

Comments on BCBS Consultative Document

Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches

Nicholas CL Beale and Michael B Thiessen

24 June 2016

We take no position on whether or to what extent constraints on the use of internal model approaches are needed. There are clearly arguments for and against. However, we strongly urge that any risk models incorporate a consideration of the forward looking economic impact of realistic prices on carbon and, where relevant, other similar externalities, in addition to the use of historical data. Although this would arguably have wider desirable consequences, we believe this consideration is justified purely on risk grounds.

Risks related to a carbon price might be based on:

- a) The impact of a Carbon Price consistent with COP21 commitments
- b) The probability of such a Carbon Price over the lifetime of the loan/exposure.
- c) The impact and probability of intermediate Carbon prices over the lifetime
- d) Where relevant, the impact and probability of correcting other unsustainable pricing of resource usage (eg Water)

Investments which were suitably certified as having minimal negative environmental impact, such as certain kinds of Green Bonds, might be exempt from the additional analysis outlined above. And of course there are some businesses where the impact of a higher Carbon Price would be positive.

Even though such a consideration is strictly justified on risk grounds, this could also progressively and smoothly adjust risk models over time, which should avoid the “tragedy of the horizon” of which Governor Mark Carney, has spoken. No-one expects a realistic global Carbon Price in the next 18 months¹, but almost everyone expects one within 18 years.

We are particularly concerned to avoid a situation where the adoption of a standard by regulators has the unintended adverse consequence of precluding the incorporation of such factors in Banks’ risk models.

Acknowledgements: we are very grateful to colleagues involved in the Global Collaboration on Financial System Stability for comments on the work which forms the basis of this note. Due to lack of time this note is not formally submitted on behalf of the Collaboration, although we hope that a subsequent longer paper incorporating this and other related points will be released by the Collaboration at a later date.

¹ Many companies already apply an internal Carbon Price – over 430 reported doing so in 2015. For example Microsoft has an internal Carbon Fee. They say “We identify projects for internal carbon reduction, e-waste recycling, green power, sustainable energy innovation, and carbon offset community projects. We divide the funds required for these environmental initiatives by our projected emissions to establish the carbon price” *Making and impact with Microsoft’s carbon fee* Tamara DiCaprio <http://aka.ms/carbon>.