Finance Watch response to the FSB Recommendations for Supervisory and Regulatory Approaches to Climate-related Risks

Brussels, 30 June 2022

General comments

The interim report provides a very comprehensive summary of the current regulatory and supervisory approaches, which highlights the options to capture climate-related risks. A particularly valuable component of the report is the systemic risk perspective, which points out the risk transfers between different types of financial institutions (in particular, banks and insurers), spillovers and feedback loops between the financial system and the real economy.

The recommendations of the report are meaningful, but also highlight the challenges already included in other reports (by NGFS, ECB, BoE) such as availability of data and the nascent stage of climate risk measurement methodologies and stress tests or scenario analysis.

The recommendations do not take into account the time dimension of the climate risk problem. By the time the supervisors and regulators will have more data and more advanced methods of measurement, climate-related risks will have increased. Our economy and financial system might face major climate-related disruptions due to non-linearities and potential tipping points, which are unique features of climate-related risks compared to the other risk types that regulators and supervisors are used to dealing with. It is therefore questionable whether the proposed recommendations will really allow to "avoid unintended consequences and a less effective transition", as stated in the interim report.

The shortcomings in the recommendations highlight the need to take a precautionary approach. This should mean holistically and explicitly integrating climate-related risks into existing prudential regulatory frameworks. Impactful actions and coordinated approach between international bodies, national regulators and supervisors are necessary to address the systemic dimension of climate-related risks, since systemic risk can be only reduced by simultaneous combined action of all actors.

Supervisory and regulatory reporting and collection of climate-related data from financial institutions

1. Does the report highlight the most important climate-related data (qualitative and quantitative) for supervisors' and regulators' identification of exposures and understanding of the impacts of climate-related risks of financial institutions and across financial sectors? Please provide examples of climate-related data deemed most relevant and that should be prioritised.

Many of the challenges related to identifying and collecting needed data are identified in the interim report. However, the biggest challenges faced with climate-related data is their forward-looking nature and the timeframe needed to collect, process and use them. As climate change is a multifaceted issue with many multiplier indicators, we are still far from being able to accurately model it. Given the carbon budget of the planet is currently around 8 years, there is very limited time to address these issues and then act[1]. This may mean that in some cases a focus on use of proxies based on qualitative data will be needed to justify taking action to address climate-related financial risks. A concrete example here would be the exposures to new projects to expand fossil fuel extraction, where the International Energy Agency has already provided analysis to show that these projects should not happen and therefore there is a high risk of losses. Another example would be the potential use of research and analysis of assets that are at risk of being stranded[2].

Given the current limitations of climate-related data and the timeline for possible action, the key priority for the use of climate-related data could be set as focusing on the forward-looking data, such as quantifying risk of stranded assets and data arising from disclosures that are needed for transition planning. Regulators and supervisors should focus on developing forward-looking metrics and common standards for such metrics, which should be agreed upon and used across the board. Such standards are of particular importance to ensure the risks are properly reflected and managed, avoid misrepresentation of mitigating actions and heterogeneity of climate-related claims.[3] Please see the response to question 7 for further information.

2. Does the report draw attention to the appropriate areas to increase the reliability of climate-related data reported by financial institutions?

The interim report highlights some important initiatives to work on principles for supervisors at international level, to help increase the reliability of climate-related data. These principles open the discussion on the topic of taking collective action and aiming for conformity. To be successful a more significant step needs to be taken in this area. As mentioned in our response to question 2, internationally agreed, robust data standards are needed to ensure that climate-related data allow

[1] Carbon Tracker, Unburnable Carbon: Ten Years On, 23 June 2022; https://carbontracker.org/reports/unburnable-carbon-ten-years-on/

[2] See for example, G. Semieniuk et al., Stranded fossil-fuel assets translate to major losses for investors in advanced economies, Nature climate change, 26 May 2022. Multiple studies on stranded assets are referred to in the IPCC Sixth Assessment Report; https://www.nature.com/articles/s41558-022-01356-y

[3] T. Philipponnat, The problem lies in the net: How finance can contribute to making the world reach its greenhouse gas net-zero target, Finance Watch, 30 June 2022; https://www.finance-watch.org/publication/report-the-problem-lies-in-the-net-making-finance-contribute-to-a-net-zero-economy

supervisors to measure the real-world impact of the financial institutions' activities and mitigating actions. This is the only way to address the systemic risk dimension of climate change.

This requires supervisory oversight and by extension an explicit mandate for supervisors in this area, by updating existing regulation to explicitly cover climate-related financial risks.

3. Does the report appropriately identify the elements of a common high-level definition of climate-related risks (physical, transition and liability risks)?

The interim report gives a good overview of physical, transition and liability risks. However, it overlooks disruption risk[4]. This is the risk of large-scale, non-linear materialisation of physical or transition risks due to accelerating climate change. This risk goes beyond the definition of acute physical risk, which captures individual severe weather events and. This could take many forms, but would result in economic disruption that would in turn risk creating a significant financial stability risk.
Adding in this risk of economic disruption arising from accelerating climate change recognises the perils of continuing with a business as usual approach, as well as the brinkmanship of governments around the world that are yet to take decisive action to make good on their climate commitments.

4. Do the proposed recommendations help accelerate the identification of authorities' climate-related information needs from financial institutions and work towards common regulatory reporting frameworks? Please elaborate on areas where the recommendations could be enhanced, if any.

Ensuring common reporting frameworks to better identify exposure and impacts of climate-related financial risks is an important starting point. Common regulatory frameworks should, however, go further and aim at a more comprehensive approach. Many financial institutions operate internationally and the impacts of climate change materialise across the globe. This makes globally-aligned standards that take a double-materiality approach essential.

Taking a **double-materiality approach** ensures that both a micro- and macroprudential view on the climate-change related risks are taken into account. Firstly at a micro level it looks at transition, physical and liability exposures of an individual entity. Then at macro level it looks at the impact on the financial system of accelerating climate change, for example where a financial institution enables an economic activity that has a negative impact on the climate. These negative impacts, in turn, translate into the systemic risk of climate change for the whole economy and financial system, which affects even financial institutions that are not contributing to the negative impact themselves.

The International Sustainability Standards Board (ISSB) could become the responsible institution to coordinate the setting of these globally-aligned standards. However, at this stage more

[4] T. Philipponnat, Breaking the climate-finance doom loop, Finance Watch, June 2020; https://www.finance-watch.org/publication/breaking-the-climate-finance-doom-loop/

ambition is required to incorporate the double materiality logic into the ISSB work leveraging on the experience of more advanced frameworks such as the work done by the European supervisory and standard-setting bodies. Supervisors and international organisations of supervisors would need to support the work with direct input and implementation.

The standards should take the approach of establishing commonly agreed forward-looking quantitative indicators. This could include the use of proxies and should focus on using available and attainable information. The standards should not rely on the staggered approach of first using qualitative indicators and gradually supplementing them with quantitative data where it becomes available. This would risk delaying action, establishing grey areas and would allow greenwashing and riskwashing, whilst creating a wild goose chase for indicators and data that may never be sufficiently robust.

Incorporating systemic risks into supervisory and regulatory approaches

5. Does the report identify relevant system-wide aspects that should be considered as part of supervisory and regulatory approaches to incorporate systemic risks arising from climate change? Please elaborate on other aspects that should be considered, if any.

The interim report rightly identifies the need to address systemic risks arising from climate change. The analysis covers important points on feedback loops and spillovers and risk transfers. It does not explicitly cover the risk of economic disruption (outlined in the response to question 3), although it falls partly into the identified potential feedback loops from tipping points and non-linearities of climate-related risks.

One key point that is missing from the analysis is the potential that financial institutions have to mitigate or enable systemic risks. This means looking at the role of financial institutions in the transition to a more sustainable economy. If financial institutions continue to provide services to enable economic activities that accelerate climate change, they are also increasing their exposure to both micro and macro level climate-related financial risks (transition, physical and disruptions risks). If financial institutions rather take an active stewardship and engagement role then they can reduce these risks, by introducing conditions for continuity of service-provision and financing. This would ensure that companies that need to transition their economic activity can still access services and financing, as long as they do actually take action and transition.

Financial institutions can also, however, play a hampering role for the transition. They may choose not to act if they do not believe that the transition provides sufficient opportunities, or do not assess the risks related to continuing on the current climate change pathways as being an issue in the short- to medium-term perspective on which the current prudential regulations are based[5]. This hampering role should be considered in the context of prudential regulation, where climate-related financial risks can and should be holistically integrated into existing frameworks to ensure that financial institutions take a risk-mitigating and managing approach.

[5] S. Battiston, I. Monasterolo, R. Irene,, K. Van Ruijven, J. Bas, Accounting for finance is key for climate mitigation pathways, Science, https://www.science.org/doi/10.1126/science.abf3877

6. Does the report accurately reflect the extent to which current supervisory and regulatory tools and policies address climate-related risks?

The interim report gives a good overview of existing supervisory and regulatory work in the area of climate-related risks. It rightly identifies the need to take a systemic perspective and to take a global approach.

Two areas that need further recognition and attention are the **limits of stress-testing and scenario analysis** as tools and related to this the limited time available to take action. Stress tests have in any case effectively been scenario analysis exercises so far. The results of these exercises do offer valuable insights into the climate-risks of financial institutions and potential channels and effects of their materialisation. These insights in turn help shape supervisors' actions and also raise awareness among financial institutions to enhance their risk management practices and adapt business models. However, reliability of scenario analyses and stress tests as tools to identify and assess climate-related financial risks crucially hinges on the complexity and limitations of the models employed[6]. Further limitations are discussed in Finance Watch's report "A silver bullet against green swans".[7]

A fundamental point that needs to be further explored is the transmission channels between climate events and financial implications for the balance sheets/capital of affected institutions. As the BCBS report from April 2021 highlighted, "Existing analysis does not generally translate changes in climate-related variables into changes in banks' credit, market, liquidity or operational risk exposures or bank balance sheet losses. Instead, the focus is on how specific climate risk drivers can impact narrowly defined sectors of particular economies, individual markets, or top-down assessments of the macro economy as a whole".[8] The report concludes that significant further research and empirical evidence are required. The EBA pilot exercise on identifying and mapping climate risks in the banks' portfolios reached similar conclusions.[9]

A key issue the interim report rightly identifies is that existing scenarios do not yet take into account feedback loops, i.e. the impact which the financial sector itself has on transition and climate developments. There can be scenarios where the financial system plays a hampering role in transition so that the resulting impacts of scenarios (risks) might be underestimated (see our response to question 5).

The ECB has made progress to overcome some of those challenges in its EU-wide stress test exercise; however, the ECB also outlined that a significant amount of work is yet to be undertaken towards "a comprehensive climate stress-testing framework".[10] The limitations of climate

[6] D. Spratt, Model-based net-zero scenarios, including those of the IPCC, aren't worth the paper they are written on, say leading economists, resilience, https://www.resilience.org/stories/2022-06-10/model-based-net-zero-scenarios-including-those-of-the-ipcc-arent-worth-the-paper-they-are-written-on-say-leading-economists/ https://blocnotesdeleco.banque-france.fr/en/blog-entry/challenges-climate-modelling-central-banks

[7] J.Symon, A silver bullet against green swans: Incorporating climate-related financial risk into bank and insurance prudential rules, November 2021.

[8] BCBS, Climate-related risk drivers and their transmission channels, April 2021, p. 2.

[9] EBA, Mapping climate risk: Main findings from the EU-wide pilot exercise, 21 May 2021.

[10] S. Alogoskoufis, N. Dunz et al, ECB economy-wide climate stress test: Methodology and results, ECB Occasional Paper Series, No 281, September 2021, p. 64-67. Some of the most notable of advancements have been the following: i) analysis

scenario exercises were confirmed by the Network for Greening the Financial System (NGFS) based on the experience of 30 central banks and supervisors across the world.[11]

The report rightfully describes that supervisory risk management expectations for financial institutions have been the most common and widely used measures. However, apart from the fact that "incorporation of climate-risk management practices across financial institutions is at an early stage", supervisory expectations have been largely generic and high-level. Given the challenges with data and methodologies on climate-related financial risks, principle-based approaches are unlikely to result in robust and consistent risk management practices. We refer to the Finance Watch comments provided in response to the BCBS consultation on the Principles for the effective management and supervision of climate-related financial risks[12].

7. Do the proposed recommendations on incorporating systemic risks into supervisory and regulatory approaches, including the expanded use of climate scenario analysis and stress testing for macroprudential purposes, address the appropriate areas? Please elaborate if there are any other features or tools that should be considered.

The proposed recommendations cover a number of important measures and in particular introduce the essential approach of incorporating systemic risk related to climate change into regulatory frameworks. To successfully achieve this climate-related financial risks should be holistically integrated into existing prudential regulatory frameworks. This means looking beyond increased supervisory cooperation and principle-based approaches, to amending pillar 1, 2 and 3 regulatory requirements for financial institutions .

The first important additional change is to re-align capital requirements (pillar 1) for financial institutions' exposures to economic activity that creates significant climate-related financial risks. The starting point here is the fossil fuel industry, where a substantial body of evidence exists to establish its negative impact on climate change and significant risks the industry faces on the road to implementing international climate commitments. This industry represents high transition risk exposures and increases physical and disruption risk. This is not reflected in capital requirements as things stand and needs adjusting. In order to expand capital requirements where needed to other sources of high exposures to climate-related risks, already available research on stranded assets should be assessed and complemented by reinforced efforts to identify these exposures[13].

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of banks´ credit and market portfolios at exposure level, thus accounting for firm-specific vulnerabilities to climate risk factors; ii) capturing key transmission channels of climate risks by means of employing models specifically developed for the exercise; iii) analysis of the interactions between physical and transmission risks. Yet, with reference to the identified limitations, the following avenues of future work have been outlined in the ECB report: i) modeling of the banks' endogenous reactions and their feedback loop to real economy; ii) consideration of additional physical risk hazards; iii) inclusion of additional sets of bank portfolios such as retail portfolio, which could not be considered due to lack of sufficient data or of sufficient granularity; iv) modeling contagion dynamics in the financing sector that could amplify the impact of climate risks.

[11] NGFS, Scenarios in Action: A progress report on global supervisory and central bank climate scenario exercises, Technical document, October 2021.

[12] Finance Watch, Consultation response to the BCBS Principles for the effective management and supervision of climate-related financial risks, February 2022;
https://www.finance-watch.org/publication/bcbs-consultation-climate-risks/

[13] For example, methodologies like Climate Policy Relevant Sectors (CPRS) can be used. Refer to Battiston, S., Mandel, A., Monasterolo, I., Schuetze, F. and Visentin, G., 2017, 'A climate stress-test of the EU financial system', Nature Climate Change, vol. 7, pp. 283-288.

A second change is needed to holistically integrate climate-related financial risks into supervisory review processes and the governance processes of financial institutions (pillar 2) using approaches which go beyond high level principles. One of the elements to be considered here is to integrate new requirements for institutions to create transition plans that are already being introduced in a disclosure (pillar 3) context into risk management processes. These plans should be subject to robust standards with respect to the definitions and contents and should include measurable climate-related targets. Supervisors and management would then both be given oversight and responsibility to check transition plans to ensure that climate-related financial risks are being mitigated.

With regards to the macroprudential tools, we refer to our response to the European Commission consultation on the review of the macroprudential framework for banks[14].

Early considerations on other macroprudential tools and policies

8. Are there other areas of work, literature or research being conducted on macroprudential tools and policies on climate-related risks that should be considered in the report?

When looking into the trade-offs for introducing buffers, the interim report does not consider the implications of inaction and continuing with the current status quo. This is an important consideration, as it likely means that pockets of systemic risk could be expanding whilst no action to address them is taken. This creates a potentially high future cost if it puts financial stability at risk.

Further, we deem the trade-off between introducing buffers for systemic risk and the amount of resources available for lending to the economy to be a misplaced consideration. Capital buffers have a fundamental role to guarantee stability of the financial system and protect against systemic risks. In case financial stability cannot be ensured, lending will also be disrupted with the impacts on economic activity and employment being far more severe than the cost to financial institutions of raising capital. Higher capital requirements are not an obstacle to lending activity, as financial institutions can always raise additional capital provided that their business model is solid and there are viable projects and companies to extend financing to.

An additional point is that in the trade-off considerations the additional costs that concentration limits may introduce would only be applicable and relevant where no transition or transition intention is indicated by the borrowing entities. This lack of intention or action from an industry or economic activity that receives financing or services from a financial institution could be considered as an indication of risky, short-termist behaviour. This could also be reflected in the assessment of trade-off considerations.

[14] Finance Watch, Consultation response "Improving the EU Macroprudential Framework for the Banking Sector", Question 16.3;
https://www.finance-watch.org/wp-content/uploads/2022/03/FW_Macroprudential-Framework-Response_final.pdf

Additional considerations

9. Are there any other issues that should be considered in future work of the FSB on supervisory and regulatory approaches to climate-related risks?

It is important to take a precautionary approach and systemic view when addressing climate-related risks. There is not sufficient time available to continue exploring and building a fuller picture of these risks before taking action.

This action should be the holistic integration of climate-related risks into existing prudential frameworks. Please refer to our responses to previous questions, including question 7 in particular.