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# Climate, Capital, and Caution

## The Basel Global Standard on Climate-Related Financial Risk

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### Summary

On December 8, 2022, the Basel Committee on Banking Supervision (BCBS) issued [guidance](#) clarifying how to incorporate climate-related financial risks into the existing Basel Framework on capital, the basis for international cooperation on bank regulation. The guidance addresses how regulators should incorporate climate risk into several existing technical standards on prudential regulation. There are two key takeaways for U.S. banks and their regulators.

- 1. Large banks should incorporate climate-related risk into their capital adequacy assessments and stress testing.**
- 2. Banks should incorporate a margin of conservatism when assessing their exposure to climate-related risks, also known as a “precautionary approach.”**

In their latest publications, U.S. banking regulators have neither acknowledged the recommendations from the Basel Committee nor suggested they will incorporate either of these approaches into their plans for regulating climate-related risks to banks and financial stability.<sup>1</sup> Such silence and delays leave the regulators out of step with their global commitments and the U.S. banking system vulnerable to climate-related risks.

### The Basel Committee on Banking Supervision and climate-related financial risk

The Basel Committee is the main global standard setter for bank regulation and supervision. The Committee sets standards for bank capital and liquidity, key tools for protecting banks and the wider financial system from macroeconomic shocks. Members agree to set a high priority on full and effective implementation of these standards with an agreed upon timeframe.<sup>2</sup> In a [2021 report](#), the Committee concluded that the main drivers of climate risk can be captured in traditional financial risk categories, and that banks should already be considering how to incorporate climate-related financial risk when applying the Basel Framework rules.

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<sup>1</sup> On December 16, 2022, the Financial Stability Oversight Council published its [annual report](#). It reiterated that climate-related risk is an emerging threat to financial stability and emphasized the role of data gaps in assessing the risks that the financial system faces. But the recommendations did not discuss bank capital or adopting a margin of conservatism in the face of data gaps. This disconnect leaves the U.S. outside the emerging global consensus on management of climate-related risk.

<sup>2</sup> The three primary U.S. banking regulators, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation, are all members of the Basel Committee.

The December guidance provides specific detail on how banks should incorporate climate-related risk into capital adequacy determinations and ongoing risk management and measurement.

## **Large banks should incorporate climate-related risk into their capital adequacy assessments and stress testing.**

Throughout the guidance, the Basel Committee repeats the expectation that banks need to incorporate climate-related financial risk into their capital adequacy assessments and stress testing. Where implemented, this expectation means that banks must start modeling potentially serious physical climate shocks or major developments in the energy transition that could have material consequences for their assets, credit exposures, or trading portfolios. They then need to use the results of those models when determining how much capital they need to hold.

Specifically, the committee expects regulators to require the largest, most systemically risky banks<sup>3</sup> to consider climate-related financial risks when stress testing their loan portfolios.<sup>4</sup> Where these banks find that climate-related financial risks would negatively affect credit or economic conditions, they may need to hold additional capital to bolster their resilience.

Similarly, where implemented, the guidance would require banks to consider climate-related risks when stress testing the impact of a sudden shock on the value of financial instruments in their trading portfolios.<sup>5</sup> Banks conduct these stress tests to understand if such shocks can create extraordinary losses in their portfolios, or if there are conditions, such as highly correlated risks or difficulty hedging those risks, that can make ordinary risk controls less effective. Elsewhere, the guidance provides specific examples of considerations that banks need to account for in making their capital adequacy assessments, such as those related to counterparty creditworthiness or the appropriateness of relying on credit rating agencies that make those determinations about creditworthiness.<sup>6</sup>

Each of the U.S. banking regulators has issued [Draft Principles for Climate-Related Financial Risk Management for Large Banks](#). These principles, aimed at banks with over \$100 billion in assets, are silent on the relationship of climate-related risk and capital adequacy. The Federal Reserve has also [announced](#) that it will launch pilot climate scenario analysis exercises in 2023 at six of the largest U.S. banks. Although this exercise will explore the resilience of financial institutions to different climate scenarios, the regulator explicitly states that there will be no capital implications. In contrast, the European Central Bank has [announced](#) that by 2024, all banks must incorporate climate risk into their internal capital adequacy assessments.

The lack of progress by U.S. banking regulators sends a message to large banks that they do not need to address climate-related financial risks as part of their capital adequacy determinations.

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<sup>3</sup> In the US, banks meeting this criteria are known as advanced approaches banks, which means they have more than \$250 billion in assets, or more than \$10 billion in foreign asset exposures.

<sup>4</sup> Guidance FAQ 11.

<sup>5</sup> Guidance FAQ 17.

<sup>6</sup> Guidance FAQ 1-4.

That message contradicts the expectations laid out in this guidance, and may leave the U.S. financial system less protected from the emerging financial risk of climate change.

### **Banks should apply a margin of conservatism when assessing exposure to climate-related risks, also known as a precautionary approach.**

In calculating capital adequacy, banks must estimate the probability of default for assets they hold, such as loans, and their losses given a default. Where banks have less satisfactory data or methods for making this estimation and the likely range of unpredictable error is larger, guidance requires banks to apply a larger margin of conservatism to those estimates.

The Basel Committee describes challenges for modeling climate-related losses, including uncertainty about the size and timing of future climate impacts and the limited relevance of historical data to future projections.<sup>7</sup> When banks lack quality data or are otherwise uncertain about models, the committee's guidance recommends that banks add a margin of conservatism to their estimates. It also notes that, in keeping with existing practices dealing with uncertainty, the margin may need to be bigger where the potentially unreliable information on climate-related financial risks is about something that could materially impact a bank's credit portfolio.

Although not directly mentioned in the framework or guidance, adopting a margin of conservatism is also the hallmark of a precautionary approach, as [endorsed](#) with regard to climate risk by the United Nations Framework on Climate Change and the Intergovernmental Panel on Climate Change, and specifically for climate-related financial risk by the White House. Such an approach means prioritizing reducing risk in the absence of perfect scientific or economic data. The Basel Committee's recognition that climate change may affect the availability of hedges is also a hallmark of a precautionary approach.<sup>8</sup>

The U.S. banking regulators have [observed](#) the data challenges inherent in climate-related risk management and stated that the need for better data cannot justify inaction on climate-related financial risk. But neither the Draft Principles issued by the banking regulators nor the latest climate risk recommendations in the FSOC's annual report emphasize the need for banks to adopt either a margin of conservatism or a precautionary approach. Without explicit guidance, it is unlikely that banks will uniformly adopt an approach that guards against their taking excessive climate-related risks that they cannot model appropriately.

### **Conclusion**

The Basel Committee's role is to identify and recommend ways to address threats to bank safety and soundness and financial stability, mandates shared by the U.S. banking regulators. The committee has concluded that this should require banks to incorporate climate-related risk into their capital adequacy assessments and use a precautionary approach in assessing those risks. U.S. banking regulators should either follow suit, or explain why they choose not to.

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<sup>7</sup> FAQ 12, 13 and 15.

<sup>8</sup> FAQ 17.