Principles for the effective management and supervision of climate-related financial risks

UK Finance response to consultative document from the Basel Committee on Banking Supervision

16 February 2022

Introduction

UK Finance is the collective voice for the banking and finance industry in the United Kingdom. Representing more than 300 firms, we act to enhance competitiveness, support customers and facilitate innovation. We welcome the opportunity to respond to the Basel Committee on Banking Supervision's consultation on principles for the effective management and supervision of climate-related financial risks.[1]

2. As a general comment, we support the Committee's aims and believe that the principles constitute a well considered framework that articulates and provides helpful guidance on the maturing expectations for climate-change risk management.

3. However, the proposals do not depart significantly from current practice, established by the principles underpinning the recommendations of the Task Force on Climate-related Financial Disclosures[2] and subsequent reviews and publications. While banks have made significant strides, there is more to do to ensure that they consistently integrate climate change into their risk-management frameworks and that regulators provide a level playing field across different jurisdictions.

4. Attempts to model inherently unpredictable outcomes will differ between banks. While many are signing voluntary commitments to achieve net zero and reallocating capital to climate-safe activities, the Committee has a role to play in "levelling up" the rules across jurisdictions to remove incentives to continue adding to fossil-fuel exposures.

5. All firms remain exposed to the risk that climate change will be worsened where those incentives to act persist without direct consequences. Interventions that help firms to internalise these risks will improve market outcomes and stability for all.

6. The same barriers that UK banks faced when trying to integrate climate change into their risk and governance frameworks—a lack of data, tools and expertise—are also true for central banks and supervisors in many jurisdictions. Only where they have access to more

[1] https://www.bis.org/bcbs/publ/d530.pdf.
[2] https://assets.bbhub.io/company/sites/60/2021/10/FINAL-2017-TCFD-Report.pdf.

data, systems and people will they be able to effectively supervise banks in their jurisdiction on such a complex topic. Without them, the quality and speed of implementation will vary unacceptably.

7. The consultation focuses on stress tests and pillar-2 and -3 responses at an individual firm level. In the absence of pillar-1 capital guidance, the main tool for regulators to supervise banks' integration of climate-related risks will be through pillar 2. However, members have suggested that supervisors are not using many of the pillar-2 measures already available to them.

8. In June 2012, the Enhanced Disclosure Task Force published recommendations and good-practice examples on enhancing the risk disclosures of banks.[3] While disclosure was the *prima facie* focus, the Task Force's report was regarded as broadly successful in significantly enhancing systemic banks' risk management around the world. As it covered similar principles to those here, the Committee should recommend the rejuvenation of the Task Force to undertake a similar exercise relating to banks' climate-related risk management (both financial and non-financial).

9. If you have any questions relating to this response, please contact Matthew Conway, Director of Strategic Policy, at matthew.conway@ukfinance.org.uk.

Consultation questions

Q1. Has the Committee appropriately captured the necessary requirements for the effective management of climate-related financial risks and the related supervision? Are there any aspects that the Committee could consider further or that would benefit from additional guidance from the Committee?

10. The principles broadly capture the requirements for effective management of climate-related financial risks.

11. In general, multiple similar regulatory requests on ESG risk reporting will result in inconsistent and duplicated reporting and will detract from work on value-added risk management by skewing efforts toward compliance with a multitude of requirements. Requests should be streamlined among supervisors, whose resources could be concentrated more efficiently.

12. We underscore the mismatch of time horizon between, on the one hand, the models widely applied in the market and, on the other hand, long-term climate-risk scenarios, which extend out 30 years. Current risk-measurement models are not developed for such long-term horizons. Moreover, the underlying capital planning is equally not targeted at taking precise capital decisions in 30 years due to the fact that uncertainty increases based on accumulating assumptions. It would be useful for the Committee to learn from the inaugural climate stress-testing being undertaken in the UK and Europe.

13. A phased-in approach for banks is important until improved data are available and definitions are aligned, ideally at a global level. A survey of the size and types of banks' current exposures, including as a proportion of total exposures, would support the design

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[3] https://www.fsb.org/wp-content/uploads/r_121029a.pdf.

and implementation of capital and liquidity measures and help determine suitable transition periods.

14. Consideration of the borrower's characteristics (e.g. revenue mix or net-zero transition plans) as part of the capital framework would help to better protect the system against financial and climate-related systemic risks. These should recognise that the risk profiles of financial assets that support activities pushing global emissions beyond the safe carbon budget are far higher than those of assets that support existing fossil-fuel and energy-transition activities. Guidance on the distinction between new and existing fossil-fuel activities would be helpful in driving consistent practices by banks and supervisors.

15. While we recognise that financial risks are the most material way in which climate-change risk may manifest, the principles should more explicitly consider non-financial risks (as referenced in principle 11). The principles are equally relevant to both financial and non-financial risk, and it would be helpful in their ongoing adoption across all elements of risk management within firms if this was mentioned explicitly at the start of the document.

16. We also welcome the articulation of principles directed toward supervisors given the wider benefits from regulatory homogeneity as capability develops. Consideration should be given to generating alignment of central data sources and benchmark climate pathways across supervisors to allow greater comparability of climate risks across institutions.

Q2. Do you have any comments on the individual principles and supporting commentary?

17. The network of supervisors should reflect on the potential for systemic intervention to align market practice. Using regulation to align all banks with climate-safe best practice, ensuring coordinated intervention and preventing leakage would help to reduce systemic climate-related risks in the system. Regulators should also try to prevent climate-related financial risks migrating to firms and investors not subject to banking regulation in order to decrease systemic risks.

18. Principle 1 is being implemented, with inaugural climate stress-testing exercises completed in the UK and the EU and a growing body of disclosures. This principle seems aligned with the TCFD recommendations.

19. Principle 2 seems reasonable, but there will not be a one-size-fits-all approach to climate governance. It is also likely to evolve over time.

20. We welcome the recognition in principle 5 that inclusion within internal capital- and liquidity-adequacy assessment processes will be iterative and progressive. Notwithstanding the nascent nature of climate-risk data and modelling, the principles should encourage their consideration *despite* their current limitations rather than wait for these to be resolved. Indeed, the context of "iterative and progressive" should be applied across all the principles to encourage early action regardless of current barriers.

21. It makes sense to have a horizon-scanning process to monitor future developments and a frequent (at least annual), robust and comprehensive refresh of climate-risk assessment exercises, which would address the spirit of principle 6. However, it is not clear how the Committee will address other material risks that may not yet be apparent. We also note that the Committee refers only to risk-data aggregation capabilities and internal risk-

reporting practices and not to the TCFD guidelines or more generally to climate external disclosures.

Q3. How could the transmission of environmental risks to banks' risk profiles be taken into account when considering the potential application of these principles to broader environmental risks in the future? Which key aspects should be considered?

22. It is too early in the journey to fully address or assess in detail the wider potential environmental risks resulting from either a changing climate or other disruptive influences. This topic should continue to evolve over the next two to five years, after banks have established their climate-risk capabilities and can widen the scope of their modelling and consideration.

23. That said, the best starting point is biodiversity loss. This has the potential to significantly affect the financial system as a result of changes in land use, food and water supply, and migration, with potential knock-on impacts through most economic sectors including commodity bubbles and sovereign defaults.

24. More generally, the approach to climate (i.e. iterative development, recognising that capability is imperfect at present) should be applied to wider environmental risks. Initiatives such as the Bank of England's Climate Biennial Exploratory Scenario have demonstrated the value of regulatory-led exercises in rapidly maturing capability in areas such as this.

25. The risks associated with growing levels of uninsurable risk (e.g. for flooding) and the consequential effect on financial markets should also be considered.