EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Template for comments

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

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General comments

Overall, we consider the draft guidance to be a commendable supervisory signal by the ECB, clearly stating its expectations that the ,identification and management of climate and environmental risks must be comprehensively embedded into the strategy, governance business, and operations of financial institutions. Yet the guidance very much places the onus on individual financial institutions to identify and manage such exposures alone - an approach which we believe may be insufficient to effectively manage the inherent complexity and radical uncertainty that characterises climate and environmental risks. In our comments detailed in the next section, we ask the ECB to acknowledge and reflect upon the fact that these risks may also arise endogenously from behaviours within the financial system itself, and that they may also have systemic consequences - attributes that, as has been well acknowledged since the 2008 financial crisis, require top-down macroprudential supervision to ensure effective management. In the guidance, there is also a notable lack of discussion as to when, if ever, the ECB expects financial institutions to be in a position to implement and effectively undertake its recommendations. Given the ongoing concerns with data availability and the heterogeneity of scenario analysis methodologies, there is a need to discuss how to reconcile *feasibility-of-implementation* with *ability-to-capture-uncertainty* within risk management approaches. Finally, and most importantly, there is no discussion as to what the potential supervisory role should be in the event that financial institutions do not or cannot adequately perceive and manage climate/environmental risks alone. It is our suggestion that incorporating such considerations into the guidance will greatly strengthen its relevance and materiality as a supervisory signal for financial institutions to follow. For further information on our arguments, please refer to the UCL IIPP Working Papers attached to our :original email, and linked below

-https://www.ucl.ac.uk/bartlett/public-purpose/sites/public-purpose/files/iipp-wp-2019-13-climate-related-financial-policy-in-a-world-of radical-undertainty-web.pdf

https://www.ucl.ac.uk/bartlett/public-purpose/sites/public-purpose/files/final_iipp-wp2020-09-kedward_et_al_nature-related_finance_edited_15_sept.pdf

This consultation response has been prepared by Joshua Ryan-Collins and Katie Kedward, of the UCL Institute for Innovation and Public Purpose, and Hugues Chenet, of the UCL Institute for Sustainable Resources

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: 25 September 2020

ID	Chapter	Paragraph	Expectation or box number	Page	Type of comment	Detailed comment	Concise statement as to why your comment should be taken on board	Name of commenter	Personal data
1						These characteristics include the far-reaching impact in breadth and magnitude, an uncertain and extended time horizon and the dependency on short-term action.		Ryan-Collins, Joshua	Publish
2	Chapter 3	3.2.1		10	Amendment	The first two paragraphs of this section fail to articulate the double materiality of climate and financial risks. Climate and environmental threats pose risks *to* the financial system, as is already described in some detail. Also important, but not acknowledged here, is that activities within the financial system also give rise to climate and environmental risks. Through lending, investing and advisory activities, the financial system *facilitates* the business activities that contribute to climate/environmental degradation. The failure to reallocate capital away from harmful corporate activities risks 'locking in' future environmental impacts. This is important as it means climate and environmental risks may arise endogenously from behaviours within the financial system itself.	The concept of 'double materiality' has been recently used by the European Commission in its Non-Binding Guidelines on Non-Financial Reporting for corporates. Yet the most prominent green finance initiatives, such as the TCFD concentrate only on financial exposures, ignoring financial impacts. For consistency with the European Commission's own characterisation of climate risk, the ECB needs to acknowledge double materiality, and articulate how its guidance is sufficient to manage the potential endogeneity of climate/environmental risks.	Ryan-Collins, Joshua	Publish

3	Chapter 3	3.2.5		12	Amendment	Incomplete characterisation of the nature of climate and environmental risks. It is essential to also mention that: - impacts are unprecedented and potentially irreversible; - climate/environmental risks are subject to non-linearities and complex system dynamics, such as feedback loops and tipping points; - the multiplicity of possible future outcomes is very large; - some environmental risks (e.g. pollinator loss) are already taking place within short-term business time horizons. Taken together, these attributes render climate/environmental risks subject to radical uncertainty rather than probabilistic risk – a distinction that is crucial to understanding challenges to managing these risks. Financial and economic models are familiar with probabilistic risk, where future outcomes are considered to have knowable probabilities calculated from past trends, but they are ill-suited to dealing with radical uncertainty, where there is no basis upon which to form any calculable probability, and the future is inherently unknowable and unpredictable.	The 'radical uncertainty' of both climate and environmental risks has been highlighted by the Bank for International Settlements in its 2020 Green Swan report, amongst others (see Chenet et al., 2019; Kedward et al., 2020 - working papers attached to our original email). This research has questioned whether voluntary disclosures, stress testing, and scenario analysis alone are able to capture this inherent complexity in order to produce reliable and meaningful results. We suggest that the ECB must both acknowledge and clarify how its guidance seeks to address these concerns.	Ryan-Collins, Joshua	Publish
4	Chapter 4	4.1.4	Expectation 1.2	16	Clarification	The phrasing of this Expectation implies that all climate/environmental risks are knowable, or at least can be assigned a probability, even far out into the future. Yet, as outlined above, there are no historical trends or known distribution functions for the present environmental crisis. Moreover, unpredictable reactions between different market players, technologies, and policies means future outcomes are inherently unknowable.	The fundamental uncertainty or 'unknown unknowns' surrounding climate and environmental risks has been recognised byt the Network for Greening the Financial System (NGFS), the Bank for International Settlements, among others (see our working papers attached to original email). We suggest that the ECB's guidance needs to clarify how institutions should attempt to manage for 'unknown unknowns', or indeed if it is within their capability to do so at an individual institutional level.	Ryan-Collins, Joshua	Publish

5	Chapter 4	4.2.2	Expectation 2.1	17	Deletion	'By developing a set of plausible scenarios to test the resilience of its business model, an institution can account for this uncertainty in its strategic decision-making.' The above statement is a misleading characterisation of the ability of scenario analysis to account for radical uncertainty. Insights drawn from scenario analysis are highly sensitive to the assumptions underlying the chosen scenarios. Moreoever, the complexity and multi-dimensionality of climate/environmental risks means the number of plausible scenarios is likely to be very large. Plausibility is also unlikely to remain fixed over time. A wide range of impacts may be explored under scenarios deemed plausible today, but bigger risks that may become more likely as time passes will not be visible. Taken together, these reasons demonstrate that scenario analysis alone cannot be assumed to be able to fully account for radical uncertainty.	The NGFS has acknowledged the limits to scenario analysis under conditions of uncertainty in its June 2020 'Guide to climate scenario analysis for central banks and supervisors', noting: "There are significant gaps in the literature, which means that the level of uncertainty is likely greater than the ranges shown in this section… studies rarely comprehensively capture tipping points, feedback effects from physical to transition risks, socioeconomic responses such as changing preferences, economic sentiment, migration and adaptation and there are other 'unknown unknowns'." (see p.24). We suggest the ECB acknowledge such limitations in its guidance and reflect upon the possible implications for financial supervision.	Ryan-Collins, Joshua	Publish
6	Chapter 6	6.1.6	Expectation 7.5	31	Amendment	'Institutions are expected to assess the impact of climate-related and environmental risks on their capital adequacy from an economic and a normative perspective.' It is necessary to reflect upon here what the incentive is for financial institutions to voluntarily provide prudent and conservative estimations of their risk exposures, given the potential materiality on regulatory responses.	There is a significant moral hazard problem in leaving it to financial institutions to assess the impacts on their own capital adequacy requirements. Moreover, there are valid reasons to question if individual insitutions alone are capable of understanding climate/environmental risks given they are both endogenous and have the potential to be systemic. As has been widely acknowledged since the 2008 financial crisis, such risks can only be effectively managed by top-down macroprudential supervision.	Ryan-Collins, Joshua	Publish
7	Chapter 6	6.5.2	Expectation 11	38	Clarification	'As part of their capital planning, institutions are expected to assess their capital adequacy under a credible baseline scenario and institution-specific adverse scenarios.' It would be useful to understand on what basis the ECB expects financial institutions to choose credible scenarios.	Given that scenario analysis results are highly sensitive to the underlying assumptions (as outlined above), allowing heterogenous modelling approaches could risk divergent or contradictory results between different insitutions.	Ryan-Collins, Joshua	Publish

8	Chapter 6	6.5.4	Expectation 11	38	Clarification	Whilst we commend the ECB's emphasis on the need for scenario analysis to encompass medium to long term horizons, given the nature of the risks, it would be useful to have further clarification on the guidance recommends undertaking scenario analysis over longer time horizons. In particular, there is the question of using static or dynamic balance sheets - the choice of which will significantly affect the interpretation of the results.	There are important reasons to question the usefulness of using static balance sheets over longer time horizons. FI balance sheets have doubled in size and shifted dramatically in composition (e.g. from firm to household lending) over the past 30 years and we can reasonably expect material portfolio changes under any future scenario, especially as physical risks emerge in the longer term. On the flipside, dynamic balance sheets add a further layer of assumptions and therefore uncertainty to analysis results. Overall, this issue demonstrates the difficulty in relying on scenario analysis alone as a tool to manage longer-term risks. We suggest the ECB address these concerns in its guidance and reflect upon the possible implications for financial supervision.	Ryan-Collins, Joshua	Publish
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