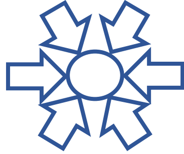

Financial Services Management

Climate Risk Management

Cite

Basel Committee on Banking Supervision, Final Principles for the Effective Management and Supervision of Climate-Related Financial Risks

Recommended Distribution:

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Impact Assessment

- Initial standards begin the process of crafting global climate scenario-analysis standards to accelerate national adoption.
- 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

The Basel Committee has finalized its proposed climate-risk management principles largely unchanged from its proposal,[1] establishing over-arching goals at which both banks and their supervisors are asked to aim. Much in the final standards echoes proposed OCC risk-management standards[2] proposed in a slightly different form by the FDIC and likely soon to be taken up by the Federal Reserve in inter-agency U.S. goals. Neither Basel's standards nor these U.S. principles are binding in terms of specific requirements related to capital, scenario analysis, stress testing, or governance. Indeed, Basel's final standards back away from suggestions in the consultation about the need in the near term for specific climate-related capital charges and for stress tests. However, these standards are intended to and likely will lay the groundwork for more binding actions as regulators gain more confidence in the data on which concrete requirements can be based and judged.

[1] See **CLIMATE12**, *Financial Services Management*, November 22, 2021.

[2] See **GREEN12**, *Financial Services Management*, January 4, 2022.

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Impact

Although global regulators believed that current standards on supervisory best practice apply reasonably well also to climate risk, they decided to issue these principles not only to target effective risk management and supervision, but also to begin the process of finalizing changes to current standards where climate risks' severe challenges warrant and existing knowledge suffices. As the high-level nature of these principles makes clear, the Basel Committee is doubtful that it has the knowledge yet to promulgate specific mandates.

Even where it begins to lay out ways to do so for scenario analysis, it is reluctant to apply general principles to any banks other than large, internationally-active ones. Indeed, Basel's principles are considerably more restrained than those outlined by the FSB for banks, insurers, and securities firms of systemic scale.[3] Thus, Basel's work here is, while final, only a preliminary framework from which both global and national regulators will proceed for large and even systemic banks as their own priorities dictate, more precise analytics allow, and any more sweeping systemic standards emerge.

The final standards include some interesting changes from the consultation likely to be reflected in the U.S. and other nations. For example, language in the consultation suggesting that nations could craft climate-specific risk weightings is omitted. This moves global regulators still farther from BIS suggestions in 2020 that regulators adopt "brown-penalty" or "green-incentive" capital requirements.[4] As noted requirements or even recommendations that banks could begin stress-testing are also dropped from the final standards in favor of somewhat more detail on scenario analyses and how these should be used to assess a bank's exposure and strategy, not set risk-adjusted capital allocations or otherwise govern capital, liquidity, or other risk buffers.

The final guidelines also state that directors and senior management should ensure that a bank's climate-risk performance matches its public statements, a stipulation doubtless included due to continuing concerns about "greenwashing." The SEC's proposed new climate-risk disclosures include an injunction for precisely this alignment, adding the risk of enforcement actions should statements not match performance less likely from bank examiners should the SEC include this requirement in its final climate-risk standards (as seems likely).

The final guidelines also include an injunction that directors consider compensation in light of climate risk. Basel is quick to note that these considerations should not override those germane to the bank's business performance, making it unclear how climate-risk management is to be differentiated from broader performance and risk considerations. However, to the extent that climate-risk is included in compensation-related incentives, it will take on even greater priority.

What's Next

These principles were released on June 15. Basel continues to evaluate how climate risk affects its overall framework, identifying gaps where this risk is not well buffered by current standards in areas such as capital regulation. No timeline for doing so is provided.

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3 See **CLIMATE13**, *Financial Services Management*, May 5, 2022.

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

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As noted, U.S. bank regulators are working towards high-level principles of their own. These will cover only the largest banks, omitting the supervisory standards Basel has also finalized by which supervisors are to judge themselves, but the agencies are likely over time also to develop examination manuals or other protocols to govern and perhaps even coordinate their climate-risk supervisory and enforcement activities. All of the agencies are also likely to work with the SEC to develop new climate-risk disclosures in accordance with the president's request in his climate-risk executive order[5] and Secretary Yellen's statements about FSOC priorities in its wake.[6]

Analysis

A. Principles for Banks

These are:

- 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 determine the extent to which climate risk should be reflected in compensation standards and clearly assign climate-risk duties throughout the organization. Governance processes should also address climate risk, with the board and senior management ensuring that risk appetite in this arena is consistent with the bank's overall business strategy and risk tolerance. The board and senior management are also to ensure that the bank's actions on climate risk are consistent with its public statements.
- 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 stress conditions. Basel also notes 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. The final standards also state that climate-risk transmission channels may be "undiscovered;" banks are thus asked to monitor and, where possible, manage emerging risks as they are likely to affect material risk.
- Reflecting the risk-management principle, the standard also says that banks

[5] See **GREEN8**, *Financial Services Management*, May 25, 2021.
[6] See *Client Report* **FSOC27**, May 12, 2022.

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should aggregate climate 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 quantitative and qualitative metrics to track climate risk on timelines based on expectations of likely exposure. These climate-risk indicators are to be disclosed along with any indicator limitation.

- 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 (e.g., shorter tenors, discounted valuations) 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 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 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 to subject their approaches to challenge from internal and/or external experts.

B. Supervisory Principles

These 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 requirements. They should also consider disclosing analytical/test results, tempering releases with recognition of the limitations of current climate-risk methodologies and data.

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