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Workshop 2
Climate-related financial risks

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Climate change may result in physical and transition risks that could affect the safety and soundness of individual banks and have broader implications for the banking system and financial stability. Targeted changes to the Core Principles have been introduced to explicitly include climate-related financial risks and to promote a principles-based approach to improving supervisory practices and banks' risk management. The Core Principles are universally applicable and emphasise that banks should understand how climate-related risk drivers may manifest through traditional financial risks such as credit risk, operational risk, etc, recognise that these risks could materialise over varying time horizons (which may go beyond their traditional capital planning horizon), and implement appropriate measures to mitigate these risks. Supervisors are also expected to consider climate-related financial risks in their supervision of banks, to assess banks' risk management processes, and to require banks to submit information that makes it possible for supervisors to assess the materiality of climate-related financial risks. Both bank and supervisory practices may consider climate-related financial risks in a flexible manner, given the degree of heterogeneity and evolving practices in this area.

A holistic approach to addressing climate-related financial risks

The Committee has adopted a holistic approach to addressing climate-related financial risks, which has included stocktakes of existing regulatory and supervisory initiatives, gap analysis and analytical work.[1] Across the three pillars of the Basel Framework spanning the regulatory, supervisory and disclosure dimensions, the Committee has focused on:

- **Regulation:** the Committee issued responses to frequently asked questions (FAQs) to clarify how climate-related financial risks may be captured in the current framework.[2] The FAQs contain clarifications for banks and supervisors, on topics such as the integration of climate-related financial risks in credit risk assessments or due diligence of external credit ratings, in assessing the adequacy of risk weights for residential real estate loans, or the estimation of internal-ratings based models' parameters.
- **Supervision:** the Committee published *Principles for the effective management and supervision of climate-related financial risks* ("Climate Principles") which aim to promote a principles-based approach to improving risk management and supervisory practices.[3] The Climate Principles provide banks with guidance on the effective management of climate-related financial risks, covering governance, internal control, internal capital and liquidity adequacy assessments, risk

1 BCBS (2020), BCBS (2021a), BCBS (2021b).

2 BCBS (2022b).

3 BCBS (2022a).

management, reporting and scenario analysis. They also provide guidance for supervisors covering the supervisory approach, responsibilities, powers, tools and techniques.

- **Disclosure:** the Committee commenced public consultation on a disclosure framework for climate-related financial risks in November 2023.[4] The proposed disclosure framework builds on the work of other international standard setters, particularly the International Sustainability Standards Board (ISSB), and complements it with bank-specific qualitative and quantitative disclosure requirements. The former covers the bank's governance, strategy, and risk management of climate-related financial risks; the latter comprise metrics, including forward-looking ones, on exposures by sectors and geographical area with a view on transition and physical risks, respectively, and on the bank's financed emissions.

Implementation of the Climate Principles by banks and supervisors

The climate-related financial risk requirements in the revised Core Principles are based on the Committee's Climate Principles, so experience with implementing the latter is likely to provides useful insights. The Committee expected member jurisdictions to implement the Climate Principles as soon as possible after their publication in June 2022, and has been monitoring implementation progress by members.

As part of its monitoring efforts, the Committee held an outreach session to understand the industry's experience with the implementation of the Climate Principles, and conducted a survey among member jurisdictions and those represented in the Basel Consultative Group (BCG) to help identify practical implementation challenges, good practices and potentially identify areas for additional guidance. The insights from these initiatives and the Committee's internal discussions regarding the implementation of the Climate Principles have been published in a newsletter.[5]

In the first 12 months following the publication of the Climate Principles, the majority of member jurisdictions had taken steps to implement the Principles in domestic supervisory frameworks and practices through the issuance of draft or final guidance, or have plans to issue such guidance. While supervisors noted that banks lacked the capacity to fully implement the Climate Principles during this initial period, banks had implemented (at least partially) a number of principles, eg those on corporate governance, internal control frameworks, and risk management processes. However, in several areas progress was particularly lagging, especially in relation to the quantification of climate-related financial risks, data collection and adequate measurement through reliable risk metrics and key risk indicators. While it is recognised that climate-related financial risks will probably be incorporated into banks' internal capital and liquidity adequacy assessments iteratively and progressively, the implementation in this area was found to generally be at very early stages.

Addressing key implementation challenges

Data limitations were identified as the main impediment for banks and supervisors to implement the Climate Principles. Banks reported that the availability and quality of data and methodologies vary significantly across sectors and counterparties, and therefore significant human resources, expertise and time are required to improve data availability and quality. Some supervisors are addressing this issue by collecting quantitative climate-related financial risk data on either a regular or an ad hoc basis (eg as part of stress testing exercises). Some are collaborating with the industry to develop common platforms,

[4] BCBS (2023b). The consultation period ended on 19 March 2024.

[5] BCBS (2023a).

templates, tools and data repositories, some of which are publicly available (eg to estimate greenhouse gas emissions). Banks use targeted questionnaires and client due diligence as part of loan granting processes to collect relevant data, use public disclosures and third-party data providers, as well as proxies using activity-based data and asset-based factors.

The second significant challenge to implementing the Climate Principles relates to capabilities. In the first year after their publication, banks lacked the required professional experience and human resources to fully implement the Climate Principles. Supervisors were also working to address their own resource limitations, for instance by building centres of excellence.

At this early stage, supervisors' efforts to implement the Climate Principles have focused on monitoring bank practices, identifying risks and establishing supervisory expectations for these risks. Some of the efforts included engaging in dialogue with banks, conducting surveys of bank practices, requesting that banks undertake self-assessments and publishing examples of good practices. A number of supervisors noted that ongoing activities as well as next steps would involve conducting targeted or thematic reviews and on-site inspections, providing feedback to banks and integrating climate-related financial risks into core supervisory processes.

Finally, banks confirmed the importance of climate scenario analysis and reported running a range of different scenarios for different purposes, such as risk management, strategic planning and public disclosure. Supervisory climate stress testing and scenario analysis exercises have been a catalyst for building up banks' resources and capabilities. These exercises also helped to identify data and methodological gaps and highlighted the benefits for supervisors and banks of closely collaborating to overcome challenges in addressing climate-related financial risks.

Q1. How are you addressing climate-related financial risks in your jurisdiction?

Q2. What are your experiences with the implementation of the Climate Principles? What better practices have you seen? What have been the challenges for both banks and supervisors?

Q3. How are you planning for the implementation of the revised Core Principles? Do you foresee any implementation challenges?

Q4. Are there any aspects of the management and supervision of climate-related risk that could benefit from additional guidance by the Committee?

Q5. How can the Committee best contribute to efforts to build capacity in supervising climate-related financial risks?

References

Basel Committee on Banking Supervision (2020): "Climate-related financial risks: a survey on current initiatives", April.

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——— (2022a): "Principles for the effective management and supervision of climate-related financial risks", June.

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——— (2023b): "Consultative document - Disclosure of climate-related financial risks", November.