The Implementation of Sustainability as a Legal Standard in European Banking Law

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Why look at this?

- Since 2008, some financial regulators have begun looking at – and acting on – the links between *systemic* environmental risks and financial stability

- However the fragmentation of international economic governance poses obstacles to international coordination/cooperation in banking and environmental regulation

- The redesign of international financial regulation – macro-prudential focus – offers opportunity to link-up the different areas of financial and environmental regulation/governance.

- G20 (2009) international regulatory reform core aim to ***"generate strong, sustainable and balanced global growth"***

- Also – UN/G20-backed enquiry into the role of regulation in the design of a sustainable financial system.

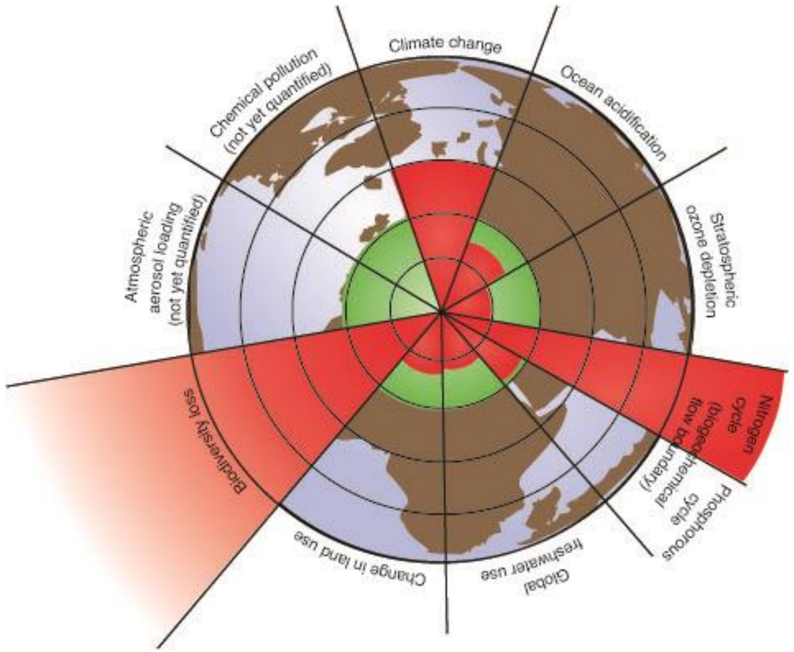
More systemic environmental risks lie ahead of us..

•‘Planetary boundaries’ – thresholds marking the “safe space for human development”

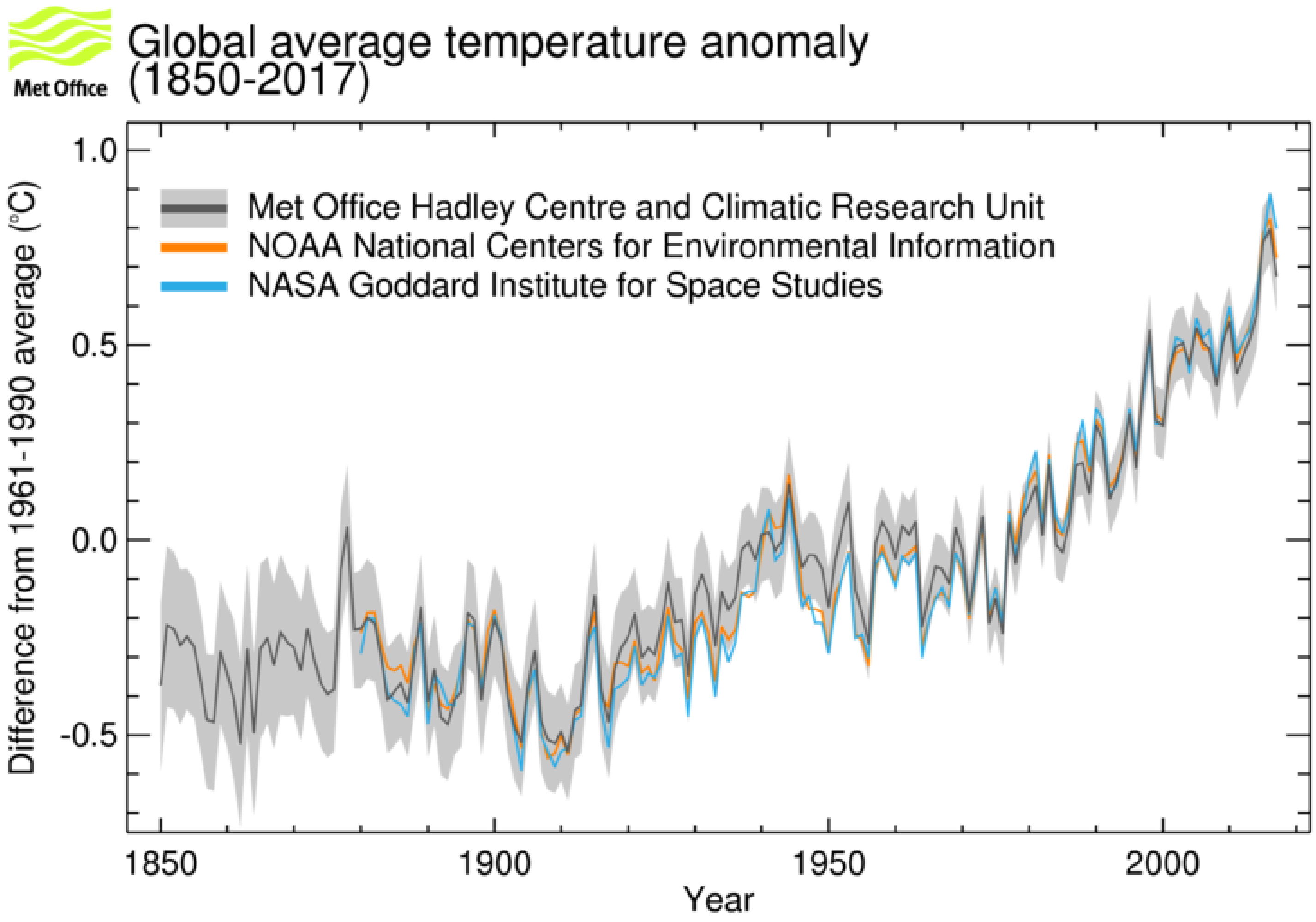
•Crossing them would trigger non-linear, abrupt environmental change within continental- to planetary-scale systems

•Of the nine, three have already been crossed (climate change, biodiversity loss, nitrogen input into the atmosphere)

•Cannot exclude links to financial stability…



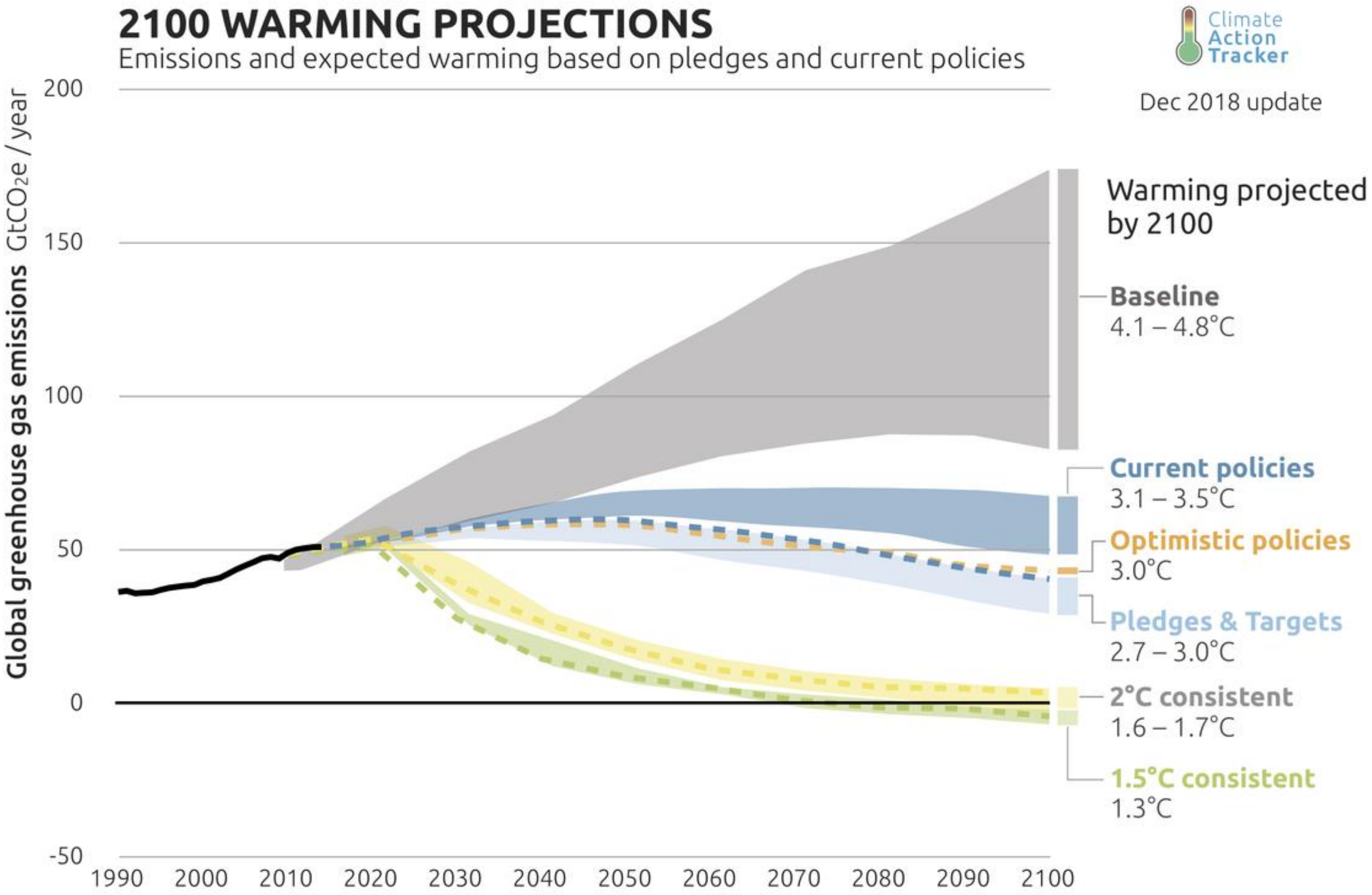
The planet is warming, over +1° already



An old joke from the internet … source unknown …!

The Physical Risks

Scenarios for global temperatures



What are the Financial Risks?

- Bank of England:

  "*The impact of climate change on the insurance sector*" (PRA 2015)

  "*The Bank of England's response to climate change*" (QB2017)

  "*Transition in Thinking: The impact of climate change on the UK banking sector*" (PRA 2018)

  Bank of England Supervisory Guidelines for banks regarding environmental risks (April 2019)

  - Physical
  - Transition
  - Legal (Liability)

http://www.bankofengland.co.uk/pra/Documents/supervision/activities/pradefra0915.pdf
https://www.bankofengland.co.uk/prudential-regulation/publication/2018/transition-in-thinking-the-impact-of-climate-change-on-the-uk-banking-sector
http://www.bankofengland.co.uk/Pages/reader/index.aspx?pub=qb17q2article2&page=1

Macroprudential policy issues (financial stability)

- Asymmetric information means that sudden crystallization of risks - physical, structural change & policy transition, legal – could cause:
  - Widespread, large changes in asset values – could impact banks and insurers systemically eg RWE, EON, Peabody energy.
  - Assets becoming uninsurable eg houses built on flood plains
  - Unexpected increase in insurers’ liabilities eg super-storm Sandy in NY;
  - Wrong-way collateral risks for banks
    eg property destruction affecting credit of borrower and value of collateral.
  - Sovereign risks for countries that have concentrated climate-related assets
    eg agricultural producers, fossil fuel producers, tourist centres (water).
  - Need to ensure appropriate risk management by financial firms (Basel Pillar II)

‘Stability and Sustainability in Banking Reform: Are environmental risks missing in Basel III?’ (Oct 2014)

- History demonstrates links between systemic environmental risks and banking instability
- The Basel Capital Accord does not adequately address systemic environmental risks
- Existing regulatory practices outside Basel that do address systemic environmental risks
- Changing the focus of the Basel Accord through Pillar 2 to address systemic environmental risks

Basel III

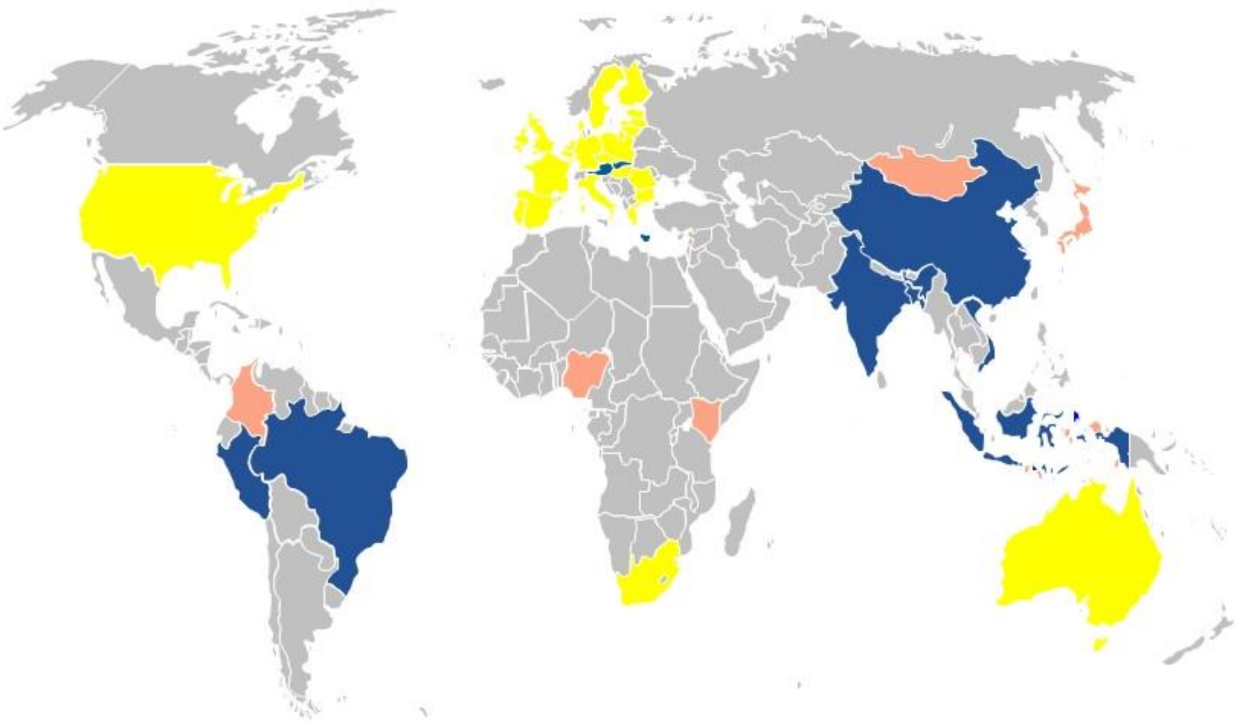
Pillar 1	Pillar 2	Pillar 3
Minimum Capital Requirements	Supervisory Review Process	Market Discipline
Additional / Refined Capital Basis	Supervision (Dialogue)	**Additional / Enhanced Disclosure**
- Liquidity Coverage Ratio (LCR)	- Firm-wide Corporate Governance	- Risk Management
- Net Stable Funding Ratio (NSFR)	- Managing Risk Concentrations	• Market
- OTC Derivatives Charge	- Alignment of LT Incentives	• Credit
- Quality and Level of Capital	- Sound Compensation Practices	• Operational
- Leverage Ratio	- Supervisory Colleges	- Regulatory Capital Components
- Capital Conservation Buffers	**Capital (ICAAP)**	- Detailed Reconciliation of Capital
- Countercyclical Buffers	- Firm-wide Risk Management	- Regulatory Capital Ratios
- Enhanced Loss Absorption Clause (Write-Off or Debt Conversion)	- Valuation Practice, Stress Tests	- Securitisation Exposures
	Supervisory Review Evaluation Process (SREP)	
	- Capital	
	- Governance	

The management of certain transaction -specific environmental risks on credit and operational risks is already required by paragraph 510

ICAAP and SREP can be used to assess portfolio risk exposures to systemic environmental risks

Standardised or harmonised disclosure of information about exposure to, and management of, systemic environmental risks could form part of additional or enhanced disclosure requirements

Are there existing practices outside of the Basel Capital Accord that are relevant to this study?



Legend:
pink = voluntary frameworks blue = regulation yellow = other relevant policy & regulation

Existing practices outside the Basel Accord relevant to this study?

China – Green Credit Guidelines

- Promoting bank lending to environmentally sustainable economic activities
- Requiring banks to include in their loan documentation covenants to comply with environmental standards
- Collect data to inform of progress and breach of environmental regulation violations

Brazil

- Using Pillar 2 to require banks to assess exposure to carbon risk
- Guidelines relating to Supervisory Review for how to consider banks' exposure to environmental and social risks
- Using Pillar 3 to require public disclosure of exposure for market discipline

Peru

- Environmental and social due diligence approach for projects
- Bank requires project manager to produce due diligence report before investment

How might the Basel Committee take forward the lessons of this study?

“The Basel Committee should **acknowledge certain environmental risks** as material risks for banks in their pillar 2 assessments with a view to understanding the impact of systemic environmental risks on banking stability. ***A capital assessment***

On this basis it should encourage and support bank regulators to work with banks to adopt current best practice in the management of environmental issues, and to collect the necessary data and conduct analysis to refine the banking sectors' understanding of, and ability to address, systemic environmental risk in the future. ***A governance assessment***

Bank supervisors should then explore the feasibility of incorporating forward-looking scenarios that estimate the potential financial stability impact of supplying credit to environmentally unsustainable or sustainable activities over time into their **Pillar 2 – Supervisory Review** stress tests.

Bank supervisors should also examine **Pillar 3 – Market Discipline** to assess the feasibility of banks disclosing information about their exposure to, and management of, systemic environmental risks in a standardised manner across countries.”

What other financial policy options are available?

1. **Monetary policy** could play a role in supporting liquidity provision for finance to support environmentally sustainable economic activities?
    - Using cost of central bank funding to promote ‘green’ lending
    - Eg Lebanon, Decree no. 7835
    - Green asset-backed securities, eg bonds, as collateral for liquidity support?

2. **Innovation to facilitate long-term investors**
    - Regulators are looking at ‘simple and transparent’ financial instruments to facilitate long-term investment…
    - Encourage more investment in ‘green’ assets at the same time?

3. Ensure that **financial and environmental policies and regulations are coordinated** across government agencies and departments in their promulgation, implementation and enforcement.

CRD V - Incorporating sustainability in EU prudential regulation (1)

- 7 June 2019 CRR II and CRD V were published in the Official Journal of the EU.
- CRR II will apply from 28 June 2021 (Art. 3 CRR II).
  - Exceptions listed in Art. 3(3) to Art. 3(8) CRR II.
- Member States must adopt the necessary measures to comply with CRD V by 28 December 2020 (Art. 2 CRD V).
- No provisions regarding the incorporation of sustainability but mandate to European Banking Authority (EBA) to prepare reports on the subject.

CRD V - Incorporating sustainability in EU prudential regulation (2)

- Uncertainty regarding risks of green assets compared to non-green assets.
- Supervisory Authorities and legislative bodies hesitant to include sustainability in prudential regulation amidst uncertain risk assessment.
  - ECB: "For the integrity of financial institutions and financial stability, it is important that prudential frameworks remain risk-based." (ECB, Financial Stability Report, May 2019, available at <https://www.ecb.europa.eu/pub/financial-stability/fsr/special/html/ecb.fsrart201905_1~47cf778cc1.en.html#toc2>.
- Further legislative proposals are only expected after the European Banking Authority's reports.
  - Report regarding prudential treatment of exposure to environmental and/or social objectives expected by 28 June 2025.
  - Report regarding inclusion of ESG risks expected by 28 June 2021.

Regulation (EU) 2019/876 (CRR II)

- Art. 449a CRR II
  - Obligation for large banks to disclose information regarding ESG risks and related physical transitional risks from late June 2022 onwards.

- Art. 501a (1)(o) CRR II
  - Banks can reduce their own fund requirements when financing infrastructure for essential public services, amongst others, if an assessment has been completed on whether the borrower has contributed to environmentally sustainable economic objectives.
- Art. 501c CRR II
  - EBA must assess whether a dedicated prudential treatment of exposures related to assets or activities associated substantially with environmental and/or social objectives would be justified.
  - The EBA shall submit a report on its findings by 28 June 2025.

Directive (EU) 2019/878 (CRD V)

- Art. 98(8) CRD V
  - EBA must assess the potential inclusion in the review and evaluation performed by competent authorities of environmental, social and governance risks (ESG risks).
  - The EBA shall submit a report on its findings by 28 June 2021.
  - On the basis of the assessment, the EBA may issue guidelines regarding the uniform inclusion of ESG risks in the supervisory review and evaluation process performed by competent authorities

EBA Working Plan 2020

- Complete the second phase of its preparatory work on disclosure and risk assessment in the area of sustainable finance.
- Discussion Paper on the incorporation of ESG into risk management and supervision (CRD and IFD mandates).
- Undertake preparatory work on the classification and prudential treatment of assets from a sustainability perspective (CRR and IFR mandates).
- Deliver TS of the Joint Committee of the ESAs on disclosures (investment and advice activities).

EU Commission's Consultation regarding final Implementation of Basel III

- 11 October 2019: EU Commission launched public consultation
  - "In your view, which further measures, if any, could be taken to incorporate ESG risks into prudential regulation without pre-empting ongoing work as set out above?" *(EC, public consultation on implementing Basel III, p. 49, available at https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/2019-basel-3-consultation-document_en.pdf)*
- EU Commission launched a study on the development of tools and mechanisms for the integration of ESG risks into institutions' risk management, business strategies and investment policies as well as into prudential supervision.
  - Results expected in early 2021

EU Technical Expert Group on sustainable finance reports

- 18 June 2019 TEG published its reports on taxonomy, green bonds and benchmarks
- Recommendation to EBA as part of its mandate to assess possibility to develop a segment of green bonds that would define the conditions to be met by EU-GBS in order to possibly benefit from a preferential prudential treatment

Network for Greening the Financial System – A call for action

- NGFS report in April 2019
- Impossible to draw general conclusion on potential risk differentials regarding green and non-green assets.
- Exploratory data collection from selected banks to be able to assess whether there is a risk differential
- Adopting Pillar 2 framework is an additional possibility to integrate sustainability to prudential regulation framework

ESMA reports report on inclusion of sustainability factors in MiFID II, UCITS and AIFMD

- On 30 April 2019 ESMA published its propositions to amend and add provisions in relevant legislation with the aim that ESG considerations and sustainable risks are taken into account.
- ESMA will work with European Commission to transform advice into delegated acts.

EIOPA reports on the inclusion of sustainability in Solvency II

- EIOPA published a consultation paper on 3 June 2019 and an opinion on 30 September 2019, recommending:
  - Undertakings should assess exposure to sustainability risk
  - Complementary tools (scenario analysis and stress testing) appear appropriate to capture impacts of climate change.
  - Assessment of the impact of climate change will depend both on the materiality of climate change-related risks and be subject to Solvency II's proportionality principle.
  - Scenarios can be used as a first step to explore the potential range of climate change related risks.
  - Further work is needed to define a consistent set of quantitative parameters that could be used in climate change-related scenarios that undertakings can then adopt
  - Regarding Pillar III in the near future further consideration should be given to mandatory requirements for public disclosure on sustainability risks.

Regulation regarding disclosure of information

- On 18 April 2019 the EU Parliament agreed on the text for a regulation on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341 (IORP II).
- Expected to enter into force in 2020
- On 18 June 2019 the Commission published a supplement to its Guidelines on the Non-financial reporting directive (2014/95/EU) related to reporting climate-related information

International Platform for Sustainable Finance

- IPSF launched on 18 October 2019 by EU and Argentina, Canada, Chile, China, India, Kenya and Morocco
- Aim is to scale up the mobilization of private capital towards environmentally sustainable investments.
- IPSF should strengthen international cooperation and, where appropriate, coordination on approaches and initiatives for the capital markets

Next steps

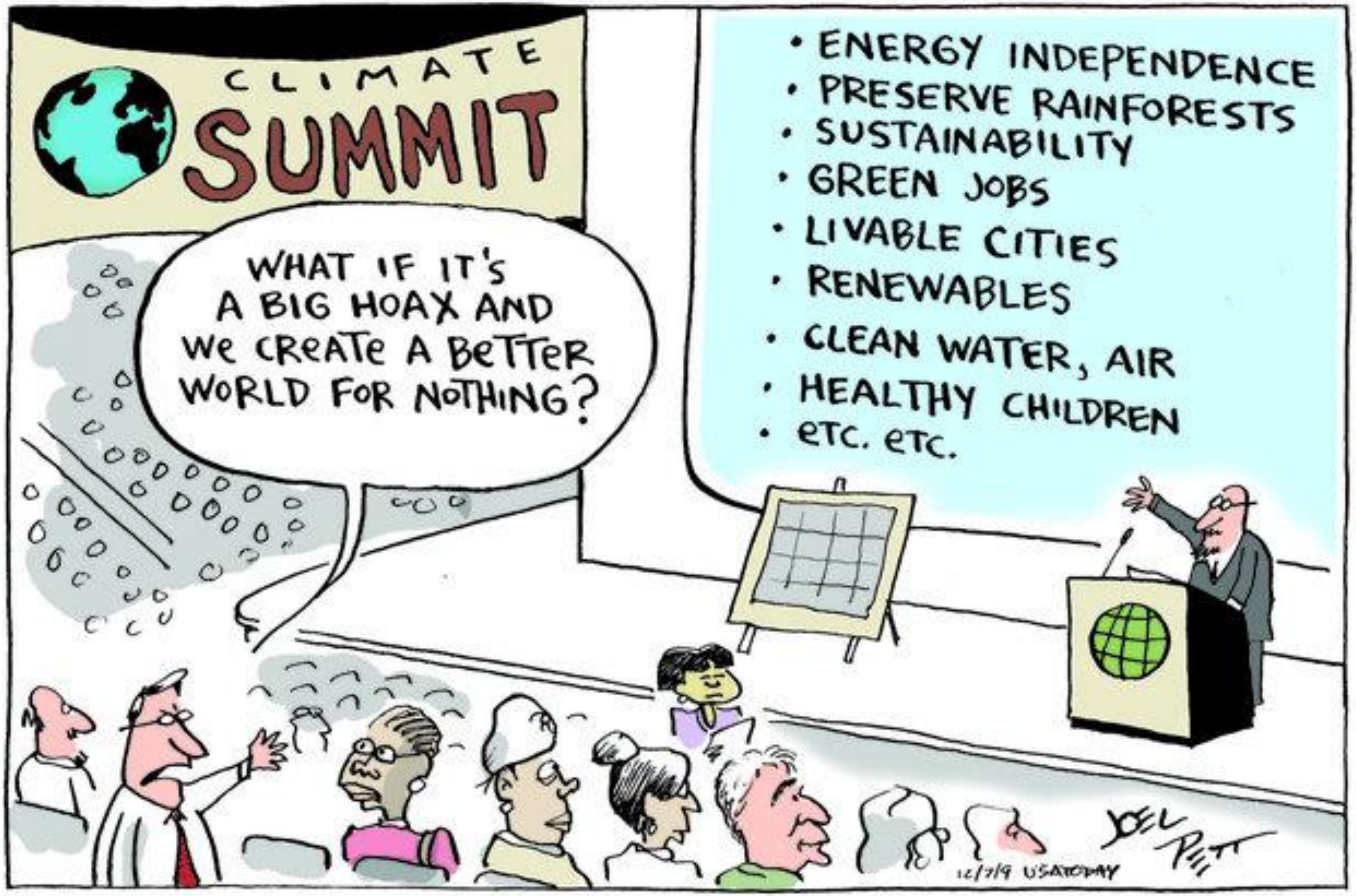
- ➢ Profound implications; further research necessary to assess the feasibility of their implementation
- ➢ This should happen on a multi-disciplinary and international basis
- ➢ It should include continuing to learn lessons from those national authorities that have already taken leadership steps and working with market actors to establish the most appropriate roles for them to play

- ❑ EU/Basel Committee should recognise systemic environmental risks as 'material risks' and encourage an international approach

Is it a social, ethical, moral, political issue?

Yes, of course it is.

But I am going to assume it isn't for this talk!




THANK YOU