Finance Watch Response to the BCBS consultative document
Disclosure of climate-related financial risks

Brussels, 14 March 2024

Finance Watch welcomes the BCBS work towards comparable and consistent climate-related disclosures that would provide a common baseline for internationally active banks. Data availability is an indispensable foundation for the management of risks and prudential supervision. The establishment of a global disclosure framework is of great importance to improve the availability and quality of risk data, yet, in itself not sufficient to ensure the risks are actually addressed. Therefore, Finance Watch encourages the BCBS to advance its work on the holistic review of the Basel framework, importantly capital requirements, as part of its mandate to strengthen the regulation and supervision worldwide. Given the delays in the release of the Committee's gap analyses of the Basel Framework compared to the original timeline per the FSB Roadmap, we would welcome more transparency on the process, including engagement with various stakeholders.

General

Questions 1 - 3

What would be the benefits of a Pillar 3 disclosure framework for climate-related financial risks in terms of promoting comparability of banks' risk profiles within and across jurisdictions and promoting market discipline? What other benefits have been identified?

Q2. What are the risks of a Pillar 3 disclosure framework for climate-related financial risks not being introduced?

Q3. Would the Pillar 3 framework for climate-related financial risks help market participants understand the climate-related financial risk exposures of banks and how banks are managing these risks?

As mentioned in the introductory section above, we see the disclosure framework for climate-related financial risks as an indispensable foundation for the management of risks and prudential supervision. However, disclosures alone will not be sufficient to ensure the risks are adequately taken into account, managed and mitigated, in particular given the specific features of climate-related risks outlined in the consultation document itself. Addressing climate-related risks will require consistent prudential measures throughout the remaining pillars of the prudential framework.

For the Pillar 3 framework to help market participants and supervisors understand the banks' exposure to climate-related financial risk and how they are managing this risk, **the disclosure framework needs to be well-defined,** i.e. i) provide clear common definitions for the metrics and other data points to be disclosed, ii) give sufficient guidance on and transparency over the underlying methodologies and approaches for the disclosed metrics, iii) set clear requirements on the time horizons to be considered (as the formulation "short, medium- and long term" leaves much room for interpretation). Importantly, the disclosures should cover longer time horizons (up until 2050) to meaningfully reflect transition-related risks and avoid their underestimation in the short term.

Only if the above conditions are fulfilled, will the reported data be consistent and comparable allowing market participants and supervisors to meaningfully assess the banks' risk profiles and banks themselves to design adequate risk management and risk mitigation measures.

Another important element missing in the proposed disclosure framework is the disclosure of **how banks' capital adequacy assessment and capital planning incorporate the consideration of climate-related financial risk.** This information is indispensable to provide transparency and confidence about the overall adequacy of banks' regulatory capital and, thus, its resilience. This is one of the major objectives of the prudential Pillar 3, as stated in the consultation document itself.

Question 4

Would the Pillar 3 framework for climate-related financial risks be sufficiently interoperable with the requirements of other standard-setting bodies? If not, how could this best be achieved?

Interoperability with the existing disclosure frameworks should be notably achieved for the disclosure of transition plans. The Committee's guidance could benefit from the already advanced transition plan disclosure requirements in the EU and UK, as well as align with the ongoing work of NGFS on transition planning as a prudential tool.

Question 6

What are your views on potentially extending a Pillar 3 framework for climate-related financial risks to the trading book?

Extending the Pillar 3 framework to the trading book is indispensable to ensure completeness of information on the banks' exposure to the climate-related risks. As possible abrupt repricing of assets subject to elevated transition and physical risks are widely seen as one of the possible drivers of risk, information on the trading book exposures is essential to be able to assess these repricing risks.

Question 7

What are your views on the proposed methodology of allocating exposures to sectors and geographical locations subject to climate-related financial risks?

Question 28

What are your views on the appropriateness of classifying sectors according to the Global Industry Classification Standard (GICS) with a six- or eight-digit industry-level code?

Regarding the allocation of exposures to sectors, it is most important to **define a consistent level of classification to be used by all jurisdictions, i.e. not leaving this as an option** ("a six or eight-digit industry level", as per the consultation text). We strongly support **disclosures at a more granular level, i.e. eight-digit industry level per the GICS**, in order to enable adequate differentiation in the risk assessment. The existing assessments are also largely based on the eight-digit classifications, such as e.g. climate impact mapping by S&P[1]. Moreover, the eight-digit industry level provides important information that will directly influence the risk level when investing in certain industries. In particular, the classification 'Oil, Gas & Consumable Fuels' requires an eight-digit granularity in order to distinguish the production/exploration activity from the storage/transportation activity.

Question 8

What are your views on which elements should be made subject to national discretion and which should be mandatory? Why?

Whilst we recognise that there might be jurisdictional specifics in the major determinants/drivers of climate-related financial risks, a sound disclosure framework should account for the specifics of such drives without compromising the completeness and consistency of information disclosed.

Thus, we do not support leaving the facilitated emission metrics to jurisdictional discretion. Recognising the challenges related to the establishment of adequate calculation methods for such emissions and other complexities related to attribution and disclosure of facilitated emissions, the Committee should instead work on providing better guidance for such disclosures to help national supervisors and market participants - instead of simply allowing for national opt-outs, which are likely to be widely used given the mentioned challenges.

We also do not support the national discretion for the metric "emission intensity per physical output", which will be a very useful complement to the absolute emission disclosures, allowing the assessment of actual improvements in GHG emissions by the producing companies within same industry/peer groups (absolute emissions might change in jumps in case of spin-offs or divestments). The Committee's argument that this metric "may pose challenges where banks have difficulty in obtaining such data from counterparties" does not seem to hold, given that absolute emission metrics are proposed as mandatory and reporting of physical output data should not represent any novel requirements for the companies. Yet, we recognise the importance of a

[1]https://www.spglobal.com/spdji/en/documents/additional-material/sp-global-gics-sub-industry-climate-impact.pdf

consistent definition of 'physical output' for the different sectors as this metric could lead to various interpretations that would hamper the comparability.

Qualitative requirements

Question 12

*Should the proposed qualitative Pillar 3 climate-related financial risk disclosure requirements be on a mandatory basis to facilitate comparability across ba*nks?

We support the mandatory qualitative disclosure requirements to facilitate comparability and provide sound basis for the other pillars of the prudential framework. Yet, this can only be achieved provided the requirements are sufficiently defined, i.e. that underlying definitions and methodologies are comparable. Please refer to our responses to questions 1-3, 14 and 15 for the missing elements in the current disclosure draft.

Question 14

What additional qualitative Pillar 3 climate-related financial risk disclosure requirements should the Committee consider?

Qualitative disclosures should be aligned with the Committee's Principles for the effective management and supervision of climate-related financial risks, thus providing transparency on the banks' practices. Important elements currently not captured by the qualitative disclosures, which should be added, include:

- **Information on how climate-related financial risks inform the capital planning process**, i.e. how the risks are considered in the capital adequacy assessment
- Information about the data sources the banks use (availability, quality and accuracy, and efforts to improve these aspects)
- **Information on actions implemented to reach the forecasts and targets**; these should be disclosed as part of the better specified transition plans, refer to the response to Question 15 for the details.
- Banks' progress to achieve the forecasts and targets (as guidance 2(c) of the Table CRFRA only mentions "the metrics used to monitor progress" without requiring the disclosure of the actual progress)
- **Information of whether and how climate-related risk management objectives are considered in the remuneration system**.

Question 15

How could the proposed qualitative Pillar 3 climate-related financial risk disclosure requirements be enhanced or modified to provide more meaningful and comparable information?

On 2. Strategy: We welcome the inclusion of transition plan disclosure requirements; however important enhancements are needed to better specify these requirements with the view of making the disclosures comparable and robust. Most notably, **Scope 3 greenhouse gas emission targets should be a mandatory part of transition plan**

disclosures, since Scope 3 emissions are the main drivers of financial institutions' climate-related risks, leaving them out would undermine the meaningfulness of transition plan disclosures as such.

The following specific elements of transition plans should also be disclosed:

- underlying climate scenarios and, if available, regional and sectoral transition pathways
- how the banks' transition planning takes into account their customers transition plans
- Measures taken by banks' to align their business models and strategies with transition/implement the stated targets; the focus should be on loan origination and investment policies, engagement with clients and contractual agreements to support sustainable transition (such as for example climate-related covenants in the financing agreements).

We also welcome separate disclosures of carbon credits and information on their verification status as part of transition plans. However, given such risk transition risks as asset stranding cannot be mitigated via the use of carbon credits, we emphasise the point made above that banks' climate-related disclosures should focus on the absolute emissions as well as actions undertaken by banks to affect emissions reductions by their clients (engagement etc.).

On 2(e) Climate resilience/climate scenario analyses: The Committee should ensure that the underlying scenarios used to assess climate resilience take into account climate science and the latest developments of climate scenarios. Given that all scenarios that exist at the moment and are widely used by supervisors, have serious flaws and limitations,[2] the latter should be clearly disclosed to give the adequate context to the disclosure of the results of climate scenario analyses.

On 3. Risk management: risk management-related disclosures in Table CRFRB should be complemented by information on the risk identification process - relevance and materiality assessment of climate-related financial risks. This includes information on criteria and time horizons used for the assessment.

Quantitative requirements

Question 21

How could the proposed quantitative Pillar 3 climate-related financial risk disclosure requirements be enhanced or modified to provide more meaningful and comparable information?

The guidance on qualitative disclosures should specifically clarify that the disclosed Scope 3 financed emissions should capture the emissions of entities/activities which are the actual final beneficiaries of the financing provided. This means that the reporting entities should apply the look-through principle in cases where their contractual counterparty is an intermediary or a holding company which then channels the funds to the actual beneficiary. The same principle is applied for the purposes of credit risk assessments under the Basel framework, where probability of

[2] As pointed out in the Finance Watch report "Finance in a hot house world" https://www.finance-watch.org/policy-portal/sustainable-finance/report-finance-in-a-hot-house-world/

default for a credit exposure is determined based on the creditworthiness of the actual borrower (and the legal risk of ownership relationship between the ultimate beneficiary and a possible intermediary/holding company are managed).

Given that the climate-related disclosures are a developing area, the above clarification is essential to prevent practices concealing the actual financed emissions and thus the possible transition-related risks in financial institutions' portfolios.

Question 22

What are your views on the relevance of the proposed quantitative Pillar 3 climate-related financial risk disclosure requirements to understand climate-related financial risks to which banks are exposed?

We welcome the disclosure of financed emissions under the quantitative requirements, as the GHG emissions are a simple and meaningful indicator of transition risk. However, emissions are a static indicator, whereas transition is a dynamic process so that **Scope 3 financed emissions alone will not be a sufficient indicator of transition risk**. We therefore strongly support the **inclusion of mandatory forward-looking information** - contrary to what is proposed by the Committee ("...the Committee proposes that disclosure of forward-looking forecasts would not be compulsory and would only be required in instances where banks have established such forecasts"). Transition plans of banks' customers/investees and eventually banks' own transition plans should be the major source of such forward-looking information.

The consultation document, incl. the disclosure templates, only refers to "forecasts" and does not mention "targets". We would like to see a clarification in this respect, as **identification and assessment of transition risk of specific exposures should necessarily be based on the analysis of the underlying companies' / activities' alignment with the respective international and national climate objectives** based on scientifically founded climate scenarios such as the ones from the IEA and the IPCC. We recognise that a robust analysis of transition risk requires more specific sectoral and regional pathways against which to compare banks' clients performance. Yet, the work on such pathways is at best nascent in most of the jurisdictions, which will remain a limiting factor until further progress is achieved.

Importantly, the following information/data should be provided as part of the quantitative disclosures:

- Baseline year for emission forecasts and targets
- Percentage of portfolio coverage for the reported emissions; explanation in cases where not 100% of the portfolio is covered and measures taken to improve coverage.

Quantitative forward-looking information should be viewed in context of the accompanying qualitative disclosures of risk mitigating measures and explanations in case material deviations from the forecasts/targets and revisions thereof.

Since the objective of the Pillar 3 and the proposed quantitative disclosures is to facilitate risk assessment, it is utmost important to reflect on the relevant **climate risk metrics.** We very much agree with the approach taken by the Committee to use GHG emissions and energy intensity as such metrics, provided these are complemented by forward-looking (forecasted) information. However, we note the need for considerations which go beyond emission indicators. Notably, the EBA Pillar 3 ESG disclosures also include an alignment metric[3]. The ESRB/ECB explored a broader set of forward-looking transition risk metrics[4], albeit all of these include GHG emissions as of the key input variables. We acknowledge the complexity of the transition risk analyses, forward-looking nature of the risk (without possibility to validate based on historical data) and uncertainties due to a lack of sufficiently granular regional and sectoral transition pathways. Therefore, the **BCBS should facilitate alignment of approaches and establish a global baseline for commonly recognised transition risk metrics** - both to promote market discipline, facilitate risk assessments and to address the risk at systemic level, where risk mitigation can only be achieved via coordinated and aligned approaches across institutions and jurisdictions.

Question 24

Would exposures and financed emissions by sector be a useful metric for assessing banks' exposure to transition risk?

Refer to our response to questions 21-22 above.

We emphasise the need for forward-looking analyses of transition risk for banks' portfolios under consideration of scientifically grounded climate scenarios and, where available, corresponding regional and industry pathways. Such analyses would allow to identify economic activities incompatible with the orderly transition, which would prompt the reflection on the associated risks and the need for adequate prudential measures.

Question 29

Would it be useful to require disclosure of the specific methodology (such as Partnership for Carbon Accounting Financials (PCAF)) used in calculating financed emissions?

Refer to our response to questions 1-3. We strongly support not only transparency of the underlying methodologies, but also a clear guidance on which methodologies should be applied to calculate financed emissions. This is indispensable to ensure consistency, comparability and reliability of disclosures in the current situation where a lot of private initiatives/methodologies have proliferated.

Question 34

What are your views on the prudential value and meaningfulness of the disclosure of the proposed bank-specific metrics on (i) asset quality (non-performing exposures and total allowances); and (ii) maturity analysis?

We consider these disclosures to be useful only in the broader context of credit risk analyses, of which climate-related financial risks are one of the drivers. Maturity

[3] https://www.eba.europa.eu/publications-and-media/press-releases/eba-publishes-binding-standards-pillar-3-disclosures-esg
[4] https://www.esrb.europa.eu/pub/pdf/reports/esrb.report202312~d7881028b8.en.pdf, page 18; https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.bankingsectoralignmentreport202401~49c6513e71.en.pdf

analysis should be useful to deliver information on the transition risks in banks' portfolios, when combined with the information about counterparties' transition planning and information on the required transformations in the respective industry/region (recognising, as mentioned above, that the availability of regional and industry passways is very limited at the moment, whereas global net zero scenarios and to an extend Nationally Determined Contributions are in use). Yet, from the macroprudential perspective, carbon lock-in effects also need to be considered, whereby even provision of short-term financing on a roll-over basis locks in future carbon emissions, which are driving physical climate-related risks.

Asset quality should be reported and viewed in a broader context, as this indicator alone will not allow conclusions about climate-related risks due to a number of factors:

- Climate related-financial risks are forward-looking in nature, in particular information on transition risks cannot be deduced from historical data until the transition credibly sets in.
- Climate-related financial risks are not the sole drivers of credit risk; as the consultative document states "This is not intended to signal that higher credit risk can be solely attributed to climate risk factors.". Moreover, physical risks are expected to increase substantially in the future in case of disorderly and/or delayed transition.

Therefore, the information on asset quality as of exposures to different sectors will not be useful as of today and without considering other drivers of credit risk.

Question 36

What additional bank-specific disclosure requirements in respect of banks' exposure to climate-related financial risks should the Committee consider?

Question 39

What type of forecasts would be most useful for assessing banks' exposure to climate-related financial risks?

The climate-related disclosure requirements should prominently include (forecasted/planned) information on banks' climate-related targets based on the counterparties' targets and transition plans. For this, the **disclosure requirements should also cover banks' policies on engaging with clients and product-specific characteristics aimed at supporting clients in transition.** See our response to question 15 for additional details.

Question 38

Would the proposed forecast information be a useful metric for assessing banks' exposure to climate-related financial risks?

Would the proposed forecast information be a useful metric for assessing banks' exposure to climate-related financial risks?

Refer to our response to question 21-22.

Question 42

What are your views on the usefulness of banks' disclosure of quantitative information on their risk concentration, i.e. of the bank's material exposures to sectors or industries subject to transition risk or to sectors/geolocations subject to physical risk relative to its total exposure?

Question 43

What are your views on complementing quantitative disclosure of risk concentrations with qualitative disclosure of contextual and forward-looking information on the bank's strategies and risk management framework, including risk mitigation, to manage climate-related concentration risk?

We support the disclosure of concentration risks and consider the broader context for such disclosures, as mentioned in question 43, necessary. However, such disclosures will only be useful when supplemented by concrete regulatory actions to manage concentration risks from the systemic risk perspective, i.e. in the presence of macroprudential measures to address climate-related systemic risks. We refer to the Finance Watch report "Finance in a hot house world" for the concrete proposals on the design of such a macroprudential tool.[5]

Question 52

What are your views on the feasibility of the potential effective date of the Pillar 3 climate-related disclosure requirements?

We consider the proposed implementation date to be feasible. We further recommend that the implementation date of the proposed qualitative disclosures is moved to 1 January 2025 based on the following considerations: The qualitative parts largely cover requirements around governance and risk management, which correspond to the requirements of the BCBS Principles for the effective management and supervision of climate-related financial risks, published in June 2022 (i.e. more than 2 years ago by the time Pillar 3 disclosures are likely to become final). In particular regarding transition plans, most of the international active banks are already disclosing their transition plans under the existing voluntary alliances such as the NZBA. Therefore, we do not see the reason for further delays in implementation of the qualitative disclosures.

[5] https://www.finance-watch.org/policy-portal/sustainable-finance/report-finance-in-a-hot-house-world/