STABILITY AND SUSTAINABILITY IN BANKING REFORM

Are environmental risks missing in Basel III?
Abstract

This report aims to trigger a deeper reflection amongst financial policymakers and regulators concerning the relevance of systemic environmental risks to banking sector stability. Recent history demonstrates linkages between risks arising both from the environment itself (e.g. extreme weather events) and from humanity’s management of environmental resources (e.g. soil quality) and banking instability. Evidence suggests this trend will become more pronounced and complex as humanity breaches more planetary boundaries.

However, international banking regulation (i.e. the Basel Capital Accord or ‘Basel III’) does not address the financial stability risks associated with systemic environmental risks. Nevertheless, a group of countries including Brazil, China and Peru, along with their banking industries, have adopted regulatory and governance practices to address systemic environmental risks. The Basel Committee should learn more from their experiences and consider reforms to the Basel III Pillar 2 Supervisory Review framework and the Pillar 3 Market Discipline framework that would involve recognising systemic environmental risks as material risks that potentially threaten banking stability.

In addition to Basel III, certain financial policies should be considered. Central bank monetary policy measures could enhance the provision of bank credit to environmentally sustainable economic activity. Also, the role of financial innovation should be considered as it relates to an array of credit risk transfer instruments that can be used to enhance the amount and quality of funding available for environmentally sustainable economic activity. Finally, financial policy and regulation should be aligned with environmental policy and regulation and coordinated so that the objectives and understanding of each area of expertise can be shared between the relevant agencies. This would create synergies for policy development and regulatory practices and standards.
Contents

Foreword 4

Executive briefing 7

1. Introduction 9

2. Are systemic environmental risks and banking instability linked? 11

3. Does Basel III adequately address systemic environmental risks? 13
   a) How does Basel III currently treat systemic environmental risks? 15
   b) Do Basel III’s Pillar 1 ‘Minimum Capital Requirements’ discourage the financing of environmentally sustainable economic activities? 15
   c) Are there existing regulatory and market practices outside of Basel III that are relevant to this study? 16
   d) How might the Basel Committee take forward the lessons of this study? 18

4. What other financial policy options are available? 22
   a) Monetary policy 22
   b) Financial innovation 23
   c) Joining up banking regulation with environmental policy 23

5. Conclusions and recommendations for financial policymakers and regulators 25

Appendices
   a) Planetary boundaries explained 27
   b) Overview of current frameworks to include environmental risks in banking 28
   c) Glossary of financial regulation terms 33

References 34

Interviews and seminars 38

About us 39
Foreword – The Banking Environment Initiative and Cambridge Institute for Sustainability Leadership

The Banking Environment Initiative (BEI) was founded by a group of leading bank Chief Executives in 2010 and is convened by the University of Cambridge Institute for Sustainability Leadership (CISL). It was formed out of the belief that a fresh approach was needed by banks to help support socially and environmentally sustainable economic activity.

The BEI’s initial focus has been threefold: first, developing customer partnerships to re-align banks’ goals with those of the real economy; second, driving industry-level consensus on standards to accelerate what banks can do individually, and third, supporting innovation in products and services to stimulate the market through commercially viable action.

With the help of CISL’s networks of corporate leaders and its ability to drive learning and change across diverse groups, the BEI has demonstrated how this model can be applied to financing activities that support commodity supply chains. The BEI’s ‘Soft Commodities’ Compact with the Consumer Goods Forum is triggering an evolution in how banks and their corporate customers, through trade finance product and services, direct capital towards sustainable practices in agricultural supply chains.

However, we have always known that it takes more than strong corporate leadership to change practices at an industry level; those who set the rules that govern the system also have a role.

Since the financial crisis of 2008, we have witnessed some regulators, especially in the faster-growth economies, concluding that financial stability may not only emanate from within the financial system itself. As was powerfully demonstrated at the China-focused BEI Forum 2014 in Hong Kong, some countries are already acting on their view that systemic environmental risks can also affect stability.

In anticipation that momentum behind this trend would only build – as well as the simple fact that some of the emerging economies where this thinking is already further progressed will be increasingly influential on the global stage – the BEI decided, on behalf of its members, to initiate an independent process to look at these issues and how regulators around the world are addressing them. We were delighted that Professor Kern Alexander, a CISL Fellow and Chair in Law and Finance at the University of Zurich, agreed to lead the study. We were also very pleased that UNEP FI, with its unique perspective at the interface between governments and the finance sector, also recognised the value of this inquiry and decided to co-commission the work with us.

This study assesses the links between systemic environmental risks and financial stability and offers insights into how some members of the Basel Committee are already acting on such links. Building on this leadership at a national level, the focus then turns to how such approaches might be harmonised internationally.

As the report itself says, this is a study that clearly has profound implications. Further analysis will certainly be required to assess the feasibility of implementing its various recommendations and we look forward to playing an active role in that debate.

Polly Courtice LVO Director, University of Cambridge Institute for Sustainability Leadership (CISL)

Jeremy Wilson Chair – Banking Environment Initiative (BEI) Working Group
Foreword – United Nations Environment Programme – Finance Initiative

While the global economy continues to be affected by the profound financial crisis of 2008, the world faces the twin challenges of dealing with the consequences of climate change and an unsustainable path for economic growth.

These trends are not unrelated and, since its inception in 1992, UNEP Finance Initiative (UNEP FI) has been a firm believer in the role of the finance sector in setting a new course towards a greener economic model.

UNEP FI, the UN’s unique and dedicated finance and sustainability partnership, was initiated by a pioneering group of commercial banks and now counts a strong, international banking membership that coalesced in 2010 as the Initiative’s Banking Commission.

The Banking Commission has pursued an agenda with a strong focus on catalytic action on the ground - it has supported, and continues to support, many of the country frameworks on sustainable finance alluded to in this report.

UNEP FI’s Position Paper at Rio+20 and the subsequent holding of its Global Roundtable in Beijing in 2013 with a focus on policy and regulation have been instrumental in bringing this topic to an international audience.

Professor Alexander’s report is the natural and necessary next step in exploring the role that financial – and in particular banking – regulation can play in the transition to a green economy.

Not only does this report provide clarity on the links between environmental sustainability and economic stability; clarity that is needed to establish the pertinence of addressing environmental risk in banking regulation. It also shows that in today’s world, practitioners and their regulators can be found to be willing to engage constructively in the global policy debate on how to build ‘the future we want’.

Indeed, while a banking regulatory regime which is cogniscent of environmental challenges and which as a consequence provides appropriate guidance to banks is important, of greater importance still is the emergence of a robust and continuous dialogue between financial and environmental policy-makers. The changes required will not be possible without greater policy coherence and cohesion between these two constituencies.

We are proud to have partnered with the BEI and CISL for this first research piece on international financial regulation and environmental risks, harnessing the full power of Cambridge’s academic excellence. Professor Alexander’s paper is intended to provoke debate, and it is our aspiration that the content, the conclusions and the recommendations will serve to inspire the financial policy community to a new way of thinking about the interdependence of finance and sustainability. We look forward to participating in the engagement which will follow, and in the further research and analysis which will contribute to this dialogue.

Charles Anderson
Head, UNEP FI Secretariat

Dag Arne Kristensen
Chair, UNEP FI Banking Commission
Acknowledgements

This report was made possible by a partnership between the Banking Environment Initiative (BEI), which is convened by CISL, and UNEP FI’s Banking Commission, with additional support from Bloomberg LP.

The principal investigator and lead author of the report was Professor Kern Alexander, Faculty of Law, University of Zurich and CISL Fellow. Professor Alexander led a research team at the University of Zurich that included Thomas Strahm and Alexandra Balmer.

The study design and editorial process were led by Andrew Voysey (Director – Finance Sector Platforms, CISL), Dr Jake Reynolds (Director – Business Platforms, CISL) and Careen Abb (Banking Commission Coordinator, UNEP FI). Rosie Jennings (CISL) managed the production process.

The study was further supported by the valuable guidance of an Advisory Group made up of BEI and UNEP FI members.
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.

By failing to addresses systemic environmental risks, Basel III is arguably overlooking an important source of risk to the financial system and broader economy, despite its overriding objective of guaranteeing banking stability.

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.

“...the regulatory framework that governs today’s banking system may not be being used to its full capacity [...] Basel III is arguably overlooking an important source of risk to the financial system and broader economy”
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.
Introduction

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 financial crisis of 2007-08 that resulted in trillions of dollars in losses and bank bail-outs, banking regulation has undergone, and continues to go through, an extensive reform process, the core aim of which is to “generate strong, sustainable and balanced global growth” (G20 Summit Leaders’ Statement 2009).

At the same time, the Earth’s planetary boundaries – defined as thresholds that, if crossed, could undermine “the safe space for human development” (Rockström et al 2009) – are under increasing stress, and represent a source of increasing cost to the global economy. Appendix A explains the concept of planetary boundaries in more detail. Experts argue that such ‘systemic environmental risks’ may be amongst the biggest risks that humanity faces today. The scale of the economic and social impacts of such risks and of the economic transformation required to address them are both significant. A study by the United Nations estimates that the annual cost to the global economy of maintaining the current scale of unsustainable economic activity will reach nearly $28.6 trillion by 2050, equivalent to 18 per cent of global GDP. Meanwhile, estimates indicate that around $1 trillion of additional investment in new green infrastructure in energy, transport, buildings and industry is needed annually to 2030 *(WEF, 2013).

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. It examines the hypothesis that banking reform, despite its best intentions, could actually be overlooking – and even aggravating – an important source of risk to the financial system and broader economy, namely systemic environmental risks.

Origins and rationale for the study

This report was made possible by a partnership between the Banking Environment Initiative (BEI), which is convened by CISL, and UNEP FI’s Banking Commission, with additional support from Bloomberg LP. CISL and UNEP FI have been working together with partners in the banking industry for many years to address issues on finance and sustainability. In the context of this work, the role of financial regulation and policy in maintaining environmental sustainability has become increasingly apparent. CISL and UNEP FI are keen to promote research on this complex and under-studied topic as part of their work towards a financial sector that fully understands, and plays its role in achieving, environmentally sustainable, financially stable and socially inclusive economic development.

This work arrives at a critical moment. In January 2014, the United Nations Environment Programme launched its two-year Inquiry into the alignment of the global financial system with long-term, sustainable development. This comes in the wake of Rio+20, in which context the United Nations is striving to establish a set of Sustainable Development Goals (SDGs), and is exploring the means of implementing and financing them. In parallel, in 2012, the International Finance Corporation (IFC) started gathering financial policymakers and regulators around sustainability issues via the newly created Sustainable Banking Network.

1 World Economic Forum ‘Global Risks 2010’: “The biggest risks facing the world today may be from slow failures or creeping risk...These are risks linked to big shifts that are recognized...For example, global population growth, ageing and the ensuing rise in consumption, have implications for resources, climate change, health and fiscal policy”. http://www3.weforum.org/docs/WEF_GlobalRisks_Report_2010.pdf (accessed 07.08.2014)
Methodology

The report is based on research that involved interviews and written questionnaires for practitioners in the banking industry, bank regulators from selected developed and emerging-market economies, officials from international organisations, and representatives from non-governmental organisations (details are listed at the end of the report). The research also consisted of analysis of the provisions of Basel III and selected national banking laws and regulations along with the official publications of international organisations on systemic environmental risks, such as the reports of the UN International Panel on Climate Change. The analysis and recommendations in the report were considered and debated by members of the study’s advisory group, consisting of academics, financial sector and legal practitioners, regulators and representatives of governmental bodies and the banking industry.

Report structure

Part 2 explores the evidence relating to the question of whether systemic environmental risks and banking sector stability are linked. It reviews the experience of recent history as well as a selection of available evidence to show that systemic environmental risks are associated with banking sector instability.

Part 3 examines how Basel III currently addresses systemic environmental risks. The question of whether Basel III creates a bias against finance for environmentally sustainable economic activities is explored and examples of some countries that have already incorporated systemic environmental risks into bank capital regulation are highlighted. Part 3 then considers what the Basel Committee might learn from the example of these jurisdictions and identifies how these lessons might be taken forward by the Basel Committee, focusing on Basel III’s Pillar 2 ‘Supervisory Review’ and Pillar 3 ‘Market Discipline’ frameworks.

Part 4 considers what other financial policy options are available outside of Basel III. This includes an examination of the utility of certain other monetary policy measures and the use of innovative financial instruments – such as ‘green’ asset-backed securities (ABS) – to enhance the flow of bank funds to environmentally sustainable economic activity.

Part 5 presents specific recommendations for financial policymakers and regulators about how Basel III and related areas of monetary and financial policy can be used more effectively to address systemic environmental risks. Finally, Part 5 sets out the conclusions of this study overall, and identifies next steps. It presents specific recommendations for financial policymakers and regulators about how Basel III and related areas of monetary and financial policy can be used more effectively to address systemic environmental risks.
Are systemic environmental risks and banking instability linked?

Economic historians have demonstrated relationships between weather, agricultural markets and financial markets to show that there are linkages between natural disasters (e.g. drought) and financial market instability. For example, the British economist William Jevons (1884) famously argued that financial crises were produced by sunspots, which could be shown to cause drought and poor harvests in key agricultural producing countries, which led to a downturn in international trade resulting in significant bank losses and related financial market stresses. The United States suffered from dust bowls in the farm belt states in the 1880s and 1890s and again in the 1930s due to soil erosion caused by unsustainable farming methods. The ensuing economic downturns during these periods resulted in substantial losses on bank loans and related financial market distress which spread contagion-like through the regional economy.

More recently, in the late twentieth and early twenty-first century, increased hurricane activity in the Caribbean and south eastern United States caused huge bank losses to businesses and individuals directly impacted by these high wind storms. Hurricane Andrew caused $24 billion in damages to the south Florida economy in 1992, while hurricanes Rita, Wilma and Katrina each caused widespread and extensive damage to Caribbean economies and to the south eastern United States. Hurricane Katrina came ashore in south Florida in August 2005, causing in excess of $200 billion in damages and ranks as one of the costliest natural disasters in U.S. history (Lambert, Noth and Schüwer 2011). The damages led to high loan losses and provisioning for banks that were based in the impacted areas. The bank losses led US regulators to review the adequacy of bank risk models regarding credit risk and hurricane damage.

Geological disasters such as earthquakes and volcanoes can also result in banking and financial market distress. The Great Kanto Earthquake of 1923, which struck the south part of the Kato district in Japan, is among the causes of the 1927 Showa financial crisis which culminated in the closure of numerous banks (Shimizu & Fujimura 2010). Similarly, the series of earthquakes which hit Turkey in 1999 required international financial assistance to rebuild the economy and avoid the collapse of the banking system (Brinke 2013). Finally, the eruption of the Soufrière Hills volcano on the island of Montserrat in 1998 destroyed Plymouth, the capital, and forced 90 per cent of the inhabitants to leave the island. The financial system was severely impacted, as the most important bank on the island, the Montserrat Building Society (MBS) collapsed due to a bank run (Clay et al 1999).

Clearly, not all of these examples relate to environmental risks that have been made more likely or severe by human activity – sunspot activity and geological disasters being cases in point. However, there are conceptual parallels between these natural disasters and those that can be aggravated by human activity in that, while inevitable in their occurrence, specific incidents are difficult to predict and can have significant impacts on banking instability unless sufficient precautions are taken. History therefore raises the fundamental question of how bank regulation can take into account the financial stability risks that can arise from environmentally unsustainable practices.

---

6 The United States economy was suffering a severe depression in the 1930s that had already caused hundreds of banks to fail across the country. Economists have demonstrated how some of the banking sector distress experienced in these farm belt states can be attributed to the dustbowl phenomenon. Hornbeck (2012) pp 1481-1483.
Further, scientists have now identified nine biophysical thresholds for the Earth, which, if crossed, could undermine “the safe space for human development”. These thresholds – known colloquially as ‘planetary boundaries’ – represent “the ‘planetary playing field’ for humanity if we want to be sure of avoiding major human-induced environmental change on a global scale” (Rockström et al 2009). Three of these boundaries (namely climate change, biological diversity and nitrogen input to the biosphere) are thought to have been crossed already.

Climate change is the boundary about which we know the most. The International Panel on Climate Change (2007, 2013, 2014) has documented the scientific evidence in support of the proposition that global warming and ocean acidification are caused by the carbon-intensive activities of humans. Carbon-intensive activities lead in the longer-term to global warming, rising sea levels, and ocean acidification. More immediately, they can lead to increasingly volatile weather patterns, including extreme temperatures and intensified flooding of coastal and low-lying areas, water shortages, and the health costs of pollution. Existing extreme weather risk is therefore being exacerbated by human activity; moreover climate systems (in manner analogous to financial systems) are likely to show non-linear responses to increased stress.

Some believe these externalities are controlled and even mitigated through adaptations in the economy, such as alternative production processes, or redirecting transport routes to avoid flooded coastlines (Nordhaus 2013). According to this view, investors, aware of the scientific evidence on the risks of climate change, would be expected to discount the value of high-carbon assets and increase the value of low carbon assets, resulting in investment shifting over time to low carbon assets (Bank of England 2012). Nevertheless, the history of financial crises demonstrates that financial markets suffer from serious over and under-estimation of risks because of asymmetric information and moral hazard. These risks translate into large externalities for the economy and society (Kindleberger and Aliber, 2011, 29-33; Schinasi, 2006, 47-66; Eichengreen, 1999, 80-82). Moreover, financial stability is a public good; market participants do not have the incentive to invest the necessary capital to provide it themselves because the benefits of stability spill over to free-riders who do not pay for it.

The absence of regulatory intervention to address such market failures has been criticised by some international organisations. In January 2014 World Bank President Jim Yong Kim, speaking at the World Economic Forum, recognised the regulatory gap in this area by stating that “financial regulators must take the lead in addressing climate change risks”, and that they should use pricing mechanisms to more effectively control negative externalities or systemic risks associated with global warming.

Therefore, the key questions addressed in the following sections are:

- To what extent are the economic and financial costs associated with systemic environmental risks currently being considered in banking regulation, and
- How might existing banking regulation frameworks be utilised better to ensure that systemic environmental risks are appropriately managed and do not contribute to banking sector instability in the future?

“...the history of financial crises demonstrates that financial markets suffer from serious over and under-estimation of risks [...] These risks translate into large externalities for the economy and society”

---

7 OECD (2013) p 12
8 OECD (2013) p 12
Does Basel III adequately address systemic environmental risks?

By way of introduction, Basel III represents the most important international financial regulation agreement. The first Accord (Basel I) was adopted in 1988 with two main objectives: 1) that internationally active banks hold a minimum amount of capital against their risk-based assets, and 2) to promote an internationally level playing field for cross-border banking (Norton 1995). Although Basel III is not legally binding under international law, it is remarkable that most countries have adopted it and claim to have implemented it. The IMF observed that countries and banking institutions which demonstrate that they have implemented the Accord benefit from a lower cost of capital than countries and banks that have not done so (Financial Stability Forum 2000). Some countries implement the Accord faithfully and strictly enforce its requirements. However, the Accord is not mandatory; some countries pick and choose what provisions to comply with, while others impose stricter standards.

Although Basel I achieved its main objective of increasing the level of regulatory capital in the international banking system, it contained many national discretions, loopholes and incentives for banks to make riskier short-term loans and to transfer less risky assets off their balance sheets (Goodhart 2011). Basel II was proposed in 1999 to address many of these gaps and weaknesses. In doing so, Basel II introduced the ‘three pillars’ concept – 1) Minimum Capital, 2) Supervisory Review, and 3) Market Discipline. The three pillars are designed to reinforce each other and to create incentives for banks to enhance their risk measurement and management. This framework is represented in Figure 1.

Pillar 1 (Minimum Capital) allows banks to calculate their regulatory capital by using statistical models that rely mainly on their own historic default and loss data to estimate their credit, market, and operational risks. Pillar 2 sets forth principles of supervisory review that authorise regulators to require banks to comply with broad principles of corporate governance and to adopt an internal capital adequacy assessment process (ICAAP) designed to enhance risk measurement and management. Pillar 3 uses market discipline to require banks to provide more information to the market so shareholders and creditors can monitor bank management more effectively to ensure the bank’s soundness and future prospects.

Basel II expanded the use of risk weightings for banks to estimate the riskiness of their assets. A number of parameters determine an asset’s risk weighting, including the maturity of the loan, the probability of default, and the bank’s loss and exposure given default. Assets with lower risk weightings generally attract lower capital charges, whereas assets with higher risk weightings generally attract higher capital charges. Corporate loans with short-term maturities attract lower risk weightings (lower capital charges), while corporate loans with long-term maturities (7 years or more) attract higher risk weightings (higher capital charges).

Basel II allowed banks to use their own estimates of credit and market risks to lower their risk weightings for certain asset classes. This risk management approach was shown to be seriously flawed when the global financial crisis began in August 2007; the risk weightings of most European and US banks were shown to be poor indicators of the financial risks to which banks were exposed.

The Basel Committee responded to the 2007-2008 financial crisis by adopting further amendments to Basel II, which became known as Basel III. Basel III requires an increased level of Tier One regulatory capital to 4.5 per cent from 2 per cent plus a 2.5 per cent capital conservation buffer, a tighter definition of tier one capital to include mainly ordinary common shares and retained earnings, and up to an additional 2.5 per cent countercyclical capital ratio that will be adjusted across the economic cycle. Basel III also contains liquidity requirements that include a ratio for stable wholesale funding, liquidity coverage ratios, and an overall leverage ratio. Also, an additional capital charge of up to 2.5 per cent regulatory capital will be required for large and interconnected systemically important financial institutions (SIFIs).

Despite significant increases in capital and liquidity requirements, Basel III essentially builds on the edifice of Basel II by leaving in place the Basel II risk-weighting regime. However, Basel III requires regulators to challenge banks more in the construction of their models and broadens regulatory authority under Pillar 2 to require banks to undergo more frequent and demanding stress tests. The Pillar 2 review also consists of a supervisory review enhancement process (SREP) that includes separate assessments of bank capital and governance. The SREP can be utilised to forecast the bank’s exposure to systemic risks and related macro-prudential risks.

### Basel III’s 3-Pillar Framework

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

**Figure 1: Overview of the ‘3 Pillars’ Framework of Basel III.**
Changes implemented in Basel III are highlighted in **red**.

---

a) How does Basel III currently treat systemic environmental risks?

Pillar 1 of Basel II (now Basel III) does require banks to assess the impact of specific environmental risks on the bank’s credit and operational risk exposures, but these are mainly transaction-specific risks that affected the borrower’s ability to repay a loan or address the ‘deep pockets’ doctrine of lender liability for damages and cost of property clean-up. For example, paragraph 510 of Basel II and III (Pillar 1) requires banks to ‘appropriately monitor the risk of environmental liability arising in respect of the collateral, such as the presence of toxic material on a property’. This would involve the bank in due diligence and transaction screening to mitigate the credit and operational risks associated with this type of lending. These transaction-specific risks are narrowly defined and do not constitute broader macro-prudential or portfolio-wide risks for the bank.

b) Do Basel III’s Pillar 1 ‘Minimum Capital Requirements’ discourage the financing of environmentally sustainable economic activities?

A concern that has arisen in relation to Pillar 1 of Basel III is the extent to which higher capital charges on longer-term project finance loans might have had the unintended consequence of undermining finance for environmentally sustainable economic activities, particularly lending for long-term endeavours such as infrastructure. Commentators holding this view argue that unless capital and liquidity requirements are relaxed, long-term project finance for environmentally sustainable economic activities will be severely restricted. This study has investigated this concern.

Basel II and III apply a lower risk weighting to short-term (1-3 year) recourse balance sheet corporate loans in comparison to longer-term (7 years or more) project finance loans to off-balance-sheet entities because the latter type of loans are riskier due to their longer maturity and non-recourse structure. The risk-weighting framework therefore results in higher capital requirements for bank lending in countries that rely mainly on longer-term specialised lending arrangements as opposed to countries that rely mainly on short-term corporate loans for such credit.

However, the form of bank lending for environmentally sustainable economic activities varies substantially between countries. In some countries (e.g. Brazil and China), this takes place almost wholly through recourse balance sheet short-term corporate lending, while in other countries (e.g. Peru and South Africa), it is mostly long-term non-recourse off-balance-sheet specialised lending (i.e. project finance). Across most countries, however, most bank exposures to financing environmentally sustainable economic activities will be through short-term corporate lending. A much smaller percentage of lending will be long-term (7 years or more), which will mainly be specialised (i.e. project finance) lending for large-scale renewable energy projects.

Do capital requirements matter?

Christopher Wells, Senior Vice President for Environmental and Social Risk for Santander’s Brazilian subsidiary, explained in an interview for this study that as far as bank risk management is concerned, managing a bank’s environmental risk exposure in respect of short-term corporate loans was not a capital allocation issue, as broader governance issues were implicated and outweighed in importance the calculation of regulatory capital.

In Brazil, a major systemic environmental risk for small and medium-sized farmers is deforestation of the Amazon and related soil erosion and productivity decline. Most Brazilian bank lending to mitigate these risks takes the form of recourse balance sheet loans, which are typically short-term corporate (1-3 years) whilst longer-term maturities are up to 3 to 5 years. In conclusion, the importance of capital requirements depends on the market context.
Based on interviews with regulators and bank practitioners from Brazil, China, India and Peru, it was uniformly observed that Basel III’s stricter capital and liquidity requirements would have only a marginal impact on lending to support environmentally sustainable activity. This is not least because bank financing of infrastructure projects, such as those relating to renewable energy, is influenced by a number of factors that relate to the economic and political riskiness of the project. These criteria are much more important in determining whether the bank lends than the regulatory capital or liquidity requirements. In fact, regulatory capital is considered by project finance specialists to be an insignificant factor in influencing the bank’s pricing of the loan or its willingness to lend.

Moreover, interviewees stated that lowering capital and liquidity requirements to benefit environmentally sustainable economic activities may create an undesirable trade-off between financial stability and environmental sustainability, and that Pillar 1’s primary role should be to support a sound financial system through higher capital and liquidity requirements. There was also a concern that lowering capital requirements for the financing of environmentally sustainable economic activities may lead to arbitrage and poor incentives for banks.13

Further, the Financial Stability Board (2013) has observed in a research paper that “The Basel III reform package does not specifically target long-term bank finance, although it may affect it...[as Basel III does] alter the incentives for different types of financial institutions to participate in this market.” The FSB further notes that “pre-crisis models and levels of financing were unsustainable and should not be the appropriate benchmark for assessing the impact of reforms on the availability and cost of longer-term finance” (FSB 2013).

Based on the above, the evidence suggests that regulatory capital and liquidity requirements as currently set forth in Basel III’s Pillar 1 approach play at most a marginal role in influencing a bank’s decision to provide specialised lending on project finance for environmentally sustainable economic activities such as renewable energy infrastructure projects.

c) Are there existing regulatory and market practices outside of Basel III that are relevant to this study?

Despite little action at the international level, some countries have already engaged in a variety of regulatory and market practices to assess systemic environmental risks and adopt practices to mitigate the banking sector’s exposure to environmentally unsustainable activity.

These initiatives have been based on existing regulatory mandates to promote financial stability by acting through the existing Basel III framework to identify and manage banking risks both at the transaction-specific level and at the broader portfolio level. What is significant about these various country and market practices is that the regulatory approaches used to enhance the bank’s risk assessment fall into two areas: 1) Greater interaction between the regulator and the bank in assessing wider portfolio level financial, social and political risks, and 2) Banks’ enhanced disclosure to the market regarding their exposures to systemic environmental risks. Figure 2 highlights countries where notable innovation is taking place. For a full review of current regulatory and voluntary frameworks aiming to promote the consideration of sustainability issues in banks, please see Appendix B.

“Despite little action at the international level, some countries have already engaged in regulatory and market practices to assess systemic environmental risks”

12 Interviews with Christopher Wells, Banco Santander Brazil (30 May 2014), Dr Rubens Sardenberg, Brazilian Federation of Banks (17 June 2014) and Malcolm Athaide, YES Bank (10 July 2014).
13 Interview, Mr Paul Collazos, Superintendencia de Banca, Seguros y AFP, (20 May 2014).
These innovative regulatory approaches and market practices are often the result of proactive policymakers and regulators adjusting to a changing world. A number of financial development institutions, such as the International Finance Corporation (IFC) which currently hosts an informal group of bank regulators and banking associations called the Sustainable Banking Network (SBN), have sought to further promote dialogue between practitioners and regulators on environmental sustainability issues and to encourage a better understanding of these issues by financial regulators. China, Brazil and Peru, among others, have all embarked on innovative risk assessment programmes to assess systemic environmental risks from a macro-prudential perspective as they recognise the materiality of systemic environmental risks to banking stability.  

China has adopted a more proactive enforcement approach to promote the management of systemic environmental risks by requiring banks to include in their loan documentation covenants to comply with environmental standards. Through its 2012 Green Credit Guidelines, the China Banking Regulatory Commission (CBRC) works towards promoting bank lending to environmentally sustainable economic activities such as the manufacturing of renewable energy infrastructure and companies that have developed lower-carbon production processes. China has multiple long-term environmental sustainability goals, including a number that focus on transportation and buildings. Banks are requested to collect data from these projects and turn them over to the CBRC, which in turn is strongly interconnected with other ministries, including the Environment

---

14 Interview, Ms Rong Zhang, International Finance Corporation (9 May 2014). Ms Zhang explained that the SBN membership has a mission to enhance the importance of financing environmentally sustainable activities in the global financial system and to adjust financial regulation so that it can incorporate environmental sustainability objectives in support of their existing financial stability objectives.
Ministry which can use the information to initiate an investigation of environmental regulation violations. In 2012, the CBRC began requiring banks to monitor its borrowers’ compliance with environmental regulations and to begin implementing loan contract changes that either allows the bank to accelerate loan repayments of a customer in violation of environmental laws or else to demonstrate compliance in a certain timeframe. If compliance cannot be shown, the bank could suspend further lending and trigger accelerated loan repayment.

In 2014, Brazil adopted similar requirements relating to the financing of sustainable activity, as well as disclosure, that are mandatory for banks as part of their Pillar 2 Supervisory Assessment and Pillar 3 Market Disclosure requirements. Unlike the supervisory practices of most other Basel Committee members, the Banco Central do Brasil (the Central Bank of Brazil) has utilised the Pillar 2 Internal Capital Adequacy and Assessment Process (ICAAP) to encourage banks to assess their individual exposures to carbon risk. Moreover, the Banco Central do Brasil implemented a regulation in 2014 which establishes guidelines for financial institutions in connection with the Pillar 2 Supervisory Review and Evaluation Process (SREP) to consider the bank’s “degree of exposure to the social and environmental risk of the activities and transactions of the institution”. This regulation also requires the bank to publicly disclose its environmental and social risks (with penalties if disregarded) as part of the market discipline disclosure rules of Pillar 3 of Basel III.

The Peruvian regulators’ approach has been to develop the principle of due diligence as the most effective way to persuade project managers to rethink how they go about project development. The due diligence process requires banks to require the project manager to complete a due diligence report on the project, which must be approved by the bank before it makes credit available. In using this approach, the regulator is not primarily imposing pressure on the company over whether or not to invest in the project, or on the bank to decide whether or not to make the loan. Instead, the company is required to more deeply analyse the underlying social, environmental and economic risks related to the loan, and to recognise these before they manifest during project development. Long before substantial amounts are invested, the developer is asked to assess the risk factors – social, environmental, economic and financial – relevant for planning, building and operating the project. The bank oversees this assessment in order to determine at a deeper level the riskiness of the loan and the extent to which it should provide credit for the project.

According to senior management at Peru’s Financial Regulation Authority, since this innovation was introduced, social conflicts have decreased markedly and affected stakeholders and community groups feel they now have more influence in shaping the investment decision. This has also resulted in improved financial risk management for banks, as defaults and restructurings on such loans have fallen dramatically. This has enhanced banks’ financial risk management and also improved broader macro-economic development for communities and the country as a whole. Based on such due diligence risk assessments, banks can obtain more information and can therefore act sooner and more effectively in managing their own risk by, for example, requiring higher quality collateral and sensitising the manager to potential social unrest because of the project and its related systemic environmental risks.

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

The evidence assessed during this study suggests that systemic environmental risks are material to banking stability. The study has found that the existing Basel Capital Accord does require banks to assess the impact of specific environmental risks on the bank’s credit and operational risk exposures, but that these transaction-specific risks are narrowly defined and do not constitute broader macro-prudential or portfolio-wide risks for the bank.
The impact of Basel III’s Pillar 1 Minimum Capital Requirements was explored with the conclusion that regulatory capital and liquidity requirements, as currently set forth in Basel III’s Pillar 1, play at most a marginal role in influencing a bank’s decision to provide specialised lending on project finance for environmentally sustainable economic activities. In addition, it is thought that lowering capital and liquidity requirements to benefit environmentally sustainable economic activities may create an undesirable trade-off between financial stability and environmental sustainability.

How, then, might the Basel Committee improve the banking sector’s management of systemic environmental risks in keeping with its responsibility to safeguard banking sector stability and sustainability? Supervisory Review under Pillar 2 and Market Discipline under Pillar 3 offer some promising avenues.

**Using Pillar 2 – Supervisory Review**

The Pillar 2 Supervisory Review process is designed to complement Pillar 1 and concerns risk management. Risk management is about diversification of risk exposures by reducing, for instance, concentration risk exposures to certain asset classes or economic sectors.

Pillar 2 of Basel III requires banks to measure and manage risks at the broader portfolio level by applying the “fundamental principles of sound capital assessment”, including “policies and procedures designed to ensure that the bank identifies, measures, and reports all material risks” (i.e. stress tests) across its portfolio. Pillar 2 allows the supervisors to have wide powers of oversight to test the bank’s corporate governance structures and its risk management practices in assessing transaction-specific risks as well as broader portfolio-level risks. Based on these assessments, modifications can be made to the Pillar 1 capital and liquidity calculation processes.

Banks should address all ‘material’ risks in the capital assessment process and, while it is recognised that not all risks can be measured precisely, the process should be developed to estimate risks by making a list of risk exposures that should “by no means constitute a comprehensive list of all risks”. This study argues that exposure to economic activity that is environmentally unsustainable falls within the scope of Pillar 2.

To be incorporated in the Pillar 2 portfolio risk assessment framework, risks must be considered ‘material’ and included in the bank’s list of material risks. However, the Basel Committee has not been addressing systemic environmental risks, nor has it been encouraging national regulators to ask bank risk officers whether they are measuring the bank’s exposure to environmentally unsustainable activities. For example, most bank supervisors have not utilised Pillar 2’s supervisory approaches to incorporate forward-looking models that estimate the potential stability impact of supplying credit to environmentally unsustainable or sustainable activities over time into their stress tests. Such an approach could equally be applied to recognise the positive impact of bank lending for environmentally sustainably activity as the negative impact for environmentally unsustainable activity.

This very limited approach to addressing banking risks that can arise from environmentally unsustainable activity could pose serious longer-term risks to the stability of the banking sector. It is an omission that is unsupported by the economic and scientific data and that is within the mandate of the Basel Committee to address. Recent studies show that the cost of environmentally unsustainable activity to the economy is becoming increasingly material in terms of financial risk exposure for banking institutions. The World Bank estimates that the average annual economic cost of human-induced environmental depletion was approximately $6.6 trillion in 2008, equivalent to 11 per cent of global GDP. The same study estimates that if environmentally unsustainable activity continues at this scale, the annual costs for the global economy will reach nearly $28.6 trillion by 2050, equivalent to 18 per cent of global GDP (UNEP FI 2011).

---

18 Basel II Pillar 2, para 731.
19 Basel II Pillar 2, para 732.
The evidence therefore suggests that systemic environmental risks are material for bank regulation purposes and therefore should be expressly incorporated into Pillar 2’s list of material risks. This would provide an internationally level playing field to guide bank risk officers and regulators in assessing the portfolio-level risks of bank lending for environmentally sustainable and unsustainable activities. This could potentially involve regulators and risk officers developing, among other things, exclusion lists, phase-out or phase-in targets for certain types of activities (e.g. replace high-carbon assets with low-carbon assets), and conduct impact screening – both negative and positive – to develop a better understanding of banks’ risk exposure to environmentally unsustainable activity.

Using Pillar 3 – Market Discipline

The Pillar 3 – Market Discipline – element of Basel III could also play an important role in enhancing risk management in respect of systemic environmental risks. It largely relies on developing a set of disclosure requirements which will allow market participants to assess relevant information about a bank’s capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution. By providing disclosures to the capital markets, it is intended that investors should learn fully of the risks to which banking institutions are exposed – including the bank’s exposure to systemic environmental risks.

Public disclosure of these risks raises a number of questions. Firstly, whether or not the public is able to comprehend the long-term effects of their investment choices. Regulators in both Brazil and Peru doubt the willingness of the individual investor to question the long-term risk exposure to carbon and other systemic environmental risks of a short-term investment, or to differentiate between a stock doing badly due to its exposure to environmentally sustainable or unsustainable activity as compared to other bad business choices. Peru’s bank regulator also questioned the usefulness of requiring banks to disclose publicly their exposure to systemic environmental risks on the grounds that this could expose banks to potential legal liability for mis-stating such risks in their disclosures. Secondly, the effectiveness of these kinds of disclosures was questioned based on the availability of data and related information, and the difficulty of forecasting systemic environmental risk exposures far into the future.

That said, the market discipline approach has been utilised by shareholders of some US banks to require the bank’s board to disclose the institution’s exposure to high-carbon activities. This has been criticised as a rather ad hoc and inflexible approach to obtaining information on a bank’s carbon exposure. Instead, our findings suggest that the market discipline approach in Pillar 3 could be enhanced to include rules on both qualitative disclosures (e.g. voluntary codes and industry standards) and quantitative disclosures (as defined by the financial regulator). This would provide an effective and a more economically efficient tool which would also improve accountability through further clarifying the fiduciary duties of the bank board to undertake risk assessments to obtain this information.

Pillar 3’s market discipline framework should be considered as another lever to enhance the banks’ governance frameworks with respect to systemic environmental risks. Basel III, however, does not require or encourage banks to disclose information about systemic environmental risks or risk management practices. In some countries, such as France, all environmental and social risk exposures must be publicly disclosed by listed companies and financial institutions. The Basel Committee should consider how Pillar 3 can be used to encourage or require banks to disclose, on a harmonised and standardised basis, information about exposure to systemic environmental risks and consequent management practices that could be useful for investors in assessing the bank’s longer-term soundness and profitability.

20 According to a recent WSJ report, shareholder resolutions have become increasingly political and less relevant to average shareholders with respect to climate risk reporting, as ‘special-interest groups’ have allegedly hijacked the shareholder resolution process, as the guidance (on disclosing emissions stemming from fossil-fuel related loans) released by regulators has not led to an increase in the quality or quantity of the disclosures.
21 What exactly could amount to a breach of fiduciary duty is, in itself, a widely contested area. Trustees who do not act on Environmental and Social Governance issues arguably increase the risk of a long-term portfolio and therefore may not be acting in the best interest of the beneficiaries. The problem is that, in practice, various financial managers believe that considering issues other than financial returns could constitute a breach. The findings of a UNEP FI legal study issued in 2005 (A legal framework for the integration of environmental, social and governance issues into institutional investment, UNEP FI, 2005), found that fiduciary duty is inclusive rather than exclusive of environmental, social and governance considerations, however differences of opinion persist in the market as regulation continues to be permissive rather than obligatory.
22 France has adopted legislation mandating banking and financial institutions to publicly disclose their environmental and social risks as they relate to the company’s financial performance and soundness. See Conseil d’Etat Decree, Regulation, Article 225. The disclosure of social and environmental
Looking ahead
Figure 3 illustrates where this study suggests the Basel Committee should focus if Basel III is to adequately address systemic environmental risks.

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

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

Figure 3: Areas of Basel III on which this study suggests the Basel Committee should focus – highlighted in orange (areas in green indicate existing coverage)

Evolving bank capital and governance frameworks to include systemic environmental risks may ultimately lead regulators and banks to agree on different risk weightings for certain activities depending on their classification as environmentally sustainable or unsustainable. This could potentially result in different capital and liquidity requirements under Pillar 1 for activities depending on whether they are classified as environmentally ‘sustainable’ (lower requirements) or ‘unsustainable’ (higher requirements).

Properly incorporating systemic environmental risk issues as suggested in this report will of course raise challenges. In the first instance, there would be a need to do sufficient data collection, analysis and modelling to estimate the financial stability risks associated with environmentally sustainable and unsustainable activity. These issues should be considered by financial policymakers and the Basel Committee, and further studied by central banks, regulators, bank risk officers, and researchers in institutes and universities.
What other financial policy options are available?

Part 2 of this study has considered how Basel III could adequately take account of systemic environmental risks. However, there are other financial policy options available to policymakers and regulators, which are also worth exploring.

a) Monetary policy

Monetary policy could play a role in supporting liquidity provision for finance to support environmentally sustainable economic activities.

In recent history, central bank monetary policy has revolved around the targeting of retail price inflation at a low rate of around 2 per cent and using an array of measures to ensure that the target is achieved and that the monetary policy transmission mechanism works effectively throughout the economy and banking system. The economic slowdown in Europe, the US and Japan in the aftermath of the financial crisis has led the world’s most influential central banks – the US Federal Reserve, the European Central Bank, the Japanese Central Bank, and the Bank of England – to follow extraordinarily loose monetary policies involving quantitative easing and generous liquidity and other financial support for the banking sector with a view to encouraging banks to lend more to the broader economy.

For example, between 2009 and 2014, the Bank of England followed a ‘funding for lending’ scheme that involved the British central bank lending money at a zero-interest rate to banks with the hope that the banks would then lend the funds on to homebuyers to support the British housing market. Banks were not obliged to lend the money, but were obliged to report the amount of funds they provided for home mortgage loans.

Experts are divided over the effectiveness of the policy. In the context of this report, however, it raises the question of whether central banks should make funding available to banks on generous terms in order to promote lending to environmentally sustainable economic activities. An example of this has been demonstrated by the Lebanese Central Bank through its Decree number 7835 to support financing for investment in environmentally sustainable projects, including green buildings and renewable energy projects.

Brazilian and Peruvian authorities and bankers explained that their central banks are very conservative and would probably not agree to the use of loose monetary policy measures to increase such lending because it might send a signal to the global capital markets that they were following an undisciplined monetary policy that could lead to higher inflation. They further asserted that monetary policy conditions in most emerging-market economies were not greatly affected by the recent financial crisis and monetary policy should therefore remain conservative and orthodox.

That said, Dr Rubens Sardenberg, Chief Economist of the Brazilian Federation of Banks, expressed the personal view that he thought there were ways that central banks could facilitate financial support for lending to environmentally sustainable economic activities. These could involve, for example, the central bank accepting ‘green bonds’ or asset-backed securities that were AAA rated as collateral for liquidity support. Dr Sardenberg also emphasised that Brazilian banks are largely well-capitalised and financed at this time and would not need such liquidity support from central banks to provide more lending to environmentally sustainable economic activities.

In contrast, Mr Han Fe of the CBRC stated that, because of recent banking stresses in 2013 in the inter-bank loan market, the Chinese central bank (the People’s Bank of China – PBOC) was considering more proactive measures to provide additional liquidity support to Chinese banks, such as...
the acceptance of ‘green’ asset-backed securities as collateral for liquidity support for Chinese banks.

b) Financial innovation

Financial innovation could play a further important role in identifying sources of finance for bank lending to support environmentally sustainable economic activity.

Chinese regulators are already acting in accordance with this view. Because China’s capital markets are evolving and becoming more sophisticated, credit risk transfer instruments, such as asset-backed securities, are increasingly viewed by regulators and bankers as potential sources of additional finance for the Chinese economy. This could perhaps play an important role in allowing Chinese banks to make more funding available for initiatives that target environmentally sustainable economic activity.

This view was supported by Dr Sardenberg, who emphasised how fast the Brazilian wholesale debt and secondary trading markets are evolving and the growing interest by banks in utilising credit risk transfer instruments that are subject to regulatory controls to attract more investment in ‘green credit’. He observed that the Brazilian market was not quite ready for these instruments yet, but when the time comes there will be a quick transition because Brazil has already been through a painful regulatory reform of its banking sector in the 1990s after a crisis that resulted in the Banco Central do Brasil obtaining broad macro-prudential supervisory powers to control and monitor the so-called ‘shadow banking’ sector. Therefore, any new financing instruments or ABS green assets would be subject to central bank oversight.

As discussed above, the involvement of central bank oversight may not be a bad thing as demonstrated in the case of the Chinese authorities considering the merits of allowing the PBOC to accept certain simple and transparent green asset-backed securities (ABS) as collateral for bank liquidity support measures. This could potentially lead to much greater bank lending for environmentally sustainable economic activities and provide more sustainable sources of funding for such initiatives.

Even without central bank acceptance of green ABS as collateral, however, Chinese regulators are considering more favourable regulatory treatment to be applied to certain innovative financial instruments, such as green asset-backed securities. Under consideration are proposals that would allow companies to issue ‘green bonds’ and for banks to securitise ‘green assets’ as a way to generate more funding for environmentally sustainable economic activity. The CBRC considers simple and transparent asset-backed securities as an important source of finance for such economic activity. Moreover, the CBRC hopes that the Chinese central bank will approve the use of certain monetary policy tools to increase green lending, such as the central bank accepting green bonds or high quality asset-backed securities as collateral for providing liquidity support to banks.

In addition, the growing sophistication of China’s wholesale securities and debt markets creates the potential for increased investment in green assets by institutional investors along with the creation of a secondary market for trading these securities. All of which would bode well for increased investment into Chinese green credit.

c) Joining up banking regulation with environmental policy

A major weakness with existing approaches to financial and environmental policy and regulation has been lack of coordination in developing, implementing and enforcing rules and standards. The problem of a lack of coordination and mutual recognition of standards arises all the way to the international level, involving the G20 and international environmental initiatives. There has been a failure of policymakers at the highest level to join up financial policy and
environmental policy with respect to putting the global economy on a more stable and sustainable footing. For instance, many bank supervisors do not believe that they have a policy mandate from their Finance Ministries to require banks and financial institutions to manage or report their systemic environmental risks.

Although the G20 has failed to recognise the importance of the linkage between financial policy and environmental policy, some countries have made much progress in establishing institutional and legal linkages between environmental and financial regulation.

The efforts of China and Peru should be noted, as they have adopted coordination mechanisms between environmental and finance ministries and banking regulators to ensure the exchange of information, data and mutual support in the investigation and enforcement of environmental laws. Both the bank and environmental regulator are required to coordinate their regulatory practices and supervision where environmental regulatory compliance and financial regulatory compliance implicate one another. Other countries, such as Brazil, have embarked on similar coordination policies by ensuring that databases of infringements of environmental laws and regulations are made publicly available, enabling banks to access them.

Most advanced developed countries, however – including most members of the Basel Committee – have no policy to coordinate environmental and banking regulation. Moreover, in EU states and the United States bank regulators and supervisors do not have an official mandate to take account of systemic environmental risks when applying and implementing their own regulatory frameworks.

Many central banks in the Sustainable Banking Network have developed national approaches that could serve as a model for the G20 and other international bodies to recommend to all countries although, of course, country-specific approaches may not be wholly transferable. Successful approaches generally involve countries developing a strong dialogue between their environmental and the financial ministries with respect to financial exposures to systemic environmental risks. This will ultimately enhance bank risk management in the areas of credit, market, liquidity and operational risk.

“Most advanced, developed countries – including members of the Basel Committee – have no policy to coordinate environmental and banking regulation”
Conclusions and recommendations for financial policymakers and regulators

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.

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. Although Basel III provides a flexible framework for regulators and bank risk management to assess and measure the financial stability risks associated with environmental risks, this has not been utilised by most bank regulators in their supervisory frameworks.

By failing to address systemic environmental risks, Basel III is arguably overlooking an important source of risk to the financial system and broader economy, despite its overriding objective of guaranteeing banking stability and sustainability. Because financial stability is a public good, regulation has a role to play to ensure that environmental risks do not threaten financial stability.

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, 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. This report suggests a roadmap for how Basel III can be used to begin assessing and measuring the systemic environmental risks that have material impact on banking stability and which can assist banks in diversifying their risk exposures to more environmentally sustainable economic activities.

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. On this basis, a number of recommendations are offered overleaf.

“Opportunities exist within the current Basel Capital Accord [...] to raise the standard of how systemic environmental risks are managed internationally”
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 sustainable or unsustainable 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. It is important that such disclosures be comparable across banks and jurisdictions. The Basel Committee should determine its role in creating an internationally level playing field.

4. Meanwhile, national financial authorities should consider their role in developing targeted monetary policy measures that would assist banks in providing more funding for green lending. For instance, central banks could consider whether to accept certain high quality green assets as collateral for central bank loans to banks.

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. This should happen on a multi-disciplinary and international basis, and 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.
Appendix A – Planetary boundaries explained

A growing number of scientists think we have entered a new geological epoch that needs a new name — the Anthropocene — to reflect the rapid expansion of human activities since the industrial revolution, which has now generated a global geophysical force equivalent to some of the great forces of nature. They have been seeking to characterise the conditions needed for our planet to continue in a stable, Holocene-like state — the state of the Earth over the past ~10,000 years in which human civilizations have thrived.

In 2009, a group of 28 internationally renowned scientists identified and quantified a set of nine planetary boundaries within which they argued humanity can continue to develop and thrive for generations to come. In their paper published in the journal, Nature (461, 472-475, 24 September 2009), they argued that “[t]ransgressing one or more planetary boundaries may be deleterious or even catastrophic due to the risk of crossing thresholds that will trigger non-linear, abrupt environmental change within continental- to planetary-scale systems.” They contended that respecting planetary boundaries reduces the risks to human society of crossing these thresholds.

This diagram, taken from their Nature paper, presents these nine planetary boundaries. The inner green shading represents the proposed safe operating space for nine planetary systems. The red wedges represent an estimate of the current position for each variable. The boundaries in three systems (rate of biodiversity loss, climate change and human interference with the nitrogen cycle), have already been exceeded.

Figure 4: The nine planetary boundaries
## Appendix B – Overview of current frameworks to include environmental risks in banking

Source: UNEP Finance Initiative (UNEP FI), 2014. The information below is partly based on information released by Environment, Social and Governance Department of the International Finance Corporation (IFC). UNEP FI would like to thank the IFC for its kind contribution.

<table>
<thead>
<tr>
<th>Country</th>
<th>Date</th>
<th>Name of Framework  &amp; sub-parts</th>
<th>Type of Framework</th>
<th>Scope</th>
<th>Main stakeholders involved in development of guidance</th>
<th>Targeted Constituency</th>
<th>Responsibility for implementation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>AFRICA-MIDDLE EAST</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| Kenya         | 2014     | Kenya Sustainable Banking Principles          | Voluntary guidelines        | TBD                                                                 | Kenyan Banking Association  
- A Working Group of commercial banks                                                                                              | Commercial banks | N/A                                                                          |
| Lebanon       | 2011     | Decree nr. 7835 on central bank reserve requirements | Incentives embedded in central bank regulation | Loans financing energy efficiency and renewable energy projects | Central Bank of Lebanon (Banque du Liban/Bdl) as part of Lebanon’s national economic and development plan | Commercial banks | Central Bank of Lebanon                                                    |
| Nigeria       | 2012     | Nigerian Sustainable Banking Principles and Guidance Note, including 3 Sector-Specific Guidelines | Quasi mandatory regulation  | - Environmental & Social Risk Management                               | Central Bank of Nigeria (CBN)  
- Nigeria Bankers Committee  
- Commercial banks                                                                                                                      | Banks, discount houses and development finance institutions | - Adviser on Sustainability (recruited from MOE) at CBN  
- Deputy Director of the Policy and Regulation Department (CBN)  
- Sustainability Committee comprising members of 13 departments of the CBN                                                      |
| South Africa  | - 1994   | King Code of Governance I  
- King Code of Governance II  
- King Code of Governance III | Voluntary Guidelines, now partially integrated into law (e.g. the Companies Act of South Africa, the Public Finance Management Act, and the Promotion of Access to Information Act | - Corporate Governance  
- Corporate Governance & Sustainability  
- Corporate Citizenship, Sustainability & Leadership | King Committee on Corporate Governance (formed upon a request of the Institute of Directors of Southern Africa) | Listed companies and large public entities, including banks and other financial institutions  
- Listed companies and a variety of public entities, including banks and other financial institutions  
- All Public, Private and non-profit institutions                                                                                     | N/A                                                          |
|              | - 2002   |                                               |                             |                                                                      |                                                                                                                      |                                               |                                                                             |
|              | - 2009   |                                               |                             |                                                                      |                                                                                                                      |                                               |                                                                             |

Other countries where practitioners and/or regulators are significantly* engaged on sustainability issues: Morocco.
### ASIA-PACIFIC

<table>
<thead>
<tr>
<th>Country</th>
<th>Date</th>
<th>Name of Framework (&amp; sub-parts)</th>
<th>Type of Framework</th>
<th>Scope</th>
<th>Main stakeholders involved in development of guidance</th>
<th>Targeted Constituency</th>
<th>Responsibility for implementation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bangladesh</td>
<td>2011</td>
<td>Environmental Risk Management Guidelines for Banks and Financial Institutions in Bangladesh</td>
<td>Mandatory regulation</td>
<td>- Environmental &amp; Social Risk Management</td>
<td>Bangladesh Bank (BB) - Commercial banks</td>
<td>Banks and Financial Organizations under the Financial Institutions Act (former Non-Bank FIs)</td>
<td>- Supervision department of BB</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>- Since 2013: newly established Green Banking and CSR Department of BB</td>
</tr>
<tr>
<td>China</td>
<td>2007</td>
<td>- Green Credit Policy (GCP)</td>
<td>Mandatory regulation</td>
<td>- Environmental &amp; Social Risk Management</td>
<td>GCP</td>
<td>Policy banks, state-owned commercial banks, joint-stock commercial banks, financial assets management companies, Postal Savings Bank of China, provincial rural credit unions; all trust firms, enterprise group finance companies and financial leasing firms directly regulated by the CBRC</td>
<td>GCP - N/A</td>
</tr>
<tr>
<td></td>
<td>2012</td>
<td>- Green Credit Guideline (GCG)</td>
<td></td>
<td>- Internal Management and management structure</td>
<td></td>
<td></td>
<td>GCG: - Statistics and Research Departments of the CBRC</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>- Information disclosure</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>India</td>
<td>2007</td>
<td>“Corporate Social Responsibility, Sustainable Development and Non-Financial Reporting – Role of Banks”</td>
<td>Non mandatory</td>
<td>- Triple bottom-line Reporting</td>
<td>Issued by the Reserve Bank of India (RBI) following consultations with Public and private sector banks</td>
<td>Commercial banks</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td>2014</td>
<td>Companies Act 2013</td>
<td>Mandatory regulation</td>
<td>- Resource management</td>
<td>Enacted by the Parliament of India</td>
<td>All large Indian corporations</td>
<td>Ministry of Corporate Affairs</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(amendment to Companies Act 1956)</td>
<td></td>
<td>- Corporate Social Responsibility</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Indonesia</td>
<td>2014</td>
<td>Green Banking Regulation</td>
<td>TBD</td>
<td>- Bank Indonesia</td>
<td>All Indonesian banks</td>
<td>All Indonesian banks</td>
<td>Banking supervisory agency (OJK)</td>
</tr>
<tr>
<td>Japan</td>
<td>2011</td>
<td>Principles for Financial Action towards a Sustainable Society</td>
<td>Voluntary guidelines</td>
<td>- Environmental and Social risk management</td>
<td>- All Japanese financial institutions</td>
<td>All Japanese financial institutions</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>- Information disclosure</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>- Supporting SMEs, society’s environmental performance and disaster readiness</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mongolia</td>
<td>2014</td>
<td>Sustainable Banking Principles</td>
<td>Voluntary guidelines</td>
<td>To be completed</td>
<td>Environmental &amp; Social Risk Management</td>
<td>- Mongolian Banking Association - 14 leading commercial banks in Mongolia</td>
<td>N/A</td>
</tr>
</tbody>
</table>

*Other countries where practitioners and/or regulators are significantly engaged on sustainability issues: Laos, Philippines, Thailand.*
<table>
<thead>
<tr>
<th>Country</th>
<th>Date</th>
<th>Name of Framework (&amp; sub-parts)</th>
<th>Type of Framework</th>
<th>Scope</th>
<th>Main stakeholders involved in development of guidance</th>
<th>Targeted Constituency</th>
<th>Responsibility for implementation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>EU</strong></td>
<td>2003</td>
<td>Directive on annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings</td>
<td>Mandatory for EU states to transpose in national legislation</td>
<td>Reporting: states that it should not be restricted to the financial aspects of the company’s business, but, where appropriate, include analysis of environmental and social aspects</td>
<td>European Parliament and Council (proposed by Commission)</td>
<td>Most credit institutions and other financial institutions</td>
<td>EU States, but under the directive they might choose to waive the obligation to provide non-financial information. Overseen by DG Internal Market</td>
</tr>
<tr>
<td></td>
<td>2011</td>
<td>EU Strategy for CSR 2011-2014</td>
<td>Recommendations for States; guidance</td>
<td>Promoting CSR in the EU space</td>
<td>European Commission communication to European Parliament, Council, Economic and Social Committee and Committee of the Regions</td>
<td>All businesses</td>
<td>EU States, invited to develop / update by mid 2012 national action plans to promote CSR. Overseen by DG Enterprise and Industry</td>
</tr>
<tr>
<td></td>
<td>2012</td>
<td>Energy Efficiency Directive</td>
<td>Mandatory for EU states to transpose in national legislation</td>
<td>Countries are required to use energy more efficiently at all stages of the energy chain</td>
<td>European Parliament and Council (proposed by Commission)</td>
<td>Indirectly, all private companies, through implementation of countries measures to comply with the Directive</td>
<td>EU States. Overseen by DG Energy</td>
</tr>
<tr>
<td></td>
<td>2014</td>
<td>Directive on disclosure of non-financial and diversity information by certain large companies and groups</td>
<td>Mandatory for EU states to transpose in national legislation</td>
<td>Disclosure on policies, risks and outcomes as regards environmental matters, social and employee-related aspects, respect for human rights, anti-corruption and bribery issues, and diversity in their board of directors</td>
<td>European Parliament and Council (proposed by Commission)</td>
<td>Large public-interest entities with more than 500 employees (includes listed as well as some unlisted companies, such as banks, designated by Member States because of their activities, size or number of employees)</td>
<td>EU States. Overseen by DG Internal Market and Services</td>
</tr>
<tr>
<td></td>
<td>2014</td>
<td>Communication on long term financing of the European economy</td>
<td>Proposal to lead to mandatory requirements</td>
<td>Proposal to lead to legislation on how to mobilize long-term financing for the European economy, including mobilizing private sources of long-term financing and enhancing the wider framework for sustainable finance</td>
<td>European Commission communication to European Parliament and the Council</td>
<td>Private and public sectors (including banks as a specific target)</td>
<td>Potentially EU states. Overseen by DG Internal Market and Services</td>
</tr>
<tr>
<td><strong>France</strong></td>
<td>2001</td>
<td>New Economic Regulations Act (NRE)</td>
<td>Mandatory Regulation</td>
<td>Requirement to disclose in annual report the way companies address the social and environmental impacts</td>
<td>Voted by Parliament</td>
<td>Companies whose securities can be traded on a regulated market</td>
<td>Various Ministries, in matters that concern them</td>
</tr>
<tr>
<td></td>
<td>2002</td>
<td>NRE implementing Decree; and Ministerial Order</td>
<td>Mandatory Regulation</td>
<td>Reporting according to a list of 19 environmental and social topics; and emissions and pollution</td>
<td>State Council</td>
<td>Companies whose securities can be traded on a regulated market</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2010</td>
<td>Grenelle II Act, followed by Decree regarding sustainability reporting requirements</td>
<td>Mandatory Regulation</td>
<td>Corporate sustainability reporting; requirement to disclose certain environmental and social information and information relating to sustainable development commitments; or provide substantive information on why certain data is not reported</td>
<td>Voted by Parliament Further to nationwide multi-stakeholder dialogue on sustainable development</td>
<td>All listed companies and companies with an annual balance and turnover of 100 million Euros and an average of 500 permanent employees</td>
<td>Ministry for Ecology, Sustainable Development and Energy, multi-stakeholder consultations</td>
</tr>
<tr>
<td></td>
<td>2013</td>
<td>Preparation National Plan for the Development of CSR</td>
<td>Action plan for implementation of EU CSR strategy 2011-2014</td>
<td>Embed CSR issues in French corporate sector, including responsible finance in support of the ecological transition, basic rights and competitiveness</td>
<td>Ministry for Ecology, Sustainable Development and Energy, multi-stakeholder consultations</td>
<td>Private and public sector; financial sector to be specifically mentioned</td>
<td>Ministry for Ecology, Sustainable Development and Energy, multi-stakeholder consultations</td>
</tr>
<tr>
<td>Country</td>
<td>Date</td>
<td>Name of Framework (&amp; sub-parts)</td>
<td>Type of Framework</td>
<td>Scope</td>
<td>Main stakeholders involved in development of guidance</td>
<td>Targeted Constituency</td>
<td>Responsibility for implementation</td>
</tr>
<tr>
<td>---------</td>
<td>------</td>
<td>---------------------------------</td>
<td>-------------------</td>
<td>-------</td>
<td>------------------------------------------------------</td>
<td>-----------------------</td>
<td>----------------------------------</td>
</tr>
<tr>
<td><strong>UK</strong></td>
<td>2006</td>
<td>Companies Act</td>
<td>Mandatory</td>
<td>Requirements to report on environmental, workplace, social, and community matters that are material to their business</td>
<td>Parliament</td>
<td>Companies listed in the London Stock Exchange</td>
<td>Department for Business, Innovation and Skills</td>
</tr>
<tr>
<td></td>
<td>2008</td>
<td>Climate Change Act</td>
<td>Mandatory</td>
<td>Report CO₂ emissions on an annual basis</td>
<td>Parliament (upon recommendation of the Royal Commission on Environmental Pollution)</td>
<td>Listed companies</td>
<td>Secretary of State for Energy and Climate Change Committee on Climate Change</td>
</tr>
<tr>
<td></td>
<td>2010</td>
<td>CRC Energy Efficiency Scheme Order (amendment in 2013)</td>
<td>Mandatory</td>
<td>Report emissions related to energy use</td>
<td>Environment Agency Department for Environment Food &amp; Rural Affairs</td>
<td>Companies that use more than 6,000MWh per year</td>
<td>Environment Agency</td>
</tr>
<tr>
<td></td>
<td>2012</td>
<td>Combined Code on Corporate Governance</td>
<td>Guiding principles; contains Listing Rules, requiring listed companies to apply and report on main principles; voluntary for wider private sector</td>
<td>Corporate Governance</td>
<td>The Financial Reporting Council (FRC)</td>
<td>Listed companies</td>
<td>Financial Reporting Council</td>
</tr>
<tr>
<td><strong>Denmark</strong></td>
<td>2008</td>
<td>Amendment of The Danish Financial Statements Act (2001) to include accounting for CSR in large businesses</td>
<td>Mandatory Regulation</td>
<td>Requirement to report on CSR policies and how policies are translated into action, or expressly state that the company will not be engaging in CSR</td>
<td>Voted by Parliament</td>
<td>State owned companies and companies with total assets of more than EUR 19 million, revenues more than EUR 38 million and more than 250 employees. Extended also to listed financial businesses not covered by the Danish Financial Statements Act by the Danish Financial Supervisory Authority</td>
<td>Danish Business Authority</td>
</tr>
<tr>
<td></td>
<td>2012</td>
<td>New amendment of Danish Financial Statements Act to include human rights and climate change issues</td>
<td>Mandatory Regulation</td>
<td>Danish companies have to also specifically address human rights and climate change</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>2011</td>
<td>Government Action Plan for Corporate Social Responsibility 2012-2015</td>
<td>Guidelines, comprising voluntary and mandatory measures</td>
<td>Businesses - integrate CSR in their core business; investors - use their investments as a driving force for sustainable growth</td>
<td>Danish Business Authority</td>
<td>Wide business community, among other stakeholders</td>
<td>The Danish Business Authority</td>
</tr>
<tr>
<td><strong>Norway</strong></td>
<td>1996</td>
<td>National White Paper on CSR</td>
<td>Action plan / voluntary</td>
<td>Placed CSR in the context of competitiveness of Norwegian business in the global economy</td>
<td>Ministry of Foreign Affairs</td>
<td>Open to all stakeholders</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1998</td>
<td>Accounting Act</td>
<td>Mandatory</td>
<td>Requirement to include sustainability-related topics in company Director’s report, such as work place environment, gender equality and environmental issues</td>
<td></td>
<td>All Norwegian-registered companies</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2013</td>
<td>Extension of the Accounting Act on CSR reporting</td>
<td>Mandatory</td>
<td>Disclosure on integration of considerations for human rights, labor rights and social issues, the environment and anti-corruption in business strategies, daily operations, and their relations with their stakeholders</td>
<td>Voted by Parliament, further to proposal from Ministry of Finance</td>
<td>Large companies</td>
<td>Ministry of Finance to adopt implementing and transitional measures</td>
</tr>
</tbody>
</table>

*Other countries where practitioners and/or regulators are significantly engaged on sustainability issues:*
- Government-led, mostly focused on CSR Reporting: Austria (2003), Netherlands (2005), Sweden (2007), Finland (2011), Germany (2011), Spain (2011)
- Industry-led: Greece, Switzerland, Turkey
<table>
<thead>
<tr>
<th>Country</th>
<th>Date</th>
<th>Name of Framework (&amp; sub-parts)</th>
<th>Type of Framework</th>
<th>Scope</th>
<th>Main stakeholders involved in development of guidance</th>
<th>Targeted Constituency</th>
<th>Responsibility for implementation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>LATIN AMERICA</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| Brazil | 2008 | Green Protocol (Protocolo de intenções) for Public Banks | Voluntary guidelines | Environmental & Social Risk Management  
General Environmental Management  
Green Products & Services | Ministry of Environment  
Public Banks  
Banking Association (Febraban) and Private Banks | Public and private banks who are signatories to the protocols | N/A |
| | 2009 | Green Protocol for Private Banks | | | | | |
| | 2008 | Resolution 3545 on the Amazon Biome | Mandatory regulation | Conditions for granting rural credit  
Financing biofuel production  
Prohibiting slave labour  
Risk assessment and capital sufficiency | Central Bank of Brazil | Regulated financial institutions, financial institutions integrated in the National Rural Credit System (SNCR) | N/A |
| | 2009 | Resolution 3813 on Sugar Cane | | | | | |
| | 2010 | Resolution 3876 on Slave Labor | | | | | |
| | 2011 | Circular 3547 on ICAAP | | | | | |
| | 2014 | Resolution N.4.327 | Mandatory regulation | Social and Environmental Responsibility Policy (PRSA) guidelines (governance structure and management of environmental risks) | Central Bank of Brazil  
Banking Association (Febraban) and Private Banks | Financial institutions and other entities authorized by the Central Bank of Brazil. | - Central Bank of Brazil |
| Colombia | 2012 | Green Protocol | Voluntary guidelines | Environmental & Social Risk Management  
General Environmental Management  
Green Products & Services | Ministry of Environment  
Sustainable Development  
Banking Association (Asobancaria)  
Commercial banks  
Public banks | The financial sector in general, signatories are public and private banks | N/A |
| Peru | 2014 | TBD | Mandatory regulation | Environmental & Social Risk Management | Superintendent of Banks, Insurance and Pension Funds (SBS) | All Peruvian banks | SBS |

Other countries where practitioners and/or regulators are significantly engaged on sustainability issues: Mexico, Paraguay.

| NORTH AMERICA | | | | | | | |
| USA | 2010 | SEC Commission Guidance Regarding Disclosure Related to Climate Change | Implementation Guidance | Disclosure related to Climate Change Issues as regards:  
- compliance with environmental laws.  
- risk investment  
- liquidity, capital resources and results of operations  
- material risks  
- environmental issues affecting to assets | Securities and Exchange Commission (SEC) | Public companies & Foreign Private Issuers | N/A |

*E.g. further instances where frameworks may be under preparation or where some form of on-going dialogue / collaborative action is underway (e.g. via dedicated networks or "clubs").
For readers that are less familiar with some of the technical financial regulation language used in this study, a glossary of key terms is presented below. Useful resources for further explanations can be found at www.bis.org and www.oecd.org.

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital buffer</td>
<td>Mandatory capital that financial institutions are required to hold in addition to other minimum capital requirements.</td>
</tr>
<tr>
<td>Credit risk</td>
<td>The risk that one party to a financial contract will fail to discharge an obligation and thus cause the other party to incur a financial loss.</td>
</tr>
<tr>
<td>Leverage ratio</td>
<td>A ratio used to calculate the financial leverage of a company to get an idea of the company’s ability to meet financial obligations.</td>
</tr>
<tr>
<td>Liquidity coverage ratio</td>
<td>The liquidity coverage ratio is designed to ensure that financial institutions have the necessary assets on hand to ride out short-term liquidity disruptions. Banks are required to hold an amount of highly-liquid assets, such as cash or Treasury bonds, equal to or greater than their net cash over a 30 day period (having at least 100% coverage).</td>
</tr>
<tr>
<td>Liquidity risk</td>
<td>The risk that assets may not be readily available to meet a demand for cash.</td>
</tr>
<tr>
<td>Macroprudential analysis</td>
<td>The assessment and monitoring of the strengths and vulnerabilities of financial systems.</td>
</tr>
<tr>
<td>Market risk</td>
<td>The risk of losses on financial instruments arising from changes in market prices. Market risk covers interest rate, foreign exchange, equity price, and commodity price risk.</td>
</tr>
<tr>
<td>Net stable funding ratio</td>
<td>The net stable funding (NSF) ratio measures the amount of longer-term, stable sources of funding employed by an institution relative to the liquidity profiles of the assets funded and the potential for contingent calls on funding liquidity arising from off-balance sheet commitments and obligations.</td>
</tr>
<tr>
<td>Operational risk</td>
<td>The risk arising from inadequate or failed internal processes, people and systems, or from external events (including legal risk).</td>
</tr>
<tr>
<td>OTC derivatives</td>
<td>A security traded in some context other than on a formal exchange. The phrase ‘over-the-counter’ can be used to refer to stocks that trade via a dealer network as opposed to on a centralised exchange.</td>
</tr>
<tr>
<td>Systemic risk</td>
<td>The risk that the inability of one institution to meet its obligations will cause other institutions to be unable to meet their obligations. Such a failure may cause significant liquidity or credit problems and, as a result, could threaten the stability of or confidence in markets. Systemic risk therefore refers to the risks imposed by interlinkages and interdependencies in a system or market.</td>
</tr>
</tbody>
</table>
References


Climate Institute, ‘Climate Change Best Practice Methodology’, Asset Owners Disclosure Project <aodproject.net/images/docs/ClimateChangeBestPracticeMethodology.pdf>.


Moody’s (2011) ‘Basel III: How it will reshape the playing field for global project finance’ <www.youtube.com/watch?v=AW8gP9P97Tm>.


5.7cf9c5aa121e17bab4280021543.html>.  


5.7cf9c5aa121e17bab4280021543.html>.  


5.7cf9c5aa121e17bab4280021543.html>.


**Interviews and seminars**

The authors would like to thank the following people and institutions for participating in interviews and seminars with the research project. In cooperating with the project, they do not express any opinion on the recommendations, conclusions or statements in this report.

<table>
<thead>
<tr>
<th>Date</th>
<th>Name</th>
<th>Institution/Position</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Discussion and presentation at Bloomberg New Energy Finance</td>
</tr>
<tr>
<td>25.03.2014</td>
<td>Dhumale Rahul, Dr.</td>
<td>Head of Risk Control, UBS Investment Bank</td>
</tr>
<tr>
<td>09.05.2014</td>
<td>Zhang, Rong</td>
<td>Environment, Social and Governance Policy Department of the IFC in Washington DC</td>
</tr>
<tr>
<td>13.05.2014</td>
<td>Collazos, Paul</td>
<td>Superintendencia de Banca, Seguros y AFP, Peru</td>
</tr>
<tr>
<td>20.05.2014</td>
<td>Schnaar-Campbell,</td>
<td>Head: Regulatory Impact and Strategy, Standard Bank Group</td>
</tr>
<tr>
<td></td>
<td>Annelle</td>
<td>Head: Group Sustainability Management, Standard Bank Group, South Africa</td>
</tr>
<tr>
<td></td>
<td>Ireton, Karin</td>
<td>Standard Bank Group, South Africa</td>
</tr>
<tr>
<td></td>
<td>Kotsovos, George</td>
<td></td>
</tr>
<tr>
<td>21.05.2014</td>
<td>Turner, Philip</td>
<td>Economist, Bank for International Settlements</td>
</tr>
<tr>
<td>21.05.2014</td>
<td>Ronquest, Madeleine</td>
<td>Head Environment and Social Risk, FirstRand Regulatory Risk Management, South Africa</td>
</tr>
<tr>
<td>21-22.05.2014</td>
<td>Hassett, Timothy</td>
<td>Director Special Project - Sustainable Finance World Wildlife Fund, Basel</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Discussion and Presentation at Global Infrastructure Basel (GIB) Foundation</td>
</tr>
<tr>
<td>22.05.2014</td>
<td>Yanfei, Ye</td>
<td>Deputy Director General of the China Banking Regulatory Commission Statistics Department</td>
</tr>
<tr>
<td>28.05.2014</td>
<td>Prudential Regulation team</td>
<td>Prudential Regulation Authority, Bank of England</td>
</tr>
<tr>
<td>30.05.2014</td>
<td>Wells, Christopher</td>
<td>Head of Environmental Risk Dpt. Bank Santander, Brazil</td>
</tr>
<tr>
<td>04.06.2014</td>
<td>Collazos, Paul</td>
<td>Superintendencia de Banca, Seguros y AFP, Peru</td>
</tr>
<tr>
<td></td>
<td>Schydlowsky, Dr. Daniel</td>
<td>Head of Superintendencia de Banca, Seguros y AFP, Peru</td>
</tr>
<tr>
<td>05.06.2014</td>
<td>Di Noia, Carmine</td>
<td>Deputy Director General, Head Capital Markets and Listed Companies Assonime, Italy</td>
</tr>
<tr>
<td>13.06.2014</td>
<td>Hong, Yin</td>
<td>Senior Vice President, ICBC, Beijing, China</td>
</tr>
<tr>
<td>17.06.2014</td>
<td>Sardenberg, Rubens</td>
<td>Chief Economist, Brazilian Federation of Banks(Febraban), Brazil</td>
</tr>
<tr>
<td>10.06.2014</td>
<td>Athaide, Malcolm</td>
<td>Senior President &amp; Chief Risk Officer – Retail, Business &amp; Inclusive Banking, YES BANK, India</td>
</tr>
<tr>
<td>10.07.2014</td>
<td>Vikas, Namita</td>
<td>Senior President &amp; Country Head - Responsible Banking, and Chief</td>
</tr>
<tr>
<td>24.07.2014</td>
<td>Cornford, Dr. Andrew</td>
<td>Observatoire de la Finance, Geneva, Switzerland</td>
</tr>
<tr>
<td>25.08.2014</td>
<td>Nieto, Maria</td>
<td>Banca de Espana</td>
</tr>
<tr>
<td>30.05.2014</td>
<td>Vasconcelos, Mario Sergio</td>
<td>Institutional Affairs (environmental) Brazilian Federation of Banks (Febraban) Brazil</td>
</tr>
<tr>
<td></td>
<td>Thompson, Robert</td>
<td>Former Counsel to US Environmental Protection Agency, New York, U.S.</td>
</tr>
</tbody>
</table>
About us

About CISL
The University of Cambridge Institute for Sustainability Leadership (CISL) brings together business, government and academia to find solutions to critical sustainability challenges. Capitalising on the world-class, multidisciplinary strengths of the University of Cambridge, CISL deepens leaders’ insight and understanding through its executive programmes, builds deep, strategic engagement with leadership companies, and creates opportunities for collaborative enquiry and action through its business platforms.

Over 25 years, we have developed a leadership network with more than 5,000 alumni from leading global organisations and an expert team of Fellows, Senior Associates and staff. HRH The Prince of Wales is the patron of CISL and has inspired and supported many of our initiatives.

About the BEI
The Chief Executives of some of the world’s largest banks created the Banking Environment Initiative (BEI) in 2010. Its mission is to lead the banking industry in collectively directing capital towards environmentally and socially sustainable economic development. At the heart of the group’s vision lies a simple thesis: banks work for their clients and an initiative like this will only work if it is aligned with their interests and vice versa.

The BEI achieves its mission by focusing on topics where industry-wide action is needed, working in partnership with its customer base by bringing independent thinking to bear on the issues and through the active leadership of its Chief Executives.

About UNEP FI
UNEP FI is a partnership between UNEP and the global financial sector created in the wake of the 1992 Earth Summit with a mission to promote sustainable finance. Over 200 financial institutions, including banks, insurers and fund managers, work with UNEP to understand today’s environmental challenges, why they matter to finance, and how to actively participate in addressing them.

UNEP FI has produced extensive research to reveal and explain the intersection between finance and the environment. It has also produced practical tools to raise awareness and to build capacity among practitioners. In recent years UNEP FI’s work has also included a strong focus on policy – by fomenting country-level dialogues between finance practitioners and their policy-makers, and, at the international level, by promoting financial sector involvement in processes such as the global climate negotiations.

About Bloomberg LP
Bloomberg, the global business and financial information and news leader, gives influential decision makers a critical edge by connecting them to a dynamic network of information, people and ideas. The company’s strength – delivering data, news and analytics through innovative technology, quickly and accurately – is at the core of the Bloomberg Professional service, which provides real-time financial information to more than 320,000 subscribers globally.
Cambridge insight, policy influence, business impact

The University of Cambridge Institute for Sustainability Leadership (CISL) brings together business, government and academia to find solutions to critical sustainability challenges.

Capitalising on the world-class, multidisciplinary strengths of the University of Cambridge, CISL deepens leaders’ insight and understanding through its executive programmes, builds deep, strategic engagement with leadership companies, and creates opportunities for collaborative enquiry and action through its business platforms.

Over 25 years, we have developed a leadership network with more than 5,000 alumni from leading global organisations and an expert team of Fellows, Senior Associates and staff.

HRH The Prince of Wales is the patron of CISL and has inspired and supported many of our initiatives.