EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Template for comments

Guide on the management and disclosure of climate-related and environmental risks

Institution/Company
University of Glasgow

Contact person

Mr/Ms
Mr

First name
Javier

Surname
Solana

Email address
javier.solana@glasgow.ac.uk

Telephone number
0044(0)1413307167

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General comments

Template for comments

Guide on the management and disclosure of climate-related and environmental risks

Please enter all your feedback in this list.
When entering feedback, please make sure that:

- **each comment deals with a single issue only;**
- **you indicate the relevant article/chapter/paragraph, where appropriate;**
- **you indicate whether your comment is a proposed amendment, clarification or deletion.**

Deadline 31 May

ID	Chapt	Paragrap	Expectati	Page	Type of comment	Detailed comment	Concise statement as to why your comment should be taken on board	Name of commenter	Personal data
1			Box 1	4-5	Clarification	As a general and introductory comment, I am grateful for the opportunity to comment on the present Guide, published by the ECB in May 2020 (hereinafter, the “ECB Guide”). The ECB's initiative is warmly welcome. In its current form, the ECB Guide can shed light on some of the risks that the aggravation of the climate emergency could pose to banks and the financial system more broadly. Nevertheless, I would like to draw your attention to a particular risk that is barely mentioned in the ECB Guide: the risk of climate change litigation. Climate change litigation has been growing rapidly and steadily for the past ten years. We can observe the same trend in financial markets. (See Solana, Javier. "Climate Litigation in Financial Markets: A Typology." Transnational Environmental Law 9.1 (2020): 103-135.) If the climate emergency continues to aggravate, financial institutions that continue to fund projects and activities that contribute to that aggravation will face an increased risk of climate change litigation. If these institutions do not manage this risk effectively, the potential costs arising therefrom can result in a significant financial burden. At an aggregate level, these costs, and the practices that financial institutions may adopt to manage the risk of climate change litigation, may give rise to risks for the stability of the broader financial system. Any attempt to understand climate related financial risks should include an evaluation of the costs that could arise from climate change litigation under different scenarios. Climate change litigation is a complex phenomenon that deserves much closer attention from financial institutions and the authorities responsible for their supervision. In this document, I provide a brief description of the costs that financial institutions could face as a result of climate change litigation (comment nº 3) and present several specific recommendations for your consideration. My responses are largely based on my recent paper "Climate change litigation as financial risk", which is currently under consideration for publication. I would be happy to provide the ECB with a copy upon request.	Failure to raise awareness amongst banks and their counterparties about the potential costs that may arise from climate litigation will result in underestimations of climate-related financial risks.	Solana, Javier	Publish
2		2.1		6	Clarification	If one of the aims of the present Guide is “to enhance the industry's awareness of and preparedness for managing climate-related and environmental risks” the Guide could be a unique opportunity to bring the industry's attention to relatively less explored climate-related financial risks such as reputational risk and climate litigation risk. Most of my comments below focus on climate litigation risk, which I have been studying for the past three years. Comment nº 3 provides a general description on which I build most of my subsequent comments.	Failure to raise awareness amongst banks and their counterparties about the potential costs that may arise from climate litigation as well as reputational costs will result in underestimations of climate-related financial risks.	Solana, Javier	Publish

3		3.2		10-11	Clarification	Climate change litigation is a complex phenomenon that deserves much closer attention from financial institutions and the authorities responsible for their supervision. In a recent paper, I present a typology of the different types of climate-related legal claims that could arise in financial markets (Solana (2020)). These claims do cut across physical and transition risks, which make so-called "liability risks" ubiquitous and therefore unique. Nevertheless, regulatory and industry initiatives that aim at managing climate-related risks rarely explore liability risks. References to these risks are minimal and generally buried in footnotes. This Consultation document is no exception (see Section 3.2). This omission suggests a misunderstanding of the potential economic impact of climate change litigation for financial institutions and underestimates climate-related financial risks. Climate change litigation exposes financial institutions to several costs. Most evidently, if financial institutions are sued for the breach of any climate-related legal obligation, financial institutions will face several direct costs: 1. Any pay-outs and fines that may result from a decision issued by a court, an arbitral tribunal or an administrative authority declaring the affected financial institution to be in breach of its climate-related legal obligations. 2. Legal and administrative costs, including the fees of the lawyers representing the affected institution and, if the latter is unsuccessful, the costs of the proceeding, which include court fees, part of the representation expenses of the successful party, and, where applicable, any experts' fees and translators' fees. 3. As the risk of facing climate change litigation increases, insurance companies are likely to react to a potential increase in their exposures. For example, insurance companies are likely to raise their liability insurance premia to reflect the increased vulnerability of a company to climate change litigation. (See e.g. Prudential Regulatory Authority, 'The Impact of Climate Change on the UK Insurance Sector' (2015) 29, available here.) Moreover, insurance and reinsurance companies have begun to exclude certain claims from the coverage of their policies to limit their liability for damages suffered by policyholders as a result of extreme weather events, which are associated with the aggravation of climate change (see ibid). Indeed, most commercial general liability policies have exclusions that seem to apply to claims that could arise in climate change litigation. (See Jason Reeves and José M Umbert, 'Climate Change and Insurance: Litigation Risks for Insurers' Insurance Law360 (23 January 2019), available here.) If climate change litigation continues to rise, insurers and reinsurers may begin to expressly exclude climate change claims from their policies. These changes will expose holders of liability insurance policies to the risk of having to meet any potential pay-outs, fines, and legal and administrative costs with their own resources. 4. Climate change litigation can increase financing costs for financial institutions in several ways. First, if the financial institution raises finance using sustainability-linked financial products (e.g. a loan), an increase in the risk of climate change litigation can trigger contractual mechanisms that will automatically increase the cost of finance (e.g. the interest rate paid under the loan). More generally, if the costs identified in the previous sub-sections are so significant as to affect an entity's creditworthiness, climate change litigation could affect the borrower's credit ratings, which might trigger interest rate increases in other products that are similar to those described for sustainability linked financial products. The downgrading of an institution's credit rating could also trigger contractual mechanisms under other financial products that could put additional liquidity pressure on the affected institution, e.g. calls for the institution to post additional collateral under derivatives and repo contracts.	Failure to raise awareness amongst banks and their counterparties about the potential costs that may arise from climate litigation will result in underestimations of climate-related financial risks.	Surname, First name	Publish
3		3.2		10-11	Clarification	5. Climate change litigation can also have reputational costs on the affected institution. These costs can manifest themselves in different forms, including: loss of customer Base (See Mikael Homanen, "Depositors Disciplining Banks: The Impact of Scandals" (November 27, 2018) Chicago Booth Research Paper No. 28, available here.), remedial actions, an increase of financing costs (See e.g. Don M Autore and others, 'The Effect of Securities Litigation on External Financing' (2014) 27 Journal of Corporate Finance 231.), and a considerable loss of market value (For example, examining the impact of the enforcement of financial regulation by the U.K. regulatory authorities on the market price of penalised firms, Armour et al find that stock price reactions are, on average, nine times larger than the financial penalties imposed by the FSA. See John Armour, Colin Mayer and Andrea Polo, 'Regulatory Sanctions and Reputational Damage in Financial Markets' (2017) 52 Journal of Financial and Quantitative Analysis 1429.). But climate change litigation against third parties can also impose indirect costs on financial institutions. For example, a financier will have an interest in understanding the potential costs that one of its client debtors might face as a result of climate change litigation and, in particular, the extent to which that litigation might affect the client debtor's ability to meet its obligations with the financier. The financier might need to hire experts to conduct such a risk assessment; but, more importantly, the financier may face losses arising from the client's default if the costs that the latter faces from climate change litigation are high enough to compromise its solvency. These costs relate to the financier's counterparty credit risk. Moreover, if the public associates the activities of the client debtor that is involved in litigation with that of its financier, the direct reputational costs that the former will face might spill over to the latter. (See e.g. Attracta Mooney and Billy Nauman, 'Climate Campaigners Turn Their Fire on the Financial World' Financial Times (20 February 2020), available here.) This would give rise to indirect reputational costs for the financier. A detrimental decision against a given financial institution can also impose indirect costs on other institutions operating in the same market. For example, a detrimental decision could have a "wake up call" effect on the customers and investors of other institutions operating in the same market, which could give rise to further indirect reputational costs. A similar "wake up call" effect might also lead providers of liability insurance to reconsider the risk of climate change litigation in the market and to revisit the conditions under which they provide liability insurance to other firms providing similar services. Interrelations between these different types of costs will be common. For example, the direct costs arising from one case might incentivise other prospective claimants to pursue litigation against the same institution, thereby increasing the risk of climate change litigation and the direct costs associated with it. Moreover, an increase in the perceived risk of climate change litigation for one institution might invite prospective claimants to consider the possibility of pursuing similar legal actions against similar institutions. Understanding these feedback effects will be essential to assess the potential economic impact of climate change litigation for financial institutions. The analysis of the different costs that financial institutions can face as a result of climate change litigation suggests that the current understanding of "liability risks", however, is very narrow. First, the term "liability risk", as defined first by Mark Carney and more recently by the Network for Greening the Financial System (NGFS), is typically regarded as a risk that will only affect insurers, since companies will typically have liability insurance policies in place that will cover any pay-outs and fines resulting from climate change litigation. Yet this assumption is highly debatable. Most commercial general liability policies have exclusions that seem to apply to claims that could arise in climate change litigation. Indeed, policyholders have been unsuccessful in claiming compensation under their liability insurance policies for costs incurred as a result of climate change litigation. (See The AES Corporation v. Steadfast Insurance Company , Virginia Supreme Court, Record No. 100764, 20 Apr. 2012.) If companies have to face the pay-outs and fines that may result from climate change litigation, these direct costs can pose significant pressure on the firm. Anecdotal evidence suggests that litigation can impose significant costs on financial institutions. (For example, at the end of August 2019, estimations of the total cost of the PPI scandal for UK banks had risen to £53.8 billion.) Moreover, the term "liability risks" only focuses on one particular cost (i.e. pay-outs and fines) associated with a detrimental decision. As evidenced by the categorisation of direct and indirect costs presented above, the total costs of climate change litigation can go well beyond pay-outs and fines. These additional costs, particularly reputational costs, can be significant. (See e.g. Armour et al (2017).) If the company's liability insurance does not cover climate change litigation, the final cost for the company could be even greater. Such a narrow conception understates the complexity of climate change litigation and threatens to underestimate the financial risks of the current climate emergency. A first step to acknowledge the complexity of climate change litigation would be to discard the term "liability risk". This term only captures one of several costs potentially arising from climate change litigation. The term "climate (change) litigation risk" (or the term "environmental litigation risk, to reflect the broader scope of the ECB's Guide) seems to better capture the complexity of the phenomenon and the diversity of costs associated with a potential climate suit. In the future, a complete analysis of climate-related financial risks will require financial institutions and supervisors to understand the complex effects of climate change litigation. The ECB's Guide on climate-related and environmental risks provides a very good opportunity to shed some light.	Failure to raise awareness amongst banks and their counterparties about the potential costs that may arise from climate litigation will result in underestimations of climate-related financial risks.	Solana, Javier	Publish

4		3.2		10		Losses resulting from so-called “liability risk” (or, as I have suggested in the previous comment, “climate litigation risk”) and reputational losses are interrelated: litigation risk may inflict reputational losses that may not be linked to an actual "fail[ure] to adequately manage climate-related and environmental risks". For example, if the filing of a suit against a financial institution leads the public, or the institutions' counterparties and/or investors, to associate the institution with an environmental harm.	In its current wording, banks and their counterparties may be led to believe that there are no reputational costs associated with climate litigation. This would result in banks and their counterparties underestimating the potential impact of climate change on their reputation.	Solana, Javier	Publish
5		3.2		11	Clarification	In general, it’s difficult to reflect the importance of risks that cut across the two main drivers, like climate litigation risk. For example, it is not possible to introduce them in Table 1 (p. 11) without adding complexity (and repetition) to the table. The challenge for regulators is how to highlight the importance of these risks when the whole document is drafted with those two main drivers in mind. One way of addressing this problem, for example, would be to ensure that examples of risks that cut across the two main drivers are included for every expectation. I provide specific suggestions in relevant commentaries. Moreover, there are a few examples of this approach elsewhere in the document. (See e.g. Expectation 13.1, last paragraph.)	Otherwise, supervised institutions may perceive that the costs arising from these risks are not as important as the costs arising from the two main drivers. This will lead to an under-estimation of their exposure to climate-related financial risks.	Solana, Javier	Publish
6		4.1	1	15	Amendment	Include litigation as one of the external factors and trends that shape the business conditions in which an institution operates or is likely to operate. Contagion like effects of litigation on reputation, as well as impact on incentives for other claimants (feedback effects) illustrate the importance of understanding litigation risk as part of the "business environment".	Understanding litigation risk will be crucial for an institution to ensure the resilience of its business model (see p. 16) and this includes understanding litigation as a risk to similar institutions and potential clients.	Solana, Javier	Publish
7		4.2	2	17	Clarification	Scenario analysis can help examine the extent to which climate litigation may be a material risk, but this will be easier for certain costs (pay-outs and fines, legal and administrative) but more difficult for others (especially reputational costs). The key for these estimations in scenario analysis will be the assumptions made by the banks, particularly given the relative scarcity of precedents of climate cases against financial institutions when compared to other industries (e.g. those financed by the banks). (See Solana (2020).) The lack of precedents, however, is not an indication of the probability of litigation in the future and banks would be advised to examine the potential costs that they might face as a result of potential litigation. Rather than calculating reputational losses based on previous cases, banks could set some assumptions about the reputational impact of business as usual in different scenarios that include litigation and calculate the cost based on those assumptions. The ECB may even want to provide some guidance to banks as to what those assumptions might look like. One example would be to use stranded assets as a proxy for climate litigation risk.	Climate litigation costs can be material, but they are difficult to capture in scenario analyses and banks may need some guidance as to how to do that.	Solana, Javier	Publish
8		5.2	4	21	Clarification	Litigation risk could be a very illuminating reference for banks to specify their risk appetite, e.g. an institution’s risk appetite may be expressed in terms of the litigation risk the institution is willing to face.	Climate litigation costs can be material, but given the lack of precedents (Solana (2020)), banks may be unable (or unwilling) to see their relevance. Linking them to risk appetite would provide banks with an incentive to explore their exposure to this type of risk.	Solana, Javier	Publish
9		5.3	5.5	25	Clarification	Litigation risk goes beyond compliance risk, particularly as illustrated by indirect costs of climate litigation. See also comment nº 3.	Failure to raise awareness amongst banks and their counterparties about the full potential costs that may arise from climate litigation will result in underestimations of climate-related financial risks.	Solana, Javier	Publish

10		6.2	8.1	32	Amendment	In order to reinstate the importance of reputational costs and costs resulting from climate litigation, include an express reference to these costs as examples of the climate-related and environmental risks that a client can face.	These costs are considerably less explored in the academic literature and regulatory initiatives than physical and transition risks. Failure to raise awareness amongst banks and their counterparties about reputational costs and costs resulting from climate litigation will result in underestimations of climate-related financial risks.	Solana, Javier	Publish
11		6.2	8.2	32	Amendment	Increased litigation risk should also be part of those scenarios and could be added to the list of examples in note 79.	Current approaches to climate-related financial risks from financial regulators underestimate the importance of climate litigation risk. So do financial institutions that rely on regulators' initiatives to frame thier approaches to the evaluation of climate-related risk. If one of th epurposes of this Guide is to increase awareness of cliamte-related financial risks among banks (see e.g. section 2.1), an express refernece to climate litigation in note 79 would make banks aware of the credit risk that may result from their counterparties facing increased climate litigation risk.	Solana, Javier	Publish
12		6.2	8.3	33	Amendment	The Guide could also include an express reference to financial collateral, which may be affected by climate-related risks too. For example, if a bank's counterparty faces reputational costs as a result of its contribution to aggravating cliamte change, those reputational costs may manifest themsleves in drops in the marekt value of that company's shares. (Those reputational costs can result from climate litigation, but not only.) The bank may be holding shares issued by that company as collateral in a secured finance transaction. Ideally, a bank's model should be able to capture exposures to climate related risks across as wide a range of assets as possible. (This comment would also be relevant for Expectation 13.5.)	In its current wording, the Guide focuses on very specific assets on banks' balance sheets (loans in the real estate sector). Broadening the scope of collateral assets that are mentioned as examples in the Guide will hint to banks the need for their models to capture potential impact of cliamte-related risks on collateral valuations in as wide a range of assets as possible.	Solana, Javier	Publish
13		6.2	8.6	34	Amendment	In addition to brief examples on costs related to physical and transition risks, this paragraph could also make an express reference to costs that may result from reputation risk and litigation risk.	In the absence of express references, costs that may arise from risks such as reputation and litigation risks, that cut across the two main drivers of climate-related financial risk, may go unnoticed.	Solana, Javier	Publish
14		6.3	9.2	35	Amendment	The section mentions reputational risk and liability risk as two important examples of climate-related risks but elaborates only on reputational risk. This implicitly conveys an impression that liability risk is less important. The Guide could also include an example that highlights how liability risk is also relevant.	Failure to include specific examples of litigation risk might lead banks and their counterparties to believe that this is not an important climate-related risk.	Solana, Javier	Publish
15		6.4	10	36	Amendment	Climate litigation risk can have an impact beyond credit risk and operational risk. For example, if banks invest in assets issued by companies whose activities contribute to the aggravation of climate change, they may be exposed to the risk of the market value of their investment declining if the issuers of the assets are exposed to considerable costs related to climate litigation, as described in comment nº 3. The Guide could add litigation as one of the factors that could lead to a decline in the value of a bank's investments as enumerated at the end of the first paragraph immediately following the statement of Expectation 10 in a grey box.	Failure to include specific examples of litigation risk might lead banks and their counterparties to believe that this is not an important climate-related risk and, in particular, that it does not have implications for market risk.	Solana, Javier	Publish

16		6.5	11	37	Amendment	Include a specific reference to risks that cut across the two main drivers (physical and transition risks) as part of the list of minimal aspects that the ECB would expect supervised institutions to consider in their scenario analysis and stress testing.	Otherwise, supervised institutions may perceive that the costs arising from these risks are not as important as the costs arising from the two main drivers. This will lead to an under-estimation of their exposure to climate-related financial risks.	Solana, Javier	Publish
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