

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

February 2022

Positive Money UK, EU, and US welcome the opportunity to respond to the Basel Committee's consultation on the management and supervision of climate-related financial risks.

We are a group of not-for-profit research and campaigning organisations, working towards reform of the money and banking system to support a fair, democratic and sustainable economy. We are funded by trusts, foundations and small donations.

If you would like to discuss any aspects of this response please contact David Barmes, Senior Economist at Positive Money: david.barmes@positivemoney.org.uk

1. 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?

- 1.1. The principles are a welcome step forward in addressing climate-related financial risks across jurisdictions, proposing a clear set of standards for both individual institutions and supervisors. However, the Committee should consider the following points.
- 1.2. **Double materiality:** The principles fail to account for the macro-contribution of finance to the causes of climate change, therefore, overlooking the build up of systemic risk. By applying a narrow lens of single materiality to climate-related financial risk, the principles only account for exposure of individual financial institutions to idiosyncratic transition and physical risks. This micro-prudential approach places the onus of responsibility for adapting to climate-related financial risk predominantly on climate vulnerable countries, which are already facing losses with limited financial capacity.¹ It does not create an incentive for financial institutions to stop the flow of finance to carbon intensive assets. As it is these flows of finance which are causing climate damage and creating financial instability, the principles do not establish a pathway for central banks and financial supervisors to fulfil their core mandates.
- 1.3. **Precautionary approach:** Climate-related financial risks are characterised by radical uncertainty, as is recognised in the introduction to the principles. Research conducted by the Bank for International Settlements itself states

¹<https://www.oecd.org/environment/managing-climate-risks-facing-up-to-losses-and-damages-55ea1c9-en.htm>

that, “the physical and transition risks of climate change are subject to multiple forces (natural, technological, societal, regulatory and cultural, among others) that interact with each other and are subject to uncertainty, irreversibility, nonlinearity and fat-tailed distributions”.² Climate-related risks do not have a calculable probability, are not represented in historical data, and do not have clear transmission channels, making them ill suited to a risk based methodological approach. In turn, the BCBS will only be able to adequately deal with climate-related financial risks by adopting the precautionary principle and falling in line with regulators in other areas, including the WHO and IPCC.³ For financial regulation, the precautionary principle advocates the utilisation of preventative macroprudential policies.

1.4. Application of Pillar 1: To prevent financial institutions from contributing to scenarios beyond 1.5 degree of warming, and thus creating systemic risk, changes to Pillar 1 capital requirements would be proportionate, impactful, and in line with the available climate science.⁴ The use of capital requirements for fossil fuel exposures would have the dual effect of building sufficient capital buffers to deal with idiosyncratic exposures to climate-related transition risk, and preventing systemic physical risk by disincentivizing the accumulation of fossil fuel assets on financial institution’s balance sheets.⁵ As central banks themselves within the NGFS,⁶ as well as the ECB⁷ and Bank of England⁸ have proposed the use of climate-calibrated capital requirements, BCBS would be operating well within the emerging supervisory consensus by establishing a standard of capital requirements for climate-related financial risks for all financial supervisors.

1.5. Solutions:

- 1.5.1. The Committee should follow recommendations from across civil society to introduce a One-for-One rule for stability: that every unit of currency of financing provided to new fossil fuel projects be matched by one equivalent unit of currency of financial institutions’ own funds.⁹
- 1.5.2. The Committee should also consider restrictions on lending to climate destructive activities. Where climate risk is excessively high, supervisors should consider imposing limits on the financing of certain categories of activities, such as new fossil fuel exploration and

² <https://www.bis.org/publ/othp31.pdf>

³ <https://www.sciencedirect.com/science/article/pii/S092180092100015X>

⁴ https://www.ipcc.ch/report/ar6/wg1/downloads/report/IPCC_AR6_WGI_SPM_final.pdf

⁵ <https://www.finance-watch.org/publication/report-a-silver-bullet-against-green-swans-incorporating-climate-risk-into-prudential-rules/>

⁶ https://www.ngfs.net/sites/default/files/medias/documents/ngfs_guide_for_supervisors.pdf

⁷ https://www.ecb.europa.eu/pub/financial-stability/macprudential-bulletin/html/ecb.mpbu202110_1~5323a5baa8.en.html

⁸ <https://www.bankofengland.co.uk/prudential-regulation/publication/2021/october/climate-change-adaptation-report-2021>

⁹ <https://www.finance-watch.org/wp-content/uploads/2021/11/One-for-One-Joint-letter-BCBS.pdf>

extraction.¹⁰ This would directly limit climate risk, which is not guaranteed by market driven approaches.¹¹

- 1.5.3. The Committee should consider using capital requirement adjustments to reflect the reduced risk of certain mortgage credit lending or renovation loans collateralized by real estate assets, if and when it can be evidenced that energy efficient renovations have decreased the risk profile of the borrower¹² and under the condition that such relief on capital requirements translates into lower interest rates for consumers on mortgages and renovation loans, as has been pioneered by the Hungarian Central Bank.¹³
- 1.5.4. Under pillar 3, banks should be required to collect data on the energy performance (such as energy performance certificates) of all real estate assets that are mobilised as underlying collateral for loans¹⁴, in order to assess and facilitate climate-risk assessment and Paris alignment of mortgage portfolios.

- 1.6. Timing:** The gradual approach proposed by the principles to addressing climate-related financial risk will itself increase both transition and physical risks. Following the available data provided by stress tests, waiting to collect granular data before acting will increase the likelihood of both catastrophic physical risk and a disorderly transition.¹⁵ The focus of the principles should be altered from the collection and disclosure of data, to action from financial institutions using the available data and climate science.¹⁶

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

2.1. Financial institutions:

- 2.1.1. Principles 5-12 offer little incentive for financial institutions to change the management of climate-related financial risks identified on their balance sheets. As long as profit can be made from financing climate-destabilising activities, stress tests, disclosures and risk management mechanisms will not alter investment behaviour.¹⁷ Pillar 2 requirements should involve mandatory targets and transition plans showing how financial institutions will achieve net zero by 2050, as well as intermediate milestones. Such transition plans should be

¹⁰ https://www.ngfs.net/sites/default/files/medias/documents/ngfs_guide_for_supervisors.pdf

¹¹ https://www.ecb.europa.eu/pub/financial-stability/macprudential-bulletin/html/ecb.mpbu202110_1~5323a5baa8.en.html

¹² <https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2020/does-energy-efficiency-predict-mortgage-performance.pdf>

¹³ <https://www.climatebonds.net/2020/01/how-hungarian-central-bank-could-help-solve-energy-efficiency-puzzle-mnb-goes-green-housing>

¹⁴ As proposed by EBA

<https://www.eba.europa.eu/eba-publishes-binding-standards-pillar-3-disclosures-esg-risks>

¹⁵ <https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op281~05a7735b1c.en.pdf>

¹⁶ <https://www.ecb.europa.eu/press/key/date/2021/html/ecb.sp210616~44c5a95300.en.html>

¹⁷ <https://www.finance-watch.org/wp-content/uploads/2021/11/A-Silver-Bullet-Against-Green-Swans-capital-requirements-climate-risk.pdf>

integrated into core governance frameworks and be linked to remuneration as is starting to be trialled in large financial institutions.¹⁸

2.1.2. Under Principles 5-12, financial institutions will be enabled to base their risk management strategies on short term investment horizons, rather than on the timeline in which these investments will impact the climate.¹⁹ The IEA is clear that to prevent climate-destabilisation in the future, financing for the energy sector must now be operating on a principle of no new fossil fuel exploration and extraction.²⁰ The principles must be based on climate science rather than investment expectations and timelines.

2.2. Supervisors: Principles 13-15 do not include any requirements for supervisors to evaluate individual institutions' perceived capital adequacy, creating a potential for regulatory arbitrage whereby financial institutions underestimate the required resilience to deal with material climate risk. Moreover, the stress tests carried out by individual institutions will not explore and understand systemic risk. These principles should require supervisors to carry out system wide stress tests to understand the wider manifestations of climate-related financial risk on the group level. Practically, this will require the incorporation of the principle of double materiality.

3. 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?

3.1. Combined climate-related and environmental risks: Climate-related financial risks are themselves connected to and overlapping with broader environmental risks. They should not be considered as separate, but tackled together, as there is the potential for negative feedback loops where climate and environmental risks reinforce one another.²¹

3.2. Radical uncertainty in environmental risk: Broader environmental risks include variables made up from the entire biosphere, which have more complex interactions and interdependencies.²² They, in turn, have a greater potential for tipping points, which create non-linear, unprecedented and irreversible outcomes.²³ As international agreements on broader

¹⁸https://www.db.com/news/detail/20201207-deutsche-bank-plans-to-link-compensation-to-sustainability-criteria?language_id=1

¹⁹<https://www.bankofengland.co.uk/speech/2015/breaking-the-tragedy-of-the-horizon-climate-change-and-financial-stability>

²⁰https://iea.blob.core.windows.net/assets/deebef5d-0c34-4539-9d0c-10b13d840027/NetZeroBy2050-ARoadmapfortheGlobalEnergySector_CORR.pdf

²¹https://www.ngfs.net/sites/default/files/medias/documents/ngfs_guide_for_supervisors.pdf

²²<https://publications.banque-france.fr/en/silent-spring-financial-system-exploring-biodiversity-related-financial-risks-france>

²³<https://www.ucl.ac.uk/bartlett/public-purpose/wp2020-09>

environmental damage have fallen behind climate action, these risks are even more likely to be overlooked by financial institutions. BCBS should act with urgency to apply the precautionary principle to protecting nature, to prevent the build-up of both environmental and climate- related financial risks.