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Regulation: Pressure on EU to Implement 'One for One' Rule, Raising Financial Institution Capital Requirements

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Activists from Peru, Senegal, Uganda, Mexico, and the U.S. met with Members of the European Parliament last month seeking support for legislation to introduce the 'one for one' rule. This follows a similar request in an open letter to the Bank of England sent by academics, economists, and climate campaigners in October.

The 'one for one' rule refers to a bank regulatory concept whereby for each euro/pound/dollar that finances new fossil fuel exploration or production, banks and insurers should set aside a euro/pound/dollar of their own funds against potential losses. The "rule" is based on the idea that fossil fuel assets of financial institutions will diminish in value or become worthless in connection with climate transition and that they will suffer significant losses as a result.

Consistent with this rule, the European Parliament has called for amendments to the Capital Requirements Regulation, due to take effect in 2025, in the form of higher capital charges on EU banks' fossil fuel exposures: 150% risk-weight for exposures that received a final investment decision by the end of 2021 and 1,250% for exposures committed to after January 1, 2022.

Taking the Temperature: Despite widespread coverage, it is uncertain whether the 'one for one' rule will be approved by the European Parliament, and even if it is, whether EU member states would in turn adopt the measure. Nor is it apparent that such a bright-line rule would be an effective method for achieving financial stability. The rule assumes financial risk associated with a particular category of assets in isolation, without considering the particular institution's overall risk exposure based on all applicable material factors, including industry exposure, strategy, and customer base. The rule also runs counter in spirit to the thrust of global prudential regulatory guidance, which is to not seek to compel financial institutions to abandon all emissions financing, but to

devote appropriate efforts to assessing climate-related risks and opportunities and disclosing such assessments. This view was reflected in an October 21, 2022 letter from Sam Woods, Deputy Governor for Prudential Regulation of the Bank of England, providing feedback on how banks are faring with respect to meeting regulatory expectations. Regarding capital in particular, Woods stated that "some firms were holding capital for climate risks. The most effective firms had undertaken a methodical consideration of how climate risks could impact capital. This had allowed them to explain why they are, or are not, holding specific capital for those risks. A number of firms demonstrated effective practice by capturing climate in their macroeconomic scenarios or using specific climate scenarios to evidence their assessment of risk." In our view, such a nuanced approach makes more sense in being tailored to the individual institution and consistent with global regulatory guidance on risk assessment.