Integrating Sustainability into Prudential Regulation

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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

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

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

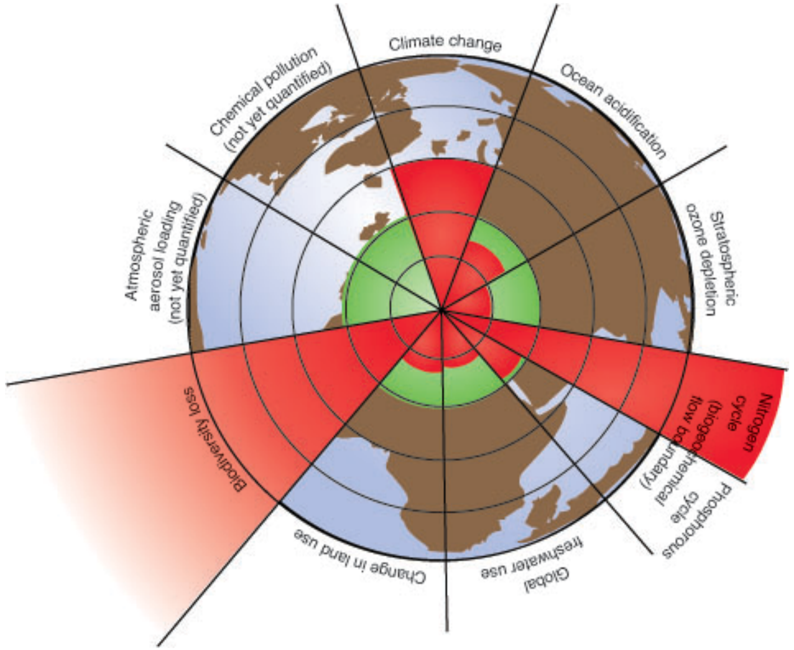
More systemic environmental risks lie ahead of us..

•‘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…



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

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 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)
  “The 2021 biennial exploratory scenario on the financial risks from climate change (PRA 2019)
  “Enhancing banks’ and insurers’ approaches to managing the financial risks from climate change” (PRA 2019)
  “A framework for assessing financial impacts of physical climate change: A practitioner's aide for the general insurance sector” (PRA 2019)
  “Insurance Stress test” (PRA 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
https://www.bankofengland.co.uk/paper/2019/biennial-exploratory-scenario-climate-change-discussion-paper
https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2019/ss319.pdf?la=en&hash=7BA9824BAC5FB313F42C00889D4E3A6104881C44
https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/2019/a-framework-for-assessing-financial-impacts-of-physical-climate-change.pdf?la=en&hash=7DE2A5E0442752ED910CF01F36BC15AA661AD1D9
https://www.bankofengland.co.uk/prudential-regulation/letter/2019/insurance-stress-test-2019

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.

European System Risk Board

- June 2020, Positively Green: Measuring climate change risks to financial stability.
- Report asks:
  - What magnitude of climate related shocks can be expected?
  - Are financial markets pricing the prospect of such shocks?
  - What are the exposures of banks and insurers to potential repricing of climate-related risks?
  - What can we learn from forward-looking scenario analysis to determine where further investment is needed.

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.

EBA Working Plan 2020

- 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).

EBA Action Plan on Sustainable Finance, 6.12.2019, p. 14
[eba.europa.eu/sites/default/documents/files/document_library//EBA%20Action%20plan%20on%20sustainable%20finance.pdf]

EBA action Plan on sustainable finance

Outlining approach and timeline for delivering mandates related to ESG risks:

Metrics, strategies, risk management → Scenario analysis and evidence

- Assess whether dedicated prudential treatment of exposures related to assets or activities associated substantially with environmental and/or social objectives would be justified.

EBA report on Pillar 3 disclosures (02 March 2020)

Findings regarding ESG disclosure

- Disclosure is scarce and not uniform.
- Institutions recognise ESG risk are increasingly important.
- Institutions recognise sustainability is taking on a leading role on the regulatory agenda.

Findings regarding inclusion of ESG risk

- credit risk policies
- reputational risk management
- IRB approaches
- operational risk management

EBA expectation

- Provide comprehensive and meaningful picture of risk profile that includes ESG and climate-related risks.
- Elaborate on potential impacts of these risks in Pillar 3 reports.
- Demonstrate how they are integrating these risks in their risk management framework.

Basel Committee on Banking Supervision - Task Force on Climate-related Financial Risks (TFCR)

- Stocktake members’ existing regulatory und supervisory initiatives.
- Produce a set of analytical reports on climate-related risks and the transmission channels of such risks to the banking system as well as on measurement methodologies.
- Develop effective supervisory practices in order to mitigate climate-related financial risks

TFCR Report on Climate-related financial risks: a survey on current initiatives (April 2020)

- Majority agrees that climate-related financial risks can have impact on stability of financial system and safety of individual institutions.
- **Majority have not yet considered factoring climate-related risks into prudential capital framework.**
- Supervisors are in process of issuing guidance, best practices etc.

Report on Climate-related financial risks: a survey on current initiatives, April 2020, p. 2 <https://www.bis.org/bcbs/publ/d502.pdf>; Basel Committee calculations and machchart.net

Network for Greening the Financial System (NGFS) - Guide for supervisors: integrating climate-related and environmental risks into prudential supervision (27 May 2020)

Key Recommendations:

- Determine how climate-related financial risks transmits to economies and financial sector and identify how these risks will be material.
- Develop a clear strategy, establish an internal organisation and allocate adequate resources to address climate-related risks.
- Identify exposures of supervised institutions.
- Set supervisory expectation to create transparency.
- Ensure adequate management of climate-related risks by supervised institutions and take mitigating actions where appropriate.

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!