Global Climate-Risk Management and Supervisory Principles

Cite

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Impact Assessment

- Initial steps are now being taken to craft global climate scenario-analysis and stress-testing standards to accelerate national adoption.
- Basel also contemplates risk-based capital charges for climate risk but has not even begun to frame how these might apply.
- No express limits on fossil-fuel exposures are contemplated beyond those a bank or its supervisors may think necessary to reduce specific risks or those due to concentrated exposures to the sector or a region.
- All global principles intend to reflect current data, methodology, and disclosure uncertainties without sacrificing near-term risk reduction.
- The principles are so broadly phrased as to encompass a wide range of national action or even inaction for all but the biggest, internationally-active banks.

Overview

Following the UN's COP26 climate-risk summit, the Basel Committee has proposed high-level principles guiding risk management and supervision related to both physical and transition climate risk. Banks that voluntarily implement these principles may be able to enhance climate-risk management that reflects their own views on risk exposure, strengthening their resilience but perhaps omitting steps to prevent regulatory arbitrage or to ensure that all risks are mitigated or that all banks have adequate capital, liquidity, and operational buffers for environment risk across the cycle and under stress scenarios. However, even if only some banks and/or jurisdictions act on these principles once they are finalized, a better understanding of how climate risk creates financial risk was likely to emerge that accelerates wider adoption of more measurable standards better suited for investor and supervisory scrutiny, comparison, and – if needed – action.

Impact

Basel decided on high-level principles issued as guidelines – not standards – due to the heterogeneity of climate risk, ongoing disclosures and data challenges, and wide variations in risk exposures at member nations. It intends these guidelines – especially where they address stress testing and scenario analysis – to serve as a baseline for internationally-active banks and as an outline from which tailored standards may be crafted for smaller banks. However, due to their general nature, a wide range of actions and even inaction could be deemed consistent with Basel's final approach if it – as seems likely – retains this principles-based approach.

Because these are only high-level principles, none of the specifics associated with standards is detailed. However, the principles do lay the groundwork for specific principles either in Basel's subsequent work (see below) or by national authorities. These could involve specific capital charges for certain types of climate risk, over-arching capital or liquidity buffers, new operational requirements, and/or additional business-continuity requirements.

In the U.S., action is already pending on the principles proposed for bank supervisors. For example, Acting Comptroller Hsu has laid out steps he believes directors should ask of management to ensure the bank has answered many of the questions detailed in the Basel principles and then to ensure appropriate risk mitigation begins. OCC standards for effective climate-risk management are expected by year-end. The Federal Reserve is also planning standards by which examiners can assess climate risk at the largest banks, but has not yet provided a time frame.

All of these actions coincide with a "whole-of-government" federal effort to reduce greenhouse gases ordered by President Biden.[1] Near-term action specifically under this order is likely to come first from the SEC, building on initial action to mandate climate-risk disclosures[2] to create specific, mandatory disclosures for SEC registrants. These will begin to collect standardized, comparable data from which additional U.S. bank-regulatory actions – e.g., mandatory scenario analyses or even stress testing – may proceed.

What's Next

This consultation was released on November 16; comments are due by February 16. In addition to this proposal, Basel is working on issues germane to disclosure and gaps in its broader prudential regime. These include the extent to which risk-based capital charges may be used either to reward green activities or penalize "brown" ones. Draft legislation pending in the U.S.[3] would mandate a

[1] See **GREEN8**, *Financial Services Management*, May 25, 2021.

[2] See **GREEN6**, *Financial Services Management*, March 18, 2021.

[3] See **GREEN10**, *Financial Services Management*, August 27, 2021.

regime along these lines following a 2020 BIS report[4] discussing how climate capital might be structured. Legislation is also pending to mandate that banks undertake climate-risk stress testing, but no action on any of these bills has occurred nor does enactment seem likely in 2022 as long as the banking agencies continue their work on the types of standards outlined above.

Analysis

A. Principles for Banks

These would be:

- Banks should understand and manage all material climate risks, including those affecting the business model over the short and medium term as well as those likely to lead to structural changes to the economy, financial system, and competitive landscape. The board and senior management should undertake this process and set clear goals, standards, and monitoring criteria.
- The board and senior management should also clearly assign climate-risk duties throughout the organization. Governance processes should also address climate risk.
- Policies, procedures and controls should capture climate risk including that at the front line related to new customers, with another principal spelling out high-level standards for relevant internal controls.
- Banks should identify and quantify material climate financial risk and incorporate these in capital and liquidity planning over "relevant" time horizons under both benign and, for liquidity, stress conditions. Basel notes in a footnote that this principle will be met in an iterative fashion given current data and methodology limitations. However, banks must now begin to identify climate risk drivers and determine how best to assess their impact.
- Banks are to manage all material climate risks that impair their financial condition, specifying this in relevant risk-tolerance policies. Banks are also to review these standards and set materiality criteria from an integrated, firm-wide perspective. Risk-mitigation measures are also to be established where appropriate.
- Reflecting the risk-management principle, the consultation also says that banks should aggregate risk. Reporting procedures should account for climate risk. "Reasonable proxies" may be used when data are under development or unclear, but banks need also to develop qualitative metrics to track climate risk on timelines based on expectation of likely exposure. Where data are limited, "stakeholders" should be told.
- Banks are also told to manage climate-related credit risk, including those related to sector or geographic concentrations, doing so across the entire credit-risk life cycle. Risk mitigation should also occur where necessary.
- Risk identification, monitoring, and mitigation should also occur for portfolio exposures, doing so via a sudden market-risk shock methodology taking

[4] See *Client Report* **GREEN**, January 22, 2020.

liquidity and volatility into account or via other approaches. Details are provided on managing mark-to-market risk across the trading book, taking the possibility of disorderly transition into account.
- Another principle details liquidity-risk management approaches, noting the possible need for liquidity-buffer recalibration.
- Operational-risk considerations are detailed in another principle, noting also the need to address strategic, reputational, and compliance risk. Steps with regard to addressing business-continuity risk are also described.
- Banks are also told, "where appropriate," to make use of scenario analysis that includes stress testing related to near-term risks under severe, yet plausible, scenarios. Analyses should address physical and transition risk over "relevant" time horizons. These analyses and tests should reflect the board-dictated climate-risk strategy, with larger banks expected to have more sophisticated analytical capabilities. However, Basel recognizes that methodologies remain uncertain due to data and other challenges; it thus tells banks to do their best and subject their approaches to challenge from internal and/or external experts.

B. Supervisory Principles

These would stipulate that:

- Supervisors should assess the extent to which banks comply with the standards described above, ensuring that they have sufficient resources to do so.
- Supervisors should not only review adherence to these principles, but also challenge banks where weakness is observed. To do so, supervisors should adopt a range of tools and follow-up as needed.
- Supervisors should share information on cross-border financial groups.
- A range of stakeholders should be involved in climate-risk policy to ensure resource optimization.
- After setting clear objectives, supervisors should consider climate-related scenario analyses and/or stress testing. They should also consider disclosing analytical/test results, tempering releases with recognition of the limitations of current climate-risk methodologies and data.

C. Request for Comment

In addition to broad views on these principles, Basel seeks comment on:

- the need for more guidance;
- the individual principles; and
- how these principles apply to future action on "broader" environmental risks in the future.