

# **Submission to the Basel Committee**

**Comments on the documents:**

**“Strengthening the resilience of the banking sector”**

**“International framework for liquidity risk measurement, standards and monitoring”**

<p><b>This document was originally submitted to the European Commission as contribution to the EU Capital Requirements Directive consultation</b></p>
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# **Submission to the CRD IV Working Document**

## **1. Introduction**

After a first consultation round closed on 4 September 2009, on 26 February 2010 the European Commission launched a new public consultation on further possible changes to the Capital Requirements Directive (CRD) aimed at strengthening the resilience of the banking sector and the financial system as a whole. The proposed changes, which are to be included in what is known as 'CRD IV', are described in a Commission Services Staff Working Document issued on 26 February. The EC proposals are closely aligned with the expected amendments to the Basel II framework and the introduction of a global liquidity standard that are currently being drawn up and their impact assessed by Basel Committee on Banking Supervision (BCBS). They also reflect commitments made by G-20 leaders in London on April 2, 2009 and in Pittsburgh on September 24-25, 2009 as regards building high quality capital, strengthening risk coverage, mitigating pro-cyclicality, discouraging leverage as well as strengthening liquidity risk requirements and forward-looking provisioning for credit losses.

The Working Document proposes changes in seven policy areas:<sup>1</sup>

1. liquidity standards
2. definition of capital
3. leverage ratio
4. counterparty credit risk
5. countercyclical measures
6. systemically important financial institutions
7. single rule book in banking

The Working Document formulates specific questions on each of these seven issues, 52 questions in total.

In this submission Friends of the Earth Europe (FoEE) will first present its vision on the financial system (paragraphs 2 and 3), followed by its view on necessary reforms in financial regulation (paragraph 4).

In paragraph 5 general comments on the Working Document on CRD IV and the entire process of reforming the CRDs are presented. In paragraphs 6 to 11, comments are made on some of the seven issues discussed by the European Commission in the Working Document. Rather than trying to answer the 52 questions raised by the European Commission in the Working Document, additional questions are raised and answered which the European Commission should deal with before elaborating on the detailed technical questions included in the Working Document. In paragraph 12 some issues discussed in the previous CRD IV Working Document are commented upon.

Finally, in paragraph 13 all proposals made by FoEE are summarized.

## **2. FoEE's vision on the financial system**

Banks and other financial institutions play a crucial role in allocating financial resources in our present, globalizing world. As a large majority of all companies and governments in the world is dependent on the financial services of private banks, these financial institutions play a key role in every segment of human activity. While their financial services are used too often for activities which are harmful to the environment, human rights, and social equity, banks can also be powerful agents of change towards a more sustainable future.

Sustainability is about meeting the needs of the present without compromising the ability of future generations to meet their needs. It is about preserving the environment and biodiversity for future generations, and about being cautious with our natural resources and climate. But sustainability is also about guaranteeing human rights and a life in dignity, free from want and poverty for all people living today and tomorrow.

Sustainable banking essentially is about contributing to make this happen. This means that financial institutions must expand their missions from ones that prioritize profit maximization to ones that aim at social and environmental sustainability. A commitment to sustainability would require financial institutions to fully integrate the consideration of ecological limits, social equity and economic justice into corporate strategies and core business areas (including credit, investing, underwriting, advising), to put sustainability objectives on an equal footing to maximization of shareholder value and client satisfaction, and to actively strive to finance transactions that promote sustainability. As most activities financed by a bank have social and environmental impacts, be they positive or negative, sustainability is already at the core of a bank's business activities. The challenge is to recognise these impacts and shift their balance in a positive direction.

### **3. Sustainability analysis supports financial stability**

Integrating sustainability factors in all lending, financial services and investment decision making processes would not only be beneficial for the global efforts to achieve global sustainable development. It would also support the objectives of financial sector regulation: building a stable financial system which is able to deal with financial risks and is supporting economic development.

We define the sustainability risks of financial transactions as the risks caused by these financial transactions themselves, or the business operations they are financing, to the environment, human rights and social justice. These risks might include: increasing poverty of low-income groups to which financial products are sold or to whom financial services are denied, financing deforestation operations in High Conservation Value Forests, financing operations which heavily pollute the water, soil and air in the area they operate, or financing operations which ignore all basic labour rights.

Characteristic of sustainability risks is that they are risks for other people or the environment outside the financial institution and not directly for the financial institution itself. Nevertheless there are three important reasons why integrating an assessment of sustainability risks in all lending and investment decision making processes is good for financial stability and the financial system:

1. Taking sustainability risks into account can, for part of a bank's credit portfolio, improve the bank's understanding of its financial risks and its capacity to deal with these risks. The risk assessment of project finance and other types of financing for sectors which are strongly involved in sustainability issues, such as the forestry, mining and oil and gas sectors, could benefit strongly by an integration of sustainability factors in the risk assessment processes - especially when these investments take place in countries with weaker regulatory and law enforcement.

For direct loans to companies operating in these sectors, either in the form of project finance or as corporate facilities, the level of sustainability of the company's operations has a direct correlation with the probability of default (PD). Ignoring sustainability risks can lead to increases in raw material prices, plant diseases and other environmental problems, conflicts with workers, civil society organisations and the local population, reputational damage, buyers severing ties, public prosecution and court cases. All these events are likely to affect the credit rating of the client and the probability of default (PD). Integrating sustainability factors in all lending and investment

decision making processes is therefore in the direct interest of the primary financier. Risk management would improve, which would strengthen the stability of the financial system.

2. For other financial products and investments, this correlation between sustainability and PD can be just as strong. But because the primary financier passes on its financial risks fairly soon to other parts of the financial system (e.g. through underwriting and placing securities, by securitization of loans, by credit default swaps, etc.), the loss given default (LGD) and the exposure at default (EAD) are fairly low for the primary financier. Integrating sustainability factors in the risk assessment process is therefore not in the direct interest of the primary financier, as ignoring differences in PD does not have significant consequences.

The counterparties of this primary financier, which are buying securities or securitized loans, often do not have sufficient information to assess the sustainability of the company issuing these securities or the borrowers of the securitized loans. For these counterparties it is therefore unclear how the ignoring of sustainability factors affects their probability of default (PD). This is exactly what happened with the American sub-prime mortgages: when the social situation of many of these borrowers would have been taken into account, it would have been clear that PD was much higher than projected.

In the derivatives trade, some derivatives essentially lead to passing through the PD to other parts of the financial system, while others are risky for the financial system because their bets underestimate the sustainability risks of the underlying assets.

In these cases, ignoring sustainability factors in risk management and decision making processes will not have a large direct impact on the primary financier. But it can and will have significant impacts on the counterparties to which it is selling its financial products, while these counterparties are less able to assess the sustainability risks of these investments. These counterparties will be buying into products with a higher PD than they assume. In short: ignoring sustainability risks by the primary financier for these type of transactions means that the associated financial risks are offloaded into the financial system, where they can easily backfire and threaten financial stability.

3. Another category of sustainability risks are not likely to turn into financial risks within the maturity of the credit to either the primary financier or the wider financial system. But these sustainability risks can ultimately threaten financial stability as well because of the devastating or destabilizing effect they have on society at large. An example are investments which contribute strongly to climate change, which in turn will increase the costs of many businesses and their capacity to repay loans. Another example are investments in the mining or forestry companies which deprive large population groups of their land and means of living, which can strongly increase political tensions and regional instability.

In a world which has to cope with a fast growing population and with limited natural resources, all investments which ignore the need to achieve sustainable development ultimately contribute to a destabilized and unsafe global society. Within that context the objective of maintaining a stable financial system will both become impossible and out of date.

#### **4. FoEE's vision on financial regulation**

Because of the crucial role banks have to play in achieving sustainable development on a global scale, all financial regulation should explicitly aim to guide the banking sector in this direction. Capital requirements and risk management regulation in particular should ensure that banks strive to minimize sustainability risks in all their lending, financing and investment decision making processes. As argued in paragraph 3, this would also support the more narrow objectives of financial sector regulation: maintaining a healthy and stable financial system.

Risk assessment and capital requirement regulations - as framed in the Basel Capital Accord and the EU Capital Requirements Directive - should be modified to ensure that banks integrate sustainability factors in all their lending, financing and investment decision making processes. This could be concretized as follows:

- Under Basel II and the CRD, large banks can choose for the Internal-Ratings Based (IRB) approaches in which credit risks are assigned to individual transactions by the bank itself. The assigned credit risks determine the amount of capital to be reserved by the bank. When a bank wants to qualify for one of the IRB approaches, regulators have to be assured that the credit risk assessment system of the bank meets certain strict data, validation, and operational requirements. Regulators could demand that banks integrate sustainability criteria in their credit risk assessment system, when applying the IRB. Concretely, banks should differentiate each of the present asset classes (corporate, sovereign, retail, etc.) in two or more groups, according to their level of sustainability. For each group, a different probability of default (PD) should be determined.
- For small and mid-sized banks, Basel II and the CRD demands the Standardised Approach, which also assigns credit risks to individual transactions. These credit risks are not determined by the bank itself, however, but derived directly from the credit ratings assigned by credit rating agencies (such as S&P, Moody's and Fitch) and export credit agencies (on sovereign risks). Basel II clearly stipulates that the credit rating agencies should meet strict criteria before banks can be allowed to use their credit ratings under the Standardised approach. To these criteria, knowledge of sustainability issues and integration of sustainability issues in the credit rating process should be added.
- Banks using the IRB approaches should take into account a wider definition of risks in their risk assessments, namely not only the direct financial risks for the bank itself, but also the financial risks which are passed on by the bank to the wider financial system through underwriting and the selling securities, by securitization of loans, by credit default swaps and other derivatives, etc. More precisely, banks should be demanded to assess the PD of all credits and financial products over the entire maturity or lifetime and they should be demanded to include sustainability risk. This assessment should be made known to the financial institutions they are selling securities, securitized loans, CDS, and other products to.

Apart from modifications in capital requirements and risk management, some other changes in the financial regulatory system are needed. The most important are:

- Every country sets demands with respect to the basic functions a bank should be able to perform before a license is granted or renewed. Among the criteria which a bank should meet, should be demands with regard to institutional knowledge and assessment capacity on sustainability risks.
- A key element in banking regulation are "approved person" regulations: the owners and higher management of a bank should meet certain integrity, knowledge and capability requirements before they are allowed to take on their position in the bank. Knowledge and capability in the field of sustainability risk should be among the requirements.
- A relatively new and heavily debated area of financial regulation concerns the bonuses of bankers. Regulations in this field, should demand inclusion of sustainability criteria in the remuneration and bonus system.

- Another part of the regulatory framework which is now under debate, concerns the competences and organisational structure of the supervisors themselves. Supervisors should explicitly be assigned with the task of supervising how banks deal with sustainability risks. To meet this task, supervisors obviously should have sufficient knowledge and competences, which should be assured by the relevant authorities.

## 5. General comments on CRD IV

The consultation document of the European Commission on CRD IV includes some useful elements. But in general, FoEE is of the opinion that the scope of the Working Document is too limited. The focus is limited too much on preserving financial stability in the strict financial sense, ignoring the strong correlation between social, environmental and economic developments and the stability of the financial system.

The Working Document is superficial in its analysis and too much focussed on technical measures which do not really solve the flaws of the financial system. The selection of issues for which changes are proposed, therefore is too narrow. When these issues are addressed, the regulatory system will still not be able to deal with the real challenge the financial sector: how to integrate the consideration of ecological limits, social equity and economic justice into their corporate strategies and core business areas. From this perspective other issues should be raised - see paragraph 4 - and other changes proposed.

It is for instance difficult to understand why CRD IV only deals with Pillar 1 of Basel II (Minimum capital requirements) and not with Pillar 2 (the Supervisory review process). The recent financial crisis has demonstrated the need to increase the ability of financial supervisors to deal with bank investments and products undermining financial stability. CRD II has responded to this by setting up colleges of supervisors for all big cross-border banks, but this only aligns procedures and decision making and does nothing to increase relevant competences of supervisors. As we have argued in paragraph 3, understanding sustainability risks will help supervisors to maintain financial stability. For financial supervisors it is therefore of great importance to increase their understanding of sustainability risks, in order to develop supervisory and regulatory tools and regarding to deal with those risks.

But also when we take the selection of issues discussed in the Working Document for granted, FoEE feels that these issues are not discussed in a fundamental way. The emphasis lies with managing the consequences of adverse financial developments, rather than trying to prevent or mitigate these developments. As managing these consequences will not always be possible or only comes with high costs to the financial system and society at large, this approach seems to be focussed too narrowly.

As the 52 questions raised in the Working Document are all originating from this narrow technical focus, this submission will not try to answer most of these questions directly. In paragraphs 6 to 11 comments are made on some of the seven issues discussed in the Working Document and additional questions are raised and answered which we think the Commission has forgotten to ask.

The European Commission has invited the *Committee of the European Banking Supervisors (CEBS)* to carry out an *European Quantitative Impact Study* to aid the assessment of the aggregate effect of the revisions of the CRD proposed. Given the shortcomings of the Working Document signalled above, FoEE recommends the European Commission to ask an independent and qualified institute to undertake a broader, qualitative assessment of the proposed revisions. This assessment should evaluate if these revisions contribute to the wider goal of reforming the financial sector into a positive force which supports sustainable development on a global scale. From this perspective, the

effectiveness of the proposals of the European Commission as well as these made in this submission should be evaluated in an objective way.

## **6. Liquidity standards**

The discussion on liquidity standards in the Working Document deals with the measures banks need to take to prepare themselves for a situation in which liquidity stress occurs. According to FoEE, the discussion should take one step backwards and discuss as well what banks can do to avoid that they run into a liquidity stress situation.

Liquidity stress can be caused by various reasons, some of which can be controlled by the bank. When a bank is involved in non-sustainable lending behaviour, this may cause severe reputation risks. Civil society organisations and media in various countries increasingly expose in which companies banks are investing, which kind of 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.

The collapse of the Dutch DSB Bank in the fall of 2009 is a case in point. Continuing negative publicity on very high-premium mortgage products which the bank had sold to low-income customers, followed by an influential financial analyst urging bank customers in a television show to withdraw their deposits, created a classic bank run. Within days, the liquidity of the bank was drained so strongly, that a collapse was inevitable.<sup>2</sup>

In this and other cases, the bank's liquidity stress is not caused by external factors which are beyond the bank's control (such as a crisis on the financial markets) but is causally related to the bank's own investment behaviour. In addition to setting liquidity standards to be better prepared for a liquidity stress (as the CRD IV Working Document proposes), it is essential to change the bank's lending, financing and investment policies to align them with the needs of society as a whole. To avoid a liquidity stress, it is a sound business practice to avoid investments which run against all principles of sustainable and socially equitable development.

The revision of the CRD should therefore amend the risk management procedures of banks to assess if specific investments or products are running against the principles of sustainable and socially equitable development. If this is the case, the investment or product should be amended or avoided also because of the possible consequences for the liquidity position of the bank.

## **7. Leverage ratio**

The way the leverage ratio is discussed in the Working Document is too limited. The objective of a leverage ratio should not only be to ensure the financial stability of financial institutions are involved, but also to limit leverage and financing of activities which are socially and environmentally damaging. In calculating the leverage ratio a differentiation should therefore be made between credits based on sustainability factors. This should include credits given to finance hedge funds and private equity funds, especially when they undertake speculative and socially or environmentally damaging investments and activities.

The options to capturing leverage as proposed by the European Commission consultation paper should be a minimum. In addition, the design of the leverage ratio should consider qualifying the leverage ratio, whereby the allowed leverage for financing trade and related operations in derivatives



that can have substantial social and environmental consequences (including credit derivatives), should be extremely low. For a further discussion of these issues see paragraph 2.8.

## **8. Counterparty credit risk**

The proposals in the Working Document on counterparty credit risks deals with the necessary capital reserves and with risk management regarding exposure from financing activities of derivatives as well as repo's and securities markets. In FoEE's view it is necessary to include sustainability criteria regarding the exposure to particular kind of derivatives, which FoEE considers to also safeguard long term financial stability.

The Working Document assesses the risks of exposure to derivatives products only from the financial risks perspective. However, not all derivatives have the same functions and effects. Derivatives can have significant social and environmental impacts, which are insufficiently recognized. Some examples are:

- The social and economic and even monetary impacts of credit default swaps (CDS) have become clear during the sub-prime mortgage crisis in which CDS played an important role, with low-income home owners feeling the consequences. During the Greek budget crisis, the role of CDS 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).
- The social and economic impacts of commodity derivatives has received some attention recently, also by the European Commission, but does not seem to be incorporated in the current Working Document on CRD IV. At the beginning of 2010, Mr. Barnier, when he was questioned by European Parliamentarians before he was appointed as the new Commissioner for the EU's Internal Market and Services, said: "Speculation in basic foodstuffs is a scandal when there are a billion starving people in the world". "We must ensure markets contribute to sustainable growth. I am fighting for a fairer world and I want Europe to take the lead on that."<sup>3</sup>

The increased speculative investment and trading in commodity derivatives, especially agricultural commodity futures, and the related services by banks have played an important role in the significant increases in food prices during 2008. These price increases resulted in riots and other forms of protest by low-income groups in countries all over the world. Indeed, people's right to food as defined in the Universal Declaration of Human Rights was being breached. The influence of increasing speculation in agricultural commodity futures and other derivative trading continues to risk disruption of these markets and to risk higher food prices.

- Equally, financial speculation on energy and metal derivatives markets can contribute to increase prices of energy and metals to such an extent to have important economic consequences and make energy inaccessible to the poor. In oil markets, a recent report to the French government points out that derivative speculation causes more volatility and systemic risks.<sup>4</sup>

So far, there are no responsible investment instruments to assess whether the energy, metal and agricultural commodities that are the underlying assets of these derivatives, are produced in a way that respects people (e.g. communities around mines) and the environment. Not only the speculating parties to the derivatives contracts but also the clearing houses have no or little information or interest in how the underlying commodities are being produced, traded and consumed. For instance, increasing prices through derivatives speculation can encourage more unsustainable production of metals and oil. At the same time, while huge amounts of money are invested in commodity derivatives (even if commodity derivatives have only a small share of the derivatives markets), there is a recognized lack of investment in agricultural production, let alone sustainable commodity production. High food prices and lack of agricultural production can undermine economies, which can lead to financial instability.

- When currency derivatives are being used to speculate against currencies from developing countries, this can have enormous economic - and consequently social and environmental - impacts on developing countries. In turn such economic destabilization can undermine financial stability.
- Derivatives based on carbon trading are said to be also on the increase and potentially lead to a bubble in carbon trading, which would undermine the claimed objective of the system of carbon trading to off-set environmentally destructive activities. Moreover, the environmental benefits of carbon trading and carbon offsetting projects are being disputed, let alone when speculators would become important beneficiaries.

Given their social, environmental and economic impacts, the derivatives mentioned above might quickly lose value, due to the social and environmental damage undermining the value of the commodities underlying the derivative contracts, or due to interventions by authorities in the actual of financial markets for these commodities, currencies and carbon trades (which again would be reflected in the value of the derivatives). By not taking these sustainability issues into account, exposure to counterparty risks of financing such derivatives might be completely wrongly assessed.

Improved measurements to better address counterparty credit risk arising from financing derivatives should include not only measuring the financial risks of exposure to derivatives but also social, environmental and economic risks of derivatives, especially commodity derivatives, credit derivatives and carbon trading derivatives. Such derivatives can directly or indirectly affect financial stability as explained above. Exposures from financing non-cleared non-transparent OTC derivatives should lead to much higher capital requirements, even punitive/prohibitive capital requirements, than derivatives traded on exchanges and derivatives that fulfil (potentially new) transparency and regulation requirements. Bank financing exposures to derivatives that are for pure financial speculation rather than hedging, should require much higher or even prohibitive capital requirements than those for hedging with end-users (e.g. of commodities).

Bank exposures to large financial institutions that engage in commodity derivatives themselves (e.g. as dealers), index related investment instruments, credit derivatives and carbon trading derivatives, and that have a high interconnectedness with other such large institutions, need to have higher capital requirements.

In addition, bank financing of hedge funds that engage in derivative trading should be strongly discouraged through prohibitive high capital requirements.

Capital requirements should result in less credit to be allocated to derivatives and financial speculation and more credit to be allocated to activities in the real economy and in society, especially to activities that have positive social (e.g. jobs, poverty reduction) and environmental effects.

In addition, new capital requirements should result in encouraging the development of new risk management products for commodity producers and foreign currency users. Such new risk management products should be less risky and less prone to speculation than current commodity and currency derivatives.

Central counterparties that clear derivatives should apply higher risk weights to collateral for commodity derivatives, credit derivatives and carbon trading derivatives. Collateral should even be higher for OTC derivatives as well as derivatives traded by financial actors for pure financial speculation and for index related investment instruments, compared to derivatives for hedging purposes in which one party is an end-user (e.g. of commodities).

## **9. Countercyclical measures**

The Working Document discusses possible approaches for to the through-the-cycle provisioning for expected losses. FoEE supports the general thoughts behind the concept of through-the-cycle provisioning, but recommends to rethink the distinction between expected and unexpected losses in this respect. FoEE is of the opinion that many losses which are classified as unexpected at present by banks, actually could be reclassified as expected losses. When a bank sells high-interest mortgages to households without a stable income, the resulting losses - for the selling bank or financial institutions further down the securitization chain - cannot 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. This is exactly what happened in the case of Asia Pulp & Paper which in 2001 was unable to service its US\$ 13.9 billion debt. This remains the largest ever default by a single company in an emerging country.<sup>5</sup>

As part of the proposals on through-the-cycle provisioning, FoEE therefore recommends to set up a historical study of the default rates of a number of large international banks. 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.

## **10. Systemically important financial institutions**

The Working Document proposes a special treatment for systemically important financial institutions. FoEE does not oppose this special treatment, but proposes to rethink the definition of what a systemically important financial institution is. A financial institution which invests large amounts in companies deforesting valuable tropical forests, depriving many local communities of their land, denying workers their basic labour rights, polluting the local environment and/or contributing excessively to global CO<sub>2</sub> emissions, should also be described as systemically important. Such financial institutions help to destabilize important social networks and ecosystems, or even the most important system we have on earth - the planet itself.

Defining systemically important banks purely in financial terms, ignores the interconnections between the environment, the economy and the financial system. Destabilizing ecosystems or depriving significant groups of the global population of their means of living, inevitably undermines the stability of the global economic system, including the financial system, in the long run.

The special treatment of banks qualify as systemically important, should include minimum requirements with regards to the inclusion of social and environmental sustainability criteria in all credit and investment decisions.

## **11. Single rule book in banking**

The Working Document proposes a single rule removal of national options and discretions in the application of the CRD at national level by the member states, regarding regulatory additions on issues that are regulated by EU directives. The European Commission aims at maximum harmonisation whereby no additional requirements may be set at national level.

FoEE opposes this proposal, where additional requirements with regard to sustainability are concerned. FoEE would prefer to see sustainability requirements firmly integrated into financial sector regulation, as is argued in this submission. When this objective is not or only partly achieved at EU level, the governments of member states should still have the authority to introduce such 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.

## **12. Issues raised in the previous Working Document**

In the previous Working Document on CRD IV, published in July 2009, 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>6</sup>

This same argument holds true for (foreign currency) loans to companies grossly violating environmental and human rights standards. Guidelines such as the UN Global Compact, the UNEP FI statement and the Equator Principles have failed to prevent these financings from taking place, as is documented for instance by a large number of *Dodgy Deals* on the FoEE website.<sup>7</sup> According to FoEE, it is therefore now appropriate to consider specific and penal capital requirements to discourage credit institutions from granting (foreign currency) loans to companies grossly violating environmental and human rights standards. Such specific and penal capital requirements should also apply to indirect investments, for instance via hedge funds and private equity, in such companies or projects.

In the previous Working Document on CRD IV, published in July 2009, the European Commission also proposed to simplify the Bank Branch Accounts Directive.<sup>8</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 those required from the parent established in other Member States. Similarly to the single rule book discussed in paragraph 11, FoEE opposes this proposal where additional information with regard to sustainability is concerned. The governments of member states should still have the authority to require bank branches in their jurisdiction to publish additional information on sustainability issues.

### 13. Summary of proposals

Financial regulation should aim at stimulating the financial sector to contribute to the necessary reform of the global economy in a sustainable direction. For this reason, as well as to further the more limited objective of maintaining a healthy and stable financial system, it is of great importance that financial institutions integrate sustainability factors in all their risk management and investment decision making processes. In this submission to the public consultation on CRD IV, FoEE therefore makes the following proposals:

- Under the IRB approach, banks should differentiate each of the present asset classes according to their level of sustainability, each with a different probability of default (PD);
- To have their credit ratings eligible for use under the Standardised approach, credit rating agencies should have knowledge of sustainability issues and integrate sustainability issues in the credit rating process;
- Banks should be demanded to assess the PD of all credits and financial products over the entire maturity or lifetime, taking into account sustainability risks, and make this assessment known to the financial institutions they are selling securities, securitized loans, CDS, commodity derivatives and other products to;
- The criteria for a bank license should include demands with regard to institutional knowledge and assessment capacity on sustainability risks.
- Approved person regulations should require knowledge and capability in the field of sustainability risk;
- Sustainability criteria should be demanded to be included in the remuneration and bonus system;
- Supervisors should explicitly be assigned with the task of supervising how banks deal with sustainability risks. To meet this task, supervisors obviously should have sufficient knowledge and competences, which should be assured by the relevant authorities.
- An independent and qualified institute should be asked to evaluate if the proposed revisions to the CRD contribute to the wider goal of reforming the financial sector into a positive force which supports sustainable development on a global scale;
- To avoid liquidity stress, banks should amend or avoid specific investments or products which are running against the principles of sustainable and socially equitable development;
- In calculating the leverage ratio a differentiation should be made between credits based on sustainability factors;
- Sustainability impacts should be integrated in the valuation of derivatives and speculative investors such as hedge funds, to improve the assessment of the bank's exposure to counterparty risks;
- Capital requirements for investments in derivatives and speculative investors should reflect the sustainability risks and should be prohibitive where need be;
- Options for capturing leverage should be kept to a minimum;

- Bank financing exposures to derivatives that are for pure financial speculation rather than hedging, should require much higher capital requirements than those for hedging with end-users;
- Capital requirements should result in less credit to be allocated to derivatives and financial speculation and more credit to be allocated to activities in the real economy and in society;
- Central counterparties that clear derivatives should apply higher risk weights to collateral for commodity derivatives, credit derivatives and carbon trading derivatives;
- A historical study of the default rates of a number of large international banks should be set up, categorising international loans with sustainability indicators, to redefine expected and unexpected losses;
- The treatment of systematically important banks should include demanding minimum requirements with regards to the inclusion of social and environmental sustainability criteria in all credit and investment decisions;
- Member states should retain the authority to introduce sustainability requirements in their national financial regulations;
- Specific and penal capital requirements to discourage credit institutions from granting loans to companies grossly violating environmental and human rights standards should be considered;
- The governments of member states should retain the authority to require bank branches in their jurisdiction to publish additional information on sustainability issues.

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