Global Alliance for Banking on Values

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GABV Response to the Basel Committee on Banking Supervision (BCBS) Consultation on Climate related Risk & the Basel Core Principles (BCPs)

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?

- The interventions selected by BCBS do not depart significantly from current practices. This is a serious shortcoming of the proposed approach as current practices have proven ineffective in adequately address climate-related financial risks.
- The BCBS's mandate – guarding financial stability across the globe – will be unmet by the proposed interventions which fail to consider the most effective, feasible and impactful approach to managing the build-up of climate risk: namely the inclusion of Pillar 1 capital measures as a way to improve banks' capital adequacy against climate-related losses.
- Climate risk has been identified by several studies as a radical uncertainty with a potential to jeopardise both economic and financial system stability. By including Pillar 1 the BCBS would correct the under-pricing of both micro- and macro-prudential climate-related risks and prevent the build-up of assets that would either be stranded or cause loss and damage through more severe climate impact.
- The estimates of loss and damage predicted by climate science are fundamentally different from previous types of risk targeted by prudential regulation. The seriousness of climate risk demands a radical measure against financing any activity that could worsen it. Despite the insufficiency of data, any doubt about the negative impact of financing fossil-based or high-use-of-pesticides ventures should be removed. The BCBS should lead in pricing the risk of financed activities' climate impact and, as soon as possible, introduce Pillar 3 measures alongside Pillar 1 measures.
- As more banks and investors sign voluntary commitments to achieve net zero and reallocate capital away from fossil fuels to climate safe activities, the role of regulators should be to 'level-up' the rules for all to prevent laggard financial institutions to continue adding to harmful fossil-fuel exposures.
- The BCBS should monitor implementation of effective supervision practices in annual country-by-country progress reports, and have this progress assessed as part of the regular Financial Sector Assessment Programs (FSAPs) by the IMF.

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

- The mere presentation of Pillar 2 principles only in this consultation paper is disappointing. Given numerous studies by among others the NGFS, and notably the ECB about the potential adverse impact of the uncertainty of climate change on financial stability across the globe, a clear message by the BCBS would have been more appropriate.
- Financing activities that harm the quality of the planet's air, soil and water are affecting the resilience of economies across the globe, with potential major implications for the stability of the financial system.
- We call upon those supervisors that do see this impact, those gathered in the NGFS, to step up and introduce limiting and pricing measures in Pillar 1 as soon as possible, supported by Pillar 3 measures for sufficient transparency.

Q3. 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?

- A key aspect is risk concentration in the system, as stipulated by the Basel Core Principles (BCP) 19 and applied to both financed emissions and financed pesticides.
- Ignoring the climate impact of banks' portfolios would imply that supervisors in the BCBS would dismiss the Committee's mandate to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability.
- To begin supervisors should act upon climate risk as a potential risk concentration in Pillar 1. This should regard both financed emissions (scope 3 emissions) and financed pesticides. Acknowledging the harm done by greenhouse gas emissions and pesticides is essential and can be seen as a proxy for monitoring other environmental impact. It is observed that financial institutions that start monitoring their financed or insured emissions reconsider their complete assessment process for environmental impact, The Basel Core Principles, especially BCP 19, can easily be adapted to this new insight by redefining "related parties" into a concept that encompasses all harmful activities that a bank finances.

Principle 1: Banks should develop and implement a sound process for understanding and assessing the potential impact of climate-related risk drivers on their businesses and on the environments in which they operate. 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. [Reference principles: BCP 14, SRP 30, Corporate governance principles for banks]

- The supervisors in the BCBS should embrace the best practice started by EBA in 2021 and apply their Pillar 2 powers to the full.
- Pillar 2 regards both the risks that are not explicitly covered in Pillar 1 as well as the banks' risk management processes. The BCBS should publish a revised interpretation of BCP14 and enrich SRP30 with the insights gathered by EBA in their SREP-guidelines: https://www.eba.europa.eu/eba-publishes-its-report-management-and-supervision-esg-risks-credit-institutions-and-investment.

- The EBA report explains that the relevant time horizons for business strategies and risk management frameworks are 10 to 30 years, not the 1 to 5 years currently assessed by banks and their supervisors. Moreover, not only the financial risks to the banks themselves, that is, the consequences of their financed activities (single materiality), but also the adverse impact they cause, the harm that their finance does to the planet (double materiality), must be incorporated and priced, as it is the latter that jeopardizes the financial stability across the globe.
- Accordingly, the analysis by the BCBS should move beyond a narrow interpretation of single materiality. Both single materiality impacts and double materiality impacts are required to maintain a genuinely prudential approach due to the transference of macro-economic impacts back into the banking sector.

Principle 2: The board and senior management should clearly assign climate-related responsibilities to members and committees and exercise effective oversight of climate-related financial risks. The board and senior management should identify responsibilities for climate-related risk management throughout the organisational structure. [Reference principles: BCP 14, SRP 30, Corporate governance principles for banks]

- Final responsibility for policies and management of any risk that can jeopardize creditors' claims with the bank in particular, and financial stability in general, should be with the board.
- Just like market developments will affect credit, market and liquidity risk, so will climate-related dynamics. Any bank that ignores the impact of climate-related risk on its market or business will in the end jeopardize its own license to operate.
- Climate-related risk must be included in SRP30, both the consequences of financed activities for the bank and the harm that is caused by the financed activities.
- Board and senior management accountability is essential for the effective handling of broadly defined risks, including climate-related financial risks. The members of the Global Alliance for Banking on Values recognise the importance of governance arrangements and have decades of combined experience demonstrating a holistic model of banking that is resilient to outside disruptions, impactful and financially viable.

Principle 3: Banks should adopt appropriate policies, procedures and controls to be implemented across the entire organisation to ensure effective management of climate-related financial risks. [Reference principles: BCP 14, SRP 30, Corporate governance principles for banks]

- EBA's report elaborates on the necessary details of banks' policies, procedures, and controls to cater for climate-related risks.
- However, it is not enough to have processes in place as financial institutions may still take risks.
- To effectively avoid adverse impact supervisors must impose transparency measures in Pillar 3 and additional capital measures in Pillar 1 for excessive risk. This regards BCP28, which must at least include financed emissions and financed pesticides, and BCPs 17, 18, 19 regarding Pillar 1 requirements and limits of credit risk, problem assets and risk concentration, which must include limits and a capital requirement for excessive exposure to harmful activities. This can be done by amending the definition of "related parties" and include "related harmful activities" in that definition.

- At a minimum all financial institutions must monitor actual financed emissions, as has been done by banks that apply PCAF, and as has been proposed for Pillar 3 by EBA.

Principle 5: Banks 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. [Reference principles: BCP 15, BCP 24, SRP 20, SRP 30]

- EBA's report elaborates upon the necessary details of banks' internal capital adequacy and liquidity adequacy assessment processes as stipulated by BCPs 15 and 24 to cater for climate-related risks and impact.
- However, even if a SREP add-on can be applied for insufficient processes, having internal assessments in place does not automatically imply that risks are not taken, and that adverse impact is avoided.
- Adverse impact will only be effectively avoided if supervisors impose transparency measures in Pillar 3 and additional capital measures in Pillar 1 for excessive risk. This regards BCP28, which must at least include financed emissions and financed pesticides, and BCPs 17, 18, 19 regarding Pillar 1 requirements and limits of credit risk, problem assets and risk concentration, which must include limits and a capital requirement for excessive exposure to harmful activities.

Principle 8: Banks should understand the impact of climate-related risk drivers on their credit risk profiles and ensure credit risk management systems and processes consider material climate-related financial risks. [Reference principles: BCP 17, BCP 19, SRP 20, Principles for the management of credit risk]

- Longer term prudential considerations are, as explained by the ECB, especially necessary as we note that longer-term climate-related risk is in many respects of a different nature than the relatively predictable credit risk.
- Not only is our capacity to assess possible damage in a forward-looking way and our ability to estimate the size of the potential damage that an individual incident could lead to in the longer run limited, but climate risk can be of such a devastating nature that the only way to mitigate it in a credible way is to put our maximum effort into prevention.
- A maximum effort into prevention means ensuring that the financial industry uses its investing capability sustainably.
- Given that the transition towards a sustainable economy comes with opportunities just as much as it comes with risks, issues that on the one hand can lead to sustainability risks, on the other hand open opportunities for adapting business models.
- The adaptation of business models will result in less transition risk. Once risk analyses recognize the interdependence between risks and opportunities their accuracy to monitor companies in transition will increase.
- BCP 19 especially should include a confirmation of the ECB's notion that concentrations in climate risk are building up, and that some banks are more exposed than others and as such are more vulnerable to shocks and no longer able to finance their local communities.
- BCP19 must underline the necessity of explicit Pillar 1 requirements with respect to potential stranded assets or a risk-concentration in harmful exposures.

Principle 12: Where appropriate, banks should make use of scenario analysis, including stress testing, to assess the resilience of their business models and strategies to a range of plausible climate-related pathways and determine the impact of climate-related risk drivers on their overall risk profile. These analyses should consider physical and transition risks as drivers of credit, market, operational and liquidity risks over a range of relevant time horizons. [Reference principles: BCP 15, Stress testing principles]

- The additional stress test requirements as proposed by the European Commission, and the new horizon of 10 years, will help ensure that banks know the impact of what they finance. BCP15 must be amended to reflect this new insight.

Principle 13: Supervisors should determine that banks' incorporation of material climate-related financial risks into their business strategies, corporate governance and internal control frameworks is sound and comprehensive. [Reference principles: BCP 9, BCP 14, BCP 26, SRP 20]

- Supervisors must follow the financed emissions and financed pesticides by the banks that they supervise. EBA's standards for ESG disclosure include the simple obligation to disclose financed emissions.
- As soon as possible, this should be included in country-by-country progress reports too, so that the BIS can follow finance emissions across the globe and supervisors become aware of leakages in the financial system.
- The revised BCPs can be included in the regular FSAPs by the IMF.
- Yet, monitoring does not automatically imply that risks are not taken, and that adverse impact is avoided.
- Adverse impact will only be effectively avoided if supervisors impose transparency measures in Pillar 3 and additional capital measures in Pillar 1 for excessive risk. This regards BCP28, which must at least include financed emissions and financed pesticides, and BCPs 17, 18, 19 regarding Pillar 1 requirements and limits of credit risk, problem assets and risk concentration, which must include limits and a capital requirement for excessive exposure to harmful activities.

Principle 14: Supervisors should determine that banks can adequately identify, monitor and manage all material climate-related financial risks as part of their assessments of banks' risk appetite and risk management frameworks. [Reference principles: BCP 15, SRP 20, SRP 30]

- Even if a financial institution has strategies and risk appetites in place it can still take risks and it can still not avoid adverse impact.
- To effectively avoid adverse impact supervisors must impose transparency measures in Pillar 3 and additional capital measures in Pillar 1 for excessive risk.
- To note, EBA's report elaborates upon the necessary details of banks' assessments and risk appetites to cater for climate-related risks.

Principle 15: Supervisors should determine that banks comprehensively identify and assess the impact of climate-related risk drivers on their risk profile and ensure that material climate-related financial risks are adequately considered in their management of credit, market, liquidity, operational, and other types of risk. Supervisors should determine that, where appropriate, banks apply climate scenario analysis. [Reference principles: BCP 17–25, Principles for sound liquidity risk management and supervision, Principles for the sound management of operational risk, Principles for operational resilience]

- Supervisory review objectives or risk management approaches do not include an evaluation of financial institutions' capital adequacy to cover climate-related financial risks.
- Accordingly, the review under the current Principles would be directed towards exploration of risks rather than ensuring the resilience against climate-related risks of financial institutions.
- For this reason, these Principles fail to deliver impactful supervisory measures for cases where climate-related risks will be identified as material.
- There are no incentives for financial institutions to change their behaviour towards climate-related financial risks.

Principle 16: In conducting supervisory assessments of supervised banks' management of climate-related financial risks, supervisors should utilise an appropriate range of techniques and tools and adopt adequate follow-up measures in case of material misalignment with supervisory expectations. [Reference principles: BCP 8, BCP 9, SRP 10, SRP 20]

- The NGFS is sharing a broad range of supervisory tools that can be used by supervisors today, given and within their current legal mandates.
- There is no need to expand BCPs 8, 9 and 10.
- Supervisors need the power to impose additional capital requirements when they observe excessive climate-related risk or adverse impact.
- The BCBS needs annual country-by-country progress reports of supervisory practices across the globe in this regard.

Principle 17: Supervisors should ensure that they have adequate resources and capacity to effectively assess supervised banks' management of climate-related financial risks. [Reference principles: BCP 9]

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Principle 18: Supervisors should consider using climate-related risk scenario analysis, including stress testing, to identify relevant risk factors, size portfolio exposures, identify data gaps and inform the adequacy of risk management approaches. Where appropriate, supervisors should consider disclosing the findings of these exercises. [Reference principles: Stress testing principles]

- Indeed, supervisors across the globe should stress test the system on various climate scenarios and publish their findings.
- The NGFS is sharing a broad range of supervisory tools that can be used by supervisors today, given and within their current legal mandates.
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- The BCBS needs annual country-by-country progress reports of supervisory practices across the globe in this regard.