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Agustin Carstens
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Basel Committee on Banking Supervision
Bank for International Settlements
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Basel
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Dear Mr. Carstens,

CIBAFI Response to the Basel Committee’s Discussion Paper “The role of climate scenario analysis in strengthening the management and supervision of climate-related financial risks”

The General Council for Islamic Banks and Financial Institutions (CIBAFI) presents its compliments to the Basel Committee on Banking Supervision (BCBS) and takes this opportunity to express its appreciation for the work that the BCBS is doing to provide principles for operational resilience.

CIBAFI is an international body representing Islamic financial institutions globally, who offer financial services and products complying with Islamic rules and principles (Shariah). CIBAFI acts as the voice of the Islamic finance industry, and our members comprise more than 130 Islamic banks and non-bank financial institutions, both large and small, from over 34 jurisdictions.

We welcome this opportunity to offer our comments and recommendations on the BCBS’s Discussion Paper (DP) “The role of climate scenario analysis in strengthening the management and supervision of climate-related financial risks”. The answers presented in

this letter represent the views of CIBAFI's Secretariat and feedback received from our members on the questions in the DP. Although our membership is diverse, they can be seen as reflecting largely the concerns of smaller banks, mainly in emerging markets.

Question 1: How does the role of CSA vary based on the objectives listed above and are there other prudential objectives where CSA could be relevant?

Answer: In addition to the objectives listed above, CSA could be relevant to some additional prudential objectives in the area of regulatory compliance:

- CSA can facilitate compliance with regulatory requirements related to climate risk disclosure and management, ensuring banks meet evolving supervisory expectations. For example, a bank uses CSA to assess the impact of different climate scenarios on its loan portfolio. By modelling various scenarios, such as a sudden increase in carbon prices or severe weather events, the bank can identify potential risks to its borrowers and the broader financial system. The bank can use these insights from the CSA to comply with regulatory requirements by providing detailed disclosures in its annual financial reports about the identified climate-related risks, including the potential financial impact under different scenarios. For instance, the bank might disclose that a scenario involving a rapid transition to a low-carbon economy could increase the risk of default among its clients in the fossil fuel sector by a certain percentage.

Furthermore, some banks tell us they will want to use CSA with an eye specifically to investor communication, since demonstrating a strong understanding of climate risks can attract investors who value sustainability and resilience. In this case, the approach taken may vary with the target audience, but a key focus will be the ability to communicate clearly the company's climate strategy, its risk management practices and the potential implications under different climate scenarios.

Question 2: What are the key challenges in the application of CSA and how can they be overcome?

Answer: Some of the potential challenges and their proposed solutions are as follows:

- 1- **Methodological Variability:** CSA methodologies vary across jurisdictions and banks, leading to inconsistencies in application and possible challenges for multinational groups in situations where parts of the group are subject to local regulatory requirements on CSA.

Proposed solution: Establishing standardized methodologies and practices for CSA can enhance consistency and comparability across institutions.

- 2- **Data Availability and Quality:** A number of our members have commented that the limited availability of quality data on climate-related risks hampers the effectiveness of CSA. Conducting robust CSA requires access to reliable climate data, economic models and analysis of the impact on specific sectors and regions. Banks, certainly smaller banks, cannot be expected to produce this for themselves.

Proposed solution: There needs to be improvements in data infrastructure supported by high-quality climate and economic modelling. While the work of bodies such as the IPCC and NGFS is helpful, it is not clear to us that anybody has accepted responsibility for undertaking this work on a global basis. It may be that the international community needs to take a further step in rationalizing the climate standards world, by assigning such a responsibility to a designated body.

- 3- **Incomplete Transmission Channels:** Many transmission channels of climate-related financial risks are not fully understood or captured in CSA, hindering scenario construction.

Proposed solution: Further research to understand and capture transmission channels of climate-related risks can facilitate more comprehensive scenario construction. Moreover, to perform a CSA it is necessary to be able to translate a given climate change into physical impacts at a very detailed level, for example, x % reduction in wheat yields, and y % increased hurricane probability in such and

such a place. These impacts are highly geospatially dependent. While the Network for Greening the Financial System (NGFS) is doing good work, as suggested above, more is needed, especially for developing economies where many Islamic banks are situated. Also, to understand transition risks banks need to understand how relevant economies expect the transition to low carbon to play out. This implies fairly detailed government transition plans.

- 4- **Regulatory and Policy Uncertainty:** Uncertainty in regulatory requirements and policies related to climate risks can complicate compliance efforts.

Proposed solution: Addressing this issue requires regulators to adopt and implement robust international standards promptly. Additionally, ongoing policy dialogue between regulators and banks is essential to help banks prepare in advance for regulatory changes. While many actions need to occur at the jurisdictional level, the BCBS can play a crucial role in promoting and encouraging these practices.

- 5- **Bank data systems:** In addition to the points made above about climate and economic data, a common concern is that bank systems often lack the capability to hold data on their assets and liabilities in a way that allows for the assessment of climate impacts, even within well-defined scenarios. For example, if a bank has financed a factory near the coast, it may not have data on its height above sea level. There is no easy solution to this at an international level, but better-defined and more stable CSA requirements can facilitate banks in collecting the necessary data.

Question 3: 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?

Answer: In addition to the highlighted challenges and the proposed solutions in the answer to Question 2, it is important to recall that many CIBAFI members are relatively small by global standards and lack the capability to develop full scenario analyses of their own; even in existing areas of scenario analysis, they may be dependent on guidance from their regulators.

Moreover, as stated in the DP, the methodology and metrics used to assess the effect of climate risk on capital or liquidity shortfalls is a work in progress and needs further research and application. The assumptions underpinning the effect of climate risks on capital and liquidity shortfalls need further study. The interface between climate risk and macroeconomic performance, needs further study as does the interface between climate risk and credit risk. We also note that some major bank clients are dependent on transnational value chains which may be disrupted by climate-related events. A bank analysis of the credit or other risks associated with these clients therefore cannot be based solely on a nation-level analysis. These shortcomings can be partly overcome through the exchange of experiences between financial institutions as well as dedicated academic research into the area by relevant entities.

Question 4: Are the key features listed above appropriately calibrated for a range of CSA exercises and should other features be considered?

Answer: The key features of the CSA exercises are appropriately calibrated, however, the application of proportionality will be particularly important. It may be important to distinguish between materiality and proportionality as commonly understood. Proportionality is often understood in relation to the size and importance of the institution in the financial system as a whole. However, climate-related risks may be highly material even for a small institution.

Some other points are as follows:

- **Interdependencies:** Banks should be required or encouraged to consider the interdependencies between climate-related risks and other financial, operational, and strategic risks faced by the institution.
- **Continuous Monitoring and Review:** Ongoing monitoring and review to ensure the relevance, accuracy, and effectiveness of the analysis over time. While the timescale of climate effects makes this challenging, it is important to assess the usefulness and accuracy of CSA outputs to the extent that this is possible.

- **Value chain vulnerability:** Value chain vulnerability could also be added as a relevant feature for CSA exercises where the transaction, assets or economic activity at risk is dependent on a transboundary value chain.

Question 5. 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.

Answer: Where the objective is **risk identification** even where the timescales are relatively long in comparison with other scenario analyses, they are unlikely to go beyond 30 years; this is generally sufficient for business planning and regulatory requirements. A wide range of scenarios will typically be used, including some extreme scenarios, to understand potential worst-case outcomes. The impact assessment will prioritise quantifying the financial implications of climate risks on assets, operations and supply chains.

Where the objective is **strategic planning**, it may be appropriate to extend the work to longer timeframes, even to 50 years, to consider long-term trends and potential tipping points. However, scenario selection may focus on a more balanced set of scenarios, including both optimistic and pessimistic outlooks, to explore a range of possibilities. The impact assessment will analyse not only risks but also potential opportunities.

Question 6: What additional usage-specific considerations are relevant for each of the different objectives of CSA listed in this paper and why?

Answer: Some additional considerations relevant to different CSA objectives include:

- Risk management process:
 - Sector-specific Scenarios: Tailoring scenarios to specific sectors to capture sectoral risk profiles accurately.
- Assessment of business model resilience and business strategy building:
 - Geographical Focus: Considering location-specific risks to account for regional differences in climate impacts.

- Temporal Dynamics: Differentiating between short-term and long-term horizons to understand immediate versus gradual risk developments.

These considerations can ensure that CSA exercises are tailored to the specific contexts and risks of different banks, enhancing their relevance and accuracy. However, there is of course a tension between bank-level exercises and jurisdiction-level exercises, especially where these are standardized for use by smaller banks.

Question 7: 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)?

Answer: For different objectives, a combination of internally developed scenarios and those from established scenario builders (e.g., NGFS, IEA) is often used. Internally developed scenarios allow banks to tailor analyses to their unique risk profiles, while externally developed scenarios provide standardization and comparability across institutions. We note also that some of our members may have difficulty in developing scenarios internally and may therefore need to use externally developed scenarios, including from regulators.

Moreover, some financial institutions are doing climate risk assessments using geospatial data by software that was endorsed by the Taskforce on Climate-Related Financial Disclosures (Acclimatise). The data and scenarios are provided by the software and this information is then used to assess effects on a particular project.

Question 8: What features and measures could be adopted in the future to enhance the utility of currently available scenarios (e.g., NGFS, IEA, IPCC)?

Answer: Some features and measures that can be adopted for the enhancements of existing scenarios might include:

- Increased Granularity: More detailed sectoral and regional data to improve specificity.

- Integration of Latest Scientific Data: Regular updates incorporating the latest climate science and technological advancements.
- Transition risk analysis: While physical risks are relatively well-understood, there remains a need for improved transition analysis models to analyse the economic impacts of policy changes, technological advances and changing consumer preferences related to climate change.
- Socioeconomic considerations: Traditional CSA tends to focus primarily on biophysical impacts, ignoring the complex social, economic and governance factors that influence vulnerability and adaptation strategies. Research to incorporate these factors would enhance scenario relevance.
- Scenario Customisation Tools: Tools enabling banks to customise baseline scenarios to better reflect their unique risk exposures and strategies.
- Customization and Localization: Tailoring global scenarios to reflect local and sector-specific conditions relevant to Islamic finance in specific countries, ensuring scenarios accurately capture regional climate risks and opportunities.
- Scenario Consistency and Comparability: Establishing standardized methodologies and metrics for scenario analysis across different providers, promoting consistency and comparability in assessing climate-related risks and opportunities.
- Continuous Scenario Updates: Regularly updating scenarios based on the latest scientific findings and climate data, ensuring relevance and responsiveness to evolving climate trends and regulatory developments.

These measures would improve the relevance and accuracy of CSA exercises, making them more useful for risk management and strategic planning.

Question 9: What alternative or novel approaches could supervisors consider for CSA and how might these be used for prudential purposes?

Answer: In regard to alternative or novel approaches, the supervisors could consider the following:

- **Dynamic Stress Testing:** Incorporating recent and updated data and adaptive scenarios that evolve with emerging climate data.
- **Machine Learning Models:** Building the necessary capability to use advanced algorithms, which will evolve over time based on data availability, to predict and model complex climate-related risks.
- **Collaborative Scenario Development:** Engaging with multiple stakeholders (e.g., industry experts, and academics) to develop more robust and comprehensive scenarios.

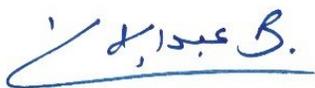
Question 10: How could the effectiveness and efficiency of supervisory exercises be improved?

Answer: Some points to improve the effectiveness and efficiency of supervisory exercises are as follows:

- **Data Enhancement and knowledge sharing:** Collaboration with industry stakeholders to develop standardized data formats, protocols for data sharing, and data collection mechanisms to facilitate the integration of climate-related data into risk assessments. Moreover, encourage relevant national bodies to develop data sources on a national basis for enhancing the effectiveness of climate scenario analysis through improved data infrastructure and quality.
- **Utilization of Technology:** Leveraging advanced analytics tools, such as machine learning, big data and artificial intelligence, can improve the efficiency and accuracy of climate scenario analysis. These technologies enable more sophisticated modelling, data analysis, and scenario generation, allowing us to have a better understanding and assess climate-related risks.

We remain at your disposal should you need any further clarifications on the above.

Yours sincerely,



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Secretary General