Basel Committee: Disclosure of climate-related financial risks

March 2024

Positive Money UK and EU welcome the opportunity to respond to the Basel Committee's consultation on the management and supervision of climate-related financial risks.

We are a group of not-for-profit research and campaigning organisations, working towards reform of the money and banking system to support a fair, democratic and sustainable economy. We are funded by trusts, foundations and small donations.

If you would like to discuss any aspects of this response please contact:
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5.1 General

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?

- Positive Money welcomes the Basel Committee's proposal to introduce a Pillar III disclosure framework for climate-related financial risks. Climate-related disclosure requirements and frameworks can serve an important function in supporting financial market participants, and importantly, financial supervisors, with the information necessary to inform policy development and investment decisions around climate-related risks.

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

- There are two reasons why a pillar 3 framework will likely have the unintended consequence of leading supervisors and market participants to underestimate the climate-related financial risk exposures of banks and how banks are managing these risks. Firstly, climate-related risks are characterised by 'radical uncertainty'. Secondly, difficulties in gathering and disclosing data on certain factors means that a pillar 3 framework may omit certain factors that contribute to risk.
- Research conducted by the BIS, for instance, states that, "the physical and transition risks of climate change are subject to multiple forces (natural, technological, societal, regulatory and cultural, among others) that interact with each other and are subject to uncertainty, irreversibility, nonlinearity and fat-tailed distributions".[1] Climate-related risks do not have a calculable probability, are not represented in historical data, and do not have clear transmission channels, making them ill suited to a financial-risk based methodological

[1] https://www.bis.org/publ/othp31.pdf

approach.[2,3] Pillar 3 requirements must thus serve as a basis to provide transparency for risk management by supervisors, not as a tool of risk management in of themselves.[4]

- There is also evidence to suggest that climate-related financial risk disclosure initiatives to date, including the TCFD, have had limited impact in influencing financial institutions' lending and investment behaviour.[5,6] This can also be recognised in the financing activities of banks. Despite TCFD recommendations having been in place since 2017, banks have continued to finance new fossil fuels,[7] conflicting with the latest climate science.[8] There is also a risk that disclosure initiatives, in the absence of accompanying precautionary policy interventions, may serve to provide avenues for greenwashing. Recent research carried out by the ECB found, for instance, that banks with more extensive environmental disclosures tend to be those specialised in lending to dirty industries.[9]
- Whilst disclosure and reporting requirements can provide a useful function, supervisors and market participants must understand the limitations, and supervisors must acknowledge that they are insufficient to drive the behavioural changes needed to manage macroprudential risks from climate change.
- In turn, financial supervisors including the BCBS will only be able to adequately deal with climate-related financial risks by adopting the precautionary principle and falling in line with regulators in other areas, including the WHO and IPCC.[10] For financial regulation, the precautionary principle advocates the use of preventative macroprudential policies. As outlined in Positive Money's 2022 response to the BCBS consultation on the principles for the effective management and supervision of climate-related financial risk[11], precautionary policies include the implementation of the One-for-One rule[12] through changes to Pillar 1 capital requirements, as well as considering direct restrictions on banks' financing of certain types of activities that are incompatible with meeting internationally agreed climate-goals, such as the exploration and extraction of new fossil fuels.[13]
- Finally, it is important to note that the proposed framework will not help market participants to understand the broader environmental risks to which banks are exposed, including nature and biodiversity loss, which are severe and inherently linked to climate risks. The need for a precautionary approach is even clearer when looking at wider environmental risks, which are harder to place into relatively simple metrics alike with carbon emissions.[14] Given the inextricable link between nature and climate, overlooking nature-related risks equates to neglecting a crucial systemic risk that can have far-reaching impacts on the stability of economic and financial systems.

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[2] https://carbontracker.org/reports/loading-the-dice-against-pensions/
[3] https://actuaries.org.uk/media/qeydewmk/the-emperor-s-new-climate-scenarios.pdf
[4] https://www.finance-watch.org/wp-content/uploads/2021/11/A-Silver-Bullet-Against-Green-Swans-capital-requirements-climate-risk.pdf
[5] https://esgclarity.com/pension-funds-tcfd/
[6] https://www.ft.com/content/ad01f2c9-9eb0-4db6-9898-220c688d16c2
[7] https://www.bankingonclimatechaos.org/
[8] https://www.ipcc.ch/report/sixth-assessment-report-cycle/
[9] https://www.ecb.europa.eu/press/blog/date/2023/html/ecb.blog231206~fecd1d1634.en.html
[10] https://www.sciencedirect.com/science/article/pii/S092180092100015X
[11] https://positivemoney.org/wp-content/uploads/V2-BCBS-climate-related-financial-risk-consultation-1.pdf
[12] https://www.finance-watch.org/wp-content/uploads/2021/11/One-for-One-Joint-letter-BCBS.pdf
[13] https://iea.blob.core.windows.net/assets/7c02e774-9d1b-4398-9313-840913e1b4e6/NetZeroRoadmap_AGlobalPathwaytoKeepthe1.5CGoalinReach-2023Update.pdf
[14] https://www.ucl.ac.uk/bartlett/public-purpose/sites/public-purpose/files/final_kedward_et_al_nature-related_finance_18_aug.pdf

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

- Allocating exposures to geographical locations subject to climate-related physical risks ought to have regard to potential unintended impacts, such as negatively impacting communities in areas subject to higher physical risk from accessing adaptation financing that would support risk reduction.

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

- We would strongly encourage the committee to implement a harmonised approach across jurisdictions given the global nature of the largest financial institutions.

5.2 Qualitative disclosure requirements

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

- We broadly support the committee's proposal to require banks to disclose their strategy for reducing and/or mitigating climate-related financial risks through the disclosure of transition plans. However, to be effective and not have unintended consequences of leading market participants and supervisors to underestimate risk, transition plans must be required to align with the Paris Agreement, follow best practice guidelines, and banks must be required to disclose these plans to allow regulatory oversight. The wording around transition plan disclosure in CRFRA 2. (c), for instance, implies a high level of optionality. Instruction 2(b) on Transition plans should commensurately define Transition plans as a strategy for alignment with the goals of Paris Agreement, rather than the more ambiguous wording of 'lower carbon economy'.

Q15. How could the proposed Qualitative Pillar 3 climate-related financial risk disclosure requirements be enhanced or modified to provide more meaningful and comparable information?

- An overall double materiality approach would be a more effective way in avoiding climate-risk being underestimated, which as outlined above (Q3), is highly likely in a single materiality approach. A double materiality approach recognises the impact that financial institutions have on climate change, should underpin disclosure requirements for banks (and the BCBS' broader approach to climate-related risks, as set out in Positive Money's response to the consultation on the principles[15]).
- Requirements around Transition Plans could be strengthened to ensure that these are robust, Paris Agreement aligned and follow best-practice frameworks. Transition plans should include Scope 3-related emissions and associated targets as mandatory, given that Scope 3 emissions form the bulk of emissions associated with financial institutions. To ensure plans are meaningful and comparable, specific guidance on the information that should be disclosed should be included, such as emission reduction metrics, as well as a

[15] https://positivemoney.org/wp-content/uploads/V2-BCBS-climate-related-financial-risk-consultation-1.pdf

plans implementation strategy, and the details of any scenario analysis upon which plans are based, including key assumptions underpinning such exercises.
- Banks' could also be required to disclose how they consider issues relating to adaptation as pertains to physical risk.

Q16. What are your views on the relevance of the proposed Qualitative Pillar 3 climate-related financial risk disclosure requirements to understand climate-related financial risks to which banks are exposed?

- As outlined above (q3) the financial risk-based approach to the qualitative disclosure requirements, which focuses on encouraging entities to seek to limit the financial risk posed by climate change to banks, rather than reducing the impacts of bank activities on climate change, limits the relevance of the proposed framework for understanding climate-related financial risk.

5.3 Quantitative disclosure requirements

Q17. What are the benefits of the proposed Quantitative Pillar 3 climate-related financial risk disclosure requirements?

- We support the proposal to require banks' to report on their financed emissions, including Scope 1, 2 and 3, inclusive of banks off-balance sheet items. As the consultation paper notes, these are often the most significant amount of banks' emissions. To facilitate comparability across banks, we are supportive of these requirements being mandatory.

Q20. What additional Quantitative Pillar 3 climate-related financial risk disclosure requirements should the Committee consider?

- The omission of the financial sector from the sectoral exposures enables emissions to be overlooked if they are intermediated by another financial institution. This would inadvertently encourage banks' to intermediate lending to high-emitting sectors without reducing climate risks whilst shifting emissions onto the balance sheet of more opaque non-bank financial institutions and exacerbating climate risk in non-bank finance.
- This loophole should be closed by including financial institution exposures, including the scope 3 of those underlying institutions thereby ensuring banks full scope of emissions are disclosed and that risks are not shifted into less regulated areas of the financial sector.

Q21. How could the proposed Quantitative Pillar 3 climate-related financial risk disclosure requirements be enhanced or modified to provide more meaningful and comparable information?

- At a minimum, banks should be required to disclose the specific methodology used to calculate both financed and facilitated emissions. The methodology used to calculate financed emissions can significantly impact the emissions accounted for. For instance, the industry-led PCAF's recently published framework on facilitated emissions reporting permits banks' to report only 33% of emissions linked to their capital markets activities.[16] Ideally, to provide sufficient transparency for regulatory oversight, banks should be required to disclose

[16]https://www.reuters.com/business/banks-vote-limit-accounting-emissions-bond-stock-sales-sources-2023-07-30/

emissions using a single required methodology developed with regulatory oversight, however given that there is currently no single comparable standard, banks' should be required to clearly disclose their methodology in the interim.

5.4 Quantitative disclosure requirements subject to jurisdiction discretion

Q49. What are the benefits of the proposed Quantitative Pillar 3 climate-related financial risk disclosure requirements subject to jurisdictional discretion?

- We are supportive of the proposal to require disclosure of real estate exposures in the mortgage portfolio by energy efficiency level, which is an important step to enable the assessment of climate-risk and Paris alignment of mortgage portfolios, as proposed by the European Banking Authority.[17] Real estate (directly and indirectly) contributes almost 40% of greenhouse gas emissions globally.[18]
- When there is a serious economic downturn, loans resold in the secondary market can be a source of risk for lending institutions and investors if borrowers default on their loan and the reclaimed collateral is less valuable than the loan. The financial risk for a RMBS or CMBS within the secondary loan market is shared by the issuer (usually a bank) and the investors. Energy efficiency data of real estate collateral at a portfolio level, could support both investors and regulators to assess the extent to which the value of that collateral might be negatively affected by increased costs associated with high emissions or by retrofitting requirements. This data should be checked against and complemented by officially verified sources. Disclosure could support both investors and regulators to assess the extent to which the value of collateral might be negatively affected by physical or transition climate risks (such as costs of retrofitting).
- We believe that in the absence of the EPC label institutions should publish the gross carrying amount of their exposures by energy efficiency buckets based on the specific energy consumption of the collateral in kWh/m2, as indicated in the Energy Performance Certificate (EPC) label of the collateral or estimated by institutions. The EPC was introduced by the EPBD to support the improvement of buildings' energy performance.
- Loans are divided by the type of property they are collateralizing, including both commercial and residential property and whether it was obtained by taking possession. In the EU context, they are divided between those properties located within the EU area. However, as the EPC methodologies vary between member states, reporting the aggregated EU position could present some challenges, therefore guidance from BCBS in this regard would be a welcomed development.
- Supervisors need to evaluate whether risk weights for real estate exposures are appropriate in their jurisdiction by considering, inter alia, climate-related financial risks (e.g., weather-related hazards, the implementation of climate-policy standards or changes in investment and consumption patterns derived from transition policies). Also, banks should determine whether the current market value of the financed property incorporates the potential changes in its value emerging from climate-related financial risks.
- Banks should however be required to give regard to the need for lending to improve energy efficiency, to ensure that households, particularly lower income communities where energy efficiency tends to be lower, are not doubly penalised.[19] More widely, we support the use of green lending operations to support the retrofitting of real estate, which would help to ensure

[17] https://www.eba.europa.eu/publications-and-media/press-releases/eba-publishes-binding-standards-pillar-3-disclosures-esg
[18] https://www.unepfi.org/themes/climate-change/climate-risks-in-the-real-estate-sector/
[19] https://www.sciencedirect.com/science/article/pii/S0140988323005601

that monetary policy complements prudential policy in this regard, and could help to avoid the risk of prudential policy having an adverse effect on climate adaptation through retrofitting.

Q51. What are your views on the feasibility, meaningfulness and practicality of banks' disclosure of facilitated emissions?

- We support the proposal to require banks' to disclose facilitated emissions, which are a substantive proportion of banks' overall emissions. We'd encourage that this be made mandatory, rather than subject to jurisdictional discretion, given their significance.
- Current practices of the industry, where facilitated emissions are being obscured from view, are giving rise to greenwashing and litigation risks. Recent research examining Europe's largest 20 banks' found that many of these exclude the majority of facilitated emissions from their emission reduction targets, whilst often including financed emissions as contributing towards their green finance targets.[20]
- However, to be meaningful, the framework used for disclosure of facilitated emissions must be robust and banks must be required to disclose the methodology used to calculate them**.** The methodology used can significantly impact the emissions accounted for, risking greenwashing. This has been demonstrated by industry-led reporting initiatives such as PCAF, whose recently published framework on facilitated emissions reporting permits banks' to report only 33% of emissions linked to their capital markets activities.[21] A method developed and overseen by supervisors for calculating facilitated emissions would be preferable to basing disclosures on industry-led initiatives such as PCAF.

[20] https://shareaction.org/news/europes-top-20-banks-need-to-be-clearer-cleaner-and-greener
[21] https://www.reuters.com/sustainability/new-bank-carbon-emissions-reporting-standard-includes-equity-bond-underwriting-2023-12-01/