Re: Comments on the Core Principles for Effective Banking Supervision

To the Basel Committee on Banking Supervision (the “Committee”):

On behalf of the Natural Resources Defense Council (NRDC), we are pleased to submit these comments on the Committee’s draft revisions to its Core principles for effective banking supervision (“Core Principles”). NRDC is an international nonprofit environmental organization with more than 3 million members and online activists. Since 1970, our lawyers, scientists, and other environmental specialists have worked to protect the world’s natural resources, public health, and environment. NRDC has offices in New York City, Washington D.C., Los Angeles, San Francisco, Chicago, Montana, and Beijing. Through its finance and legal experts, NRDC remains engaged in financial regulation and views sensible financial regulation as an integral part of mitigating climate change.

The explicit inclusion of climate-related financial risk in the Core Principles is pivotal for continuing to integrate this risk into the banking supervisory and risk management framework (following last year’s release of the Committee’s stand-alone Principles for the effective management and supervision of climate-related financial risks). Currently, the Core Principles offer little instruction to bank supervisors on how financial institutions can integrate climate-related financial risks into their risk management frameworks and manage them along with traditional risks. The proposed new references to climate can help ensure that banks begin to manage these risks, but must be strengthened to provide further guidance for supervisors to help them understand the specific ways in which climate risk can manifest as traditional financial risk. Additional tools, such as transition plans where appropriate, and further refinements of existing methodologies, will help supervisors develop stronger approaches for incorporating climate-related financial risks into their oversight and assist banks in maintaining solvency and business continuity in the face of climate change.

The Core Principles Should Instruct Supervisors on Climate Risk as Traditional Risk

The proposed revisions give only cursory attention to climate risk as a component of other recognized risk types; this limited coverage provides inadequate guidance for supervisors. The consultative document references climate-related financial risk in the context of Principle 8 – Supervisory approach, Principle 10 – Supervisory reporting, Principle 15 – Risk management process, and Principle 25 – Operational risk and operational resilience. At the same time, the consultative document specifically covers many important areas of risk management without mentioning climate-
related financial risk at all. While it is heartening to see climate-related financial risk introduced with reference to basic principles of supervision, this is not adequate to instruct supervisors on how to supervise. Climate-related financial risk must be taken into account in more specific risk management areas.

We encourage the Committee to consider the ways that climate-related financial risk can manifest itself through the lens of the traditional types of risk already addressed in the Core Principles – in particular, Principle 17 – Credit, Principle 22 – Market risk, Principle 24 – Liquidity risk, and Principle 25 – Operational risk. We recommend that the consultative document’s treatment of the supervision of these specific types of risk be enhanced to make explicit for supervisors how climate risk factors into those risk types:

- **Principle 17 – Credit risk.** Credit risk includes both credit exposure, and valuation and safeguarding of collateral held to cover that exposure. Some counterparties may be particularly vulnerable to climate-related financial risks (including climate-related market risks as described further below); credit risk analyses must take account of these risks.

Supervisors considering how climate risk may manifest itself as credit risk should ask:

- **Physical risk:** How are borrowers, counterparties, and investments subject to climate-related losses from climate disasters or incremental climate shifts, including storms, flooding, wildfires, etc.?
- **Transition risk:**
  - Will borrowers or counterparties suffer higher probabilities of default and losses-given-default as markets transition away from carbon?
  - What is the stranded asset value-at-risk that a financial institution faces?
    - What are the bank’s plans for reducing this risk in an orderly fashion?
    - Is there fire sale risk?
- **Credit committee:** Does the bank’s credit committee factor in climate-related financial risks in its decisions?
  - Does the bank’s credit committee consider climate-related risks in decisions to make new loans, particularly to the borrowers and projects with the highest degree of physical and transition risk, including for oil, gas, and coal projects and including for overseas projects? How does the bank evaluate climate-related risks in loan underwriting, particularly for longer-term loans?
  - How does the bank treat mitigation by borrowers of climate-related risks in loan underwriting and pricing decisions?
  - Is the bank’s credit committee considering climate-related risks in decisions to waive loan covenants, restructure loans, or take other actions with respect to outstanding credit and exposures?
  - How does the bank’s loan documentation mitigate climate-related risks?
- **To what extent have climate-related risks led to asset impairment?**
- **How does the bank hedge climate-related credit risk?**
• **Principle 19 – Concentration risk and large exposure limits.** Climate-related financial risk can affect a portfolio via industry and geographic concentrations. For example, a loan or derivatives portfolio may be heavily exposed to drought risk via loans to farmers, or an insurance portfolio may be exposed to hurricane and flood risk via mortgages on coastal property (note, for example, the recent insolvency of U.S. regional insurers in Florida, Louisiana and Texas\(^1\)). As extreme climate events increase, assets with geographic diversification may face near simultaneous climate-related shocks: for example, drought in one region and multiple hurricanes in another. Similarly, heavy exposure to fossil fuel loans, investments, or counterparties comes with transition risk, given the risk of a disorderly transition with dramatic declines in fossil fuel prices as the market reacts to manifestations of climate change; a disorderly transition could precipitously impair the value and liquidity of collateral and loan repayment prospects in the fossil fuel sector.

Supervisors considering how climate risk may manifest itself as concentration risk should ask:

- Are the bank’s assets concentrated in geographic areas or industries subject to physical or transition risk?
- How is the bank hedging these risks?
- Do risk-spreading and risk transfer mechanisms (such as insurance, reinsurance, or capital markets) have the capacity to absorb increases in correlated risk?

• **Principle 22 – Market risk.** Factors affecting market risk can include, among other things, market exposure, price volatility, basis and correlation risk, leverage, and position concentration. Climate-related events can have significant effects on asset prices. The prices of assets exposed to physical climate risks or transition risks may be inflated due to market opacity, underestimation of the relevant risks, or the potentially correlated nature of risks. A significant climate event can trigger a sudden re-valuation of assets or asset classes. A re-valuation can also be triggered by businesses’ efforts to mitigate their exposure to such an event; for example, by suddenly exiting short-term assets that are exposed to climate-related financial risk.\(^2\)

Supervisors considering how climate risk may manifest itself as market risk should ask:

- **Physical risk:** What losses will a bank face if securities and commodities investments are repriced because of climate-related disruptions?

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\(^1\) For a list of Florida insurance companies in receivership, see State of Florida Chief Financial Officer, *Rehabilitation and Liquidation: Companies in Receivership*, https://www.myfloridacfo.com/division/receiver/companies. For a list of Louisiana insurance companies in receivership, see Louisiana Department of Insurance, *Receivership Section*, https://www.ldi.la.gov/industry/financial-regulation/receivership. For a list of Texas insurance companies in receivership see Texas Department of Insurance, *Receiverships in Texas and contact information*, https://www.tdi.texas.gov/receiverships/officesofsdrs.html#house.

Transition risk: What losses will a bank face due to price fluctuations in securities and commodities investments if carbon-intensive assets are repriced, whether due to government action or other market changes?

Does the bank use Value-at-Risk models to assess this risk? What are the assumptions embedded in, and limitations of, these models? What is the tail risk?

Does the bank base its physical climate risk projections on historical data alone? How do its climate forecasting tools model the changing frequency and loss severity of future climate-related disasters?

How does the firm hedge climate-related market risk?

What risks does the bank face from a rising cost of capital if investors and bondholders seek out banks with lower climate risk and less financing of carbon emissions? (This could also be classified as “reputational risk.”)

Principle 24 – Liquidity risk. Direct or indirect exposure to acute or gradual climate harms may hurt borrowers’ ability to repay their debts, leading to a cascade of defaults. In the United States, for example, long-term mortgages are bank assets that are traditionally paired with annually renewed homeowner insurance policies. A repricing of, or failure to renew, those insurance policies as insurers price in the risk of acute climate events (as we are seeing already in several regions) may increase the cost of homeownership with serious financial implications for borrowers, leading to delinquencies and defaults on a critical scale and affecting property values in climate-exposed areas. Banks with balance sheets subject to the related credit and market risks could find themselves unable to refinance in the short term.

Supervisors considering how climate risk may manifest itself as liquidity risk should ask:

Are long-term assets exposed to physical climate risk or transition climate risk?

Does the bank have exposure (or potentially rising exposure) to assets that may become difficult to sell due to climate-related policy or technological developments?

Are sources of short-term financing at risk of disruption due to climate events?

Principle 25 – Operational risk. Regional climate disasters may result in widespread impairment of financial market infrastructures or systems. For instance, a weather disaster may affect the physical operations of banking institutions themselves, or the operations of multiple counterparties or clearing houses, causing cascading failures across other institutions or sectors. With the heavy reliance on internet resources, weather risks that potentially threaten reliable

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access to internet may be of particular concern. Risk management units should consider how acute climate events or long-term climate shifts may adversely affect operations and operational resilience across business lines, including third-party operations.4

Supervisors considering how physical climate risk may affect a bank’s operations should ask:

• Are the firm’s headquarters and its major operational centers subject to increased risk of catastrophic storms, flooding, or wildfires? How could these events affect operations, particularly timely transaction capabilities?
• How is the infrastructure on which the firm relies (including information systems) subject to these risks? Is the firm subject to operational losses because of climate-related threats to:
  o exchanges and market utilities; or
  o electrical and water supply?
• How has the firm modeled the climate-related aspects of operational risk? What are the limitations of that modeling?
• What contingency plans does the firm have for operational risk and its climate-related aspects?

Add Transition Plans as a Supervisory Tool in the Core Principles to Ensure Accountability for Net-Zero Commitments

For banks that make net zero commitments, the Core Principles should include transition plans in the set of tools for supervisors to add specificity to the bank’s decarbonization strategy.

• CP8 Supervisory Approach and CP9 Supervisory Techniques and Tools. Recently, the U.S. Treasury Department published principles that lay out best practices for financial institutions that have made or are considering making net-zero commitments. The Treasury’s principles are voluntary, but many financial institutions have already taken actions according to the best practices they highlight. A key element of the Treasury’s principles is the development of transition plans. Transition plans translate an institution’s net-zero commitment into specific objectives and actions that are aimed at reducing real-economy GHG emissions, providing credibility and accountability to net-zero commitments. They help set shared expectations and goals for net-zero commitments between the institution, its clients, and the regulating bodies.

A forward-looking approach and a long-term view are essential when addressing climate-related financial risks. The Core Principles should mention transition plans as a tool to help supervisors understand and oversee climate-related financial risks in a forward-looking manner for those banks with net-zero commitments. Financial supervisors have already recognized the role of

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transition plans as a source of information and a possible supervisory tool.\textsuperscript{5} It is important that supervisors also recognize the 2050 net-zero emissions horizon established in the Paris Agreement objectives (2050) as a common anchor point for transition planning. Supervisors should then assess whether banks have set appropriate climate targets, including intermediate targets, and whether they are reaching those targets to mitigate relevant risks.

- **CP10 Supervisory Reporting.** The proposed revisions to Core Principle 10(1) would provide that supervisors have the power to require banks to submit information to allow for the assessment of the materiality of climate-related financial risks. This is a meaningful provision, and it should be made explicit that such information should include banks’ transition plans when banks have made net-zero commitments. They are essential to understand banks’ climate strategy, targets, and decarbonization accomplishments to date, and, based on these, to assess whether banks are in the position to manage their climate-related risks.

- **CP15 Risk Management Process.** Risk management guidance is essential and should endeavor to introduce new tools to manage climate-related financial risks. Numerous supervisors have previously emphasized the existing challenges in the management and supervision of climate-related risks in the supervisory guidance of their respective jurisdictions.\textsuperscript{6}

The Core Principles Should Help Supervisors Develop Approaches to Mitigate the Impact of Climate-Related Financial Risks


\textsuperscript{7} The CSRD will be the first reporting regime to introduce mandatory double materiality-based climate change disclosures for nearly 50,000 entities operating in the European Union.
Supplementing the Core Principles with more climate-specific guidance and tools will help supervisors develop better approaches to mitigate impending climate risks.

- **CP 9 Supervisory Techniques and Tools.** Climate scenario analysis is a crucial tool for understanding and preparing for the potential risks of climate change. Many central banks and financial institutions have taken the critical first step in quantifying climate-related financial risks for their operations and the financial system.\(^8\) Now that initial results of those analyses have been published or are in process, banks and supervisors can work to refine their use of these analyses to align more closely with 1.5 degree warming targets. By aligning with agreed-upon targets, climate scenario models can more precisely project the relevant risks to individual institutions and the financial system. Current dominant climate models are calibrated on historical data which do not provide good estimates for climate-related financial risks.

Given the uncertainty and complexity associated with climate change, using a precautionary approach—emphasizing caution and risk mitigation—to assess climate-related financial risks prioritizes financial solvency and operational sustainability in the face of a changing climate. A precautionary approach in climate scenario analysis involves taking proactive measures and making decisions that prioritize avoiding or mitigating potential harm from climate change in the face of scientific uncertainties. By emphasizing worst-case scenarios and prioritizing actions that reduce risks associated with climate-related impact, the scenario analyses will reflect the idea that it is prudent to take proactive measures to address climate change, especially given the scientific uncertainties inherent to modeling climate change.

- **CP16 Capital Adequacy.** The Core Principles’ guidance for bank supervisors does not include evaluation of the adequacy of banks’ capital levels to cover climate-related financial risks. If supervisors identify material climate-related risks, the proposed revisions should provide supervisors the tools to ensure banks remain safe and sound, such as ensuring stronger capital adequacy standards. Thus, supervisors should help develop approaches that will assist financial institutions mitigate the impact of climate-related financial risks on their solvency.

Allowing supervisors to impose a simple, transparent, non-risk-based measure that captures all on- and off-balance sheet exposures to supplement risk-based capital requirements to constrain the build-up of leverage, as provided in proposed CP16 (7), is a reasonable first step and can help to create a critical buffer to avoid the build-up of leverage like those that preceded the 2008 financial crisis. Raising the leverage ratio requirement by adding a capital add-on requirement—potentially reflecting the inclusion of climate considerations—can ensure a strong

backstop for risk-based capital. Consistent with the risk-based nature of prudential capital rules, this will permit supervisors to increase capital requirements when they determine that such an increase is warranted by identified climate-related financial risks.

Use Insurance or Derivatives as a Mitigation Strategy with Caution

- **CP 26 Internal Control and Audit.** Beyond internal controls, banks frequently use insurance and derivatives to mitigate climate-related financial risks, but there is a danger of relying on such measures to mitigate these risks. Banks require insurance coverage to mitigate potential losses due to any loss event, including climate disasters. However, risks from both the insured and/or the insurer could revert the climate-related risks to the banks themselves.

  For example, borrowers are often required to provide proof of insurance coverage for loan closing purposes. However, as regions prone to climate change effects are subject to increased risk pricing, hollowed-out policies or higher premiums (or worse, the discontinuation of coverage) can lead to lapses in coverage for borrowers in these areas. Moreover, even when an asset is covered by an insurance policy, there can be a severe underweighting of risk for these assets if the insurance policy is valued incorrectly because the associated climate risk is not accurately modeled.

  Counterparty credit risk could also swell during climate disasters as the insurers themselves are highly susceptible to climate-related risks. Many insurers invest their assets in investments vulnerable to climate disasters or transition risk. Climate events could drain the liquidity of asset pools insurers use for funding payouts. Moreover, improperly assessed climate risks can lead to insufficient payouts as risk assessment maps of disaster-prone regions are not up to date.

The Core Principles should provide guidance on these issues and direct supervisors to review related principles, such as “Recognising the risk-mitigating impact of insurance in operational risk modelling,” to reflect the evolving concerns around insurance and its climate-related risks.

Supervisors and Banks Should Seek to Avoid or Mitigate Disproportionate Negative Effects on Disadvantaged Communities

In addition to the comments above, we highly recommend taking potential impacts on disadvantaged communities into account. There is a real danger that the adoption of enhanced climate risk mitigation measures by banks may disproportionately affect climate-burdened communities, including lower-income communities and communities of color. We urge the Committee to consider additional research and guidance to address likely effects on these communities.

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A substantial and growing literature demonstrates that many climate-related risks, such as the risk of weather-induced hazard or sea level rise, are likely to be disproportionately borne by lower income communities and communities of color. Of particular concern are risk mitigation measures that force individual households and small businesses to internalize climate-related risks without providing solutions to reduce their risk. Such measures may significantly restrict access to credit within already-disadvantaged communities, further reducing their capacity to respond to climate-related challenges such as weather-related disasters or sea level rise. Mitigation options such as imposing loan restrictions or limiting exposure to certain geographical regions, could have this effect. NRDC recommends that banks evaluate a broad range of mitigation options and prioritize options that do not restrict fair access to credit for climate-burdened communities.

In addition, fiscal policies and civil society will necessarily play an important role in mitigating local effects like these of changes in bank risk management practices. For this reason, NRDC strongly supports the recommendations that banks collaborate with a broad and diverse set of stakeholders and establish frameworks for communicating and coordinating changes in bank policy with relevant domestic and cross-jurisdictional authorities, set forth in the *Principles for the Effective Management and Supervision of Climate-Related Financial Risks*\(^\text{10}\), and incorporating them directly into the Core Principles.

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We thank the Committee for its consideration of our comments. If we can be of any further assistance, please do not hesitate to contact us.

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