INSTITUTE OF INTERNATIONAL FINANCE

December 9, 2019

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Re: Climate Risk Analysis and Measurement

Dear Chairs,

The Institute of International Finance (IIF) and its members, which broadly represent the global financial services industry ("industry"), share the regulatory community's view that climate-related risks are a source of financial as well as non-financial risks, and thus clearly within the scope of central bank and financial supervisory mandates. The efforts made by the NGFS collectively, and a number of central banks and supervisory agencies individually to further thinking on how to analyse and measure climate change risk are therefore very much welcomed. Your willingness to publish documents outlining emerging thinking and preliminary results shows true thought leadership. However, given the proliferation of climate risk analysis frameworks—which could lead to unwanted fragmentation and slow progress—we strongly urge all central banks and supervisors to move quickly to seek alignment on approach.

The IIF Sustainable Finance Working Group (SFWG), comprising over 150 firms from the IIF's commercial and investment bank, asset manager, and insurance members, is keen to contribute to this effort and work collaboratively with the supervisory community to develop robust analytical approaches that provide further insights into both risks and sustainable transitions. This builds on the long history of collaboration between the industry and the regulatory community through the IIF. There are many such examples, including the development of the Basel Accord, the work of the Enhanced Disclosure Task Force, and the development of the Principles for Stable Capital Flows and Fair Debt Restructuring. In all cases, collaboration between the industry and regulatory community furthered the safety, soundness and effectiveness of the international financial system. The SFWG would like to replicate this type of collaboration with regard to climate issues specifically and sustainable finance more generally. This short note offers industry perspectives on four sets of issues:

- The evolving policy agenda on climate risk analysis
- NGFS handbook—fostering global alignment
- Industry perspectives—need for agreement on methodologies, scenarios
- Avoiding fragmentation

The evolving policy agenda on climate risk analysis

The issues demand urgency, and there is no time to waste. Climate risk analysis and measurement is—rightly—rising quickly on both the industry and regulatory agenda. Both regulators and firms want to better understand risk profiles to ensure effective management of transition and physical risks as well as potential adequacy of financial resources. In addition, firms want to substantiate and communicate credible progress on their contributions to helping achieve key global objectives such as the Sustainable Development Goals (SDGs) and Paris Agreement targets, and as part of broader commitments such as the Principles for Responsible Banking. Finally, the industry is firmly committed to implementation of the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD), which include disclosure of metrics and targets for both risks and opportunities.

However, as has been stated elsewhere, financial firms rely heavily on disclosures from the corporate sector in order to be able to complete their own TCFD disclosure. While take-up of the TCFD disclosure recommendations continues to improve, progress has slowed as indicated by the recent TCFD summary progress reports. The SFWG encourages policymakers to consider how to spread and speed up its adoption. The recent announcements in the UK that the TCFD is expected to be mandatory by 2022 are a useful example in this context.

The most recent NGFS report[1] provides an informative summary of academic work modeling the impact of climate change on the economy and financial system. It includes indicators to monitor risks and suggests options for central banks and supervisors to assess risks. Some supervisors have or will be undertaking such exercises soon. Most notably the Dutch[2] and French central banks have conducted quantitative exercises, and the UK Prudential Regulatory Authority has included climate change scenarios as an exploratory topic in the 2019 General Insurance Stress Test[3] with plans to do so for banks in 2021. In Hong Kong the HKMA has plans to rate the greenness of banks in 2020. The European Banking Authority has a mandate to consider how to integrate ESG risks into the Supervisory Review and Evaluation Process (SREP) by 2021 and has indicated plans to publish a multi-year roadmap of expectations for banks. In Switzerland, FINMA and the SNB will likely receive formal mandates soon to assess climate-related financial risks. Finally, in the U.S., the Commodity Futures Trading Commission (CFTC) has established a Climate-Related Market Risk Subcommittee, while recent remarks[4] from Fed Governor Lael Brainard highlighted implications of climate change for monetary policy and financial stability.

NGFS handbook—fostering global alignment

Given the rapidly increasing activity within individual jurisdictions, the SFWG appreciates the NGFS commitment to develop a "handbook of supervisory practices," as this could be very useful in helping avoid inconsistencies in approach. To help foster global alignment, the SFWG urges the NGFS to also incorporate—to the extent possible—perspectives from jurisdictions currently outside formal NGFS membership. While realizing that the NGFS does not wish to be a standard-setter, it would be tremendously valuable to have a document that helps guide supervisors on which approaches and methodologies may be most appropriate given the current state of industry practice and data availability. Additionally, while recognizing that the formal inclusion of this topic within the agendas of the FSB and the Basel Committee is still evolving, such a handbook could still be integrated into activities supporting the supervisory community such as those of the Financial Stability Institute. The SFWG is contributing to the efforts of NGFS Workstream 1 to produce a document outlining different methodologies and approaches for climate and environmental risk analysis. While this will be very useful transparency on the current state of development, it will not necessarily provide supervisors or firms guidelines on how to further develop either supervisory programs or firm internal work. The SFWG believes there would be

[1] *Macroeconomic and financial stability Implications of climate change*, NGFS (July 2019) https://www.banque-france.fr/sites/default/files/media/2019/08/07/ngfs_report_technical_supplement_final.pdf
[2] https://www.dnb.nl/en/news/dnb-publications/dnb-occasional-studies/dnb379398.jsp
[3] https://www.bankofengland.co.uk/prudential-regulation/letter/2019/insurance-stress-test-2019
[4] https://www.federalreserve.gov/newsevents/speech/brainard20191108a.htm

great value in the NGFS developing guidelines on supervisory approaches—particularly as a number are already under development in different jurisdictions.

The SFWG also appreciates the NGFS commitment to develop voluntary guidelines on scenario-based risk analysis. The industry is actively researching methodologies to analyze, measure and report climate risk and opportunity. First, there is a United Nations Environment Programme Finance Initiative (UNEP FI) sponsored project that produced publications in 2018 on transition risk[5] and physical risk,[6] and which is now continuing into 2020 in a second phase with more than 30 banks. Second, there is a 2 degrees investment initiative (2dii) project piloting application of the Paris Agreement Capital Transition Assessment (PACTA) methodology to loan books with more than 15 banks[7]. Third, there are efforts focused on carbon performance and green activity initiatives to measure exposure (e.g. Partnership for Carbon Accounting Financials[8]; taxonomy-based measures etc.). Finally, the United Nations Principles for Responsible Investment (UN PRI) has announced an initiative to outline policy changes individual countries may adopt in an "Inevitable Policy Response" to economic, environmental and social pressures.[9]

Industry perspectives—need for agreement on methodologies, scenarios

Against this backdrop, the IIF SFWG met in New York during Climate Week to discuss the current state of market development and hear directly from many of the leading initiatives noted above. The SFWG has partnered with these initiatives and others to organize a series of workshops with industry participants in key financial centers to promote discussion of these issues and gather a wide range of views from market participants. Early findings from our November workshops in Europe suggest it will be essential to arrive at consolidation and alignment of various developing methodologies as soon as they mature. The immediate priorities[10] in our view are the following:

- Focus of analysis (i.e., questions to be addressed and relevant metrics to be used to identify climate-related risks)
- Scenarios to be used
- Sectors in scope
- Data gaps and how to address them

Ideally the industry and regulatory community can agree on key issues in the short term so further work can be done both individually and collectively. There may be a useful historical analogy in the shift that occurred from Basel 1 to Basel 2. During the late 1990s and early 2000s there was a high degree of interaction between industry and regulators. In particular, IIF expert groups and Basel Committee groups worked collaboratively to establish key principles and test approaches to

[5] https://www.unepfi.org/publications/banking-publications/extending-our-horizons/
[6] https://www.unepfi.org/publications/banking-publications/navigating-a-new-climate-assessing-credit-risk-and-opportunity-in-a-changing-climate/
[7] https://www.transitionmonitor.com/
[8] http://carbonaccountingfinancials.com/
[9] https://www.unpri.org/climate-change/the-inevitable-policy-response-policy-forecasts/4849.article
[10] For a general discussion of stress testing goals, guidelines and process components see the GARP publication, *A Code of Practice for Supervisory Stress Tests* (December 2018) www.garp.org/#!/garp-risk-institute/supervisory_stress_tests

determine which might be suitable for internal risk measurement and inclusion into the regulatory framework. As a key priority, climate change risk analysis and measurement would benefit from a similar approach, particularly given data limitations, timeframes involved, and methodology uncertainties. In this context, we strongly encourage a dynamic and intense period of collaboration between the industry and regulators at both high-level and working-level—particularly as we share a common goal and expert resources are finite.

The work currently being done in the UK in the joint PRA-FCA Climate Risk Council is a useful model but is only one jurisdiction. Given the global nature of this topic and the need to make rapid progress, the SFWG would like to work with the NGFS to expand the scope of the efforts or find a way to leverage and broaden such work. There is little value to be gained in having multiple authorities repeating efforts or developing slightly different approaches to issues such as the scenarios to be used. There is far more value to be gained in discussing the results of the analyses, but such analyses must have common elements and approaches to allow for comparability across firms and across jurisdictions.

Avoiding fragmentation

Given the above, the NGFS could play a key role in organizing such activity to avoid fragmentation and help generate efficiencies given the evident limitations on resources both in the regulatory community and in the industry. We should aim to avoid a repeat of the post-financial crisis experience in stress testing, where different approaches were adopted across jurisdictions with limited efforts at coordination—making comparability and alignment difficult, if not impossible, to achieve. While that was understandable at the time due to the urgent need to develop approaches in the midst of a financial crisis, there is the chance now to proceed with greater alignment from the beginning—before the climate crisis becomes still more acute. The post-financial crisis experience with regulating the previously unregulated OTC derivatives markets and developing the new supervisory tool of resolution planning clearly shows the benefits of establishing key principles and concepts first followed by a staged implementation path. The new domain of climate/environmental risk analysis and measurement would unquestionably benefit from a similar constructive approach.

Climate change, environmental stress, and sustainability issues are global in nature and a global response is appropriate. We believe the industry and regulatory communities share a mutual interest in avoiding multiple regimes that are similar in intent but different enough in the details that the same implementation processes cannot be used. Such fragmentation would be particularly unfortunate with respect to climate change, which has no jurisdictional, geographic or sectoral boundaries.

Therefore, building on the dialogue started between the IIF Board of Directors and the NGFS during the IMF/World Bank Annual Meeting week in Washington D.C., the SFWG would be pleased to work with the NGFS on the potential for collaborative cross-jurisdictional activities that can help further understanding on the insights from, and limitations of, current methodologies and practices. A global approach to learning and experimentation—perhaps similar to the Quantitative Impact Study (QIS) exercises that have occurred to road-test various

Basel Committee capital proposals—would be helpful to ensure alignment and rapid progress, while recognizing the starting points of the different jurisdictions. We have addressed you collectively and circulated this letter widely among relevant regulators and supervisors given the experience with the Basel institutions on such exercises. There is value in approaching this topic in a coordinated manner—particularly given that some individual institutions have started their own approaches as noted above.

Finally, the SFWG underscores the need to find innovative ways to scale green and sustainable finance solutions, particularly related to infrastructure finance. For example, sustainable infrastructure is still an undefined asset class; better definitions are needed, along with greater support from relevant public sector actors on risk mitigation solutions and blended finance. Appropriate risk-taking—e.g. equity finance for early-stage cleantech companies—should be facilitated within the regulatory framework. The SFWG would be pleased to discuss this topic with the NGFS and other interested parties, particularly if there are policy initiatives that could help enhance the flow of finance for this important activity.

On behalf of the IIF Sustainable Finance Working Group, we hope that these industry views will contribute to your work. We would appreciate the opportunity to discuss these matters further early in the new year, and look forward to your reactions and continued dialogue on these important issues.

Sincerely,

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Andrés Portilla
Managing Director
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CC: Mr. Mark Carney, Governor, Bank of England
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Mr. Ryozo Himino, Chair, FSB Committee on Supervisory and Regulatory Cooperation, Vice Minister for International Affairs, Financial Services Agency, Government of Japan
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