Comments on the Basel Committee on Banking Supervision Consultative Document

"Principles for the effective management and supervision of climate- related financial risks"

By Stefano Battiston

I am writing in my personal capacity, as scientist and citizen. My comments are based on my specific scientific expertise of financial stability as well as on climate-related financial risks.

I am Professor of Banking at the Univ. of Zurich, Professor of Economic Policy at Univ. of Venice and Lead Author in the Chapter Finance and Investments of the IPCC Assessment Report 6, Working Group III.

The document tries and establish a set of Principles to encourage banks across jurisdictions to incorporate climate-related financial risks in their risk management processes.

It is certainly useful for the purpose of financial stability that the BCBS elaborates a set of principles and recommendations on this topic. I am very pleased to see this development.

I report below some comments.

Principle 5 recommends to identify and quantify climate-related financial risks and incorporate them into their internal capital and liquidity adequacy assessment processes. This principle is in line with the scientific literature and the work of a number of national financial supervisors. However, it lacks specific recommendations on how to carry out such an incorporation. As a result, it could fail to prevent banks to underestimate the adjustments in terms of capital and liquidity requirements that climate risks imply.

Principle 7 recommends to build internal risk data aggregation capabilities and reporting systems capable of monitoring material climate-related financial risks. This is certainly very useful. However, climate relevant data is still very sparse and it will take several years before firms will report in consistent and comparable way climate relevant KPI. At the same time, banks will take several years to build those capabilities. In contrast, the feasibility window of the low-carbon transition is closing, and a few 5 years of delay can make the difference between achieving and missing the transition. It should be noted that climate mitigation means a stabilization of the warming below 2 degrees C. This in turn requires to bring net emission to zero by 2050. Therefore, Principle 7 is certainly useful but it does not seem to set in motion a process that can realistically deliver the needed results in time.

The Principles do not seem to suggest procedures to make risk assessments replicable and verifiable by financial supervisors. Moreover there seems to be no reference to the comparability of the result of risk assessments across banks, at least within the same jurisdiction. Without these elements, the Principles could lack the necessary dent to have a real impact.

The Principles do not acknowledge the fact that climate-related financial risks are largely endogenous and that expectations can also be self-defeating, as discussed in an article on the journal Science by Battiston et al. 2021. For instance, a perception of low climate risk in the short term by banks can lead to a level of capital reallocation from carbon intensive to low-carbon activities that is insufficient to reach the 2 degrees target and therefore lead to high risks, both physical and transition. Therefore, financial stability objectives require to tame this endogeneity by encouraging banks to assess their risks under comparable and severe scenarios of a disorderly transition, as well as under scenarios of high physical risk in line with the recommendations of the NGFS.

Remarkably, the document never mention the term “systemic risk” and it mentions “financial stability” only in general terms in the first paragraph. This is an important and surprising gap in the document. Considerations about the systemic relevance of climate-related financial risks have been made by several authoritative central banks (see e.g. the ECB report https://www.ecb.europa.eu/pub/financial-stability/macroprudential-bulletin/html/ecb.mpbu202110_1~5323a5baa8.en.html)

In this regard, the Principles could make some recommendations that are more concrete and immediately actionable. For instance, it could recommend that all financial assets whose value largely depends on fossil fuels (in terms of exploration, extraction, manufacturing and sales) are recognized as assets with a systemic risk relevance. It could also recommend that the financing of new fossil fuel projects, which are clearly misaligned with climate objectives, is covered with internal funds.

I find the idea of these principles useful and timely and I am glad to see this initiative in motion. However, I am not convinced that, as they stand now, these Principles can lead to sufficient incentives for banks to adequately take into account climate-related financial risks.