Response to the BCBS Consultation on Disclosure of Climate-Related Financial Risks

1. Background and General Feedback

We generally welcome the BCBS' proposal and efforts to adapt the prudential framework considering climate-related risks.

For now, the BCBS only offered guidance to financial institutions as to how to address climate-related risk. It is yet to amend the design of the existing prudential framework and to recommend that jurisdictions evolve their regulatory frameworks. In a context marked by intensifying climate impacts and increased tension around the climate transition, **we strongly support the pivot to regulation and a holistic review of the prudential framework as the best course to secure consistent and meaningful treatment of climate risk by financial institutions**.

We note that, as various disclosure frameworks for private sector institutions are being implemented across jurisdictions, **the BCBS should provide an ambitious global reference point on prudential disclosures**. In doing so, the BCBS should consider major frameworks that are being rolled out like the EU ESRS and IFRS S1 and S2. Furthermore, we stress that **the forward-looking nature of climate-related risks and the degree to which these could prove material at microprudential and macroprudential levels implies an evolution of the scope of Pillar 3 disclosures** to incorporate relevant forward-looking climate-related information.

However, as identified in this consultation response, several key elements remain missing from the BCBS' draft document. Overall, the proposed disclosures are much too unprecise and standardized to foster good risk management practices of climate-related risks and could result in a wide range of practices that would contribute to mask systemic risks and individual banking weaknesses. Our following consultation response proposes several improvements to the disclosures to avoid such an outcome. **Major changes are notably needed on: 1) Transition plan disclosures; 2) GHG disclosures and targets; 3) Additional alignment metrics and information**.

Finally, the proposed disclosures are a necessary in addressing climate-related risks but are far from sufficient to do so. We ask the Committee to complete the work on reviewing Pillar 1 and 2 of the Basel frameworks, in line with the Q4 2024 communicated timeline. We also push the Committee to mandate the changes proposed in this consultation for all internationally active banks without national discretion and to finalize this work as soon as possible, targeting an implementation date starting January 2025.

2. Qualitative information section

The BCBS should make clear that climate related targets, strategies and elements must consider a 1.5°C no/low overshoot scenario with a limited level of negative emissions:

The BCBS' draft fails to clarify what the ambition of banks should be regarding their climate strategy and plans. This vagueness can translate in financial risks, with banks not being prepared for a "real" transition.

Today, initiatives related to GHG target setting and transition planning require the use of 1.5°C low/no overshot scenarios (see: Reclaim Finance, *Corporate Climate Transition Plans: What to look for*, 2024). Key initiatives also consider the level of negative emission in these scenarios, trying to ensure only a limited level is used. Such considerations are highly relevant to a risk approach: (i) Higher overshot scenarios are often linked to a delayed transition that brings higher transition risks and are connected to periods of higher global warming and tipping points that could increase physical risks; (ii) Relying on high levels of negative emissions means that high carbon activities are less exposed to transition risk, but such a high level of negative emissions is not likely to materialize and therefore risk are artificially underestimated.

Therefore, the BCBS should state that banks should use 1.5°C no/low overshot with a limited level of negative emissions scenarios in transition planning and – together with higher warming scenarios – in risk management.

The BCBS should require the disclosure of transition plan and be more prescriptive on their content:

In a recent report, Reclaim Finance analyzed 26 prominent public frameworks to identify the essential elements that should be included in any corporate transition plan (see: Reclaim Finance, *Corporate Climate Transition Plans: What to look for*, 2024). We showed that including these elements would enable companies to comply with CSRD obligations in a meaningful way, while also providing banks with the information needed to meet the ECB supervisory expectations on climate related risks. New analysis from the Climate and Sustainable Finance Commission (CCFD) of the French Market Authority (AMF) underlines the key elements needed to comply with the CSRD and contains quality factors that largely converge with our analysis (see: Climate and Sustainable Finance Commission of the AMF, *Reporting on climate transition plan in ESRS format*, 2024 – full version only available in French).

Compared to the elements gathered in these analyzes, the BCBS' draft is much to unprecise on the content of potential transition plans. **As noted in Reclaim Finance's report (see: Reclaim Finance, *Corporate Climate Transition Plans: What to look for*, 2024), many supervisory expectations set by the ECB can be linked to key aspects of transition plans, notably:**

- **The criteria applied to fossil fuels and other harmful activities.**
- **The decarbonization targets and their quality/alignment.**
- **The decarbonization strategy, and especially the elements related to financial planning.**
- **Engagement activities and their consequences for companies.**
- **The integration of climate objectives in reporting and governance.**

While this analysis specifically considered the ECB's expectations, it is worth noting that such expectations on climate-related risks set by different supervisors over the world tend to converge and that previous publications of the BCBS have many similarities with the ones of the ECB. **We therefore urge the BCBS to be more prescriptive on the content of transition plans**, notably building on the "red flags" identified by Reclaim Finance (see: Reclaim Finance, *Corporate Climate Transition Plans: What to look for*, 2024). Doing so would significantly contribute to climate-related risk management and mitigation, and notably contribute to address specific risks stemming from misalignment with climate goals, insufficiently substantiated net-zero commitments, and high carbon exposures.

The BCBS should require specific disclosures on engagement activities and link them to clear timebound objectives and an escalation strategy, with specific attention being devoted to investment/development of high carbon activities:

Engagement from financial institutions covers a wide range of activities with very different impact on the behavior of counterparties. It can refer simply having side discussions with companies on ESG topics ("tea and biscuits" engagement), or merely being a member of joint engagement initiatives. But it can also mean having a detailed engagement strategy that include an escalation process and clear timebound objectives to put pressure on companies, with a real impact on their practices and plans (see: Reclaim Finance, *Climate Stewardship: A guide for effective engagement practices*, 2023).

Only effective engagement practices that result in changes to company behavior are susceptible to contribute to mitigate risks. On the contrary, ineffective engagement could contribute to higher exposure to risks by contributing to maintaining exposure to companies that do not mitigate their own risks exposures. The BCBS should therefore add disclosure requirements on the topic and clarify that engagement should be based on clear timebound objectives and an escalation strategy that include ceasing all or part of the financial services provided to the company (see: Reclaim Finance, *Climate Stewardship: A guide for effective engagement practices*, 2023).

The BCBS should ensure banks consider capex allocation of counterparties in their assessment of risks:

Prominent methodologies on transition planning converge on the need for investment to align with the transition strategy, notably by reducing investment in "brown" activities and increasing those in "sustainable" ones (see: Reclaim Finance, *Corporate Climate Transition Plans: What to look for*, 2024). Some investment, including in new fossil fuel production projects, must even immediately stop. It is therefore not surprising to see investment allocation is one of the key elements that investors look for in climate strategies and plans (see: Climate Action 100+, *Net Zero Company Benchmark*, 2023 / Climate and Sustainable Finance Commission of the AMF, *Reporting on climate transition plan in ESRS format*, 2024 – full version only available in French).

In this context, it is important for the BCBS to ensure financial institutions look at capex allocation from counterparties (see: Reclaim Finance, *Corporate Climate Transition Plans: What to look for,* 2024). Misalignment of capex allocation could indicate potential high risk, notably in the perspective of a sudden/disorderly transition.

3. Quantitative information section

The BCBS should acknowledge that fossil fuels have already been connected to high level of climate-related risks and specific measures should be adopted to monitor and reduce exposure:

Page 5, the BCBS notes that: "*The Committee's analytical reports highlighted that the economic and financial impacts of transition risks can vary according to the sector in which an obligor is operating, as certain sectors will have greater sensitivity to the transition to a low-carbon economy driven by changes in government policies, technology and market sentiment. These could impact a bank's profitability – for example, through lower revenue, higher credit losses, and increased operational, legal and regulatory costs – and have implications for its overall risk profile and credit worthiness.*"

Indeed, the fact that a few highly emitting sectors and activities have already been identified as concentrating climate-related risks cannot be ignored. And in this regard, the fossil fuel sector stands out as especially risky:

- Despite major limitations in scenario and stress testing (see: Sandy Trust and all, *The Emperor's New Climate Scenarios*, 2023 / Finance Watch, *Finance in a hot house world*, 2023), preliminary exercises all identified fossil fuel activities as higher risk. This is notably the case of the stress test conducted by the ECB, the ACPR and other European regulators and supervisors (see: ESRB, *Towards macroprudential frameworks for managing climate risk*, 2023 / ECB, *The Road to Paris: stress testing the transition towards a net-zero economy*, 2023 / ACPR, *Les principaux résultats de l'exercice pilot 2020*, 2021 / Luis de Guindos, "Shining a light on climate risks: the ECB's economy-wide climate stress test", ECB, 2021). Recent scenario analysis conducted by the Department of Insurance of California further underlined that the plans of oil and gas companies in US West Coast insurers' portfolios are not aligned with policies implemented in 2021 implies "exposure to transition risk even in the absence of any additional collective climate action", and that coal and oil and gas have the highest probability of default in delayed/disorderly transition scenarios (see: California Department of Insurance, *Executive Summary The hidden cost of delaying climate action for West Coast insurance market*, 2024).
- Beyond the results of stress tests and quantitative analysis, fossil fuel assets are notably exposed to a "stranding risk" (see: Carbon Tracker, *Oil & Gas: 2023 Assessments for Climate Action 100+*, 2023 / Harry Benham, "Energy is a very long game: yet fossil fuel companies are taking a lot of short-term risks", Carbon Tracker, 2024 / Institut Rousseau and al, *Actifs fossiles, les nouveaux subprimes ?*, 2021). This is especially the case for assets tied to new production projects, as these assets are not needed in a scenario where actions are carried out to limit global warming to 1.5°C and will take decades to recover their investment cost. New fossil fuel production assets have a high chance to be closed before amortization or require the faster closure of pre-existing assets, and thus are a major source of risks as identified by the International Energy Agency (IEA) (see: IEA, *World Energy Outlook 2023*, 2023 / IEA, *The Oil and Gas Industry in Net Zero Transitions*, 2023 / IEA, *NZE 2023 Update*, 2023). This also means that bank's continued support to fossil fuel developers (see: Rainforest Action Network and al, *Banking On Climate Chaos 2023*, 2023 / Reclaim Finance, *Oil and Gas Policy Tracker*, online tool / Reclaim Finance, *Coal Policy Tracker*, online tool) breaches their net-zero and climate commitments, thus bringing additional transition risks (see: ECB, *An examination of net-zero commitments by the world's largest banks*, 2024). However, asset stranding risk is not considered by banks, despite its effect being potentially amplified by the indirect exposure to fossil fuels and second-round effects in financial markets in case of sudden loss of value (see: Winta Beyene and al, *Financial institutions' exposures to fossil fuel assets: An assessment of financial stability concerns in the short term and in the long run, and possible solutions*, Economic Governance Support Unit of the European Parliament, 2022). This is especially worrying since fossil fuel exposures already constitute a high share or even exceed the Common Equity Tier 1 (CET1) of these banks (see: ECB, *Risks from misalignment of banks' financing with the EU climate objectives*, 2024 / Institut Rousseau and al, *Actifs fossiles, les nouveaux subprimes ?*, 2021 / Bank of England, *Financial Stability Report*, 2019).
- At a macro-prudential level, the ECB and European Systemic Risk Board (ESRB) have long used fossil fuel exposures and related criteria in their analysis (see: ESRB and ECB, *The macroprudential challenge of climate change*, 2022 / ESRB, *Towards macroprudential frameworks for managing climate risk*, 2023). The EIOPA is now considering introducing additional capital requirements on fossil fuels (see: EIOPA, *Consultation on the Prudential Treatment of Sustainability Risks*, 2023), a proposal that has been championed by civil society organizations focusing on financial stability (see: Finance Watch, *A safer transition for fossil banking: Quantifying capital needed to reflect transition risk*, 2022). Additionally, establishing

restrictions on financial services to the fossil fuel industry is an element of the good practices identified by the ECB on climate and environmental risk management (see: ECB, *Good practices for climate and environmental risk management*, 2022), and that excessive support to this industry is one of the factor of misalignment of European banks with climate goals identified by the central bank (see: ECB, *Risks from misalignment of banks' financing with the EU climate objectives*, 2024).

Providing these elements, the BCBS's proposal that banks "disclose exposures to nonfinancial corporates according to standardised sectors of economic activity" is insufficient. Concretely:

1. BCBS should underline that fossil fuel assets are tied to high risk, and that assets linked to fossil fuel development are even riskier. **The exposure to fossil fuel assets should therefore be monitored using both (i) standardized sectors (like GICS categories) and (ii) specific data sets that enable to single out exposure to companies that develop new fossil fuel infrastructures such as the Global Coal Exist List (GCEL) and Global Oil and Gas Exit List (GOGEL).**
2. BCBS should **require banks to disclose the sectoral policies adopted regarding the fossil fuel sector and how this policy aligns with the goal to limit global warming to 1.5°C**. Such disclosures must enable supervisors to understand which financial services are granted to which type of fossil fuel company and activity.

Additionally, the BCBS should acknowledge that immediately ending financial services to new fossil fuel projects and the companies that develop them and phasing out support to fossil fuels – starting with coal - are important for managing climate-related risks at the global level.

It is worth noting that beyond climate-related risks, fossil fuel activities have been connected to numerous biodiversity, human and indigenous rights scandals and can be deemed highly risky from a broader social and environmental standpoint (see: Fossil Fuel Non-Proliferation Treaty, *How coal, oil and gas sabotage all seventeen Sustainable Development Goals*, 2022). This "cross-risk" or "ESG risk" exposure should be acknowledged by the BCBS and backs the case for more detailed requirements on fossil fuel exposures and financial services.

The BCBS should ensure the full scope of emission – including both financed and facilitated emissions – are reported and covered by GHG reduction targets:

In its draft, the BCBS rightfully considers both financed and facilitated emissions. However, the proposed disclosure of facilitated emissions is subject to jurisdictional discretion, opening a significant loophole that could create major gaps between jurisdictions.

Indeed, off balance sheet activities constitute a large share of bank activities and has been increasingly contributing to the financing of the economy (see: Greg Buchak and al, "The Secular Decline of Bank Balance Sheet Lending", *National Bureau of Economic Research*, 2024). But, so far, these activities remain largely out of the scope of both bank's voluntary climate-related targets and commitments and climate-related financial supervision. This partly explains the fact that between 2016 and 2022 49,1% of the fossil fuel financing of the world's 60 largest banks to the 100 biggest fossil fuels companies came from underwriting (see: Rainforest Action Network and al, *Banking on Climate Chaos 2023*, 2023). If this trend continues, the risk of a migration of the financing of ESG/climate negative activities and of the financial risk they bring to off balance sheet activities is high. This has potential macro stability implications and repercussions in the non-bank financial sector.

Furthermore, like on balance sheet exposures, off balance sheet exposures are not without direct risks for banks. EU regulators and supervisors have acknowledged climate-related risks that comes from high-carbon – and even more so fossil fuel - bonds (see: ECB, "Climate-related risks to financial stability", *Financial Stability Review 2021*, 2021 / EIOPA, *Consultation on the Prudential Treatment of Sustainability Risks*, 2023). Financial institutions themselves have acknowledged their responsibility on facilitated emissions and off-balance sheet activities (for example through involvement in the PCAF or SBTi Financial Net-Zero workstreams). Additionally, failing to consider fully off-balance sheet activities and related emissions in prudential regulation would encourage banks not to include these activities into their climate alignment strategies and transition plans. This would increase the transition risk related to misalignment of bank activities with climate goals. Using attribution factors to reduce the reported volumes of facilitated emissions would have similar effects, while also exposing financial institutions to increased controversies and litigation risks (see: Shareaction, *Why banks should account for their full share of facilitated emissions*, 2023).

Providing all these elements, the BCBS should **mandate the full disclosure of both facilitated and financed emissions in all jurisdictions and without the use of attribution factors**. Furthermore, the BCBS should go beyond merely requiring disclosure on emission to **ask for detailed decarbonization targets covering the same scope in all jurisdictions**. In the current draft, such targets are surprisingly not explicitly required for all jurisdictions, despite qualitative information including element coherent with them (such as transition plans) and mentions of "climate-related forecasts" in the CRFRA table. As it is, the BCBS' draft therefore leaves a major gap in term of quantitative forward-looking information.

The BCBS should make clear that analysis of the alignment of portfolio and related risks should go beyond mere emission-based metrics to consider the real alignment of specific sectors:

A consensus is emerging that methodologies that measure the alignment of portfolios are unprecise and not sufficient to measure alignment with climate policy goals (see: OECD, *Assessing the climate consistency of finance*, 2022 / OECD, *Assessing net-zero metrics for financial institutions*, 2023 / Institut Louis Bachelier, *The Alignment Cookbook*, 2020). Focusing on a single GHG-based alignment indicator at portfolio level could easily give a misleading image of the risk level of the portfolio through changes – even provisional – in portfolio affectation and/or assets prices.

It is therefore essential the BCBS pushes banks to look beyond GHG emissions to consider how companies in their portfolio transition their activities and how they contribute to "real-world" decarbonization (see: Paddy McCully, "Financial institutions targets must be based on real-world decarbonization", *Reclaim Finance*, 2023). This implies looking at sectoral transition milestones identified in the IEA NZE. For example, such milestones require coal to be phased-out by 2030 in the EU/OECD and 2040 worldwide and no new investment to be conducted in new oil and gas production (see: IEA, *World Energy Outlook 2023*, 2023 / IEA, *The Oil and Gas Industry in Net Zero Transitions*, 2023 / IEA, *NZE 2023 Update*, 2023). While such milestones are not identifiable for all sectors in the short term, they exist for most of the ones regularly considered as high risk like the Climate Policy Relevant Sectors (CPRS). For example, building on the work of the IEA, the BCBS could notably push them to adopt a ratio to allocate six euros to sustainable power supply for each euro allocated to fossil fuels (see: Reclaim Finance, "6:1, a ratio to successfully transform our energy system", *Reclaim Finance*, 2023 / Beyond Fossil Fuels, *Why Beyond Fossil Fuels favours the 6:1 sustainable power supply to fossil fuel financing ratio*, 2024).

Contact: Paul Schreiber, Senior Policy Advisor, paul@reclaimfinance.org