

# Climate Safe Capital Rules for the Global Banking Sector

## Summary of discussion, 20th September 2022

(Event held under Chatham House Rules)

- Chair: James Vaccaro, Executive Director, Climate Safe Lending Network
- Moderator: Stuart Mackintosh, Executive Director, The Group of 30
- Presenters:
  - Josh Ryan Collins, Associate Professor, University College London
  - Julia Symon, Head of Research & Advocacy, Finance Watch
  - Senator Rosa Galvez, Canadian Senate
- In attendance: 25 banking professionals from across the world, 10 bank regulation experts and senior regulators

## INTRODUCTION

The [Climate Safe Lending Network](#) held a closed-session discussion on climate-aligned global bank capital requirements on September 20<sup>th</sup>, 2022.

Capital rules and requirements have been at the forefront of many regulatory conversations about how to stay below a 1.5°C global temperature increase – from the UK Financial Services Bill, the Canadian Climate Aligned Finance Act, to the EU Capital Requirement Regulation. Given we have approximately seven years remaining of the 1.5°C carbon budget at current rates of emissions, **we are at a critical moment to address the rules for the financial system** to prevent an irreversible systemic failure.

This discussion focused on the merits of targeted action in light of current global developments. Participants were invited to reflect on the impacts to their own business and the climate, design considerations based on how various actors would respond, and to share their perspectives on how various forms of regulation could be implemented most effectively in service of maintaining a climate safe world (and banking sector).

## HIGH LEVEL SUMMARY

The discussion looked at (1) the rationale for using capital requirements to address climate-related financial risks, (2) the options to do this, and (3) the political context and mechanics of implementation. There were three short presentations, each followed by a facilitated discussion.

Overall, the discussion revealed a number of perceived **tensions** between:

- avoiding climate catastrophe and expanding the prudential framework,
- transition objectives and profitable growth,
- the urgency to act and the time needed to change business models, and
- which stakeholders – corporates, banks and governments – should act first.

## RATIONALE DISCUSSION SUMMARY

The first intervention discussed highlighted a gap in the prudential treatment of climate risks and the need for new thinking or even a new 'Pillar 4' in the Basel prudential framework. The fundamental uncertainty and endogenous nature of climate related financial risks call for a **precautionary and pragmatic regulatory approach** that does not rely on unavailable historical data and that considers more fully the impacts of finance on the climate and the financial system. There are legislative proposals in the EU and Canada to apply capital measures to banks' fossil fuel assets.

Some participants warned not to conflate policy objectives and said that mixing prudential with political goals could **distort or dilute** the risk-sensitive Basel framework. They said financial regulation should not be a back-door way to decarbonise industry, which is a task for politicians. However, it was noted that financial regulation can influence flows of finance which in turn can be a leverage point for real economy decarbonisation.

Others said the legislative proposals are **fundamentally about risk** and are based on climate science and studies of asset stranding risk. They disagreed that it is ideological or political to take prudential action against likely but uncertain future losses. However, central bank mandates and prudential rules need to be interpreted more widely to consider the full impacts of climate risk, including second and third order effects in addition to the first order effects on banks.

Other participants said the misalignment of the financial sector with climate goals is itself a risk to financial institutions and noted that financial stability is more at risk when people feel insecure.

Most participants agreed that using capital requirements to promote **green lending** would weaken bank resilience. Green credit will flow anyway if there is demand and could be further incentivised by other means, such as green TLTROs and technical measures, for example to counter the lack of data on circular economy and other new business models.

## OPTIONS DISCUSSION SUMMARY

The second intervention discussion focused on policy options, including proposals for a full equity requirement (the “1-for-1 rule”) on lending for fossil fuel expansion and a 150% risk weight on exposures to existing fossil fuel assets. These have been proposed in the EU and in Canada, where the proposal is combined with stricter risk disclosure and climate alignment duties for financial institution directors.

Applying capital measures through **Pillar 1** would create a level playing field for banks and overcome the lack of historical data and the lack of modelling techniques. For banks, it would reduce the risk of supervisors rejecting their treatment of climate risk in internal models.

To avoid slowing the transition, **transition financing** (e.g. explicitly ringfenced for emissions reduction or capital expenditure for sustainable alternatives) for fossil fuel companies should be exempted. This is easier for companies with separate legacy and clean energy businesses. For others, supervisors can distinguish between general purpose corporate lending, to which the capital measures would apply, and separately-rated instruments to finance transition projects, which would be exempted. For the 1-for-1 rule, “**new**” fossil fuel activities could be identified by applying a cut-off date to final investment decisions.

Some participants argued against a Pillar 1 approach on the grounds that a **lack of historical data** for climate-related losses makes it hard to validate or size capital measures. Others said a mismatch between the usual one-year time horizon for Pillar 1 risks and the longer period over which climate risks materialise could favour a **Pillar 2** approach.

Some participants argued for **concentration limits** implemented through Pillar 2. Advantages include that some central bankers see this as easier to implement, it would take effect regardless of interest rates, and it would reflect that transition risks are concentrated in larger banks. The disadvantages include that it would not increase loss absorbing capacity in the banking system, it would not internalise systemic costs, it would tend to redistribute rather than reduce risks, and it would not constrain banks with originate-to-distribute models. There could also be opposition from US states with anti-ESG mindsets. Several participants said that concentration limits could be helpful as a supervisory measure in combination with capital measures but not as a substitute for them, if the goal is to increase loss-absorbing capacity.

Another option would be to increase at the national level **systemic risk buffers** for the largest banks, which have the highest fossil fuel exposures. The add-on could be calibrated to the fossil fuel exposures of each bank or country.

## IMPLEMENTATION DISCUSSION SUMMARY

The third intervention discussion described the Canadian legislative proposal, the Climate Aligned Finance Act, and its context. There were concerns that **reducing the supply of fossil fuels** relative to demand could lead to hardship and localised job losses. The response was

that replacing fossil fuels with renewables brings down living costs and the legislative proposal supports the growth of all non-fossil energy technologies.

Some participants focused on **disclosure and transition plans**. They said that fossil fuel companies that do not transition will become higher risk and banks will adjust their lending anyway, so regulation should focus on transition plans instead of capital. On the other hand, some participants said that many fossil fuels companies do not really want to transition, so focusing on transition plans would reward greenwashing without reducing financial risk. Some participants said that rules to mandate and enforce transition plans and tools to assess them would be useful for supervisors in combination with capital measures.

There was a concern that capital measures could push financing onto **capital markets**, with banks acting more as underwriters and placing agents and less as lenders, or into **shadow banks** as credit is routed through private equity firms and other intermediaries. In Europe this may happen less than in the US due to a higher European corporate reliance on bank credit. **Carbon pricing** could help to address this as it would internalise the systemic costs of fossil fuel lending through the cost of capital regardless of financing mechanism. On the other hand, academic studies have predicted that carbon pricing would have a limited effect on bank behaviour and recommended that emissions taxes be complemented with capital regulation.

Whichever regulatory approach is taken, its effectiveness will depend on the availability of **supervisory resources**. This could be a reason to prefer a Pillar 1 approach, which would reduce complexity and could be applied to a narrow scope of assets as supervisors gain experience. Some participants noted that the NGFS has a role to play in reducing the divergence between central banks in their approaches to climate risk.

LINKS TO SUPPORT THE INTERVENTIONS:

<https://www.ucl.ac.uk/bartlett/public-purpose/publications/2019/dec/climate-related-financial-policy-world-radical-uncertainty>

<https://www.finance-watch.org/the-one-for-one-rule-a-way-for-cop26-ambitions-to-manifest-in-policy/>

<https://rosagalvez.ca/media/50883/2022-03-cafa-white-paper-en.pdf>

LINKS SHARED DURING THE DISCUSSION

<https://www.cepweb.org/wp-content/uploads/2021/06/Monnin-2021.-Climate-systemic-risk-buffer-for-Europe-Final.pdf>

<https://www.finance-watch.org/publication/response-to-the-eba-discussion-paper-on-environmental-risks-in-the-prudential-framework/>

[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4024366](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4024366)

<https://static1.squarespace.com/static/5e0a586857ea746075c561a3/t/620ce73dd4d79b0bb31572b3/1645012798469/CSL+N+BCBS+Consultation+Response.pdf>

[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3748642](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3748642)

<https://carbontracker.org/reports/unburnable-carbon-ten-years-on>

<https://www.nytimes.com/2022/09/14/climate/oil-industry-documents-disinformation.html>