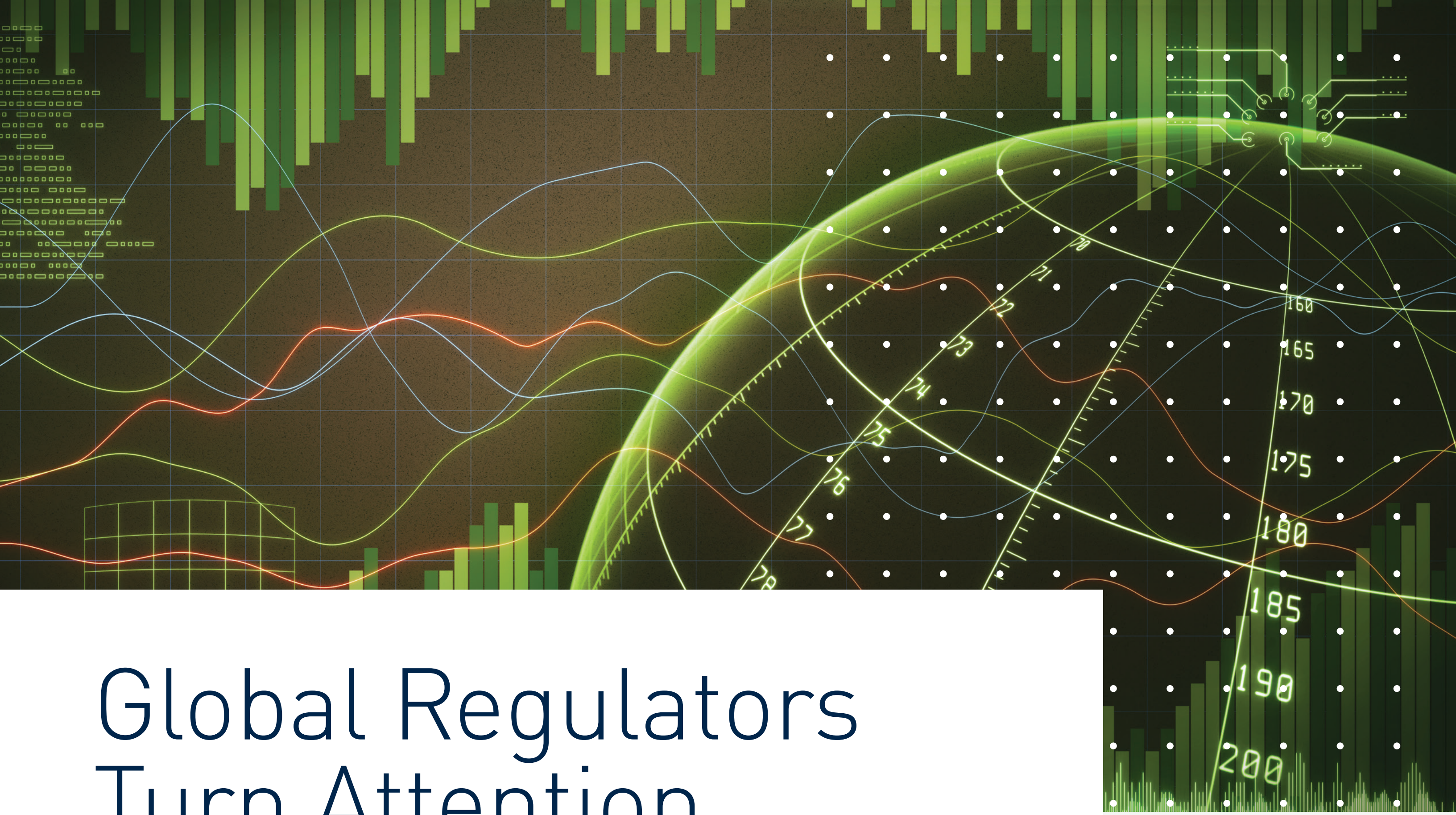

Global Regulators Turn Attention to Climate Risk Supervision

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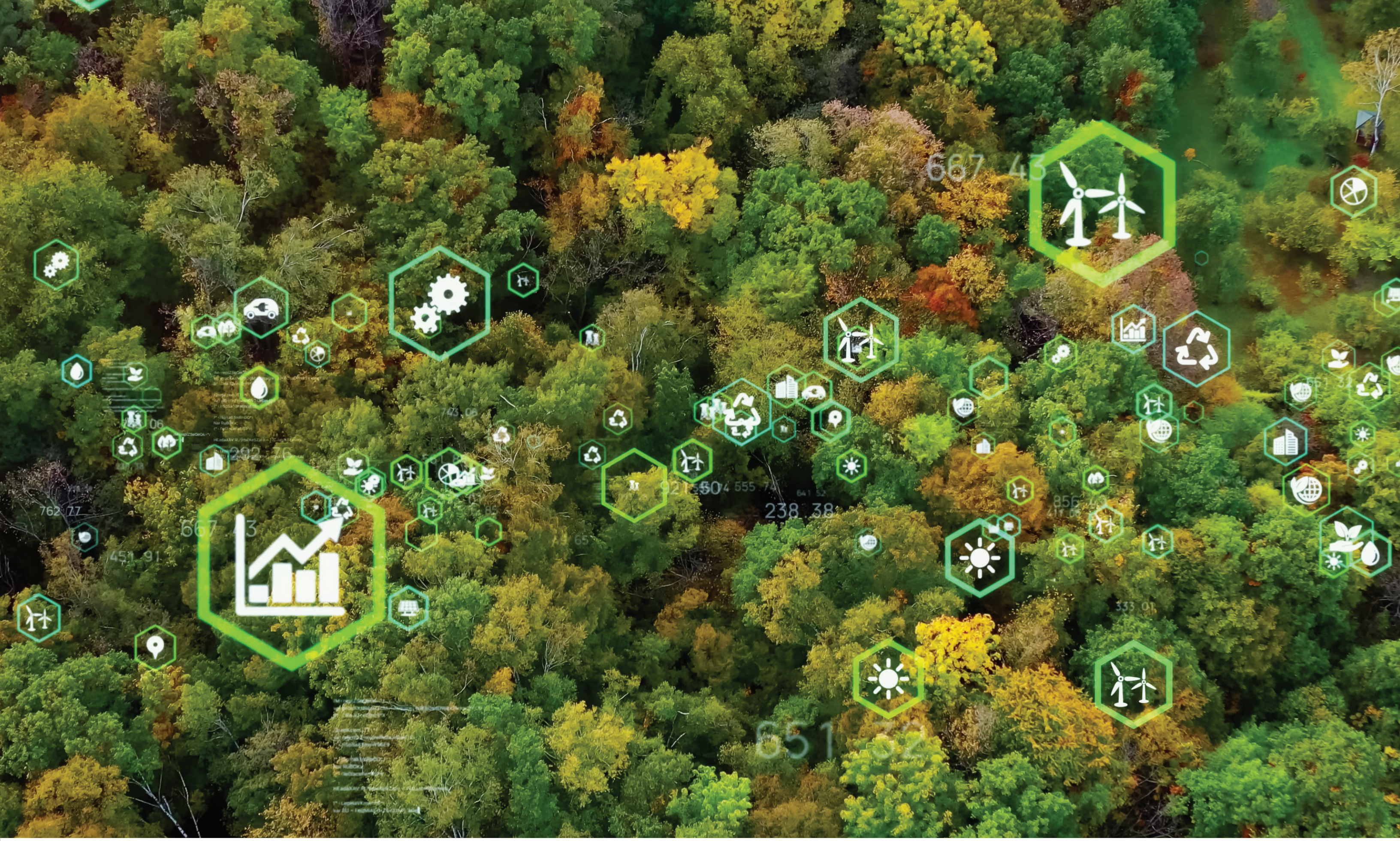

The potential impact of climate risk on financial institutions has intensified significantly over the last eighteen months. Financial institutions have been struggling to prepare for an uncertain array of potential economic, financial, and regulatory impacts. While financial institutions may have started to realign portfolios or assess the impact of climate change on their lending and asset pools, there has been little impetus beyond some market drivers. Regulators have been quiet on what they expect to see from financial institutions—until now.

In November 2021, the Basel Committee on Banking Supervision (BCBS)[1] issued a consultative document, *Principles for the effective management and supervision of climate-related financial risks*.[2] This document provides a series of principles that global regulators are suggesting be used for banks to manage their exposure, and for supervisors to use to assess financial institutions' programs.

The consultative document is open for comment until February 16, 2022.

According to the BCBS, all banks regardless of size and complexity are exposed to climate-related financial risks. Financial institutions should have processes to identify and assess their exposures to determine materiality of both direct and indirect exposures. The time horizon for climate-related financial risks is still fluid and may be out of standard planning-time horizons. Financial institutions will need to think beyond traditional timelines.

1 The Basel Committee on Banking Supervision is a committee of banking supervisory authorities that was established by the central bank governors of the Group of Ten countries in 1974. It provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide.

2 BCBS, *Principles for the effective management and supervision of climate-related financial risks*, consultative document (November 16, 2021). https://www.bis.org/bcbs/publ/d530.htm

The BCBS emphasized the following principles:[3]

Principles for the management of climate-related financial risks

1. Banks should develop and implement a sound process for understanding and assessing the potential impact of climate-related risk drivers on their businesses and on the environments in which they operate. Banks should consider material climate-related financial risks that could manifest over various time horizons and incorporate these risks into their overall business strategies and risk management frameworks.
2. The board and senior management should clearly assign climate-related responsibilities to members and committees and exercise effective oversight of climate-related financial risks. The board and senior management should identify responsibilities for climate-related risk management throughout the organisational structure.
3. Banks should adopt appropriate policies, procedures and controls to be implemented across the entire organisation to ensure effective management of climate-related financial risks.
4. Banks should incorporate climate-related financial risks into their internal control frameworks across the three lines of defence to ensure sound, comprehensive and effective identification, measurement and mitigation of material climate-related financial risks.
5. Banks should identify and quantify climate-related financial risks and incorporate those assessed as material over relevant time horizons into their internal capital and liquidity adequacy assessment processes.
6. Banks should identify, monitor and manage all climate-related financial risks that could materially impair their financial condition, including their capital resources and liquidity positions. Banks should ensure that their risk appetite and risk management frameworks consider all material climate-related financial risks to which they are exposed and establish a reliable approach to identifying, measuring, monitoring and managing those risks.
7. Risk data aggregation capabilities and internal risk reporting practices should account for climate-related financial risks. Banks should seek to ensure their internal reporting systems are capable of monitoring material climate-related financial risks and producing timely information to ensure effective board and senior management decision-making.
8. Banks should understand the impact of climate-related risk drivers on their credit risk profiles and ensure credit risk management systems and processes consider material climate-related financial risks.
9. Banks should understand the impact of climate-related risk drivers on their market risk positions and ensure that market risk management systems and processes consider material climate-related financial risks.
10. Banks should understand the impact of climate-related risk drivers on their liquidity risk profiles and ensure that liquidity risk management systems and processes consider material climate-related financial risks
11. Banks should understand the impact of climate-related risk drivers on their operational risk and ensure that risk management systems and processes consider material climate-related risks. Banks should also understand the impact of climate-related risk drivers on other risks and put in place adequate measures to account for these risks where material. This includes climate-related risk drivers that might lead to increasing strategic, reputational, and regulatory compliance risk, as well as liability costs associated with climate-sensitive investments and businesses.
12. Where appropriate, banks should make use of scenario analysis, including stress testing, to assess the resilience of their business models and strategies to a range of plausible climate-related pathways and determine the impact of climate-related risk drivers on their overall risk profile. These analyses should consider physical and transition risks as drivers of credit, market, operational and liquidity risks over a range of relevant time horizons.

3 BCBS (2021).

Principles for the supervision of climate-related financial risks

13. Supervisors should determine that banks' incorporation of material climate-related financial risks into their business strategies, corporate governance and internal control frameworks is sound and comprehensive.
14. Supervisors should determine that banks can adequately identify, monitor and manage all material climate-related financial risks as part of their assessments of banks' risk appetite and risk management frameworks.
15. Supervisors should determine that banks comprehensively identify and assess the impact of climate-related risk drivers on their risk profile and ensure that material climate-related financial risks are adequately considered in their management of credit, market, liquidity, operational, and other types of risk. Supervisors should determine that, where appropriate, banks apply climate scenario analysis.
16. In conducting supervisory assessments of supervised banks' management of climate-related financial risks, supervisors should utilise an appropriate range of techniques and tools and adopt adequate follow-up measures in case of material misalignment with supervisory expectations.
17. Supervisors should ensure that they have adequate resources and capacity to effectively assess banks' management of climate-related financial risks.
18. Supervisors should consider using climate-related risk scenario analysis, including stress testing, to identify relevant risk factors, size portfolio exposures, identify data gaps and inform the adequacy of risk management approaches. Where appropriate, supervisors should consider disclosing the findings of these exercises.

Assessment of the Principles: Implications for Financial Institutions

- The principles provide strong insight into the current thinking of international regulators as it relates to climate-related financial risk.
- The regulators do not use one clear silver bullet in analyzing and assessing climate-related financial risks for financial institutions. Instead, they are looking for financial institutions to assess their risks individually.
- The regulators call out scenario analysis as a useful tool for informing the materiality assessment over a variety of time horizons. This will mean using an approach to scenario analysis that does not fit into the CCAR[4] aapproaches many banks have used historically. These tools may be useful in forming the base, but they will need to be expanded to incorporate broader time horizons, economic implications that may not yet be clear, and assessments of the transitions risk exposures may take over time. Financial institutions should look to analyze their individual portfolios and develop analytics to assess the impact of policy decisions and market movements.
- Regulators will be looking to make sure that financial institutions are incorporating the climate-related financial risks into their traditional risk management, governance, and decision-making capabilities.
- There is an acceptance that climate-related financial risks will impact financial institutions, but it is unclear exactly how. Regulators are looking for financial institutions to conduct the due diligence so that, in some respect, those analyses can inform regulatory policy.
- Regulators are providing a roadmap on how to make sure the assessment of climate-related financial risks is comprehensive. They specifically call out the need to assess climate-related financial risks as they relate to credit, market, operations, liquidity, and capital. They also identify the need to assess reputational, strategic, and regulatory compliance risks. Financial institutions need to ensure that their analyses contemplate the impacts for each risk type.
- Regulators consistently use the term "material" throughout the document. The use of this term indicates that the supervisors recognize that climate-related financial risk is not a meaningful risk to all institutions. There is no one-size-fits-all approach. This allows financial institutions to decide their own paths and create their own assessments. However, it does not provide a clear path that many financial institutions look for from regulators.

4 Comprehensive Capital Analysis and Review

How Can BRG Help?

BRG's Energy & Climate and Financial Institution Advisory practices work together to assist financial institutions with the development of climate-related financial risk assessment programs, including:

- incorporating climate-related financial risk assessments into existing risk identification processes
- providing proxy data to assist in the determination of materiality
- developing analytics to support portfolio analytics, optimization, and asset liability management analytics
- providing market insight for context into the assessment of the impact for market and liquidity implications
- designing scenarios and providing data related to market transactions and credit implications based on our professionals' experience with energy and industrial loan portfolios
- providing strategic analysis of energy industry market, economic, and environmental fundamentals

About BRG

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