Triodos Bank

Triodos Bank's response to the public consultation on principles for the effective management and supervision of climate-related financial risks

Date of submission: 14 February 2022

Question 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?

Response: No, the BCBS ignores the core of its mandate, guarding financial stability across the globe. Climate risk has been identified by several studies as a radical uncertainty which could jeopardize economies' stability and the stability of their financial systems. These warnings are thus serious, that a radical measure against financing any activity that could worsen this risk should be implemented. Despite the insufficiency of data, any doubt about the negative impact of financing fossil-based or high-use-of-pesticides ventures should be taken away. The BCBS should lead in pricing the risk of financed activities' climate impact and introduce both pillar 3 and pillar 1 measures as soon as possible. Moreover, the BCBS should monitor implementation of effective supervision practices in annual country-by-country progress reports, and have this progress assessed as part of the regular Financial Sector Assessment Programs (FSAPs) by the IMF.

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

Response: The mere presentation of pillar 2 principles only in this consultation paper is disappointing. Given numerous studies by among others the NGFS, and notably the ECB about the potential adverse impact of the radical uncertainty of climate change on financial stability across the globe, a crystal clear message by the BCBS would have been more appropriate. Financing activities that harm the quality of the planet's air, soil and water is affecting the resilience of economies across the globe, with potential major implications for the stability of the financial system. We call upon those supervisors that do see this impact, those gathered in the NGFS, to step up and introduce limiting and pricing measures in pillar 1 as soon as possible, supported by pillar 3 measures for sufficient transparency.

Question 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?

Response: A key aspect is risk concentration in the system, as stipulated by BCP 19, and applied to both financed emissions and financed pesticides. Ignoring the climate impact of banks' portfolios would imply that supervisors in the BCBS would dismiss the Committee's mandate to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability. Climate impact by now has been identified by scientists to be as significant to financial stability as credit, liquidity or market risk. For starters, supervisors should act upon climate risk as a potential risk concentration in pillar 1. This should regard both financed emissions (scope 3 emissions) and financed pesticides. Acknowledging the harm done by greenhouse gas emissions and pesticides will only be part of the story, but a big part of it. It is observed that financial institutions that start monitoring their financed or insured emissions reconsider their complete assessment process for environmental impact, so monitoring financed and insured emissions and pesticides can be seen as a proxy for monitoring other environmental impact. The Basel Core Principles, especially BCP 19, can easily be adapted to this new insight by redefining "related parties" into a concept that encompasses all harmful activities that a bank finances.

Principle 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. [Reference principles: BCP 14, SRP 30, Corporate governance principles for banks]

The supervisors in the BCBS should all embrace the best practice started by EBA in 2021 and apply their pillar 2 powers to the full. Pillar 2 regards both the risks that are not explicitly covered in pillar 1 as well as the banks' risk management processes. The BCBS should publish a revised interpretation of BCP14 and enrich SRP30 with the insights gathered by EBA in their SREP-guidelines: https://www.eba.europa.eu/eba-publishes-its-report-management-and-supervision-esg-risks-credit-institutions-and-investment

This report explains that the relevant time horizons for business strategies and risk management frameworks are 10 to 30 years, not the one to five years currently assessed by banks and their supervisors. Moreover, not only the financial risks to the banks themselves, i.e. the consequences of their financed activities, but also the adverse impact they cause, the harm that their finance does to the planet, must be incorporated and priced, as it is the latter that jeopardizes the financial stability across the globe.

Principle 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. [Reference principles: BCP 14, SRP 30, Corporate governance principles for banks]

Final responsibility for policies and management of any risk that can jeopardize creditors' claims with the bank in particular, and financial stability in general, should be with the board. Just like market developments will affect credit, market and liquidity risk, so will climate related dynamics. Any bank that ignores the impact of climate related risk on its market or business will in the end jeopardize its own license to operate. Climate related risk must be included in SRP30, both the consequences of financed activities for the bank and the harm that is caused by financed activities.

Principle 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. [Reference principles: BCP 14, SRP 30, Corporate governance principles for banks]

EBA's report elaborates upon the necessary details of banks' policies, procedures and controls to cater for climate related risks. We note however, that having processes in place does not automatically imply that risks are not taken and that adverse impact is avoided. Adverse impact will only be effectively avoided if supervisors impose transparency measures in pillar 3 and additional capital measures in pillar 1 for excessive risk. This regards BCP28, which must at least include financed emissions and financed pesticides, and BCPs 17, 18, 19 regarding pillar 1 requirements and limits of credit risk, problem assets and risk concentration, which must include limits and a capital requirement for excessive exposure to harmful activities. This can be done by amending the definition of "related parties" and include "related harmful activities" in that definition. Alternatively, a less complicated start would be to monitor actual financed emissions, as has been done by banks that apply PCAF, and as has been proposed for pillar 3 by EBA.

Principle 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. [Reference principles: BCP 26, SRP 20, SRP 30]

Of course, banks should incorporate any relevant risk into their internal control frameworks, but this is not sufficient to avoid risks and adverse impact. BCP26, also enriched with mechanisms that monitor climate related risks and adverse impact, will be empty and useless to that end, if not supported by pillar 1 and pillar 3 requirements and limits in BCPs 17, 18 and 19 and in BCP28.

Principle 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. [Reference principles: BCP 15, BCP 24, SRP 20, SRP 30]

EBA's report elaborates upon the necessary details of banks' internal capital adequacy and liquidity adequacy assessment processes as stipulated by BCPs 15 and 24 to cater for climate related risks and impact. We note however, that having internal

assessments in place does not automatically imply that risks are not taken, and that adverse impact is avoided, not even if a SREP add on can be applied for insufficient processes. Adverse impact will only be effectively avoided if supervisors impose transparency measures in pillar 3 and additional capital measures in pillar 1 for excessive risk. This regards BCP28, which must at least include financed emissions and financed pesticides, and BCPs 17, 18, 19 regarding pillar 1 requirements and limits of credit risk, problem assets and risk concentration, which must include limits and a capital requirement for excessive exposure to harmful activities.

Principle 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. [Reference principles: BCP 15, SRP 30]

EBA's report elaborates upon the necessary details of banks' risk management frameworks as meant by BCP 15 to cater for climate related risks and adverse impacts. We note however, that having frameworks in place does not automatically imply that risks are not taken and that adverse impact is avoided, not even if a SREP add on can be applied for insufficient processes. Adverse impact will only be effectively avoided if supervisors impose transparency measures in pillar 3 and additional capital measures in pillar 1 for excessive risk. This regards BCP28, which must at least include financed emissions and financed pesticides, and BCPs 17, 18, 19 regarding pillar 1 requirements and limits of credit risk, problem assets and risk concentration, which must include limits and a capital requirement for excessive exposure to harmful activities. This can be done by amending the definition of "related parties" and include "related harmful activities" in that definition. Alternatively, a less complicated start would be to monitor actual financed emissions, as has been done by banks that apply PCAF, and as has been proposed for pillar 3 by EBA.

Principle 7: Risk data aggregation capabilities and internal risk reporting practices should account for climate-related financial risks. Banks should seek to ensure that 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. [Reference principles: BCP 15, SRP 30, Principles for effective risk data aggregation and risk reporting]

Climate risk is a typical group risk in the sense of the Joint Forum principles, in fact an uncertainty that cannot adequately be predicted with historical data. Like the JF's risk aggregation and risk concentration principles, BCP 15 on risk aggregation must be revised in order to include climate related risk. For starters, financed emissions must be measured, monitored and managed. If financed emissions of a bank this year are higher than financed emissions last year, supervisors will observe the bank is not on a path to zero emissions and should apply a risk concentration add on. The BIS can even aggregate financed emissions worldwide and monitor whether the financial sector is on a path to zero in 2050. If supervisors observe that the financial sector deviates from

that zero-path, an additional macro-economic buffer must be imposed. BCP15 must be revised to cater for this new group risk and macroeconomic risk.

Principle 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. [Reference principles: BCP 17, BCP 19, SRP 20, Principles for the management of credit risk]

Longer term prudential considerations are, as explained by the ECB, especially necessary as we note that longer-term climate-related risk is in many respects of a different nature than the relatively predictable credit risk. After all, humans' capability to assess possible damage in a forward-looking way is limited, as well as to estimate the size of the potential damage that an individual incident could lead to in the longer run. In fact, we are of the opinion that climate risk can be of such a devastating nature that the only way to mitigate it in a credible way is to put our maximum effort into prevention by ensuring that the financial industry uses its investing capability sustainably. Moreover, the transition towards a sustainable economy comes with opportunities just as much as it comes with risks. The issues that can lead to sustainability risks on the one hand open up opportunities for adapting business models on the other, which in their turn will result in less transition risk. Risk analyses which recognize the interdependence with opportunities would increase the accuracy of monitoring companies in transition. Especially BCP 19 should thus include a confirmation of the ECB's notion that concentrations in climate risk are building up, and that some banks are more exposed than others, as such more vulnerable to shocks and no longer able to finance their local communities. BCP19 must underline the necessity of explicit pillar 1 requirements with respect to potential stranded assets or a risk-concentration in harmful exposures.

Principle 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. [Reference principles: BCP 22]

Principle 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. [Reference principles: BCP 24, Principles for sound liquidity risk management and supervision]

Principle 11: Banks should understand the impact of climate-related risk drivers on their operational risk[5] 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[6] 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.

[Reference principles: BCP 25, Principles for the sound management of operational risk, Principles for operational resilience, SRP 20, SRP 30]

Principle 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. [Reference principles: BCP 15, Stress testing principles]

The additional stress test requirements as proposed by the European Commission, and the new horizon of 10 years, will help ensure that banks know the impact of what they finance. BCP15 must be amended to reflect this new insight.

Principle 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. [Reference principles: BCP 9, BCP 14, BCP 26, SRP 20]

Indeed, supervisors can no longer choose to look away. For starters, they must follow the financed emissions and pesticides by the banks that they supervise. EBA's standards for ESG disclosure include the simple obligation to disclose financed emissions. As soon as possible, this should be included in country-by-country progress reports too, so that the BIS can follow finance emissions across the globe and supervisors become aware of leakages in the financial system. The revised BCPs can be included in the regular FSAPs by the IMF.

Still, monitoring does not automatically imply that risks are not taken, and that adverse impact is avoided. Adverse impact will only be effectively avoided if supervisors impose transparency measures in pillar 3 for all and additional capital measures in pillar 1 for excessive risk. This regards BCP28, which must at least include financed emissions and financed pesticides, and BCPs 17, 18, 19 regarding pillar 1 requirements and limits of credit risk, problem assets and risk concentration, which must include limits and a capital requirement for excessive exposure to harmful activities.

Principle 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. [Reference principles: BCP 15, SRP 20, SRP 30]

EBA's report elaborates upon the necessary details of banks' assessments and risk appetites to cater for climate related risks. We note however, that having strategies and risk appetites in place does not automatically imply that risks are not taken, and that adverse impact is avoided. Adverse impact will only be effectively avoided if

supervisors impose transparency measures in pillar 3 and additional capital measures in pillar 1 for excessive risk. This regards BCP28, which must at least include financed emissions and financed pesticides, and BCPs 17, 18, 19 regarding pillar 1 requirements and limits of credit risk, problem assets and risk concentration, which must include limits and a capital requirement for excessive exposure to harmful activities.

Principle 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. [Reference principles: BCP 17–25, Principles for sound liquidity risk management and supervision, Principles for the sound management of operational risk, Principles for operational resilience]

Supervisory review objectives or risk management approaches do not include an evaluation of financial institutions' capital adequacy to cover climate-related financial risks. Thus, these Principles effectively miss impactful supervisory measures in cases where climate-related risks will be identified as material. In essence, the supervisory review would be directed towards exploration of risks rather than ensuring financial institutions´ resilience against climate-related risks. Absent capital adequacy implications of the supervisory review, there are no incentives for financial institutions to change their behaviour towards climate-related financial risks.

The climate scenario analyses as indicated in this Principle 15 should also be applied by supervisors themselves for the system they supervise. This exercise must become part of annual country by country progress reports, as well as a returning element in the regular FSAPs.

Principle 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. [Reference principles: BCP 8, BCP 9, SRP 10, SRP 20]

The NGFS is sharing a broad range of supervisory tools that can be used by supervisors today, given and within their current legal mandates. There's no need to expand BCPs 8, 9 and 10, but the application of these BCPs must be extended to climate related risk and impact. What supervisors miss, is the power to impose additional capital requirements when they observe excessive climate related risk or adverse impact. What the BCBS misses, is annual country-by-country progress reports of supervisory practices across the globe in this regard.

Principle 17: Supervisors should ensure that they have adequate resources and capacity to effectively assess supervised banks' management of climate-related financial risks. [Reference principles: BCP 9]

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Principle 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. [Reference principles: Stress testing principles]

We agree that supervisors across the globe should stress test the system on various climate scenarios and publish their findings. The NGFS is sharing a broad range of supervisory tools that can be used by supervisors today, given and within their current legal mandates. There's no need to expand BCPs 8, 9 and 10. What supervisors miss, is the power to impose additional capital requirements when they observe excessive climate related risk or adverse impact. What the BCBS misses, is annual country-by-country progress reports of supervisory practices across the globe in this regard.