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# Basel climate report: Key takeaways for the banking sector

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Here are our key takeaways from the Basel Committee's final *Principles for the Effective Management and Supervision of Climate-Related Financial Risks* (the "Basel Principles").

## 1. The core elements of the Basel Principles align closely with proposed principles from the OCC and FDIC

- The Basel Principles[1] align closely with the climate-related risk management principles proposed by the Office of the Comptroller of the Currency (the "OCC Proposal")[2] and the Federal Deposit Insurance Company (the "FDIC Proposal").[3]
- The Basel Principles are part of the Basel Committee on Banking Supervision's (the BCBS or the "Basel Committee") work of assessing how the Basel framework can address climate-related financial risks, identifying potential gaps and possible measures to address any such gaps. The BCBS intends for the Basel Principles "to promote a principles-based approach to improving risk management and supervisory practices related to climate-related financial risks." To that end, the Basel Principles are divided into two main parts: guidance for banks on the effective management of climate-related financial risks and guidance for prudential supervisors.
- For banks, the Basel Principles outline climate-related risk management approaches to corporate governance and strategic planning; the internal control framework across the three lines of defense; internal capital adequacy and internal liquidity adequacy assessment processes; risk appetite framework and risk mitigation measures; risk data aggregation, collection and reporting;

[1] Basel Committee on Banking Supervision, *Principles for the Effective Management and Supervision of Climate-Related Risks* (June 2022), https://www.bis.org/bcbs/publ/d532.pdf (hereinafter the "Basel Principles"). The Basel Principles build on two reports issued by the BCBS in April 2021: *Climate-Related Risk Drivers and Their Transmission Channels*, https://www.bis.org/bcbs/publ/d517.pdf (hereinafter the "Risk Drivers Report") and *Climate-Related Financial Risks – Measurement Methodologies*, https://www.bis.org/bcbs/publ/d518.pdf (hereinafter the "Methodologies Report"). The Risk Drivers Report concluded, among other things, that banks are exposed to climate change through two types of climate risk: (1) physical risks (economic costs and losses resulting from the severity and frequency of physical climate risk drivers) and (2) transition risks (risk drivers arising from efforts to reduce greenhouse gas emissions, such as changes in government policies, technological developments and investor sentiment). *See* Risk Drivers Report, at 6-8. The Risk Drivers Report also concluded that the impact of these two categories of risk drivers can be captured through traditional risk categories already used by financial institutions and reflected in the Basel framework, i.e., credit risk, market risk, liquidity risk, operational risk and reputational risk (although this last category is not specifically reflected in either the Basel capital framework or the Basel liquidity framework). *See id.* at 1; The Basel Principles, at 2. The Methodologies Report concluded, among other things, that both banks and supervisors are at an early stage of translating climate-related risks into robustly quantifiable financial risks and that more work needs to be done in two main areas: (1) measurement gaps in the data available for assessing physical and transition risks, and in methods of mapping climate risk drivers to financial exposures, and (2) methodologies for capturing climate-related financial risks need to overcome uncertainties inherent in projections of physical and transition risk drivers, uncertainties arising from data gaps, and uncertainties in the models to be used for quantitatively assessing identified climate risk drivers and their impacts on banks. *See* Methodologies Report, at 2-3.

[2] Office of the Comptroller of the Currency, *Principles for Climate-Related Financial Risk Management for Large Banks* (Dec. 21, 2021), https://www.occ.gov/news-issuances/news-releases/2021/nr-occ-2021-138a.pdf (hereinafter the "OCC Proposal").

[3] Federal Deposit Insurance Company, *Statement of Principles for Climate-Related Financial Risk Management for Large Financial Institutions*, 87 Fed. Reg. 19,507 (Apr. 4, 2022), https://www.federalregister.gov/documents/2022/04/04/2022-07065/statement-of-principles-for-climate-related-financial-risk-management-for-large-financial.

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the impact of climate-related risk drivers on banks' management of credit, market, liquidity, operational and other risks, including business continuity; and, with a particular focus on larger banks, climate scenario analysis.

- For supervisors, the Basel Principles include guidance to the effect that they should determine that banks are addressing climate-related financial risks in accordance with the Basel Principles; should set supervisory expectations accordingly; should ensure they have adequate expertise and resources to assess banks' management of climate-related financial risks; should consider using supervisory climate scenario analysis; and may also consider the use of climate-related stress testing.
- Given the close alignment between the Basel Principles and the OCC Proposal and FDIC Proposal, and the Basel Committee's guidance to supervisors on information-sharing and cross-jurisdictional harmonization, it is likely that any final guidance from the OCC and FDIC will closely align with the Basel Principles.

## 2. The principles affirm a tailored approach to climate risk management

- The Basel Committee, OCC, FDIC and New York Department of Financial Services (NY DFS) all suggest that banking organizations should calibrate climate-related risk management programs to their circumstances.
- The Basel Principles are intended "to accommodate a diverse range of banking systems" and to be applied "on a proportionate basis depending on the size, complexity and risk profile of the bank or banking sector for which the authority is responsible."[4]
  - For example, the Basel Principles state that the guidance on scenario analysis and stress testing "[is] formulated with a view towards application to large internationally active banks,"[5] a term which the Federal Reserve's final tailoring rules on enhanced prudential standards and the U.S. banking agencies' final tailoring rules on capital and liquidity requirements have effectively applied to Category I and II firms.[6] The Basel Principles also state that "smaller banks . . . can benefit from a structured consideration of the potential impact of climate-related financial risks."[7]
- In their proposals, the OCC and FDIC state that they "intend to appropriately tailor any resulting supervisory expectations to reflect differences in [banks' or financial institutions'] circumstances such as complexity of operations and business models."[8]
- The NY DFS expects that "each organization should take a proportionate approach that reflects its exposure to the financial risks from climate change and the nature, scale, and complexity of its business."[9]

[4] The Basel Principles, *supra* note 1, at 2.
[5] *Id.*
[6] *See* Board of Governors of the Federal Reserve System, *Prudential Standards for Large Bank Holding Companies, Savings and Loan Holding Companies, and Foreign Banking Organizations*, 84 Fed. Reg. 59,032, 59,035, 59,047 (Nov. 1, 2019), https://www.federalregister.gov/documents/2019/11/01/2019-23662/prudential-standards-for-large-bank-holding-companies-savings-and-loan-holding-companies-and-foreign; Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation, *Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements*, 84 Fed. Reg. 59,230, 59,233-34 (Nov. 1, 2019), https:// www.federalregister.gov /documents/2019/11/01/2019-23800/changes-to-applicability-thresholds-for-regulatory-capital-and-liquidity-requirements.
[7] The Basel Principles, *supra* note 1, at 2.
[8] The OCC Proposal, *supra* note 2, at 2; 87 Fed. Reg. at 19,509.
[9] Letter from N.Y. Dep't Fin. Servs., Chief Executive Officers or the Equivalents of N.Y. Regulated Fin. Institutions Concerning Climate Change and Financial Risks (Oct. 29, 2020), https://www.dfs.ny.gov/industry_guidance/industry_letters/il20201029_climate_change_financial_risks. *See also* The Basel Principles, *supra* note 1, at 2 ("Banks should manage climate-related financial risks in a manner that is proportionate to the nature, scale and complexity of their activities and the overall level of risk that each bank is willing to accept.").

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## 3. The Basel Principles contemplate banks assessing climate-related financial risks using existing risk categories and risk management oversight and control structures, but with a documented focus on climate change

- Consistent with the Basel Committee's Risk Drivers Report, the Basel Principles expect banks to assess and manage climate-related financial risks through the lens of existing categories of risk addressed by the Basel capital and liquidity framework, such as credit risk (including counterparty risk), market risk, liquidity risk and operational risk.[10]
- The Basel Principles also contemplate banks using their existing board and management governance structure to provide effective oversight of climate-related financial risks, and their existing internal control framework across the three lines of defense to identify, measure and mitigate material climate-related financial risks.[11]
- At the same time, the Basel Principles contemplate that banks would specifically identify, consider and address climate-related financial risks and their impact, including by:
  - Taking material physical and transition risk drivers into consideration and incorporating them into the bank's overall business strategy and risk management framework;
  - Clearly assigning responsibilities for managing climate-related financial risks to board members and/or committees, and clearly defining and explicitly assigning roles and responsibilities for identifying and managing climate-related financial risks throughout the bank's organizational structure;
  - Embedding the management of climate-related financial risks in policies, procedures and controls, including, for example, in client onboarding and transaction assessments;
  - Clearly defining and assigning climate-related responsibilities and reporting lines in all three lines of defense (for example, the risk management function should be responsible for undertaking climate-related risk assessments and monitoring independently from the first line of defense);
  - Incorporating material climate-related financial risks in a bank's internal capital adequacy assessment process (ICAAP);
  - Incorporating material climate-related financial risks in a bank's internal liquidity adequacy assessment process (ILAAP); and
  - Clearly defining and addressing climate-related financial risks in the bank's risk appetite framework, including the development of key risk indicators for managing climate-related financial risks.[12]

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[10] The Basel Principles, *supra* note 1, at 4, 6-7.
[11] *Id.* at 3-4.
[12] *See id.* at 3-5.

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## 4. The Basel Principles suggest using "risk concentrations" to identify and manage climate-related financial risks

- As part of a bank's overall risk management process, particularly in managing climate-related credit risks, the Basel Principles suggest that banks consider identifying and monitoring risk concentrations within and between categories of climate-related financial risks, especially concentrations by industries, economic sectors and geographic regions.[13]
- The Basel Committee defines "risk concentration" as "any single exposure or group of similar exposures with the potential to produce (1) losses large enough to threaten a bank's creditworthiness or ability to maintain its core operations or (2) a material change in a bank's risk profile. In the context of climate-related financial risks, concentrations could be within and between risk types associated with climate-related financial risks (e.g., between physical risk and transition risk or between traditional financial risk types), and they could include, but are not limited to, geographies, sectors, and counterparties."[14]
- Banks are also encouraged to consider a range of risk mitigation options for managing climate-related credit risks, including:
  - Adjusting credit underwriting criteria;
  - Imposing loan limitations or restrictions, such as shorter-tenor lending, lower loan-to-value limits or discounted asset valuations; and
  - Setting limits on or applying "appropriate alternative risk mitigation techniques" to exposures to companies, economic sectors, geographic regions or segments of products and services that do not align with a bank's business strategy or risk appetite.[15]
- The OCC Proposal and FDIC Proposal similarly encourage a dynamic approach to analyzing financial risks, encouraging banks to use "tools and approaches for measuring and monitoring exposure to climate-related risks includ[ing] exposure analysis, heat maps, climate risk dashboards, and scenario analysis."[16]

## 5. The Basel Principles recognize current limitations on the data used to analyze climate-related financial risks

- In its April 2021 Methodologies Report, the BCBS recognized the limitations of data for climate-related financial risks and concluded that further investment was needed to develop new and more granular data for physical and transition risk assessments, including geolocational data capturing risks of physical damage and financial data to capture exposures by financial institutions, such as data reported by banks' counterparties.[17]
- Consistently with the Methodologies Report, the Basel Principles recognize that (1) "the methodologies and data used to analyze [climate-related financial] risks are currently evolving and are expected to mature over time," and (2) these risks "will probably be incorporated into banks' internal capital and liquidity adequacy assessments iteratively and progressively as the methodologies and data used to analyze these risks continue to mature over time and analytical gaps are addressed."[18]

[13] *Id.* at 5-6.
[14] *Id.* at 5, n.7.
[15] *Id.* at 6.
[16] The OCC Proposal, *supra* note 2, at 3; 87 Fed. Reg. at 19,510.
[17] *See* Methodologies Report, *supra* note 1, at 2, 37-39.
[18] The Basel Principles, *supra* note 1, at 2, 4.

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- At the same time, the Basel Principles state that:
  - "a bank's risk data aggregation capabilities should include climate-related financial risks to facilitate the identification and reporting of risk exposures, concentrations and emerging risks," including systems to collect and aggregate climate-related financial risks data and processes to "ensure the aggregated data is accurate and reliable"; and
  - Banks should consider engaging with clients and counterparties and collecting additional data from them to develop a better understanding of their transition strategies and risk profiles but may use "reasonable proxies and assumptions" where reliable and comparable climate-related data is not available.[19]

## 6. Banks are encouraged to incorporate climate-related financial risks in their ICAAPs and ILAAPs

- For ICAAP, a bank should include climate-related financial risks that are assessed as material over the relevant time horizons, and that may negatively affect its capital position through their impact on traditional risk categories (which, for capital adequacy, would consist of credit and counterparty risk, market risk and operational risk).[20]
  - For market risk, a bank should evaluate the potential risk of losses on and increased volatility of its portfolios, including the potential use of a sudden shock scenario featuring variations in the liquidity of assets exposed to climate-related risk and the speed at which exposures could be closed out, as well as the potential impact of changes in the pricing and availability of hedges.[21]
- For ILAAP, a bank should include climate-related financial risks that are assessed as material over the relevant time horizons, and that may impair its liquidity position, including whether climate-related financial risks could cause net cash outflows or a decrease in the value of assets (e.g., high-quality liquid assets, or HQLAs) comprising their liquidity buffers.[22]
- The OCC Proposal and FDIC Proposal have also signaled the importance of considering climate-related financial risks in capital planning, stating that banks and financial institutions should consider "material climate-related financial risk exposures when setting the bank's overall business strategy, risk appetite, and financial, capital, and operational plans."[23]

## 7. The Basel Principles contemplate both company-run and supervisory climate-related risk scenario analysis and stress testing

### *For banks*

- Climate scenario analysis should reflect the bank's overall climate risk management objectives as determined by its board and management.

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[19] *Id.* at 5-6. To this end, banks may have to invest in data infrastructure and enhance existing systems. In the meantime, limitations that prevent complete climate risk data assessments should be disclosed to stakeholders "where relevant." *Id.* at 6.
[20] *Id.* at 4.
[21] *Id.* at 6-7.
[22] *Id.* at 4, 7.
[23] The OCC Proposal, *supra* note 2, at 2; 87 Fed. Reg. at 19,509-10.

- Scenario analysis should reflect relevant climate-related financial risks, including physical and transition risks relevant to a bank's business model, exposure profile and business strategy, and should use a range of time horizons, from short- to long-term.
- Scenario analysis capability and expertise should be proportionate to a bank's size, business model and complexity, with larger and more complex banks expected to have "more advanced analytical capability."
- Climate scenario models, frameworks and results should be subject to challenge and regular review by a range of internal and/or external experts and independent functions.[24]
- As part of incorporating climate-related financial risks into its ICAAP and ILAAP, a bank should, where appropriate, incorporate climate-related financial risks into its capital and liquidity stress testing programs.[25]

## *For supervisors*

- Supervisors should clearly articulate their objectives for supervisory climate scenario analysis, which could include:
  - Exploring the impact of climate change and the transition to a low-carbon economy on banks' strategies and business models;
  - Identifying and assessing relevant climate-related risk drivers affecting individual banks or the banking system;
  - Facilitating information-sharing and identifying common data and methodological gaps and limitations in climate-related risk management; and
  - Assessing the adequacy of banks' risk management frameworks, including their risk mitigation options.[26]
- Supervisors "may also consider" the use of supervisory climate-related stress testing to test the adequacy of banks' financial positions.[27]
- In designing either of these supervisory exercises, supervisors should consider:
  - Material climate-related financial risks, including physical and transition risks that take into account the nature, scale and complexity of banks in their jurisdictions;
  - Using a range of time horizons, from short- to long-term, depending on whether the objective is to measure the impact of risks that could materialize within banks' "traditional capital planning horizons" or the more uncertain objective of gauging exposures to structural changes in the economy or financial system or the distribution of risks; and
  - Collaborating with a broad and diverse set of stakeholders, including the "climate science community," to develop scenarios.[28]
- Supervisors should recognize the limitations of their analyses when communicating their results or using them in supervisory assessments and should take into account the level of uncertainty associated with scenarios when determining whether to disclose their results.
  - Supervisors may disclose the results of these supervisory exercises "at an appropriate level of aggregation," including the appropriate level of detail on methodologies, assumptions, uncertainties and key sensitivities.[29]
- The OCC Proposal and FDIC Proposal do not expressly advise banks and other financial institutions to use stress testing, noting only that scenario analysis "differ[s] from traditional stress

[24] The Basel Principles, *supra* note 1, at 7-8.
[25] *Id.* at 4.
[26] *Id.* at 10.
[27] *Id.*
[28] *Id.*
[29] *Id.* at 11.

testing exercises that typically assess the potential impacts of transitory shocks to near-term economic and financial conditions."[30]

## 8. The Basel Principles encourage international data sharing among the regulators

— The Basel Principles state that "[t]o foster cross-border collaboration, home and host supervisors of cross-border banking groups should share information related to the climate risk resilience of banks and banking groups, leveraging existing frameworks for sharing information and undertaking collaborative work."[31]

[30] The OCC Proposal, *supra* note 2, at 4; 87 Fed. Reg. at 19,510.
[31] The Basel Principles, *supra* note 1, at 9.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.


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