



S&P Global Response to BaFin Consultation 16/2019 – Dealing with Sustainability Risks

S&P Global welcomes the opportunity to respond to BaFin Consultation 16/2019 – Guidance Notice on Dealing with Sustainability Risks.

S&P Global has been engaged in the policy debate in this space at international, regional and national levels through membership of the Task Force on Climate-related Financial Disclosure (TCFD) and the EU High Level Expert Group on Sustainable Finance (HLEG). This response draws on research from across our divisions.

We hope that our comments on the draft Guidance Notice are helpful to the ongoing work of BaFin and would be happy to contribute further. We particularly welcome the inclusion of Section 10 of the Guidance Notice (“Use of ratings”) and fully support the BaFin’s reasoning in this regard. Specifically, we agree that, in line with requirements under the EU Credit Rating Agency Regulation, credit ratings should only take account of the factors required to assess the creditworthiness of an entity or the credit risk of a financial instrument. As BaFin points out in its Guidance Notice, Environmental, Social, and Governance (ESG) factors can have an impact on creditworthiness. However, we agree with BaFin that if ESG factors have no influence on the creditworthiness of an entity or the credit risk of a financial instrument in a particular case, then they should not be included as part of the credit analysis for the credit rating. Where relevant and material to creditworthiness, ESG criteria are taken into account by S&P Global Ratings, as explained below.

S&P Global is a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide. The company's divisions include S&P Global Ratings, S&P Global Market Intelligence, S&P Dow Jones Indices, and S&P Global Platts.

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Comments on BaFin Guidance Notice on Dealing with Sustainability Risks

General Remarks

We share BaFin’s view regarding the importance of sustainable finance and that risks stemming from climate change and ESG should be taken seriously (Section 2.3). S&P Global has been investing in this space for a number of years across our four divisions, S&P Global Ratings, S&P Global Market Intelligence, S&P Dow Jones Indices, and S&P Global Platts.

In this regard, we agree with the BaFin’s view outlined in section 10 that when ESG factors have no influence on the creditworthiness of an entity or the credit risk of a financial instrument in a particular case then they should not be included as part of the credit analysis for the credit rating. We agree with BaFin that any move to mandate the inclusion of ESG factors which are not material to credit risk in the credit risk analysis for credit ratings would distort the credit ratings’ meaning as an opinion on

creditworthiness, which would likely create confusion among investors and could thereby contribute to increased financial stability risk.

As explained below, S&P Global Ratings incorporates ESG credit factors into its credit analysis across all sectors if we believe the factors are material and relevant to our opinions of creditworthiness. The influence of ESG credit factors depends on our opinion of how much they affect the capacity and willingness of an obligor to meet its financial commitments. ESG credit factors can influence ratings, rating outlooks, and ratings headroom. ESG credit factors' influence differs across industries.

Introduction

We agree with BaFin's general assessment that financial risks from climate change may crystallise over longer-term horizons and that adopting a strategic approach to evaluating, modelling, and addressing potential climate-related risks can help financial institutions to mitigate them.

Financial Risks from Climate Change

We also recognise the BaFin's identification of the distinct channels (physical and transition, as well as the nature of interdependencies between both risks, including liability risks) through which these risks can materialise as well as their potential effect on the financial situation of a given financial institution. Similar aspects are assessed in our credit ratings in order to evaluate risks associated with ESG factors and to feed into the analysis of the competitive position and the financial profile of these entities.

Transition

In addition to the risks listed by BaFin in Section 2.3, the potential impact of carbon pricing (as referred to in section 2.2) can be another potential transitional risk. By applying a carbon pricing risk premium to a company's regional Green House Gas (GHG) emissions, it is possible to quantify the potential additional costs that could materialize in the transition to a low-carbon economy. This approach to assessing financial risk from carbon pricing trajectories – based on the scale and spread of an individual company's current operations – allows an estimation to be made as to how a company's market valuation could be affected in the future. S&P Global's in-house ESG data provider Trucost believes that carbon pricing will feature prominently in global efforts to address climate change, with carbon prices already implemented in many countries and regions. To help companies understand their exposure, Trucost has quantified current pricing schemes in over 130 regions together with potential future carbon pricing scenarios required to limit global warming to 2 degrees Celsius. Business analytics assess the potential impact of future carbon prices on key financial metrics and competitiveness.¹ This approach has also been applied by S&P Dow Jones Indices via the launch of our S&P Carbon Price Risk Adjusted Indices to embed future carbon price risk into today's index constituents.

Data

We note and share BaFin's assessment in section 1 that "that sustainability risks are sometimes difficult to measure and manage given the frequent absence of relevant historical data, the wide range of factors requiring consideration and the various uncertainties regarding future climate and political scenarios". We therefore also welcome BaFin's statement in this section that "this also makes it necessary to adapt existing processes and potentially develop new and innovative measurement,

¹ S&P Global, Trucost Carbon Pricing Tool – <https://www.trucost.com/corporate-advisory/carbon-pricing-tool/>

management and risk reduction tools". In this context, we would like to highlight the work we are undertaking to develop new tools and metrics to assess ESG exposure.

Although it is not a credit rating, our proposed ESG Evaluation tool combines our opinion of an entity's relative exposure to observable ESG related risks and opportunities (the ESG "Profile"), with our qualitative opinion of the entity's long-term preparedness for ESG related opportunities and disruptions (ESG "Preparedness"). An S&P Global Ratings ESG Evaluation is a cross-sector, relative analysis of an entity's capacity to operate successfully in the future and is grounded in how ESG factors could affect stakeholders and potentially lead to a material direct or indirect financial impact on the entity.

The S&P Global ESG Evaluation tool was launched in April 2019. The manner through which we approach ESG Evaluations may be informative in the context of this BaFin consultation. In our analysis, we take a broad view of governance to include potentially material risks or opportunities that the entity faces.

The final outcome of the ESG Evaluation is a qualitative opinion from S&P Global Ratings' analysts based on their sector and country knowledge and analysis, with entity-level analytical adjustments, and will be informed by interactive discussions with the entity's senior management, including members of the board. Our ESG Evaluation helps investors to assess an entity's adaptability through our assessment of each industry's sector-specific ESG risks and opportunities, geographic risk, management engagement, and our assessment of the entity's preparedness for potential disruptions due to ESG factors in the longer term.

The ESG Evaluation utilizes data that entities supply directly through a new ESG Diagnostic questionnaire and incorporate environmental and other data from S&P Global Trucost and other S&P Global divisions.

It is important to state that the proposed ESG Evaluation is not a credit rating, a measure of credit risk, or a component of our credit rating methodology. However, the information we gather for an ESG Evaluation can inform our credit analysis of rated entities. The ESG Evaluation is a stand-alone, on-request service and is separate from our credit ratings.²

Governance and Risk Management

With regard to the sections on Governance and on Risk Management (sections 4, 6, and 7), rather than commenting directly on BaFin's proposed expectations for firms we wish to share our approach to assessing the ESG factors relevant to credit risk for banks and insurers in our credit ratings. We hope that this will provide BaFin further useful information on how we approach governance, risk management, scenario analysis, and disclosure in our assessment of climate-related financial risk in our credit ratings.

How Our Credit Rating Criteria Capture ESG Factors

For a more comprehensive explanation of how we capture ESG factors for banks and insurance firms in our credit ratings we would refer the BaFin to S&P Global Ratings' article entitled "How Environmental, Social, And Governance Factors Help Shape The Ratings On Governments, Insurers,

² More information on S&P Global's ESG Evaluation can be found at <https://www.spglobal.com/ratings/en/products-benefits/products/esg-evaluation>.

And Financial Institutions”.³ The following summarises our approach primarily with regard to environmental risk, in line with the contents of BaFin’s Guidelines.

S&P Global Ratings incorporates ESG considerations into its ratings methodology and analytics, enabling analysts to factor in short-, medium-, and long-term impacts – both qualitative and financial – into their considerations at a number of points in their credit analysis. We continuously monitor the impact of ESG factors, as we do all relevant factors, on an entity's credit profile.

Our credit ratings are forward-looking and incorporate our financial forecasts. These forecasts reflect the period over which we consider we have a clear view of an entity's potential financial performance, taking into account capital structure, and the potential impact of relevant factors (including ESG risks and opportunities). Generally, our forecasts cover up to two years for speculative-grade corporate entities (those rated BB+ and below) and no more than five years for investment-grade issuers (BBB- and above). We also consider whether the credit profile is sustainable beyond those periods. If we have a high degree of certainty about risks or opportunities that happen beyond the typical forecast period, we factor those into our ratings, and potentially our financial forecasts, as appropriate.

Therefore, we factor the impact of ESG risks and opportunities, if sufficiently visible and material, into our financial forecasts. In some cases, our view of the materiality and visibility of ESG risks and opportunities, and how effectively an entity is mitigating those risks, extends beyond our forecast timeframe. Our qualitative rating considerations could still capture these factors if we are fairly certain about their risks and opportunities. We monitor the impact of these ESG factors and our view will evolve as new information becomes available, or as the issuer's fundamentals change.

Insurance

With respect to insurance, S&P Global Ratings identifies the intricate and complex relationships with greenhouse gas emissions, climate change, natural resource contamination and scarcity, pollution, and biodiversity impact on insurers' operating models and their exposure through their counterparties via investments and insurance contracts with other (re)insurers. Our focus on environmental risk within insurance credit ratings goes beyond weather-related phenomena, given that most insurance business models, by definition, are exposed to natural catastrophe risks across sectors (for instance, property damage, fatality, or medical spending). With environmental risk, we look to anticipate additional operational costs for insurers due to inability to operate or recover from investments vulnerable to environmental issues.

In addition, insurers may incur sizable claim settlements due to climate-related liability exposure. Climate change could end up affecting human mortality and morbidity in significant ways. Rising temperatures, heavy rains, and droughts can pose health risks, possibly leading to increased deaths. For example, populations exposed to areas affected by extreme heat or poor air quality could experience a shift in health threats stemming from reduced food and water quality.

Our insurance methodology takes a similar approach to our corporate and bank criteria frameworks, weaving analysis of ESG risks and opportunities into several aspects of the overall credit rating process.

In assessing an insurer's business risk profile, we analyze the risks inherent to the insurance markets in which it operates. The insurance industry and country risk assessment incorporates our view of the insurance markets' economic, political, and financial system risks; its regulatory framework; and its

³ S&P Global Ratings, “How Environmental, Social, And Governance Factors Help Shape The Ratings On Governments, Insurers, And Financial Institutions”, 23 October 2018 – [Link](#).

growth prospects. Climate change could affect all of these factors. Exposure to ESG risks could also affect the strength of the insurer's brand name, profitability, and competitive position.

Our assessment of an insurer's financial risk profile includes our prospective view of capital adequacy. Applying our capital model criteria, we incorporate a risk charge to capture the impact of 1-in-250-year catastrophe losses (that is, the level of annual losses that has a probability of 0.4% of being exceeded) in our evaluation of capital adequacy. Although climate change might affect the magnitude or frequency of extreme weather events, there is no scientific agreement about the precise quantitative impact the industry can use in its natural catastrophe models.

The uncertainty in an insurer's capital and exposure management relating to catastrophe models could lead us to conclude that risks are understated in our capital analysis, affecting our capital and earnings assessment.

The financial risk profile assessment also incorporates our analysis of the insurer's risk position. Here, we measure risks not captured in the capital and earnings analysis and risks that could make capital more volatile. If we conclude that exposure to climate change (or other ESG risks) is material and contributes to above-average volatility in prospective capital adequacy, we might lower our risk position assessment.

Our credit rating analysis also incorporates our view of an insurer's management, governance, and enterprise risk management. How well insurers prepare themselves to deal with the challenges from ESG risks is a relevant consideration in these assessments.

Banks

Like insurers, banks could be vulnerable to what the TCFD would define as "acute risk," that is, deterioration in the quality of its loan exposures or securities investments and attrition of its revenues base immediately after a severe natural catastrophe. However, risk could also result from loan portfolio concentration, or securities investments in potentially environmental unfriendly sectors (such as mining and arctic drilling), whose main players could see their financial health deteriorating if the legal, technological, or reputational context changes rapidly.

Although our capital assessment looks at expected credit- and market-risk elements of a bank's activities, our assessment incorporates risks that our capital model does not capture directly.

Therefore, we consider ESG factors in our assessment of risk position. For example, we could revisit our credit ratings if we anticipate that a bank will suffer losses due to the impact of climate change on its loan and investment portfolios. This could include losses from climate-risk-related exposures from assets acting as collateral for loans. The risk position assessment might also weaken if, in our view, the bank is exposed to significant legal risks. Costly litigation from mis-selling or other conduct issues has given rise to risks not related to the credit quality of loans and investments, even for traditional banking activities in developed countries.

Risk Management

With regard to section 6 of the Draft Guidance Notice on risk identification and measurement as well as on risk monitoring, we agree that sustainability risks should be clearly defined within the framework of the existing risk types relation to changes in interest rates or other economic parameters. We also see benefits if mitigation plans are openly articulated and communicated publicly.

However, we would expect prudential capital planning to remain focused on a purely risk-based approach. We believe that the risk-weights associated with any exposure, in order to serve their intended purposes, are best correlated with their respective credit risk and not their “green nature”.

Scenario Analysis and Disclosure

With regard to section 7 of the Draft Guidance Notice on stress tests and scenario analysis, we believe that the BaFin proposals could help enhance transparency and inform strategic planning.

Additional disclosures as a result of the adoption of the TCFD recommendations should, over time, further enhance our ability to take these risk factors and opportunities into account in our credit rating analysis and to compare exposures via sensitivity analysis.

The main challenges when trying to evaluate climate risks for individual corporates are the lack of disclosure generally and – where disclosure does exist – the lack of comparability across peers. The TCFD's recommendations should help to standardize the types and quality of climate-related disclosures by providing a unified framework of what to disclose and how to disclose it. If the TCFD disclosure standards are taken up, or required via regulation, and adhered to by a wide range of companies, this will change the current status quo of inconsistent and incomparable disclosure – or indeed non-existent disclosure.

TCFD-based disclosure would provide climate risk-related information that is much more useable in the financial markets, including by S&P Global Ratings. We expect that this change in the status quo will take time to develop as organizations will have to decide whether to follow the voluntary disclosure guidelines and might have to increase certain capabilities in order to facilitate the disclosure requirements.

Use of credit ratings

As mentioned above, we agree with BaFin's findings outlined in section 10 of the Guidance Notice on credit ratings.

Specifically, we agree with BaFin that, in line with requirements under the EU Credit Rating Agency Regulation, credit ratings should only take account of the factors required to assess the creditworthiness of an entity or the credit risk of a financial instrument. As BaFin points out in its Guidance Notice ESG factors can have an impact on creditworthiness. However, we agree with BaFin that if ESG factors have no influence on the creditworthiness of an entity or the credit risk of a financial instrument in a particular case, then they should not be included as part of the credit analysis for the credit rating. Where relevant and material to creditworthiness, ESG criteria are taken into account by S&P Global Ratings.

As discussed above, S&P Global Ratings incorporates ESG credit factors into its credit analysis across all sectors if we believe the factors are material and relevant to our opinions of creditworthiness. The influence of ESG credit factors depends on our opinion of how much they affect the capacity and willingness of an obligor to meet its financial commitments. ESG credit factors can influence ratings, rating outlooks, and ratings headroom. ESG credit factors' influence differs across industries.

S&P Global Ratings incorporates ESG considerations into its credit ratings methodology and analytics, enabling analysts to factor in short-, medium-, and long-term impacts – both qualitative and financial – into their considerations at a number of points in their credit analysis. We continuously monitor the impact of ESG factors, as we do all relevant factors, on an entity's credit profile. Strong ESG credentials

do not necessarily indicate strong creditworthiness. Weak ESG credentials do not necessarily indicate weak creditworthiness.

We agree that specialised ESG ratings can be used to determine the sustainability of financial investments and, where applicable, to infer additional information regarding sustainability risks. We also agree with BaFin that “pure ESG ratings that have no bearing on credit risk should be clearly distinguished from established market credit ratings, in order to avoid any confusion and to provide the necessary security for the market”.

