



Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland
Submitted via bis.org

To Whom It May Concern:

The RFI Foundation is a non-profit organization working as a catalyst to promote adoption of responsible finance in Islamic markets and in Islamic finance. We appreciate the opportunity to respond with comments in relation to the Consultative Document's questions.

Question 1: Has the Committee appropriately captured the necessary requirements for the effective management of climate-related financial risks and the related supervision? Are there any aspects that the Committee could consider further or that would benefit from additional guidance from the Committee?

We appreciate the comprehensiveness of the principles as they are currently presented in the Consultative Document titled "Principles for the effective management and supervision of climate-related financial risk" issued in November 2021.¹

We would bring attention to one potential scenario where the financial institution approach to risk management and national approach to supervision could result in creating a gap that would allow for insufficient monitoring and mitigation of certain climate-related risks connected to a "Divergent Net Zero" scenario, where an orderly transition is unsuccessful because different countries and sectors are subjected to significantly different approaches to pursue Net Zero.²

One major risk that could be overlooked by the risk management and supervisory approach described in the draft Principles is the consequence of transition risks that might manifest in emerging and development economies that are fossil fuel-export dependent as a result of disorderly transitions that result from multifarious decisions by developed, emerging and developing countries and creates the potential for synchronous cross-border transmission of transition risk through international financial institutions with operations in these countries and in global financial markets.

¹ For brevity, we will refer to these Principles as the "BCBS' Climate Risk Principles" during the rest of our comment.

² Network for Greening the Financial System. 2021. *NGFS Climate Scenarios for central banks and supervisors*. Paris: NGFS.

The approach laid out by in the BCBS' Climate Risk Principles would rely solely on financial institutions and national supervisors, or on voluntary cooperation between them, to select appropriate risk management and supervision tools that may pay insufficient attention to risks that may not rise to the level of materiality or regulatory requirements to which a financial institution is subject, or within the mandate of a single supervisors. Currently, these issues are address through voluntary cooperation among financial institutions or between central banks and supervisors and it might not be as effective as needed to achieve the principles' objectives of "improving risk management and supervisory practices related to climate-related financial risks".

In assessing climate-related financial risks from the financial institution's perspective, their risk management process will be driven by risk assessment and mitigation for individual customers with some risk assessment, stress testing and scenario analysis conducted at the financing portfolio level. Their risk assessment in a given country will be driven by their individual customer exposures to physical or transition risks, and the requirements established by that country's supervisory authorities.

For internationally active financial institutions at the Group level, they will manage their risk assessment, mitigation, stress testing and scenario analysis in a similar way, but the exposure to individual fossil fuel-export reliant countries may not be significantly large enough to become a focus for a deep dive within the institution's stress testing and scenario analysis. It may be of limited enough materiality that an (orderly) transition risk scenario is deemed sufficient.

An internationally active financial institution's home country supervisor may view their exposures to fossil fuel-export reliant customers as being sufficiently limited to not warrant further assessment into alternative (disorderly) transition scenarios to fulfill its own financial stability mandate. In both home country and the fossil fuel-dependent markets, supervisors may require consideration of different climate pathways, but their regulatory focus is likely to be anchored to comparing a business-as-usual ('hot house world') scenario where physical risks predominate or an orderly transition ('Net Zero by X') scenario showing alignment to a national Net Zero target.³

This approach will be the easiest for financial institutions and supervisors to operationalize because it provides a binary choice of outcomes at opposite ends of the spectrum where either physical or transition risk dominate. Given the newness of the exercise of analyzing climate-related financial risks by supervisors and financial institutions and the limited capacity to implement, this is understandable.⁴

However, for some fossil fuel-dependent economies, the most significant macroeconomic risk they face is not from an orderly transition, but from the possibility of a disorderly transition where other countries adopt diverging Net Zero policies focusing on different sectors. However, the implications of the disorderly transition are likely to be outliers in their cross-border transmission potential through both

³ The NGFS Scenarios Portal includes an image describing this in its "Portraits of two opposite scenarios" which contrasts the predominance of physical and transition risk between "Net Zero 2050" and "Current Policies". NGFS. "Scenarios Portal". <https://www.ngfs.net/ngfs-scenarios-portal/explore> (Accessed 11 February 2022).

⁴ The BCBS Principle 5 recognizes the need for "iterative and progressive" incorporation of climate-related risks to capital and liquidity adequacy as "the methodologies and data used to analyse these risks continue to mature over time and analytical gaps are addressed".

cross-border lending and global financial markets and the Principles do not clearly establish how these types of risks would be incorporated in risk management or supervision of climate-related financial risks.

Research by the Financial Stability Board examining the global financial stability risks of physical risk has found evidence that “cross-border lending may therefore serve to amplify climate-related risks in countries that are the recipients of cross-border border lending”.⁵ The basis for this conclusion was comparing the cross-border bank lending to different regions, both weighted and unweighted to their underlying *physical* risk. The increase between unweighted and weighted cross-border lending was highest for Latin America, Africa and the Middle East & Central Asia, which includes many commodity export-dependent economies (including those dependent on fossil fuel export revenues).

With this assumption that physical risk events could be significant enough to potentially lead international banks to reduce their cross-border lending into emerging and developing markets facing such a shock, it would seem to be likely as well that transition risks could have a similar impact. However, unlike the impact of physical risk events, the transition risk events would prospectively have a more synchronous impact that could transmission beyond emerging & developing countries.

Although climate change will increase the frequency of physical events that trigger such shocks which would be detrimental to individual countries’ financial stability, they would tend to be asynchronous risks in relation to global financial stability considerations. The FSB concluded that from the perspective of the financial stability implications on the lenders’ side, the risks would be more likely to be well diversified for international financial institutions and unlikely to create cross-border transmission of financial instability.

However, transition risks could create more systemically meaningful impacts because the effects would be more synchronous (and thus unlikely to be fully reflected in any national supervisor’s own stress test). They would potentially be amplified further because the significant GDP declines included in the NGFS Divergent Net Zero scenario would likely provoke a countercyclical response by countries that could require a reduction in their large holding of foreign financial assets by their Sovereign Wealth Funds.

For example, based on the NGFS scenario, the impact of a Disorderly Net Zero scenario would be twice as adverse and more concentrated within the economies of the Gulf Cooperation Council countries by 2030 than an Orderly Net Zero strategy.⁶ International financial institutions are active in these markets, and these economies are significant asset owners of global financial assets as well. This channel for international transmission of climate-related financial risks is likely to be under-emphasized compared

⁵ Financial Stability Board. 2020. *The Implications of Climate Change for Financial Stability*. Basel: Bank for International Settlements. Graph 10.

⁶ Based on the GCAMS5.3_NGFS scenarios for Current Policies, Net Zero 2050 and Divergent Net Zero, World annual GDP growth would be 0.1% (\$121 billion) lower between 2030 under the Net Zero 2050 and Current Policies and 0.2% (\$242 billion) lower under Divergent Net Zero compared to Current Policies. Approximately 28% of the global Net Zero 2050 impact would fall on GCC countries while 39% of the global Divergent Net Zero impact would fall on the GCC countries. This impact would be on the order of 0.25 to 0.5 percentage point and 2.5 to 3.0 percentage point impact on GCC GDP over the period for Net Zero 2050 and Divergent Net Zero, respectively.

with an orderly transition due to the Principles' focus only on financial institutions and national supervisors for ensuring adequate risk management is undertaken.

Furthermore, the assumptions underlying 'divergent Net Zero' scenarios is likely to depend on a wide range of policy assumptions by each supervisor that does consider this risk. Unlike climate-related physical risks, where there is an international consensus-building process to use as a reference point for scenarios, there is likely to be significant divergence between the scenarios for divergent Net Zero adopted by each financial institution or supervisor which limits the ability to evaluate cross-border transmission risks.

One possible mitigation strategy for this outcome would be for the Financial Stability Board to designate specific Divergent Net Zero scenario (such as the one produced by the NGFS) as a common benchmark for use across jurisdictions without limiting the ability of financial institutions or supervisors to adopt additional alternative scenarios. To avoid pre-empting national supervisors, this type of approach could, have limited applicability to only those financial institutions that have been designated as Global Systemically Important Financial Institutions (G-SIFI) or Global Systemically Important Banks (G-SIB), reflecting the nature of the risks to be mitigated.⁷

Question 2: Do you have any comments on the individual principles and supporting commentary?

Our comment on the individual principles is focused on the guidance provided in relation to climate risk data aggregation. We would note that there exists substantial limitations on the availability of data on financed emissions risks in emerging and developing countries that most financial institutions haven't taken into account in either their internal processes or in their public disclosures.

Research from CDP on review of bottoms-up disclosures by financial institutions found:⁸

"Financial institutions more commonly identify direct operational climate-related risks, such as physical damage to their operations (41%), but the vast majority are not yet reporting credit risks (65%), such as borrowers' default on loan repayments and market risks (74%), such as stranded assets and financial asset price devaluation. Yet these credit and market risks have a much higher reported potential financial impact (over US\$1 trillion combined versus just US\$34 billion for the operational risks reported)."

In our research, which uses a top-down methodology to identify the location and relative magnitudes of financed emissions risk in Islamic markets, we have found that very limited information is currently

⁷ Principle 12 (paragraph 42) appears to allow room for this possibility: "Scenario analysis should reflect relevant climate-related financial risks for banks. This should include the physical or transition risks that are relevant to a bank's business model, exposure profile and business strategy. **Scenarios should cover a range of plausible pathways, as appropriate.**" (emphasis added)

Principle 9 (paragraph 37) also appears relevant: "In evaluating mark-to-market exposure to climate-related risks, banks may consider how the pricing and availability of hedges could change given different climate and transition pathways, **including in the event of a disorderly transition.**" (emphasis added)

⁸ CDP. 2021. The Time to Green Finance. London: CDP. <https://www.cdp.net/en/articles/media/finance-sectors-funded-emissions-over-700-times-greater-than-its-own>

disclosed in relation to the specific practices by financial institutions across large parts of the banking market.⁹

Consequently, it will be difficult for financial institutions in emerging and developing markets to undertake and disclose the results of “a comprehensive assessment of climate-related financial risks [with] definitions and thresholds for materiality [...] with an integrated firm-wide perspective on risk[,] includ[ing] those posed by concentrations, in particular those related to industry, economic sectors and geographic regions”.¹⁰

Rather than use the lack of these data as an excuse for inaction or delay, which will allow for the further build-up of climate related financial risks, there should be an element of the principles that addresses how financial institutions facing severe data limitations should approach the analysis and disclosure of climate-related financial risks they face.

We appreciate the Committee’s recognition that “as the methodologies and data used to analyze [climate-related financial] risks continue to mature over time and analytical gaps are addressed” that “banks should start building risk analysis capabilities by identifying relevant climate-related risk drivers that may materially impair their financial condition, developing key risk indicators and metrics to quantify exposures to these risks, and assessing the links between climate-related financial risks and traditional financial risk types such as credit and liquidity risks”.

However, we hope regulators will be more proactive in outlining principles that would allow for financial institutions and supervisions to make progress on build capacity for identifying climate-related financial risks even where data coverage is currently very limited. This would support more widespread adoption of regulations informed by these principles, as some already have, to encourage banks and financial institutions to start working to identify, mitigate and disclose the risks they already face using the data that we have, even if it isn’t as comprehensive as would be desirable.

Question 3: How could the transmission of environmental risks to banks’ risk profiles be taken into account when considering the potential application of these principles to broader environmental risks in the future? Which key aspects should be considered?

In addition to the risks directly emerging from environmental risks – effects on revenue and costs as well as ability to repay existing finance, secure additional access to financing at similar costs – we would highlight companies’ capital structure and their degree of reliance on debt as being critical aspects to consider as relevant to banks’ risk profiles.

The RFI Foundation have conducted research together with INCEIF, a post-graduate university in Malaysia, that offers some insights as to how reliance on debt can impact the performance of financial

⁹ Our research to-date (published and in progress) covers on Malaysia, Indonesia, Saudi Arabia, United Arab Emirates, Turkey and Bangladesh.

¹⁰ RFI Foundation. “Research”. <https://www.rfi-foundation.org/research> (Accessed 7 February 2022).

assets. Although our research is strictly focused on global listed equities, it provides clear evidence that the performance of companies facing with greater susceptibility to ESG risks is different based on whether their capital structures rely more heavily on debt financing.

The research identified consistent outperformance of equity in companies with poorer ESG ratings (measured using the ESG data within Refinitiv's Asset 4 platform) that complied with Islamic screens compared to similar companies in ESG risk that did not comply with Islamic screens. The screening process includes some sector-based exclusions covering sectors that are deemed unethical, as well as exclusion of companies that have debt levels above a permissible threshold. We did not find a similarly clear relationship for companies with higher ESG ratings.

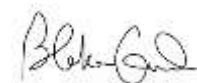
Although the research did not consider fixed income investments or bank financing, which could provide more directly relevant information to guide banks' risk profiles related to environmental (and more broadly ESG) issues, we believe there is a compelling reason to believe that companies' debt levels have relevance to their financial risk profile.

One hypothesis we believe would be worth further exploration would be that the financial prudence of companies that are compliant based on Islamic screening offer a 'margin of safety' to investors in those companies when environmental, social or governance risks are realized. An alternative hypothesis that would also be consistent with our research findings would rely on a different direction of causality would be that companies with lower leverage are less likely to face realization of environmental risks.

The explanation for this relationship between debt and environmental risk profile would be that companies with very high leverage are incentivized to weight short-term profits more highly with less regard to the long-term environmental risks they take. In contrast, lower leveraged companies may be able to make decisions with a longer time horizon and avoid creating future environmental risks because they face a less acute need to generate short-term profits to service the debt, make dividend payments, or remain within current loan covenants.¹¹

We thank the Committee for the opportunity to comment on the BCBS Climate Risk Principles.

Sincerely,

A handwritten signature in dark ink, appearing to read "Blake Goud".

Blake Goud
CEO
RFI Foundation

¹¹ The BCBS' Climate Risk Principles already reflect some of this in Principle 8 (paragraph 34) which says "Banks should consider a range of risk mitigation options to control or minimise material climate-related credit risks [including] imposing loan limitations or restrictions such as [...] lower loan-to-value limits".