BASEL FRAMEWORK AND E&S RISK MANAGEMENT
Basel II – addressing risks in banking sector;
E&S Risk – Materiality Test;
All material risks faced by the bank should be addressed in the capital assessment process. While the Committee recognizes that not all risks can be measured precisely, a **process should be developed to estimate risks.**

- Credit Risk Assessment/Credit risk concentration;
- Operational Risk Assessment;
- **Other risks** (although the Committee recognizes that ‘other’ risks, such as reputational and strategic risk, are not easily measurable, it expects industry to further develop techniques for managing all aspects of these risks)
Fundamental elements of sound capital assessment include:

- Policies and procedures designed to ensure that the bank identifies, measures, and reports all material risks;

- A process that relates capital to the level of risk;

- A process that states capital adequacy goals with respect to risk, taking account of the bank’s strategic focus and business plan; and

- A process of internal controls, reviews and audit to ensure the integrity of the overall management process.
**Assessment of Material Risks – The ‘4M’ Model**

1. **Is it material?** (If not, still need to document why not)
2. How is it **managed**?
3. How is it **measured**? (if it can be)
4. How is it **mitigated**?

- **All risks**
  - Not material
  - Cannot be measured
  - Can be measured, but no capital
  - Can be measured, and capital held

- **Still need to document**
- **Still need to manage and mitigate (e.g. reputational risk)**
- **Still need to measure, manage and mitigate (e.g. liquidity risk)**
Is E&S risk material for banking institutions?

Environmental/social costs are becoming increasingly financially material;

Borrowers with poor E&S performance can impact banks’ bottom line – E&S risk as a factor of credit, operational (lack of proper coverage by existing systems) and reputational risks

Asset class risks/credit concentration risk from E&S perspective and capital allocation
E&S Risk – Materiality Test

UNIVERSE OF SUSTAINABILITY ISSUES
Environmental Capital | Social Capital | Human Capital | Business Model & Innovation | Leadership & Governance

- Evidence of Interest
  - Issue frequency in 5 data-driven tests:
    - Financial risks
    - Legal drivers
    - Industry norms
    - Stakeholder concerns
    - Innovation opportunity

- Evidence of Financial Impact
  - Issue impact on 4 business value drivers:
    - Revenue impact
    - Return on capital
    - Risk management
    - Management quality

- Forward-looking Adjustment
  - Issue relation to 3 sustainability principles:
    - Magnitude
    - Probability
    - Externalities

PRIORITIZED SUSTAINABILITY ISSUES
Examples of indicators needed to better understand the reasons for non-performance:

- environmental accidents/disasters;
- social unrest;
- strikes;
- changes in E&S regulations;
- etc.
ANSWERS AND QUESTIONS

- Is it material? Yes
- Can it be managed? – Yes
- Can it be measured? – Yes
- How to measure?
- Would it justify a discrete capital charge?
- Should guidelines be included in the Basel framework?
- Other?