February 16, 2022

Basel Committee on Banking Supervision
Bank for International Settlements

Re: Request for Comment on the Basel Committee on Banking Supervision's Consultative Document "Principles for the effective management and supervision of climate-related financial risks"

Dear Ladies and Gentlemen:

Better Markets[1] appreciates the opportunity to comment on the consultative document captioned above ("proposed principles"),[2] issued by the Basel Committee on Banking Supervision of the Bank for International Settlements ("Committee"), regarding the principles it has outlined for both banks and supervisors to consider in the management and supervision of climate-related financial risks ("climate risks").

Better Markets applauds the publication of these principles as an important step in addressing climate risks, which can have serious effects on the safety and soundness of banks as well as overall financial stability. Considering the broad range of risks that climate change can pose, we welcome the Committee's approach of largely integrating climate risks into existing risk management principles with some additions that capture unique aspects of climate risks—in particular, the use of scenario analysis to identify and size risks, the consideration of longer time horizons, and the recognition that climate risks and their management are an evolving process.

We urge the Committee to finalize these principles with some enhancements. First, considering the evolving nature of climate risks and the current absence of mandated measurements or metrics, and the development of so-called best practices being in early stages, the Committee should encourage banking institutions to look to available internationally agreed-upon metrics and best practices for either direct use or use as a benchmark to their own internally developed practices. Second, the language regarding scenario analysis should similarly include

[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies— including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.
[2] Available at https://www.occ.treas.gov/news-issuances/bulletins/2021/bulletin-2021-62a.pdf

promotion of banking institutions' use of internationally agreed-upon scenarios and scientific projections to ensure plausibility and minimum severity of their own scenarios. Third, the principles must recognize the connection between publicly communicated commitments and risk management practices.

The Proposed Principles Take the Appropriate Approach of Largely Integrating Climate Risks into Existing Risk Management Principles

Banks themselves are the "first line" in identifying, sizing, and managing risks, and so it is necessary for banks to ensure they have robust risk management and governance processes in place. It is the responsibility of prudential regulators to assess banks' processes and hold banks accountable when they are not effective. Put another way, it is the responsibility of banks to design and execute processes that are necessary to effectively manage their risks on a day-to-day basis. The responsibility of prudential regulators is to assess risk management and governance *processes* at banks and to take supervisory actions to require banks to fix weaknesses in those processes that are identified through supervisors' assessments of banks.

Climate risks have been recognized in the U.S. and internationally as risks that pose a threat to the safety and soundness of banks and overall financial stability. Numerous global regulatory authorities and organizations have made this recognition – the central banks of Japan, the United Kingdom, France, Germany, the Netherlands, the United States, and others as well as inter-agency and international bodies such as the U.S. Financial Stability Oversight Council, the Bank for International Settlements, and the Financial Stability Board. As a broadly recognized and clearly material risk, climate-related risks must be a part of banks' risk management and governance practices and assessing those must be part of the supervisory assessment processes of bank regulatory authorities. An integral part of that incorporation is including climate risks in supervisory guidance. More important still is including it in supervisors' assessment criteria.

Principles-based guidance does not explicitly outline all aspects of supervisory expectations, and so the principles themselves must be well-founded, specific enough to make the intention of the expectation clear and to promote safe and sound practices, and general enough to allow for evolution and innovation in the creation of best practices. The proposed principles largely achieve this goal by integrating climate risks into the existing principles framework for the risk management and governance of more "traditional" risks, such as credit, market or operational risks and adding components to the principles to capture certain aspects that are unique to climate risks. Indeed, nearly all the proposed principles for climate risks align one-for-one with those of traditional risks. This is sensible and appropriate because climate risks are a risk to safety and soundness just as with more traditional risks and can manifest as more traditional risks. For example, changes in weather patterns could significantly decrease the output of farmland that collateralizes a loan, thereby harming the farmland's income and its inherent value. This would have the effect of increasing both the probability of default on the loan and the loss given default.

Importantly, the proposed principles appropriately focus on the governance of climate risks and the responsibility of boards of directors and senior management. Senior management is responsible for the day-to-day management of all risks to a bank and boards of directors are ultimately responsible for overseeing the risk management and governance processes and holding senior management accountable for ensuring sufficient and effective risk management and governance processes. Both parties must have sufficient knowledge and understanding of climate risks to fulfill those responsibilities. Key to the principles around governance is the emphasis on a bank ensuring that their board and senior management has sufficient knowledge and understanding of climate risks and the impact on a bank's strategic direction, business model and risk appetite. Considering the evolving nature of climate risks and that they are likely new and less understood risks to boards and senior management, without this emphasis there may be an incentive to pass on responsibility of the management of climate risks to lower-level employees and claim ignorance.

In this regard, the principles also sensibly discuss the assignment of climate-related risks by board members and senior management to specific members and committees. This specific assignment can help ensure that climate risks are being managed, the assigned parties have the necessary knowledge and understanding, and the appropriate parties can be held accountable for any issues that arise. Additionally, identified risks can be escalated more easily and efficiently and understood by each responsible party along the chain of escalation.

Of course, the measurement of climate risks is appropriately a central theme throughout the principles. Measurement and analysis of risks are foundational to their identification, sizing, management, and mitigation. In the spirit of largely treating climate risks similar to other, more traditional risks, the principles reasonably promote the measurement and tracking of climate risks just as with other risks through risk management processes such as: data aggregation; qualitative or quantitative metrics or indicators to assess, monitor, and report climate-related financial risks; materiality thresholds; key risk indicators that align with their regular monitoring and escalation arrangements; and internal risk limits for the various types of material climate-related financial risks. However, the language around data and measurement should be more instructive, as discussed in more detail below.

Outside of the more standard risk management principles, the Committee has made some welcome additions. The Committee recognizes the key point that risks arising from climate change are evolving just as climate change is itself, a point that defines a major distinguishing factor of climate risks and one that is the basis for the following two additions beyond existing risk management principles. First, the Committee recognizes climate risks can materialize over longer time horizons as compared to more traditional risks and that banks must consider this in their management of climate risks. This is true for both physical and transition risks. Such recognition is necessary for climate risks to be properly considered and managed and appropriately encourages banks to think about how the risks will evolve over time and plan or take current actions accordingly. Second, the Committee specifically promotes the use of scenario analysis as a critical tool for sizing and identifying climate risks. Stress testing and scenario analysis are widely recognized as important tools for assessing evolving risks that can take many different paths over varying time horizons. These additions will promote banks to be both nimble and forward-looking, necessary aspects of managing climate risks.

Measurement is the Linchpin to Effective Risk Management, and So the Principles Should Promote of Minimum Standards

Being able to measure climate-related risks and exposures is fundamental to almost all categories of principles in the consultative document—capital and liquidity adequacy, the risk management process, management monitoring and reporting, and the comprehensive management of credit, market, liquidity, operational, and other risks. The guidance principles appropriately discuss the risk management processes noted above: data aggregation; qualitative or quantitative metrics or indicators to assess, monitor, and report climate-related financial risks; materiality thresholds; key risk indicators that align with their regular monitoring and escalation arrangements; and internal risk limits for the various types of material climate-related financial risks.

Without sufficient measurement techniques and criteria, banks will not be able to properly execute any of these risk management processes. For example, the process of simply determining which climate risks rise to the level of being material could yield unreliable results or underestimate the amount of material climate risks to the bank. Similarly, in the process of setting risk limits and monitoring against them, if data and measurements are unreliable, then not only would the limits be unreliable but so would the measurements against them, potentially making the entire process a worthless exercise.

So, while it is beneficial that the principles encourage banks to "put in place processes to ensure that the aggregated data is accurate and reliable," when it comes to data and measurements the principles do not address the "evolving nature of climate-related risks" that is also noted in the consultation document. This evolving nature and the general absence of data collection and climate risk measurement at banks make these processes more difficult to establish and more uncertain in their execution. This should be addressed in the proposed principles by promoting the use of or comparison to climate risk measurement "best practices."

Considering the consultative document is intended to support a principles-based approach to addressing climate risks, it is prudent not to be explicitly instructive as to which data to collect and which metrics to utilize. Discretion should be left to the banks so that they can collect data and design metrics and thresholds that are appropriate to the structure and risk profile of their business. The approach also allows for evolution and innovation within and among banks to create new best practices or improve upon existing practices.

However, given that climate risk management is in early stages and that there are not currently any generally accepted climate risk metrics or data collection requirements, banks should not be left entirely to their own discretion, and the supervisory principles should explicitly promote the use of or comparison to some agreed-upon best practices with regard to data collection and metrics. That is, the guiding principles should state that as banks establish their risk management practices, they should be looking to international organizations such as the Financial Stability Board's Task Force on Climate-Related Financial Disclosures or the United Nations International Panel on Climate Change for their recommendations on data collection, climate risk measurements, and risk management as an example of best practices.

In fact, many banks are already doing exactly that. All the U.S. Global Systemically Important Banks are disclosing information that is aligned with the TCFD recommendations with plans to increase the amount of such information and are registered supporters[3] of the TCFD recommendations. The most recent TCFD annual report published by the FSB from October 2021[4] shows that over 50% of firms disclosed climate-related risks and opportunities aligned with their recommendations. But just because some banks are voluntarily utilizing international recommendations does not mean there is no need to include the promotion of their use in the principles. It is even more reason to do so.

Not only will the use of or comparison to measurements from broadly available best practices be beneficial to banks, but it would be beneficial to supervisors as well. It will help set minimum expectations for banks and promote broad-based general standards across the industry, allowing for comparison between banks and the aggregation of risks across supervised institutions. Data and risk aggregation supports the monitoring of systemic risk build-up, which is critical to examining the safety and soundness of the system as a whole and is a key component to assessing overall financial stability within a country and across countries through collaboration or international supervisory organizations. This is especially important for climate risks, which are truly global.

Similarly, the Principles Regarding Scenario Analysis Lack the Promotion of Plausible Scenarios with Minimum Levels of Severity

Similar to data collection and climate risk measurement, the principles leave too much discretion to banks regarding their scenario analysis. While it is positive that the principles identify scenario analysis as a key tool for banks to be using in sizing and assessing their climate risks, the principles fail to include language that promotes the use of plausible scenarios that have some minimum level of severity.

Again, discretion is an important component of a bank's internal risk management practices. For scenario analysis, it allows a bank to design scenarios that are specific and unique to their business model and risk profile and to create new scenarios that may not have been imagined by their peers or regulatory authorities. However, allowing too much discretion can lead to banks potentially ignoring certain important aspects of climate change or designing scenarios that may not be as severe as generally accepted by the scientific community.

Therefore, the principles should encourage banks to benchmark their scenarios against internationally agreed-upon scenarios and scientific projections, such as those produced by the Network for Greening the Financial System or the climate projections created by the United Nations, to ensure some reasonable level of plausibility and severity. By looking to these scenarios and projections when designing their own scenarios, banks can determine a reasonable minimum level of severity. Of course, as noted banks must create scenarios that capture their unique risk profiles, but any material deviations from the benchmark scenarios that are used to capture unique risks can be explained in their summaries of scenario analyses to note why the deviations were made.

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[3] See the full list of registered supporting institutions at https://www.fsb-tcfd.org/supporters/

[4] Financial Stability Board's Task Force on Climate-related Financial Disclosures *2021 Status Report* (October 2021), available at https://assets.bbhub.io/company/sites/60/2021/07/2021-TCFD-Status_Report.pdf

The Principles Must Recognize Some Connection Between Banks Publicly Communicated Commitments and Their Risk Management Practices

The principles fail to draw a connection between the plans that have been publicly communicated by banks and their risk management practices. For example, many banks have made public commitments about transitioning to "net zero" by 2050 in accordance with the Paris Agreement. This is an indication of and public commitment to a business strategy that will affect the banks' positions regarding climate risks over time. Therefore, these commitments could influence how a bank manages its business around climate risks, and so the principles should be explicit that banks must draw the connection with their climate-related commitments in their risk management planning and reporting.

This is something the U.S. Office of the Comptroller of the Currency has addressed in its proposed climate supervisory principles: "Where banks engage in public communication of their climate-related strategies, boards and management should ensure that any public statements about their banks' climate-related strategies and commitments are consistent with their internal strategies and risk appetite statements." Including language like this is necessary to encourage banks to align their public commitments around climate goals within their businesses—whether short or long-term—with their internal risk management practices, such as risk limits. If there is not alignment, supervisors are left to wonder which is valid—banks' risk management practices or the public commitments, and the public is left to wonder if the commitments are valid and if the banks are effectively managing their risks.

Conclusion

Better Markets is fully supportive of the Committee in its efforts to promote the incorporation of climate risks into supervisory examinations and assessments. The proposed principles are significant and positive step in doing so, and we urge the Committee to finalize these principles as soon as possible and incorporate the enhancements we discuss above.

Sincerely,

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