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EBF Response to the BIS discussion paper on the role of climate scenario analysis in strengthening the management and supervision of climate-related financial risks

We welcome the work carried out by the BIS on promoting common guidelines on the design and use of Climate Scenario Analysis (CSA), which also cover Climate Stress Testing activities (CST) as a subsection.

These guidelines should foster the alignment of practices between supervisors across the world, facilitating the consistency of risk analysis of climate risk drivers. While alignment is needed to address level playing field concerns, it is also important to maintain some leeway for fine-tuning design features to institutions' specific risk profiles, business models and geographical locations. This would ensure that supervisory practices are proportionate to the specific risks of each institution. The guidelines should ensure supervisors build their understanding of climate risk factors on solid and shared pillars of CSA/CST.

International banks will benefit from an alignment of practices, which would avoid contradictory messages from the various parts of their supervisory landscape.

As stated by the BIS, the field of scenario analysis is highly dynamic, and practices are expected to evolve rapidly, especially as climate science advances. For this reason, regular updating of these guidelines through targeted work with banks and supervisors will be required.

Q1. How does the role of CSA vary based on the objectives listed above, and are there other prudential objectives where CSA could be relevant?

CSA has already played a key role in the risk identification objective, and it is progressively being included in risk management processes.

With respect to capital and liquidity assessments, climate risk drivers should be approached in the same manner as other financial risk drivers when institutions run their ICAAP and ILAAP processes, with only those assessed as material incorporated into the assessment. This approach is in line with regulatory expectations and with the guidance on CSA in the 2022 Principles for the effective management and supervision of climate-related financial risks.

The discussion paper appears to suggest that banks should use CSA to assess the “resilience” of a bank’s decarbonization targets and net zero transition plan (i.e., a bank’s business strategy with respect to transition). It is important that the alignment pathways used for target-setting and transition planning are not conflated with the stress scenarios that banks use for climate scenario analysis. The discussion paper also suggests that “the outcomes of climate scenario analysis can be inputs to inform banks’ strategies” and that “long-term scenarios can be employed to study the potential effects on banks’ profitability and the growth prospects of economic structural changes.” However, it is important to recognize that climate scenarios are not forecasts that can be used to predict impacts on a bank’s profitability over time, but are rather scenarios that can be used to understand financial risk transmission channels.

No other prudential objective is identified as missing in the proposals.

Q2. What are the key challenges in the application of CSA and how can they be overcome?

Key challenges relate to:

- **Data limitations** - though information flows are progressively becoming organized. In the meantime, guidelines on how to fill data gaps could limit heterogeneity in banking and supervisory hypothesis management.
- **Availability of scenarios that are granular enough** to be applied to different jurisdictions (e. g, LATAM, US, EU...).
- The **complexity of achieving consistent scenarios** given the fact that there cannot be just one scenario.
- The fact that despite all the disclosure regulation in the EU and in other jurisdictions, there are **no requirements for corporates to disclose under specific scenario choices**.
- The **lack of short/medium term plausible scenarios of diverse severities**. Such scenarios would contribute to all four prudential objectives.
- **Insufficient level of information on transmission channel projections** for long-term scenarios (already updated annually by NGFS). This can lead to banks and

supervisors individually adding information without precise guidelines, which may result in lack of comparability.

Q3. What are the key areas where CSA methodologies and capabilities need to be further developed to be useful and relevant for the different objectives listed in this paper?

Scenario design is the most critical field for which new capabilities are needed. Work is needed both on the availability of short/medium term scenarios and on the level of information for key transmission channel projections.

Existing scenarios also lack granularity, particularly regarding physical risk per geography, broken down by relevant sector. This means that banks have to make additional assumptions and categorize by sector on a best-efforts basis. Diverging approaches may also reduce comparability.

Concerning data, guidelines on how to fill data gaps would limit undue noise in risk assessments. Collective data infrastructure could also help close the data gap.

Regulators should clarify the objective of the scenario: is it to describe what is most likely to happen, what would happen with current policies, or what needs to be done in order to achieve net zero scenarios?

Q4. Are the key features listed above appropriately calibrated for a range of CSA exercises, and should other features be considered?

The key features are well calibrated, and no other features need to be considered.

However, we would like to flag the fact that it requires a lot of in-house expertise to develop scenarios using these criteria. This is challenging even for larger entities, not to mention smaller ones. The required granularity of the input is resource intensive.

Q5. How does the design of CSA exercises vary depending on the objectives? Please elaborate on the main usage-specific considerations for each of the different objectives.

The **risk identification** objective should be fed by all forms of CSA that can inform the understanding of the transmission channels for climate risk factors and assess the likelihood and severity of risk events that can be triggered by climate risk factors.

The **risk management** objective should leverage on the risk identification process to focus on material risks for the institution, taking into account the different horizons of analysis depending on the duration of the various portfolios and, for business risk, the time needed to adapt an activity's business model. Risk management use cases should try as much as possible to capitalize on ICAAP/ILAAP and supervisory CSA to ensure an adequate

challenge and operational insertion of the exercises run for objective 3 and, for longer-term horizons, 4.

An **ICAAP/ILAAP and regular supervisory climate stress test** should focus on climate risk factors that are material over a planning horizon and be part of the macroeconomic supervisory stress test:

- As the purpose is to assess banks' resilience, the focus should be on financial risks for banks that could be material on a short/medium-term horizon (usually three years) in a severe but plausible stress scenario.
- When the framework is ready for it (there are challenges regarding scenario design, data representativeness and methodological consistency), material climate-related risk drivers should be included with the other macroeconomic risk drivers considered in the supervisory stress test, as:
 - Having two separate supervisory stress tests would generate double counting of some stresses;
 - Going forward, key climate variables will directly be part of the macroeconomic landscape, making it challenging to define a macroeconomic stress without climate features.
- Based on banks' risk identification processes, we propose that both physical and transition risk drivers be integrated, focusing on material transmission channels:
 - For physical risk drivers, acute events on most exposed locations for credit and operational risks;
 - For transition risk drivers, abrupt policy changes or climate-related disputes for credit, operational, market and business risks.
- Supervisory and ICAAP exercises could interplay to enhance climate resiliency assessments, as an extension of solvency stress testing practices.

For **business model resilience assessment and more broadly business strategy building**, the use of supervisory climate stress testing should remain exceptional.

- As the purpose is to assess the long-term soundness of banks' business models in the light of climate change, the focus should be on consistent analysis of climate-related financial risks.
- Different kinds of scenarios should be covered (orderly, disorderly, hothouse, too little too late...).
- Scenario design should cover both physical and transition risk drivers, focusing on material transmission channels:

- For physical risk drivers, acute events on most exposed locations for credit and operational risks with potentially chronic impacts taken through their macroeconomic impact;
 - For transition risk drivers, abrupt policy changes, technological changes, client behavioural changes, and the risk of climate-related disputes for credit, operational, and business risks;
 - The risk of higher dependencies between climate physical and transition risk factors should also be considered.
- The granularity of scenario design should be enhanced to enable strategic thinking on the balance between limiting financial risks for banks and fostering banking system efficiency to reduce the consequences of climate-related financial risk (and to avoid individual enhancements which would impede comparison). Additional key hypotheses would include the targeted energy mix for regions of the world, the pace of investment of different sectors of the economy and the technological switches expected to occur. Hypotheses on constraints that could limit the pace of transition due to the scarcity of some earth resources (metals, biophysical resources etc.) should also be shared – of note here is Carbone 4’s three-year project to design climate scenarios taking into account the scarcity of the Earth’s resources.

As previously flagged, it is also necessary to develop a more granular breakdown by relevant sector. Without this, each entity will make its best effort to categorize by sector, but differing approaches may also reduce comparability.

Q6. What additional usage-specific considerations are relevant for each of the different objectives of CSA listed in this paper and why?

The way to efficiently communicate on CSA outcomes will depend on the range of readers involved in the various exercises. If broad public disclosure is involved, particular efforts will be needed on the key features of transparency and plausibility. Reputational risk will increase for banks with public CSA disclosures, so joint learning exercises between banks and their supervisors should be the rule here, with a strong focus on cross-reviews of disclosures.

Regarding the usage-specific considerations listed in the Discussion Paper:

- **Balance sheet assumptions:** there is no clarity in the approach to be used. While the discussion paper refers to static balance sheet in the short term and dynamic balance sheet in the long term as valid options, supervisors require dynamic balance sheets irrespective of the time horizon. Moreover, it is extremely difficult to project the evolution for certain sectors (e.g power, transport..) that are currently transitioning or are expected to transition in the medium or long term. The evolution of the transition may be dependent on public policies and the different speeds of transition of local economies.

- The Basel Committee assumes that institutions are capable of defining a **baseline scenario** for climate. We believe that it only makes sense to talk about a baseline when it is possible to determine the probability of occurrence of different possible scenarios. For the time being, institutions do not have the capacity to do so, Therefore we should not talk about baseline scenarios, but rather only about scenarios.

Q7. Which scenario and scenario features are used for the different objectives listed above (i.e., internally developed, those from scenario builders or a combination of the two)?

Scenario design is highly demanding both in terms of in-house expertise (when institutions need to develop detailed scenarios) and of costs (in case institutions need to buy outside their organizations), and most banks leverage scientifically based anchor scenarios for their CSA. However, banks need to expand these scenarios - notably in terms of sectoral or geographical dimensions - to be able to run them. Some banks use scenario builders for this, while others have internalized these capacities.

Q8. What features and measures could be adopted in the future to enhance the utility of currently available scenarios (eg NGFS, IEA, IPCC)?

Having several time horizons, with notably a 3 to 5-year horizon, is the most needed feature to feed the ICAAP/ILAAP and risk management objectives.

Adding further details on sectoral and geographical dimensions, and geography-specific scenarios, will limit the need for internal modelling to expand scenarios.

More information on developments in the energy mix, corporate and public capital expenditure and anticipation of technological innovation will also improve the usability of anchor scenarios.

In addition, as mentioned in previous questions, it is essential to clarify what the objective of the scenario is: whether to describe what is most likely to happen, what would happen with current policies, or what needs to be done in order to achieve net zero scenarios; and how to construct it.

Q9. What alternative or novel approaches could supervisors consider for CSA and how might these be used for prudential purposes?

The supervisory assessment of micro prudential safety and soundness should be carried out in a holistic way to account for the different pillars of the framework (Pillar 1, Pillar 2 and the macroprudential framework) in which each plays a distinct role. Further research is needed to understand the interactions between climate and other macroeconomic risk

drivers for purposes of integrated scenario analysis or stress testing exercises. This would ensure that risks are not ‘double-counted’ or missed in stress tests.

CSA could be included in the usual supervisory stress testing, if designed appropriately, as discussed in the DP and considering the comments above.

Q10. How could the effectiveness and efficiency of supervisory exercises be improved?

We agree that while standardization may improve comparability of bank results for regulators and supervisors, it will also make it more difficult for banks to take idiosyncratic risks into account. Increased standardization also has the potential to restrict innovations in CSA design and approaches.

Guidance on supervisor-led CSA should foster standardized methodologies for estimates and proxies, to ensure consistency among banks and improve comparability.

As mentioned in the response to question 9, supervisory CSA could be included in traditional supervisory stress testing for solvency assessment. For strategic thinking or banking efficiency analysis, it should leverage institutions’ transition plans and top-down exercises conducted by supervisors.

Ensuring consistent guidelines between supervisors throughout the world will enhance the effectiveness and efficiency of supervisory exercises and level playing field. Nevertheless, it is also important to maintain some leeway for fine-tuning design features to institutions’ specific risk profiles, business models and geographical locations.
