BANK POLICY INSTITUTE

February 14, 2022

Via Electronic Mail

Basel Committee on Banking Supervision
Basel, Switzerland

Re: **Comment on *Principles for the Effective Management and Supervision of Climate-related Financial Risks***

Ladies and Gentlemen:

The Bank Policy Institute[1] appreciates the opportunity to comment on the Basel Committee on Banking Supervision's proposed *Principles for the Effective Management and Supervision of Climate-related Financial Risks* (the "Principles"),[2] which seeks to promote a principles-based approach to improving risk management and supervisory practices for climate-related financial risks.

BPI supports the Basel Committee's efforts to develop and articulate internationally consistent, principles-based guidance for climate-related financial risk management, which we believe can be helpful to both banks and supervisors as they work to ensure that banks identify and manage the possible manifestations of physical- and transition-related risks of climate change on their businesses and operations.[3] Our members are actively evaluating climate-related financial risks and their potential

1 The Bank Policy Institute is a nonpartisan public policy, research and advocacy group, representing the nation's leading banks and their customers. Our members include universal banks, regional banks and the major foreign banks doing business in the United States. Collectively, they employ almost 2 million Americans, make nearly half of the nation's small business loans, and are an engine for financial innovation and economic growth.

2 Basel Committee on Banking Supervision, *Consultative Document: Principles for the effective management and supervision of climate-related financial risks* (Nov. 2021), https://www.bis.org/bcbs/publ/d530.pdf.

3 For purposes of our comments, the terms "climate-related financial risk," "physical risk," and "transition risk" have the meanings as outlined in the Financial Stability Oversight Council's Report on Climate-Related Financial Risk (Oct. 21, 2021), https://home.treasury.gov/system/files/261/FSOC-Climate-Report.pdf; and Basel Committee on Banking Supervision, *Climate-related risk drivers and their transmission channels* (April 2021), https://www.bis.org/bcbs/publ/d517.pdf.

impacts, and are devoting substantial resources to developing risk management capabilities to identify, measure, and mitigate these risks.

I. Executive Summary

Given BPI member banks' experience in this space, we believe six overarching concepts should guide the Basel Committee in finalizing its consultative paper. These principles and associated recommendations are summarized below:

- <u>The principles-based nature of the Principles appropriately reflects the diversity of climate-related financial risks to which banks may be exposed and the need for flexibility in the design and implementation of risk management approaches in this area.</u>
  - <u>The final Principles should retain their flexible approach and acknowledge it would be premature at this time to require banks to establish and apply quantitative limits or thresholds for climate-related financial risk.</u>
  - <u>The final Principles should affirm that banks may manage climate-related financial risk within existing risk management programs and risk categories.</u>
  - <u>The Principles should retain their recognition of the significant variability of potential climate-related financial risk outcomes over longer time horizons.</u>
- <u>The final Principles should clearly acknowledge that banks' approach to managing climate-related financial risk should be fundamentally risk-based, such that individual banks may tailor their risk management programs to the risks presented and calibrate that program to the risks identified.</u>
  - <u>The final Principles should clarify that for purposes of risk management, individual banks will need to define "materiality" in the context of their individual circumstances and risk appetite framework.</u>
  - <u>The final Principles should recognize that banks may design their risk management programs in a manner that best reflects their individual circumstances, as appropriate and over time.</u>
- <u>The final Principles and their underlying expectations should reflect the fact that data and tools to measure and quantify climate-related financial risk remain nascent and not fully developed.</u>
  - <u>The final Principles should not establish any expectation that banks will incorporate climate-related financial risk into capital and liquidity planning at this time.</u>

- It is crucial that the final Principles recognize the important distinction between climate scenario analysis and regulatory stress testing.

- The final Principles should acknowledge that it may be appropriate and beneficial for banks to support customers through their respective low-carbon transition plans.

- We urge the Basel Committee to continue coordinating with international bodies and national supervisors to ensure consistent supervisory expectations with respect to climate-related financial risk management.

We believe that two of our comments are particularly important for the Basel Committee's consideration: (i) unrealistic expectations with respect to the incorporation of climate-related financial risk into capital and liquidity planning, as discussed in section IV; and (ii) the need to better distinguish stress testing and scenario analysis, as discussed in section V.

II. The principles-based nature of the Principles appropriately reflects the diversity of climate-related financial risks to which banks may be exposed and the need for flexibility in the design and implementation of risk management approaches in this area.

We strongly support the principles-based nature of the Principles, which in many cases appropriately reflect that climate-related financial risks may vary significantly across banks and that there is likely to be considerable diversity in the specific risk management tools and approaches that individual banks deploy, particularly as efforts to identify and measure climate-related financial risks remain relatively nascent.

We encourage the Basel Committee to retain this overall approach in the final Principles, and to avoid the types of prescriptive or detailed mandates that are likely to hinder banks' abilities to explore, test, refine, and adapt how they manage climate-related financial risks over both the short- and long-term. For example, it is important that banks have sufficient flexibility to develop and adapt their internal risk taxonomies, to make decisions about how to incorporate climate-related financial risks organizationally within their existing risk management framework, and to determine the relative materiality of climate-related financial risk exposures to the bank's financial condition. To that end, our comments identify a number of specific areas where maintaining this principles-based approach is particularly important to provide banks with appropriate flexibility.

A. The final Principles should retain their flexible approach and acknowledge it would be premature at this time to require banks to establish and apply quantitative limits or thresholds for climate-related financial risk.

The Principles reference the use of quantitative limits as a risk mitigation tool. For example, Principle 6 states that, where appropriate, banks should consider risk mitigation measures such as establishing internal limits for the various types of material climate-related financial risks to which they are exposed, and Principle 8 states that banks should consider risk mitigation options such as adjusting credit underwriting criteria or imposing loan limitations.

The final Principles should be clear that the use of quantitative limits and thresholds for climate-related financial risk as a risk management tool is likely to be premature for many banks at this time for several reasons. First, banks should be permitted to initially use their directional analysis to develop and inform their risk appetite and risk management frameworks prior to assessing whether any limits and thresholds would be appropriate.[4] Second, some banks already may consider climate-related financial risks, particularly physical risks such as flooding, fire, and other severe weather-related risks, in their credit underwriting processes as appropriate. It should also be noted that banks may already impose limits or certain thresholds for industrial or geographic sectors based on a variety of risk factors and it is not clear that any climate-related risk for such sectors would in any way alter or replace existing risk limits or thresholds. Significantly more analysis is needed to make such assessments. Third, requiring the imposition of limits before they have been properly tested could have unintended consequences on bank lending and access to credit.

B. The final Principles should affirm that banks may manage climate-related financial risk within existing risk management programs and risk categories.

Climate risk is a transversal risk that may manifest in any one or more of the risk types that banks have traditionally managed on a dedicated basis, such as credit, liquidity, operational, and legal risk. The final Principles therefore should affirm that climate-driven risks may be incorporated into and addressed through a bank's existing risk management governance program if the bank determines that this is the most effective means of risk management. The final Principles should make clear that they do not introduce a supervisory expectation that banks create new, bespoke governance structures and reporting regimes for climate-related financial risk as a standalone matter, as this would limit banks' flexibility to integrate climate-related financial risk into existing risk management approaches and would effectively create a new risk type.

For the same reason, we also do not believe that a new type of regulatory or other external reporting specifically directed at climate-related financial risk by banks is appropriate or necessary at this point in time. Many banks are already engaged in voluntary reporting efforts through the Task Force on Climate-Related Financial Disclosures (TCFD) as well as other industry-led reporting frameworks.

C. The Principles should retain their recognition of the significant variability of potential climate-related financial risk outcomes over longer time horizons.

The Principles accurately note that, while some physical and transition risks are already evident, others may materialize only over the maturities of longer-dated positions or an even longer time horizon. At the same time, the Principles note that banks should understand and evaluate how these risks could impact the resilience of a bank's business model over the short, medium, and longer terms and that banks should consider different time horizons in the process of risk identification and

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4 This recognition is particularly important because banks may be developing their respective approaches to climate-related financial risk management in a phased manner with multiple dependencies. For example, banks may have established different prioritizations and timelines for data collection and standardization or scenario analysis.

assessment as well as in scenario analysis. Given the significant variability of outcomes over longer time horizons, supervisory expectations with respect to longer-term governance, strategic planning, scenario analyses, and other aspects of the final Principles should allow for appropriate flexibility in approaches to developing and leveraging these components of risk management. Similarly, it would be useful for the Basel Committee to acknowledge that relatively more resources and effort may be applied to shorter-term risk management approaches—where plausibility and degree of certainty is higher—and less to longer-term approaches.

III. The final Principles should clearly acknowledge that banks' approach to managing climate-related financial risk should be fundamentally risk-based, such that individual banks may tailor their risk management programs to the risks presented and calibrate that program to the risks identified.

As an important complement to a principles-based approach, the final Principles should recognize that each bank has the discretion to develop climate-related financial risk management in a risk-based manner that is consistent with the concept of proportionality. This not only means that supervisory expectations should be tailored to the *circumstances of each institution*—including with respect to its size, business model, and client portfolio—but also that banks should develop and deploy various capabilities to the extent proportionate with the *risk management utility and effectiveness* of those capabilities, which may vary considerably. For example, supervisory expectations with respect to the scope and extent of data or scenario analysis capabilities should reflect the utility of those capabilities as a risk management matter, which is likely to evolve considerably over time. The final Principles should clearly accommodate these kinds of risk-based approaches, as described further below.

A. The final Principles should clarify that for purposes of risk management, individual banks will need to define "materiality" in the context of their individual circumstances and risk appetite framework.

The Principles frequently note that banks should ensure their risk management frameworks are designed to address "material" climate-related financial risks. We suggest the Basel Committee clarify that the meaning of "material" for purposes of risk management is distinct from materiality in the context of securities laws and it is for the individual bank to determine what is material in the context of its risk appetite and framework. For example, some important components of how banks may assess materiality for risk management could be the plausibility and certainty of risk (i.e., there will be potential risks that will be so speculative or distant as not to be material).[5]

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[5] It will also be important for the Basel Committee to recognize that banks may not be in a position to evaluate the plausibility and certainty of the risk—and therefore make materiality determinations—at this time due to underlying data challenges. Relevant data must first be generated, translated, validated, analyzed, and weighted before materiality can be determined. As discussed in section IV below, banks generally are in the early stages of this process.

B. The final Principles should recognize that banks may design their risk management programs in a manner that best reflects their individual circumstances, as appropriate and over time.

While recognizing that banks should manage climate-related financial risks in a manner that is proportionate to the nature, scale, and complexity of their activities and risk tolerance, the Principles, particularly Principle 4, prescribe specific practices that banks should adopt across the three lines of defense. These overly prescriptive expectations would not enable banks to have sufficient discretion to design a risk-based approach that is appropriate for their respective circumstances, particularly while climate-related financial risk data and methodologies remain under development. The final Principles should acknowledge that banks' internal risk management approaches may be appropriately phased, and as such pass through an extended transition state that is initially short, and perhaps well short, of the fully mature approach identified in the Principles.

IV. The final Principles and their underlying expectations should reflect the fact that data and tools to measure and quantify climate-related financial risk remain nascent and not fully developed.

The final Principles should reflect the evolving nature and understanding of climate-related financial risks and the fact that existing data and tools to measure and quantify climate-related financial risk—and in particular, longer-term physical and transition risks—are only just emerging, and will need to undergo substantial exploration, refinement, and adaptation over time. Although data capabilities are improving, significant gaps in data sourcing, capture, standardization, and aggregation substantially affect the accuracy of projections and risk assessment.[6] Given these challenges, the Basel Committee should give banks due flexibility to develop, adopt, implement, and refine both (i) data capabilities and methodologies and (ii) quantitative risk management tools that depend on that data, such as risk limits, risk appetites, or scenario analysis. For this same reason, we also believe it is important that the final Principles acknowledge and affirm that, in many cases, banks may need to rely on qualitative assessments and judgments about climate-related financial risks, particularly in the near-term while more sophisticated and standardized data and measurement tools are being developed.

A. The final Principles should not establish any expectation that banks will incorporate climate-related financial risk into capital and liquidity planning at this time.

Principle 5 notes that 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 (ICAAPs and ILAAPs). Given data gaps and the evolution of climate and risk transmission models, banks are generally in the data collection and risk identification and measurement stage of risk management. Therefore, any expectation that banks incorporate climate-related financial risk into their capital and liquidity planning processes at this time would be

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6 Climate-related data provided by borrowers and counterparties is often limited and not consistent or comparable. For example, while property, asset, and supply chain data are available for larger public clients, there are gaps when assessing smaller and privately-held clients or those in less carbon-intensive sectors. Further, and importantly, we note that emissions data may not necessarily be indicative of risk.

inappropriate in light of the need for further maturation of the relevant quantitative tools.[7] As the Basel Committee recently determined, there is limited research and accompanying data that explore how climate-related financial risks feed into the traditional risks faced by banks.[8]

V. It is crucial that the final Principles recognize the important distinction between climate scenario analysis and regulatory stress testing.

Principle 12 describes stress testing as a type of scenario analysis and states that banks may explore the use of stress testing to assess the adequacy of their financial positions in the near term under severe yet plausible scenarios, noting that these capabilities are expected to mature more progressively over time as methodologies evolve. We strongly urge the Basel Committee to recognize the important distinction between scenario analysis and traditional stress testing exercises, which typically assess the potential impacts of transitory shocks to near-term economic and financial conditions.[9] Stress testing exercises of the type developed over the past decade to assess capital adequacy over the near-term (e.g., 2-3 years) are simply not an appropriate tool to evaluate the impacts of climate-related financial risks, as assessing vulnerability to these risks generally must be performed over a much longer time horizon (e.g., 10-30 years). In addition, measuring climate-related financial risks extends well beyond most asset and portfolio maturities, and involves substantially more modelling uncertainty given the long horizons and lack of reliable historical data. These challenges will likely lead to a misestimation of the impact of climate-related financial risks on a bank's financial position.[10] Thus, inappropriately conflating these two risk management processes would both undermine the integrity and reliability of existing stress testing exercises and present a poor view of climate-related financial risks by attempting to shoehorn them into an existing stress testing framework designed for different purposes and based on different assumptions and parameters.

Furthermore, it is important that any expectations with regard to specific climate-related scenarios for integration into risk management frameworks should focus on severe but *plausible* scenarios and not exaggerated scenarios that unrealistically frontload physical and transition risks. For

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[7] Moreover, to the extent that banks are expected to incorporate climate-related financial risk into their capital planning process, it is critical that the capital planning framework maintains its existing parameters, especially as relates to time horizon, plausibility, and expected and unexpected losses. Banks already incorporate short-term, evolving physical risk into capital planning, as is appropriate given the purpose and goals of capital planning.

[8] Basel Committee on Banking Supervision, *Climate-related risk drivers and their transmission channels* (April 2021), https://www.bis.org/bcbs/publ/d517.pdf.

[9] For example, U.S. regulatory agencies generally recognize this distinction. The FSOC report on climate-related financial risk likewise distinguished scenario analysis from stress testing, noting that the former is "exploratory in nature" while the latter is linked to regulatory requirements such as loss-absorbing capital. FSOC Report on Climate-Related Financial Risk (Oct. 21, 2021), 90, https://home.treasury.gov/system/files/261/FSOC-Climate-Report.pdf. So too does the Office of the Comptroller of the Currency's *Principles for Climate-Related Financial Risk Management for Large Banks* (Dec. 16, 2021), https://www.occ.treas.gov/news-issuances/news-releases/2021/nr-occ-2021-138a.pdf.

[10] *See* Basel Committee on Banking Supervision, *Climate-related financial risks – measurement methodologies* (April 2021), 17-18, https://www.bis.org/bcbs/publ/d518.pdf.

the reasons discussed in section VII below, it is also important that supervisors coordinate principles for scenario analysis designs and leverage existing scenarios (e.g., NGFS, IEA, and RCP), rather than design bespoke scenarios that diverge from those employed in other jurisdictions.

VI. The final Principles should acknowledge that it may be appropriate and beneficial for banks to support customers through their respective low-carbon transition plans.

It is crucial that the final Principles acknowledge and affirm that it is appropriate—and indeed, in many cases desirable—for banks to support and serve customer needs over the course of any climate-driven economic transition. This recognition is not only important to ensuring an effective and orderly transition to a carbon-neutral economy, but it is also to be encouraged as a matter of safety and soundness, as giving banks the flexibility to support customers through that transition is likely to produce better outcomes for the bank in both the short- and long-run.

As described in section II.A above, this recognition also means that the final Principles should clarify that banks are not expected to mitigate credit risk by establishing and managing to prescriptive limits on lending to certain sectors or otherwise. The final Principles should recognize that banks are supporting these clients' transition to a low-carbon economy across a necessarily long-term horizon, and managing any climate-related financial risks of doing so within the construct of their internal risk appetite and management frameworks.

VII. We urge the Basel Committee to continue coordinating with international bodies and national supervisors to ensure consistent supervisory expectations with respect to climate-related financial risk management.

BPI urges the Basel Committee to continue coordinating closely with national supervisors and the international standard-setting bodies, including the Financial Stability Board, to help ensure that supervisory expectations for the management of climate-related financial risk are internationally coordinated. Such coordination will be crucial to avoid the potential for duplicative or conflicting requirements imposed on banks, which would not only be burdensome, but would also likely undermine rather than support banks' abilities to manage climate-related financial risk. Simply put, it will be untenable and counterproductive for larger banking organizations to be expected to manage climate-related financial risk one way at the local subsidiary level and another at the holding company level, or one way in one jurisdiction and another in other jurisdictions. Successful management of climate-related financial risk is a global, enterprise-wide endeavor. Furthermore, we recommend any future guidance developed at the international level be subject to robust public comment given that banks are at the forefront of some of the technological developments that are occurring in relation to climate-related risk tools and analytics.

VIII. Other Comments on the Principles

A. The final Principles should affirm that the board of director's role in climate-related financial risk management is effective oversight of senior management's implementation of risk management.

The Principles reference the role of the board of directors in many instances. For example, Principle 1 states the board of directors should be involved in all relevant stages of taking physical and transition risk drivers into account when developing and implementing business strategies. It is important that the final Principles follow clear and longstanding legal and safety and soundness principles that clearly distinguish the roles and responsibilities of the board of directors and senior management, respectively, and not conflate the two. As discussed in a recent industry report issued by the Bank Policy Institute,[11] a central tenet of effective corporate governance is the distinction between, and complementary nature of, the board of director's responsibility for *oversight* of the business and affairs of the bank, and management's responsibility for the *day-to-day operations* of the organization. Further, the final Principles should provide sufficient flexibility to accommodate jurisdictional differences in how responsibilities are allocated between the board of directors and management under local laws.

B. The final Principles should center on the management of climate-related financial risk and not incorporate "broader environmental risks" to avoid ambiguity or confusion in terms of scope.

The Basel Committee's third question asks how the transmission of "environmental risks" to banks' risk profiles could be taken into account when considering the potential application of the Principles to "broader environmental risks" in the future. This term is not defined, and it is not clear what "broader environmental risks" are being referenced and how they differ (or not) from the climate-related financial risks that are the subject of the Principles. To avoid ambiguity or confusion, we strongly urge the Basel Committee to retain the existing definition in the Principles of, and focus on, "climate-related financial risk," and not to focus on broader, undefined concepts. A failure to clearly bound the Principles by reference to climate-related financial risks would undermine efforts to employ a single term and concept across supervisory jurisdictions and would skip the important policymaking step of seeking to first identify such "broader environmental risks" and assess whether they are already appropriately addressed within existing bank and supervisory risk management constructs.

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11 *See generally*, Bank Policy Institute, *Guiding Principles for Enhancing U.S. Banking Organization Corporate Governance* (Jan. 12, 2021 Exposure Draft Edition), https://bpi.com/wp-content/uploads/2021/01/BPI-Guiding-Principles-on-Enhancing-Banking-Organization-Corporate-Governance.pdf. *See also* The Clearing House, *The Role of the Board of Directors in Promoting Effective Governance and Safety and Soundness for Large U.S. Banking Organizations* (May 2016), https://bpi.com/wp-content/uploads/2021/03/58463da32970443bb9e2ab796a0dc699.pdf.

Bank Policy Institute appreciates the opportunity to comment on the Principles. If you have any questions, please contact the undersigned by phone at +1 202.737.3536 or by email at *Lauren.Anderson@bpi.com.*

Respectfully submitted,

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