

Finance Watch response to the BCBS

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

Q1. 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?

As mentioned in the consultative document itself, the Principles for the effective management and supervision of climate-related financial risks (referred to as the Principles) seek to adapt the existing BCBS Core principles for effective banking supervision (BCPs) and the supervisory review process (SRP) to climate-related financial risks. By this, the document makes it clear that climate-related financial risks should be taken into account throughout the whole banking prudential framework – banks' business strategies, governance, internal controls, risk management process and supervision, including scenario analyses and stress testing, which is a step forward compared to the current situation, where national supervisory guidance differs across jurisdictions in terms of the areas covered. [1]

The missing piece of the approach taken by the BCBS is environmental materiality. The fact that the Committee considers only financial materiality is a most significant gap in its apprehension and its comprehension of the interaction between climate change and banking institutions. Financial materiality is, of course, essential and at the heart of the mission of the BCBS but, when it comes to climate change, financial materiality is fed by environmental materiality. In other words, attempting to address financial materiality without addressing environmental materiality is tantamount to deciding to ignore the root causes of climate-related financial risks. There exists a doom loop by which financial institutions, and in particular banking institutions, make climate change possible by providing financing to the fossil fuel industry, which is at the source of the bulk of CO2 emissions. At the same time, banking institutions are themselves threatened by climate change. The lack of consideration of the double materiality approach by the BCBS not only hinders its ability to apprehend this vicious circle but, most importantly, also the possibility to develop macro-prudential policies to tackle it.

The Principles appear comprehensive, however, mostly generic in trying to fit climate-related financial risks into the well-established Basel framework. We argue that due to the factors discussed in the sub-sections below, high-level principles-based guidance for supervisors and financial institutions will not be sufficient to achieve timely and impactful outcomes in managing climate-related financial risks of the banking sector. In addition to the Principles, the BCBS should adopt further more prescriptive measures, in particular Pillar I requirements, based on a precautionary approach in tackling these risks, which can and should be done as part of the holistic review of the Basel framework that the BCBS is undertaking.

Systemic nature of the climate-related financial risks. The world's leading regulators, supervisors and researchers have long recognised the link between climate change and financial stability. Thus, managing climate-related financial risks is not only relevant from the perspective of individual institutions, but also from the systemic perspective. However, the Principles mostly address short-term financial implications of climate change for each institution's financial position. By this, the Principles overlook the systemic risk dimension - the fact that continued financing of climate change accelerating activities leads to the situation where individual institutions will no longer be able to mitigate their risk due to irreversible changes of the climate.

Specifics of the climate-related financial risks. Most importantly, climate-related financial risks are characterised by radical uncertainty and forward-looking nature, which makes predicting and modelling impossible with any degree of reliability. Thus, applying the existing prudential tools will not be sufficient to ensure financial institutions are resilient against the risks. This view is confirmed by the experiences of supervisors-NGFS members, which reported a common methodological challenge of “the extended horizon of these risks compared to conventional prudential risks, their evolving nature, the uncertainty of their impact and transition pathways as well as the likelihood of materialisation, given their non-linearity and multiple points of impact on financial institutions”. [2] The UK Prudential Regulation Authority (PRA) referred to this as a “**regime gaps**”: “due to the unique features and uncertainties of climate-related financial risks, there could be gaps fundamental to the way current regimes and current methodologies address firm-specific exposures, in particular the short-term calibrations based on historical data”. [3]

Capital adequacy perspective missing in supervisory assessment. The Principles state that financial institutions should include climate-related financial risks in their internal capital assessment process (ICAAP). By design of the ICAAP, this implies that financial institutions should maintain adequate capital to cover the risks identified as material and not covered under the Pillar I prudential requirements, which is the case for climate-related financial risks as per the current design of the Basel framework. However, the proposed Principles for the supervision (Principles 13-15) do not include supervisory evaluation of the adequacy of financial institutions' capital to cover climate-related financial risks in cases where the latter will be identified as material. The Principles do not envisage a possibility of supervisory capital add-ons for such risks, whereas capital is the ultimate tool to ensure financial institutions remain stable in case of risk materialisation. Such an approach is not in line with the original core Basel principles of supervisory review, which stipulate that supervisors should “evaluate banks' internal capital adequacy assessments and strategies”, as well as “have the ability to require banks to hold capital in excess of the minimum”. [4]

With regard to supervisory stress testing, missing capital adequacy perspective appears particularly incoherent: The Principles broadly speak about including climate risk considerations in climate *scenario analyses*; however, the wording is vague, as it suggests that stress tests are a subcategory of scenario analyses (“Supervisors should consider using climate-related risk scenario analysis, including stress testing...”). Clarity on this aspect is most important, as there is a fundamental difference between scenario analysis and stress testing: stress testing as a prudential tool should necessarily reach conclusions about financial institutions' capital adequacy, whereas scenario analysis is an exploratory exercise, which cannot address the financial stability objective of prudential regulation.

Existing challenges beyond a lack of common international standards. Although the Principles are an important step forward to set a common global supervisory standard on climate-related financial risks, there are further significant challenges to achieve effective management and

supervision of these risks. The NGFS “Guide for supervisors on Integrating climate-related and environmental risks into prudential supervision” (NGFS Guide for supervisors) has been in place since May 2020. Yet, the NGFS progress report on the Guide, published in October 2021, outlines challenges beyond the existence of supervisory guidance: [5]

- lack of internal capacity and resources, with funding, headcount and lack of expertise
- lack of harmonised methodologies, indicators and metrics to assess climate-related and environmental risks, including forward looking methodologies
- limited availability and granularity of data
- specificities of the various risk factors and transmission channels, which mean that available methodologies may have a limited scope of application.

The below extracts from the NGFS progress report are worth noting to support our arguments above:

“78% of supervisors have included climate-related risks in their supervisory activities in one form or another, with many of them having engaged with financial institutions under their supervision to better understand their climate-related risks exposures (recommendation 3). On the other hand, the understanding and measurement of environmental risks more broadly are still at a nascent stage”.

“Progress made by supervisors in terms of setting supervisory expectations for climate-related and environmental risk management has significantly accelerated since 2019, with 83% having developed or developing supervisory expectations for climate-related risks and 59% for environmental risks (recommendation 4). Nevertheless, supervisors have made less headway in effectively integrating these risks into their set of formal and binding supervisory tools, although most of them report ongoing actions or plans to do so (recommendation 5)”.

“When the NGFS Guide was published, it acknowledged that it was difficult for supervisors to properly quantify the impact of climate-related and environmental risks on capital adequacy. This remains the case. Supervisory tools with sound approaches to translate climate-related and environmental risks into quantifiable financial risks remain at a nascent stage. Supervisors acknowledge that even relatively advanced financial institutions are at an early stage in the process of developing sound quantitative approaches and metrics for assessing climate-related risks, and even more so for broader environmental risks. As discussed in Chapter 3, gaps in data, risk classification and assessment methodologies have hindered faster progress in this area”.

The results of the supervisory assessment by the UK PRA and the ECB also confirm that despite the supervisory guidance being in place [6], financial institutions are not yet in the position to fully comply with the requirements and effectively identify, measure, monitor and manage their climate-related financial risks. [7]

Based on the insights gained by supervisors until now when setting supervisory expectations and conducting supervisory assessments, we conclude that the high-level principles-based supervisory guidance is only the first step towards effective supervision and management of climate-related financial risks. Substantial more granular work is needed to ensure coherence of approaches and methodologies to manage climate-related financial risk and with this – ensure comparability and reliability of outcomes.

Gradual process, but concerns over impact and timeliness. We agree with the perspective taken in the consultative document that:

- Achieving effective management and supervision of climate-related financial risks will be a gradual and iterative process, as financial institutions and supervisors continuously develop their capabilities and expertise, identify good practices, which can then be incorporated into supervisory expectations and dialogue.
- Notwithstanding the above, financial institutions and supervisors should start acting on the available data and using the available analytical capabilities.

However, the perspective of gradual improvement does not take into account the temporal dimension of climate-related financial risk developments: First, physical climate risks are increasing as long as no tangible actions are taken to reduce greenhouse gas emissions. Second, transition risks to the financial sector are also predicted to be higher in case of late and disorderly transition. In its economy-wide stress test, the ECB reached the conclusion that “there are clear benefits to acting early: the short-term costs of the transition pale in comparison to the costs of unfettered climate change in the medium to long term.” [8]

None of the supervisory measures to date have delivered tangible results to provide for the resilience of financial institutions in the wake of major climate-related risk materialisation [9]. The Principles, too, hardly offer incentives for financial institutions to change their behaviour, as they mostly suggest short-term risk mitigation measures, which do not address the long-term systemic implications of pursuing business activities associated with high climate-related risks in the long term. Despite the guidance for banks to consider long-term implications for the business strategy, the Principles do not suggest tools that would influence banks’ incentives to *act* with a long-term perspective in mind. The Principles admit the high degree of uncertainty associated with such long-term horizons. Taken together, these statements mean that it will be very hard for supervisors to evaluate the appropriateness of the banks’ long-term assessments and actions and thus impact their behaviour with the aim of ensuring long-term financial stability.

Precautionary, timely and risk-based measures should be prioritised. Considering the arguments above, we argue that application of Pillar I capital requirements to cover climate-related financial risks would deliver the most tangible outcomes to ensure resilience of the financial sector to climate-related financial risks. Risk-based Pillar I requirements, based on a precautionary principle, are a way for regulators to take timely action against materialisation of climate-related financial risks, which will have systemic implications, instead of waiting until cases of materialisation are significant enough and regulators are left without tools to address them. Finance Watch has developed proposals that allow to incorporate these risks into the current prudential frameworks for banks [10]. In a context of radical uncertainty where, as recognised by central banks, supervisors and academics, measuring precisely the impact of climate change on financial institutions is and will remain an illusion, capital requirements should be calibrated to ensure the internal coherence of prudential regulation, i.e. reflect the risks inherent in financial institutions’ exposures. Supervisory review process (Pillar II measures) can only be effective given strong Pillar I requirements, as only application of “hard-coded” and thus consistent capital requirements across financial institutions can ensure their resilience and solvency in case of a financial crisis. In the best of cases, development and implementation of more precise methods to measure climate change-related financial risks will take years, by when the financial system and economy overall will be disrupted by irreversible climate-related events.

Finance Watch proposals seek to increase minimum capital requirements for those types of exposures, which are clearly identifiable as the source of particularly high climate-related financial risks. The scope of such exposures covers fossil fuel exploration, expansion, exploitation and

production activities and fossil fuel power plants - as the root cause of CO2 emissions. The logic is grounded in the **double materiality principle**: By financing fossil-fuel related activities, banks contribute to accelerating climate change, which in turn, increases the risks that banks face as the result of climate change - both physical and transition (the so-called doom loop). Fossil fuel-related assets represent an increasing source of transition risk, as they will have to be largely abandoned and/or will significantly depreciate, as governments embark on their declared transition policies. The proposals differentiate between production and exploitation of existing fossil fuel resources on the one hand, and the exploration, expansion, production and exploitation of new resources on the other hand. Such differentiation is based on the risk profile of the respective projects:

- Assets associated with exploration, expansion and exploitation of new fossil fuel reserves will pose a particularly high financial stability risk and will, with near certainty, become stranded and lose 100% of their value. This is supported by the conclusions of the IPCC and IEA that there is no room for new fossil fuel exploration in the net-zero 2050 scenario. [11] Therefore, prudential rules should require that such exposures be entirely equity funded, i.e. impose a risk weight of 1250%.
- Assets associated with exploitation of existing fossil reserves are at a high risk of becoming stranded and increasingly depreciating. Therefore, such assets should be treated as the items currently associated with particularly high risk in prudential regulation and receive an increased credit risk weight – the amount of such increase to be made consistent with other exposures associated with particular high risk as per the Basel standard. For example, in the EU implementation of the Basel standard such risk weight amounts to 150% as per Article 128 of the current version of the Capital Requirements Regulation. [12]
- For banks using internal models to determine capital requirements (IRB approach), the above risk weights should represent the effective floor when determining the capital requirements for fossil fuel exposures.

Q2. Do you have any comments on the individual principles and supporting commentary?

The specific comments below are provided on selected principles in addition to the more general comments made on question 1, which are relevant for all principles.

Principles 1 and 5

Principle 1 says that “Banks should consider material climate-related financial risks that could manifest *over various time horizons* and incorporate these risks into their overall business strategies and risk management frameworks”. Principle 5 further recommends that “[b]anks should identify and quantify climate-related financial risks and incorporate those assessed as material *over relevant time horizons* into their internal capital and liquidity adequacy assessment processes”. However, as mentioned in our response to question 1, practical implementation of this guidance is faced with an inherent challenge, as the current design of the banks’ risk management framework does not fully allow for incorporation of the long-term perspective of climate-related financial risks materialisation. Credit risk ratings, which play a key role in the credit decision processes and determination of capital levels, are mostly based on a one-year time horizon. Internal capital adequacy assessment and financial planning horizons usually span to no more than three years. Refer to our response to question 1 under the subsection “Specifics of the climate-related financial risks”.

Principle 5

Principle 5 urges banks to “identify and quantify climate-related financial risks and incorporate those assessed as material over relevant time horizons into their internal capital and liquidity adequacy assessment processes”. However, existing challenges to measure and model climate-related financial risks, as well as lack of sufficient expertise at supervisors and financial institutions, will result in heterogeneous and hardly credible outcomes across the banks. [13] From the financial stability perspective, this will jeopardise the effectiveness of supervisory measures. If anything, at the current stage more precise supervisory guidance is needed to ensure coherence of the results, which will be a precondition for supervisors to derive meaningful conclusions about the climate-related financial risks in the financial system overall.

Principle 6

The Principle suggests that, where appropriate, banks should consider “risk mitigation measures such as establishing internal limits for the various types of material climate-related financial risks to which they are exposed, e.g. in their credit, market, liquidity and operational risk profiles”. Given the current lack of universally agreed transmission channels and indicators to measure climate-related financial risks, such principle-based risk management guidance leaves ample discretion to individual banks. Combined with numerous uncertainties with respect to climate risk, this might jeopardise reliability and consistency of the outcomes.

Principle 8

The Principle advises to incorporate climate-related risk considerations into credit policies and processes and “the entire credit life cycle”. However, the Principle does not explicitly mention incorporation of climate-related financial risks into credit ratings of the counterparties, whereas credit rating is a major component of the cycle, as it determines the amount of capital requirement to cover banks’ credit risk, i.e. unexpected future losses.

Further, refer to our response on question 1 for our comment on the short-term mitigating measures suggested by this Principle (paragraph 34 of the consultative document) vs long-term systemic impacts of climate-related financial risks.

Principle 12-16, 18

Refer to our comments on question 1, sub-section “Capital adequacy perspective missing in supervisory assessment”.

Principle 16 mentions that supervisors should “adopt adequate follow-up measures in case of material misalignment with supervisory expectations”. However, the principle does not indicate any possible options for the supervisors to act. Considering that the Principles remain silent on the supervisory assessment of banks’ capital adequacy to cover climate-related financial risks, this contributes to the concerns about impactfulness of supervisory actions from the financial stability perspective.

Further, the BCBS should monitor implementation of the supervision practices on climate-related risks in annual country-by-country progress reports to make sure there is effective action to mitigate the identified risks, convergence of practices, as well as exchange of expertise.

Footnotes:

- [1] NGFS, [Progress Report on the Guide for Supervisors](#), October 2021, p. 46-47.
- [2] NGFS, [Progress Report on the Guide for Supervisors](#), October 2021, p. 26.
- [3] Bank of England / Prudential Regulation Authority, Climate-related financial risk management and the role of capital requirements, [Climate Change Adaptation Report 2021](#), 28 October 2021, p. 30.
- [4] BCBS, [Overview of Pillar 2 supervisory review practices and approaches](#), June 2019, p. 3.
- [5] NGFS, [Progress Report on the Guide for Supervisors](#), October 2021, p. 13, 24, 26.
- [6] ECB [Guide on climate-related and environmental risks](#), May 2020; PRA [Supervisory Statement SS3/19](#) Enhancing banks' and insurers' approaches to managing the financial risks from climate change, April 2019
- [7] ECB, [The state of climate and environmental risk management in the banking sector](#), Report on the supervisory review of banks' approaches to manage climate and environmental risks, November 2021; Bank of England / Prudential Regulation Authority, [Climate-related financial risk management and the role of capital requirements](#), Climate Change Adaptation Report 2021, 28 October 2021, p. 18-19.
- [8] S. Alogoskoufis, N. Dunz et al, [ECB economy-wide climate stress test: Methodology and results](#), ECB Occasional Paper Series, No 281, September 2021.
- [9] For the detailed analyses of the underlying reasons and discussion refer to: Finance Watch, [A silver bullet against green swans](#), November 2021.
- [10] Finance Watch, [Breaking the climate finance doom loop](#), June 2020; Finance Watch, [Breaking the climate-finance doom loop: Finance Watch amendments proposal to the Capital Requirements Regulation and Solvency II](#), May 2021. Note that the proposals cover prudential requirements for the insurance sector.
- [11] IPCC, [Sixth Assessment Report](#); International Energy Agency, [Net Zero by 2050, A Roadmap for the Global Energy Sector](#), Flagship Report, May 2021.
- [12] [Regulation \(EU\) No 575/2013](#) of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012.
- [13] For the detailed discussion, see Finance Watch, [A silver bullet against green swans](#), November 2021.