

I4CE's recommendations to the Basel Committee

Regulators must seek to support an orderly transition to a low-carbon economy, as the only way to effectively prevent the risks of financial instability

For I4CE, the Basel Committee's proposals for bank supervision must go beyond the mere integration of climate risks and their financial impacts into the traditional major risk factors (default risk, market risk, etc.). Regulators must seek to support an orderly transition to a low-carbon economy, as this is the only way to effectively prevent the risks of financial instability that a disorganized transition would present. It is not enough for banks to measure their exposures and the carbon footprint of their activities, but rather for them to begin a transformation of their portfolio by financing their clients' transition.

To do this, the Basel Committee must formulate more specific and operational proposals. The Basel texts are organized according to three pillars: the first defines the minimum capital requirements for banks, the second organizes micro and macro-financial prudential supervision. Finally, the third pillar deals with transparency and market discipline.

I4CE makes recommendations for each of the three pillars, which we summarize here before elaborating on them:

- Strengthen the minimum capital requirements for Pillar 1 for the riskiest assets, such as coal, without reducing them for green activities: such a reduction is not justified in view of its low impact on the transition and the risk it represents for banks.
- Strengthen Pillar 2 with a transition plan requirement for banks and the integration of climate issues into the Supervisory Review and Evaluation Process (*SREP*), and implement supervisory actions for banks with high exposure to climate risks.
- Still within the framework of Pillar 2, integrate a very detailed sectoral approach into stress tests and risk management tools.
- Finally, for scenario analyses, clarify the notion of scenario plausibility and incorporate the use of disordered transition scenarios.

Pillar 1: Strengthen relative minimum capital requirements for the riskiest assets

Under Pillar 1, I4CE recommends strengthening the minimum capital requirements for the riskiest fossil fuel activities (coal, unconventional energy, new exploration and exploitation) on which there is an international consensus to exit. *Risk weights* for these activities could be increased from 100% to 250%. To formulate this recommendation, I4CE has conducted an impact study modelling the effects of prudential relief and strengthening factors on banks and transition financing.

<https://www.i4ce.org/download/indexing-capital-requirements-on-climate-what-impacts-can-be-expected/>

For the strengthening of prudential requirements, I4CE has modelled 3 scenarios and it emerges from the modelling that, to have a significant impact on the cost of the project, the calibration must be high. With a 250% increase in capital requirements, the cost increase for some carbon projects (such as coal) would be around 10%, especially for projects with a long maturity as it is the case for energy projects.

This therefore creates a strong incentive for banks to quickly exit from the relevant activities. It thus makes the effects of the credit crunch transitory and limited. On the other hand, applying a PF on a wider perimeter limits the effectiveness of the penalty. The individual cost of the projects is slightly increased and the number of sectors is too large to consider a quick exit. The contractionary effects on credit are more important and more lasting. They would therefore also affect a fraction of green credits, as banks would be forced to reduce their overall volume of credits. The risk of penalizing companies that have historically been carbon-intensive, but are in the process of transition, is also greater.

Regarding a possible easing of minimum capital requirements for green projects, the I4CE study shows that its impact on financing conditions would remain very limited. I4CE modelled the impact of a 25% Green Supporting Factor (GSF), corresponding to the existing relief for SMEs and infrastructure, as well as a 15% and a 50% reduction. The results show that, for the mobility and energy renovation sectors, the impact of the GSF is very low (e.g. a gain of €200 for a €30,000 electric vehicle). For renewable energies, these projects already benefit from prudential relief thanks to the Infrastructure Supporting Factor. It would be more interesting to limit the existing scheme to green infrastructure only, as it currently supports all infrastructure, including those that have a negative impact on the climate.

Pillar 2: Incorporate a transition plan requirement for banks and strengthen climate oversight within the SREP

To support the implementation of an orderly transition and thus limit climate risks, I4CE recommends that regulators require bank transition plans. These transition plans should include a 2050 carbon neutrality target, as well as intermediate GHG emission reduction targets. They should also cover all of bank's activities: investment lending and investment banking activities (mergers and acquisitions, IPOs, bond issues, structuring of complex financial products, etc.). Initially, these plans may focus on high-emission sectors and large corporations, and eventually they are intended to cover all economic sectors and all of bank's clients. With regard to high-emission sectors, supervisors should verify that financing is conditional on the existence of transition plans for large corporate counterparties. Finally, the use of carbon offsetting must be kept to a minimum and supervised by the supervisor. To do this, supervisors will first need laws to regulate the use of offsetting by companies.

To operationalize this monitoring of an orderly transition, changes to the SREP are necessary. First, the analysis of business models and strategy must evolve in order to monitor the exposure of banks to sectors that are high emitters and for which the risk of failed operations is significant. On the other hand, elements of analysis must be integrated into the risk management rating, in order to verify that these risks are taken into account within the bank, that they are monitored in the evolution of the portfolios and that climate metrics are taken into account in the lending decisions. The internal organization of banks regarding climate issues must also be supervised, so that governance is structured in such a way as to regularly address climate issues and that these are integrated into risk management departments, and not left solely to the responsibility of the CSR department.

Finally, actions may be envisaged by supervisors, initially in the form of supervisory actions: requests for training, reorganization of risk management and governance in particular. In a second phase, and in the event that certain banks fail to implement their transition plan, sanctions such as additional capital requirements could be considered.

Pillar 2: Include detailed geographic and sectoral analysis of climate-related risks within the climate scenarios used in stress tests and risk management tools in general

Because transition and physical risks are systemic in nature and can propagate throughout the value chain of economic agents and their environment, it is important for banking institutions to consider the full range of sectors and geographic areas covered by their portfolios in their analysis of climate-related risks, and not just the sectors or areas most at risk.

<https://www.i4ce.org/download/climate-stress-tests-the-integration-of-transition-risk-drivers-at-a-sectoral-level/>

For each sector of activity, banks must take into account a set of risk factors that can potentially combine within the same scenario. For example, transitional risk factors can come from an increase in carbon prices, but also from regulatory, technological or market behavior risks. With respect to physical climate risks, a set of climate hazards may overlap in the same geographic region.

Thus, understanding the characteristics and possible developments of each sector is essential to identify in detail the transition risk factors specific to each sector that may impact banking institutions, as well as the different transmission channels and the main indicators of vulnerability among sector players.

These risk factor analyses are valuable analytical tools, both in the construction of climate scenarios used in stress tests and in the improvement of internal transition risk management tools for banking institutions.

Pillar 3: Scenario analyses: clarify the notion of "plausibility" of scenarios in a context of deep uncertainties, and encourage the use of disordered transition scenarios.

Clarifying the notion of "plausible trajectories" is crucial because it conditions the robustness of the approach used. Taking into account "plausible" scenarios can potentially challenge the traditional views or beliefs of financial actors on how the transition can be achieved. Indeed, it is important for financial actors to recognize that the transition process is an unprecedented transformation of economic systems and that the exact form the transition may take is uncertain. The scenarios should therefore represent potential future transition paths for the institution, taking into account its key issues, while being consistent with its potential internal dynamics. It should be emphasized that no objective probability of realization can be attributed to each of these scenarios.

<https://www.i4ce.org/download/taking-climate-related-disclosure-to-the-next-level-minimum-requirements-for-financial-institutions/>

Including disorderly transition scenarios with abrupt shocks may be relevant in the analysis of bank portfolios, both asset portfolios and loan portfolios (e.g., potential liquidity bottlenecks for counterparties due to abrupt changes in consumer demand, loss of operating licenses, etc.).

Using qualitative information for risk management:

Our research on physical climate risks has shown the persistent difficulty of quantifying losses in euros. When the results obtained are fragile, they can give a false impression of precision and comparability. Faced with this observation, some banks have preferred to focus on classification systems for the level of physical climate risk to which their portfolio is exposed: from very low to very

high, for example. The result is not perfect, but it allows these banks to start managing this risk without waiting for a reliable estimate of losses in euros on their entire portfolios.

<https://www.i4ce.org/download/addressing-challenges-of-physical-climate-risk-analysis-in-financial-institutions/>