BaFin

Bundesanstalt für
Finanzdienstleistungsaufsicht

BaFin – Dealing with sustainability risks

Climate change vs. economy

"Who wants to be successful in the financial services sector in the long term, cannot ignore this issue any longer."
(Felix Hufeld, 09 May 2019)

Estimated macroeconomic impact under different warming scenarios:

Economic impacts	<2 °C		3 °C	5 °C
Global GDP impact (2018: $80tn)	-10%	-13%	-23%	-45%
Stranded assets	Transition: fossil fuel assets (supply, power, transport, industry)		Mixed: some fossil fuel assets mothballed, some physical stranding	Physical: uninhabitable zones, agriculture, water-intense industry, lost tourism etc
Food supply	Changing diets, some yield loss in tropics		24% yield loss	60% yield loss, 60% demand increase
Insurance opportunities	New low-carbon assets and infrastructure investment (e.g. CCS)		Increasing demand to manage growing risks	Minimal: recession, tensions, high and unpredictable risks

(compared to baseline scenario)

Source: Chief Risk Officers Forum (January 2019)

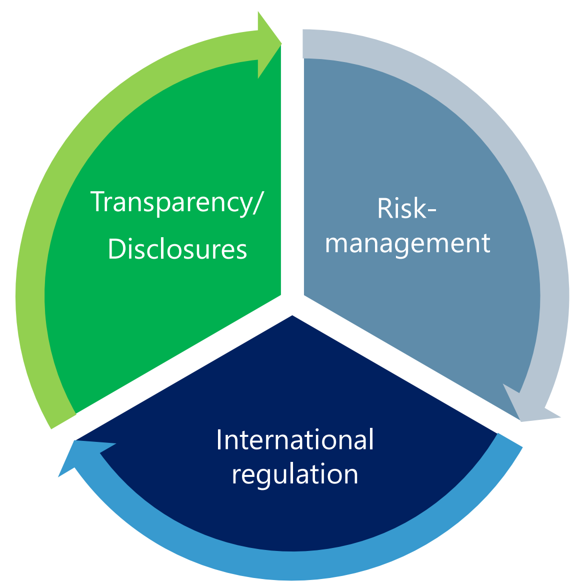
Financial risks

- Sustainability risks are not a new risk category, but drivers of established risk categories, such as:

	Credit risk	Market risk	Operational risk	Insurance risk
Physical risks	Re-evaluation of lenders and collateral	Declining market values after catastrophes	Physical damages and business interruption	Settlement of damages; un-insurability?
Transition risks	Stranded assets; Impact on PDs and LGDs	Sudden extreme market volatility	Reputational damages for unsustainable business	Liability risks

BaFin‘s approach

- BaFin promotes maintaining the stability and integrity of the German financial market, within the framework of European integration, international cooperation as well as with regard to its responsibilities for collective consumer protection.
- As an integrated supervisor, BaFin addresses **sustainability across all sectors**.
- BaFin will **integrate sustainability** into its **risk-based supervisory approach** and publish a guidance notice on the treatment of sustainability risks in December 2019.



Milestones

- March 2018: BaFin Directorate adopts **strategy** on environment and climate risks.
- April 2018: Establishment of a BaFin-wide network for knowledge sharing, internal coordination + decision-making. Frank Pierschel was appointed as **Chief Sustainable Finance Officer** in May 2019.
- July 2018: BaFin commenting on COM Sustainable Finance legislative proposals to Ministry of Finance.
- April 2019: Appointment of Frank Pierschel as **Chief Sustainable Finance Officer**.
- May 2019: BaFin **conference "Nachhaltige Finanzwirtschaft"** in Berlin for the German financial sector.
- May 2019: An whole edition of **"BaFin-Perspektiven"** dedicated to Sustainable Finance.
- September 2019: BaFin consults **"Merkblatt zum Umgang mit Nachhaltigkeitsrisiken"**.
- End of 2019: Scheduled publication of the final version of the guidance notice.

Just a reminder...

§ 25a Banking Act
(1) An institution shall have in place a proper business organisation which ensures compliance with the legal provisions to be observed by the institution as well as business requirements. The management board is responsible for ensuring the institution's proper business organisation; it shall take the necessary measures to formulate the applicable internal policies except where such decisions are taken by the supervisory board. A proper business organisation shall comprise, in particular, appropriate and effective risk management, on the basis of which an institution shall continuously safeguard its internal capital adequacy; (...)

§ 28 Capital Investment Act
(1) The management company has in place a proper business organisation, which ensures compliance with the legal provisions to be observed by the management company. A proper business organisation shall comprise, in particular, an adequate risk management system; (...)

§ 29 Capital Investment Act
(2) The management company shall have in place adequate risk management systems, which ensure that the material risks related to the respective investment strategies of the investment funds can be identified, measured, managed and monitored at all times. The management company shall regularly, at least once a year, review and, where appropriate, amend the risk management systems.

§ 26 Insurance Supervision Act
(1) Insurance undertakings shall have in place an effective risk management system which is well integrated into the organisational structure und the processes for decision-making of the undertaking whilst appropriately taking into account the information needs of the persons effectively managing the undertaking or other key function holders by adequate internal reporting arrangements. The risk management system comprises the strategies, processes and internal reporting procedures necessary to identify, assess, monitor and manage the risks the undertaking is actually or potentially exposed to as well as to meaningfully report on those risks. It shall enable a continuous risk management on an individual and aggregated level, also considering the interdependencies between the risks (...)

§ 80 Securities Exchange Act
(1) Investment firms must comply with the organisational requirements under section 25a(1) and section 25e of the Banking Act. (...)

The guidance notice: Development and legal status

- In order to implement **recommendation 1 b) of the NGFS**, BaFin is working on a **guidance notice** on dealing with sustainability risks (English version available on our website).
- Addressees: All BaFin-supervised entities.
- That sustainability risks must be addressed already follows from existing laws as well as MaRisk, MaGo, KaMaRisk. The guidance notice provides ideas and recommendations, but with regard to the „How to" allows for **methodological freedom**. However: *„BaFin expects that institutions ensure dealing with such risks and document this in an adequate way."*
- Development since March 2019 with the support of BaFin's internal Sustainable Finance Network and Deutsche Bundesbank.
- **Public consultation** from 24/09 to 03/11/2019: https://www.bafin.de/dok/13008594
- Publication scheduled for end of 2019.

Table of contents

0) Summary
1) General remarks
2) Introduction
3) Strategies
4) Responsible management
5) Business organisation
6) Risk management
7) Risk management: stress tests including scenario analysis
8) Outsourcing
9) Groups
10) Usage of ESG ratings

Chapter 6: Risk management

- **Basics**: Definition of tasks, responsibilities and timeframe for the management of sustainability risks within established risk categories. Assessment of the need for sustainability experts. Regular review of methods and procedures. Consideration in risk management policies. Establishment of an escalation process to the management body. Risk indicators, where appropriate.
- **Risk management methods**: exclusion criteria/limits; white lists; best-in-class approach; norm-based screening/ESG-integration; positive investment; engagement. Application in practice frequently only in investment decisions, but eventually adaptable to loan origination and underwriting.
- **Risk classification process**:
  - Identification, assessment and (contractual) limitation of sustainability risks.
  - Belonging to emissions-intensive sectors/heatmaps;
  - In case of higher risks, more in-depth analysis necessary (e.g. GHG emissions, market environment, regulatory requirements, likely impact on future profitability and solvency as well as strategies for the future);
  - Risk classification should result in adequate measures.

Chapter 6: Risk management (continued)

- **Risk classification process** (continued):
  - Possible measures resulting from a risk classification (partially applicable in particular for investment decisions):
    - Entry into a dialogue;
    - Execution of voting rights at investee companies;
    - (contractual agreement of) measures on risk mitigation/management up to comprehensive action plans;
    - Warranty to comply with certain sustainability standards;
    - Progress monitoring;
    - Advice on investments for lowering sustainability risks;
    - Rejection of transaction or limitation.
  - Result of risk classification -> Approval and conditions

Chapter 6: Risk management (continued)

- **Tools for risk assessment or portfolio analysis (potentially only as an annex or separately on website)**:
  - Already some tools available on the market.
  - BaFin does not assume any responsibility.
  - Do not replace own risk assessment, but may support.
- **Reporting**: Sustainability in risk and internal reporting.

Chapter 6: Risk management (continued)

- **Supplement for institutions:**
  - Consideration of material sustainability risks in risk inventory (within credit risk, market risk, spread risk and OpRisk);
  - Sufficient risk coverage potential for material risks, including sustainability risks (ICAAP);
  - Integration in loan origination and further credit administration, e.g. solvency of debtor, whose income is generated essentially from leasing of credit-financed buildings to emissions-intensive companies;
  - Consideration of value-adding factors into valuation of collateral.
- **Supplement for asset management companies.**
- **Supplement for insurance undertakings & IORPs:**
  - Consideration of material sustainability risks in risk inventory and ORSA.
  - Risk management areas (e.g. asset-liability-management, technical reserves);
  - Underwriting of insurance risks.

Feedback from consultation

- Support from NGOs and some individual institutions.
- Not strict enough, should be binding.
- Concrete examples helpful in guiding ESG risk integration.

- Criticism from financial industry associations.
- Too strict, too prescriptive.
- Examples discriminate against individual sectors.
- Should wait for EU-wide regulation.
- No suitable for fund managers.
- Supervisory expectations will make a business case for auditors / tick-boxing exercise.

Thank you for your attention

Christian Elbers, LL.M.

Federal Financial Supervisory Authority (BaFin)
Senior Advisor to the Chief Sustainable Finance Officer

Graurheindorfer Str. 108
53117 Bonn
Fon: +49 [0]228 4108-4488
e-mail: Christian.Elbers@bafin.de