Response to BCBS consultative document

Disclosure of climate-related financial risks

March 2024

Introduction

We thank the Basel Committee for providing this opportunity to respond to the consultative document on the disclosure of climate-related financial risks.

The New Economics Foundation is an independent UK charity that aims to create an economy that works for people, within planetary boundaries. We are funded by a broad cross-section of individuals and organisations. We are committed to transparency and publish the names and amounts of all major donors.

For any questions relating to our response, please contact theo.harris@neweconomics.org

Responses

Q1. What would be the benefits of a Pillar 3 disclosure framework for climate-related financial risks in terms of promoting comparability of banks' risk profiles within and across jurisdictions and promoting market discipline? What other benefits have been identified?

Q2. What are the risks of a Pillar 3 disclosure framework for climate-related financial risks not being introduced?

Q3. Would the Pillar 3 framework for climate-related financial risks help market participants understand the climate-related financial risk exposures of banks and how banks are managing these risks?

[We have answered questions 1-3 in combination, given their interrelation]

This would be a highly welcome development. Developing a cohesive and comprehensive framework for the disclosure of climate risks is a vital and urgent step towards ensuring the stability of the global banking system.

The international financial system as it stands is characterised by gross mismanagement of climate-related risks. The banking sector daily demonstrates an enormous disconnect from the emissions reduction pathway enshrined in the Paris Agreement, and the inevitable policy response that this pathway implies. The continued mass-financing of fossil fuels projects and the destruction of carbon sinks represent a transition risk that threatens not only the viability of individual banks, but the stability of the financial system as a whole.

A Pillar 3 disclosure framework for climate-related financial risks is a crucial and urgent step in addressing this disconnect.

The mandate of the BCBS is "to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability." Given that the mismanagement of climate-related risks represents a serious threat to financial stability, the BCBS has a responsibility to act. It is therefore encouraging to see the significant progress made in this document.

Although climate risk drivers ought to be captured in traditional financial risk categories – as demonstrated by BCBS research – banks have not yet developed the processes to properly and transparently account for climate risk within the existing disclosure framework. As the consultation document lays out, this is in part because climate risks demand a departure from banks' traditional methods and frameworks of risk management. Features such as non-linearity, the existential magnitude of the risk, and high levels of uncertainty require a step-change in banks' approach to risk. It is also a problem of political economy, related to the influence of fossil fuel lobbyists and the short-term returns banks can realise from continuing to finance these activities. Banks have proved themselves unwilling to subject themselves to additional scrutiny where they stand to make a short-term profit. Consequently, there is systematically too little information available about the climate risks faced by banks, and the available information does not follow consistent standards.

In the absence of a Pillar 3 disclosure framework for climate risks, market participants are generally in the dark as to the nature and scale of the climate risks faced by banks. This leads to a system-wide inadequacy in the capital coverage of those risks, creating deep systemic risk and failing to disincentivise banks from taking on further unaccounted climate-related risks.

Moreover, the permitted variability of climate-risk disclosure practices between individual banks and between jurisdictions makes fair comparison difficult or impossible, negating the potential for market discipline to play a moderating role against excessive risk-taking. This also creates a perverse disincentive against better climate disclosures, known as a 'first-mover penalty'. Banks and jurisdictions who individually improve the disclosure of climate risks might find themselves penalised by markets, while banks elsewhere (with equal or greater climate risk) continue to escape scrutiny.

The new framework will give market participants access to a fuller and more accurate picture of banks' exposure to climate risks. By ensuring an international standard, this information will be more easily comparable between banks, both within and between jurisdictions. As such, market discipline will be enabled to work towards the correct management, coverage, and mitigation of those risks.

The disclosure requirements will also place a duty on banks to develop the necessary in-house capabilities to assess and manage climate-related risks. For some banks, this will be little departure from their current practices, but for other banks this will represent a significant upgrade to their frameworks and resources for managing risk.

Q5. Would there be any unintended consequences of a Pillar 3 framework for climate-related financial risks? If so, how could these be overcome?

Improved measurement of the physical risks of climate change could have unintended social consequences via the creation of financial red-zones in places with high physical risk. It is foreseeable that there are geographic areas where access to finance could become unavailable or prohibitively expensive for economic actors, with adverse consequences for regions and nations. A similar phenomenon is already being observed in insurance markets.

This is in no way an argument against the introduction of the framework. Rather, it is a strong reason to increase the coherence of global economic governance between institutions. Clear and forward-looking communication and collaboration between standard-setters, nations, supra-national bodies (such as the UN), and civil society will help policymakers address the social and economic consequences of climate change in a just manner. The BCBS should identify relevant institutions and communicate to them the potential social and economic effects of any new framework ahead of its implementation. In this way, the consequences can be anticipated and addressed (in this instance via increased adaptation finance and public subsidies to credit risk in vulnerable geographies, for example).

Q6. What are your views on potentially extending a Pillar 3 framework for climate-related financial risks to the trading book?

We believe this is important and should be pursued with urgency.

Q7. What are your views on the proposed methodology of allocating exposures to sectors and geographical locations subject to climate-related financial risks?

The principle of 'full look-through' must be applied to all disclosure methodologies. This means that the disclosure must pertain to the end recipient of the financing. Without this, the GICS sector codes and geographical location disclosures could be circumvented via the use of financial intermediaries, shell companies, etc. This runs the risk of diminishing the quality of the data to the extent that it could be almost useless for market participants.

Provided that 'full look-through' is applied, we find the proposed methodology to be broadly appropriate.

Q8. What are your views on which elements should be made subject to national discretion and which should be mandatory? Why?

Given that one of the key purposes of the framework is to improve the comparability of banks' risk profiles across jurisdictions, the highest possible degree of consistency should be required. Therefore, as many of the elements as possible should be mandatory. Where certain jurisdictions demonstrate a lack of resource or available data to implement an element, there should be a negotiated 'timeline towards mandatory implementation'. This is a halfway-house that recognises the current infeasibility of some elements in certain jurisdictions, but still targets a future date at which these elements will become consistently mandatory across the globe.

Q9. What are your views on whether potential legal risks for banks could emanate from, or be mitigated by, their disclosures as proposed in this consultation, and why?

Firstly, the type of evidence required by the framework is unlikely to increase the vulnerability of banks to litigation. Secondly, the purpose of a regulator/supervisor is not to shield banks from litigation. If banks are engaging in climate-related activities which leave them vulnerable to legal risks, then it is right that market participants should know of this so that they can accurately assess the adequacy of those banks' capital provisions.

Simultaneously, the disclosure requirements will act as a deterrent for banks against engaging in illegal practices in the first place, ultimately decreasing the overall risk posed to financial stability by climate-related litigation, in a manner consistent with the aims of the Basel Committee.

Q11. What are the benefits of the proposed qualitative Pillar 3 climate-related financial risk disclosure requirements?

One of the chief benefits of the proposed qualitative disclosures is their forward-looking nature, which is necessary to complement the primarily backward-looking quantitative disclosures. In particular, transition plans are a very powerful tool for providing market participants with the necessary information to make judgements on the climate-risk approach and trajectory of a bank. It is highly important that transition plans are a mandatory element in the final framework.

Secondly, in a more general sense, the qualitative disclosures will provide context for the quantitative information and insight into the decision-making processes that is not provided by quantitative information alone. For example, sectoral exposure data might suggest that a given bank is highly exposed to transition risk, but their qualitative disclosures might mitigate this by demonstrating that they have strong governance and risk management practices, and a transition plan which includes proactively engaging with high-emission clients to help them decarbonise. Without this type of information, the value of the quantitative disclosures would be reduced.

Finally, the qualitative disclosure requirements would have the effect of improving banks' climate-risk management processes in each of the sub-categories specified in the consultative document. The process of gathering and disclosing the data would encourage banks to more proactively engage with their exposure to climate-related risks, as well as incentivising them to improve their processes via the effect of market discipline.

Q37. What are your views on the proposed inclusion of forecast information in the Pillar 3 climate-related financial risk disclosure requirements in instances where banks have established such forecasts?

We welcome the proposed inclusion of forecast information. But it is vital that banks also disclose the key aspects of the forecasting methodology used. There are vast differences in scenario outcomes between different climate-economic models. For market participants to draw meaningful conclusions from forecast information, they must have insight into how the forecasts have been reached. Ultimately, the BCBS should mandate regulations pertaining to climate modelling and forecasting practices, to improve the comparability of forecast information between banks.

Q52. What are your views on the feasibility of the potential effective date of the Pillar 3 climate-related disclosure requirements?

The suggested effective date of 1 January 2026 is too far into the future, leaving serious climate-related risks undisclosed for a further two years. We strongly exhort the BCBS to bring the implementation date forward to early 2025.