



## **BRIEFING NOTE**

# ADJUSTING BANKS' CAPITAL REQUIREMENTS IN LINE WITH SUSTAINABLE FINANCE OBJECTIVES

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28 February 2018

## **OVERVIEW**

The EU parliament and the Committee for Economic and Monetary Affairs are currently considering the recommendations of the High-Level Expert Group (HLEG) final report on Sustainable Finance.<sup>1</sup> One of the HLEG's proposals is to align banks' capital requirements with sustainable finance goals, and in particular to introduce a 'Green Supporting Factor' (GSF). A GSF would reduce capital requirements for low-carbon lending – a proposal that is currently the focus of intensive debate. This briefing sets out the issues at stake and argues that, while the objective behind the GSF proposal should be applauded, the GSF would not lead to a noticeable increase in the level of sustainable investment. Instead, it risks weakening an already fragile banking system and undermining the efficacy of the still developing field of sustainable finance. A better approach would be to increase the capital requirements for highly carbon intensive lending, which would not only have the same desired effect whilst enhancing financial stability, but would also reflect the very real systemic risks posed by continuing these investments.

## **WHAT ARE CAPITAL REQUIREMENTS?**

Capital requirements compel banks to back a proportion of their lending with shareholders' equity, ensuring that investors have 'more skin in the game' when banks grant loans. In this sense, capital requirements are intended to act as a cushion to absorb losses when loans default – so that the bank can continue functioning after taking a financial hit, without taxpayers coming to the rescue. Capital requirements

are designed to prevent a repeat of the 2008 Global Financial Crisis (GFC), and are conventionally considered a useful measure to protect taxpayers against potential bank bailouts.

By ensuring banks have more skin in the game, higher capital requirements may also reduce their risk-taking practices. Higher capital requirements tend to make loans more expensive for banks – i.e. they must acquire more capital from shareholders to grant a loan. If raised high enough, capital requirements can thus decrease the volume of loans granted by the banking sector to households and firms.

## **WHAT IS THE 'GREEN SUPPORTING FACTOR'?**

The introduction of a GSF would lower capital requirements for green lending – i.e. banks would have to back their green loans with less capital. This means banks would have less of a buffer against losses, but also that green loans would be cheaper for banks than brown loans, as far as mobilising capital has some cost for banks. Proponents of the GSF claim that it will boost green bank lending and encourage sustainable investments.

## **WHY A GSF IS NOT AN APPROPRIATE INSTRUMENT**

While laudable in aim, a GSF is not an appropriate instrument for two interlocking reasons:

### **1. FINANCIAL STABILITY RISKS**

Capital requirements are there to mitigate risks in the banking sector. They are the legislative result of a long, hard-fought battle aimed at fostering banking system stability, protecting tax payers from future bailouts, and preventing a repeat of the 2008 GFC and ensuing recession. A reduction in capital requirements erodes the hard work and progress made in stabilizing our financial system.

An argument can be made that lower capital requirements could be justified for loans that are less risky than others, but there is currently no evidence of lower risk for green loans.<sup>2</sup> The 'real risks' to green investment could be underestimated – for example, green investment in novel technologies might not get adequately tested or could be swiftly surpassed.

If capital requirements are reduced below their level of economic risk, lending can become increasingly concentrated in imprudent lenders, heightening financial risks and potentially leading to a 'green bubble'.<sup>3</sup> The ensuing instability could divert investment away from green sectors and risk reputational harm to the entire concept of sustainable finance.<sup>4</sup>

Credit rating agency Moody's, for example, has signalled that a GSF could lead to a downgrading of credit ratings for EU banks, because it would lead to banks holding less capital for green loans that, in their eyes, carry the same level of risk as traditional loans.<sup>5</sup> Such a downgrade would weaken the resilience of the banking system, and could ultimately make green and all other shades of borrowing more costly (defeating the purpose of the GSF).

A GSF is also hazardous given the current state of the European banking sector. Despite some improvements, banks in the Eurozone are still holding a considerable sum of loans that are at risk of default. Most recent statistics suggest that the Eurozone's biggest banks had around €770bn worth of non-performing loans (NPLs), representing 5.15% (compared with an average of 1.3% for the USA and 0.9% for the UK). In Ireland, Spain and Italy – countries with systemically important banks – NPL ratios are in double digits. Over 60% (€460bn) of NPLs are for regular businesses.<sup>6</sup> In the face of such high levels of NPLs, it would seem prudent not to reduce the cushion needed to absorb loan defaults.

In line with Minneapolis Federal Reserve President Neel Kashkari, there is good reason to believe many banks are still too big to fail.<sup>7</sup> Banks need more capital, not less.

## **2. LOWER CAPITAL REQUIREMENTS DO NOT LEAD TO HIGHER LEVELS OF LENDING**

Despite the intention, evidence that lowering banks' capital requirements will lead to higher levels of green investment remains unclear. Empirical findings of the University of Cambridge and the United Nations Environment Programme Finance Initiative suggest that higher capital requirements play a trivial factor in determining the pricing and allocation of bank credit.<sup>8</sup> Meanwhile similar results were observed by studies by the Bank for International Settlements, where capital requirements are not found to notably constrain levels of bank lending.<sup>9</sup>

A recent report by the European Banking Authority (EBA) found that the reduction of capital requirements for loans to small and medium-sized enterprises (SMEs) had

virtually no influence in boosting bank lending when compared to large corporates.<sup>10</sup> In fact, the same study found that banks with more capital have higher lending growth rates to SMEs than less capitalised banks: this could suggest that a better tool to increase green investment is more capital (but this notion certainly requires more research).<sup>11</sup>

Indeed, as noted by Finance Watch,<sup>12</sup> the EBA report shows that minor adjustments to capital requirement (sector-specific risk-weight changes of 25%) in both directions do not affect levels of lending. Evidence suggests<sup>13</sup> that only a dramatic reduction in capital requirements (i.e. between 50-150% change to risk weights) might have some minor success in boosting lending – but halving capital requirements or dispensing of them all together could be catastrophic for financial stability.

Proponents of a GSF have also suggested that it will not be applied to two of the highest priority lending areas – SMEs and infrastructure projects – since these sectors already have supporting factors.<sup>14</sup> Accordingly, the GSF will either be aimed at real estate lending and/or corporate loans. However, since corporates are already benefitting from historically low interest rates due to the ECB's corporate bond purchase programme and other financing instruments, it is even more doubtful that lower capital requirements will boost corporate borrowing.

Meanwhile, real estate loans are presently not considered risky and already entail a low capital weight, while residential mortgages benefit from capital relief under securitisation regulations.<sup>15</sup> As with corporates, interest rates on mortgages are already at an historic low – a dramatic reduction in capital requirements will not lead to a substantive increase in mortgage lending. Accordingly, for Eurozone banks currently exposed to risks of real-estate bubbles, low interest rates coupled with a significant reduction in capital requirements could be a recipe for financial instability.

## **ALTERNATIVE INSTRUMENTS FOR REDUCING CARBON RISK**

Instead of a GSF it is worth considering whether higher capital requirement for brown loans (e.g. fossil-fuel intensive and dependent assets), a 'brown penalising or "add-on" factor', is a better alternative.<sup>16</sup> A sufficiently high capital requirement for loans carrying carbon risk, or entities that are severely reliant on fossil fuels, would reflect the real and growing systemic risk of investing in carbon-intensive activities and could discourage further investment that contributes to climate change. It would

also give banks a greater buffer to withstand losses related to the risks of a carbon bubble<sup>17</sup> and sudden value losses due to the repricing of stranded assets.

Higher capital requirements for loans to carbon-intensive firms seem thus to be a win-win policy option. Firstly, they would increase the resilience of the financial system by adding a capital buffer to banks to reflect climate-related risks. Secondly, if high enough, they could potentially create an incentive for banks to lend relatively more to economic activities that support the transition to a low carbon economy, while not eroding the capital held against green lending nor introducing more systemic risk.

Finally, a number of other options could be investigated that would have the same desired impact, without endangering financial stability: ceilings or quotas on green/brown credit, liquidity support and guarantees for green loans, green reserve ratios, or green targeted refinancing lines.<sup>18</sup>

- <sup>1</sup> High-Level Expert Group on Sustainable Finance (2018). 'Financing a European Economy'. Available at: [https://ec.europa.eu/info/publications/180131-sustainable-finance-report\\_en](https://ec.europa.eu/info/publications/180131-sustainable-finance-report_en)
- <sup>2</sup> As noted by Moody's credit rating agency, see: Reuteurs (2018) Moody's raps EU plans for lower capital charges on banks' green investment, December 18<sup>th</sup>, 2017. Available at: <https://uk.reuters.com/article/eu-climatechange-banks-moodys/moodys-raps-eu-plans-for-lower-capital-charges-on-banks-green-investment-idUKL8N1OI2BA>
- <sup>3</sup> High-Level Expert Group on Sustainable Finance (2018). 'Financing a European Economy'. Available at: [https://ec.europa.eu/info/publications/180131-sustainable-finance-report\\_en](https://ec.europa.eu/info/publications/180131-sustainable-finance-report_en)
- <sup>4</sup> Matikainen, S. (2018). Green Doesn't Mean Risk-Free: Why we Should be Cautious About a Green Supporting Factor in the EU. Grantham Institute Publication. Available at: <http://www.lse.ac.uk/GranthamInstitute/news/eu-green-supporting-factor-bank-risk/>
- <sup>5</sup> Reuteurs (2018) Moody's raps EU plans for lower capital charges on banks' green investment, December 18<sup>th</sup>, 2017. Available at: <https://uk.reuters.com/article/eu-climatechange-banks-moodys/moodys-raps-eu-plans-for-lower-capital-charges-on-banks-green-investment-idUKL8N1OI2BA>
- <sup>6</sup> All statistics are available from: European Central Bank – Banking Supervision (2018). Supervisory Banking Statistics. Available at: <https://www.bankingsupervision.europa.eu/banking/statistics/html/index.en.html>
- <sup>7</sup> CNBC (2018) 'Fed's Kashkari: Biggest banks need to double current capital levels, January 9<sup>th</sup>, 2018. Available at: <https://www.cnbc.com/2018/01/09/fed-neel-kashkari-biggest-banks-need-double-current-capital-levels.html>
- <sup>8</sup> CISL & UNEP-FI (2014). Stability and Sustainability in Banking Reform: Are Environmental Risks Missing in Basel III? Available at: <http://www.unepfi.org/fileadmin/documents/StabilitySustainability.pdf>
- <sup>9</sup> Cohen, G. (2013) How have banks adjusted to higher capital requirements? BIS Quarterly Review, September (2013). Available at: [https://www.bis.org/publ/qrtrpdf/r\\_qt1309e.pdf](https://www.bis.org/publ/qrtrpdf/r_qt1309e.pdf)
- <sup>10</sup> European Banking Association (2016). 'EBA Report On SMEs And SME Supporting Factor'. Available at: <https://www.eba.europa.eu/documents/10180/1359456/EBA-Op-2016-04++Report+on+SMEs+and+SME+supporting+factor.pdf>
- <sup>11</sup> Martini, M. (2018) 'A green supporting factor would weaken banks and do little for the environment', Finance Watch Publication. Available at: [http://finance-watch.org/hot-topics/blog/1506-green-supporting-factor#\\_ftn1](http://finance-watch.org/hot-topics/blog/1506-green-supporting-factor#_ftn1)
- <sup>12</sup> Martini, M. (2018) 'A green supporting factor would weaken banks and do little for the environment', Finance Watch Publication. Available at: [http://finance-watch.org/hot-topics/blog/1506-green-supporting-factor#\\_ftn1](http://finance-watch.org/hot-topics/blog/1506-green-supporting-factor#_ftn1)
- <sup>13</sup> Bank of England (2014) 'The Financial Policy Committee's powers to supplement capital requirements' <https://www.bankofengland.co.uk/-/media/boe/files/statement/2014/the-financial-policy-committees-powers-to-supplement-capital-requirements-january-2014>
- <sup>14</sup> European Banking Federation (2017) Towards a Green Finance Framework. Available at: <https://www.ebf.eu/wp-content/uploads/2017/09/Geen-finance-complete.pdf>
- <sup>15</sup> Martini, M. (2018) 'A green supporting factor would weaken banks and do little for the environment', Finance Watch Publication. Available at: [http://finance-watch.org/hot-topics/blog/1506-green-supporting-factor#\\_ftn1](http://finance-watch.org/hot-topics/blog/1506-green-supporting-factor#_ftn1)
- <sup>16</sup> Boot, A. and Schoenmaker, D. (2018). 'Climate change adds to risk for banks, but EU lending proposals will do more harm than good' Bruegel Publication. Available at: <http://bruegel.org/2018/01/climate-change-adds-to-risk-for-banks-but-eu-lending-proposals-will-do-more-harm-than-good/>
- <sup>17</sup> Carbon Tracker Initiative (2012). Unburnable Carbon: are the world's financial markets carrying a carbon bubble? Available at: <https://www.carbontracker.org/wp-content/uploads/2014/09/Unburnable-Carbon-Full-rev2-1.pdf>
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