STABILITY AND SUSTAINABILITY IN BANKING REFORM

ARE ENVIRONMENTAL RISKS MISSING IN BASEL III?

Executive Briefing

The role of the financial system in the economy and broader society is 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. The role of financial regulators is to ensure that excessive risks that would threaten the stability of the financial system – and hence imperil the stability and sustainability of the economy – are not taken.

In the wake of the 2007-08 financial crisis, an extensive reform of banking regulation was initiated to "generate strong, sustainable and balanced global growth". At the same time, the Earth's planetary boundaries – defined as thresholds that, if crossed, could generate unacceptable environmental changes for humanity – are under increasing stress and represent a source of increasing cost to the global economy. Experts argue that such 'systemic environmental risks' may be amongst the biggest risks that humanity faces today. This study analyses whether the Basel Capital Accord ('Basel III') adequately addresses systemic environmental risks in the context of its overriding objective of banking stability.

Core Findings

The analysis presented in this report suggests that the regulatory framework that governs today's banking system may not be being used to its full capacity. With some notable exceptions, systemic environmental risks appear to be in the collective blind spot of bank supervisors.

Despite the fact that history demonstrates direct and indirect links between systemic environmental risks and banking sector stability and that evidence suggests this trend will become more pronounced and complex as humanity breaches more planetary boundaries, the current Basel Capital Accord does not take explicit account of, and therefore only marginally addresses, these issues.

However, this report also offers insights that solutions are within reach, should regulators and industry practitioners work together proactively.

A number of national authorities, especially in emerging markets such as Brazil, China and Peru, are already acting to use the existing regulatory framework to address these links. Opportunities exist within the current Basel Capital Accord to learn from these practices and to raise the standard of how systemic environmental risks are managed internationally.

Additional options relating to monetary policy and measures to increase the potential for long-term investors to allocate capital to environmentally sustainable activities are also available to regulators.

Recommendations

1. The Basel Committee should **explicitly acknowledge environmental risks** and their increasing impact on the stability and sustainability of the economy as an emerging source of systemic risk for banks and 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.

4. National financial authorities should consider their role in developing targeted **monetary policy** measures, such as accepting certain high-quality ‘green’ assets from banks as collateral for central bank loans that would assist banks in providing more funding for environmentally sustainable economic activity.

5. As financial regulators are assessing standards and rules that allow banks and other financial institutions to use simple and transparent financial instruments and investment structures to facilitate longer-term investment, they should aim to **encourage more investment in 'green’ assets and other forms of environmentally sustainable economic activity**. For instance, sustainable asset-backed securities issued in transparent and simple structures could increase long-term investment in ‘green’ credit and related assets.

6. Finally, far greater effort must be made to ensure that **financial and environmental policies and regulations** are coordinated across government agencies and departments in their promulgation, implementation and enforcement.

Next Steps

These findings and recommendations clearly have profound implications. Further research is necessary to assess the feasibility of their implementation. CISL and UNEP FI are keen to engage a multi-disciplinary and international process to this effect. This would include learning 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.

The full report can be downloaded from the CISL and UNEP FI websites: www.cisl.cam.ac.uk www.unepfi.org.

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