

London, 30 June 2022

IBFed response to the FSB consultation on supervisory and regulatory approaches to climate-related risks

Dear Sir, Madam,

We thank the FSB for the opportunity to respond to its consultation on supervisory and regulatory approaches to climate-related risks.

Before answering the questions, we would like to make some overarching comments on the role of the FSB on climate-related risk:

Since 2017, the FSB has played a key role in prefiguring (voluntary) climate disclosure standards through the TCFD, and we note that they were reviewed and improved in 2021. This work has been widely adopted by the industry with more than 2600 companies publishing a TCFD report, which is a huge achievement. However, the limit of voluntary standards has now been reached and the responsibility for climate and ESG disclosure standards has now been assigned to the ISSB. In addition, banking regulation standards are being defined by the BCBS, and securities-related climate disclosures standards are defined by IOSCO. The overall coordination is done by the G20 and the G20 Sustainable Finance Working Group.

In this context, it is important that the FSB leverage the work of various regions, bring value in addition to existing initiatives, and foster convergence in an already fragmented landscape.

While we welcome the opportunity to provide comments on the FSB report, we are concerned with the timing of this public consultation given that there are already several regulatory and supervisory requirements in place or awaiting implementation with very specific data requirements (Pillar 3 in the EU, SEC proposed disclosures in the US, scenarios analysis exercises in several jurisdiction, etc.).

Also, several consultations have already taken place on climate, including by the BCBS which echoes the important initiatives of the NGFS and by local regions and jurisdictions such as Singapore, EU, the UK, etc. Furthermore, there are ongoing consultations concerning sustainability reporting standards launched by the ISSB, SEC, and EFRAG. This makes the report by the FSB less useful in comparison to the other emerging topics that the FSB could focus on. We would therefore appreciate more details on how this report and its findings will be used.

Given the breadth of initiatives, we suggest that the FSB play the necessary and important role of ensuring that any forthcoming standards or guidance are flexible enough to adapt to the unique circumstances of each jurisdiction and do not create unintended consequences.

We see the greatest leverage in mitigating physical and transition risks not in the issue of capital adequacy, but in the strategic orientation of an institution and the anchoring of these risks in the organisation's guidelines and, especially, in the credit decision process.

Questions:

Supervisory and regulatory reporting and collection of climate-related data from financial institutions

- 1. Does the report highlight the most important climate-related data (qualitative and quantitative) for supervisors' and regulators' identification of exposures and understanding of the impacts of climate-related risks of financial institutions and across financial sectors? Please provide examples of climate-related data deemed most relevant and that should be prioritised.**

Data

The most relevant issue regarding climate-related supervisory reporting is data standardization, reliability and maturity. The availability and granularity of such data is highly dependent on the sector, region, and size of the company for which such data is being collected.

ESG data providers acknowledge that there are still many data quality issues and completeness gaps and that solving those issues may take some time. For instance, there is a general lack of information on the location of the production facilities and their respective share in the total production of the counterparties. This impedes accurate assessment of the physical risk due to climate change. Another example is related to the lack of information given that corporates (and only the large or listed ones) have only recently commenced disclosing relevant data in relation to climate. Each of these factors, among others, must also be addressed in light of internal control and auditing expectations of the relevant data sources and service providers.

To date, the authorities have not provided 'fallback' methodologies or more detailed guidance as to how to fill data gaps, for example by using proxies and estimates. Such developments could be the cornerstone enabling comparability amongst reporting entities and avoid any potential legal suits against financial institutions, should proxies and/or estimates used by banks to fill for the data gaps be deemed to be inaccurate.

We would also like to highlight that the maturity and availability of ESG data differ significantly according to the topic. For instance, even if climate data are becoming more available, it is often rare to find data on other topics such as biodiversity, water consumption and specific social impacts (such as financial inclusion). Therefore, we believe that a sequenced, yet holistic, approach with the end in mind, should always be considered among the ESG topics.

We agree with the FSB recommendation to incrementally enhance the reporting of climate-related data beginning with qualitative information supplemented with available quantitative information

and then increasing the quantitative component as measurement methodologies improve. For any updates to regulatory data and reporting, we request that banks be provided sufficient time to prepare and build out their infrastructure. It should also be done on a gradual and incremental basis.

In general, there is a need to allow transition time for integration and improvement in data availability, access, and quality from a range of sources including the science community, consultants, and customers. A start small approach for comparative metrics, with growth over time as data and methodologies allow, should be considered. Authorities should consider expanding reporting and analysis over time across key agreed sectors, rather than going straight for a system-wide view. This will allow regulated entities time to build and grow capacity and an understanding of where and how they can gather data across sectors, and then aggregate the data and metrics, to monitor cross-sectoral risks (e.g. risk transfers).

Impact

Despite several initiatives, it is premature to expect financial institutions or their supervisors to fully understand the impacts of climate related changes. We don't disagree with the end game highlighted in the recommendations on page 3, which says:

“iii) interdependencies between physical and transition risks, geographical and sectoral risks, as well as improved understanding of impacts on financial risks; and (iv) system-wide aspects of climate-related risks such as indirect exposures, risk transfers, spill overs and feedback loops.”

However, as the FSB is aware, climate-related financial assessment tools and approaches are evolving and there is a significant amount of uncertainty about the policies governments will take to mitigate and/or adapt to climate change, whom they will affect and under what timeframe.

Regarding the financial impact (direct and indirect) of climate risk on a firm's balance sheet and income statements, as indicated by the FSB, we request more examples and guidelines on how these impacts should be estimated as they are generally not directly observable.

2. Does the report draw attention to the appropriate areas to increase the reliability of climate related data reported by financial institutions?

We believe the following topics should be further developed:

Convergence

While international harmonization and level playing field are welcome and we see an active role for the FSB to facilitate international harmonization and standardization, the current flexibility regulators and supervisors are providing in terms of methodologies as well as proportionality needs to be maintained over time, given the large-scale investments and time required for the development of methodologies and internal systems. Jurisdictional developments will have to be considered, as will the need to enable flexibility of scenario choice and approaches to accommodate the different ways in which climate impacts are felt across the globe.

Data value chain

The reliance of financial institutions on the publicly available information from their 'counterparties' should be better considered in the report. It will be difficult for financial institutions to fulfil their disclosure requirements should non-financial companies not provide data that financial institutions need for their own reporting on their counterparties. In this context, it is important to ensure broad and consistent use of companies' data from publicly available sources in order to minimize the need for bilateral engagement and avoid multiple and likely diverging information requests that companies are facing either from financial institutions or as part of a supply chain.

We believe the data value chain must be correctly framed. The FSB states: *"Supervisory oversight on financial institutions' governance, processes and controls on climate-related data reported, along with reviews by financial institutions' internal audit function, could strengthen the reliability of data. Establishing supervisory expectations addressing these areas would serve as an effective mechanism. Where appropriate within jurisdictions' legal and regulatory frameworks, supervisory and regulatory authorities should consider the need for third-party verification to strengthen the reliability of climate-related data, such as on emerging key metrics, that will be relied on by authorities and financial market participants more broadly. (Third-party verifications could play an important role also in avoiding greenwashing risks.)"*

This assumes the data reliability rests with the financial institutions; however, banks are not regulators and the quality of banks' data, if they can get it, will only be good if counterparty data or source data is good. This dependence has not been sufficiently recognized in the report. The rest of the economy needs to report good data if FIs are to have good data to work with.

We therefore believe the focus should be on reporting of companies first, including ensuring accurate disclosure of their GHG emissions (including scope 1,2,3). Third party verification, that currently varies among standard setters and climate disclosure regimes, should be placed with the origin of the data, not on financial institutions (or only financial institutions). Strong oversight, governance and processes should be placed on all actors in the value chain, subject to proportionality.

The value chain should be better defined and we note that methodologies to assess the value chain not only for climate but also for other environmental, social and governance topics are still to be developed. Furthermore, in terms of liability, the responsibility a corporate could have for the parties in its value chain with whom it has direct contractual relationships should not be put on an equal footing with those entities where such a direct contractual relationship does not exist.

We agree that data reporting and collection will likely be an iterative process. Increasing reliability of what FI's report requires access to better data and investments in processes and system to integrate new forms of data (e.g. geocoded and geo spatial etc., scenario data).

Global data repositories

We see a need for global data repositories. Repositories should be downscaled to intra-country level and to appropriate levels of granularity. These data sources would represent a reliable source for reporting entities.

We therefore support the establishment of public data repositories at national, regional or global levels for various forms of climate-related data to increase the efficiency and quality of data collection and risk management by financial institutions.

The report highlights that a significant variety of information is already gathered by prudential authorities to varying degrees through various information collection exercises. We encourage the FSB to share the available data, at least at an aggregated level, to increase data availability for the market and to facilitate the use of estimates and the development of proxies to fill the gaps where data are not directly available.

3. Does the report appropriately identify the elements of a common high-level definition of climate-related risks (physical, transition and liability risks)?

We agree with the common elements identified by the FSB for defining physical and transition risks and for differentiating between these two types of risk. Concerning liability risk, while we do not believe it should be separately defined, we would like to stress the fact that regulators asking financial institutions to disclose information that they cannot verify (since they often rely on ESG data providers). Furthermore, requiring them to use estimates or proxies is a way to increase their liability risks.

We agree that common reporting on exposures to physical risk would be useful. It requires common definition as well as:

- agreement on sector codes and level of granularity,
- models that define the activities with a greater degree of sensitivity,
- the impact of the physical risks in the value chain of those obligors (how it affects their supply and suppliers, and of course their customers),
- differentiation by type of physical risk and probability (based on projected climate change scenarios).

As the FSB noted in its 2020 Report, the NGFS should continue its work to refine and develop climate scenarios, which authorities should make use of in their climate scenario analysis, as appropriate, in order to align the data and methodologies used in such analysis. We would support this, but banks need more granular country/in country-regional data, maybe even to postcode level data in some cases, in order to have the appropriate data available for analysis.

We would welcome further work by the NGFS to facilitate common data sets for scenario analysis and stress testing. Collective need/pressure may be required to improve available data quality for use by FIs. We recommend that supervisors provide additional clarity on the definitions, and the criteria for the classification of various components of climate-related risks, such as unifying the definitions of carbon-intensive industries (i.e., TCFD vs NZBA definitions of carbon-intensive), and an acceptable list of financial products supporting decarbonization (i.e., green bonds vs. sustainability-linked bonds criteria).

Given the data available is uncertain and complex, regulatory reporting returns, including reporting on forward-looking information, may need to be provided to regulators on a confidential basis to

ensure that FIs are not put in a position where liability risk arises in association with external parties' reliance on outputs of scenario analysis.

The report also mentions that common definitions are foundational to providing clarity to financial institutions and international coherence. It is not clear, who is expected to provide definitions and when and how differences are expected to be reconciled.

In addition, we would like to provide the following specific comments on the text in the report:

- With regards to the following text: '*...technological developments that would make less environmentally friendly technology obsolete...*', when defining transition risk, 'less environmentally friendly' does not necessarily mean obsolete. It just may be outperformed by another environmentally friendly technology. Given the technological advancements necessary for a successful transition, assumptions of obsolescence will likely need continuous reassessment.

4. Do the proposed recommendations help accelerate the identification of authorities' climate related information needs from financial institutions and work towards common regulatory reporting frameworks? Please elaborate on areas where the recommendations could be enhanced, if any.

The regulators and supervisors in several jurisdictions already have very specific data requirements (e.g., under Pillar 3 in the EU banks will have to disclose quantitative disclosures on physical and transition risk as well as quantitative information and key performance indicators (KPIs) on climate change mitigating measures). Supervisors and regulators could work towards more consistency by providing guidelines on the use of proxies and estimates as financial institutions need more clarity from regulators and supervisors on what reference / benchmark / baseline assumptions, scenarios and forecasts they should be using when it comes to measurement.

When authorities require financial institutions to publish a public report in an aggregated format, those institutions will have to use proxies or estimates that are discretionary. For example, the same borrower in several financial institutions may have different levels of physical risk impact measured in a significantly different way. However, if the reporting authorities establish the necessary guidelines or proxies to determine the physical risks to which it would be subjected, the reporting could gain consistency and comparability.

We would also like to provide a more specific comment on the exposures to top carbon intensive companies, a requirement that is already envisaged to be reported in the EU and is mentioned in the FSB report as an example of regulatory reporting content. We suggest that when reporting of this kind is required by regulators or supervisors, a list of 'top carbon-intensive companies' be provided by the regulators. There are many potential criteria to build such a list, and leaving the design choices in the hands of the financial entities can lead to inconsistencies, comparability problems, and may lead to significant differences depending on whether or not scope 3 has to be considered, etc. Moreover, if such reporting is meant for public disclosure instead of for regulatory purposes, additional legal and confidentiality issues may arise.

Incorporating systemic risks into supervisory and regulatory approaches

5. Does the report identify relevant system-wide aspects that should be considered as part of supervisory and regulatory approaches to incorporate systemic risks arising from climate change? Please elaborate on other aspects that should be considered, if any.

System-wide aspects should be incorporated once there is a common approach at an international level. The authorities that are considering potential system-wide effects of climate change are in the initial stages of analysis, which leads us to believe that it is too early to do this exercise.

We would like to emphasize that risks arising from climate change start from outside the financial system. It is therefore necessary to look beyond the financial system to fully understand how climate-related risks flow through and impact the financial system and economy. As currently drafted, the FSB frames climate-related risk as starting with the funding provided by financial intermediaries. We believe the report should provide a clear understanding of the drivers of a financial institution's climate-related risk that fall outside of the financial system. Moreover, the FSB should consider the essential role that banks and other financial entities play in funding the transition of carbon heavy companies to a more sustainable economic basis, and that cutting off that funding will impede a smooth transition.

6. Does the report accurately reflect the extent to which current supervisory and regulatory tools and policies address climate-related risks?

No. We believe the report is missing some essential topics on the role of environmental risks in the prudential framework. In particular, in relation to potential double-counting:

- The report does not mention anything on the extent to which these risks are already considered or mitigated in the prudential framework (credit risk, market risk, operational risk), for example in internal models or in external ratings, and would therefore have an overall neutral impact,
- The report does not mention anything on the extent to which these risks are already taken into account in accounting data (probable losses as opposed to unexpected losses covered by Pillar 1).

Please also find below some further general comments:

- If the current prudential capital time horizon were to be extended to accommodate consideration of longer-dated climate-related risk drivers, the effect could be to widen the window over which the distribution of potential bank losses is measured/considered, leading to (probably) higher capital requirements "today" i.e., potentially long before those risks may materialize.
- Explanation of the difference between bullets 1 (Supervisory review and evaluation processes, including risk assessments, supervisory expectations of financial institutions' risk management practices) and 3 (supervision and reviews, as well as deployment of supervisory capital add-ons to address deficiencies in the risk management) in the description of the regulatory/supervisory 'toolbox' would be welcome.

- ‘Stress test’ and ‘Scenario analysis’ are used as interchangeable. It might be worth establishing the differences between the two types of exercises. Scenario analysis is typically a forward-looking assessment of a potential future state of the world over time, resulting from a plausible and possibly adverse set of assumed events or sequence of assumed events. Stress testing typically assesses the potential impacts of transitory shocks to near-term economic and financial conditions. Stress testing usually has capital planning implications and regulatory consequences. “Climate scenario analysis” is a tool used to enhance critical strategic thinking and inform strategic decision-making to assess business risks and opportunities against a range of plausible future climate scenarios. To avoid confusion, we recommend that the FSB provide further clarity and use the term “climate scenario analysis” to connote an exploratory exercise for banks’ assessment of the impact of climate-related risks and opportunities over short, medium, and long-time horizons.

7. Do the proposed recommendations on incorporating systemic risks into supervisory and regulatory approaches, including the expanded use of climate scenario analysis and stress testing for macroprudential purposes, address the appropriate areas?

No. Nothing is said about the need for supervisors to develop robust and reliable methodologies for assessing climate risks. The FSB affirms these risks exist but says nothing about the need for supervisors to know how to identify and measure them in a harmonized way. In the past supervisors invented the internal models that they imposed on banks in Basel II. We expect that once the work of supervisors progresses, they will be in the position to come up with robust and convergent methodologies for measuring climate risk.

Please elaborate if there are any other features or tools that should be considered.

The other feature that should be considered is that the prudential framework should be based on risks, not on political considerations. It would be useful for the FSB to ensure that basic risk principles are respected at the international level, to avoid prudential divergences based on other than risk considerations. Prudential requirements must reflect risk exposures and should be risk- and fact-based. Risk assessments must be based on objective and observable data.

Climate- Stress Tests

As experienced in the recent climate stress test exercises, such as the ongoing one of the European Central Bank, huge challenges remain for this novel process with major differences with traditional stress tests, with data and modeling capabilities (like projections for the following 30 years) under construction. The integration into the Supervisory Review and Evaluation Process (SREP) of the climate Stress Test exercises and the potential capital impact via Pillar 2 is premature. Particular caution should be exercised when interpreting the results and assessing the comparability of the exercise among entities or regions given that methodologies have not converged yet. We are still at a learning stage.

The results of internal and external scenario analyses ought to be used to set out (strategic) courses of action. They do not, however, indicate a concrete risk that can be mitigated with capital.

Not every perceived systemic risk requires a macroprudential solution. We do not believe that macroprudential intervention is necessary as long as climate-related risks are appropriately covered by the microprudential policy and there should not be a double counting of risks. Some ESG risks are already analysed in the supervisory review process (SREP) and they might be covered, if necessary.

It would be very premature to include these risks in the macroprudential framework, at least until it is clear how microprudential supervisors include them in their supervisory process. Otherwise, there is the risk of overlapping requirements to cover the same risks. An additional buffer introduced as part of the EU macroprudential framework would be counterproductive as it would both dis-incentivize banks to invest in their own risk management capabilities, and “freeze” capital resources that are much-needed for such investments. There is however a need to avoid overlapping and double counting among the different approaches.

Before presenting any proposal, regulators should assess and prove that the use of macroprudential tools is the most adequate and efficient way to address ESG risks. Macroprudential approach should play a part once it is proven the microprudential one is not fit for purpose and the risks and related uncertainties are not sufficiently covered.

Early considerations on other macroprudential tools and policies

8. Are there other areas of work, literature or research being conducted on macroprudential tools and policies on climate-related risks that should be considered in the report?

We propose that the FSB research differences in transition risk in equity instruments vs. debt instruments. Equity instruments may have more influence on management actions of the investee. Debt instruments have much shorter maturities than the long timeframes typically included in scenario analysis. Cash flow timing is different, yet we have “financed emissions” concepts that do not differentiate. It is generally agreed that a significant jump in technology will be required to make affordable renewable energy widespread. Such technology will likely require financing of speculative technologies where the PD (risk of loss) is higher. If successful, such technology will then likely be subject to significant other transition risks (and perhaps shorter transition periods) as newer technologies will be expected to come about. If banks are counted on to finance the transition to renewables, how do prudential regulators see the role of banks given this dynamic?

We would also appreciate if supervisors could share the best practices and insights they gain from other supervisors and from across the industry, including on climate-related transmission channels.

Under Section 3.1, we agree that supervisory and regulatory risk assessments and policies need to better incorporate an understanding of these channels and how climate-related risks to financial institutions may be transferred across sectors or borders. However, we believe such system-wide perspective should be further extended beyond financial macroeconomic considerations and be considered for other effects as well. Unintended consequences can spill over to non-financial sectors.

Additional considerations

9. Are there any other issues that should be considered in future work of the FSB on supervisory and regulatory approaches to climate-related risks?

Given the transverse nature of climate-related financial risks and their correlation to a variety of risk categories, we support integrating governance of climate-related financial risks into existing risk management frameworks and structures, where applicable. Banks already have well-developed and effective policies, procedures, and controls for addressing traditional risk categories. We believe that regulators should consider how to leverage existing risk frameworks to address climate-related financial risks. This would avoid duplicative frameworks that would lead to inefficiencies in governance policies and procedures.

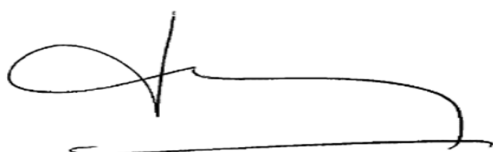
There are several references in the report to ‘*carbon intensive sectors/exposures*’ for designing the set of tools. This has to be carefully considered, as it might become a de-facto brown/red taxonomy. In addition, the current emphasis on “carbon intensive sectors/exposures” is on manufacturing and production/supply of energy. However, there is likely more transition risk in industries that demand such energy or manufacturing (travel and entertainment, for example). The FSB needs to be clear on how risk is identified.

Considerations should also be given to avoid unintended consequences. For instance, when talking about buffers, it is important to remember that buffers require financial institutions to limit the amount of resources that can be used to support lending. This can potentially reduce profitability and impact financial intermediation (e.g. lending decisions) to minimize buffer requirements. Reduced lending may as well have an impact on regional employment and economic activity’. If companies in need of transition finance are penalized too soon, they may find it difficult to access finance, aggravating their initial difficulties as they seek to transition.

Modelling climate risk impacts requires multidisciplinary teams with the right mix of skills to correctly interpret the complexities of climate science relative to their industry. This expertise is currently maturing and consideration should be given to the current availability of adequate skillsets in the marketplace (including within regulatory teams) to achieve the required reporting and scenario outcomes. Without this consideration, there is a risk that all the efforts of these teams with maturing capabilities and limited capacity will be focused on regulatory reporting requirements, rather than other activities such as supporting the integration of modelling outcomes safely into business risk management decisions.

We thank you in advance for considering our comments and would be pleased to discuss our letter in greater detail at your convenience should you have any questions.

Yours sincerely,



Hedwige Nuyens
Managing Director IBFed