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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

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Consultative Document – Principles for the Effective Management and Supervision of Climate-Related Financial Risks

Dear Sir/ Madam:

State Street Corporation (“State Street”) appreciates the opportunity to comment on the consultative document issued by the Basel Committee on Banking Supervision (“Basel Committee”) regarding proposed Principles for the Effective Management and Supervision of Climate-Related Financial Risks (the “Principles”).¹ We recognize the fundamental importance of assessing and managing the impact of climate risk in the banking system and we welcome the Basel Committee’s work to develop Principles that seek to achieve a balance in providing a common baseline for internationally-active banks and supervisors, while retaining sufficient flexibility given varying industry business models and the evolving policy practices in this area.²

Headquartered in Boston, Massachusetts, State Street is a global custody bank which specializes in the provision of financial services to institutional investor clients. This includes investment servicing, investment management, data and analytics, and investment research and trading. With \$43.7 trillion in assets under custody and administration and \$4.1 trillion in assets under management, State Street

¹ <https://www.bis.org/bcbs/publ/d530.pdf>

² <https://www.bis.org/press/p211116.htm>

operates in more than 100 geographic markets.³ State Street is organized as a United States (“US”) bank holding company, with operations conducted through several entities, primarily its wholly-owned Massachusetts state-chartered depository institution subsidiary, State Street Bank and Trust Company. While our primary prudential regulators are therefore the Massachusetts Division of Banks and the US Federal Reserve System, we are subject to oversight by numerous banking regulators in the various jurisdictions in which we operate.

State Street supports the Basel Committee’s efforts to establish a principles-based approach to the management of climate-related financial risks. These Principles are timely given ongoing efforts by national regulators to establish supervisory expectations and practices regarding climate risk management, particularly in the European Union and the United Kingdom. Considerable divergence in such expectations and practices will be highly impactful for banks with global business operations, such as State Street. The principles-based nature of the Basel Committee’s recommendations is therefore crucial, as is its recognition that climate-related financial risks can vary significantly across banking business models and that risk management tools and approaches will necessarily differ.

Consistent with its policy remit, we urge the Basel Committee to devise Principles which address the safety, soundness and stability of the banking system, globally. We note that measures which span beyond safety and soundness considerations and seek to implement policy in ways not tied to these considerations are more appropriately addressed by policymakers outside of the prudential framework for banks. Among the key strengths of the Basel Committee’s work as a global standard-setter for banks is its commitment to the objective assessment of financial risk. We are concerned that the adoption of measures unrelated to financial risk could undermine the standard-setting process, and may also result in unintended consequences for the risk-based capital framework.

We strongly urge the Basel Committee to work with both national banking supervisors and other relevant global standard-setters to develop consistent standards for the identification and assessment of climate-related financial risk, thereby helping to promote a strong degree of alignment in supervisory standards and practices.

Our comments on the draft Principles are structured in two parts. The first section describes State Street’s approach – as a custody bank – to the integration of climate-related financial risks. This is followed by overarching observations and policy recommendations based on our experience in integrating climate-related issues into decisions that correspond to State Street’s overall governance, business strategy, risk management and disclosure practices.

³ As of December 31, 2021.

I. A custody bank approach to climate risk management

Global custody banks, such as State Street, specialize in the provision of financial services to institutional investor clients. These clients, which include regulated and unregulated investment funds, public and private pension plans, sovereign wealth funds, endowments and official sector institutions, contract with custody banks to ensure the proper management of their assets through the provision of safekeeping, securities settlement and asset administration services, as well as the provision of access to deposit accounts used to facilitate day-to-day transitional activities.

The assets held by custody banks belong to the client and are fully segregated from the custody bank's own assets. Hence, custody banks provide services to their clients as a directed agent, and therefore do not have discretion over assets, acting solely in accordance with explicit instructions received from clients.

Furthermore, custody banks have balance sheets that are constructed differently than other banks with extensive retail, commercial, investment banking and capital markets operations. The custody bank balance sheet is liability driven and built around client deposits derived from the provision of safekeeping and asset administration services.

These deposits represent a stable source of funding, whose value is monetized via the purchase of large and well-diversified portfolios of high-quality and appropriately termed investment assets. Unlike other banking business models, custody banks make relatively few loans and do not engage in the asset securitization process. Furthermore, they do not engage in significant trading activities and do not rely extensively on sources of wholesale funding to manage their business activities.

Against this backdrop, State Street considers climate-related exposures across four primary pillars which are managed across our three lines of defense oversight model:

- *Our physical footprint and operations.* In addition to considering our impact on the environment through the emissions profile of our physical footprint and operations, we continue to assess the potential impact of climate risk on our operational resiliency. We believe that climate change imposes physical risks which may impact our ability to service our clients, and are establishing frameworks to assess and manage such risks.
- *Our balance sheet.* As a custody bank, our direct exposure to significant climate-related final risk is limited. Nevertheless, we are establishing methodologies to assess areas of relatively higher climate risk exposure, and developing policies and guidelines to better integrate climate change

and wider sustainability issues into our investment decision-making processes. We are also working with data providers, industry bodies, and peers to provide meaningful disclosures around these risks.

- *Assets we custody and service.* Climate change presents both opportunities and risks for our clients. As such, we are actively seeking to provide them with the services and tools they seek to allow them to integrate climate change and ESG considerations into their investment activities.
- *Assets we manage.* We plan to partner with our asset owner clients to help position their portfolios for the transition to a low-carbon economy. We also plan to continue our climate stewardship program to encourage our investee companies to provide better disclosures and to drive and demonstrate success in a net-zero future. The asset management arm of our business, State Street Global Advisors, has signed up to the global Net Zero Investment Management initiative and aims to provide relevant transparency around this commitment.

It is therefore essential that the Basel Committee ensures these Principles are pragmatic and risk-sensitive in their consideration of the incorporation of climate-related financial risks into the global banking policy framework.

II. State Street's recommendations for Basel Committee Principles

We provided four overarching recommendations to guide the Basel Committee in its finalization of its Principles. We also provide two specific recommendations aiming to clarify provisions relating to the roles and responsibilities of the board and senior management for climate-related financial risks, and the relationship between climate scenario analysis and stress testing.

- i. **The Basel Committee should clarify that its Principles are intended to address the supervisory objective of ensuring the 'safety and soundness' of banks and of the global financial system as a whole. A principles-based approach is essential to meeting that objective.**

The Basel Committee's approach with its principles-based framework for the management and supervision of climate-related risks is highly welcome. Although State Street is generally supportive of efforts to reduce exposures to high carbon-emitting companies, sectors and industries, the Basel Committee should refrain from establishing Principles which are not consistent with its core supervisory objectives of maintaining safety and soundness of the banking system. As such, the Basel Committee should focus on the adoption of both a principles-based and risk-based approach designed to provide banks and supervisors with common guidance on the identification, monitoring, reporting, management and supervision of climate-related financial risks.

We urge the Basel Committee to retain flexibility in its final Principles and to avoid prescriptive mandates that are likely to hinder banks' abilities to explore, test, refine and adapt relative to how they manage climate-related financial risks over the short- and long-term. Banks require sufficient flexibility to develop and adapt their internal risk taxonomies, to make decisions about how to incorporate climate-related considerations within their risk management framework, and to determine the relative materiality of climate-related exposures. Accordingly, we recommend that the Basel Committee withdraw its expectation for banks to establish and apply quantitative limits or thresholds for climate-related risks.

- ii. **We agree with the Basel Committee's approach to focus on "climate-related financial materiality", as this ensures that the Principles are risk-based and can be implemented across jurisdictions in a proportionate way.**

As previously noted, financial materiality will not be the same across all banks (e.g., custody banks compared to peers with different business models) and should therefore be understood in the context of individual business models and in accordance with local laws.

We therefore strongly agree that the Basel Committee's Principles should be applied based upon the nature of a bank's business activities and exposure to material climate-related financial risks. We do not believe, in this respect, that 'size' is an appropriate criteria to determine the application of these Principles. In particular, the Basel Committee should consider the nature and purpose of a bank's balance sheet and the magnitude of climate risk-sensitive assets to which it is exposed. As a custody bank, our balance sheet has limited direct exposure to climate-related financial risks given the nature of its composition, whereas these risks may pose a much greater threat to a smaller bank with significant exposure through its direct financing of carbon-emitting industries, or other similarly climate risk-sensitive assets.

The Basel Committee should also clarify that individual banks can make their own materiality determinations based on the metrics most relevant to their business model and activities, to ensure that the principle of risk sensitivity is maintained, particularly with respect to requirements relating to scenario analysis. The Basel Committee should also make clear that the materiality of exposures has a direct link to the breadth and depth of scenario analysis expectations and requirements as appropriate for individual banks.

- iii. **The ability of banks to implement effective climate risk management programs is currently limited by absent or inconsistent climate-related data. The Basel Committee should allow for flexibility in approaches for the quantification of climate-related financial risks and seek to promote international alignment of data standards.**

One of the primary challenges banks face is the lack of historical data as to climate-related impacts on their financial risks and the significant uncertainty and variability around potential future outcomes for these risks. There are also notable data gaps with regard to the availability and standardization of both physical and transition climate risk data across issuers and asset types. Given these gaps, the Basel Committee should allow banks flexibility in their development of data capabilities and methodologies, as well as in their use in risk management frameworks. The alignment of global rules with regard to data and methodological standards is critical to foster the continued evolution and growth of banks' climate-related financial risk management efforts. The Basel Committee's Principles should therefore seek to ensure such expectations are aligned across supervisors and institutions to support the development of quantitative risk management tools.

- iv. There is a danger that in the haste to implement climate risk mitigation programs, banks may experience fragmented or inconsistent supervisory expectations, which could be detrimental to the efficient functioning of the global banking system. The Basel Committee should therefore recommend a 'phased' approach to the adoption of the Principles.**

Amidst a fast-evolving regulatory landscape, the effective coordination and alignment of supervisory standards for banks is critical. As such, the Basel Committee should encourage banks and supervisors to adopt a phased approach when implementing these Principles in order to allow for climate risk measurement methodologies to mature, achieve greater standardisation, and improve data availability, in addition to alignment across jurisdictions.

Furthermore, we believe that the Basel Committee is well-placed to support the sharing of best practices across banks and supervisors, thus providing for a common understanding of how to address climate-related financial risks across the financial system and to aid in developing a globally consistent approach to the management of these risks. Ensuring that banks are using consistent or comparable data and methodologies will allow for a greater understanding of 'like-for-like' risks, thereby further supporting key safety and soundness considerations.

A phased approach would also allow banks to build and implement data governance and IT structures that are needed to support increased risk data aggregation capabilities, and to facilitate the identification and reporting of exposures and emerging risks.⁴

⁴ Basel Committee Consultative Document, Para 28.

- v. The Basel Committee should ensure the Principles do not conflate the respective roles and responsibilities of the board and senior management.**

We agree that banks should ensure appropriate governance arrangements for the management of climate-related financial risks in a manner that is proportionate to the level of risk posed by climate change. As drafted, Principle 2 would require the board and senior management to clearly assign climate-related responsibilities to members and committees.

We recommend that the Basel Committee modify the language in Principle 2 to better distinguish the respective roles and responsibilities of the board and senior management. While the proper role of the board is to provide oversight, the draft Principles could be interpreted as suggesting that the board has more direct involvement in the day-to-day matters of a banking organization to “ensure” certain outcomes. Rather, the board’s responsibilities are to direct management to take certain actions and to hold management accountable for execution.

Also, to more accurately reflect how responsibilities are typically assigned to the board, Principle 2 and supporting commentary 13 should be revised to state that climate-related responsibilities should be assigned to committees or subcommittees, rather than to individual board members.

- vi. Since banks and supervisors are in the early stages of developing strategies for the effective management of climate risk, and in view of the inherently longer time horizons in which climate risks manifest, supervisory stress testing is not appropriate at this time, especially if used to determine specific capital/ liquidity mandates.**

We welcome the Basel Committee’s recognition that climate-related financial risks are drivers of our existing risks and that banks are at an early stage in embedding these drivers into their risk management frameworks. As such, we believe that it would be premature to proceed with the recommendations under Principle 5 – which require banks to identify and quantify climate-related financial risks and incorporate those deemed material over relevant time horizons into their internal capital and liquidity adequacy assessment processes.

While we agree that scenario analysis could help to diagnose “data and methodological limitations in climate risk management”,⁵ the draft Principles do not appear to incorporate sufficient flexibility that would ensure supervisors take a proportionate approach, particularly with respect to climate scenario analysis,

⁵ Basel Committee Consultative Document, Para 42.

in view of inconsistent, incomplete or incomparable datasets and methodologies across various exposure types and loans.

Additionally, the Basel Committee should consider the significant challenges of aligning the impact of climate-related financial risks with the maturity profile of banks' assets. While the Basel Committee notes that climate risks may impact banks over the short-, medium-, and long-term and that banks should consider these varied time horizons in identifying and managing their risks, given the uncertainty and variability of outcomes over longer time horizons and the ability of banks to reduce their exposure to or otherwise manage risks across these time horizons, the final Principles should remain flexible in considering projected impacts over the medium- and long-term and refrain from the use of prescriptive outcomes.

Principle 12 recommends that banks use scenario analysis in their approach to the management of climate risk. As a threshold matter, we believe that it is not appropriate to consider stress testing as a component of scenario analysis. These are distinct tools that are both qualitatively and quantitatively different.⁶ Rather, the Basel Committee should clarify that stress testing should be understood in terms of internal stress simulations, as opposed to integrating climate risk stress testing into existing supervisory stress testing frameworks, such as the US Federal Reserve Board's Comprehensive Capital Analysis and Review ("CCAR"). Few jurisdictions have conducted supervisory climate stress tests to date, and those that have conducted were standalone exercises that did not result in adjustments in banks' capital and/or liquidity requirements.

Thank you once again for the opportunity to comment on the important matters raised within the consultative document. To summarize, State Street supports the Basel Committee's work on climate risk management and supervision, particularly the emphasis on developing a common principles-based approach, globally. However, there are certain areas that require further consideration --- in particular, distinguishing the respective roles and responsibilities of the board and senior management, as well as scenario analysis and supervisory stress testing.

Please feel free to contact me at jjbarry@statestreet.com should you wish to discuss the contents of this submission in greater detail.

Sincerely,



Joseph J. Barry

⁶ Basel Committee Consultative Document, Para 6.