



**Research** Jan Willem van Gelder (Profundo), Myriam Vander Stichele (SOMO)  
**Editor** Daniel Pentzlin (FoEE), [daniel.pentzlin@foeeurope.org](mailto:daniel.pentzlin@foeeurope.org)



Available for download at [www.foeeurope.org/finance](http://www.foeeurope.org/finance)

This publication has been produced with the financial assistance of Oxfam Novib, the Isvara Foundation, the Dutch Ministry for Development and the European Commission (DG Environment). The contents of this report are the sole responsibility of Friends of the Earth Europe (FoEE), BankTrack, CRBM and Berne Declaration, and cannot be regarded as reflecting the position of the funders mentioned above. The funders cannot be held responsible for any use which may be made of the information this production contains.

Friends of the Earth Europe (FoEE), Rue d'Edimbourg 26, 1050 Brussels, Belgium  
Tel: +32 2 893 1000, fax: + 32 2 893 1035, e: [info@foeeurope.org](mailto:info@foeeurope.org) [www.foeeurope.org](http://www.foeeurope.org)

# Sustainability criteria in banking rules:

## How to integrate sustainability in capital requirements

March 2011

### Executive summary

In 2011, the European Union will discuss legislation to implement the revised Basel Capital Accord ('Basel III'): This is the so-called 'CRD IV' (Capital Requirement Directive IV) decision-making process. Basel III intends to improve banks' resilience to financial crises. This report provides constructive arguments that if the EU incorporates social and environmental criteria in the new standards, banks' risk management and decision making processes, it will more effectively promote financial stability and be more capable of addressing diverse challenges banks are facing now and in the future. Moreover, such regulation would stimulate the financial sector to contribute to a more ecologically and socially sustainable, economically just and peaceful world. Sustainability criteria in capital requirements will encourage banks to better align their operations with economic, social and environmental needs. Regulators and supervisors who develop regulatory and supervisory tools should improve their understanding of sustainability risks.

This report calls upon the EU to complement its proposals for a new capital requirements legislation with provisions that ensure banks integrate sustainability criteria in their lending, financing and investment decision making processes:

### **1. Capital requirements: improving the quality of capital reserves**

→ Banks should be required to integrate social and environmental sustainability criteria in their credit risk assessment system. Banks using the internal rating based approaches should differentiate risk weighting factors for various categories of borrowers according to their level of sustainability. As sustainable borrowers have a lower probability of default, their risk weighting factor should be lower. Non-sustainable categories with a higher probability of default should have higher risk weighting factors. Banks using the standardised approach should only use credit rating agencies that integrate sustainability criteria in the credit rating process and in determining risk weighting factors. As this proposal would not affect the overall capital reserve level, it would advantage banks focussing primarily on sustainable borrowers.

### **2. Counterparty credit risk: assessing the sustainability risks**

→ Banks that engage in, or finance, (agricultural) commodity derivatives, foreign exchange derivatives and credit derivatives should assess the sustainability risks of these derivatives. This should lead to appropriate high risk weighting factors.

→ Sustainability impact assessments of derivatives (e.g. impact of the trading itself, impact on counterparties) should be undertaken by supervisors or by the originators of the derivatives.

### **3. Specific and penal capital requirements: avoiding sustainability hazards**

→ Specific and penal capital requirements should be considered for banks providing credit to companies grossly violating environmental and human rights standards, as well as for banks financing other investors that invest in such companies, such as private equity funds.

→ Banks exposed to, or financing, commodity, credit and foreign exchange derivatives trades, as well as any kind of OTC derivatives, which have no hedging purposes and stimulate excessive financial speculation, could be required to hold specific and penal capital requirements, especially in times of high volatility and high prices.

### **4. Liquidity standards: avoiding unsustainable liquidity stress and liquidity buffers**

→ Liquidity stress should be avoided by ensuring that all risk management assesses if specific loans, investments or financial products are contrary to principles of sustainable and socially equitable development.

→ The assets held as liquidity buffers need to undergo risks assessments that include core social and environmental criteria.

### **5. Countercyclical measures: adding sustainable preventive measures**

→ Banks should reduce their unexpected losses by integrating sustainability criteria in their risk assessment procedures, which would have implications for the subject of through-the-cycle provisioning.

→ Banks should be demanded to assess the probability of default of credits and financial products over their entire maturity or lifetime; they should include sustainability risks in this analysis, also when they are underwriting issuances or securitizing credits. The results of this analysis should be made available to the buyers of the securities or credits.

### **6. Single rule book in banking to allow additional sustainability criteria**

→ When no agreement can be reached on the EU level with regard to the aforementioned proposals to integrate sustainability criteria in financial regulation, each European member state should be allowed to add specific tailor-made requirements to integrate social and environmental criteria in risk assessments and capital requirements.

→ Each member state should still have the authority to require bank branches in its jurisdiction to publish additional information on sustainability issues.

### **7. Sustainability impact assessment of CRD proposals**

→ All CRD IV impact studies should evaluate whether sustainability impacts are being fully integrated and whether the financial sector will be reformed into a positive force that supports sustainable development on a global scale. An independent and qualified institute should be assigned to undertake such a study.

## 1. Towards implementation of Basel III at European level

After the different elements of the third Basel Accord ('Basel III') have been decided at the end of 2010, the European Commission announced to propose implementing legislation by June or July 2011. The proposal to implement Basel III at EU level can take the form of a regulation, a directive, or – most likely – a combination of a regulation (for pillar 1: capital requirements) and a directive (for pillar 2: supervisory review). For the moment, this EU process is referred to as 'Capital Requirements Directive IV' or 'CRD IV'.

Basel III complements Basel II to a large extent. It deals with advancing the quality and quantity of capital buffers of banks in order for them to better cope with stress and crisis situations. The capital reserve - already included in Basel I and II - should consist only of high-quality capital reserves (defined as common shares of the bank and retained earnings). Basel III introduces specific buffers against a lack of liquidity and the impact of swings in economic cycles, as well as a leverage ratio to limit risks of too much lending (leverage) by banks.

Basel III hardly deals with the risk assessment methodology introduced in Basel II, except for the risks from derivatives trading. Basel III defines how to assess the risks from counter parties when a bank itself is engaged in derivatives contracts as well as the risks from lending to entities that are trading in derivatives, including high leveraged counter parties or entities (e.g. hedge funds). This should improve the resulting necessary capital reserves a bank is holding for its exposure to such "counterparty credit risks".

In the following chapters, this report provides specific proposals on how the quality of capital buffers and risk assessments could be strengthened beyond the new financial safeguards introduced in Basel III. Financial stability measures that exclude social and environmental risks are inadequate to deal with all challenges which banks face now and in the future. Such measures will ignore how to anchor banks operations' in the economy and society. The proposals in this report therefore respond to an urgent need in the economy and the society as a whole to redirect more financing to forms of production and consumption that are socially and environmentally sustainable.

The report follows the argumentation that, by requiring integration of social and environmental criteria into banks' risk assessment models and those of credit rating agencies used by banks, banks would be less exposed to defaults and less prone to situations of financial stress. For instance, current lending by ethical banks to non-for-profit and cooperative entities does not only create jobs for a lot of people and contribute to sustainable development, it also has a record of low loan default rates (the average default rate at ethical banks is a fourth of the average rate of major commercial banks).

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 how to avoid negative social and environmental consequences by their investments and how to focus on investments which contribute to environmental sustainability and social justice. The Ten Principles of the UN Global Compact provide a first starting point, 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.<sup>1</sup>

Supervisors at EU and national levels could play an important role in requiring banks to improve the criteria they use to assess risks, including in stress testing and back testing models. Improved understanding of sustainability risks would help supervisors to adjust supervisory and regulatory tools and better maintain financial stability. Thus, the policy proposals in this paper are both relevant to the capital requirements (pillar 1 of the Basel Accords) as well as to the supervisory requirements for banks' risks assessment systems (pillar 2). The liquidity and leverage ratios that are currently being introduced have a transition period during which these ratios will be evaluated. Thus, it is possible to introduce and review the liquidity ratio proposals of this report during the transition period and to include them in the new standards to be implemented after the transition period.

## 2. Capital requirements: improving the quality of capital reserves

In order to improve the quality of the capital reserves of a bank, Basel III requires that the core part of the reserves needs to consist mainly of the common shares of the bank plus its retained earnings. However, in order to avoid unexpected profit losses and maintain or increase the market value of the bank's shares, the bank needs not only to increase and improve its buffers. It also needs to improve its risk assessment systems to include social and environmental risks. By excluding these risks, banks increase their exposure to defaults, reputational risks, claims for damages, and even less employee loyalty, which ultimately affects the bank's results.

Box 1: The pulp producer Asia Pulp & Paper became unable to service its US\$ 13.9 billion debt in 2001 after the government cracked down on illegal logging in the region. The company had expanded its capacity far beyond what its wood plantations could sustain. That remains the largest ever default by a single company in an emerging country,<sup>2</sup> exposing the banks to serious losses.

- Under Basel III, as under Basel II and the EU's Capital Requirement Directives (CRDs), large banks can choose to have their own models (Internal Ratings Based (IRB) approaches) to assess the credit risks (risks of default) of each loan and transaction. The assigned credit risks determine - through the risk weighting factor - the amount of capital the bank needs to reserve for each loan or transaction, while the bank needs to be in line with the overall capital requirements per category of loans as defined by Basel II and III. A bank using one of the IRB approaches has to assure supervisors that the credit risk assessment system of the bank meets certain strict minimum data, validation, and operational requirements (as explained in the 'Pillar 2' of the Basel Accord).

→ Banks should be required to **integrate social and environmental sustainability criteria in their credit risk assessment system as part of their IRB approaches**. Concretely, banks should differentiate various categories of borrowers (e.g. companies according to the sector and/or country in which they operate) and divide each category in two or more groups, according to their level of sustainability. For each group, a different probability of default (PD) should be assessed, determining the risk weighting factor for this group. The categorisation into groups according to their sustainability performance will need, and should encourage, improvement in the existing disclosure by borrowers on the social and environmental operational risks they face. As sustainable borrowers have a lower probability of default, their risk weighting factor should be lower. Non-sustainable categories with a higher probability of default should have higher risk weighting factors. As this proposal would not affect the overall capital reserve level, it would advantage banks focussing primarily on sustainable borrowers. 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. Supervisors should check if banks meet minimum data, validation, and operational requirements to be able to integrate sustainability criteria in the credit rating process.

- Small and mid-sized banks that have to use the Standardised Approach under Basel II and Basel III, determine the credit risks according to risk assessments and resulting ratings made by credit rating agencies (CRAs such as S&P, Moody's and Fitch) and by export credit agencies (ECAs) for 'sovereign risks' i.e. credit risks of governments. CRAs and ECAs have to meet strict criteria before banks are allowed to use their credit ratings under the Standardised Approach.

→ Additional criteria that should be required from Credit Rating Agencies (CRAs) and Export Credit Agencies (ECAs) before they can be used for the Standardised Approach: They should have knowledge of sustainability issues and integrate sustainability criteria in the credit rating process (see below: accompanying legislation of credit rating agencies). For instance, they should take into account that non-for-profit and cooperative borrowers not only provide jobs for a lot of people and contribute to sustainable development, but also have a lower than average loan default rate. How exactly to integrate sustainability criteria in the credit rating process, is not necessarily to be prescribed by the regulator and can be part of a continuous learning process. Supervisors should check if CRA's meet minimum data, validation, and operational requirements to be able to integrate sustainability criteria in the credit rating process.

### **Continued regulation of credit rating agencies (CRAs) accompanying the capital requirements directive (CRD IV): apply according sustainability criteria**

New EU Regulation on credit rating agencies (CRAs) agreed in 2009 and 2010 aims at improving the quality of credit ratings. In addition, the European Commission issued a consultation in November 2010<sup>3</sup> about further more fundamental changes in CRA regulation. So far, the proposals ignore that the quality of credit ratings will be strongly enhanced if social and environmental sustainability criteria would be included in the ratings of CRAs.

→ Further regulation of CRAs should include that CRAs should have the knowledge, frameworks and capacity to include social and environmental sustainability criteria in credit ratings and assess the (low) default rate of non-profit and cooperative borrowers.

→ The European Securities and Markets Authority (ESMA) should issue guidelines on the common standards for assessing compliance of credit rating methodologies with the requirements set out in Article 8(3) of the *Regulation on credit rating agencies (CRAs)*.<sup>4</sup>

### **3. Counterparty credit risk from derivatives: assessing the sustainability risks to increase capital requirements**

Basel III provides for better risk assessments and risk management, which should lead to higher than current capital requirements, when banks are trading in derivatives and securities markets as well as when banks are lending to derivatives traders. The financial crisis has shown the enormous risks of 'counter parties' in derivatives contracts with banks, as well the risks of borrowers, in particular the highly leveraged hedge funds.

Financial regulation focuses on assessing only the financial risks of exposure to counterparties and borrowers engaged in derivatives. However, not all derivatives have the same functions and effects. Some derivatives have particular social, environmental and economic risks, especially commodity derivatives, credit derivatives and emission allowance derivatives. By not measuring social and environmental risks of such derivatives, the counterparty risk is underestimated, as was the case of credit default swaps (CDS) related to sub-prime mortgages. These derivatives can therefore directly or indirectly affect financial stability. Not only do speculating parties in the derivative trade and the clearing houses have no or little information on, or interest in, the social and environmental risks of underlying assets or markets etc. on which the derivatives are based. More importantly, derivative trading itself creates social and environmental risks.

The following are examples of social and environmental risks of derivatives and their trading:

- **Credit derivatives**

The social and economic and even monetary impacts of credit default swaps (CDS) have become clear during the sub-prime mortgage crisis. The offering of non-transparent ('OTC') CDS resulted in more sub-prime mortgages to be sold in an unfair way to low-income people. When interest rates went up, default followed and many people lost their homes. When the CDS issuers could no longer fulfil all the due payments, a total mistrust led to a stop in interbank lending. During the Greek budget crisis, the role attributed to CDS against Greek bonds resulted in making credits to Greece and Greek sovereign bonds more expensive, aggravating the Greek crisis and its social consequences (e.g. cuts in public services).

- **Agricultural commodity derivatives**

The increased speculative investment and trading in agricultural commodity futures, and the related services by banks (e.g. index funds), have played a role in the significant increases in food and agricultural prices during 2008<sup>5</sup>. Price increases then resulted in riots by low-income groups in poor and food importing countries. Indeed, too high food prices breach poor people's right to food as defined in the Universal Declaration of Human Rights. The influence of increasing and excessive financial speculation in agricultural commodity derivative trading continues to risk

disruption of these markets and to risk volatile and higher food prices – a risk that could affect again food consumption and production after prices peaked again in 2011. This could lead to social, economic, political and financial instability. Moreover, none of the derivatives trading assesses whether the commodities of the underlying contracts are being sustainably produced and transported.

Box 2: At the European Parliament hearing, before his appointment as the new Commissioner for the EU's Internal Market and Services, Michel Barnier said in January 2010: "Speculation in basic foodstuffs is a scandal when there are a billion starving people in the world".<sup>6</sup>

- **Energy and metal derivatives markets**

Financial speculation on energy (oil, gas) and metal derivatives markets can also contribute to volatility and increases in prices of energy and metals.<sup>7</sup> This can have important economic consequences such as impacting on inflation. Social consequences can follow when high energy prices make energy inaccessible to the poor and fertilisers too expensive to poor farmers. Also, metal prices driven up by speculation can encourage more socially and environmentally harmful activities for mining, such as driving communities off their land for swift production increases.

- **Foreign exchange derivatives**

Foreign exchange derivatives can be used to speculate against currencies from developing countries, and are currently playing a role in the increasing value of emerging countries' currencies. Speculation against a country's currency can have enormous economic and financial - and consequently social and environmental - impacts in a country. In addition, banks selling foreign exchange derivatives can have harmful effects (see box).

Box 3: Banks are selling foreign exchange derivatives to small exporters in developing countries, often without explaining all the risks. After unexpected movements in foreign exchange, exporters in developing countries like Brazil and India (Tirupur<sup>8</sup>) lost huge sums and some (near) bankruptcies made many workers unemployed.

- **Emission allowance derivatives**

Derivatives that are based on carbon trading and offsetting projects are called emission allowance derivatives and often categorised with commodity derivatives. There are so far no regulations in place to avoid that emission allowance derivatives, and their incorporation in commodity indexes, might increase and potentially lead to a bubble in carbon trading, which would undermine the functioning of carbon trading. Moreover, the environmental benefits of carbon trading and carbon offsetting projects are being disputed, let alone when speculators would become important beneficiaries.

The underestimated and undesirable potential social, environmental and economic impacts of derivatives and their trading mentioned above might eventually undermine the value of the underlying commodity asset or index. Also, by not taking sustainability issues into account, exposure to counterparty risks or risks of default by borrowers who engage in such derivatives might be completely wrongly assessed.

→ Banks that engage in, or finance, the above mentioned derivatives trade should be required to hold higher capital reserves. They should assess sustainability risks of these derivatives (e.g. impact of trading, impact on counterparties), and in particular their potential social and environmental impacts on the underlying assets, leading to appropriate high capital reserves.

→ Supervisors should be entrusted to do their own thorough sustainability impact assessments of derivatives. Alternatively, they should require sustainability risk assessments to be conducted by originators of derivatives, with according consequences for capital requirements.

→ Bank exposures to large, highly leveraged or highly interconnected financial firms that engage in credit derivatives, commodity and foreign exchange derivatives and their index related investment instruments, should face higher capital requirements than for other counterparty credit risks.

### **Accompanying regulation of central counterparties (CCPs): include sustainability criteria**

The way how central counterparties (CCPs) that clear derivatives have to be regulated, is being decided in 2011 by the European Parliament and the Council of Ministers of Finance through the regulation on OTC derivatives, central counterparties and trade repositories.<sup>9</sup> In addition, the EC and the Basel Committee are holding consultations beginning 2011, how to assess counter party credit risks of CCPs.

→ The new legislation on CCPs should apply higher collateral ('margins') for commodity derivatives, credit derivatives, foreign exchange derivatives and emission allowance trading derivatives. Collateral should also be prohibitively higher for OTC traded derivatives as well as derivatives traded for pure financial speculation (see above), compared to derivatives for hedging purposes in which one party is a producer or an end-user (e.g. of commodities).

## **4. Specific and penal capital requirements to avoid sustainability hazards**

In its July 2009 Working Document on CRD IV, the European Commission made an interesting proposal on the issue of residential mortgages denominated in a foreign currency: "Given the failure of guidelines or other 'soft law' approaches, it is now appropriate to consider specific and penal capital requirements to discourage credit institutions throughout the credit cycle from granting foreign currency loans to private households."<sup>10</sup> The same argument holds true for discouraging financial services to companies grossly violating environmental and human rights standards.

Almost all corporate activities create social and environmental risks, which should be managed in an appropriate way by the companies concerned. By integrating sustainability risks in credit risk assessment (as proposed in chapter 2), banks would have a strong incentive to stimulate borrowers to take such appropriate measures.

While this approach would cover all of the bank's corporate lending activities, it would not prevent banks from lending to a small minority of companies which grossly violating environmental and human rights standards - especially when these companies are above-average profitable. As the activities and products of these companies undoubtedly have very negative social and environmental consequences, lending to them creates sustainability *hazards* rather than *risks*. To prevent these sustainability hazards from occurring, it is appropriate to consider specific and penal capital requirements.

#### **Box 4: Banks and Human Rights:**

Guidelines such as the UN Global Compact, the UNEP FI statement and the Equator Principles have failed to prevent banks from financing companies, which grossly violate environmental and human rights standards. Many such cases are documented in the "*Dodgy Deals*" repository of BankTrack.<sup>11</sup> Another example is provided by companies exporting arms to Libya and other countries that face severe civil unrest. Various banks and pension funds have financed these arms exporters, while it was well-known that they supplied arms to the dictatorial regime of Gadaffi.<sup>12</sup>

→ Specific and penal capital requirements should be considered for banks providing credit to companies grossly violating environmental and human rights standards, e.g. through illegal logging or arm supplies to dictatorial regimes. Such specific and penal capital requirements should also apply to indirect investments, for instance financing of hedge funds and private equity funds, in such companies or projects.

→ Banks exposed to, or financing, commodity, credit and foreign exchange derivatives trades that serve purely for financial speculation rather than hedging risks (of producers and end-users) could be required to hold higher capital requirements, especially in times of high volatility and high prices. In general, bank financing of hedge funds that engage in derivative trading should be strongly discouraged through prohibitive high capital requirements.

→ Given the problems due to the lack of transparency in OTC derivatives trade (90% of all derivatives trade), bank exposures to, or financing of, non-cleared or other non-transparent OTC derivative trades should lead to much higher capital requirements than proposed in Basel III.

## 5. Liquidity standards: avoiding unsustainable liquidity stress and liquidity buffers

The Basel Committee has introduced an observation period to introduce and test two new liquidity standards that banks should meet to prepare themselves for a stress situation in which liquidity is not easily available or being withdrawn. According to the Liquidity Coverage Ratio (LCR), banks must hold sufficiently large and sufficiently liquid reserves to cope with a 30-day stressed cash outflows. These buffers must at least consist of 60% government securities (bonds, etc.). The Net Stable Funding Ratio (NSFR) intends to change the banks' funding model to reduce their dependence on short term lending and improve the matching between their lending and borrowing periods.

Bank liquidity stress can be caused by various reasons, such as external factors which are beyond the bank's control (such as a crisis on the financial markets). However, liquidity problems are more caused by the banks own financing, servicing and investment behaviour than generally is assumed, and can thus be controlled by the bank. When a bank is involved in non-sustainable lending behaviour, this may cause severe reputational risks that lead to liquidity stress. Civil society organisations and media in various countries increasingly expose which companies banks are financing, which kinds of financial products they are offering and which social and environmental risks are related to these activities. This publicity can seriously threaten the reputation of the bank and stimulate public and private customers to close their accounts and withdraw their deposits. This process can easily bring a bank into serious liquidity problems.

Box 5: The Dutch DSB Bank collapsed in the fall of 2009 after continuing negative publicity on very high-premium mortgage products which the bank had sold to low-income customers. After many complaints were left unheard, an influential financial analyst urged bank customers in a television show to withdraw their deposits. This created a classic bank run. Within days, the liquidity of the bank was so much drained that the bank went bankrupt.<sup>13</sup>

→ In addition to setting liquidity standards to be better prepared for a liquidity stress, it is essential to avoid a liquidity stress. A bank's lending, financing, servicing and investment policies should be changed and the risk management procedures amended so as to assess if specific loans, investments or products are running against the principles of sustainable and socially equitable development.

→ Also, the assets held as liquidity buffers need to undergo risks assessments that include core social and environmental criteria.

→ These new risk assessment requirements should be introduced during the observation period and assessed before the liquidity ratio's are being decided.

## 6. Countercyclical measures: adding sustainable preventive measures

Basel III requires that banks set up a countercyclical capital buffer regime to build up capital in good times to be used when a bank faces losses in bad economic times (a compulsory conservation buffer of 2.5% of risk weighted assets) and to help protect banks against too rapid credit growth (an optional countercyclical buffer up to 2.5% of risk weighted assets).

The concept of through-the-cycle provisioning is sound, but in the methodology the distinction between expected and unexpected losses should be rethought. Many losses which are classified as unexpected at present by banks, could actually be reclassified as expected losses. When a bank sells high-interest mortgages to households without a stable income, the resulting losses – including for those further down the securitization chain – should not be categorized as unexpected. Similarly, when a bank lends heavily to a pulp producer expanding its capacity far beyond what its wood plantations can sustain, the bank should expect losses when the government cracks down on illegal logging in the region (see box 1).

→ As part of the guidelines on through-the-cycle provisioning, a historical mortality study and back testing of the default rates of a number of large international banks should be undertaken. The study

should categorise all international loans in vulnerable sectors - forestry, mining, electricity, oil and gas, agriculture - again, using sustainability indicators. This study should test the assumption that - within a given sector - default rates for sustainable companies are significantly lower than default rates for non-sustainable companies. If this assumption holds true, banks can reduce their unexpected losses by integrating sustainability criteria in their risk assessment procedures. This would also have implications for the subject of through-the-cycle provisioning.

Beyond direct financial countercyclical measures, banks should prevent themselves from transferring long term risks into the system. Banks that provide financial services such as underwriting, selling securities and securitizing loans should widen their risk assessments. Banks should also do so when buying credit default swaps as an insurance against defaults of the loans they provide. They should not only assess the direct financial risks for the bank itself, but also the direct financial *and* non-direct (sustainability) risks which are passed on by the bank to the wider financial system.

→ Banks should be demanded to assess the probability of default of credits and financial products over their entire maturity or lifetime and they should be demanded to include sustainability risk in this analysis, also when they are underwriting issuances or securitizing credits. The results of these assessments would have to be disclosed to the responsible supervisory agency and made known to the financial institutions and investors that are buying securities, securitized loans, CDS, and other products.

## **7. Single rule book in banking should allow additional sustainability criteria**

Regarding the implementation of EU capital requirement legislation based on Basel III at national level by the member states, the European Commission intends to remove additional requirements and options at national EU member state level. Aiming for maximum harmonisation is welcome with regard to providing level-playing-fields and harmonising markets. Indeed, it is preferable that sustainability risks are included in capital requirements regulations on the EU level. However, if this is not feasible, the second-best option would be to leave open the possibility of introducing additional important national requirements with regard to sustainability.

→ European member states should be allowed to add specific tailor-made requirements to integrate social and environmental criteria in risk assessment and capital requirements. Especially if the above proposed sustainability requirements are not being firmly integrated into financial regulation on the European and international levels, governments and supervisors of European member states should still have the authority to introduce such sustainability requirements in their national financial regulations. The urgency to reform the present economic development into a sustainable direction and the important role financial institutions have to play in this process, justifies this exception to the proposed single rule book.

In the July 2009 Working Document on CRD IV, the European Commission also proposed to simplify the Bank Branch Accounts Directive.<sup>14</sup> The simplification would prohibit any member state to require that branches of banks or other credit institutions with their head offices in other Member States, to publish additional information than what is required from the parent established in other Member States.

→ In line with the proposal to keep flexibility in the single rule book discussed above, governments of member states should still have the authority to require bank branches in their jurisdiction to publish additional information on sustainability issues.

## **8. Sustainability impact assessment of CRD proposals**

In preparation of the new EU capital requirement legislation ('CRD IV') and to accompany the European Commission's presentation of the CRD IV proposal, impact studies are being carried out, such as the quantitative impact study<sup>15</sup> by European supervisors, to assess the aggregate effect of the

revisions of the CRD proposed. In the past, the assessment of the environmental and social effects have been non-existent in the impact studies of the European Commission accompanying new legislative proposals of CRD II and CRD III<sup>16</sup>, and such assessments have been minimal for other financial legislative proposals<sup>17</sup>.

→ Beyond assessing the financial and economic impact, all CRD IV impact studies should evaluate if these revisions contribute to the wider goal of reforming the financial sector into a positive force that supports sustainable development on a global scale.

→ An independent and qualified institute should undertake an additional, qualitative assessment of the proposed revisions. It should evaluate in an objective way the effectiveness of the proposals of the European Commission as well as whether sustainability impacts are being fully integrated and whether the proposals in this paper could be integrated.

-----

## Endnotes

- 1 For an extensive discussion of standards for the most crucial sectors and important issues, see: BankTrack, "Close the Gap - Benchmarking investment policies of international banks", BankTrack, April 2010.
- 2 E. Matthew and J.W. van Gelder, "Paper Tiger, Hidden Dragons - The responsibility of international financial institutions for Indonesian forest destruction, social conflict and the financial crisis of Asia Pulp & Paper", Friends of the Earth England Wales and Northern Ireland, May 2001; Shari, M., "Asia's Worst Deal", Business Week, 13 August 2001.
- 3 European Commission, Public consultation on credit rating agencies, 5 November 2010 (deadline for the consultation was 7 January 2011).
- 4 European Union, Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, Official Journal of the European Union, 17 November 2009.
- 5 For the role of financial speculation in agricultural commodity derivatives plaid in the food price hikes in 2007-2008, see for instance: J. Baffes and T. Hanniotis (2010), "Placing the 2006/08 commodity price boom into perspective", World Bank Policy Research Working Paper 5371, July 2010.
- 6 European Parliament, "News", European Parliament, 12 January 2010.
- 7 J. Chevalier, "Rapport du groupe de travail sur la volatilité des prix du pétrole", Ministry of Economic, Industrial and Employment Affairs, February 2010: . The report pointed out that derivative speculation caused volatility and systemic risks in oil markets in 2008.
- 8 K. Singh, Fixing Global Finance, 2010, p 72-73.
- 9 European Commission, Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories, (COM(2010) 484 final, 15 September 2010).
- 10 European Commission, "Commission Services Staff Working Document - Possible Further Changes To The Capital Requirements Directive", European Commission, 24 July 2009.
- 11 See BankTrack's website: <http://www.banktrack.org>
- 12 Eerlijke Bankwijzer, "Stop investeringen in wapenbedrijven die leveren aan Libië!", Eerlijke Bankwijzer, 23 February 2011; Profundo, "Investments of Dutch pension funds in EADS, BAE Systems and Finmeccanica", Profundo, 24 February 2011 (<http://www.profundo.nl/files/download/RTL1102.pdf>).
- 13 NRC Handelsblad, "DSB: Een chronologie van 'De Snelle Belofte Bank'", NRC Handelsblad, 9 October 2009.
- 14 Council Directive 89/117/EEC of 13 February 1989 on the obligations of branches established in a Member State of credit institutions and financial institutions having their head offices outside that Member State regarding the publication of annual accounting documents
- 15 See: <http://www.eba.europa.eu/Publications/Quantitative-Impact-Study.aspx>
- 16 See the impact assessments by the European Commission accompanying the CRD II and CRD III proposals in 2008 and 2009 respectively: [http://ec.europa.eu/internal\\_market/bank/docs/regcapital/impact\\_assessment\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/regcapital/impact_assessment_en.pdf); [http://ec.europa.eu/internal\\_market/bank/docs/regcapital/com2009/impact\\_assesment\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/impact_assesment_en.pdf)
- 17 See for instance: European Commission, Commission staff working document – Impact assessment accompanying document to the proposal for a regulation of the European Parliament and the Council on OTC derivatives, central counterparties and trade repositories, SEC(2010) 1058/2, Brussels, [15 September 2010], [http://ec.europa.eu/internal\\_market/financial-markets/docs/derivatives/20100915\\_impact\\_assessment\\_en.pdf](http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20100915_impact_assessment_en.pdf) : the social and environmental impact is very generally assessed in 5 sentences.