Sustainability risks pose both a direct and an indirect challenge to the financial sector. Damage caused by extreme environmental or climate change or as a consequence of developments in society can have a direct impact on financial market participants, such as insurers. This can also create indirect risks: developments such as a stigmatisation of established technologies, short-term changes in the politico-economic framework conditions and ethico-social transformations can lead to a significant loss in the value of assets and, thus, to so-called stranded assets.

At the same time, the financial sector itself can contribute to a successful social transition by adequately assessing current and future investment risks and opportunities using reliable information and, as a consequence, achieving more efficient capital allocation. However, it is currently difficult to estimate the extent of these opportunities and risks.

**Definition**

**Sustainable finance**

The term sustainable finance describes the financial markets' contribution to changes in social and economic factors as well as in factors that have an impact on the environment in order to pave the way for humanity's long-term survival on earth. Environmental and climate-related risks are the major focus of this topic area.
BaFin's primary objective is to ensure and promote the proper functioning, stability and integrity of the German financial market within the framework of European integration and international co-operation and to strengthen collective consumer protection. Bearing in mind the importance of sustainability management for the financial sector and its social implications, BaFin has been dealing with this issue for some time now in all of its directorates. This is because climate, environmental and social changes can entail substantial risks for individual financial market participants as well as for the financial market as a whole, a fact many market participants still underestimate.

BaFin takes a risk-based approach in this context too. It will give increased and systematic consideration to sustainability in its ongoing supervision and advocates the introduction of guidelines on an international level that are as uniform as possible.

Supervised entities are supposed to clearly incorporate current and future environmental, social and governance risks in their risk management and strategic planning in order to contribute to more efficient capital allocation and play a more constructive role in the transition towards a sustainable economy.

In addition, BaFin participates in international working groups on this topic and is engaged in an exchange of professional views with important representatives from the public and private sectors and from civil society. It will also establish partnerships to co-operate more closely on certain topics. Another aspect of BaFin's work in this area is following innovative developments and initiatives by market participants and other supervisory authorities to include them in its analyses and, if appropriate, integrate them into its supervisory practice. It will initiate portfolio analyses with regard to carbon risks as well as other analyses in order to be able to better assess and quantify environmental and climate-related risks.

In general, BaFin will review all measures with regard to their effectiveness and ensure that the burden for itself and market participants is appropriate.

**Reporting**

BaFin has identified three important topics with regard to sustainability risks: reporting, dealing with physical and transitional risks and regulation. The availability of reliable and standardised information is a necessary precondition for enabling market participants to adequately account for risks in their internal risk management. At the moment, there is a deficit as regards the availability of information on environmental and climate-related risks.

However, there are already numerous initiatives to establish reporting standards for these risks, some of which are currently being implemented. The European CSR Directive [https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0095&from=EN] 2, for example, requires certain companies, especially large ones, to comply with corresponding disclosure requirements. In addition, the Financial Stability Board (FSB) published non-binding recommendations [http://www.fsb.org/wp-content/uploads/P290617-5.pdf] in June 2017. Other bodies such as the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS) and the newly founded international Network for Greening the Financial System (NGFS) [https://www.banque-france.fr/en/financial-
stability/international-role/network-greening-financial-system] are also working on corresponding proposals. BaFin is a member of the respective working groups and is therefore actively involved. A key focus here is counteracting fragmentation at an early stage and creating a harmonised and, thus, efficient international framework.

Dealing with risks

Standardised information enables market participants to assess substantive sustainability risks and integrate them into their risk management. As these risks show their effects in the middle to long term, risk management needs to be designed with a long-term focus in order to take account of them. This way, it will also be easier to identify transitional risks, i.e. risks associated with the transition towards a sustainable economy, and to integrate them into risk and strategic management.

As companies are responsible for their own risk management systems, they are obliged to further develop methods and instruments to take account of sustainability risks independently. In addition to adjustments to existing risk models, scenario-based analyses and stress tests could be useful tools to quantify these risks and their effects within the overall risk management system.

BaFin will work to increase awareness of these issues among the companies under its supervision and will require them to integrate sustainability risks into their risk management systems.

Regulation

Against the backdrop of its global dimension, the strong interconnectedness of international financial markets and the crucial supranational and international legislative and standard-setting initiatives, the matter of sustainability risks requires coordinated action on an international level. The central initiatives implemented on a European level include the sustainable finance report [https://ec.europa.eu/info/publications/180131-sustainable-finance-report_en] issued at the end of January, which forms the basis for the European Commission’s action plan [https://ec.europa.eu/info/publications/180308-action-plan-sustainable-growth_en] (see March 2018 edition of BaFinJournal – only available in German). Both documents will form central starting points for the drafting of a harmonised European strategy on the matter. In addition, the European Commission has suggested in its proposal [https://ec.europa.eu/info/law/better-regulation/initiatives/com-2017-536_en] to amend the regulations on the three European supervisory authorities (ESAs, see October 2017 edition of BaFinJournal – only available in German) that the ESAs’ mandate be extended to include the matter of sustainable finance and, thus, to increase its significance.
As a risk-oriented supervisor, BaFin’s primary task is to evaluate financial risks and ensure the integrity of the financial markets, while at the same time also taking account of the interdependence between the financial markets and ethical, social and environmental investment criteria. In doing this, BaFin concentrates on two areas: firstly, it analyses the extent to which existing regulatory and supervisory frameworks contain potential barriers to the consideration of sustainability risks and, to the extent it is able, works towards removing them. In this regard, the European sustainable finance report serves as a promising basis. Secondly, BaFin seeks to identify relevant international developments early on and to assess whether they could lead to undesirable side effects and interdependencies.

Based on this proactive approach, BaFin is able to contribute its standpoints and assessments to international committees at an early stage, swiftly address international developments in its supervisory practice and accompany the political process with its expertise. In its efforts to achieve a risk-appropriate regulation, it will in particular advocate the principle that there should be no regulatory bonus if it is not justified with regard to the underlying risks.

Author
Frank Pierschel
BaFin Division for International Banking Supervision

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Footnote:
1 CSR: Corporate Social Responsibility.

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