Finance Watch Response to the BCBS public consultation on revisions to the Core principles for effective banking supervision

Brussels, 5 October 2023

Finance Watch welcomes the revision of the Core principles for effective banking supervision ("Core Principles"). Given that the Core Principles constitute a global standard for the sound prudential regulation and supervision of the banks and serve as baseline for the national rule of BCBS members and beyond, it is essential that these Principles keep pace with the developments of the financial system and supervisory practices, in particular adequately reflect new and emerging risks, as well the growing complexity of the financial system as such. Moreover, incorporating climate-related financial risks into the Core Principles is an important step in bringing these risk considerations into the bank prudential framework holistically - following the publication of the stand-alone BCBS Principles for the effective management and supervision of climate-related financial risks in 2022.

In particular, we would like to focus our response on climate-related financial risks in relation to bank risk management practices, supervision and macroprudential aspects.

General comments

When considering the revised Core Principles, we emphasise the need to evolve risk management and supervisory practices in response to the specific and in the meantime widely-recognised features of climate-related financial risks such as: i) their forward-looking nature where historical data is not useful in deciding on prudential actions due to the unprecedented developments of physical climate risk, on the one hand, and no precedents of transition in the past, on the other hand; ii) path-dependency of climate developments and endogeneity of financial sector actions, i.e. its actions today determine the level of risk in the system in the future iii) unpredictable and partially longer-time horizons of climate risk materialisation; iv) inherent uncertainty in climate science and the pace of climate change, non-linearity and irreversibility of climate developments, presence of tipping points; v) a high degree

of complexity of economic impacts of climate change, which are not limited to direct physical damage and transition effects, but also include broader socio-economic impacts such as loss of economic activity/GDP in multiple sectors, mass migrations, loss of labour productivity etc. And finally and probably most importantly, the most disruptive climate-related events represent radical uncertainty rather than risk, which requires a completely different approach when dealing with it compared to other risk types financial institutions are dealing with.

All this means that precautionary principle should guide supervisory and risk management actions on climate risk. Supervisors should crucially expand their time horizon of consideration and focus on the system-wide macroprudential view on the risk. For this, the double materiality perspective is crucial from the supervisory perspective, as given the existing design of the prudential framework, individual financial institutions are not in the position to account for the externalities/impacts of their individual actions on the level of systemic risk.

Comments on specific core principles

CP8 Supervisory approach and CP9 Supervisory Techniques and Tools

We welcome the explicit incorporation of climate-related risk considerations, adoption of the forward-looking view and appropriate time horizons into the supervisory approach. We also agree that these considerations are crucial when analysing sustainability of the banks´ business models.

However, practical implementation of this guidance is faced with an inherent challenge when assessing the adequacy of banks' practices, as climate-related financial risks are highly uncertain: On the part of the physical risks, there is a degree of uncertainty with respect to the pace of climate change, its timing and effects, in particular with regards to the tipping points[1]. On the part of the transition risk, despite the international Paris Agreement commitments, government policies put in place so far are not sufficient to secure a clear pathway to net zero emissions in 2050[2], so that transition risk does not yet fully manifest itself. Further, the current design of the banks' risk management framework and the supervisory toolbox has a limited possibility to account for the potentially longer time-horizons and other specifics of climate-related financial risks. In particular, risk measurement and modelling practices are mostly backward-looking. Assessing climate-related risks also puts a strain on supervisory resources, as it requires building supervisory expertise, including on climate issues beyond the realm of finance[3].

[1] Institute and Faculty of Actuaries, The Emperor's New Climate Scenarios, University of Exeter, July 2023;
[2] International Energy Agency, An updated roadmap to Net Zero Emissions by 2050
[3] Experts increasingly point out a discrepancy between climate science, which is preoccupied with climate models, and financial industry and decision-makers using those models, which are not always in the position to understand model limitations.

Role of transition plans in supervision. We therefore consider that for an effective implementation of the CP8 revisions, a further specification of the supervisory guidance is warranted (possibly under CP9 Supervisory techniques and tools, 40.21 (3)). In particular, with respect to the long-term view on climate-related financial risks, banks' transition plans should be mentioned as a source of information[4]. The role of transition plans for the micro-prudential supervision has been recognised by the NGFS in the stocktake exercise, which concluded that "transition plans could be a useful source of information for microprudential authorities to develop a forward-looking view of whether they risks resulting from an institution's transition strategy are commensurate with its risk management framework".[5] Further, in order to provide for a common reference point when reviewing such plans, a time horizon for transition plans should be defined - net-zero alignment by 2050 as a final target, which is in line with the international agreements. Supervisors should then regularly review such plans to determine:

- if the supervised institutions have designed a strategy, intermediate targets and a set of actions to mitigate transition risks over time
- if they are achieving their intermediate targets and, if not, if escalation processes are in place and/or if they have adequate capital provisioned for the risks which remain unmitigated.

Macroprudential dimension. With respect to the revised CP8, 40.19 (5), we welcome the macroprudential considerations in the supervision, which are fundamental to address climate-related financial risks, as individual institutions are not necessarily immediately impacted by their own business/risk management decisions, but their actions contribute to the systemic risk over time (externality). In order to better understand and monitor systemic climate-related risks, supervisors should also use banks' transition plans to gain a consolidated view across the system. Based on this, macroprudential supervisors can decide on the appropriate macroprudential tools to prevent a build-up of risks over time.

It is important to emphasise the **principle of double materiality** in banks' transition planning. Whilst the relevance of financial materiality is the most straightforward to comprehend from the microprudential perspective, impact materiality is indispensable to assess transition risk in banks portfolios (as a proxy), as well as for supervisors to obtain a system-wide view / monitor systemic risk[6].

[4] Finance Watch, Europe must harmonise its patchwork of transition plan requirements, 3 April 2023
[5] NGFS, Stocktake on Financial Institutions´ Transition Plans and their Relevance to Micro-prudential Authorities, Technical document, May 2023.
[6] J. Boissinot et al, Aligning financial and monetary policies with the concept of double materiality: rationales, proposals and challenges, SOAS Centre of Sustainable Finance, LSE Grantham Research Institute on Climate Change and the Environment, 9 June 2022.

CP10 Supervisory reporting

We welcome the explicit incorporation of climate risk into the supervisory reporting principles. We further consider it essential to specify that "information that allows for the assessment of the materiality of climate-related financial risks and emerging risk" (40.24(1)) should include banks´ transition plans as an important source of information on transition risk at the individual institution´s level, as well as systemic risk on the aggregate banking system level. We further refer to our comments above on CP8 and CP9. We understand that it is beyond the remit and expertise of prudential supervisors to perform an assessment of all elements of transition plans, in particular with respect to the credibility of climate objective setting. We therefore, point out a need for independent validation (assurance/audit) of such transition plans, whereas prudential supervisors should focus on the risk dimension and assessment of the progress made with respect to achievement of the stated objectives, i.e. risk mitigation.

CP15 Risk management process

We support the suggested holistic reflection of the climate-related financial risks throughout the banks' risk management - in business strategies, governance, internal controls, risk assessment and monitoring, capital and liquidity adequacy assessment. However, as stated above in our comments on CP8 and 9, dealing with climate-related financial risks using the existing tools and arrangements (risk identification, measurement, modelling) is faced with challenges due to uncertainties around the materialisation of these risks. This might jeopardise the coherence and consistency of approaches of different banks and supervisors, alongside their ability to mitigate the climate-related financial risks. Consideration of longer time horizons is currently at odds with the existing prudential framework, which is mostly rather short-term oriented. For example, credit risk ratings, which play a key role in the credit decision processes and determination of capital levels, are mostly based on a one-year time horizon. Internal capital and liquidity adequacy assessment and financial planning horizons usually span to no more than three years with a qualitative view on a longer-term perspective.

We therefore see a need for an additional specification of the approaches to be used in order to provide more concrete guidance and clarity to the institutions and supervisors. As already mentioned above, transition plans should be recognised in CP15 as a tool to manage climate-related risks over time. The time horizon of consideration for such transition plans should be anchored around 2050, which is an internationally agreed timeline to mitigate climate risk overall that is based on conclusive scientific evidence.

For additional comments on the risk management part, we refer to our response to BCBS consultation on the Principles for the effective management and supervision of climate-related financial risks[7].

With respect to the incorporation of climate-related financial risks into stress testing, we emphasise the need for a clarification of the difference between climate stress tests and scenario analyses, similar to what was done in the final version of the BCBS Principles for the effective management and supervision of climate-related financial risks. There is a fundamental difference between scenario analysis and stress testing: Stress testing as a prudential tool should necessarily reach conclusions about financial institutions' capital adequacy in stressed circumstances. Scenario analysis, on the contrary, is an exploratory exercise and cannot be alone relied upon to deliver the financial stability mandate of prudential regulation. Given the limitations of the current approaches to simulate the effects of climate change on the financial system[8], the term "stress tests" should not even be used, as it has led to a false sense of security and overreliance on the so far benign results of these exercises by regulators/policymakers. Therefore, additional provisions should be included in CP15 as well as correspondingly in CP9 to require explicit disclosure of the limitations and assumptions of climate scenario analyses when communicating their results.

We also draw attention to the work by experts, in particular, actuaries pointing out to the serious flaws of the current economic models, which are used in climate scenario analyses[9]. We urge the Committee to consider expanding the "stress test-related" risk management and supervisory toolkit for climate-related financial risks to include the following: reverse stress tests and qualitative narrative-based scenarios to reflect the emerging reality of climate change to complement the backward-looking models; additional adjustments based on precautionary principle to reflect uncertainty. Such qualitative scenarios and adjustments should aim to provide a more realistic simulation of bad-to-worst-case scenarios because low-probability, high-impact extreme outcomes will have disruptive damages which cannot be quantified using traditional models. The radical uncertainty of climate developments and associated economic events should be exactly the reason to prioritise such realistic scenarios rather than ignore them[10].

CP 16 Capital adequacy

In order to tackle climate-related financial risks, we particularly welcome the newly added provision 40.38(3): "Laws or regulations permit the supervisor or relevant

[7] Finance Watch, BCBS Consultation response on the principles to effectively manage and supervise climate-related financial risk, 16 February 2022.
[8] For the concise discussion on the limitations of climate stress tests, see J. Symon, Climate risk: strong Pillar II prudential measures are needed but not enough, Finance Watch, 29 March 2022.
[9] See, for example, Institute and Faculty of Actuaries, The Emperor's New Climate Scenarios, University of Exeter, July 2023; A. Simic, NGFS climate scenarios underestimate the impact of climate change, Sustainable Finance Lab, 20 March 2023.
[10] D.Spratt, Betting against worst-case climate scenarios is risky business, The Bulletin, September 4, 2023.

authorities to require banks to maintain additional capital (which may include sectoral capital requirements) in a form that can be released when system-wide risk crystallises or dissipates."

We encourage the BCBS to include additional clarification to this principle to state that it should be specifically used to address-climate related financial risks. Supervisors should be empowered to use a forward-looking precautionary approach and require additional capital to be provisioned for exposures, which are subject to high transition risk and are a source of systemic physical risk, primarily exposures related to the fossil fuel sector. In the absence of Pillar 1 provisions to account for climate-related risks and until the work on Pillar 1 is complete, supervisors should apply their discretion to overcome the limitations of the existing prudential framework in order to ensure banks are sufficiently capitalised to bear future climate-related losses. In addition, supervisors should use their discretion to apply macroprudential buffers to address the systemic risk of climate change. It is in line with the existing purpose of macroprudential tools to prevent the build-up of risks in the system and ensure an orderly transition[11]. The timeliness of application of macroprudential tools is crucial given that both - unabated climate change and delayed and disorderly transition - represent a major risk to the stability of the financial system, as recognised by the supervisors.

Remarks on the further BCBS work in addressing climate-related risks

In addition to the comments on the Core Principles, and as previously highlighted in our response to the BCBS Consultation on the principles to effectively manage and supervise climate-related financial risks[12], we would like to emphasise that a principles-based guidance for supervisors and financial institutions will not be sufficient to achieve timely and impactful outcomes in managing climate-related financial risks in the banking sector. In addition to the Principles, the BCBS should adopt further measures based on a precautionary approach in tackling these risks, in particular Pillar 1 capital measures. The scope of application of Pillar 1 capital requirements for climate-related financial risk can be gradually calibrated: As a matter of priority, capital requirements should be adjusted for exposures for which a heightened risk can be clearly identified based on the conclusive scientific evidence such as is the case for exposures to the fossil fuel sector. Pillar 1 measures should be adopted as part of the holistic review of the Basel framework that the BCBS is undertaking, as per the latest update of the FSB Roadmap of climate and environmental risks.

[11] ECB, ECB response to the European Commission's call for advice on the review of the EU macroprudential framework, March 2022.
P.Monnin, P. Hiebert, Climate-related systemic risks and macroprudential policy, INSPIRE, Policy briefing paper 14, August 2023.
[12] Finance Watch, BCBS Consultation response on the principles to effectively manage and supervise climate-related financial risks, February 2022.