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

The Draft Guidelines are an extremely meritorious initiative, showing the ECB's willingness to show international leadership on an issue that will be defining for the XXIst century. The comments made here try to help in this aim. Without prejudice to the more specific comments, there are three main shortcomings in the ECB's approach to the issue: (1) it treats climate-related risk as a microprudential issue, by inserting it as part of the Supervisory Review and Evaluation Processd (SREP), which is aimed at setting Pillar 2 requirements on a bank-by bank basis. No attention is paid to issues such as (i) the patterns of interconnectedness in the banking(and also disclosures) ,system, which are crucial to understand how a large shock (like climate-related shocks promise to be) would spread across the system and whether said system could withstand it; or (ii) how macroprudential tools could be used to supplement micro-prudential ones. (2) The Draft Guidelines treat climate-related risk like "just another" kind of risk, which can be addressed by merely expanding the time horizon of existing risk models. Economic research suggests instead that low-probability-catastrophic outcome scenarios are prone to "ambiguity" and unawareness", which may suggest a different framework for risk assessment. (3) The Draft Guidelines treat matters pertaining to bank" culture in a traditional fashion (based on "risk appetite"). For climate-related risks the problem may not be one of "risk appetite", which suggest that units consciously decide to take on more risk, but , again, ambiguity, and unawareness. Another problem, important to assess Transition risk, is the alignment between the perception of climate-change goals within the institution, when compared with social (or government) perceptions. It is not a matter of "monitoring opinions", but of monitoring that a misalignment between the social norms inside the institution, and outside it does not lead the institution to underestimate the risk of sudden policy changes, reputational costs, and damage. Indeed, the treatment of liability risks, reputational risks, etc, (including their relationship to social norms) is another part where the . . .treatment is unclear and/or ambiguous

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	Chapter 2	2.4.		7-8		Guidelines focus on SREP provisions, (CRD arts. 73-76, 79, 83-85) and disclosure provisions (CRD arts. 431-432). It should mention credit risk provisions, and systemic risk provisions and capital buffers (CRD arts. 128 et seq, especially arts. 129 (capital conservation buffer) 133 (systemic risk buffer) and 135 (countercyclical buffer)	Climate-related risk is systemic in nature. The ECB shows remarkable initiative in tackling climate-related risk, but doing it wrong can backfire by creating complacency. If the supervisor is asking banks to focus on "operational" risks it is asking banks to concentrate on immediate effects, within a short time span. This unfortunately shows a gross misaprehension of the risk.	Ramos Muñoz, David	Publish
2	Chapter 3	3.1.		10		Guidelines should mention "Liability risk", and describe it in terms that are workable.	Neither the reference to "Physical Risk" or "Transition Risk" make reference to "Liability risk", which greatly concerns the greatest carbon-emitters. This cannot be fitted within broader categories like "changes in market sentiment and preferences". It should be made explicit.	Ramos Muñoz, David	Publish

3	Chapter 3	3.1.		10		Guidelines should mention "Connectivity risk", resulting from the pattern of connections in the system.	The ECB Guidelines, which are commendable for the initiative they show, have a blind spot. They fail to perceive that climate-related risk is systemic in nature, and largely depend on the pattern of connections within the financial system. Under this premise, whether a large shock wipes out 1-2 relevant institutions matters less than whether that shock wipes out the whole system, due to the connectivity between banks. The question is whether the connectivity pattern is optimal to withstand a shock having the characteristics of a climate-related shock.	Ramos Muñoz, David	Publish
4	Chapter 3	3.2.		12		Guidelines refer to the "time horizon" as the problem of risk appraisal. It should mention "ambiguity" and "unawareness" of the risk involved, as the main problems.	Expanding the "time horizon", or taking a "forward-looking" approach suggests that banks can simply use the same risk models, and simply expand the "t". Instead, for cases were low probability but catastrophic risk are involved, it is suggested that the problem may involve "ambiguity" (same information can be subject to different interpretations) and "unawareness", which means that different models (maximin with multiple priors) should be used. The Guidelines do not stress that different models may be needed.	Ramos Muñoz, David	Publish
5	Chapter 4	4.1.	1.1.	16		Guidelines say that policy changes to promote an environmentally-resilient economy "may reduce the demand for real estate in certain, for example high flood risk, areas". It should include a reference to "reduce profitability and increase the risk of industries that are high carbon-emitters, carbon-intensive or heavily rely on those (e.g. long supply chains heavily reliant on high-emitting transport and logistics)".	Policy changes will most likely impact carbon-emitting or carbon intensive industries, through taxes, subsidies, regulation or all of the above. The impact is potentially higher than that of "demand for real estate in flood risk areas", which seems almost anecdotal in comparison. Thus, at least both should be included.	Ramos Muñoz, David	Publish
6						Policy changes to promote an environmentally-resilient economy may reduce the demand for real estate in certain, for example high flood risk, areas		Ramos Muñoz, David	Publish

7	Chapter 4	4.1.	1.2.	16		Complete reference to "enhance their understanding of the potential changes to their business environmentgoing forward" with "especially in light of the nature of low-probability-large-shock risks, which may require different models for their assessment"	The Guidelines' approach, although positive, seems to perceive climate-related risk as a risk of the same kind as other risks, but materializing in the longer-run. It is a different risk. The Guidelines seem to have a fixation with "real estate-related" risks, which may distract attention from industry changes, which may be more momentous.	Ramos Muñoz, David	Publish
8	Chapter 4	4.2.	2.1.	17		Complete reference to "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" writing instead "developing a set of plausible, even if low-probability scenarios to test the resilience of its business model, an institution can account for this uncertainty in its strategic decision-making"	Developing a stress test for catastrophic but low-probability events is difficult, even for experienced risk managers. Thus, it is possible that some may cling to the "plausibility" requirement to exclude scenarios with a low probability, even though one of the catastrophic scenarios will be likely to materialize. By making banks include at least some low-probability and catastrophic scenarios supervisors will make sure to "nudge" banks to consider the plausible, albeit unpalatable. An alternative would be to ask the entity to ensure that its "stress test" includes "catastrophic scenario" examples.	Ramos Muñoz, David	Publish
9	Chapter 4	4.2.	2.2.	18		Complete reference to "Depending on the nature of the institution’s activities, these KPIs should be cascaded down to relevant business lines and portfolios (...)" with a reference to "or, to the extent that they cannot be allocated to them, to the institution as a whole", or similar language.	The ECB Guidelines follow the SREP playbook to the letter, which means that their approach is, in large part, bottom-up. This is dangerous when it comes to climate change, which is systemic, and top-down. The risk is that entities will "concentrate on the trees and not see the forest", i.e. that they will neglect the risk that cannot be pinned down to a specific portfolio or business line.	Ramos Muñoz, David	Publish
10	Chapter 4		Box 2	18		The "Observed practice" should be completed with a more detailed description of whether the financial entity applies risk criteria to corporate loans or credit facilities extended to corporate borrowers (or projects) in light of their vulnerability to regulatory shocks (e.g. carbon-based energy companies v. renewable energy projects). It should also clarify whether the risk of litigation exposure of corporate borrowers is accounted for.	If the idea is to exemplify "good practice", this does not provide sufficient detail of the exposure to "Transition risks" (namely, regulatory risks), nor to "Liability risk".	Ramos Muñoz, David	Publish

11	Chapter 5	5.1.	3.1.	20		The reference "assigning the responsibility for climate-related and environmental risks to a member of an established committee or may consider setting up a dedicated committee" should be completed with "In any event, the relationship between the member or the dedicated committee, and the risk committee should be clearly established". Alternatively, expectation 3.2. should be placed before expectation 3.1. (also, both changes could be implemented).	If the idea is to "mainstream" climate-related risks it is important that they are not perceived as ancillary or marginal. Even if specialized roles are assigned, the crucial element is their relationship to the main risk committee to ensure that climate-related concerns are a proper input in the entity's overall risk strategy. This idea is present in expectation 3.2. However, by placing 3.1. before, the ECB may be sending conflicting signals, i.e. that climate-related risk is an ESG-related consideration, and then that it must be included as part of the main risk management strategy	Ramos Muñoz, David	Publish
12	Chapter 5	Box 3	3.1.	20		The "Observed practice" should be described in more detail to determine whether climate-related risk is important in the entity's overall risk strategy.	The tendency to lump together climate-related risk with ESG considerations is dangerous. It involves more catastrophic scenarios, which should affect the entity's risk perception as a whole. From the example it is unclear whether the entity perceives climate-related risks as such.	Ramos Muñoz, David	Publish
13	Chapter 5	5.2.	4.1.-4.2.	20-21		The description of the adjustments to be made should include references to the "unawareness" and "ambiguity", and also to "risk culture".	The ECB Guidelines treat climate-related risk like a "conventional" risk, where "risk appetite" drives risk-taking. This does not seem a accurate description of how climate-related risk works. Rather, managers may be incapable to react towards a low-probability-but-catastrophic shock, and behave not recklessly, but "unaware". In terms of culture, an indicator would not be risk-taking per se, but a "misalignment of social norms", e.g. between public (society, government) attitudes towards carbon-emitting industries, and the perception of the same issue within the credit institution. These "social norms-based" processes are not captured by a conventional treatment centered on "risk appetite" or "risk culture"	Ramos Muñoz, David	Publish
14	Chapter 5	5.4.	6	26		The reporting requirements should make reference to the need to report the "connectivity to other financial institutions".	Climate-related risk can be a large-shock risk. Its practical effects largely depend not only on whether individual institutions are prepared, but on how they are connected between themselves. The pattern of links is crucial to assess the resilience of the system as a whole.	Ramos Muñoz, David	Publish

15	Chapter 6	6.2.	8.3-8.5.	33		The description should be completed with some reference to systemic risks.	The Guidelines show the right instinct, by identifying that climate-related risks can have effects on collateral valuations, or sectoral/geographic concentrations of exposures, but it does not go one step further, by inferring that it can have a systemic impact, and should also be managed through systemic risk tools. It seems a bit odd to accept that climate-related risks can impact whole sectors, geographical areas, or collateral categories, and then assume that it can be managed by institution-specific requirements like Pillar 2 measures.	Ramos Muñoz, David	Publish
16	Chapter 6	6.3.	9.2.	35		The description should clarify the need of each institution to assess the relationship between its own operational risk arising from liability or reputational damage, and the liability risk of its own clients.	The treatment of liability risk arising from litigation is, in general, not satisfactorily addressed in thiese otherwise very meritorious Guidelines. There is no reference to the connection between a bank's clients' liability/litigation/reputational risks, and the bank's own risks.	Ramos Muñoz, David	Publish
17	Chapter 6	6.5.	11	38		The text "For the adverse scenarios, the institution is expected to assume unusual but plausible developments with an adequate degree of severity in terms of their impact on its regulatory capital ratios" is too ambiguous.	The text does not clearly indicate that even very low probability scenarios need to be considered. The problem is that, although most low-probability scenarios will not occur, one low-probability scenario will likely take place, wih catastrophic consequences.	Ramos Muñoz, David	Publish
18	Chapter 7		13	40-41		Disclosures should also include the connectivity of the institution to other institutions that may have high exposures to climate-related risks.	The Guidelines seem to be considering only "direct climate-related risk". It is likelier that the risk with more serious effects for the system will be indirect risk, i.e. the risk of impact from institutions that have, themselves, suffered the impact of climate-related risks.	Ramos Muñoz, David	Publish
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