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UNEP Finance Initiative : Sustainable Financing Policy & Basel III

By

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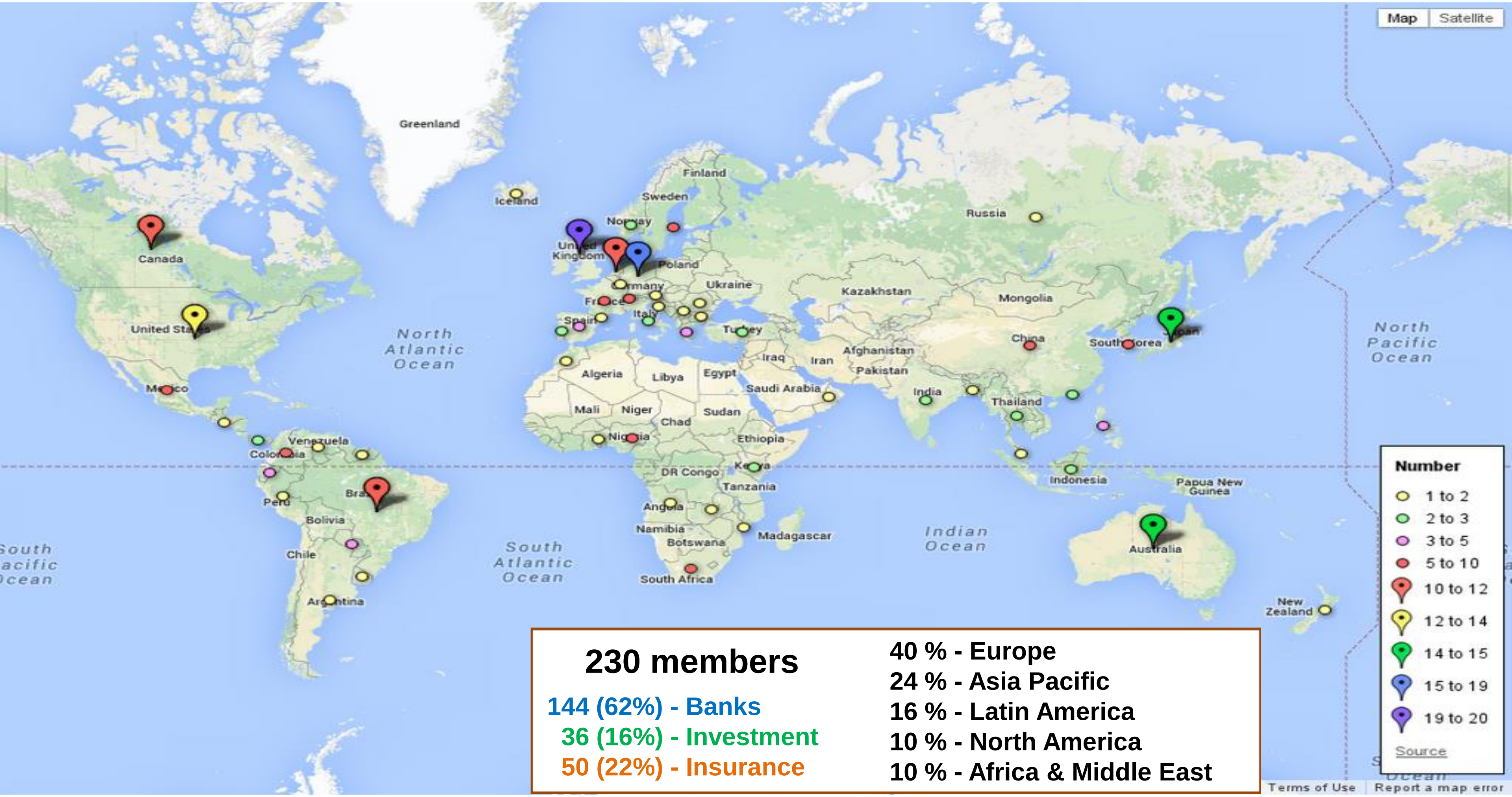
UNEP FI : MISSION

"to promote the integration of ESG considerations in decision making across the financial services sector

and

to help develop financial systems that support a sustainable world"

GLOBAL INITIATIVE



230 members

144 (62%) - Banks
36 (16%) - Investment
50 (22%) - Insurance

40 % - Europe
24 % - Asia Pacific
16 % - Latin America
10 % - North America
10 % - Africa & Middle East

INTERVENTIONS IN THE FINANCIAL SYSTEM

- Macroeconomic Policy
- System
- Sector
- Institution

INTERVENTIONS : SECTOR & INSTITUTION

- Macroeconomic Policy
- System

→ Sector

- Banking
- Investments
- Insurance

→ Institution

Developing **tools, standards** and **principles** to enable mainstreaming ESG issues in finance Sector

- Fiduciary Duty and ESG Materiality
- Sustainable Stock Exchanges (SSE) initiative
- Principles for Sustainable Insurance (PSI)
  - Global Climate Resilience & Natural Disaster Risk Management
- Sustainable Banking Platform (SBP)
- Banking and Human Rights
- Reporting and Disclosure of Climate action of Financial Industry (Portfolio Decarbonization Coalition & Greenhouse Gas Protocol)
- Integrated Reporting – Sustainable Reporting + Financial Reporting (Asset Management Working Group)
- Business case for Energy Efficiency in Property Portfolios (Property Working Group & Energy Efficiency)
- Environmental Risk for Financial Markets – E-RISC, Water Risk for Bonds (Natural Capital Declaration)

INTERVENTIONS : SECTOR & INSTITUTION

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Capacity Building

- Bankers' training on Environmental and Social Risk Assessment (ESRA) practices (e.g. Nigeria, Kenya, Turkey; online training)
- Investment managers training on ESG issues (e.g. India)

Research

- Implementation partner for REDD+ activities
- Series – Materiality issues, Fiduciary duties, CEO Briefings
- Through Academic centers of Research excellence (e.g. BASEL III, Integrated reporting)
  - Harvard Business School
  - Cambridge University
  - Frankfurt School of Business

Showcasing Private Sector leadership & best practices

- UN SG's Climate Summit – Portfolio Decarbonization pledge
- UN Environment Assembly Symposium
- PAGE Conferences
- UNFCCC CoPs (Side events)
- UNCTAD's World Investment Forum
- RIO+20 (NCD, SSE initiative)

INTERVENTIONS : MACROECONOMIC POLICY & SYSTEM

→ Macroeconomic Policy
→ System
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- Support on Researches and Events of Partnership for Action on Green Economy (PAGE)
- Collaborative work with European Union (EU) on Energy Efficiency
- Regular Inputs on Human Rights to European Union (EU)
- Central Bank Engagements (e.g. Morocco, Nigeria)
- UNEP Inquiry consultation Processes
  - Central banks, financial market regulators, policy makers
- UNCTAD: Financing the Sustainable Development Goals
- Country Engagement (e.g. Vietnam)
- Partnering with Multilateral Financial Institutions – World Bank, IFC)

University of Zurich[UZH]
Faculty of Law

UNEP Finance Initiative
Changing finance, financing change

UNIVERSITY OF CAMBRIDGE
INSTITUTE FOR SUSTAINABILITY LEADERSHIP

Stability and Sustainability in Banking Reform: Are environmental risks missing in Basel III?

A Study by Professor Kern Alexander
University of Zurich

STARTING POINTS

- The role of the financial system in the economy and broader society

  "…to provide the necessary financing and liquidity for human and economic activity to thrive – not only today but also tomorrow. In other words, its role is to fund a stable and sustainable economy." G20 (2009)

- The role of financial regulators

  "…to ensure that excessive risks that would threaten the stability of the financial system are not taken."

"The focus of the Basel Committee is on prudential matters, safety and soundness of banks, and financial stability. While we consider environmental issues an important goal, this is not the primary focus of the Committee but should be pursued by other means."

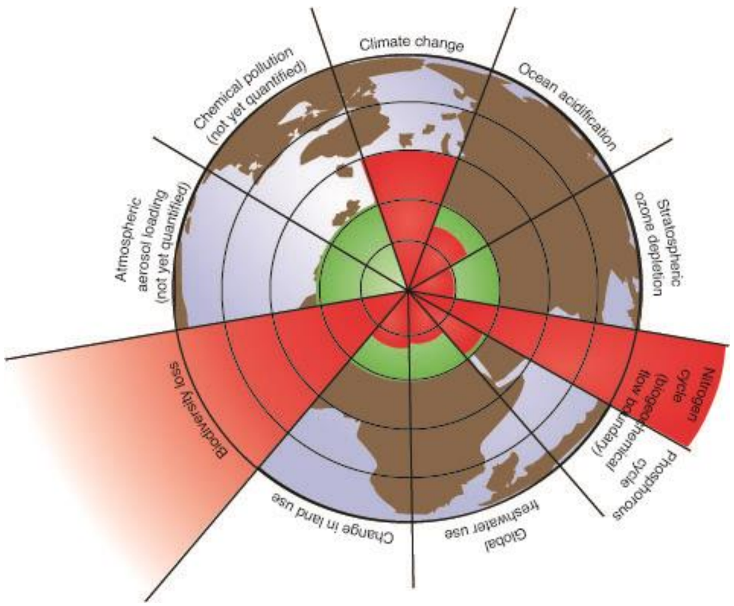
ENVIRONMENTAL RISKS & BANKING STABILITY

History demonstrates links between systemic environmental risks and banking instability:

- **Sunspots and financial crises** – drought, poor harvests, downturn in trade, bank losses and financial stresses
- **US Dust Bowls** – unsustainable farming methods, soil erosion, defaults on bank loans, contagion in regional economy
- **Hurricanes in Caribbean** – bank losses led US regulators to review the adequacy of bank risk models for credit risk

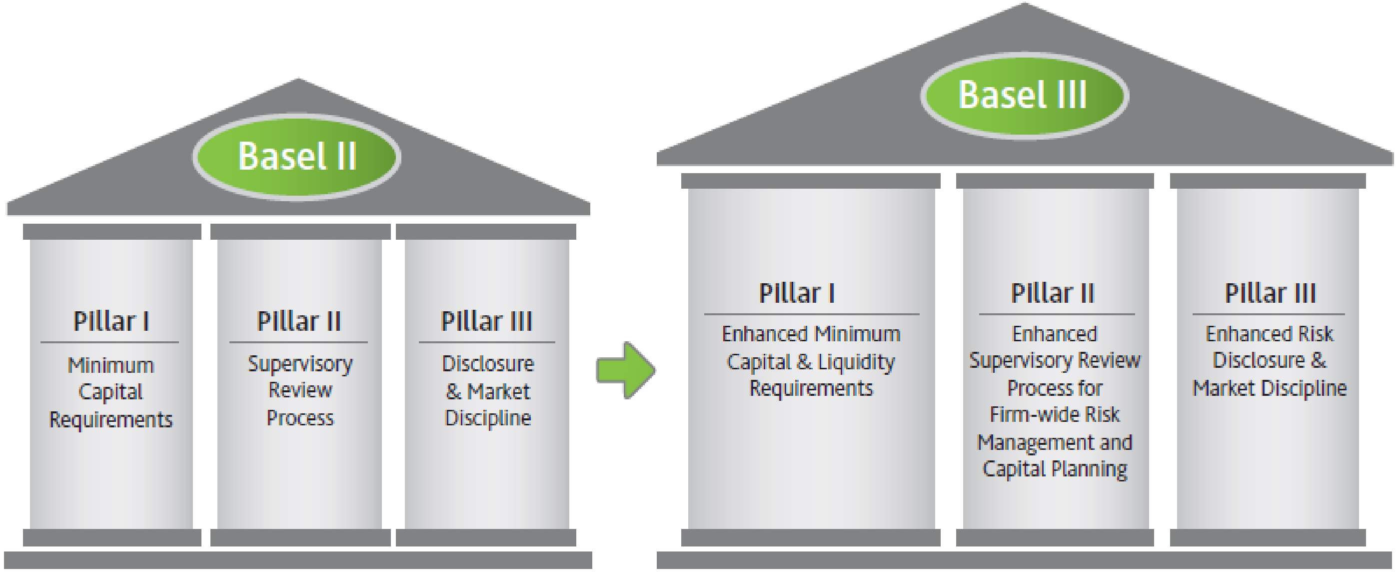
MORE SYSTEMIC ENVIRONMENTAL RISKS LIE AHEAD OF US..

- ‘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 BASEL ACCORDS

From Basel II to Basel III: "*Strengthen global capital and liquidity rules with the goal of promoting a more resilient banking sector*."



Basel III strengthens the three Basel II pillars, especially pillar 1 with enhanced minimum capital and liquidity requirements.

Does the Basel Capital Accord adequately address systemic environmental risks?

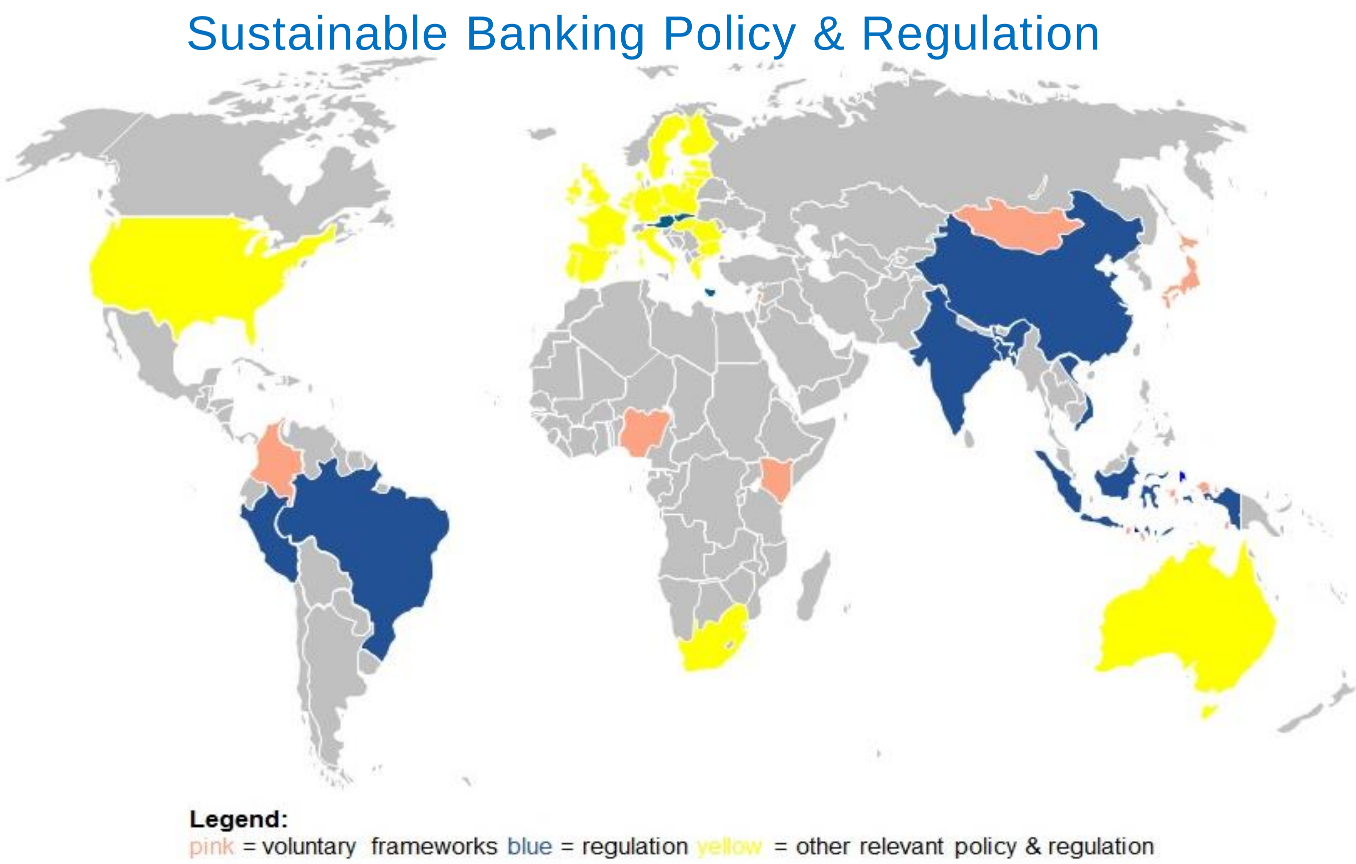
Basel III's 3-Pillar Framework		
Pillar 1	Pillar 2	Pillar 3
Minimum Capital Requirements	Supervisory Review Process	Market Discipline

- Pillar 1 requires consideration of narrow, transaction specific risks, eg environmental liability from toxic substances
- This does not address wider, macro-prudential or portfolio-wide risks

Does Pillar 1 discourage the financing of environmentally sustainable economic activities?

- Concern over role of long-term project financing
- True that shorter-term recourse balance sheet corporate loans receive lower risk weighting than longer-term project finance to off-balance-sheet entities
- But sources of ‘green’ finance vary widely, eg Brazil and China vs Peru and South Africa, and lean towards the former
- Governance and risk issues outweigh influence of cost of capital
- Pillar 1’s primary role should be to support a stable financial system

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



Examples of Sustainable Banking Policy & Regulation

CHINA

- 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?

1. "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.

   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."

2. "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."

3. "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."

SUGGESTED FOCUS AREAS PER PILLAR

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

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

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.

IN CONCLUSION

The Basel Committee should recognise systemic environmental risks as ‘material risks’ and encourage an international approach

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

Thank You

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