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Why to integrate Sustainability criteria in financial regulation?

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Executive summary

Banks and other financial institutions play a fundamental role in allocating financial resources. Society expects banks to make their financial resources available for the real economy and to provide products and services that serve, rather than harm, the public interest. Therefore, it is of utmost importance that banks actively assess and manage their impact on social and environmental sustainability. The products of banks, as well as the products and production processes of companies financed by banks, are naturally prone to sustainability risks.

For example, financial products can create the risk of insolvency for low-income consumers; banks can run the risk that some of the companies they are financing deforest land for agriculture, excessively contribute to global warming, deprive workers from labour rights or otherwise cause social and environmental problems.

Social or environmental risks might not necessarily result in financial risks in the short-term. However, there is good reason that they do so in the mid- and long-term, both for the affected financial institution and for the financial system as a whole. Social and environmental incidents can increase costs, threaten the viability of businesses and thus, increase their probability of default. Moreover, they can threaten global financial stability through their devastating or destabilising effects on the society at large, for instance, by exacerbating climate change or amplifying resource crises and, with it, political tensions.

If banks integrate sustainability criteria in their risk assessment and decision making procedures, they will strengthen their financial soundness, improve systemic financial stability and, at the same time, they will contribute to a more ecologically sustainable, just and peaceful world.

This report proposes to use financial regulation for incentivising banks so that they integrate sustainability criteria in their risk assessment and decision making processes. It argues that integrating sustainability criteria in financial regulation will contribute to fulfilling all objectives of the different areas of financial regulation: prudential regulation, conduct of business regulation and systemic regulation. To integrate sustainable criteria in financial regulation a number of concrete proposals are offered in the fields of capital requirements, credit rating agencies, financial supervision, banking licenses, approved person regulations, and remuneration and bonus systems.

1. The role of banks and financial regulation in society

Commercial banks and other financial institutions play a crucial role in allocating financial resources. They provide lending, underwriting, advisory, insuring, and other financial services to a large majority of companies and governments worldwide. By helping companies and governments perform their tasks, run their operations and enabling investments in new developments, banks play a key role in every segment of human activity.

Originally, banks were established to perform these activities as a social function: help matching saving and lending needs. By granting or denying access to credit, (commercial) banks played an important role for the development of the real economy and for social distribution. Financial regulation was intended to ensure that the banking sector could perform this social function in a reliable, accessible and efficient way.

Gradually the banking sector evolved well beyond the field of commercial banking. By developing investment banking, trading and other financial products, banks enlarged their businesses and contributed to the growth of global financial markets. This development progressively shifted the attention of regulators and supervisors from ensuring effective commercial banking to plainly maintaining and restoring global financial stability. New regulation, such as the Basel Capital Accord, which promotes a single global market for finance, and other recommendations of the Basel Committee on Banking Supervision (BCBS), rather encouraged this development. Adjustment of rules favoured global financial conglomerates and their financial innovations, at the expense of other traditional financial actors. Non-financial and non-economic considerations were deliberately kept out of the financial system, despite the risks this autonomous development of financial markets caused for economies, society and the environment.

The present discussions on financial regulation and possible answers to the financial crisis held in international bodies, such as the BCBS, the Financial Stability Board (FSB), the European Union (EU), the G-20 and others, are focussed on restoring financial stability and refining risk management. They avoid addressing key questions that emerged during the financial crisis: What are banks for? How can banks contribute to the necessary rendering of our economies more equitable and ecologically sustainable?

No efforts to increase global financial stability will be sufficient to prevent future financial crises, if the problem of financial markets allowing for innovation that contradicts general economic, social and environmental policy objectives is not addressed. Risk management is per definition complex, case-by-case and uncertain in outcome. A pure risk-based approach in financial regulation would not be sufficient, but invite banks to circumvent or evade regulation.

Financial regulation should aim beyond financial stability and improved risk management. It should contribute to redefining the current banking model. Banks should earn their social license to operate by providing products and services that serve, rather than harm, the public interest.¹ This might require braking-up global conglomerates that are “too big to fail” and separating commercial and investment banks.

The various initiatives in the sphere of alternative banking - including ethical and social banking, mutual lending and micro-credit enterprises - offer valuable experiences on how banks could operate more responsibly. In this respect a paradox outcome of the financial crisis is that some financial regulation, in particular capital adequacy rules, disadvantage alternative banking institutions (see Box 1).

Box 1. Ethical banks and the Basel Capital Accord

Because of their size, ethical banks have to apply the standardised approach of the Basel Capital Accord II, which is very rigid and puts ethical banks on a competitive disadvantage. More importantly, the implementation of the standardised approach by national supervisors disadvantages lending to non-for-profit and cooperative entities. These types of borrowers create jobs for a lot of people and contribute to sustainable development, but also have a good financial track record. In fact, by lending mainly to non-for-profit-organisations and cooperatives, ethical banks suffer a low loan default rate, since on average their default rate is a fourth of the average rate of major commercial banks. Therefore, ethical banks' lending to these actors is less risky.

This lower default rate of borrowers such as cooperatives is not reflected in the risk weight factor for these borrowers in the standardised approach. The weight factor is set by supervisors and is set in some European countries (i.e. Italy) at 100% for non-profit borrowers. In comparison the risk weight factor for for-profit SMEs is 75%, although these economic actors often generate higher loan default rates, and the risk weight factor for hedge funds is even lower although more riskier. This generates a competitive disadvantage for those ethical and cooperative banks lending primarily to less risky and more environmentally and socially useful actors.

Alternative approaches to strengthen social and responsible banking could be to encourage cooperative ownership of banks, and to tighten transparency and disclosure requirements, in particular on banks' investment policies. Public complaint and accountability mechanisms should be in place to allow stakeholders and civil society to look for corrections and justice when social and environmental interests are harmed by a bank's financial decision making.

This report focuses on arguments and proposals that are conducive to those objectives of financial regulation that now guide the discussions and policy making, namely restoring financial stability and refining risk management. Even with a focus on these fields only, it provides sufficient arguments why banks should be incentivised to fully integrate consideration of ecological limits, social equity and economic justice into their core business and corporate strategies. Why and how financial regulation should take on this challenge is discussed in the following chapters.

2. How banks are related to sustainability risks

Most activities financed or facilitated by banks have social and environmental impacts, be they positive or negative. The challenge is to recognise these impacts and shift their balance in a positive direction. Banks and institutional investors should therefore assess the social and environmental impacts of the projects and companies they finance. Social and environmental risks have to be evaluated and factored in when deciding about pursuing financial transactions. Eventually, such processes should contribute to creating incentive structures for businesses to reduce sustainability risks of their operations and investments.

To some extent it is already common practice for banks to evaluate social and environmental risks when assessing new business opportunities, especially when such risks increase the probability of default of loans or investments. To what extent banks are doing this is, however, unclear as the quality of risk assessment of banks and other financial institutions is highly intransparent, insufficiently accountable and poorly regulated.

However, a focus on default risks alone does not take banks far enough down the road towards rendering their policies more responsible and contributing to a more sustainable future. Sustainability risks are the risks run by society and the environment because of the products and production practices of banks themselves as well as the companies financed by banks. These risks need to be defined in a comprehensive way, including both the social risks caused by financial transactions themselves and all sustainability risks caused by the companies and governments they are financing.

Social risks, directly associated with financial transactions of banks, might include the risk of causing a debt overload and insolvency of consumers to which certain financial products are sold. The sustainability risks related to business as well as sovereign finance might be operationalised by referring to the UN Global Compact. For example, banks run the risk that some of the businesses they finance are grossly violating one or more of the Ten Principles (see Box 2), for instance by deforesting land for agriculture, depleting natural resources, excessively contributing to global warming or depriving workers from labour rights.

Box 2. The Ten Principles of the UN Global Compact

- **Human Rights**
 - Principle 1: Businesses should support and respect the protection of internationally proclaimed human rights; and
 - Principle 2: make sure that they are not complicit in human rights abuses.
- **Labour**
 - Principle 3: Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;
 - Principle 4: the elimination of all forms of forced and compulsory labour;
 - Principle 5: the effective abolition of child labour; and
 - Principle 6: the elimination of discrimination in respect of employment and occupation.
- **Environment**
 - Principle 7: Businesses should support a precautionary approach to environmental challenges;
 - Principle 8: undertake initiatives to promote greater environmental responsibility; and
 - Principle 9: encourage the development and diffusion of environmentally friendly technologies.
- **Anti-Corruption**
 - Principle 10: Businesses should work against corruption in all its forms, including extortion and bribery.

A characteristic of sustainability risks is that they are not necessarily direct risks for the financial institution itself. To adequately deal with sustainability risks, banks need to take steps which go beyond their direct, short-term self-interest. Living up to the expectations of society with regard to the role of banks and linked reputational risks can be a motivation to take these steps.

Increasingly, the financial sector is acknowledging that through its financing activities it runs the risk of becoming involved in violations of human rights, severe damage to the environment or other negative sustainability impacts. A number of banks have therefore made commitments on a collective or individual basis to integrate sustainability risks in their risk assessments (see Box 3).

Box 3. Voluntary sustainability commitments in the financial sector

In the past ten years, an increasing number of financial institutions made collective commitments towards sustainability, of which the following initiatives are the most relevant:

- **Equator Principles**

The set of Equator Principles (EP) is a financial industry benchmark for determining, assessing and managing social & environmental risk in project financing. The signatories of the EP commit to take social and environmental risks into account when providing project finance and to adhere to the International Finance Corporation (IFC) Performance Standards and environmental sector guidelines. Currently 70 financial institutions have adopted the Equator Principles.

- **UNEP-FI**

The Finance Initiative of the United Nations Environment Programme (UNEP-FI) is an initiative to develop and promote and understand the linkages between the environment, sustainability and financial performance with a view to promoting socially and environmentally responsible investment. The UNEP-FI currently has nearly 200 signatories under which predominantly banks, insurers and fund managers.

- **Principles for Responsible Investment (PRI)**

The Principles for Responsible Investment (PRI) is an initiative between investors, the UNEP Finance Initiative and the UN Global Compact. It is a framework in the form investment principles which can be used for incorporating environmental, social and corporate governance (ESG) issues into mainstream investment decision-making and ownership practices. PRI currently has 873 signatories of which 485 investment managers, 220 asset owners, and 168 professional service partners.

In a study on the sustainability policies of 49 large, international banks published in April 2010, the NGO network BankTrack concluded that many banks now have publicly available policies in place. Only 6 banks out of 49 have developed no policies at all for any of the 7 sectors and 9 issues evaluated. But overall the quality of the investment policies developed by the 49 banks researched is fairly poor. The contents of many policies are vague, hardly expressing any firm commitment and usually do not meet best international standards. Also, implementation of the policies in the decision making processes of these banks often is far from complete and stringent.

3. Integrating sustainability criteria strengthens financial regulation

3.1 What are sustainability criteria?

Sustainability criteria are indicators and standards on specific sustainability issues, such as biodiversity, climate change, labour rights, human rights and social justice. To integrate sustainability criteria in financial regulation, they need to be formulated in such a way that they give clear direction to banks on how to avoid negative social and environmental consequences of their investments and on how to focus on investments that contribute to environmental sustainability and social justice.

The Ten Principles of the UN Global Compact provide a first starting point (see Box 2), but they can be further detailed and expanded with a large body of internationally agreed conventions, covenants and declarations of UN- and other international bodies, as well as multi-stakeholder initiatives. Examples are the Universal Declaration on Human Rights, the ILO-conventions on labour rights, the guidelines and principles of the World Commission on Dams and the Forest Stewardship Council, the Convention on Biodiversity and the UN Framework Convention on Climate Change.²

To integrate sustainability criteria in financial regulation, it is not necessary for regulators to specify them in detail. The Internal Ratings based approach in the Basel Capital Accord gives banks a certain room to set their own criteria for risk evaluation, which could also be the case for their integration of environmental and social risk criteria in their risk assessment. As long as banks do this in a transparent, thorough and consistent way, supervisors can evaluate if their sustainability risk assessment meets certain quality criteria. A similar freedom can be given to credit rating agencies, when integrating sustainability criteria in their risk assessment processes. This can be a continuous learning process, in which banks, credit rating agencies, supervisors and civil society cooperate to develop better defined and more practical criteria.

3.2 Basic fields of financial regulation

In response to the financial crisis, various steps are taken by the G20, the European Union and others to strengthen financial regulation. Although strengthening financial stability is the overarching goal of all these proposals, they cover three basic fields of financial regulation:³

1. **Prudential regulation:** ensuring stability and soundness of financial institutions by safeguarding capital and liquidity adequacies as well as the quality of their risk management;
2. **Conduct of business regulation:** ensuring that financial institutions conduct business with their customers in a fair, transparent and honest way;
3. **Systemic regulation:** ensuring financial stability and access to finance for businesses and other organisations; preventing the financial system from jeopardising the economy as a whole.

In order to strengthen these three basic fields of financial regulation, banks and other financial institutions should be requested to integrate sustainability criteria in their lending, investing, underwriting and other financial services decision making processes. The following chapter will explore how this approach would strengthen the different fields of regulation.

3.3 Prudential regulation

Integrating sustainability criteria can **improve the financial results** of financial institutions and thereby strengthen their soundness. A large number of studies have considered the correlation between the integration of sustainability criteria in investment decision processes and investment results (see box 4).

Box 4. Sustainability criteria and financial performance

A recent study of the consultancy firm Mercer reviewed 36 scientific studies on the relationship between environmental, social & governance (ESG) factors and financial performance. They concluded that 20 studies found a positive relationship and only 3 studies showed evidence of a negative relationship.⁴ A research report of Deutsche Bank concluded in June 2010: "There are a number of reasons why financial, environmental and social objectives can be consistent with each other and consideration for ESG criteria can increase shareholder value. Moreover, it is likely that the avoidance of environment-related and social risks can reduce the company's reputational risk and its exposure to claims for damages."⁵

Taking sustainability risks into account can **strengthen banks' credit risk management** by improving their understanding of the credit risks of their portfolio and their capacity to deal with these risks. This is of particular relevance in countries such as the United Kingdom, where a secured lender, executing a charge and taking possession of the land, may be liable under the Environmental Protection Act for cleaning up contaminated land.⁶

Besides liability risks, there are other relationships between sustainability risks caused by a debtor and a bank's risk profile. The risk assessment of forms of financing for sectors which have potentially negative environmental impacts, such as the forestry, mining and oil and gas sectors, could benefit from an integration of sustainability criteria – especially when these investments take place in countries with weak regulatory and law enforcement frameworks (such as the DR of Congo or Indonesia).

The social and environmental sustainability of the operations of any company has direct implications for its probability of default. For example, a pulp & paper company relying on illegally logged pulpwood could face significant increase in raw material prices. Monoculture operations which disregard biodiversity could be plagued by plant diseases and other environmental problems. Oil companies ignoring environmental safety requirements could risk a highly expensive and embarrassing oil spill (see Box 5). Companies violating labour rights or human rights could be confronted with conflicts with workers, civil society organisations and the local population, reputational damage, buyers severing ties, public prosecution and court cases.

Box 5. The BP oil spill in the Gulf of Mexico

The April 2010 explosion on the Deepwater Horizon oil rig in the Gulf of Mexico, which was operated by the British oil company BP, not only killed a dozen workers, caused a major oil spill which continued for three months and harmed thousands of small and medium enterprises (such as shrimp farmers) along the Gulf coast. It also resulted in multi-billion dollar claims for clean-up and compensation and caused giant losses among BP's banks and shareholders, including many British pension funds.

In financial risk assessment, environmental catastrophes or major accidents such as this one are often referred to as "black swans": unpredictable events. However, insufficient safety measures on the Deepwater Horizon oil rig were reported and well documented before the blowout. This "black swan" proved black and dirty, but not unpredictable. Recognizing the probability of an environmental catastrophe when business is conducted like it was on the Deepwater Horizon, would have helped financial institutions, in particular pension funds, to better manage these risks. In turn, this might have resulted in higher financing costs for the companies involved, which possibly would have stimulated BP and its contractors to rethink their lax environmental safety scheme.

All such developments are likely to affect the credit rating of the company and its probability of default. A recent scientific study by the Austrian Gesellschaft für Organisation und Entscheidung (GOE) preliminarily confirmed this relationship, stating: “results show that sustainability criteria can be used to predict the financial performance of a debtor and improve the predictive validity of the credit rating process. We conclude that the sustainability a firm demonstrates influences its creditworthiness as part of its financial performance.”⁷

Nevertheless, the credit risk assessment of most banks is still largely based on the business sector and the country in which the company operates - rather than its commitment to sustainability. Putting greater emphasis on social and environmental risks, when assessing new investment opportunities, would reduce the probability of default and strengthen the credit risk management of banks.

Including sustainability criteria in credit risk management would also help banks to **avoid reputational risks**. Civil society organisations and media increasingly expose where the banks are investing, which kind of products they are offering and how harmful these activities are for human rights, biodiversity and other sustainability issues. The involvement of a bank in a non-sustainable lending carries with it severe reputational risk. Publicity around this behaviour can seriously threaten the reputation of the bank and prompt public and private customers to close their accounts and withdraw their deposits. This process can easily bring a bank into serious liquidity problems (see Box 6).

Box 6. The collapse of the Dutch DSB Bank

Continuing negative publicity on very high-premium mortgage products which the Dutch DSB Bank had sold to low-income customers, followed by an influential financial analyst urging bank customers in a television show to withdraw their deposits, created a classic bank run in the fall of 2009. Within days, the liquidity of the bank was drained so strongly, that a collapse was inevitable.⁸

3.4 Conduct of business regulation

Ensuring that financial institutions conduct business with their customers in a fair, transparent and honest way is one of the key objectives of financial regulation. Integrating sustainability criteria in financial regulation will help to achieve this objective, as these criteria provide additional guidance to financial institutions on the conduct of fair, transparent and honest conduct of business. Increasingly, customers expect financial institutions not to be involved in financing producers of controversial weapons, companies severely polluting the environment or employing child labour. Banks trying to sell a savings account to retail customers are expected not only to offer a fair interest rate but also transparency on the “fairness” of their investments.⁹

In response to this public expectation, more and more financial institutions are developing general or sector-specific sustainable investment policies. The quality of these policies rather varied and often does not meet international best practices. Implementation is often not thorough or limited to a very specific niche market.¹⁰ Despite these weaknesses, many financial institutions are making “green” claims and are advertising how very “responsible”, “sustainable” or “environmentally friendly” they are. When these claims are not warranted, based on the quality and implementation of their policies, they might in fact mislead customers with false promises. Financial regulation demanding financial institutions to integrate sustainability criteria in their decision making processes in a structural and controllable way, would help **prevent the banks from making misleading green claims**.

Retail customers also increasingly distrust bankers earning huge bonuses, as they sell financial products which are very profitable for the banks but not for their customers. Banks need to respond to such worries, in order to retain the confidence of the public. Integration of sustainability criteria in decision making processes would force financial institutions to **study the consequences of selling subprime financial products** for the income security of low-income households. Such an analysis would help financial institutions understand the social risks for their customers of such products and would force them to adapt their products and or their marketing strategy.

3.5 Systemic regulation

As abovementioned, more and more financial institutions are developing investment policies on sustainability issues and sectors. The financial institutions taking this development seriously by aligning their policies with best international standards and implementing them in a rigorous way might lose market share in some markets. Companies which have trouble meeting the bank's sustainability standards might decide to choose another financier. To **ensure a level playing field** among financial institutions, integration of sustainability criteria in decision making processes should be a prerequisite for all financial institutions.

Demanding financial institutions to integrate sustainability criteria in their decision making processes and to report on their implementation to their counterparties, to which they sell securities, securitized loans or derivatives, would **prevent contagion of the financial system** and would therefore strengthen financial stability. One of the characteristic of sustainability risks is that they evolve over time and only become acute in the mid- or long-term. Financing a company that bases its business model upon unsustainable practices, such as illegal logging or violation of labour rights, can be profitable and fairly risk-free in the short-term. However, in the mid- to long-term, the company's negligence of basic social and environmental standards is likely to backfire and bring the company in severe financial trouble.

By the time social and environmental risks become acute financial risks, the primary financiers of these companies have often already sold their investments and passed on their financial risks to other institutions. This happens for example, when an investment bank underwrites shares or loans and then sells them to other investors, when loans are securitized and sold, or when credit default swaps and other derivatives are used to pass on the financial risk. The primary financiers involved in such transactions do not have much incentive to analyse the credit risks related to the company's sustainability practices, as the probability of default is very small in the short term. The fact that this probability is likely to increase in the mid- or long-term, renders it irrelevant to the primary financier, as they will have passed on the risks by the time they become significant.

If the primary financier is ignoring sustainability criteria in its risk management and decision making processes, this will not have a large direct impact on this financial institution itself. It can and will, however, have significant impacts on the counterparties of the financier, to which it is selling its investments or derivatives. These counterparties are less able to assess the sustainability risks of these investments. These counterparties will be buying into products which might have a higher probability of default than they assume. In short: ignoring sustainability risks by the primary financier for these type of transactions means that the associated financial risks are offloaded into the financial system, where they can easily backfire and increase systemic risks. An example is provided in Box 7.

Box 7. American subprime mortgages

The American subprime mortgage crisis in 2007 was caused by mortgage banks selling subprime mortgages to low-income households which could not really afford these products. When interest rates went up, house prices fell or people lost their jobs, they could not pay interest and principal anymore. A wave of defaults followed, but this did not hurt the mortgage banks only. Large parts of their portfolio were already securitised and sold to other investors, which were not informed about the high probability of default of these loans on the middle to long term.

If the mortgage banks had been forced to consider sustainability risks in their risk management process and to report on this assessment when they were securitizing their portfolios, they would have been obliged to acknowledge and report that the income situation of many households would result in a high probability of default on the middle to long term. This would have prevented contamination of the financial system with the risks of these subprime mortgages.

Other sustainability risks might not turn into financial risks within the maturity of a credit or investment to either the primary financier or its counterparties and the financial system as a whole. However, also these sustainability risks can ultimately threaten financial stability because of the devastating or destabilizing effect they have on society at large. Examples:

- Investments in businesses that exacerbate climate change, will, in effect, increase costs for many businesses and people and their capacity to repay loans.
- Investments in mining or forestry companies that deprive indigenous people or local communities of their land and means of living, can, in effect, increase political tensions and regional instability.

Taking these sustainability risks into account will ultimately strengthen global financial stability. In a world which has to cope with a growing population and limited natural resources, all investments which ignore the need to achieve sustainable development ultimately contribute to an unstable and unsafe global society. Financial stability is only achievable within a world which is not torn apart by violent conflicts over scarce natural resources and worsening social injustice. Demanding financial institutions to integrate sustainability criteria in their decision making processes would help to avert such risk.

4. Proposals for integrating sustainability criteria in financial regulation

Better and more thorough integration of sustainability criteria in all lending, financing and investment decision making processes of banks and other financial institutions need to be addressed in national, European and international financial regulation. Several current legislative procedures to reform certain areas of financial regulation provide particular opportunities:

- **Capital requirements** - as defined in the Basel Capital Accord II, the recommendations for the Basel Capital Accord III and transposed into the EU Capital Requirements Directive (CRD)¹¹ - force banks to put aside a minimum percentage of their capital to cover for potential defaults of other loans or investments. These current requirements should be modified to ensure that banks better and more thoroughly integrate sustainability factors in all their lending, financing and investment decision making processes. Sustainability risks can and should play an important role in differentiating the risk weighting factors for sectors and types of companies, while leaving the overall capital requirement at the same level.

- **Credit rating agencies** play a large role in guiding financing and investment decisions of banks and other financial institutions. Credit rating agencies should integrate sustainability criteria in all their ratings and other services and should be obliged to prove their knowledge and capacity in these fields as a precondition for their license to operate.
- **Supervisors** should explicitly be assigned with the task of supervising how banks deal with sustainability risks. To meet this task, supervisors should have sufficient knowledge and competences, which should be assured by the relevant authorities. This would not require supervisors to prescribe the sustainability criteria banks should use, but would entail a mutual learning process to develop clear and practical criteria.
- Every country sets requirements on the basic functions that a bank should be able to perform in order for a **banking license** to be granted or renewed. Institutional knowledge and assessment capacity with regard to sustainability risks should be one of these requirements.
- A key element in banking regulation are **approved person regulations**: owners and high-level management of a bank should meet certain integrity, knowledge and capability requirements before they are allowed to take on their position in the bank. Knowledge and capability in the field of sustainability risk should be among these requirements.
- Bank regulations and supervision should demand inclusion of sustainability criteria in **remuneration and bonus systems**. Progress towards integrating sustainability criteria in all lending, financing and investment decision making processes of the bank should be an essential condition in all remuneration and bonus systems.

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