Risk-based Capital Provisioning – an Adequate Approach to IGF?

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Based on my papers:

Regulating Sustainable Finance in the Dark: www.ssrn.com/abstract=3871677
The EU Sustainable Finance Framework in Light of International Standards: www.ssrn.com/abstract=3984511
Towards Sandbox Thinking in EU Sustainable Finance Regulation: www.ssrn.com/abstract=4147295
Building Blocks of a Green Fintech System: www.ssrn.com/abstract=4163002
Towards a European Social Taxonomy: A Scorecard Approach: www.ssrn.com/abstract=4218874

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Risk-based Capital Provisioning – the Principle

- Basel III guide financial institutions' risk-weighted assets.
- Credit rating of loans and assets determine risk coefficients.

⇒Loans backed with collateral less risky than unsecured debt

source of repayment + collateral > source of repayment

Risk-based Capital Provisioning – Objective

- Clients as risk
- Risk-based Optimization of FI's portfolio
- Less risk on the balance sheet

$\Rightarrow$ more stable institutions
$\Rightarrow$ less risk of insolvency
$\Rightarrow$ better protection of depositors

I. Three arguments against RWA in IGF

1. Basel‘s Systemic Risk Perspective too narrow

- Clients, collectively, constitute sectors crucial for survival;
- Broader dimension of Systemic Risk requires maintenance of these sectors as a whole

- Example:
  - Many „clients“ in EMDEs live from agriculture
  - These clients together constitute food supply.
  - Full exclusion undesirable: food crisis ⇔ financial crisis

2. IGF Risk types difficult to steer by clients

Double Materiality

Sustainability Dimensions

Sustainability Risks (internalized externalities)

Perspective: Value of own private Goods (Portfolio)

Impact on Sustainability Factors (externalities)

Perspective: Environment, Public Goods

Sustainability Risks („internalized risks“)

Climate Change	Impact	Risk Management
Rising sea level	Reduction in Real Estate value on some islands	Building dams
Droughts	Shortage of water supply for farmland and population	Irrigation systems; new wells; desalination
More severe storms	Greater likelihood of severe damages in storm season	Contracting (insurance); reallocation of farm land (inside farming)
Loss in biodiversity	No / fewer bees	Genetic modifications; pollinating machines

Sustainability Risks („internalized risks“)

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Climate Change	Impact	Risk Management

Timing uncertain

Impact Dimension uncertain

Costs certain

Traditional risk management

3. Transaction Costs Excessive for MSMEs‘ generation of sustainability data

- Financial Data: self-generated by clients
- Sustainability Risks: origin not controlled by clients, only impact measurements
- Sustainability Impacts: data (eg loss of biodiversity, GHG emission) not measured by clients
- MSMEs lack means to generate and provide meaningful data
- Requiring client-based data generation will raise costs of credit
- Potentially exclusionary effects

II. Alternative view

1. Sectorial Approach
2. Ensure representation of sector on balance sheet
3. Aggregate Handling of Clients in terms of sustainability

II. 1. Sectorial Approach

- Understand clients, collectively, as **sector** (eg agriculture palmoil, agriculture wheat, oil & gas production)
- Supplement clients‘ financial data with sustainability data from official sources (statistical offices, endorsed estimates)
- Define desirability of sectors‘ future under sustainability perspective (eg „reduce oil & gas“, „enhance wheat“)

II. 2. Ensure representation of sector on balance sheet

- Supply of basic needs requires sectorial mix in FI‘s portfolio (systemic risk / macroprudential perspective)
- Diversification also requires sectorial mix in FI‘s portfolio (microprudential perspective)
- Define representative range for each sector under sustainability perspective (eg „wheat production“: 20-30%)
- Use this range as „asset allocation guideline“

II. 3. Aggregate Handling of Clients‘ Sustainability Dimension

- MSMEs too small for individual ratings
- Traditional risk management of little effect (high operational risk, dependency on core staff; no means to diversify)
- Basel recognizes aggregate approaches for small retail clients („bulk approaches“) in terms of financial risk
- Aggregate handling crucial for MSMEs also for sustainability risk and impacs on sustainability factors
- Within the ‚bulk‘ (eg of all wheat farmers) financial data matter as to whom gets credit, and at what conditions. But Fis to refrain from additional sustainability screening.

III. Counter Arguments

1) Sustainability Risks will end up on the Central Banks‘ balance sheet

⇒ True. But this is exactly where a) they are already now, and b) where they belong.

2) Impact on Sustainability Factors may not be reduced.

⇒ Not true. Regulators to define desirability of sectors.

3) Regulator- rather than market-driven development.

⇒Partly true. But markets poor at pricing long-term developments with vague data.

Conclusions and Takeaways

1) Markets without regulation unable to achieve sustainability. Regulation crucial from various perspectives.

2) Risk-based capital provisioning, *as per client approach,* inadequate.

3) *Aggregate per sector* approach with regulatory steering of sustainability concerns the better alternative for MSMEs and IGG.

4) Active role of regulators and interdisciplinary capacity building indispensable.

Thank you!

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Expect the forthcoming book:
« EU Sustainable Finance Regulation
– An Article-by-Article Commentary », CUP 2023

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EU SF Framework in Light of International Standards
www.ssrn.com/abstract=39845

1 Million or 100 Million Casualties? – COVID-19 vs EMDEs and LDEs
www.ssrn.com/abstract=3597657

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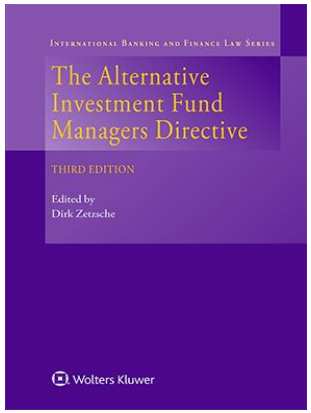
Sustainability, Fintech & Financial Inclusion
www.ssrn.com/abstract=3387359

Zetzsche/Bodellini/Consiglio, Towards a European Social Taxonomy: A Scorecard Approach

Zetzsche/Bodellini, Towards Sandbox Thinking in EU Sustainable Finance Regulation, www.ssrn.com/abstract=4147295



Recommended Readings

- **Louis Kaplow**, Rules and Standards: An Economic Analysis, 42 Duke L.J. 557 (1992), Rules versus Standards: An Economic Analysis (harvard.edu)
- **Platform on Sustainable Finance** (official EU advisory body on Sustainabe Finance), Platform Recommendations on Data and Usability, cf Platform on Sustainable Finance's recommendations on data and usability of the EU taxonomy (europa.eu)