

Key messages for responses to the consultative document of the Basel Committee on Banking Supervision (BCBS) on the Principles for the effective management and supervision of climate-related financial risks (the Principles)

Context: The Principles seek to adapt the existing BCBS Core principles for effective banking supervision (*BCPs*) and the supervisory review process (*SRP*) to climate-related financial risks, i.e. they do not represent a complete review of all components of the *Basel framework*. A holistic review of the framework to address climate-related risks is underway (as per the consultative document) and should be used to implement more impactful regulatory measures beyond supervisory guidance.

Important step, but not a sufficient measure: The Principles set a direction towards harmonising supervisory approaches to climate-related financial risks across jurisdictions. This is a positive step and a recognition of the significance of these risks to the financial system. However, the gradual approach (building expertise, progressive development of risk management capabilities) will not be sufficient to achieve impactful and timely outcomes and prevent a climate-related financial crisis, triggered by intensifying climate-related physical events and the transition from a carbon-based economy.

Precautionary measures to be prioritised: Risks related to certain financing activities/exposures such as fossil fuels are clearly identifiable based on climate science (IPCC¹, IEA²). Moreover, supervisors around the world confirm clear benefits of acting early as short-term costs of transition will be much smaller than long-term costs of unabated climate change (ref. ECB³). Therefore, regulators and supervisors should adopt precautionary prudential measures without further delays.

Capital requirements as a feasible and impactful solution: In order to achieve impactful outcomes for banks' resilience towards climate-related financial risks, capital requirements for the exposures clearly identifiable as the most risky from the climate-related perspective - namely fossil fuel exposures - should be increased. The suggested increase is in line with the risk-based nature of prudential capital rules, as the increased capital requirements reflect the high risks associated with fossil fuel financing i.e. physical risks (systemic disruption due to climate-related events leading to financial instability) and transition risks (depreciation of fossil assets) risks. This will allow financial institutions to build capital buffers to cover the risks, as well as restore risk-based incentives of banks by incorporating the currently unaccounted for climate-related financial risks.

Very generic guidance: The Principles adapt the existing supervisory guidance in a rather generic manner. However, specifics of the climate-related risks can hardly be accommodated within the existing framework, in particular given insufficient advances in data and methodologies. The risks are characterized by radical uncertainty, where probabilities of future events are not reflected in the past data. Further, there are many other challenges in the management and supervision of climate-related risks, which go beyond the existence of supervisory guidance such as lack of expertise, understanding of transmission

-
- 1 IPCC, *Sixth Assessment Report*.
 - 2 International Energy Agency (IEA), *Net Zero by 2050, A Roadmap for the Global Energy Sector*, Flagship Report – May 2021; IEA, *World Energy Outlook 2021*, October 2021.
 - 3 S. Alogoskoufis, N. Dunz et al, *ECB economy-wide climate stress test: Methodology and results*, ECB Occasional Paper Series, No 281, September 2021.

channels data, credible measurement methods, etc. These have already been pointed out by numerous supervisors, who had previously put supervisory guidance in their respective jurisdictions. Refer to the reports by BCBS⁴, NGFS⁵, Bank of England⁶, ECB⁷.

No conclusions on capital adequacy: As per the Principles, supervisory review objectives (Principles #12-15, including supervisory stress tests) do not include an evaluation of financial institutions' capital adequacy to cover climate-related financial risks, which is otherwise the case for the supervisory review process under the Basel framework. Thus, the Principles effectively miss on impactful supervisory measures in cases where climate-related risks will be identified as material. In essence, the supervisory review is directed towards exploration of risks rather than ensuring financial institutions' resilience against climate-related risks.

No incentives for behavioural changes: Absent capital adequacy implications of supervisory review, the Principles offer little incentives for financial institutions to change their behaviour towards climate-related financial risks. The suggested risk mitigation measures are short-term: They do not consider long-term risks from financial institutions continuing to finance climate-change accelerating activities such as those related to fossil fuels.

-
- 4 BIS, *Climate-related financial risks – measurement methodologies; Climate-related risk drivers and their transmission channels*, April 2021.
 - 5 NGFS, *Progress Report on the Guide for Supervisors*, October 2021.
 - 6 Bank of England / Prudential Regulation Authority, *Climate Change Adaptation Report 2021*: Report on climate-related financial risk management and the role of capital requirements, 28 October 2021.
 - 7 ECB, *The state of climate and environmental risk management in the banking sector*, Report on the supervisory review of banks' approaches to manage climate and environmental risks, November 2021.