Basel and Climate Risk: How will Guidelines Evolve?

By Xavier Dubois

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With updated guidelines on the way, institutions must prepare for changes to their data management processes.

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Institutions, public and private, large and small, are devoting time and resources to climate change, and the Basel Committee on Banking Supervision is no exception. The architect of global financial regulation has made clear that climate risk will be a priority in 2022, and so banks must make it a priority, too.

They will have to address two main types of risk associated with uncertainties surrounding climate: Physical risk is harm caused by the short- and long-term material effects of climate events – storms, heat, cold – on a bank or its customers. Transition risk concerns the effects of legislative or regulatory developments that affect operations.

Climate risk is clearly an area of concern and action, but it remains unclear what exactly financial institutions must do and how they should go about it. That hinges on what the Basel committee does, and that apparently is still being determined. But the committee has laid out its thinking, notably in November 2021 in "Principles for the Effective Management and Supervision of Climate-Related Financial Risks." The document includes a request for comment from the industry, so it is not the committee's last word on the subject, but it offers a glimpse into guidelines that will be translated into laws and regulations for institutions to follow.

Basel IV: Change at the margins, not at the core

The document reiterates two broad themes underpinning Basel IV, proportionality and interdependency, that will guide the committee's approach to climate risk. Larger banks will have more work to do because of their greater potential impact on the stability of the financial system, and each risk that an institution must manage – credit, liquidity, market, for example, and now climate – must not be considered on its own but in relation to the others.

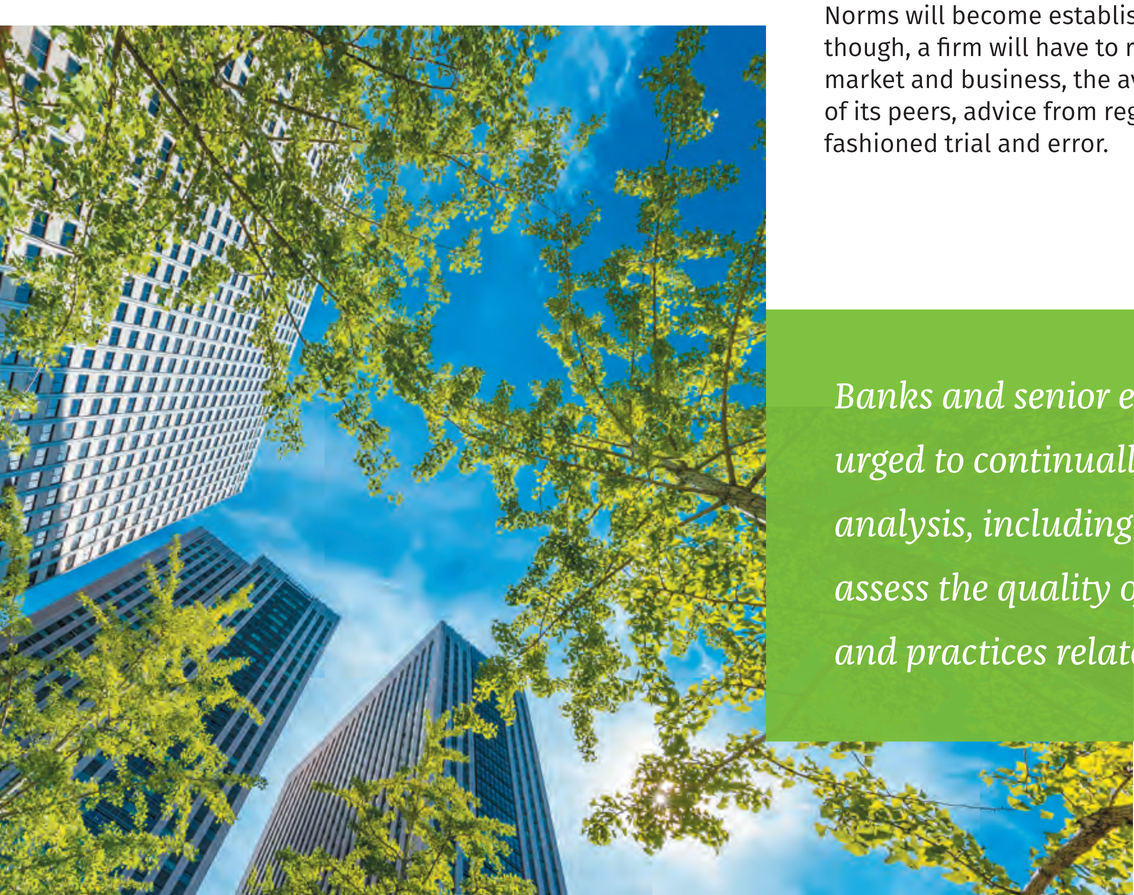
The committee sets out 12 principles in which they urge banks and their senior executives to:

- Factor climate risk into everything they do, including when considering new business strategies, and the potential impact on market, liquidity, operational and other significant types of risk, and to **ensure that climate risk is incorporated into risk management systems and processes**.
- Keep an especially close eye on factors that could be incompatible with a firm's risk tolerance and lead to impairments, such as building up excessive exposures to certain industries, and to consider risk mitigation measures where appropriate.
- Appoint dedicated personnel and implement appropriate policies throughout an organization to identify and manage climate risks.
- Make sure risk data aggregation capabilities and internal reporting practices take climate risk into account.
- Keep in mind that climate risks can originate pretty much anywhere and may take more time to fully manifest than banks are accustomed to with other types of risk.
- Continually use scenario analysis, including stress testing, to assess the quality of their strategies and practices related to climate risk.

Much of the document presents these ideas in the context of capital and liquidity adequacy, so it is reasonable to think that finalized **guidelines will include updates to ICAAP and ILAAP processes**. It also advises banks to focus on three "lines of defense" against adverse climate-related risks: during the credit review process with clients, through continuous assessment and monitoring, and through the internal audit function.

The industry has much work ahead of it. The Basel committee no doubt will find a deft way to incorporate climate risk formally into its broad risk assessment principles. Banks then will have to incorporate the updated guidelines, after supervisory authorities have codified them, into their risk models. That likely will be difficult because climate risk is unlike the other risks that they are used to dealing with. Lenders can rely on a wealth of experience to gauge the odds that a homeowner will run into financial difficulties and default on a mortgage, for instance, and calculate how much money is likely to be lost as a result.

That means banks are likely to need a different approach for modeling climate risk than for other risks. Just what that approach might look like remains to be determined. Norms will become established over time. For a while, though, a firm will have to rely on an understanding of its market and business, the available science, the actions of its peers, advice from regulators and, of course, old-fashioned trial and error.



Banks and senior executives are urged to continually use scenario analysis, including stress testing, to assess the quality of their strategies and practices related to climate risk.

The result will be a massive superset that combines prudential data, financial data and climate risk data as climate risk becomes a new dimension of the finance and risk worlds.

Showing the way forward

Fortunately there is a clear, well marked path to follow when it comes to incorporating climate risk into the broader risk assessment that a bank conducts for regulators and for making commercial decisions. **It is signposted in the Basel consultative document by the emphasis on interdependency – the principle that financial institutions should take a holistic approach to risk management by considering the impact of a particular risk not just on its own but due to its effect on other risks.**

Adhering to this principle requires an understanding of the mutual influence among risk factors and the sensitivity of each to others, a feat that can be accomplished only through the integration of key departments like finance, risk and compliance, and the data systems they use. It is a formidable task, but it does give banks an item to add to their to-do lists while they wait for the Basel committee to update its guidelines for climate risk. They should take stock and make sure they have a data management architecture that is able to generate business projections and compute all economic and regulatory risk types under unlimited modeling scenarios. This is particularly important for climate risk because it is likely to have substantial impacts on various other risk factors.

That means a solution that focuses on a single risk type, say credit or market risk, definitely will not be good enough for planning or stress testing. A solution also must be able to integrate both economic and regulatory risk metrics, and not proxies. That is especially true with respect to stress testing, for which the proxy would have to be a close approximation of the exact factor being measured, a difficult endeavor when dealing with something as out-of-the-ordinary as climate risk.

Beyond these qualitative requirements, a data solution that can handle climate risk – and all the others – must meet prodigious quantitative demands, too. Climate risk modeling, however it ends up being done, will require copious amounts of data that then will need to be merged with the vast amounts of data already required under Basel guidelines. The result will be a massive superset that combines prudential data, financial data and climate risk data as climate risk becomes a new dimension of the finance and risk worlds.

Climate risk will have a great effect on all financial risks in ways that for some time will remain hard to understand and measure. What is clear, though, is that climate risk is holistic and therefore requires a holistic approach to risk management and a solution that will enable it to be carried out effectively. That is not a new message from the Basel committee, even if it is being repeated in the context of a new sort of risk that presents new unknowns. Banks that have heeded it are on their way to managing climate risk already. Banks that have fallen behind have another good reason to start listening and catching up.

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