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A resilient transition to net zero

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Opening remarks

Thank you for inviting me to take part in this panel alongside such a distinguished set of speakers. Of the various challenges that we face today – be they economic, political or social – there is a growing consensus that climate change is the most existential. This is for three reasons.

First, it is truly global in nature. Unlike pandemics and infectious diseases, we cannot “self-isolate” in the hope of stopping it. Greenhouse gas emissions play out according to the textbook definition of spillovers and negative externalities. We are all in this together. This is why the recent report by the Intergovernmental Panel on Climate Change (IPCC) rightly states that “international cooperation is a critical enabler for achieving ambitious climate change mitigation goals”.¹

Second, the time horizon goes beyond the typical business, credit or political cycles that usually shape public policy and most of our decisions. In a world where there is no shortage of short-term issues clamouring for attention, our response to climate change is perhaps the ultimate test of our ability to adopt a medium and longer-term perspective. As Mark Carney described it, we are facing a “tragedy of the horizon”.²

Third, the shape and impact of climate change over the coming years is in our own hands. The actions that we take, or do not take, together, today will influence the trajectory of climate change for the next three decades and more. The headline messages from the recent IPCC report make for a sobering read – most notably that warming will exceed 1.5°C during this century based on the Nationally Determined Contributions announced prior to COP26. But they also gave grounds for hope by noting that mitigation efforts adopted today “can increase the pace, depth and breadth

¹ IPCC (2022).

² Carney (2015).

of emissions reductions”.³ This is why the coming years will be crucial to our ability to mitigate the impact of climate change.

What does this mean for the work of the Basel Committee? As you may already know, the Committee is the primary global standard setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters. Its mandate is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability. Our members’ banking systems preside over 90% of the world’s total banking assets.

So what does climate change mean for the global banking system? It is now generally accepted that climate change may result in physical and transition risks that could undermine the safety and soundness of individual banks, to say nothing of the broader financial stability implications. Banks worldwide are potentially exposed to such risks regardless of their size, complexity or business model. The scale of such risks is potentially tremendous: a recent study estimates that G20 financial institutions have exposures worth almost \$22 trillion to carbon-intensive sectors, of which on-balance sheet bank lending accounts for 60%.⁴

The commitments by the Glasgow Financial Alliance for Net Zero and the Net-Zero Banking Alliance to publish and adopt transition plans to a net-zero economy are in principle laudable.⁵ But recent geopolitical events have highlighted how the transition to net zero is likely to be a bumpy one. As such, there is a need to proactively assess and mitigate transition risks. And emerging research suggests that there are many ways in which institutions can reduce their carbon footprints, also with regard to their exposures to different sectors and regions.⁶ So it is crucial to ensure that banks are resilient to climate-related risks as we navigate the uncertain path towards net zero.

Against that backdrop, the Committee is pursuing a comprehensive programme to mitigate climate-related financial risks to the banking system. This work encompasses three elements. We started several years ago by taking stock of our members’ regulatory and supervisory initiatives on climate-related financial risks.⁷ This was important to gauge how closely our members were focusing on this topic. As it confirmed that our members were ready and willing to pursue further work in this area, this was in many respects the starting point for global standard-setting bodies.

Building on the stocktake, we published a set of analytical reports that assessed the transmission channels of climate-related financial risks to the banking system and the current state of play for measurement methodologies.⁸ These reports were vital in setting out a common understanding of the climate-related financial stability risks to banks and showed how traditional risk categories used by banks – such as credit and market risk – can be used to mitigate such risks.

³ IPCC (2022).

⁴ Moody’s (2021).

⁵ UNEP (2021) and GFANZ (2022).

⁶ Jondeau et al (2021).

⁷ BCBS (2020).

⁸ BCBS (2021a, 2021b).

The reports also highlighted the current gaps and methodological challenges when it comes to quantifying such risks.

We are now assessing whether global measures are needed for the supervision, regulation and disclosure of banks' climate-related financial risks. I'd like to focus the rest of my remarks on this plank of our work.

First, on supervision, the Committee agreed that some of its existing documentation – most notably the *Core principles for effective banking supervision* – are sufficiently broad and flexible to accommodate climate-related financial risks. At the same time, there was a need to issue additional guidance at a global level to both supervisors and banks.⁹ This is why we published a set of high-level principles last month that seek to improve risk management and supervisory practices on climate-related financial risks.¹⁰ These include supervisory guidance related to corporate governance, risk management processes, scenario analyses and supervisory responsibilities.

Second, on regulation, we are looking into whether there are any gaps in our "Pillar 1" standards that would mean that climate-related financial risks to banks are not adequately mitigated. As this work is still under way, I will just offer a few personal remarks.

The primary role of prudential regulation is to mitigate risks to banks. A resilient and healthy banking system is one that can best support households and businesses through the provision of key financial services, also during the transition to net zero. As such, prudential regulation forms part of a much broader set of tools and measures – including fiscal, technological or legislative – when it comes to responding to climate change and the transition to net zero. As Jan Tinbergen argued over 50 years ago, the number of achievable policy goals cannot exceed the number of policy instruments.¹¹ We already have a goal and instrument when it comes to the resilience of banks, and should therefore refrain from using prudential regulation to meet other climate-related objectives (such as promoting "green-type" investments). We should be setting capital requirements based on the inherent risk profile of each asset class.

In transitioning towards net zero, the risks to banks are two-sided.¹² While much of the focus has rightly been on exposures to "brown" assets that risk becoming stranded over time, we should also remain vigilant to the risks from "green bubbles". Initiatives aimed at tightening the regulatory and supervisory oversight of green taxonomies and labels will be important in helping mitigate such risks.

Lastly, there are some fundamental conceptual issues when it comes to incorporating climate risk into a Pillar 1 framework – including data limitations and differing time horizons. We should continue to address these challenges and remain open to a broad range of solutions. When

⁹ BCBS (2012).

¹⁰ BCBS (2022).

¹¹ Tinbergen (1952).

¹² Borio et al (2022).

mitigating risks in a world of uncertainty, it can make sense to err on the side of caution, prudence and simplicity.¹³

The third leg of our work is on disclosures. Data and information gaps on institutions' exposures to climate-related financial risks are one of the major stumbling blocks that we face today. This is why the Basel Committee is preparing work to develop high-quality and globally consistent "Pillar 3" climate-related disclosure requirements for internationally active banks in parallel with various international initiatives.

In the climate context, the Pillar 3 framework could help reduce information asymmetry and promote the comparability of banks' risk profiles within and across jurisdictions by focusing on the climate-related information necessary to understand the potential impact of climate change on banks' risk exposures. This will let stakeholders to make informed decisions and tighten market discipline. Bolstering confidence in banks by helping to address some of the uncertainties about climate-related financial risks and associated vulnerabilities will also support financial stability.

But there are also a number of key questions that need to be answered first. These include: (i) what definitions are needed to build comparable disclosures, and whether a common taxonomy of activities at a global level is feasible; (ii) whether and how we can develop a common sector classification that identifies the relative transition and physical risks of different industries; and (iii) how best do we balance the disclosure of qualitative and quantitative information. These are questions that require ongoing analysis and discussions at the global level.

Let me end by noting the critical importance of ongoing cooperation and coordination when it comes to work on climate-related financial risks. Given the parallel initiatives and discussions under way at other global forums, most notably the Financial Stability Board, the Network for Greening the Financial System and the International Sustainability Standards Board, the Committee is carefully liaising with these and other bodies as we move forward. Events such as the Conference of Montreal are also provide the Committee with an important venue for hearing the views of a broad set of external stakeholders.

Thank you.

¹³ Hernández de Cos (2022).

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