

June 30, 2022

Via electronic mail

Secretariat to the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland



Re: IIF/ISDA/GFMA Response to FSB Consultation on Interim Report on Supervisory and Regulatory Approaches to Climate-related Risks

Dear Chairman Knot and Secretary General Domanski:

The Institute of International Finance (IIF),¹ the International Swaps and Derivatives Association (ISDA),² the Global Financial Markets Association (GFMA),³ and their members (hereafter the 'Associations') appreciate the opportunity to provide public comments to the Financial Stability Board (FSB) on its Interim Report on '*Supervisory and Regulatory Approaches to Climate-related Risks*' (hereafter the 'report'). The Associations collectively represent the global financial industry, including commercial and investment banks, asset managers, re/insurers, ratings agencies, market infrastructure providers, and professional services firms (hereafter 'financial institutions').

Our feedback is structured in two parts: (1) overarching messages, which are relevant to all the discussion questions; and (2) specific feedback on the FSB's nine discussion questions listed in the report, grouped according to the thematic headings used in the report.

¹ The Institute of International Finance is the global association of the financial industry, with 400 members from more than 60 countries. Its mission is to support the financial industry in the prudent management of risks; to develop sound industry practices; and to advocate for regulatory, financial, and economic policies that are in the broad interests of its members and foster global financial stability and sustainable economic growth. IIF members include commercial and investment banks, asset managers, insurance companies, sovereign wealth funds, hedge funds, central banks, and development banks.

² Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 960 member institutions from 78 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org.

³ GFMA represents the common interests of the world's leading financial and capital market participants to provide a collective voice on matters that support global capital markets. It also advocates on policies to address risks that have no borders, regional market developments that impact global capital markets, and policies that promote efficient cross-border capital flows to end users. GFMA efficiently connects savers and borrowers, thereby benefiting broader global economic growth. The Association for Financial Markets in Europe (AFME) located in London, Brussels, and Frankfurt; the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong; and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian, and North American members of GFMA.

1. Overarching Messages

The Associations support and welcome the FSB's initiative in developing the report to assist supervisory and regulatory authorities in developing their approaches to climate change, focusing on cross-sectoral and system-wide aspects of climate-related financial risks. The global nature of climate-related financial risks means that the FSB has a pivotal role to play to help coordinate the development of common principles to support financial institutions in developing expertise and building capacity to identify, assess, and manage climate-related financial risks. The potential for system-wide manifestations of climate-related financial risks also means that the FSB is well placed to help identify risks and issues across financial institutions, and as such can play a determinant role in helping establish good risk management practices.

We support the FSB's initiative to consult on the collection of supervisory and regulatory climate risk data, given that well-balanced and aligned data standards are key for effective implementation of climate-related decision-making for financial institutions, as well as policymakers. Furthermore, fostering effective risk management practices for climate-related financial risks and providing a common baseline for internationally active financial institutions and supervisors, while maintaining sufficient flexibility to support necessary innovation in a fast-evolving landscape and associated practices, is key in the eyes of financial institutions. Having said that, we believe it would be valuable for the FSB to delve more deeply into how financial regulatory policy intersects with overall non-financial economic and climate policy.

We consider climate change to be a critically urgent global issue, which therefore warrants a globally coordinated and harmonized approach across jurisdictions, including in supervisory principles and standards with respect to climate risk management. As recognized by the FSB,⁴ numerous jurisdictional authorities have already moved ahead to develop and implement local prudential responses to climate-related risks and opportunities that face the banking, and broader financial, sector. It is encouraging that many authorities across the world are seeking to move swiftly on these extremely important and pressing topics; however, an uncoordinated and rapid proliferation of new policies – given significant uncertainties and data and knowledge gaps – could foster a fragmented and less effective policy landscape. Steps towards greater policy and supervisory coordination are particularly important with respect to risk management approaches of major cross-border financial institutions, many of which are currently facing a multitude of differing supervisory expectations and requirements focused on aspects of climate-related risk. As such, we support the FSB's view that a consistent global approach to addressing climate-related risks will help to better assess and mitigate financial vulnerabilities. Market fragmentation is not conducive to achieving the goals of the Paris Agreement. While we are aware that the call for a globally coordinated approach to global risks faces significant practical and geopolitical challenges, it remains the best way to move forward and achieve the Paris Agreement's objectives. A global risk demands a globally coordinated response, not more fragmentation.

⁴ FSB 2020, "[Stocktake of financial authorities' experience in including physical and transition climate risks as part of their financial stability monitoring.](#)" (July).

Recognizing the work underway by global standard-setting bodies (SSBs, including the Basel Committee on Banking Supervision [BCBS] and the International Association of Insurance Supervisors [IAIS]), the FSB can add value by targeting supervisory and regulatory approaches which can complement microprudential instruments. To convey views on approaches for achieving greater coordination, the IIF has submitted a public comment letter to the BCBS consultation on *"Principles for the effective management and supervision of climate-related financial risks."*⁵ In that letter, the IIF welcomes the development of global principles to support supervisory cooperation and collaboration. The IIF's detailed comments on the BCBS consultative document may also be relevant to the FSB consultation from a banking industry perspective given the two documents cover bank management of climate-related financial risks and the supervision of climate-related financial risks. In addition, in 2021 the IIF submitted a public comment letter to the IAIS on their *"Application Paper on the Supervision of Climate-related Risks in the Insurance Sector"*⁶; this document may be relevant to the FSB from an insurance industry perspective. GFMA and ISDA have also submitted a response to the BCBS consultation on *"Principles for the effective management and supervision of climate-related financial risks"*⁷ highlighting the need for global coordination in tackling climate risks.

As expressed in these comment letters and several analytical reports addressing the topic of supervisory and regulatory approaches to climate-related risks, the Associations and their members consider that supervisory engagement, risk management, disclosure, and scenario analysis exercises are likely to be an effective toolkit for financial institutions to measure, manage, and take steps to mitigate climate-related risks.⁸

The Associations and our members would appreciate further information on how this report will be used by the FSB in regard to additional policymaking, and how the FSB plans to engage with other SSBs which are currently undertaking work relevant to the topics raised in the report. Furthermore, the Associations encourage the FSB to continue addressing the challenges from data gaps, the need for real economy data, and the cross-sectoral transmission of climate risks through engagement with the G20 and other relevant international bodies responsible for the broader economy.

⁵ IIF 2022, "[IIF responds to BCBS Consultation on Principles for the Effective Management and Supervision of Climate-related Financial Risks](#)" (February).

⁶ IIF 2021, "[IIF Response to IAIS AP on Supervision of Climate-Related Risks](#)" (January).

⁷ ISDA, GFMA 2022, "[Response to BCBS on Principles of Climate-related Financial Risk](#)," (February).

⁸ IIF 2021, "[Prudential Pathways: Industry Perspectives on Supervisory and Regulatory Approaches to Climate-related and Environmental Risks](#)" (January).

2. Specific feedback on the FSB Interim Report Discussion 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 prioritized.

Issues of quality and availability of climate-related data remain a significant challenge for financial institutions, supervisors, and policymakers alike.⁹ Data issues were identified early on as a potential obstacle to financial institutions' progress on the range of fundamental tasks in relation to climate-related risks, including risk management, strategic decision-making, modelling, scenario analysis, and disclosure.¹⁰ The Associations consider that many of the challenges raised by the FSB in its 2021 report on climate-related data remain persistent, including: low granularity of data on financial institutions' exposures for purposes of assessing potential exposure to physical risks; challenges in relying on ESG ratings in different applications; the early stage of maturity of forward-looking metrics; and specific issues affecting emerging markets and developing economies.¹¹

The onus of data collection is often placed on regulated/supervised financial institutions – specifically banks and insurers – given their unique role and their ability to survey and influence customers and counterparties; however, gathering such data requires significant effort and involves high transaction costs for financial institutions. This is especially the case for financial institutions that have a large proportion of mid-market and small and medium-sized enterprises (SME) clients.

Against this background, we would like to stress that any supervisory/regulatory data collection should also strongly focus on the usability and availability of the data for financial institutions internally, including for capital allocation, strategic decision-making, and underwriting purposes. The data metrics should also be compatible with current and planned regulatory reporting to avoid additional adaptation costs.

The Associations and their members consider that several types of climate-related risks identified in the report could be relevant from an identification, assessment, and management perspective; however, **further clarity is needed regarding the objective and scope of the array of data relevant to supervisors' and regulators' understanding of climate-related risks.** Specifically, it is not clear if the list of items in section 2.4.1 is intended to serve as guidance for supervisors and regulators, or whether the items in Table 1 are intended to serve

⁹ For example see: BCBS 2021, "[Climate-related financial risks - measurement methodologies](#)" (April), hereafter referred to as "BCBS April 2021"; FSB 2021, "[The Availability of Data with Which to Monitor and Assess Climate-Related Risks to Financial Stability](#)" (July), hereafter referred to as "FSB 2021"; IAIS 2021, "[Application Paper on the Supervision of Climate-related Risks in the Insurance Sector](#)" (May), hereafter referred to as "IAIS 2021"; NGFS 2021, "[Progress Report on Bridging Data Gaps](#)" (May).

¹⁰ In July 2021, an IIF survey of 20 large banks globally showed that availability of necessary data was their number one challenge to modelling the financial risks under different climate scenarios (see IIF [2021]).

¹¹ FSB 2021.

as a 'menu' of options that supervisors could consider. While the climate-related analytical and methodological landscape within the financial sector and broader economy is developing rapidly, designing reporting requirements that allow for targeted use of data for policymakers and financial institutions alike is daunting at the moment.

While the report does recognize that there are many areas where there are "significant data gaps and remaining information needs," it is necessary to fully reflect the challenges that different types of financial institutions may face in delivering data in the context of supervisory reporting. **Here, the FSB could add value to its members and the broader financial system by placing greater focus on the level of maturity of different types of climate-related data, and the associated challenges that financial institutions face in their efforts to gather necessary data from customers and counterparties.**

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

The Associations believe that proposed recommendations to increase the reliability of climate-related data should reflect the issues associated with financial institutions' reliance on climate-related data produced by corporate entities, which may not be provided through corporate disclosure alone. In a 2021 report, the BCBS provided a helpful description of the categories of data which are required for each step of the analytical chain: from data on the physical and transition risk drivers for purposes of linking to economic risk factors, to exposure-level data to link changes in economic risk factors to specific exposures, and financial exposure data to link climate-adjusted economic risk factors to financial risks which may affect the financial institution. The combination of data types, time series, and models required to comprehensively account for climate-related risk drivers in financial risk management adds to the complexity of the task and the time required for financial institutions to develop a quantitative approach to climate-related risk management.

In response to customer demand and supervisory expectations, many financial institutions are seeking to make progress on risk management, quantitative analysis, and transition planning on a much quicker timetable than is likely for progress on enhancements to corporate disclosures and other data. This begs the crucial question of how best to bridge the climate/ESG data gap in the meantime. Some supervisors, recognizing the present data limitations, have publicly encouraged financial institutions to take "ambitious"¹² or "strategic"¹³ approaches to filling data gaps, as well as developing data improvement strategies. Examples of near-term steps to meet data needs in the absence of full information are the use of proxy data or estimates, acquisition of data from third-party sources, and use of qualitative risk classifications informed by expert judgement.

¹² Bank of England Prudential Regulation Authority (UK PRA) 2021, "[Climate-related financial risk management and the role of capital requirements](#)" (October).

¹³ ECB 2021, "[The state of climate and environmental risk management in the banking sector: Report on the supervisory review of banks' approaches to manage climate and environmental risks](#)" (November).

The Associations and their members are concerned about a risk of over-reliance on rough estimates, proxies, or inappropriate data for purposes of decision-making and disclosures. Concerns relate to the potential for biased or inaccurate estimation of the risks or opportunities associated with a particular client or project, concerns that the financial institution will expose itself to reputational or liability risks if its stakeholders consider its use of data to be inappropriate, and the challenges and costs associated with re-engineering internal databases and reporting systems for “temporary” data sources which may be phased out.

As such, we encourage the FSB to reflect these concerns within Recommendation 2 and propose that supervisory and regulatory authorities work with regulated financial institutions and other regulators (e.g., securities regulators) to develop integrated frameworks that address broader issues in the climate data information chain through the economy and financial system. By the same token, we encourage the FSB to raise the awareness of the G20 and other policy makers, including ministries of finance and other international bodies, of persistent data gaps from the real economy that constrain the ability of supervisors and financial institutions alike to progress towards the objectives of the Paris Agreement. With the goal of addressing the lack of climate data from the broader economy, French President Emmanuel Macron and UN Special Envoy Michael Bloomberg recently announced the creation of the UN Climate Data Steering Committee which will present recommendations on an open-data public platform during the September 2022 meetings of the UN General Assembly. However, prior to addressing the lack of data, there needs to be an understanding of the important concepts of sustainability risks that are relevant to climate risk, e.g., double materiality, climate risk as a risk driver, time horizon (long-term/20-30 years), and reporting (supervisory reporting distinct from public disclosures). Once a baseline has been established, supervisors should focus efforts on promoting a consistent cross-sectoral, globally coordinated approach to the disclosure of data, while recognizing industry specificities.

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

The Associations support the FSB’s efforts to identify elements of a common high-level definition of climate-related risks. We would note that existing definitions of such risks, including those advanced by the Task Force on Climate-Related Financial Disclosures (TCFD), have provided a useful framework for financial institutions and official-sector stakeholders. As supervisors and regulators begin to deepen their approaches to consideration of climate risks, greater clarity and granularity in definitions could potentially be warranted. **We would encourage the FSB to advance a formal stock-take of definitions of physical and transition risks, specifically identifying which definitions proposed by SSBs would be considered common definitions.** While further clarity or definitions of liability risk as it relates to climate-related risks could be further standardized, it should be done so in the context of existing operational risk frameworks and guidance, rather than exclusively in climate risk frameworks. This clarification would enhance the value of Recommendation 3 above and beyond the existing framework of definitions already available from market-based and public sources.

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.

With respect to the identification of climate-related information needs from financial institutions, we recommend that official-sector efforts focus on fostering common approaches to addressing data gaps, such as the appropriate use of proxies, recognizing the contingencies on corporate disclosures and counterparty data noted above. Linked to this, we recommend the FSB consider the relationship between global disclosure frameworks, including the standards being developed by the International Sustainability Standards Board (ISSB), in order to avoid the risk of multiplicative and inefficient regulatory reporting frameworks which perpetuate fragmentation.

Further public-private discussions at the global level are required to analyze the relationship between supervisory reporting, Pillar 3 (i.e., risk-related disclosures), and corporate disclosure requirements that affect financial institutions. For example, while the global standards being developed now by the ISSB for climate-related disclosures may provide useful input to regulatory reporting needs, they are not designed with the objective of risk-related reporting. The industry would welcome an opportunity to further discuss this topic at the global level to prevent further fragmentation of jurisdictional approaches to regulatory reporting, which some authorities have already started to design and specify in some detail.¹⁴

We would encourage the FSB to consider facilitating technical dialogue between industry and supervisory stakeholders on technical aspects of climate-related data management, in order to identify a suite of common approaches that could be recognized at jurisdictional levels - while also reflecting the need for flexibility as approaches evolve and data sources mature. While this work would need to be led by SSBs, the FSB could usefully contribute to this from a cross-sectoral perspective, engaging with relevant industry groups and market-based frameworks, with the aim of encouraging uptake of approaches and principles within global frameworks.

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.

Understanding of the potential impacts and implications of "system-wide" aspects of climate change remains at an early stage. While it is evident that over the long-term, significant disruptions to the economy, contractions of economic activity, and falls in asset prices stemming from the impacts of physical and transition risks could pose system-wide shocks to the economy, it is important to note that there are many variables which may influence the degree to which such system-wide shocks may lead to systemic risks to the financial system.

¹⁴ For example, see the European Banking Authority's (EBA) recently finalized draft [ESG Pillar 3 standards](#).

Recent geopolitical events impacting energy markets have made these assessments increasingly complex.

The FSB could add significant value to important open questions by focusing its efforts on developing a consistent framework for the identification of how system-wide aspects of climate change could potentially lead to the build-up of financial system vulnerabilities and system-wide risks.

One aspect of the report which may warrant revision in this regard is the framing of various transmission channels and feedback loops which may amplify climate-related shocks across the financial system and broader economy. Specifically, discussion of the relationship between financial sector capital allocation and customers' transition pathways should be more nuanced. While the Associations agree in principle with the FSB's statement that "reductions in bank lending and in insurance coverage in response to climate-related risks could adversely affect the supply of financial services to the real economy, which in turn could lower economic growth and feedback negatively to the financial system via an increase in financial losses," it is important to recognize that these decisions are made in response to the strategies of customers and counterparties where service relationships exist. As such, the feedback loop affecting the provision of transition financing, insurance, or capital in support of decarbonization starts with decisions made in the real economy; the actions of regulated financial institutions alone are unlikely to influence corporate behavior, not least due to the availability of other sources of capital for industries which may otherwise be affected by strategic choices by financial institutions in the absence of transition plans from customers and counterparties (e.g., implementation of exclusion policies).

Financial institutions and other organizations, e.g., Glasgow Financial Alliance for Net Zero (GFANZ), Net Zero Insurance Alliance (NZIA), and Net Zero Asset Owner Alliance (NZAOA), have committed to achieve Net Zero emissions in operations by specific dates, e.g., 2030 and 2050. Even though these financial institutions have made public commitments, the private sector needs transparent supervisory intervention and advocacy to create a successful partnership in addressing financial risks from climate change. As the BIS recently noted, "It is unrealistic to expect that financial institutions can drive the required reallocation of resources in the absence of adequate environmental policymaking in the broader economy. Such unrealistic expectations could undermine financial stability and may derail the green transition itself."¹⁵

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

The report provides a helpful summary of current supervisory and regulatory approaches across jurisdictions. **However, the Associations and their members believe that the report**

¹⁵ Bank for International Settlements, "Finance and climate change risk: managing expectations", Article by Mr. Claudio Borio, Head of the Monetary and Economic Department of the BIS, Mr. Stijn Claessens, Deputy Head of the BIS Monetary and Economic Department, and Mr. Nikola Tarashev, Head of Financial Systems and Regulation, BIS7 June 2022.

does not adequately address the question of whether current supervisory and regulatory tools and policies enable climate risks to be appropriately accounted for, and whether or not specific macroprudential measures could be warranted in the future, when foundational work has sufficiently progressed, to address cross-sectoral transmission of climate risks.

One particular area of concern is the evolving debate on potential use of the capital framework, an issue which is of primary importance and under progress in multiple jurisdictions. There is an emerging consensus that climate-related and environmental risks may already be generally captured within regulatory and risk frameworks i.e., industry quantitative and qualitative frameworks, the Basel framework for banks, and within the development of the Insurance Capital Standard (ICS) by the IAIS ICS. With regard to re/insurers, supervisors in many jurisdictions currently rely on re/insurers Own Risk and Solvency Assessment (ORSA) reporting to allow for a review of re/insurers' climate-related risks based on climate-related scenarios, but not as a means of defining capital add-ons.¹⁶

Furthermore, the FSB's report does not sufficiently explore the extent to which risks (e.g., credit, market, operational) are already considered or mitigated in the prudential framework such as in internal models or in external ratings, nor does it explore the extent to which these risks are already taken into account in accounting data. While climate risk management is a nascent discipline with a paucity of reliable data sources, tools, and infrastructure capabilities in various stages of development, the assessment of the financial impacts to wider environmental risks is at an even earlier stage. However, data and methodologies are developing at pace, and there is a clear need for coordination to support a smooth incorporation of any new practices and policies adopted by authorities. These should be implemented through well thought-out and aligned sets of definitions, standards, and supportive regulatory treatment.

The Associations and their members remain firmly of the view that no climate-related amendment of the Pillar 1 (i.e., quantitative framework) is warranted. Recognizing that conceptually the regulatory framework has been designed to capture all risks, any prudential discussion should therefore start with a targeted gap analysis on whether there are elements introduced by climate-related risks that are not yet effectively captured, as the BCBS is currently undertaking on the banking side. Authorities, industry, and relevant experts should collaborate to gather data and build knowledge and modelling capabilities. It should be acknowledged that different types of data, analytical techniques, levels of precision and time horizons may be appropriate, considering the unique characteristics of climate-related and environmental risks. For example, supervisors should recognize the degree of uncertainty as to the extent and timing in which climate risks may materialize over a long-term time horizon of 20-30 years. Climate scenario analyses are long-term, multi-period projections that pose unique challenges to modelling capabilities when compared to short-term stress tests and scenario analysis. Longer term modelling exercises are more complicated, and less reliable or robust than short-term stress tests. Therefore, due

¹⁶ An ORSA generally reflects a time horizon of 1-3 years, while some climate risks may occur over a longer time horizon, such as 20-30 years. Therefore, allocating capital to risks that may or may not occur in 20-30 years' time could cause unintended consequences and potentially generate additional levels of systemic risk

consideration should be given to how long-term and more uncertain risk elements are embedded in short-term risk frameworks and standards.

We share the view of the BCBS and other supervisors that climate-related risk factors are not a new category of risk per se: they are 'risk drivers' of the existing prudential risk categories, especially credit risk, with a potential positive or negative impact. Given the nascent nature of the collective understanding of how climate risk drivers will impact existing risks, it seems premature to define a supervisory or regulatory capital treatment. In any case, while some progress has been made in order to capture climate-related risks under Pillar 2 (i.e., qualitative analysis), it will be important to ensure that, over time, overlap or double counting between supervisory requirements and macroprudential requirements does not occur. Alignment of prudential treatment globally is critical to foster the continued evolution and innovation of financial institutions' climate-related financial risk management efforts. Multiple, similar regulatory and supervisory requests on climate risks is a significant burden on financial institutions and the principles should reflect the need for streamlining among supervisors and institutions.

Other issues which may warrant further consideration include supervisory approaches in evolving areas - such as oversight and engagement of financial institutions' transition plans - which are evolving rapidly. Prudential authorities in particular should clarify whether and how financial institutions' Net Zero activities are relevant to their micro- or macro-prudential mandates. Furthermore, prudential authorities could consider the use of tools such as supervisory climate scenario analysis exercises to assess the impacts and implications of broad-based alignment activities within the financial sector and real economy. However, prudential authorities should not assume the responsibility of regulating the general approach to the development of Net Zero alignment frameworks *per se*, as other mechanisms - including market discipline - should be used to ensure the technical appropriateness and integrity of such frameworks. We would underline the need to achieve a balance in fostering effective risk management practices for climate-related financial risks and providing a common baseline for internationally active financial institutions and supervisors, while maintaining sufficient flexibility to support necessary innovation in a fast-evolving landscape and associated practices.

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

Numerous jurisdictional central banks and other supervisors have recently undertaken, or are currently undertaking, Scenario-based Climate Risk Measurement (SCRM) exercises, including scenario analysis and stress testing. Separately, financial institutions are also increasingly turning to industry-led climate scenario analysis as a useful tool for internal risk management purposes, as input to disclosures, and to inform strategic decision-making - such as setting climate-related targets and commitments. However, supervisors should continue recognizing the limitations of scenario analysis and stress testing with regard to climate-related risks given

the long-term time horizon of 20-30 years and the existing lack and consistency of data from the real economy.

While scenario analysis and stress testing approaches have things in common - e.g., they are both forward-looking and involve the use of scenarios to estimate financial impacts - there are important differences between the two tools, which affect their uses, design, and potential relevance in a macroprudential context. The BCBS has distinguished scenario analysis from stress testing on the basis of scope, relevance across climate risk time horizons, and potential applications by firms and supervisors. In its April 2021 analytical report, *"Measurement Methodologies,"*¹⁷ the BCBS differentiates forward-looking climate risk assessment approaches (involving the use of scenarios) into three main groups of tools for risk quantification – scenario analysis, stress testing, and sensitivity analysis – with the latter two considered as subsets of the first.

Supervisory SCRM exercises to date have varied significantly in terms of key design choices, such as scenarios applied, institutional scope and portfolio coverage, the format and specification of exercises (e.g., top-down vs. bottom-up components), key modelling assumptions (e.g., dynamic vs. static balance sheet assumptions), and the quantification and communication of outputs (e.g., metrics applied to quantify exposures or financial system vulnerabilities). These design choices have significant implications for exercise feasibility, comparability of exercise results and, ultimately, the value of these exercises for supervisors and financial institutions in terms of supporting progress towards an orderly transition to Net Zero with minimal risks to financial stability.

It is extremely important that there is a continued emphasis on collaborative development in technical areas of climate scenario analysis, such as prioritizing the lack of underlying data and existence of conceptual gaps, and on enhancing the comparability of supervisory exercises in terms of scenario choice, technical specification, and presentation of results. **Until those efforts are further advanced, it is important for authorities to - as stated by the BCBS - "recognise the limitations of their analyses when communicating their results or using them in supervisory assessments."**¹⁸

While the recently released BCBS principles are a helpful step forward, there is still not yet a common international approach or guidance for supervisors on applying the results of SCRM exercises in the context of the prudential framework. The results of supervisory SCRM exercises could potentially be applied in a number of ways; therefore, it is important that such applications reflect the high levels of uncertainty inherent in forward-looking analysis, the medium- to long-term nature of most climate risks, and the interrelated and contingent nature of climate risks and socioeconomic responses to them, as well as acknowledging the current levels of maturity of analytical approaches.

From a technical perspective, the results of medium- or long-term climate scenario analysis exercises should be treated with caution and should not inform capital evaluations, particularly as there are more efficient tools available to incentivize and

¹⁷ BCBS 2021 (April).

¹⁸ BCBS 2021.

oversee financial institutions’ management of longer dated risks. There are conceptual issues with setting capital requirements - which are intended to be a cushion against unexpected losses that could occur in the near-term - for risks that could materialize in 10, 20, or even 50 years. In addition, the simplifying assumptions and degree of uncertainty in long-term scenario analysis makes such exercises generally indicative of risks, rather than sufficiently robust to inform prudential requirements for individual institutions. Finally, the introduction of near-term capital implications for potential medium- to long-term risks could potentially have a counterproductive impact on the goal of an orderly transition to Net Zero with minimal risks to financial stability, for example, by disincentivizing flows of transition finance and insurance to high-carbon sectors. Nevertheless, climate scenario analysis is a powerful tool for medium- and longer-term risk assessment, such as horizon scanning, identification of risk transmission channels, and exploration of the impact of alternative transition and physical risk scenarios on financial stability.

While near-term climate stress testing could conceptually serve as an input to capital adequacy assessment, we believe it would currently not be appropriate to do so as the foundations are not in place with respect to knowledge, data, and modelling. As recognized by the BCBS, caution is required when using climate stress testing to assess resilience.¹⁹ Several conditions, which are unlikely to be met in the next few years, would need to be met before climate stress tests could be informative for quantitative capital planning.

Given the current state of data and evolving nature of methodologies, the FSB should not urge supervisors or financial institutions towards following a prescriptive approach to the expanded use of scenario analysis and stress testing in a macroprudential context.

Financial institutions are likely to start with a more qualitative approach until data improves and as such climate stress tests should be conceived as learning exercises with no impact on capital requirements. Indeed, for a robust quantitative portfolio-wide assessment of climate risks, advancements across data availability, comparability, and reliability are important to assess the potential impacts of climate risks on the performance of financial assets. We support the development of a principles-based approach, leveraging common standards including the NGFS, Representative Concentration Pathways (RCPs), and International Energy Agency (IEA) to accelerate the development of good practice to foster comparability of information. Such initiatives can work best as a joint industry and regulatory initiative. Examples include the establishment of the Climate Financial Risk Forum (CFRF) in the UK.

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?

¹⁹ For example: “Climate stress testing evaluates the effects of severe but plausible climate scenarios on the resiliency of financial institutions or systems. However, the uncertainty inherent in longer-dated assessments ... and the limited predictive power of historical observations to describe future climate-economic relationships ... render estimates of capital shortfall (or other measures of resiliency) less reliable than those of conventional stress tests employed by supervisors and banks to evaluate resiliency.” BCBS April 2021.

There is considerable work remaining in relation to understanding the macroprudential considerations of climate risk, stemming from a degree of methodological and data uncertainty. In February 2022, the Financial Stability Institute (FSI) highlighted in its Brief No. 16 'The regulatory response to climate risks: some challenges' that applying the macroprudential framework to system-wide climate-related financial risks is likely to be ineffective and potentially counterproductive for financial stability.²⁰ The FSI states that "supervisors may increase the resilience of financial institutions by using the pillar 2 framework."

Indeed, through stress tests, supervisors take into account adverse macroeconomic developments, such as the failure of carbon intensive industries. Hence, while potentially helpful, it is not obvious that a climate macroprudential framework is essential to ensure that the financial system is able to absorb system-wide shocks generated by climate-related events. Macroprudential measures aimed at reducing exposures to carbon intensive firms and sectors may not always be conducive to reducing aggregate climate-related financial risks. In particular, a significant increase in capital requirements for brown exposures, by curtailing the availability of credit and insurance to carbon intensive industries, would increase the vulnerability of those sectors and hinder affected firms from adjusting their business models.

The potential interplay between macroeconomic cycles and climate risk factors has yet to be clearly established and so the use of macroprudential tools in this area would be slightly premature at this stage. Authorities and financial institutions would need to invest more time in understanding the interconnectedness before engaging in any formalization. While some progress has been made in order to capture climate-related risks under Pillar 2 (i.e., qualitative analysis), it will be important to ensure that, over time, overlap or double counting between supervisory requirements and macroprudential requirements does not occur.

At a wider level, while financial institutions can clearly form a very effective part of the solution to achieve the objective of Net Zero greenhouse gas (GHG) emissions by 2050, they should not be the primary enforcers of climate policy. There is a political responsibility in defining the relevant industrial and tax policies that could ensure an orderly transition and limit transition and physical risk levels, for both climate and financial stability purposes. This was expressed well by the Bank of England in its statement, "regulatory capital cannot substitute for government climate policy."²¹

Financial institutions and regulators continue to invest significant resources to understand the transmission channels between climate risk drivers and prudential risk categories - for example through exploratory supervisory scenario analysis and stress testing exercises. A progressive and iterative development of methodologies and data availability would enable financial institutions to strengthen their risk management frameworks (for example through the building of risk and information technology infrastructure and the development of climate-specific scenarios).

²⁰ Financial Stability Institute (FSI) 2022, "[The regulatory response to climate risk: some challenges](#)," (February).

²¹ Bank of England 2021, "[Climate-related financial risk management and the role of capital requirements](#)" (October).

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?

As described in the answer to Question 8 above, there are important overarching questions that remain for supervisors and regulators to consider when evaluating the depth and breadth of their response to climate-related risks, including the use of macroprudential tools in the context of other government policies.

While scenarios can be envisioned under which a stronger and more direct macroprudential response to climate-related risks could potentially be necessary, there is a lack of agreement across jurisdictions on the desirability or feasibility of such an approach. More importantly, there is no consensus amongst supervisors and regulators on the conditions under which such an approach could be warranted. Furthermore, we would encourage the FSB to undertake a more holistic and thorough approach to the cost and benefits of the potential tools that could be adopted and, in particular, an assessment of the unintended consequences that such tools could have regarding the ability of the financial sector to provide the financing necessary for the transition. As already noted above, the importance of public policies on climate (beyond prudential financial policies) is essential. It is unrealistic to expect that financial institutions alone can drive the necessary shifting of resources in the absence of adequate environmental policymaking in the real economy.

In conclusion, we would encourage the FSB to consider acting as the coordinating mechanism to assess the aggregate impact of changes in the use of supervisory and regulatory tools and policies from an impact and effectiveness perspective, with adequate inclusion and voice for the SSBs.

The Associations appreciate the opportunity to comment on this consultation. For further elaboration, please feel free to contact Sonja Gibbs (sgibbs@iif.com), Andres Portilla (aportilla@iif.com), Panayiotis Dionysopoulos (pdionysopoulos@isda.org), or Allison Parent (aparent@global.gfma.org).

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