Utrecht, October 5, 2023

Sustainable Finance Lab input on the BCBS consultative document Core principles for effective banking supervision

We welcome the explicit inclusion of climate-related risks in the Core principles for effective banking supervision ('Core Principles'). This is a positive step towards integrating climate-related risks into the supervisory framework.

However, we suggest to also include other environmental risks as these are financially material as well. As there are clear links and trade-offs between nature and climate an integrated approach to climate and other environmental ("C&E") risks is needed. This is also recognised by the NGFS (NGFS, 2023a; NGFS-INSPIRE, 2022).

We also believe a precautionary approach is needed because when C&E risks materialize it may be too late to remedy that situation, through tipping points there may be no way back to the old equilibrium.

C&E risks also cannot be addressed with existing tools only. A more forward-looking approach and precautionary measures are needed to mitigate the risks resulting from climate change and biodiversity loss. Our feedback on some of the updated principles is summarised below.

Principle 8 Supervisory approach and Principle 9 Supervisory techniques and tools

We agree supervisors should apply a forward-looking assessment of the risk profile of banks and that the time horizon should appropriately reflect C&E risks. We also welcome the references to assessment of financial stability and the inclusion of systemic risks. Credible, science-based transition plans are a useful supervisory tool for such a forward-looking assessment, and these should specifically be mentioned. Any misalignments with the defined targets and pathways are an indicator of transition risks of individual banks. On a macro level, they provide insights in the endogenous contribution to systemic C&E risks and therefore financial stability, the double materiality concept (NGFS, 2023b).

Principle 10 Supervisory reporting

Transition plans should be reported as well and be included in supervisory reviews. The supervisor should assess whether transition plans are adequate; whether the right targets are set (absolute rather than relative) for all relevant lending and whether the implementation plan is sound, like the use of science based scenarios.

Principle 14 Corporate governance

Financial institutions should have the right capabilities and knowledge levels to be able to assess C&E risks. C&E risks are included in the fit and proper assessment of the ECB. However, in order to ensure sufficient knowledge on management level, it is important to explicitly assess in the fit and proper assessment the knowledge of other environmental risks as well and to put more emphasis on the underlying dynamics of these risks. Potential new board members should understand how C&E risks could impact their portfolio. This means understanding the different drivers of nature loss, the key sectors, the transmission channels and associated potential financial risks. Board members also need to understand the concept of endogenous risks; how the organisations' negative impact on climate and nature leads to the build-up of physical risks and thereby affecting financial risks again. It is also key to understand the link between nature and climate change, to avoid potential trade-offs between nature and climate and to benefit from the shared solutions.

Principle 15 Risk management process

Transition plans should be mentioned as a tool for financial institutions to manage C&E risks.

We agree with the mention of scenario analysis and stress testing linked to climate-related risks. However, current tools and methodologies have their limitations and are not able to capture these risks completely. Concretely, NGFS scenarios, based on Integrated Assessment Models (IAMs), are currently plagued by considerable deficiencies. Among other gaps, they omit tipping points, social effects of climate change (conflicts, migrations, etc), use damage functions with dubious damage outputs for high temperature increases, do not model the financial sector accurately, etc. All of these issues raise a question of whether IAMs are fit for purpose in the financial sector and whether such modelling could be preferably based on other kinds of models.

More qualitative assessments are needed as a substitute or to complement the inherently limited modelling.

Principle 16 Capital adequacy

Supervisors should implement specific capital measures for C&E risks. C&E risks are material financial risks and without additional buffers may leave banks exposed to losses and systemic shocks. C&E risks are currently not captured sufficiently enough in the Pillar I framework, given the short-term horizon of the framework and the lack of forward-looking information. Therefore, an adjustment factor needs to be considered to increase risk weights for carbon-intensive sectors or sectors harmful to nature. In addition, supervisors should require capital add-ons in Pillar II for banks not sufficiently managing their C&E risks. On the macroprudential side, to account for the systemic risks, systemic risk buffers for C&E risks or concentration limits need to be included.

Principle 19 Concentration limits and large exposure limits

We propose to specifically mention C&E risks as example risks that could lead to concentration risk.

[51] Concentration risk may result from credit, market, ***C&E risks*** *and other risk where a bank is overly exposed to particular asset classes, products, collateral, currencies or funding sources. Credit concentrations include exposures to: single counterparties (including collateral credit protection and other commitments provided); groups of connected counterparties; counterparties in the same industry, economic sector or geographic region; and counterparties whose financial performance is dependent on the same activity or commodity.*

References

NGFS. (2023a). *Nature-related Financial Risks: A Conceptual Framework to guide Action by Central Banks and Supervisors*.

NGFS. (2023b). *Stocktake on Financial Institutions' Transition Plans and their Relevance to Micro-prudential Authorities*.

NGFS-INSPIRE. (2022). *Central banking and supervision in the biosphere: An agenda for action on biodiversity loss, financial risk and system stability*.