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Regulatory Alert

Regulatory Insights for Financial Services

June 2022

Climate-related risk: Final BCBS Principles for managing and supervising climate-related financial risks

The BCBS' initial consultative release was quickly followed by similar proposals from the Financial Stability Board and the OCC and FDIC. Movement toward consistency across the climate-related risk management frameworks is highlighted by the BCBS addition/adoption of guidance suggesting banks develop and invest in appropriate capabilities and expertise, tie compensation policies to climate-related elements in the business strategy and risk management, align internal climate-related policies and procedures with publicly-facing strategies and commitments, and incorporate physical and transition risks into scenario analysis and stress testing. Some industry participants suggest the finalization of the BCBS principles will prompt other supervisors, including those in the U.S., to finalize their own guidance in the near term. Financial services companies should expect, however, that the U.S. regulators will set their own course, informed by international frameworks and standards; they will focus on climate-related governance, risk management, and scenario analysis, inclusive of higher expectations in areas like stress test, portfolio/sector analysis, due diligence, and integration across all risk pillars.

The Basel Committee on Banking Supervision (BCBS) finalized principles for the effective management and supervision of climate-related financial risks. The document is substantially similar to the draft principles issued for consultation in November 2021, retaining each of the 18 principles and offering limited supplemental guidance. Key additions include guidance to banks to:

- Continuously develop their capabilities and expertise in climate-related risks and ensure the allocation of appropriate resources to manage that risk
- Consider whether changes to compensation policies are warranted to align with the incorporation of climate-related risks in the business strategy and risk management frameworks
- Ensure that internal strategy and risk appetite statements are consistent with any publicly communicated climate risk strategies and commitments
- Incorporate physical and transition risks that are relevant to the bank's business model, exposure profile and business strategy, and are assessed as material over relevant time horizons, into their stress testing programs.

BCBS suggests that the principles, outlined below, are formulated to improve practices related to climate-related financial risk management and provide a common baseline for large, internationally active banks and supervisors. They add that, "smaller banks and authorities in all jurisdictions can benefit from a structured consideration of the potential impact of climate-related financial risks." Member jurisdictions are expected to implement the principles "as soon as possible;" BCBS will be monitoring progress.

Principles for banks

The BCBS recommends the following twelve principles for banks, grouped into eight high-level topics.

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Corporate governance	
Principle 1	Adopt a **process for understanding and assessing climate-related risk drivers and their impacts on business and operations**. This should include consideration of material physical and transition risks that could manifest over different time horizons, incorporation of these risks into their overall strategies and risk management frameworks, and consideration of exposure to structural changes in the economy, financial system and competitive landscape as a result of these risks.
Principle 2	Clearly **delegate climate-related responsibilities and exercise effective oversight** of climate-related financial risks throughout the organizational structure to ensure material risks are appropriately considered as part of the bank's business strategy and risk management framework.
Principle 3	Adopt and embed appropriate **policies, procedures, and controls** to ensure effective management of climate-related financial risks across all relevant functions and business units.

Internal control framework	
Principle 4	Incorporate climate-related financial risks into 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. — In the frontline, **climate-related risk assessments** may be undertaken during the client onboarding, credit application, and credit review processes. — The second line should be responsible for undertaking **independent** climate-related risk assessment and monitoring, including **challenging** the initial assessment conducted by the frontline. — The third line 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	
Principle 5	Identify, quantify, and incorporate material climate-related financial risks into **internal capital and liquidity adequacy assessment processes**. To accomplish this, banks should begin to develop **risk analysis capabilities** by identifying relevant climate-related risk drivers that may materially impair their financial condition, developing key risk indicators and metrics to quantify exposures to these risks, and assessing the links between climate-related financial risks and traditional financial risk types such as credit and liquidity risks.

Risk management process	
Principle 6	Ensure that **risk appetite and risk management frameworks** consider all material climate-related financial risk exposures that could impact their financial condition, including capital resources and liquidity positions, and establish a reliable approach to identifying, measuring, monitoring, and managing those risks including establishing definitions, thresholds for materiality, and risk mitigation measures.

Management monitoring and reporting	
Principle 7	Ensure that internal reporting and data **systems are capable of monitoring material climate-related financial risks and producing timely information** to ensure effective decision-making. Areas for banks to consider when building out reporting and data capabilities include incorporating climate-related financial risks into risk **data aggregation capabilities; investing in data infrastructure and enhancing existing systems;** and developing **qualitative or quantitative metrics or indicators**.

Comprehensive management of credit risk	
Principle 8	Understand and assess the impact of climate-related risk drivers on **credit risk profiles** and ensure **credit risk management systems and processes** consider material climate-related financial risks. Banks should employ a range of risk mitigation options to control or minimize material climate-related credit risks, such as adjusting credit underwriting criteria, imposing loan limitations or restrictions, or limiting exposures to companies, economic sectors, geographical regions, or segments of products and services.

Comprehensive management of market, liquidity, operational, and other risks	
Principle 9	Understand the impact of climate-related risk drivers on **market risk positions** and ensure that **market risk management systems and processes** consider material climate-related financial risks. Considerations might include analysis of a sudden shock scenario and how the pricing and availability of hedges could change given different climate and transition pathways, including in the event of a disorderly transition.
Principle 10	Understand the impact of climate-related risk drivers on **liquidity risk profiles** and ensure that **liquidity risk management systems and processes** consider material climate-related financial risks.
Principle 11	Understand the impact of climate-related risk drivers on **operational risk** and ensure that **risk management systems and processes** consider material climate-related risks; expect to analyze how physical risk drivers can impact their business continuity and account for them when developing business continuity plans.
Scenario analysis	
Principle 12	**Develop and utilize scenario analysis, including stress testing,** to assess the resilience of business models and strategies to a range of climate-related situations and determine the impact of climate-related risk drivers on 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. Banks should also consider the following: — The objective(s) of climate scenario analysis should be reflected in the overall climate risk management framework as determined by the board and senior management, and could include exploring the impacts of climate change and transition on strategy and resiliency, identifying key risk factors, measuring vulnerabilities, diagnosing data or methodological problems, or informing the adequacy of the overall risk management framework. — Sufficient capacity and expertise are crucial to conduct climate scenario analysis, and should be proportionate to an institution's size, business model, and complexity. — Climate scenario analysis is highly dynamic, and practices are expected to evolve rapidly, therefore, climate scenario models, frameworks, and results should be subject to challenge and regular review by a range of internal and/or external experts and independent functions.

Principles for supervisors

The BCBS recommends six principles for supervisors in two broad categories.

Supervision of banks	
***Principles 13-15:** Supervisors must look for banks' climate-related risk management to:*	— Be soundly and comprehensively incorporated into business strategies, corporate governance, and internal risk control and management frameworks. — Provide for adequate identification, monitoring, and management. — Identify and assess the impact of climate-related risk drivers on their risk profile.
Supervisor responsibilities	
***Principles 16-18:** In carrying out their responsibilities, supervisors must:*	— Utilize an appropriate range of techniques and tools and adopt adequate follow-up measures in case of material misalignment with supervisory expectations. — Employ adequate resources and capacity to effectively assess management of climate-related financial risks. — Use climate-related risk scenario analysis, including stress testing, to identify relevant risk factors, exposures, and data gaps, and inform the adequacy of risk management approaches.

Please refer to:

- BCBS Press Release: Principles for the effective management and supervision of climate-related financial risks
- BCBS Document: Principles for the effective management and supervision of climate-related financial risks
- BCBS Consultative Document: Principles for the effective management and supervision of climate-related financial risks
- KPMG Regulatory Alert: BCBS consultation: Principles to manage climate-related financial risks
- KPMG Regulatory Alert: Supervisory and Regulatory Approaches to Climate-related Risks: FSB, OCC and FDIC

For additional information, please contact Amy Matsuo or Steven Arnold.

Contact the author:

Amy Matsuo
Principal and Leader
Regulatory and ESG Insights
amatsuo@kpmg.com

kpmg.com/socialmedia

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