the entire organization to ensure effective management of climate-related financial risks*.

Also, it is stated that management climate-related risks should be "applied" to clients and their transactions. What timeline is the Committee considering for the implementation of these practices?

Principle 4. The proposed principle states that "The third line of defense, the internal audit function, should carry out regular reviews of the overall internal control framework and systems …" As clarity on the time intervals of these reviews should be provided, we suggest specifying the expected periodicity of reviews.

Principle 5. Whereas we support the need for identification and quantification of climate-related financial risks and their inclusion into banks' capital and liquidity adequacy frameworks, we welcome the acknowledgement under paragraph 23 that the 'probable' inclusion into ICAAPs and ILAAP should be 'iterative and progressive'. We believe that both paragraph 21 on ICAAP provisions and paragraph 22 on ILAAP provisions should be made consistent with the concept of a gradual inclusion and thus, we suggest adding 'iteratively and progressively' to qualify the inclusion in both processes ('Banks should include iteratively and progressively climate-related financial risks…').

The rationale behind this is that at this stage, the precise relationship between risk drivers and actual risk levels on capital and liquidity cannot be precisely quantified as it lacks:

i. The required methodologies which are still a work in progress: methods for integrating climate-related and environmental risk drivers should be defined and implemented by banks as deemed adequate for internal economic risks monitoring and decision-making purposes.

ii. The required available and reliable statistical data elements, whether internal or from regulated and audited external data providers

There are still a lot of uncertainties as to the evolution of climate change (speed, magnitude, non-linearity) and physical and transition risk drivers (e.g., climate policies, technology, investor and consumer behavior, etc.), as summarized by BCBS in the section 2 of its April 2021 report (Climate-related risk drivers and their transmission channels) which make the capital and liquidity impact difficult to assess at this stage.

It is important to mention that each country may have differences in the availability, comprehensiveness and consistency of the information. Therefore, we suggest that the guidelines issued by the Basel Committee should consider that the implementation in each country will depend on the reliability of the information required according to the characteristics, criteria, local regulations, and risks identified. For example, in Mexico ICAAP 2022 (solvency exercise this year) considers the incorporation of climate risk based on scenarios with three different approaches, which will require an additional effort to ensure the quality of information of our customers, economic sectors, CO2 emissions, energy efficiency certificates, etc.

In terms of scope, we believe that since ESG risk drivers are expected to materialize over a long-term time horizon, they do not have a meaningful impact on banks' liquidity in the short term.

Our comments are: 1) Is capital expected to be required for this type of risk in the future? 2) Should consumer credit portfolios also be included in these evaluations? (given that there is very little work on a global scale in terms of assessing climate risks in consumer portfolios). 3) What should banks keep in mind when measuring liquidity risks related to climate change? (example – how to compute a potential depletion of liquidity buffers when there is no statistical evidence that, say, more CO2 emissions lead to massive withdraws or even bank runs?).

Principle 6. It is relevant that banks identify, monitor and manage this kind of risks.

Will a guidance or reference framework to develop, implement and monitor the risk process be published, in order to have "homogeneous metrics", or will be up to each institution to define?

Flexibility should be allowed on whether, how and to which extent Banks incorporate these risks as, for instance, the usefulness of setting climate risk limits for market and liquidity scenarios is unclear. We consider it should be incorporated into the risk profile and risk appetite. In fact, the proposal incorporates climate risk into existing risk types, rather than treating climate risk as a separate risk type.

We recommend that the local regulator define the taxonomy to be used for the classification of economic activities and the possible impact of climate risks. This would facilitate comparison between different institutions. For example, NAICS (North American Industry Classification System) and/or NACE (Nomenclature of Economic Activities). (Also applies to paragraph 33). The proposal would specifically require concerned banks to develop appropriate metrics to support climate risk management, including risk limits and key performance indicators ("KPIs"), and would require these metrics to be incorporated into policies and procedures. It would not, however, prescribe any particular limits, KPIs, or other metrics that must be used. Therefore, limits and KRIs should also be established for this type of risk.

Moreover, greater standardization on particular KRIs (to be defined by the Committee in a further stage) associated to climate change could be useful to improve comparability across banks and across jurisdictions

Principle 7. Is this principle applicable to both the transitional risk and physical risk aspects of climate change? Some concepts should be defined more clearly, for instance, what do climate-related financial risks include? We believe that information standards and data requests should aim to have a homogenous international standard to ensure data comparability and provide a common ground to assess progress on climate-related financial risks in different jurisdictions. To that end, it would be useful to provide a reporting template to banks.

Similarly, when the Committee states that reporting should be "timely and updated regularly", How often is regularly? Is there any recommendation of an appropriate interval? Will that reporting interval be defined by the Committee, or locally by each regulator?

Principle 8. We recommend adding the word "possible": "Banks should understand the possible impact…" What kind of risks does "material climate-related financial risks" include? Is this also contemplated for consumer banks?

How does the Committee define "prudent policies"? We appreciate the Committee to share the criterion to keep in mind so that banks can act to this end.

Banks may also consider setting limits or applying appropriate alternative risk mitigation techniques to their exposure to companies, economic sectors, geographic regions, or product and service segments that are not aligned with their business strategy or risk appetite. What alternative risk mitigation techniques is the Committee referring to? Given the complexity of this recommendation, help by an external consultant may be needed; therefore, enough time should be given to banks to achieve this goal.

Principle 9. Does the recommendation stated in this principle also apply to short-term financial instruments?

When evaluating mark-to-market exposures to climate-related risks, what framework can be taken as a reference for this type of analysis? Strengthening and expanding the weather insurance market could help parameterize this item. As this recommendation will be different considering the size of the bank, it might be difficult to reflect on the potential results.

Principle 10. Given that it is likely that a bank's ESG team will not be specifically involved in the activity of liquidity risk management, the document should consider providing training to different areas of the bank.

Principle 11. No comments on this principle.

Principle 12. Will there be guidance on what scenarios to use and will the pathways be standardized? It is important to be clear about how climate risk will affect the macroeconomic environment in order to determine which sectors or economic activities will be more susceptible to such risk and be able to estimate potential losses. Also, it is important to clearly know which additional information will be required.

Similarly, will the Committee set the scenarios and variables of interest, or will it be locally set by the regulator, or will it be according to banks' own criteria?

Finally, what would the consequences of these stress tests be? We believe that these exercises should be informative, given that most of the analyses could be targeting risks already assessed on the current scenario analysis framework (and stress tests), and that the methodologies, data and mitigation options for climate-related risks need to be further developed to be effectively implemented.

Scenario design for climate risk assessment should be standardized as much as possible.

Principle 13. We suggest developing this point to include banks that depend on a global business strategy and international regulations, as well as ensuring that local regulatory bodies incorporate climate-related risk management into their agendas in the short term - subject to the guidelines determined locally by the authority.

Comments on this regard from regulators and supervisory authorities would be very convenient to further develop these principles.

Principle 14. For developing countries, it would be desirable for the local regulator to publish reference frameworks that banks can gradually adopt, with a goal of identifying, monitoring, and managing climate risks and not merely supervising each banks' activities.

Similarly, how often will these reviews take place? How can supervisors verify that the evaluation is comprehensive?

Principle 15. No comments on this principle.

Principle 16. We suggest considering aligning the point with the type of functions of the bank (commercial or development), as well as the type of portfolio. Having a list of tools could help to implement this principle. Maybe meetings with other banks could help to increase the range of techniques and tools.

Similar to previous comments, it is key to be as precise as possible when it comes to determining supervisory expectations.

Principle 17. We recommend that local regulators promote the collection of relevant data through government agencies that have the capacity to do so and share it with banks. Supervisors could use existing regulatory reporting to assess the materiality of climate-related financial risks to banks. In the event of data gaps, supervisors may collect additional information from supervised banks, such as sector exposures and internal bank reports.

Principle 18. The level of capital should be determined based on the associated risk. However, for quantifying the climate-related risk, the scenario analyses are still in piloting phase and will become more sophisticated by repeated exercise over time. Stress testing methodologies for ESG risks have so far mainly been applied in an exploratory manner. We understand that some assumptions and simplifications are needed so that the exercises are doable given the limitation in the data and methodologies to date. But because of these limitations, the framework and its results might be unrealistic, and special care has to be taken when analyzing the results. Therefore, until data, methodologies and results of regulatory stress testing practices are stabilized, these exercises should not imply any quantitative impact on the capital requirement.

4. **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?**

The key aspect to evaluate would be the expected impact of climate phenomena on economic, social and political variables relevant to the environment each bank operates. Also, to consider climate risk scenarios by each region a bank operates on, so that potential impacts can be identified and measured depending their particular location.

We suggest considering the following factors:

- The methodology that the institution would be using
- The entity's strategy
- Destination of credits
- Climate risk impact measurements
- Risk taking in the portfolio
- Regulatory incentives to generate attractive rates in projects with zero carbon footprint.
- Stakeholders' expectations
- Legal implications
- Technological advancements

On the other hand, given that environmental risks can have transmission channels similar to those of climate risk, we consider appropriate to develop risk management methodologies associated to the use of natural capital and its depletion. Therefore, beyond recommending the development of guidelines related to these aspects, we ask the Committee to determine whether those guidelines should converge to both physical and transition risks, or if they have to be developed separetly.

A clear and universal methodology must be built in order to allow this transition to be made in a more homogeneous way among banking institutions, regardless of their size and complexity. Today, there are various methodologies and frameworks that take different elements into account to address the same problem. If in the future, regulators must include these elements in their reviews, that is why we must have a framework that is applicable to all.

Some banks are currently starting by working on governance and including the guidelines for the correct management of climate-related financial risks in their risk profile. Other banks do not have clear metrics defined to include in their risk profile.

Creating scenarios will help to have a better understanding of the risks, but the key is monitoring and updating them regularly.

The role of multilateral banks is key when it comes to the potential implementation of these principles at regional and local level, as they have always been supportive in terms of capacity building and support in these specialized fields. At the same time, they help banks to standardize methodologies according to their particular context.

The proposed principles should be adapted for the microfinance sector and banks who specialize in this field. Given their size, their approach, the operations they manage, the sectors they operate in and their relevance in regional and national financial inclusion policies, any proposed supervisory methodology should carefully address these kind of entities, so that they are not deterred from operating in this highly specialized business niche.

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FELABAN wishes to thank the Committee for considering the above comments. We acknowledge climate-related financial risks will grow in terms of frequency, severity and financial impact over the near future, and we trust these comments will enrich the discussion around regulatory and supervisory best practices on these affairs. Should any clarification arise regarding our comments to this consultative document, we look forward to discussing them further.

Sincerely,

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Secretary General

FELABAN – FEDERATION OF LATIN AMERICAN BANKS