Implementing a Rights-Based Approach for Financial Regulation

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Outline

I. Conceptual issues

II. An Actual Case: Peru

III. A Concrete Proposal

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I. Conceptual issues
States have **the obligation to design policies and rules** that ‘respect, protect and fulfill economic, social and cultural rights’.

Two questions (one general, one particular):

i. Can policymakers design **austerity measures** that minimize their effects on vulnerable populations, preventing potential episodes of **social unrest**?

ii. Can **financial authorities** influence the evaluation of projects to mitigate their externalities on communities and prevent potential episodes of **social conflict**?

This presentation focuses on the latter.
**Externalities: The link connecting Rights, Risks and Regulation**

- Finance is all about **risk**. Investing is making a (calculated) bet on the future. Two kinds of risk are involved:
  - *Private risk* relates to possible losses incurred by the lender, which are passed on to borrowers (through the interest rate).
  - *Social risks* refers to possible losses suffered by third parties, when -for example- some projects incite social unrest.

- Both kind of losses affect people’s economic, social and (even) cultural **rights**. Because the second kind are borne by third parties, we call them externalities.

- Externalities are typically tackled through **regulation**.
II. An actual case: Peru
Where Human Rights and Economic Imperatives Often Collide: Mining

The perceived conflict:

- Income Needs and Modernity versus ..
  ..Tradition and Tried-and-True Survival Strategies

Specific Conflict Over:

- Water
- Air pollution (e.g. coal or mineral dust)
- Tailings
- Economic surplus (profits, taxes, voluntary contributions)
- Control
- Status (reinforce: price changes)
The Epidemiology of Conflict

- Conflict, like infection, exists, dormant everywhere and all the time.

- It becomes virulent and dangerous in spots where resistance is weak.

- Contagion plays hopscotch:
  - No geographical contiguity
  - Similarity of motivations
  - Similarity of correlations of forces
Social Conflicts in Peru

How many and what kind?

Where?
The Side Effects Dominate

Externalities are the name of the game:

- Co-workers and Related Divisions of Companies
- Suppliers and Clients
- Communities
- Local Authorities (Tax & Expenditures)
- Downstream and Upstream from Communities
- National Authorities
- International Spillovers (via price, quantity or finance)
The chickens come home to roost..

...at the banks:

- Direct funders
- Funders of suppliers and clients
- Funders of third parties
- Funders of government

Social Conflict winds up on some bank’s bottom line

- Pro-cyclical monetary policy can aggravate further
- Prudential policy: provisioning can further spread the epidemic
III. A Concrete Proposal
Voluntary Action

Various precedents:

- The Equator Principles
- IFC Performance Standards
- The OECD Common Approaches
- The UN Guiding Principles on Businesses and Human Rights

These standards have been signed onto by various banks and investors, but they are all voluntary and do NOT provide a level playing field.
Using clout

- Companies listen to their bankers.
- Bankers listen to their Regulators...

  ...Regulators can affect what companies do in the field.

Intervention:

- We want loss prevention or abatement.
- Through conflict prevention or abatement.

How:

- Early and thorough diagnosis.
- Early and sustained conciliation.
An illustrative example

1) Evaluation
   - Early diagnosis and conciliation

2) Exploration
   - Risk categorization

3) Development
   - Provisioning
   - Write-offs

Life cycle of a project

New Regulatory Approach
- Early diagnosis and conciliation

Voluntary Approach
- Risk categorization

Traditional approaches
- Provisioning
- Write-offs

Project Interruption
- conflictive scenario (e.g. Conga)

Ongoing Project
- good firm-community relationship
The Proposed Regs: a 4 legged stool

1) Assessment
- Environmental **and social** baselines
- Due diligence
- Impact assessments
- Preventive standards
- **Dialogue**
- **Grievance** mechanisms

2) Risk mapping
- High risk
- Medium-high risk
- Medium-low risk
- Low risk

3) Independent review

4) Lending decision
- **No**
- **Yes**

Emphasis on social aspects

Covenants and Action plans
IV. Conclusions
Key Messages

Rights-based Risk Regulation can be seen as a particular case of Right-based Economic Policies, where the aim is mitigating externalities that adversely affect third parties’ rights.

Regulations seem an effective remedy because:

- They level the playing field so lenders are not tempted to compete by offering more lenient standards.
- They encourage lenders to apply stricter standards and covenants to provide their borrowers with incentives to protect human rights.

This is a concrete regulatory proposal whose publication is expected in late October/early November.