

Climate Safe Lending Network Response to European Banking Authority: The Role of Environmental Risks in the Prudential Framework

EBA/DP/2022/02

Consultation response from the Climate Safe Lending Network (CSLN), an international multi-stakeholder collaborative dedicated to accelerating the decarbonization of the banking sector to secure a climate-safe world.

Chapter 3 – Background and rationale: Q1- IN YOUR VIEW, HOW COULD EXPOSURES ASSOCIATED WITH SOCIAL OBJECTIVES AND/OR SUBJECT TO SOCIAL IMPACTS, WHICH ARE OUTSIDE THE SCOPE OF THIS DP, BE CONSIDERED IN THE PRUDENTIAL FRAMEWORK? PLEASE PROVIDE AVAILABLE EVIDENCE AND METHODOLOGIES WHICH COULD INFORM FURTHER ASSESSMENT IN THAT REGARD.

1. The transmission of risks from social factors into the financial system and from the financial system to society are multi-layered and complex. Through a predominantly climate-risk lens, there have been both risks to society (e.g. stranding communities as a consequence of a disorderly transition) and opportunities for society (e.g. addressing fundamental resilience in the face of increasing vulnerability). Likewise, there are many studies showing the negative impacts of social inequality on an economy (Wilkinson & Pickett, 2010) which is being investigated further in a nascent 'Taskforce for Inequality-related Financial Disclosures (TIFD, www.thetifd.org)

People living in low-income urban areas with poor infrastructure, and, generally speaking, population groups with lower incomes and assets, are more exposed to climate impacts but have less capacity to face them:

- *Women may be disproportionately impacted by climate change and are at a disadvantage when expensive*

adaptation measures are required. At the same time, women are key actors in adaptation and more generally sustainable practices.

- *Unemployed and socially marginalised people are among the most vulnerable to climate risks.*
- *Europe's ageing population, disproportionately affected by reduced mobility or health impediments, will result in a higher share of the population being vulnerable to climate change impacts.*

([European Commission, 2021](#))

As resilience is eroded by climate damage, there is a significant potential for financial flows to amplify and exacerbate inequality. For example, communities who live in areas (increasingly) vulnerable to heavy floods or forest fires may struggle to retain insurance and will be unable to secure mortgages. This may trigger macro-economic impacts as citizens are at risk of economic displacement, with consequential financial system impact. These risks and the transmission channels are worthy of further research.

Chapter 4 – Principles, premises and challenges: Q2 - DO YOU AGREE WITH THE EBA'S ASSESSMENT THAT LIQUIDITY AND LEVERAGE RATIOS WILL NOT BE SIGNIFICANTLY AFFECTED BY ENVIRONMENTAL RISKS? IF NOT, HOW SHOULD THESE PARTS OF THE FRAMEWORK BE INCLUDED IN THE ANALYSIS?

2. No, we do not agree that liquidity ratios (LCR, NSFR) are neutral or out of scope. In the increasingly likely event that the entire 1.5-degree carbon budget is used up in the next 5-10 years, then there is a greater likelihood of governments implementing measures collectively referred to as the 'inevitable policy response' ([UNPRI, 2018](#))

As we move closer to that point, commentary and speculation about the safety of financial institutions is likely to become more prominent. As a consequence, those financial institutions thought to be most at risk will also be vulnerable to liquidity pressures as customer trust is eroded and the potential of rapid and aggressive policy action becomes more imaginable to the public.

Q3: IN YOUR VIEW, ARE ENVIRONMENTAL RISKS LIKELY TO BE PREDOMINANTLY ABOUT REALLOCATION OF RISK BETWEEN SECTORS, OR DOES IT IMPLY AN INCREASE IN OVERALL RISK TO THE SYSTEM AS A WHOLE? WHAT ARE THE IMPLICATIONS FOR OPTIMUM LEVELS OF BANK CAPITAL?

3. Climate change will impact all sectors and the economy will continue to need all sectors to function. Within each sector, however, there will need to be a fundamental reallocation – for example within energy, there will be a necessary transition from fossil-fuel energy to 100% renewable energy. It would be impossible for an economy to function by allocation between sectors alone (we cannot substitute energy with another sector. Therefore, the question should be framed as an overall risk to the whole system, albeit with unevenly distributed contributions to the overall systemic risk (and unevenly distributed risk consequences).

The consequences of this are profound. As systemic risk increases (as evidenced by the impacts described by the IPCC in their AR6, Working group-II assessment) a larger proportion of the economy becomes stranded and unable to be financed. This causes a shrinkage of the financial system, not unlike 2008, with a feedback loop flowing through further economic downturn.

The fundamental difference between the situation in 2008 and what we can say with relative certainty about the impacts of climate change is that many of the expected climate impacts are deemed to be ‘irreversible ... within centuries or millennia’ (IPCC, 2022). The implications for bank capital are fundamental from a first-principles perspective: if faced with an irreversible ‘collapse’ rather than a significant (but manageable) crisis then a deeper precautionary approach is necessary in order to maintain financial stability. We have expanded on this concept in other articles: ([Vaccaro, 2022](#))

Q4: SHOULD THE ‘DOUBLE MATERIALITY’ CONCEPT BE INCORPORATED WITHIN THE PRUDENTIAL FRAMEWORK? IF SO, HOW COULD IT BE ADDRESSED?

4. Double materiality in the context of central bank regulation of the banking sector could be better expressed as the ‘contribution to macro-level overall systemic risk’ and should be addressed by **complementary** provisions in the capital requirements framework. In essence, pillar-1 measures at a micro-prudential level require a mirror at a macro-prudential level (pillar-1b) to address the inevitable build-up of systemic risks which would be impossible to address within a collapse (see answer to (3)).

In the widely publicised speech by Stuart Kirk of HSBC (Kirk, 2022) the argument was put forward that because a bank's exposures are merely six years, it need not worry about climate risk since the world will not have changed enough in seven years. Under the current capital requirements regime, Kirk's view is correct in that there are no enforcement measures which disincentivise 'contribution to systemic risk', only those which impact exposures who may be 'vulnerable to systemic risk'. The current system addresses the risks for the 'polluted' whilst ignoring the 'polluters'. To some degree, Kirk's perspective may underestimate the impact of transition risks, however his opinion appears to be based on the very minimal evidence of near-term transition policies which would significantly impact a loan with tenure of six years. Central bankers have also cited the 'lack of empirical evidence' of these risks showing up as a reason not to impose further capital measures. Ironically it is within this timeframe that the [carbon budget to stay within 1.5-degrees](#) may be exceeded, triggering non-linear feedback-loop cycles which may endogenously drive further risks. Kirk's view also reflects an assumption that may be held by many in the financial sector including regulators that society will simply adapt, citing "Who cares if Miami is six metres underwater in 100 years? Amsterdam has been [two] metres underwater for ages." This viewpoint has been strongly rebuffed by climate scientists such as Corinne LeQuéré who said *"It's a legitimate question: could we just adapt to climate change? [...] And the answer is no. Because the warming continues. You cannot just adapt because the target keeps moving."* (Unlike Amsterdam, Miami can't protect itself via sea walls, because water bubbles up through the porous limestone on which it's built.) (Financial Times, 2022)

For as long as there are no balancing regulations that address the contribution to systemic risk (double materiality) banks will be able to profit without penalty and regulators should expect this activity (and therefore systemic risk) to increase, ultimately to the point where it can no longer be adequately or feasibly addressed in the face of irreversible impacts. A **parallel framework of contribution to systemic risks (from climate, but also from the degradation of natural systems and other critical environmental and social**

factors) is necessary ahead of time before we breach planetary boundaries and trigger irreversible tipping points.

Q5: HOW CAN AVAILABILITY OF MEANINGFUL AND COMPARABLE DATA BE IMPROVED? WHAT SPECIFIC ACTIONS ARE YOU PLANNING OR WOULD YOU SUGGEST TO ACHIEVE THIS IMPROVEMENT?

5. Data quality is incrementally improving and even with the data gaps that exist today, meaningful strategies can be formulated. Or as an ECB executive board member put it: 'Patchy data is a good start'. ([Frank Elderson](#), 2021).

Initiatives such as the Partnership for Carbon Accounting in Financials ([PCAF](#)) is rapidly becoming a global standard in carbon accounting amongst financial institutions (now more than 250 worldwide). At a local level, PCAF members have been successful in driving data quality improvements – for example in the Netherlands, direct data on energy consumption for mortgage portfolios are now attached via the Dutch Central Bureau of Statistics (CBS) – see <https://carbonaccountingfinancials.com/newsitem/cbs-publishes-co2-emissions-of-dutch-banks-mortgage-portfolios>

There are emerging initiatives such as the Partnership for Biodiversity Accounting in Financials and increasing integration of satellite and ground monitored data to quantify fugitive methane emissions and emissions/sequestration resulting from land use.

Consistency in data approaches will be assisted by frameworks such as the GHG Protocol (WRI, WBCSD). Further clarifications may be given by standards bodies (and ultimately regulators) on sensitive issues relating to the comparability of data. For example, despite global frameworks such as the Science-based Targets Initiative stating that offsets (in particular, those based upon 'avoided emissions') cannot be used by financial institutions or their clients in arriving at a net position of their emissions, there is still a wide variance in how this is being applied amongst financial institutions. Early regulation which secures consistency across all actors (not just those signed up to voluntary sustainability disclosure initiatives) would help in avoiding data discrepancies which could otherwise undermine progress.

Q6: DO YOU AGREE WITH THE RISK-BASED APPROACH ADOPTED BY THE EBA FOR ASSESSING THE PRUDENTIAL TREATMENT OF EXPOSURES ASSOCIATED WITH ENVIRONMENTAL OBJECTIVES / SUBJECT TO ENVIRONMENTAL IMPACTS? PLEASE PROVIDE A RATIONALE FOR YOUR VIEW.

6. EBA's current assessment is based upon an implicit assumption that the capital framework does not already act as a behavioural influence on the allocation of risk and capital. This is in stark contrast to the consensus amongst those within banks, investors, NGOs, and academia that capital is a major behavioural driver of bank strategy. The argument that capital cannot be used to influence activity contradicts proposals in other areas (not related to climate) – for example the BIS paper on proprietary trading of crypto-currency assets ([BIS](#), 2021). There is ambiguity on the narrowness of definition of a 'prudential risk-based approach' as to whether this is only to be defined at a micro-prudential level for those risks that directly impact institutions on the basis of their exposures, or whether it also includes the macro-prudential analysis of risks which can be transferred between institutions asymmetrically, incorporating the double materiality (contributions to systemic risk) as part of a risk-based framework (see answer to 5). At present, the narrow micro-prudential interpretation is favoured by the lobbyists for those who are 'overweight' in their contributions to systemic risks compared to their micro-prudential risk-based assessments. This includes, for example, the financiers of fossil fuels who are continuing to finance the expansion and exploration of further fossil fuel assets and reserves despite the proven reserves which exist today being 10-times what can be safely used within a 1.5-degree world ([Carbon Tracker](#), 2022). Maintaining a narrow approach to interpreting a risk-based approach to ignore contributions to systemic risk therefore enables those firms to operate at a relative advantage which is reinforced by advocacy and lobbying. This was highlighted by UN Secretary General, Guterres, in his statement that [*Fossil fuel companies and the banks that finance them*] "have humanity by the throat" ([Guardian](#), 2022)

Q7: WHAT IS YOUR VIEW ON THE APPROPRIATE TIME HORIZON(S) TO BE REFLECTED IN THE PILLAR 1 OWN FUNDS REQUIREMENTS?

7. [With reference back to Q4, we cite the example of Stuart Kirk's "average exposure of six years" and the inadequacy of existing frameworks to incorporate the contributions to systemic risks from

these activities – see response to (4)]

Whilst uncertainties always exist when predicting the future, climate science and the confidence intervals provided by the assessments of the IPCC suggests that there may be far greater uncertainty on near-term unforeseen events (the Covid-19 pandemic, war in Ukraine) compared to the long-term impacts of climate change (sea-level rise, frequency and severity of storms, droughts, extreme temperatures).

It would be helpful for there to be a clarification amongst central banks that the maintenance of financial stability is part of the mandate **for the long term**. In relation to climate change, it is the impacts in the later part of the century which result from actions that **may happen as a consequence of the activity in the decade ahead** that are most salient in determining the feasibility for long-term financial stability. As a consequence, modelling should be undertaken to translate the impacts up to the end of this century (e.g. **2099**, equivalent of taking the horizon to the life expectation of an average European) and allocating the potential negative consequences to the activities which contribute to systemic risk today (e.g. including to loans today which may only have a “six year” tenure).

EBA’s argumentation from its consultation document suggests a worldview that it is not the function of a regulator to police for ‘moral hazard’ (a situation where an economic actor has an incentive to increase its exposure to risk because it does not bear the full costs of that risk). From a philosophical standpoint, this suggests that either (a) EBA believe that moral hazard does not contribute to systemic risk, (b) that action can only be taken by financial regulators in relation to the victims suffering the consequences of systemic risk, or (c) that another arm of government or regulatory body (beyond central banks) should be policing moral hazard.

It would be useful for EBA to clarify its opinion on its underlying philosophical stance in relation to the conjecture above.

As noted earlier we have expanded further on this topic previously in other journals ([Vaccaro, 2022](#))

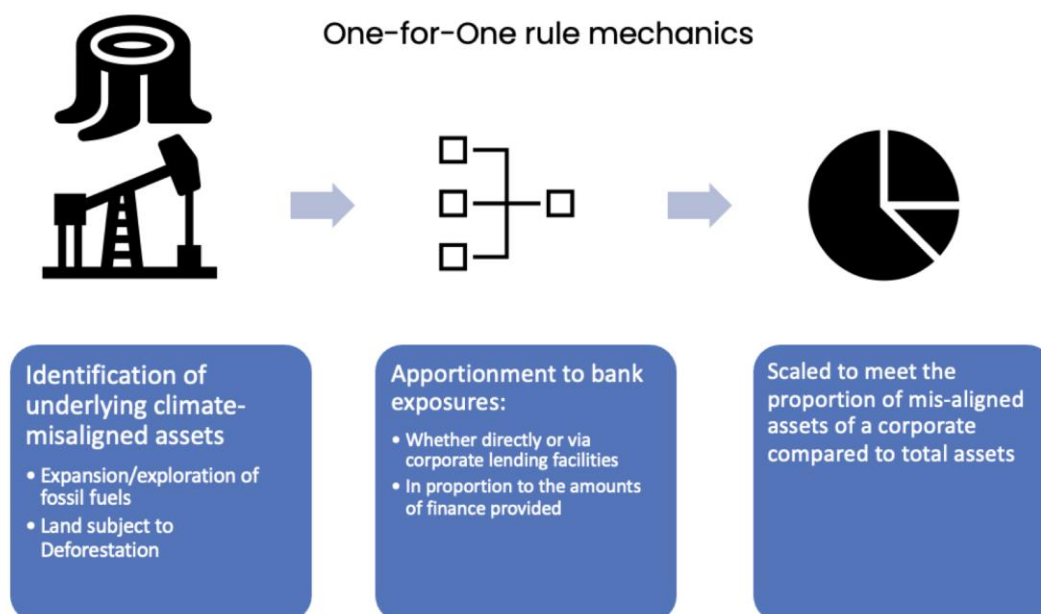
Q8: DO YOU HAVE CONCRETE SUGGESTIONS ON HOW THE FORWARDLOOKING NATURE OF ENVIRONMENTAL RISKS COULD BE REFLECTED ACROSS THE RISK CATEGORIES IN THE PILLAR 1 FRAMEWORK?

8. We refer to the practical mechanisms which we submitted to the Basel Committee on Banking Supervision in 2022 outlining the specific mechanics of how the capital requirements regulations could be adapted to address the most egregiously misaligned elements of contribution to systemic risk (e.g. linking exposures to new fossil fuel expansion/exploration or deforestation).

We refer you to our submission with worked examples here:

[Climate Safe Lending Response to BCBS consultation on climate risk supervision](#)

The mechanics of a One-for-One rule on Capital Requirements relating to expansion and exploration of fossil fuels and deforestation:



9. [not answered]

10. [not answered]

11. We recognise that institutions may experience challenges with integrating broader due diligence requirements, however it is unclear why this should be a reason not to implement further requirements. At present, financial regulators ensure that banks maintain sufficiently rigorous customer due diligence for the prevention of financial crime (AML, sanctions regime etc). In these cases, lack of due diligence is not a defence in law against claims of customer actions and consequential impacts. A similar mindset could be applied to critical and sensitive environmental and social risks – for example the UK’s Global Resource Initiative Taskforce ([Global Resource Initiative](#), 2022) which included diverse participation across the financial sector and stakeholder groups, recently concluded that:

- The financial sector should be covered by a similar obligation, requiring financial institutions to exercise due diligence in order to avoid their lending and investments funding deforestation. Further work will be required to investigate the appropriate mechanism(s) and sequencing to achieve this.
- In addition, government, standards bodies and natural accounting frameworks should explore aligning and building deforestation and land conversion risks into existing accounting standards, disclosure frameworks and taxonomies where appropriate, in order to support the transition to mandatory due diligence

We fully endorse this assessment. Likewise, we have argued for a ‘KYCO2’ (know-your-carbon) regime that would oblige banks to carry out basic due diligence assessments of GHG supply chains for its business lending customers. (taken from ‘[Financial Stability in a Planetary Emergency](#)’ (CSLN, 2021))

12 through 27. [not answered]

28. Exclusively relying upon pillar 2 as a means of managing environmental risk would neither be sufficient nor adequate. Leaving

it to individual supervisors is likely to result in timid regulation with measures mostly directed at the 'sufficiency of process', aimed exclusively at the narrow definition of risk-based being micro-prudential (see previous answers). The quantity of misalignment from environmental thresholds (e.g. the level of emissions in relation to the available carbon budget) is material to the contribution to systemic risk, yet this quantification is unlikely to be picked up in a Pillar-2 assessment. As we head towards more extreme levels of systemic risk (at 1.5-degrees and beyond) it is very doubtful that pillar-2 measures would be calibrated to adequately reflect the future systemic risks that would be locked-in by present day misalignment of financial flows.

29-30 [not answered]

Chapter 8 – Concentration risk: Q31 - WHAT IS YOUR VIEW ON THE POTENTIAL NEW CONCENTRATION LIMIT? DO YOU IDENTIFY OTHER CONSIDERATIONS RELATED TO SUCH A LIMIT? HOW SHOULD SUCH A LIMIT BE DESIGNED TO AVOID THE RISK OF DISINCENTIVISING THE TRANSITION?

31. The concentration risk limit is more likely to trigger a rebalancing of business models towards capital markets activities as banking institutions maintaining long-term relationships with clients in high-emitting sectors adapt their earnings model towards fee-based off-balance-sheet business, capping levels which remain on balance sheet. From this perspective, it does not necessarily contribute to real-economy decarbonisation. It still leaves banks with a significant residual exposure, which if it were to be removed completely would change the political calculus (e.g. if banks no longer held exposures related to assets that were misaligned to climate goals, then this is likely to make it easier for more aggressive transition policies to be enacted by governments – especially within the G-SIB banks who still, de-facto, are considered to be 'too big to fail').

32- 35 [not answered]