Pillar 1 capital charge for climate risk: Wrong tool for the right purpose

EBF staff paper

Introduction

Two years ago, governments, supervisors and regulators pleaded banks to use their capital, reducing the ratios, in order to keep on financing the economy after the outbreak of the pandemic.
We learnt some lessons:

- The prudential status of the banking system is solid enough to withstand a major unexpected shock.
- However, the EU regulatory framework is too rigid. Too much weight has been put on Pillar 1 measures. So much, that authorities were trapped when their intervention was necessary.
- As a consequence, a regulatory quick fix had to be promptly enacted in order to ease off Pillar 1 measures and let banks play their role as part of the solution.
- Since then, global standard setters, central bankers, prudential regulators and academics, are discussing about how to make the prudential framework more flexible without detriment to its level of confidence. Flexibility means less hardwired regulation and more manageable and targeted prudential tools.

Climate change will bring about new risk considerations. The prudential framework offers multiple tools to tackle them progressively. Some argue that hardwired Pillar 1 capital increases by means of risk-weighted adjustment factors should be imposed. The lesson of the pandemic taught us that Pillar 1 is not the right measure at this point. It would make the regulation more rigid but not more robust.

Transition to low carbon EU economy needs significant and urgent financing

There is lot of focus on the greening of balance sheet of banks today. While investors could divest from certain activities relatively quickly, banks are best placed to work with their clients on decarbonization or exit strategies that may be taking place over longer time horizon – **greening the EU economy while managing and distributing the related risks.**

The EU Platform for Sustainable Finance recently issued report on extended Taxonomy where they are distinguishing the following activities in need of transition finance:

1) Activities requiring urgent transition to avoid significant harm or improve their environmental performance
2) Activities that cannot improve their performance given lack of technological possibilities and that should be either exited or decommissioned. Such activities need investments as part of the decommissioning plan with a Just Transition effort.

While we need to distinguish between urgent transition and urgent exit, both are in need of urgent and scarce financing. Indeed, the European Commission has estimated that the EU-wide net greenhouse gas (GHG) emissions reduction target by 2030 of at least 55% over 1990 levels, will require an annual investment in the energy system 350 billion euro higher in this decade, mainly to replace old power and industrial plants. In addition, the deficit in sustainable investment is assessed between 100 and 150 billion euro per year, and the needs for social investment in 142 billion euro. Altogether, the additional financing effort amounts to 600 billion euro per year until 2030. To put things in perspective, the net flows of funding in the euro area, including bank credit, debt and shares, sums up 460 billion euro per year. The funding needs to meet the EU target therefore exceed the normal funding capacity.

Climate risk can lead to financial losses, but can be managed in an orderly fashion

Assessment, management, transformation and absorption of financial risk is a key expertise and role of the banks that benefit the society at large. Such credit assessment includes the company's ability to repay the loan.

Following the introduction of the regulatory expectations and guidelines in the area of risk management, the existing credit assessment processes will be complemented with ESG related assessment. This is important for banks' risk management, reporting, as well as capital allocation in line with their own strategies and targets (e.g. commitments to align banks' activities with Paris Agreement objectives or SDGs). The risk assessment process will also include forward-looking information such as companies' investment plans as well as transition plans.

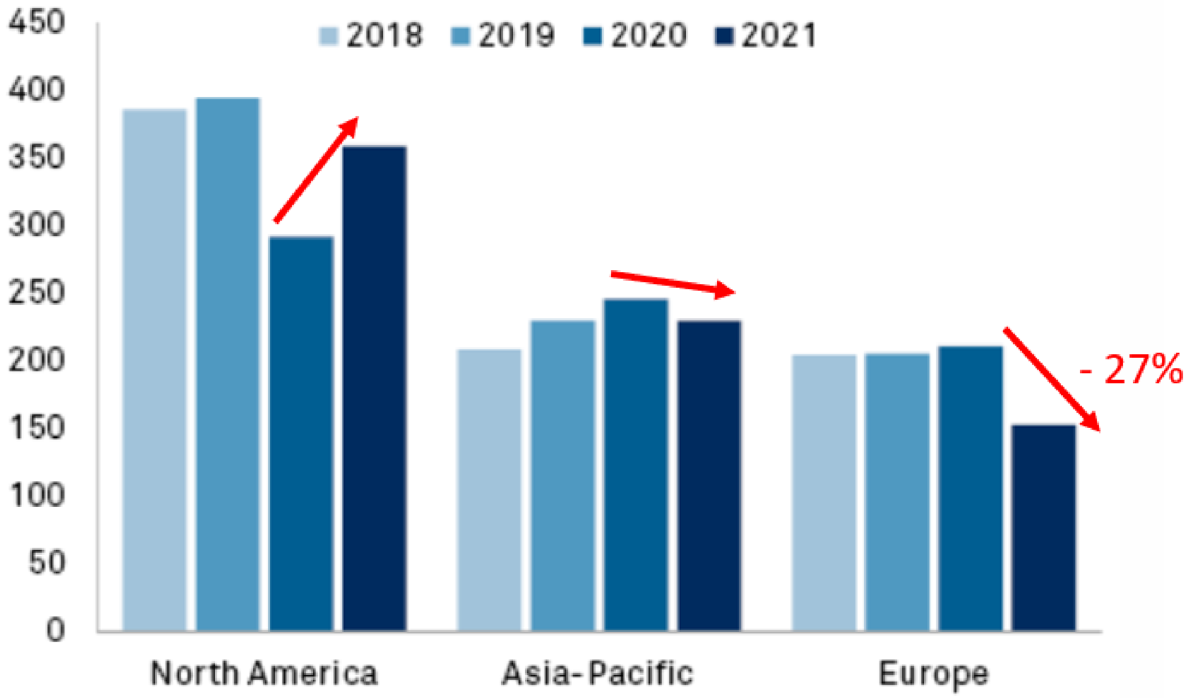
The objective of the prudential framework of banks is to safeguard the soundness of individual institutions and financial system as a whole, ensuring that risks are well understood and managed and banks have enough capital to withstand the unexpected risks. Indeed, in the prudential framework, capital is used to cover unexpected losses. For instance, the effect of the pandemic or the burst of geopolitical crises like the current invasion of Ukraine.

Climate, or even more broadly environmental factors, can lead to financial losses and must therefore be incorporated both in risk management of banks and supervisory framework policies. Climate risk can to large extent be mitigated if the transition is handled in an orderly, transparent and controlled manner. Carbon intensive activities will be gradually reduced alongside with the financing of such activities.

However, to achieve climate neutrality, it is not necessary to stop financing of certain activities or sectors overnight. As acknowledge by the International Energy Agency, the oil and natural gas play critical role in todays' energy and economic systems and will be critical for some key capital-intensive clean energy technologies to reach maturity. As in a marathon, one cannot run the 42 kilometers in 10 minutes. We need to keep the planned end objective, the pace at which to run and check regularly, the adherence to the planned milestones and adjust the rhythm accordingly.

Fossil fuel is often referred to as stranded assets. The term "stranded assets" at this point is misleading. It should be referred to as "assets that could be stranded in the future if the transition plan is not followed". From a risk perspective, indeed transition risk is lowest in a scenario of a predictable, smooth, and orderly transition to a low-carbon economy. In contrast, an abrupt collective withdrawal from certain sectors, if done y at the same time could decrease the viability of such sectors in a short term, exacerbating credit risk and putting at risk financial and social stability. There is already evidence that the financing trend of European banks toward fossil fuel is decreasing significantly. Large European banks cut financing to fossil fuel companies by 27.6% in 2021 setting a clear downward trend that will continue in the next years.

Fossil fuel financing by region ($B)



Data released March 30, 2022.
Analysis covers lending and equity and debt underwriting by 60 of the world's largest banks by total assets to approximately 2,700 fossil fuel companies.

Understanding the impact of policy measures on risk

While it is essential to understand the interrelation of policy and risk measures, meaning clear understanding of the impact of EU or national policy objectives on risks and impact of any risk measures on the policy objectives, the prudential framework measures should remain risk sensitive. As stated by the European Banking Authority1 in the recently issued consultation document, it is key to ensure that the calculation of RWAs is not distorted and to maintain risk-based capital requirements which fulfil their function as safeguards against unexpected losses, hence contributing to safeguarding financial stability.

As accumulated changes in government policies could result in disruption and increase transition risk, full transparency on government policies in the short, medium and long term is necessary for a smooth and orderly transition It is also important to understand how potentially conflicting policies or extraordinary events such as the current war in Ukraine impact

[1] EBA launches discussion on the role of environmental risks in the prudential framework | European Banking Authority (europa.eu)

EU energy industrial policies and social impacts and transition plans of companies.

The prudential regulation cannot however be used to substitute for different direct policy Measures – be it regulation of companies or fiscal measures. For illustration, according to the recent report of the EU Court of Auditors, based on data from before the war in Ukraine, half of the EU governments are still subsidizing fossil-fuels more than renewables. As Mark Carney, UN special envoy on climate action and finance, stated, governments must step up their regulation of businesses to tackle the climate crisis and force industries to follow clear rules, on everything from energy generation to construction and transport and set carbon prices that would drive investment towards green ends and close down fossil fuels. In that sense, banks' role should be understood as supplementary – to support the transformation of the industry and the whole economy including the decarbonization of emission intensive activities.

Capital treatment should not be designed in a way that would penalize entire sectors

Capital treatment should not be designed in a way that would penalize entire sectors, as it cannot distinguish the best-in-class corporates from the laggers, in terms of their alignment with the net zero pathways of their sector.

To manage transition risk and allocate capital, banks need not only greater transparency of government transition plans, but also to understand companies' approaches to transition. Companies setting ambitious carbon reduction targets are facilitating banks' climate-related risks management and helping support a transition to a low-carbon economy. Indeed, a positive assessment of the company's management of these risks will have a positive impact on the risk profile of the bank (taking into consideration forward looking financial robustness of the company).

The credibility of transition or exit plans of companies and understanding of the the impacts on the balance sheet, profit and losses and cash flows in short, medium and long term both at level of companies and activities is crucial for banks. As acknowledged in the consultation paper of EBA, bank lending and investment is made to companies rather than to specific assets or projects and there are few companies that are 'pure green' or 'pure brown' along all the value chain. As companies receive general credit facilities in the form of general-purpose loans or revolving credit facilities provided by banks, transition plans at company level are important. Such general-purpose loans in fact represent the majority of banking transactions in terms of volume and banks' balance sheets and are used by companies to cover diverse corporate expenditures and are not solely related to specific capital investments. These products provide companies with flexibility to finance their day-to-day operations. In the future, we expect growth in the sustainability linked loans which are similar to general purpose loans but where interest rate is linked to the environmental performance of the companies on the basis of achieving certain targets or key performance indicators. These should result in the business of the borrower being more stable and creditworthy, thus justifying possible margin decreases.

Any prudential measure should therefore be risk-sensitive and should not penalize entire sectors.

Why Pillar 1 is not the right tool to address climate risk

While the Pillar 1 framework already enables inclusion of climate risk drivers into internal modes, credit ratings and collateral valuations, it is not easy to address climate risk in the current core risk management processes of banks. While climate risk is not a new risk category and climate factors are drivers of existing risk categories (credit risk, operational risk, liquidity risk…) current risk measure models are not developed for long time horizons. Also, it is difficult to do capital planning for 20-30 years due to the fact that uncertainty increases with accumulated assumptions. It is also difficult to capture the interrelation between physical and transition risk evolutions. Regarding the forward-looking aspect, climate-related events are uncertain and likely to grow over time, their evolution will arguably involve non-linearities and tipping points. As a consequence, the largely backward-looking traditional approach based on historical loss experience will probably fail to capture the forward-looking elements of these risks.

This is also why Pillar 1 approach to climate risk is not optimal and explains the preference, including amongst regulators, to address climate risk through Pillar II which is more flexible and more targeted to the companies and portfolios that are carrying enhanced risk.[2] The EBA also differentiates approaches to address environmental risks within the structure of the prudential framework as opposed to the introduction of a specific risk-weighted adjustment factors. The initial analysis indicates that targeted amendments to the existing prudential requirements would address these risks more accurately compared to such adjustment factors, given various challenges associated with their design and implementation[3].

Introducing Pillar 1 capital charge through adjustment factor is not consistent with the construction of the prudential framework. Setting

[2] E.g. FSI Briefs No. 16: The regulatory response to climate risks: some challenges (bis.org)
[3] https://www.eba.europa.eu/calendar/discussion-paper-role-environmental-risk-prudential-framework

capital today for risks that may materialize after the maturity of the current assets or failing to take into account the transition plans of companies is not justifiable from a risk perspective[4].

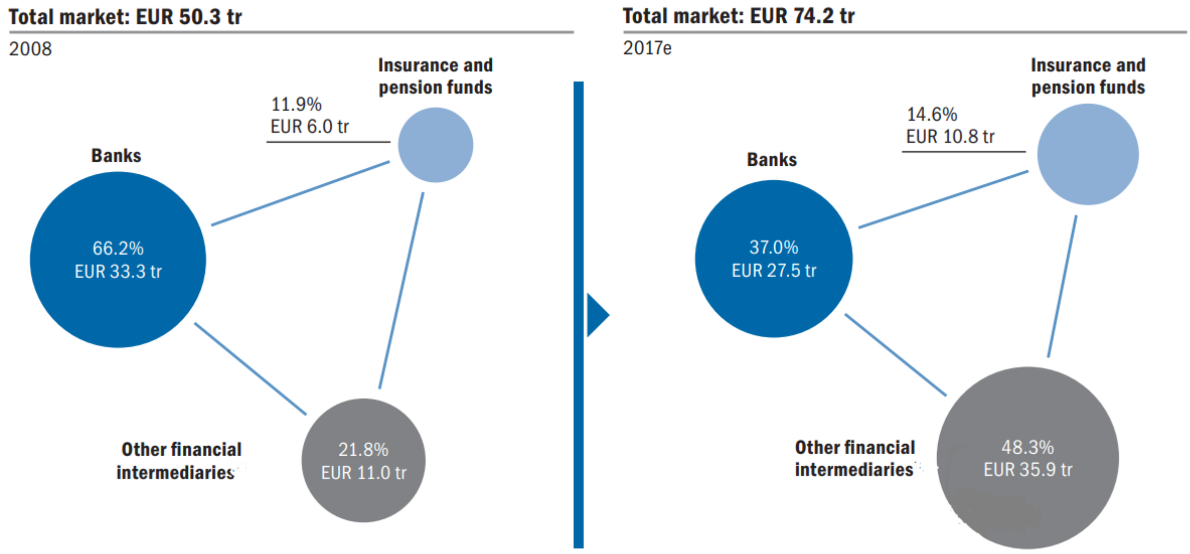
Understanding the impact of risk measures on policy objectives

If we lock Pillar 1 capital today under the presumption that it might be needed in 10 years only if the energy transition goals are not met, that capital will not be available for unforeseen risks that will likely emerge in the meantime. Such Pillar 1 measure will simply reduce the overall lending capacity of banks, detracting scarce funds needed to finance the transition.

To cope with increased capital requirement, banks will have to either increase capital or reduce their balance sheet. The capital increase in turn would mean increased cost of financing. Given that the 2030 emissions target and the net zero goal in 2050 are firmly committed, the demand of funds to finance the transition is very inelastic, therefore one can only expect that a reduction in the supply of funds will push up significantly the cost of the transition. In addition, further increase of the regulatory costs for European banks is unlikely to attract their own investors, making it hard for banks to raise additional capital needed to finance the transition.

In addition, while introducing Pillar 1 capital for e.g fossil fuel financing, both new and existing, will increase the price of capital and reduce the overall lending capacity of banks, it will not reduce the demand for fossil fuel activities. Their funding will be likely served by non-bank financial institutions or non -EU institutions outside of the prudential regulatory perimeter. These days, two thirds of the financial assets are already being managed out of the banking prudential perimeter, and half of the financial assets in Europe are managed by financial intermediaries not subject to regulatory and supervisory requirements as banks. Fighting climate change is a global challenge, which requires global response, coordination and level playing field. Given the interconnectedness of the financial system, introduction of Pillar 1 capital charge for European banks will not safeguard the financial system as a whole, nor protect the European banking sectors.

[4] BCBS Consultative Document - Principles for the effective management and supervision of climate related financial risks Issued for comment by 16 February 2022 (November 2021)



Source: ZEB – European Banking Study 2018

Pillar 1 charges will move financing of fossil fuel to unregulated unsupervised areas or outside the EU. As a result, while the demand for finance will remain the same, a significant part will flee the bank prudential purview, there will be less control over its projected reduction and less lending capacity for banks overall. History may repeat itself, and we might see authorities and supervisors again with their hands tied by a pile of idle Pillar 1 capital required by regulation that is not available for immediate purposes.

Respecting the due process envisaged in CRR/CRD

The due process envisaged in the CRR is to have EBA analyzing the case and issuing a report on the appropriateness of Pillar 1 capital for certain assets. The EBA Discussion paper on this topic has just been issued.

Any potential Pillar 1 measure should be subject of a thorough impact assessment analysis, including considerations whether current capital requirements already adequately capture such risks (as climate risk is part of credit, operational and liquidity risk) or there are significant gaps in the loss absorbing capacity.

Conclusion

A capital increase upfront is the wrong tool for the right purpose. The challenges of climate change and the net-zero target are vast and global. We have embarked in a long journey that will demand a lot of finance and banks are a crucial partner to get there, because banks are close to their clients and should be permitted to help businesses navigate through the transition to net zero. Increasing capital requirements at this point would only detract money from the economy that is so needed to finance the transformation of consumption patterns and production methods.

About EBF

The European Banking Federation is the voice of the European banking sector, bringing together national banking associations from across Europe. The federation is committed to a thriving European economy that is underpinned by a stable, secure, and inclusive financial ecosystem, and to a flourishing society where financing is available to fund the dreams of citizens, businesses and innovators everywhere.

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