16 February 2022

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EBF response to BCBS Consultation 'Principles for the effective management and supervision of climate-related financial risks'

General comments

- Banks' shifting of resources towards a low-carbon economy and engagement with customers is key in financing the transition. While banks are fully aware of their responsibilities and are committed to play their role, it is not realistic to expect financial services to make this shift in the absence of a major change in the incentives of the underlying economy. The climate objectives must be transposed in the industrial policies and relevant national legal frameworks. We welcome that the Basel Committee‵s focus is on the risks associated with climate change, not the banks' action to tackle climate change. Indeed, banks cannot be put in the position of being the primary enforcers of climate policy, neither should prudential framework be used as a substitute for direct mechanisms such as taxes or industrial measures. The role of supervisors should be ensuring that risks that can be stemming from climate change are considered by the institutions, identified, understood, and managed.

- We indeed support the ongoing efforts of banks and regulators to ensure proper identification, understanding management and supervision of risk stemming from climate related factors. Banks have an inherent interest in measuring and managing risks properly as risk management and risk redistribution is core to the banking business Management, transformation and absorption of financial risks will be a key element in the transformation of global economy to net zero as substantial investments e.g. in new technologies need to be financed. Where material risks exist, it must be up to the institution to cover or mitigate them in line with their own business strategy and risk appetite. The role of supervisors should be to ensure that such risks are considered by the institutions, identified, understood, and managed.

- With the view to achieve harmonization at global level, the national/regional regulatory authorities should respect the principles of the Basel Committee. However, several authorities around the globe have already issued their supervisory expectations for climate-related risk management by banks. This requires that the Basel Committee be fully aware of the discussions and developments in each jurisdiction and takes them into account in developing the final principles. While we welcome harmonization efforts at global level, the current flexibility regulators and supervisors are providing in terms of methodologies as well as proportionality needs to be maintained over time given the large-scale investments required for the development of methodologies and internal systems.

- Global harmonization and streamlining are in particular essential for reporting and disclosures requirements requirement to avoid multiple reporting obligations. Also reporting a similar but slightly different information given the diverging regulatory request and definitions may not only be burdensome but also confusing for the market. Reporting requests must be streamlined among supervisors for which harmonization and alignment of data definitions is needed, ideally at a global level.

- From a model perspective, we want to underline the mismatch of time horizon of the models widely applied in the market on the one hand, and long-term climate risk scenarios on the other hand, which cover a time horizon of 30 years. Current risk measure models are not developed for such long-time horizon. Moreover, the underlying capital planning likewise cannot be designed to take capital decisions in 30 years due to the fact that uncertainty increases based on accumulating assumptions. BCBS should provide more detail on the time-horizons it considers 'relevant' given the challenges with data access, skills and methodologies to understand the expected impact, taking in particular into consideration the interrelation between physical risks and transition risks respective evolutions (according to climate policies, technology, investor and consumer behavior, etc.) and the non-linear (incremental) nature of physical risks over time in particular.

- We agree that capital should be determined with risk sensitive metrics. At this stage however, the relationship between risk drivers and actual risk levels on capital has not been established yet. In this context, work is also ongoing in the regulatory authorities of the BCBS jurisdictions, which in our view should feed into the BCBS work.

  There are still a lot of uncertainties as to the evolution of climate changes (speed, magnitude, non-linearity) and physical and transition risk drivers (e.g. climate policies, technology, investor and consumer behavior, etc.). Coupled with lack of reliable statistical data elements, whether internal or from regulated and audited external data providers, makes the capital impact assessment difficult at this stage. Scenario analyses are also still in a pilot stage and will become more sophisticated over time. Stress testing methodologies for ESG risks have so far mainly been applied in an exploratory manner. While some assumptions and simplifications are needed so that the exercises are doable given the current limitations regarding data and methodologies, the framework and its results might be unrealistic, and special care has to be taken when analysing the results.

Therefore, as long as data, methodologies and results of regulatory stress testing exercises are not stabilised, these exercises should not imply any quantitative impact on the capital requirement of the entities, and qualitative impacts in the supervisory review process should be restricted to very limited cases (for example, where it is unequivocal that a bank has not started to set up the governance and internal processes to integrate and account for climate-related financial risks). Climate-related stress testing should also be kept separate from "regular" stress testing.

- Concerning the impact of climate risk drivers on the liquidity of a bank, we believe that given that the climate risk drivers are expected to materialise over a long-time horizon, they do not have a meaningful impact on the liquidity of banks in the short term.

- Given the current lack of available quality data, harmonized definitions and forward-looking risk methodologies to assess the impact of climate-related risk on existing risk categories we believe it is necessary to underline the need for a phase-in approach for banks

I. Principles for the management of climate-related financial risks

Corporate Governance

Principle 1: *Banks should develop and implement a sound process for understanding and assessing the potential impact of climate-related risk drivers on their businesses and on the environments in which they operate. Banks should consider material climate-related financial risks that could manifest over various time horizons and incorporate these risks into their overall business strategies and risk management frameworks. [Reference principles: BCP 14, SRP 30, Corporate governance principles for banks]*

- We believe that BCBS principles should carefully distinguish the roles and responsibilities assigned to the board from those assigned to the Senior management. In particular, we believe it would be useful to clarify the following sentence in paragraph 12 '*The board and senior management should be involved in all relevant stages of the process' by adding in the end* ***', according to their respective roles'***.

- Also, as acknowledged by the Basel Committee, climate risk is not a new, standalone category of risk. All ESG factors can positively or negatively impact the current risk categories. We believe the text should be clarified accordingly to avoid possible misinterpretations: "*...assessing the potential* ***positive or negative*** *impact of climate-related* ~~***financial risks***~~ ***factors*** *and incorporate these* ~~***risks***~~ ***factors*** *into their overall business strategies and risk management frameworks"*

- In line with our general comments, we request clarification of the "various time horizons" that banks should consider for material climate-related financial risks manifestation according to this principle
- As raised in the summary, harmonization at global level is key.

Principle 2: *The board and senior management should clearly assign climate-related responsibilities to members and committees and exercise effective oversight of climate-related financial risks. The board and senior management should identify responsibilities for climate-related risk management throughout the organisational structure. [Reference principles: BCP 14, SRP 30, Corporate governance principles for banks]*

- We believe that BCBS principles should carefully distinguish the roles and responsibilities assigned to the board from those assigned to the Senior management. In particular, we suggest the following wording change in Principle 2 itself to avoid any ambiguity:
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  *'**<u>According to their respective roles</u>**, **t**he board **and** **<u>or the</u>** senior management should identify responsibilities for climate-related risk management throughout the organisational structure.'*

- Moreover, we understand that Principle 2 (at high level and under paragraph 13) would require the assignment of climate-related responsibilities to <u>individual</u> board members board <u>and</u> specific committees. In our view, this would go counter to the general principle of collective responsibility of the board and conflict with the provisions of some national laws. To address this issue, we suggest amending the wording of the consultative document so that these responsibilities can be assigned to the board and committees, in line with the solution defined, for example, by ECB in its expectations for Eurozone banks.

Principle 3: *Banks should adopt appropriate policies, procedures and controls to be implemented across the entire organisation to ensure effective management of climate-related financial risks. [Reference principles: BCP 14, SRP 30, Corporate governance principles for banks]*

Seems reasonable. However, we believe the flexibility regulators and supervisors are providing in terms of methodologies as well as proportionality needs to be maintained over time given the large-scale investments required for the development of methodologies and internal systems.

Internal control framework

Principle 4: *Banks should incorporate climate-related financial risks into their internal control frameworks across the three lines of defence to ensure sound, comprehensive and effective identification, measurement and mitigation of material climate-related financial risks. [Reference principles: BCP 26, SRP 20, SRP 30]*

Capital and liquidity adequacy

Principle 5: *Banks should identify and quantify climate-related financial risks and incorporate those assessed as material over relevant time horizons into their internal capital and liquidity adequacy assessment processes. [Reference principles: BCP 15, BCP 24, SRP 20, SRP 30]*

- Whereas we support the need for identification and quantification of climate-related financial risks and their inclusion into banks' capital and liquidity adequacy frameworks, we welcome the acknowledgement under paragraph 23 that the 'probable' inclusion into ICAAPs and ILAAP should be 'iterative and progressive'/ We believe that both paragraph 21 on ICAAP provisions and paragraph 22 on ILAAP provisions should be made consistent with the idea of a gradual inclusion and thus, we suggest adding 'iteratively and progressively' to qualify the inclusion in both processes ('Banks should include **iteratively and progressively** climate-related financial risks…').

  The rationale behind this is that at this stage, the precise relationship between risk drivers and actual risk levels on capital and liquidity cannot be precisely quantified at it lacks:

  (i) the required methodologies which are still work in progress: methods for integrating climate-related and environmental risk drivers should be defined and implemented by banks as deemed adequate for internal economic risks monitoring and decision-making purposes.

  (ii) the required available and reliable statistical data elements, whether internal or from regulated and audited external data providers

  Moreover, there are still a lot of uncertainties as to the evolution of climate changes (speed, magnitude, non-linearity) and physical and transition risk drivers (e.g. climate policies, technology, investor and consumer behaviour, etc.), as summarised by BCBS in the section 2 of its April 2021 report (*Climate-related risk drivers and their transmission channels*) which make the capital and liquidity impact difficult to assess at this stage.

  Finally, in terms of scope, we believe that since ESG risk drivers are expected to materialise over a long-term time horizon, they do not have a meaningful impact on the liquidity of banks in the short term.

- With reference to paragraph 23 we suggest complementing the wording with the following: "Finally, it is expected that national competent authorities, implementing the proportionality criteria, will define a framework of standardized climate scenario models and simplified methodologies to assess climate-related risks (e.g. for ICAAP-

ILAAP purposes), that could be more easily applied by less significant institutions with non-material exposures to climate-related risks, as long as those do not significantly impair the quality level of risk assessments.

Risk management process

Principle 6: *Banks should identify, monitor and manage all climate-related financial risks that could materially impair their financial condition, including their capital resources and liquidity positions. Banks should ensure that their risk appetite and risk management frameworks consider all material climate-related financial risks to which they are exposed and establish a reliable approach to identifying, measuring, monitoring and managing those risks. [Reference principles: BCP 15, SRP 30]*

- Paragraph 25 state that "*Banks should regularly carry out a comprehensive assessment of climate-related financial risks and set clear definitions and thresholds for materiality, bearing in mind that a bank's risk management framework should enable it to recognise all material risks with an integrated firm-wide perspective on risk*."

  We understand that the objective of this process is to ensure that a regular review of climate-related financial risks is performed by each bank to identify those that are material at firm level and that this should be done under a formalised harmonised framework that includes clear definitions and materiality thresholds.

  However , we consider that this review should be performed consistently with banks' own internal processes (e.g. internal stress testing).

  Hence, we propose the following wording to replace the above sentence:

  "*Banks should regularly carry out a* ***mapping of their*** *climate-related financial risks according to their internal processes,* ***after having set*** *clear definitions and thresholds for materiality, bearing in mind that a bank's risk management framework should enable it to recognise all material risks with an integrated firm-wide perspective on risk*."

- With reference to paragraph 27, we request clarification of the phrase '*may not yet be apparent*' in '*banks should monitor future developments and seek to understand and, where possible, manage the impact of climate-related risk drivers on other material risks that may not yet be apparent'*, that we see as equivocal as risks need first to be identified to be managed; otherwise, the scope of this impact would be unclear and too broadly defined.

  Therefore, we suggest replacing the above sentence by the following: '*banks should monitor future developments and seek to understand and, where possible, manage the* ***potential*** *impact of climate-related risk drivers on other material risks* ***that may not yet be apparent which have been identified but have not materialised yet.***

- In addition, it would be also important to flag that setting specific limits or risk appetite for all climate-related risks is not needed in a prescriptive way. Flexibility should be allowed to entities on whether, how and to which extent they incorporate them as, for instance, the usefulness to set climate risk limits for market and liquidity scenarios is not clear.

Management monitoring and reporting

Principle 7: *Risk data aggregation capabilities and internal risk reporting practices should account for climate-related financial risks. Banks should seek to ensure that their internal reporting systems are capable of monitoring material climate-related financial risks and producing timely information to ensure effective board and senior management decision-making. [Reference principles: BCP 15, SRP 30, Principles for effective risk data aggregation and risk reporting]*

Comprehensive management of credit risk

Principle 8: *Banks should understand the impact of climate-related risk drivers on their credit risk profiles and ensure credit risk management systems and processes consider material climate-related financial risks. [Reference principles: BCP 17, BCP 19, SRP 20, Principles for the management of credit risk]*

- With reference to paragraph 33 we suggest adding the following sentence:" Banks *should also identify, measure, evaluate, monitor, report and manage the concentrations within and between risk types associated with climate-related financial risks.* ***Supervisors have to take into consideration the geographical areas and economic sectors constraints of less significant intermediaries, especially the ones with a local customer base"***

Comprehensive management of market, liquidity, operational and other risks

Principle 9: *Banks should understand the impact of climate-related risk drivers on their market risk positions and ensure that market risk management systems and processes consider material climate-related financial risks. [Reference principles: BCP 22]*

Principle 10: *Banks should understand the impact of climate-related risk drivers on their liquidity risk profiles and ensure that liquidity risk management systems and processes consider material climate-related financial risks. [Reference principles: BCP 24, Principles for sound liquidity risk management and supervision*

Principle 11: *Banks should understand the impact of climate-related risk drivers on their operational risk and ensure that risk management systems and processes consider material climate-related risks. Banks should also understand the impact of climate-related risk drivers on other risks6 and put in place adequate measures to account for these risks where material. This includes climate-related risk drivers that might lead to increasing strategic, reputational, and regulatory compliance risk, as well as liability costs associated with climate-sensitive investments and businesses. [Reference principles: BCP 25, Principles for the sound management of operational risk, Principles for operational resilience, SRP 20, SRP 30]*

Scenario Analysis

Principle 12: *Where appropriate, banks should make use of scenario analysis, including stress testing, to assess the resilience of their business models and strategies to a range of plausible climate-related pathways and determine the impact of climate-related risk drivers on their overall risk profile. These analyses should consider physical and transition risks as drivers of credit, market, operational and liquidity risks over a range of relevant time horizons. [Reference principles: BCP 15, Stress testing principles]*

- When assessing whether or not a proportionate treatment should be applied, we consider it important that this assessment is not only guided by size, but that also factors such as business models and geographical location/presence are taken into consideration.
- Stress testing methodologies for ESG risks have so far mainly been applied in an exploratory manner for the climate-related risks only. We understand that some assumptions and simplifications are needed so that the exercises are doable given the limitation in the data and methodologies to date. At this stage climate stress tests should be conceived as learning exercises with no impact on capital, given the foundations are not in place.

III. Principles for the supervision of climate-related financial risks

Prudential regulatory and supervisory requirements for banks (p. 12 - 13)

Principle 13: *Supervisors should determine that banks' incorporation of material climate-related financial risks into their business strategies, corporate governance and internal control frameworks is sound and comprehensive. [Reference principles: BCP 9, BCP 14, BCP 26, SRP 20]*

Principle 14: *Supervisors should determine that banks can adequately identify, monitor and manage all material climate-related financial risks as part of their assessments of* *banks' risk appetite and risk management frameworks. [Reference principles: BCP 15, SRP 20, SRP 30]*

Principle 15: *Supervisors should determine that banks comprehensively identify and assess the impact of climate-related risk drivers on their risk profile and ensure that material climate-related financial risks are adequately considered in their management of credit, market, liquidity, operational, and other types of risk. Supervisors should determine that, where appropriate, banks apply climate scenario analysis. [Reference principles: BCP 17–25, Principles for sound liquidity risk management and supervision, Principles for the sound management of operational risk, Principles for operational resilience]*

Responsibilities, powers and functions of supervisors

Principle 16*: In conducting supervisory assessments of supervised banks' management of climate-related financial risks, supervisors should utilise an appropriate range of techniques and tools and adopt adequate follow-up measures in case of material misalignment with supervisory expectations. [Reference principles: BCP 8, BCP 9, SRP 10, SRP 20]*

- Paragraph 56 of the principle states that collaboration between home and host supervisors should be fostered by enhancing the information sharing framework. We do support the sentence and we consider that the Supervisory College also is the appropriate forum to be used for information sharing between supervisors.

Principle 17: *Supervisors should ensure that they have adequate resources and capacity to effectively assess supervised banks' management of climate-related financial risks. [Reference principles: BCP 9]*

- While we acknowledge and support the objective to develop the supervisory tools to effectively assess banks' climate risk management, we would also like to highlight that banks and supervisors are following a close and almost parallel learning curve on climate-related risks, building a set up with appropriate expertise and resources.
- The risk set ups within banks are still in a ramp up phase: a balance between inspections, which might be, at this stage, less relevant, and reporting on the roll out of these set-ups has to be set. Conducting stress tests or participating in consultation are time-demanding and banks need to dedicate sufficient resources to the building of their risk framework. This makes it necessary to strike the right balance to make the best use of banks' capacities. We consider it important to adopt a pragmatic approach in this intermediate stage to ensure a meaningful use of supervisors' and banks' resources.

***Principle 18:** Supervisors should consider using climate-related risk scenario analysis, including stress testing, to identify relevant risk factors, size portfolio exposures, identify data gaps and inform the adequacy of risk management approaches. Where appropriate, supervisors should consider disclosing the findings of these exercises. [Reference principles: Stress testing principles]*

- We agree that capital should be determined with risk sensitive metrics. However, for quantifying the climate-related risk, the scenario analyses are still in piloting phase and will become more sophisticated by repeated exercise over time. Stress testing methodologies for ESG risks have so far mainly been applied in an exploratory manner. We understand that some assumptions and simplifications are needed so that the exercises are doable given the limitation in the data and methodologies to date. But as a consequence of these limitations, the framework and its results might be unrealistic, and special care has to be taken when analysing the results.

- Therefore, until data, methodologies and results of regulatory stress testing practices are stabilised, these exercises should not imply any quantitative impact on the capital requirement of the entities. Qualitative impacts in the SREP should be reserved for very limited cases (for example, where it is unequivocal that a bank has not started to set up the governance and internal processes to integrate and account for climate-related financial risks). Climate-related stress testing should also be kept separate from "regular" stress testing.

- Moreover, we caution against any regulatory capital add-on on the most carbon intensive sectors (penalizing factors), without a prior sound risk analysis performed according to the usual Basel standards.

IV. Questions on the proposed principles

***Q1.** 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*

***Q2.** Do you have any comments on the individual principles and supporting commentary? **(Note:** Members may wish to refer to any comments under the respective Principles above)*

***Q3.** 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?*

- At this stage, capturing the impact of environmental risks other than climate risks on existing risk categories is challenging due to the lack of data, method and academic research. A first step could consist in a qualitative approach, based, for example, on exclusion policies or processes to identify the most sensitive transactions according to internal assessments or on standards that are progressively established by international bodies and/or the industry.

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