Global Risk Regulator

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Contents

2 European Commission's capital requirements review sparks mixed responses
8 EU sets out capital plan for qualifying securitisations
10 Markets race to avoid cyber risk overload
12 US regulatory round-up
14 New CVA framework still leaves accounting gaps
16 Data gaps initiative runs into confidentiality fears
17 Substitute trading eludes market abuse rules
Newsroom (18-21) EU mulls radical EMIR overhaul; Concerted push to modify leverage ratio; Insurers question higher loss absorbency; China removes key bank ratio; Call for greater regulatory coordination in China; Request for extra research on bank ratios; EU ducks hedge fund equivalence decision; CFTC commissioner Wetjen steps down
22 Infrastructure revisions touch wider Solvency II debate

Environmental risk pushes onto financial stability agenda

The G20 and UN are keen to find a way to incorporate sustainability issues into financial regulation.

By Philip Alexander

With the UN summit on climate change approaching in Paris in December 2015, there is growing pressure for bank regulators to integrate environmental risk into the supervisory process. In their April 2015 communique, the G20 governments called on the Financial Stability Board (FSB) to "convene public and private sector participants to review how the financial sector can take account of climate-related issues".

The FSB will be able to draw on extensive work undertaken by the UN Environment Programme (UNEP). In January 2014, UNEP initiated an inquiry into the "design of a sustainable financial system", which has already issued a number of working papers and is intended to complete its work in time for the Paris summit.

Achim Steiner

"We have initiated the inquiry in order to examine both best practice and emerging innovations across the world that demonstrate that aligning our financial system with the objectives of sustainable development is no longer just a hypothesis or a theory. It is already happening, both in response to the emerging needs for a different kind of economy in the future, but also to the opportunities," UNEP executive director Achim Steiner said in July 2015.

UNEP runs a finance initiative *to page 4*

SEC presses for internal whistleblower protections

North American regulators are expanding whistleblower programmes, but European whistleblowers say more needs to be done to protect them. *By Charles Piggott*

US regulators have done much recently to promote whistleblowers and sing of their bravery. With each financial award made by the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC), the Dodd-Frank Act whistleblower programme is gaining credibility.

Describing the Dodd-Frank whistleblower programme as a proven game changer earlier this year, SEC chair Mary Jo White added: "We have seen enough to know that whistleblowers increase our efficiency and conserve our scarce resources."

Both the SEC and CFTC are rolling out whistleblower programmes enacted by the Dodd-Frank Act. The SEC's whistleblower office now supports 11 regional offices, each with a growing inventory of cases. The SEC's largest whistleblower award to date is more than $30m and in May 2014 the CFTC made its first award, for $240,000.

Sean McKessy

"We needed to up the ante with incentives for people who might be on the fence about whether to come forward," says Sean McKessy, chief of the SEC Office of the Whistleblower. "Notwithstanding our best investigative efforts, there have been certain frauds uncovered only because a person behind the scenes was brave enough to come forward. That's a sign that the programme is working."

The SEC and CFTC will soon both have dedicated whistleblower websites, *to page 6*

Environmental risk pushes onto financial stability agenda

from page 1

(UNEP FI) which brings industry practitioners into the discussion. The banking commission of UNEP FI oversaw a report in October 2014 by Kern Alexander, a professor of law and finance at the University of Zurich, which called for the Basel Committee on Banking Supervision to factor environmental risk into pillar two (the supervisory reporting and evaluation process) of the Basel bank capital framework.

"Basel II took into account only the microprudential risks associated with bank lending with respect to environmental exposures – for example, if a bank had made a loan that was secured by collateral exposed to toxic waste. A major theme of Basel III is to include macroprudential risk, and the interviews we conducted showed concern that there needed to be a merging of the environmental sustainability agenda with this new financial stability agenda," says Mr Alexander.

National examples

The UNEP FI study also examined a number of national initiatives to integrate environmental risk into bank regulation, including China's 2012 green credit guidelines and new rules in Brazil and Peru. In 2014, the Brazilian Central Bank (BCB) published principles and guidelines for the implementation of an environmental and social responsibility policy by local financial institutions, with a particular focus on Amazon rainforest protection. This uses both pillar two and pillar three (market disclosure) of the Basel framework to oblige banks to examine their environmental risk exposures in a way that is proportionate to the size and complexity of the institution's operations.

"This principle-based regulation seeks to promote environmental and social risk awareness and management and encourage transparency on this issue in the relationship between the institutions and stakeholders," says Otávio Damaso, deputy governor for financial regulation at the BCB.

In Peru, the superintendent of banks and securities markets (SBS) introduced enhanced due diligence requirements for socio-environmental risk that entered force in March 2015. The new code includes minimum risk assessment and categorisation requirements, the conditions that would trigger an independent review and the obligation to include "loan agreement clauses that commit the borrower to take specific actions to build and maintain a good relationship with the community and to protect the environment". These rules followed the long-running conflict between Peru's Conga mining project and local residents protesting against potential environmental damage, which began in late 2011.

"Of course, reducing conflicts is a vital goal in itself. But these conflicts can also have a wider impact on financial stability, not just in the directly affected sector such as mining, but also by increasing problem loans indirectly in sectors such as tourism and transport," says Daniel Schydlowsky, head of the SBS.

Mr Schydlowsky says banks have seen the fallout on their balance sheets from incidents such as the Conga conflict, and were consequently very supportive when the SBS introduced the new regulations. The main reason to bring organisations such as the FSB and Basel Committee into the discussion is because project finance, which contributes a significant part of banks' environmental risk exposures, is a global business.

"Further international co-operation will help to generalise best practice and make it easier to move forward together. Harmonising good practices helps to institutionalise them. A level playing field also makes sure there is no unfair competition or regulatory arbitrage. It will take some work to fit this into worldwide agreements such as the Basel framework, but the logic is there," says Mr Schydlowsky.

Christopher Bray
"The key question is what will the numbers be used for – different metrics may be more relevant for different purposes"

Currently, 80 financial institutions worldwide have signed up to the voluntary Equator Principles on managing environmental and social risks in project finance. There is a consensus among bankers and regulators that the adoption of tougher environmental risk controls has not so far prompted competitiveness questions, such as non-Equator banks stepping in and providing loans with fewer conditions attached.

"It is worth emphasising that adequate risk management and a stronger corporate governance structure for environmental risk have the potential to increase the competitiveness of Brazilian institutions," says Mr Damaso.

However, for cross-border banks, it can be challenging to decide where to draw the line when different countries have varying standards for environmental protection. One European banker says many Equator Principles banks are seeking to reduce exposure to lignite-related activities, but in India the government is actively supporting coal-based energy and industrial projects.

"We have internal policies, and we are also sensitive to the level of maturity of local legislation relating to particular sectors in particular geographies. We measure how everything fits into our environmental and social risk policies, we set conditions that are realistic so that our clients can continue their work, but we also want to gradually improve the way that they work. We do not want them to go out of business if and when increased regulation is introduced," says Portia Bangerezako, senior environmental and social risk manager at Standard Bank in South Africa and a co-chair of the UNEP FI banking commission.

Hard to measure

What may well serve to deter the Basel Committee, however, is the challenge of fitting environmental risk into a capital framework that is heavily quantitative.

"An international standard would have to take into account two key aspects: compliance costs associated with a strict and long-ranging evaluation of clients and operations from a societal and environmental perspective, and the depth of measures and controls needed to ensure an adequate coverage of such risks," says Mr Damaso.

Christopher Bray, head of environmental risk management at Barclays and co-chair of the UNEP FI banking workstream, says the bank has tended to avoid putting hard numbers on environmental risk. In particular, he notes that there is rarely any linear scalability between the size of the loan and the associated environmental risk. Reputational risks can stem from association with a project even before any money is lent, and in a recovery situation, there are scenarios where a bank can be saddled with the environmental clean-up liabilities

from a defaulting project borrower.

"The measurement of embedded carbon, for example, is also very difficult to address. If you just select a loan book figure, you may be omitting underwriting, advisory work, some hedging instruments and other, non-credit based transactions and services. The key question is what will the numbers be used for – different metrics may be more relevant for different purposes, whether for internal risk management or as public information for stakeholders," says Mr Bray.

The greenhouse gas protocol has established a global standard for companies to report carbon emissions to the usual financial reporting parameters. Banks can integrate this information, if made available to them, to measure the cumulative emissions of clients operating in carbon-intensive sectors. But of course a pure retail bank would have almost no exposure to carbon based on this corporate emission measure. However, retail banks' auto loan books would arguably be a significant but indirect contributor to emissions.

Leonie Schreve
"Measuring environmental costs remains difficult, but as we build data each year, there will be better insight"

"Banks can put hard numbers on these issues, provided the end-users understand the limitations of those numbers. Only if there are consistent methods across banks does that allow comparisons to be made for the specific areas covered, even if there is no comprehensive number for carbon exposures," says Mr Bray.

He adds that regulation can also encourage consistency, but recognises the challenges stemming from the difficulties in building appropriate financial models, especially given the interconnectivity of environmental risk factors. The Basel Committee is gradually tackling qualitative factors. Indeed, its updated principles for corporate governance, released in July 2015, called on banks to "consider and evaluate harder-to-quantify risks", such as reputational risk and the risks of specific complex transactions.

Mr Alexander participates in ongoing work by the Cambridge Institute for Sustainability Leadership that seeks to bring together financial risk managers with environmental scientists to help build the science into bank stress testing. This could help develop a model for examining environmental risk under pillar two of the Basel framework.

"The bank risk managers want more interaction with scientists who work with scenarios such as environmental tipping points, the melting of polar ice caps, water scarcity and so on. The banks also need to look at the scenario of the global economy moving away from reliance on carbon – it may be a smooth transition, but there could be herding out of high-carbon assets because of asymmetric information," says Mr Alexander.

Paul Collazos, head of specialised lending risk at the SBS, believes the stress-testing component of the Basel pillar two process seems to offer a more likely solution than some form of "pillar one-lite" supervisory capital add-ons. What matters, he says, is that a bank must understand the nature of the risks, which can affect others well beyond the lending bank itself; this is a systemic risk.

"The [Peruvian] rules are very different from using traditional provisioning or capital charges as incentives, because in the case of avoiding conflict it is too late to require provisioning or capital once the risk has already actualised. So we need preventative prudential regulation based on the loan granting process and the structuring of project finance deals, which typically have a long evaluation period," says Mr Collazos.

Beyond prevention

The banks themselves are already thinking beyond risk prevention, to try to identify strategies that can have a positive impact in fostering a more sustainable economy. Expectations from stakeholders, including institutional investors, are rising.

"With the Paris meeting, there is an idea that we are moving toward banking for a changing world, with new financing models to meet new financing needs. The banking industry should be driving positive impact, there is broad agreement on that in principle, but the question is how to do that programmatically – what is the shift going to look like and how will we know when we have arrived?" says Ms Bangerezako.

Leonie Schreve, global head of sustainable finance at ING and a board member of UNEP FI's banking commission, says one of the commission's important tasks is to streamline and define common industry standards on definitions and methodologies to determine the sustainability and positive impact of companies and what activities banks aim to stimulate. Once banks have those definitions, it will be possible to gather data more quickly and join forces in accelerating sustainable business opportunities.

ING currently uses data from Dutch research company Sustainalytics, which follows 4500 companies, all based on the same criteria. The bank itself also analyses clients based on similar questions for each company, to create its own internal standards.

"Measuring environmental costs remains difficult, but as we build data each year, there will be better insight into the profitability of investments based on environmental measures, and how loans perform in our books," says Ms Schreve.

The nine largest Brazilian banks are examining how much finance goes to projects with environmental screening, and to factors that the UN defines as the green economy. This will initially be based on data for 2013 and 2014.

"We hope to have this data ready by September this year, to establish a baseline against which we can measure progress in the future. The Brazilian financial system is a pioneer on this matter," says Murilo Portugal, president of the Brazilian banking federation Febraban and a member of the advisory council to the UNEP inquiry.

However, Mr Portugal says the benefits of regulation tend to be limited to a "do no harm" approach for banks. If there is a desire for banks to be more ambitious and actively "do good", then relative pricing in the real economy will be important – specifically, the price of carbon emissions. Banks will be even more effective when the real economy internalises the cost of carbon emissions.

"The banking sector is good at making decisions based on market prices, and it is very difficult for a private enterprise to make decisions that are not based on market prices. If the price of carbon is right and it reflects the externalities that are generated by carbon emissions, I am sure that the banking sector would automatically pay attention to that and integrate that information," says Mr Portugal. Alongside the new focus on bank regulation, the Paris summit will still have to resolve the long-standing debate on carbon pricing. GRR