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Principles for the Effective Management and Supervision of Climate-related Financial Risks

Nov 2021

Executive Summary

Through the publication of this consultative document in the form of BCBS Guidelines, the Committee seeks to promote a **principles-based approach** to improve risk *management* and *supervisory* practices related to **climate-related financial risks**.

The approach builds on the **review of the current Basel Framework**, particularly the Core principles for effective banking supervision (BCPs) and the supervisory review process (SRP) and **draws from existing supervisory** initiatives undertaken by individual prudential authorities and other international bodies.

At a Glance

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Introduction

Introduction

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The consultative document includes **18 high-level principles**. Principles 1 through 12 provide banks with guidance on ***effective management*** of *climate-related financial risks*, while principles 13 through 18 provide guidance for ***prudential supervisors***.

The proposed principles seek to achieve a balance in improving practices related to the ***management of climate-related financial risks*** and providing a ***common baseline for internationally active banks and supervisors***, while maintaining sufficient flexibility given the degree of heterogeneity and evolving practices in this area.

The proposed principles were drafted in a way to accommodate a **diverse range of banking systems** and are intended 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.

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Management of Climate-related Financial Risks

Corporate Governance

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Management Monitoring and Reporting & Comprehensive Management of Credit Risks

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Corporate Governance

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Banks should consider the **unique characteristics** of climate change risks, including, but not limited to, the ***complexity*** of the impact on the economy and ***uncertainty*** related to climate change.
The impacts of climate change could manifest over **varying time horizons** and are likely to exacerbate over time. Therefore, different time horizons should be considered in the process of risk identification and assessment as well as in scenario analysis.

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 organizational structure.

3

Banks should adopt appropriate policies, procedures and controls to be implemented across the entire organization to **ensure effective management** of climate-related financial risks.

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Internal Control Framework, Capital and Liquidity Adequacy and Risk Management Process

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Internal Control Framework

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Banks should incorporate climate-related financial risks **into their internal control frameworks** across the three lines of defense to ensure sound, comprehensive and effective identification, measurement and mitigation of material climate-related financial risks.

1) **Frontline staff** should have sufficient **awareness** and understanding to identify potential climate-related risks.
2) The **risk function**, should be responsible for undertaking independent climate-related risk assessment and monitoring.
3) The **internal audit function**, should carry out regular reviews of the overall internal control framework and systems in the light of changes in methodology, business and risk profile, as well as in the quality of underlying data.

Capital and Liquidity Adequacy

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.

Risk Management Process

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.

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Management Monitoring and Reporting & Comprehensive Management of Credit Risks

Management Monitoring and Reporting

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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.

- Banks should consider actively engaging clients and counterparties and collecting additional data in order to develop a better understanding of their **transition strategies** and risk profiles.
- The reporting should be timely and **updated regularly**.
- Banks should develop qualitative or quantitative metrics or indicators to assess, monitor, and report climate-related financial risks.

Comprehensive Management of Credit risk

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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.

Management of Climate-related Financial Risks 4/4

Comprehensive Management of Market, Liquidity, Operational and Other Risks & Scenario Analysis

Comprehensive Management of Market, Liquidity, Operational and Other 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.

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 were 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.

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.

Scenario Analysis

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

03

Supervision of Climate-related Financial Risks

Prudential Regulatory and Supervisory Requirements for Banks

Responsibilities, Powers and Functions of Supervisors

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Prudential Regulatory and Supervisory Requirements for Banks

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Prudential Regulatory and Supervisory Requirements for Banks

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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**

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Supervisors should:

- Determine that **roles and responsibilities** for climate-related financial risks are clearly assigned.
- Assess the **effectiveness of board** and **senior management oversight** of climate-related financial risks.
- Determine that banks consider the **potential impacts** of climate-related risk drivers when developing and implementing their **business strategies** and that banks adequately incorporate climate-related financial risks into their **corporate governance**.
- Assess the extent to which **material climate-related financial risks** are **included in banks' risk management** frameworks.

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**

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Supervision of Climate-related Financial Risks 2/2

Responsibilities, Powers and Functions of Supervisors

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Responsibilities, Powers and Functions of Supervisors

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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 supervised 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.

Sources and Literature

[01] **Basel Committee on Banking Supervision.** *Principles for the effective management and supervision of climate-related financial risks*. Consultative Document, November 2021.

Company Profile

Iason is an international firm that consults Financial Institutions on Risk Management. Iason integrates deep industry knowledge with specialised expertise in Market, Liquidity, Funding, Credit and Counterparty Risk, in Organisational Set-Up and in Strategic Planning.

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