

Re: Comments on the *Principles for the Effective Management and Supervision of Climate Related Financial Risks*

To the Basel Committee on Banking Supervision (BCBS):

On behalf of the Natural Resources Defense Council (NRDC), we are pleased to submit these comments on the BCBS's proposed *Principles for the Effective Management and Supervision of Climate Related Financial Risks*. NRDC is an international nonprofit environmental organization with more than 3 million members and online activists. Since 1970, our lawyers, scientists, and other environmental specialists have worked to protect the world's natural resources, public health, and environment. NRDC has offices in New York City, Washington D.C., Los Angeles, San Francisco, Chicago, Montana, and Beijing. Through its finance and legal experts, NRDC remains engaged in financial regulation and views sensible financial regulation as an integral part of mitigating climate change.

We appreciate the inclusion of climate-related financial risks, and it is a crucial step that the Basel Committee has recognized the significance of climate-related financial risks to the banking system and suggested that supervisors and banks worldwide consider these risks.

More Incentives Need to Be in Place for Behavioral Changes

The Principles are very high-level and offer little incentive for financial institutions to change their long-term behavior towards climate-related financial risks. The suggested risk mitigation measures encourage banks to recalibrate their current resilience to climate-related financial risks yet fail to properly address long-term risks that stem from activities such as the continuation of financing for climate-change accelerating activities.

Guidance for the supervisors, included in the Principles, does not include evaluation of the banks' capital levels to cover their climate-related financial risks. Even in cases where supervisors identify high climate-related risks, this will not result in a requirement for banks to raise capital reserves and in turn raise their resilience against climate shock. Thus, there is no imperative for banks to act.

Risk Mitigation Efforts Beyond Internal Limits Should Be Carefully Considered

Beyond internal controls, banks frequently use insurance and derivatives to mitigate climate-related financial risks, but there is a danger of relying on such measures to mitigate these risks. Banks require insurance coverage to mitigate potential losses due to any loss event, including climate disasters. However, risks from both the insured and/or the insurer could revert the climate-related risks to the banks themselves.

Borrowers are required to provide proof of insurance coverage for loan closing purposes. However, as regions prone to climate change effects are subject to increased risk pricing, higher premiums (or worse, the discontinuation of coverage) can lead to a lapse in coverage for borrowers in these areas. These lapses in coverage can be overlooked due to the loose enforcement of maintaining the required coverage.

Counterparty risk could also swell during climate disasters as the insurers themselves are highly susceptible to climate-related risks. Many insurers invest their assets in investments vulnerable to climate disasters or transition risk. Climate events could drain the liquidity of asset pools used for payouts. Moreover, improperly assessed climate risks can lead to insufficient payouts as risk assessment maps of disaster-prone regions are not up to date.

Addressing Impacts on Disadvantaged Communities

There is a real danger that the adoption of enhanced climate risk mitigation measures by banks may disproportionately impact climate-burdened communities, including lower-income communities and communities of color. We urge BCBS to consider additional research and guidance to address likely impacts on disadvantaged communities.

A substantial and growing literature demonstrates that many climate-related risks, such as the risk of weather-induced disaster or sea level rise, may be disproportionately borne by lower income communities and communities of color. Of particular concern are risk mitigation measures that force individual households and small businesses to internalize climate-related risks. Such measures may significantly restrict access to credit within already-disadvantaged communities, further reducing their capacity to respond to climate-related challenges such as weather-related disasters or sea level rise. Several of the mitigation options listed in the draft document, such as imposing loan restrictions or limiting exposure to certain geographical regions, could have this effect. NRDC recommends that banks evaluate a broad range of mitigation options and prioritize options that do not restrict fair access to credit for climate-burdened communities.

In addition, fiscal policies and civil society will necessarily play an important role in mitigating the local impacts of changes in bank risk management practices. For this reason, NRDC strongly supports the recommendations that banks collaborate with a broad and diverse set of stakeholders and establish frameworks for communicating and coordinating changes in bank policy with relevant domestic and cross-jurisdictional authorities. We suggest that these recommendations for public consultation and disclosure be elevated to a foundational principle (rather than sub-recommendations).

Engaging Counterparties and Clients to Obtain a Complete Picture of Climate Risks

We recommend that the BCBS ask banks to obtain a complete picture of climate risk for significant borrowers and counterparties. The data providing such a complete picture has three key components: Scope 1, 2, and 3 greenhouse gas emissions, geolocation information for significant infrastructure, and any climate or sustainability disclosures made by the borrower or counterparty.

Scope 1, 2, and 3 greenhouse gas emissions tell banks about a borrower or counterparty's contribution to climate change and their vulnerability to transition risk in an orderly or disorderly move to a low emissions economy. "Scope 1 emissions are direct [greenhouse gas emissions that occur from sources that are controlled or owned by an organization. . . . Scope 2 emissions are indirect [greenhouse gas] emissions associated with the purchase of electricity, steam, heat, or cooling." Scope 3 emissions are everything else: "the result of activities from assets not owned or controlled by the reporting

organization, but that the organization indirectly impacts in its value chain. . . Scope 3 emissions, also referred to as value chain emissions, often represent the majority of an organization’s total GHG emissions.” The volume and trend of greenhouse gas emissions informs a bank’s picture of how a borrower or counterparty is managing transition risk.

To gauge physical risk, banks should also obtain geolocational information for key infrastructure from borrowers. This would certainly include any collateralized infrastructure, but also information on any infrastructure that underpins significant operations. If, for example, a borrower has significant property on a coastline vulnerable to tidal flooding and extreme weather, that information ought to inform a bank’s risk analysis.

Finally, banks should obtain borrower or counterparty disclosures under any climate or sustainability disclosure framework. Some of this information would be duplicative of the greenhouse gas emissions and physical risk inventory discussed above, but disclosure frameworks also call for information about board oversight of climate risks, internal processes for identifying and managing climate risk, and projected financial impacts of climate risk.

Scenario Analyses

We agree that scenario analysis is an important climate risk management tool, and we believe it is one that all banks should be using to evaluate their climate risk and take appropriate steps to mitigate that risk. While banks seem to agree that scenario analysis is important, a recent study suggests that fewer than 10 percent of all banks are using it at the moment, and small banks are less likely to have incorporated scenario analysis into their climate risk management plans.

Obtaining reliable information about borrowers’ climate risks is a problem for all banks (indeed, obtaining reliable information about companies’ climate risk is a general problem for regulators and stakeholders). For small banks that do not lend to public companies, it is an even greater challenge. The BCBS can advance banks’ use of scenario analysis by providing guidance for supervisors on its role in risk management and the appropriate scenarios for banks to use in scenario analysis.

We strongly support the inclusion of scenario analysis for understanding the risks banks face. Past risks from extreme weather will not be a reliable predictor of climate risk, so banks will need to use models that consider that future risk. Thus, any guidance from the BCBS on scenario analysis should emphasize the importance of using models that align with the latest climate science and that assume a range of global average temperature increases, including worst case scenarios. And to model transition risk, scenario analyses should include orderly and disorderly transitions to a low carbon economy.

Enhancing Reporting Requirements

In conjunction with the internal management monitoring and reporting guidance, we recommend that the BCBS have banks collecting and calculating their financed emissions, which is the volume of greenhouse gas emissions attributable to the bank’s lending portfolio. The Partnership for Carbon Accounting Financials has developed guidance to assist financial institutions with calculating their financed emissions, including guidance about how to estimate the percentage of emissions from an

activity attributable to the bank's financing. As with knowing a borrower's footprint of greenhouse gas emissions, a bank's financed emissions footprint and its trajectory over time helps regulators assess the bank's vulnerability to transition risk.

Increasing Capital Requirements for Climate Risk Exposures

In order to achieve impactful outcomes for banks' resilience towards climate-related financial risks, capital requirements for the exposures clearly identifiable as the riskiest from the climate-related perspective – namely fossil fuel exposures – should be increased.

The suggested increase is in line with the risk-based nature of prudential capital rules, as the increased capital requirements reflect the high risks associated with fossil fuel financing i.e., physical risks (systemic disruption due to climate-related events leading to financial instability) and transition risks (depreciation of fossil assets) risks.

In conjunction with the Principles, a timeframe for implementation along with a monitoring function should be published to ensure an expeditious application of the principles.

We thank the BCBS for its consideration of our comments. If we can be of any further assistance, please do not hesitate to contact us.

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