

BaFin Guidance Notice

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BaFin

Bundesanstalt für
Finanzdienstleistungsaufsicht

Guidance Notice on Dealing with Sustainability Risks

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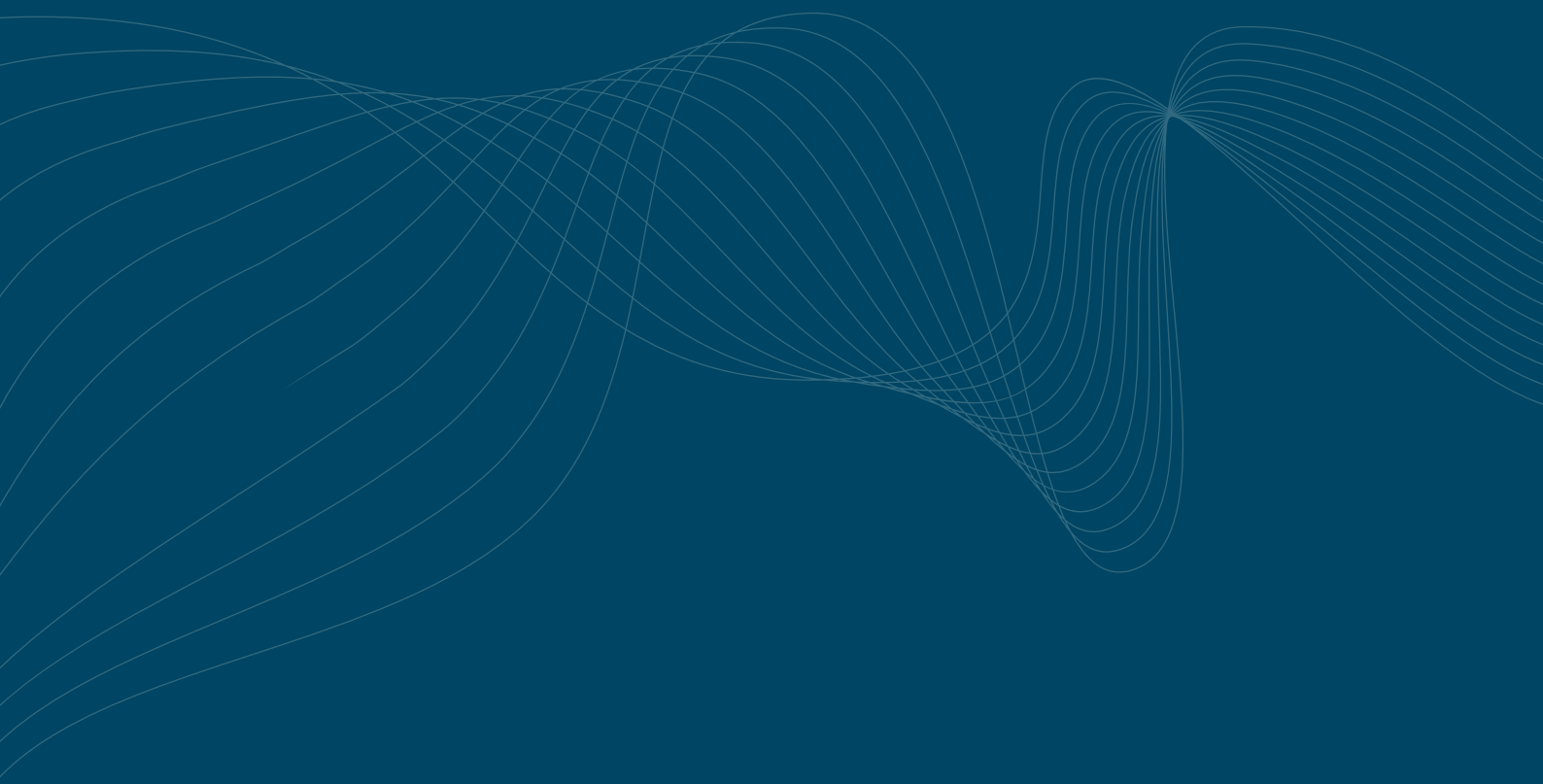
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Summary



The objective of this Guidance Notice is to provide entities supervised by the Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht – BaFin) with guidance on dealing with the increasingly important issue of sustainability risks. It cites numerous examples and potential questions for the purposes of illustration.

BaFin intends this Guidance Notice to serve as a compendium of non-binding procedures (good practice principles) to be applied, with regards for the principle of proportionality, by supervised entities in the area of sustainability risks to implement the legal requirements for a proper business organisation and an appropriate risk management system. This Guidance Notice can thus be seen as initiating a useful addition to the minimum requirements for risk management for credit institutions, insurance undertakings, pension funds, asset management companies and financial services institutions. However, it does not aim to formulate concrete inspection requirements.

The Guidance Notice defines the term sustainability on the basis of ESG (environmental, social and governance) criteria, and illustrates physical and transition risks that may unfold with increasing intensity through existing risk types. BaFin expects supervised entities to ensure that the relevant risks are adequately considered.

The Guidance Notice considers details of strategies, responsible governance and business organisation. BaFin recommends a strategic assessment of sustainability risks. The management board has overall responsibility for the business and risk strategy and its communication and implementation within the entity, as well as for maintaining an appropriate business organisation with the responsibilities, processes, resources and functions to address the risks.

The central focus of the Guidance Notice is risk management. It considers risk identification, management and control processes together with traditional methods and procedures, with specific reference to sustainability risks. This section also highlights the specific features relating to entities supervised under the KWG (*Kreditwesengesetz* – German Banking Act), VAG (*Versicherungsaufsichtsgesetz* – German Insurance Supervision Act) and KAGB (*Kapitalanlagegesetzbuch* - German Investment Code), regarding the inclusion of sustainability risks into risk management.

In addition, the Guidance Notice considers issues regarding stress tests including scenario analyses, particularly with regard to entity-specific tests, and considers transition and impact scenarios. External stress tests are not covered. Finally, BaFin takes a stance on questions relating to outsourcing, group issues and the use of sustainability ratings.

BaFin invited consultation on this Guidance Notice on Dealing with Sustainability Risks and received a total of 39 opinions and commentaries. Major objections and individual technical points were taken into account when finalising the Guidance Notice.

1 General information

1.1 Classification and objective of the Guidance Notice

The specific objective of this Guidance Notice is to provide entities supervised by BaFin with guidance on dealing with the increasingly important issue of sustainability risks, thereby also implementing recommendation 1(b) of the Network for Greening the Financial System (NGFS) to include climate-related risks in the supervisory function and to formulate supervisory expectations¹. The principles and processes demonstrated in this Guidance Notice can be thought of as non-binding good practice guidelines with which entities can align their in-house handling of sustainability risks; this also applies with regard to the Supervisory Review and Evaluation Process.

What is important to note: existing legal requirements detailed in e.g. the BaFin Circulars MaRisk², MaGo³ and KAMaRisk⁴ remain unaffected, i.e. all (material) risks must be identified, assessed, monitored, managed and communicated. Sustainability risks have an impact on existing risk types. **BaFin expects supervised entities to ensure that sustainability risks are also considered and that this process is documented**. Supervised entities are free to choose their approaches and methods. In this respect, alternative or additional approaches to the principles and processes established in this Guidance Notice are

possible. The initial aim of BaFin is not to formulate concrete inspection requirements. However, inspection requirements for supervised entities will be introduced at a later date to implement European Regulations, Directives and Guidelines.

BaFin wishes to point out that this Guidance Notice neither reduces nor extends any binding legal or supervisory requirements as regards sustainability risks⁵. This applies in particular to pending European action on the integration of sustainability risks for insurance undertakings⁶, investment firms⁷ and asset management companies⁸, and credit institutions⁹. In this context, adjustments will also be made to this Guidance Notice where applicable.

1.2 Cross-sectoral application

This Guidance Notice serves as an orientation for all entities supervised by BaFin; specifically, credit institutions, insurance undertakings and pension funds, asset management companies and financial services institutions, with their registered offices in Germany, and includes their foreign branch offices. The Guidance Notice also applies to the branches of third-country entities, provided that they are supervised in Germany like domestic entities.

As this Guidance Notice applies across sectors, implementation at the individual entity level should also appropriately reflect relevant sector-specific characteristics. Evidently, the explanations included in

1 "A call for action", NGFS, 2019.

2 Minimum Requirements for Risk Management (*Mindestanforderungen an das Risikomanagement* – MaRisk).

3 Minimum requirements on the system of governance of insurance undertakings (*Mindestanforderungen an die Geschäftsorganisation von Versicherungsunternehmen* – MaGo). In the future, there will also be "Minimum requirements under supervisory law on the system of governance for institutions for occupational retirement provision" and "Minimum requirements under supervisory law on the system of governance for small insurance undertakings pursuant to section 211 of the German Insurance Supervision Act (*Versicherungsaufsichtsgesetz* – VAG)".

4 Minimum requirements for the risk management of asset management companies (*Mindestanforderungen an das Risikomanagement von Kapitalverwaltungsgesellschaften* – KAMaRisk).

5 For example, there is no requirement for occupational pension schemes to set up a compliance function.

6 See "Technical Advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD", EIOPA, 30 April 2019.

7 See "Technical advice to the European Commission on integrating sustainability risks and factors in MiFID II", ESMA, 30 April 2019.

8 See "Technical advice to the European Commission on integrating sustainability risks and factors in the UCITS Directive and AIFMD", ESMA, 30 April 2019.

9 See Mandate to the EBA in Article 98(8) of the CRD V.

this Guidance Notice can only serve as an indication for supervised entities if relevant to their actual business models. For example, requirements specifically relating to banks shall not apply to asset management companies when implementing procedures to address sustainability risks.

1.3 Proportionality

In dealing with the issue of sustainability risks, supervised entities are also required to develop an appropriate documented approach for their business model and risk profile, and this should be adjusted over time for any change in circumstances. With regards to the principle of proportionality, this means that simpler structures, processes and methods may be sufficient for a more limited business scope or lower risk profile. However, more extensive structures, processes and methods are required for supervised entities with more significant sustainability risks. The principle of proportionality applies on a sector-specific basis, as incorporated in the respective relevant legal requirements.

The sometimes long time horizon associated with sustainability risks (in particular for physical risks) poses major challenges for companies.

BaFin is aware 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; yet this can also serve as impetus to adapt existing processes and develop new and innovative measurement, management and risk reduction tools suited to the risk profile in question. In this context, it should be noted that transition risks in particular may arise over a very short time horizon. Interdependencies between transition risks and physical risks are also conceivable (for details see 2.4 Risk comprehension).

1.4 Examples and potential questions

The examples and potential questions detailed in this Guidance Notice are non-binding and for the purposes of illustration. They provide supervised entities with guidance on the issue of integrating sustainability risks into their specific strategies, business organisation and risk management. They are neither exhaustive nor cumulative, and do not represent a definitive assessment by BaFin.



2 Introduction

2.1 Climate-related risks

According to the Intergovernmental Panel on Climate Change (IPCC), the atmospheric concentrations of carbon dioxide, methane and nitrogen oxide are the highest they have been for at least 800,000 years¹⁰.

Climate change has already led to average global warming of around 1.0°C versus the pre-industrial level. The 1.5°C global warming limit agreed in the Paris Agreement will probably already be reached between 2030 and 2052, according to the IPCC Climate Change Synthesis Report¹¹.

Continued greenhouse gas emissions will lead to further warming and sustained changes in the overall climate system, increasing the probability of serious, pervasive and irreversible consequences for people and ecosystems¹². Warming of 3-4°C by the end of the century currently seems to be the most likely outcome, whereby a scenario of 5°C warming and the catastrophic consequences it would entail cannot be ruled out. Even the scenario of 3°C warming could lead to a 0.4-0.9 metre rise in the sea level, which would pose a serious threat to low-lying coastal towns and regions. Strong tropical hurricanes could increase by 28% and the frequency of extreme precipitation events by as much as 70%, the extent of wildfires would double, and 80 times more people would be exposed to extreme heatwaves. Global GDP could decline by 23% versus a scenario of zero climate change impact, and the global harvest could fall by 24% (with a higher global population than today)¹³.

2.2 The Paris Agreement

In December 2015, the parties to the United Nations Framework Convention on Climate Change, which includes Germany and all EU countries, agreed in Paris to the target of limiting global warming to significantly below 2°C, and to pursue efforts to limit warming to 1.5°C, which would have less dramatic effects.

Germany ratified this Agreement in September 2016¹⁴.

The European Commission has called for a reduction in greenhouse gas emissions to net zero by 2050¹⁵. Achieving these objectives will require dramatic changes to the economy and will pose enormous challenges to some economic sectors. The reform of the EU Emissions Trading System in 2018 has already resulted in a tripling of the price of emissions certificates¹⁶.

2.3 Sustainability risks are ESG risks

BaFin takes the risks stemming from climate change seriously. Calculations in recent models estimate that the resulting damages could amount to USD 550 trillion worldwide if current developments continue unchecked¹⁷. BaFin therefore encourages its supervised entities to focus more strongly on these risks. However, sustainability should not be restricted to climate issues; other environmental and social trends may also present serious financial risks for supervised entities. For example, one million animal and plant species are threatened with extinction, many within several decades. This loss of biodiversity could have the same kind of serious financial impact as climate change; for example, scientific estimates suggest that the risk to agriculture from the loss of pollinators could amount to USD 577

¹⁰ "Climate Change Synthesis Report", Intergovernmental Panel on Climate Change (IPCC), 2014.

¹¹ "Special Report on the impacts of global warming of 1.5°C", IPCC, 2018.

¹² "Climate Change Synthesis Report", IPCC, 2014.

¹³ "The heat is on", Chief Risk Officers Forum, 2019.

¹⁴ Act Implementing the Paris Agreement of 12 December 2015, Federal Law Gazette Part II, 2016, p. 1082.

¹⁵ "A Clean Planet for all", pages 3 and 5, EU COM (2018).

¹⁶ See <https://www.eex.com/en/market-data/environmental-markets/spot-market/european-emission-allowances>.

¹⁷ "The heat is on", Chief Risk Officers Forum, 2019.

billion per annum¹⁸. BaFin therefore believes that all ESG (Environmental, Social and Governance) risks should be considered; ESG factors include:

Environmental

- Climate mitigation
- Adjustment to climate change
- Protection of biodiversity
- The sustainable use and protection of water and maritime resources
- The transition to a circular economy, the avoidance of waste, and recycling
- The avoidance and reduction of environmental pollution
- The protection of healthy ecosystems
- Sustainable land use

Social

- Compliance with recognised labour standards¹⁹ (no child labour, forced labour or discrimination)
- Compliance with employment safety and health protection
- Appropriate remuneration, fair working conditions, diversity, and training and development opportunities
- Trade union rights and freedom of assembly
- Guarantee of adequate product safety, including health protection
- Application of the same requirements to entities in the supply chain
- Inclusive projects and consideration of the interests of communities and social minorities.

Governance

- Tax honesty
- Anti-corruption measures
- Sustainability management by the board
- Board remuneration based on sustainability criteria
- The facilitation of whistle blowing
- Employee rights guarantees
- Data protection guarantees
- Information disclosure

2.4 Risk comprehension

Sustainability risks within the meaning of this Guidance Notice are environmental, social or governance events or conditions (see 2.3 Sustainability risks are ESG risks), which if they occur have or may potentially have significant negative impacts on the assets, financial and earnings situation, or reputation of a supervised entity²⁰.

Sustainability risks in the area of climate and the environment are split into *physical risks* and *transition risks*:

¹⁸ "Global Assessment on Biodiversity and Ecosystem Services", IPBES, 2019.

¹⁹ E.g.: the ILO's International Labour Standards; the UN Guiding Principles on Business and Human Rights; section 289(c) of the German Commercial Code (Handelsgesetzbuch – HGB); and the Communication from the Commission - Guidelines on non-financial reporting (methodology for reporting non-financial information) (2017/C 215/01).

²⁰ Additionally, for supervised entities managing portfolios on behalf of third parties, sustainability risks also relate to the portfolios managed.

Physical risks

arise both from individual extreme weather events and their consequences (e.g. heatwaves, droughts, floods, storms, hail, forest fires and avalanches), and from long-term changes in climate and environmental conditions (e.g. rainfall frequency and volume, volatile weather conditions, rising sea levels, changes in sea currents and winds, ocean acidification, and global warming with regional extremes).

Physical risks may also have indirect consequences (e.g. the collapse of supply chains, abandonment of water-intensive operations, culminating to climate-induced migration and armed conflict).

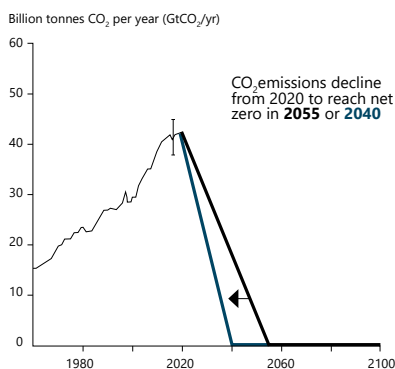
The perpetrators of environmental damage or entities that have fuelled climate change could eventually be held responsible for its consequences by governments (e.g. Ontario Bill 21, Liability for Climate-Related Harms Act of 2018) or court rulings.

Transition risks

exist in connection with the change to a low-carbon economy.

Political measures may lead to fossil fuels or emissions certificates becoming more expensive and/or scarce (e.g. fossil fuel phase-out and CO₂ taxes), or to high investment costs as a result of the required clean-up of buildings and plants. New technologies may replace existing ones (e.g. electro-mobility) and a change in counterparty²¹ preferences and societal expectations may endanger entities that have failed to adjust.

The following IPCC chart²² shows the extent to which global CO₂ output must be reduced in order to meet the climate goals of the Paris Agreement:



21 Depending on the context, “counterparty” within the meaning of this Guidance Notice may refer to borrowers, policyholders, insured persons, beneficiaries, investors, service providers, etc.

22 “Special Report on the impacts of global warming of 1.5°C”, IPCC, 2018.

Interdependence of physical risks and transition risks.

A sharp increase in physical risks would require the economy to transition more rapidly, leading in turn to higher transition risks.

If the required reduction in greenhouse gas emissions is not carried out in time, physical risks and the pressure for action will increase.

In the least favourable scenario, extreme climate-induced damages as a result of long delays in energy transition will eventually force a sudden and radical change in the economy.



Sustainability risks in the social and governance areas

Events, developments or behaviours associated with social and governance areas may also lead to negative impacts on the asset, financial and earnings situation of an entity if the probability of their occurrence is not sufficiently priced into the valuation of the affected assets or liabilities. Reputational impacts are also possible. Social risks are characterised *inter alia* by negative effects on the stakeholders of an entity. *E.g.*: successful billion dollar damages claims against cigarette manufacturers; the refusal of approval for a major construction project due to violations of the land rights of indigenous peoples; fines for tax evasion or wrongful tax reimbursements.

Reputational impacts for entities

Reputational risks are a key element of sustainability risks. Firstly, potential financial damages are an additional consequence of the occurrence of the events, developments or behaviours outlined above. Secondly, supervised entities are also exposed to potential damages independently of any concrete event arising, simply by having a business relationship with an entity that may be exposed to a sustainability risk.

Furthermore, the omission of adequate sustainable measures in the external and internal perception which may lead to a loss of confidence by counterparties and employees may potentially represent a key reputational risk.



2.5 Transmission channels

Sustainability risks may damage productivity, the valuation of entities in the real economy, the value of

real estate, and the income and assets of individuals in a variety of ways:

Figure 1: From physical risk to financial stability risks

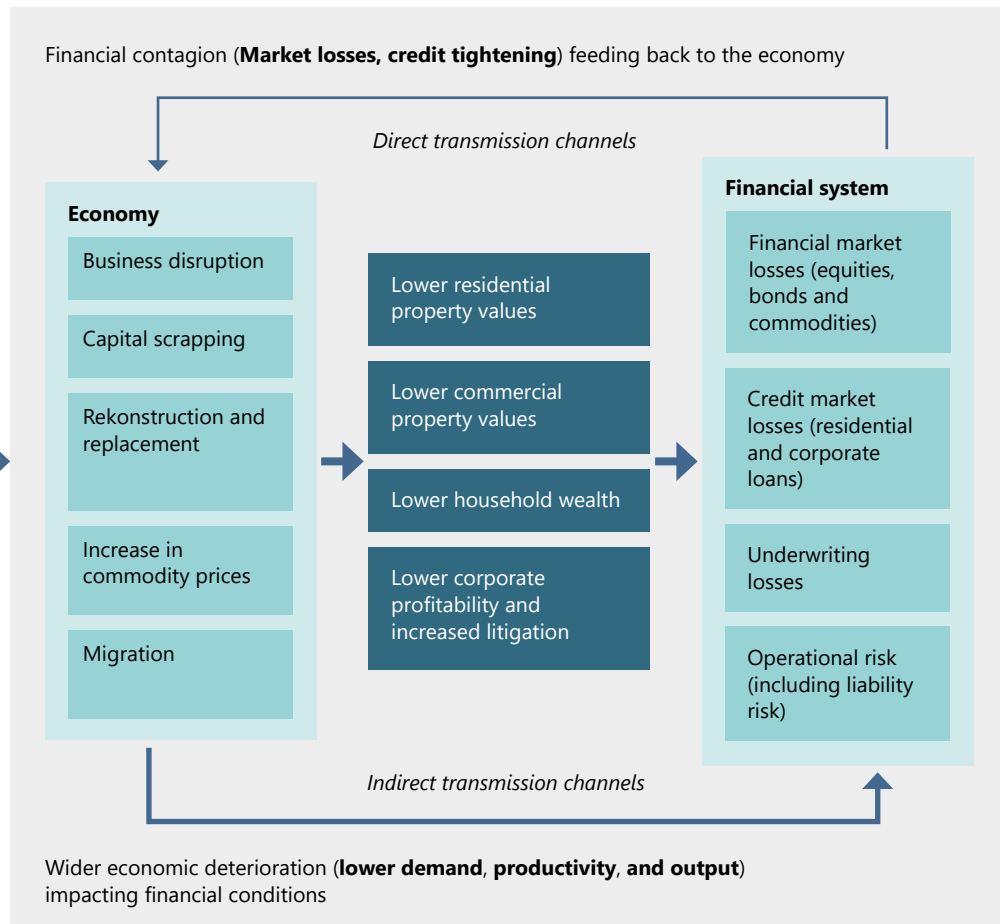
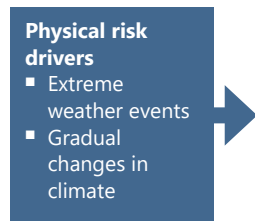
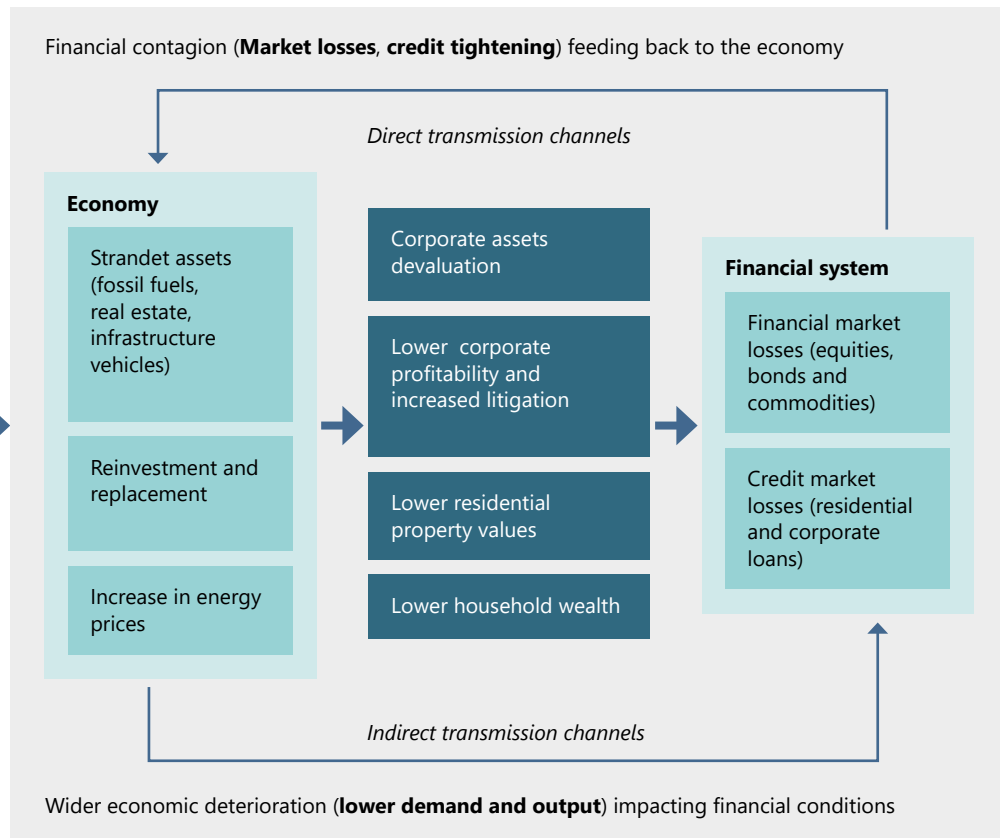
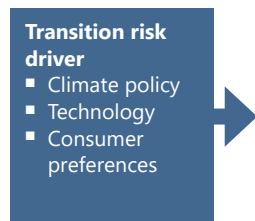


Figure 2: From transition risk to financial stability risks



(Charts: "A call for action", NGFS, 2019)

2.6 Characteristics of sustainability risks

Sustainability risks may potentially have a negative impact on all business areas and risk types; real estate or assets provided as collateral or covered by insurance may be damaged or even destroyed; the time horizon and extent of sustainability risks are extremely uncertain; and the historical data basis for assessing the impact of future sustainability risks is insufficient. Sustainability risks may become relevant and lead to pressure for action in the short term, as well as over the medium and long-term; physical and transition risks are interdependent (the longer society waits to reduce its greenhouse gas emissions, the worse the physical consequences of climate change will be); and there is frequently a lack of environmental and social expertise within the financial sector.

2.7 Translation into known risk types

BaFin considers sustainability risks as factors of the existing risk types listed below. We are not advocating a separate risk type of "sustainability risks", as segregation would be extremely difficult. Sustainability risks may have a significant impact on all of these existing risk types and be a factor that contributes to their materiality. *Examples* for different sectors:

- i) Credit risk/counterparty default risk: A credit institution providing a loan to an entity with a business model that is significantly damaged by political decisions on ESG issues (such as a CO₂ charge).
- ii) Market risk: A pension fund or investment fund could be invested in companies which do not demonstrate sustainable management or use the invested monies for transition towards sustainability. An abrupt change in market sentiment (e.g. to reflect the cost of regulatory measures) might lead to declines in value.
- iii) Liquidity risk: After a catastrophic flood, tens of thousands of clients withdraw money from their accounts at a regional credit institution in order to finance damage repairs. The credit institution has to sell a high level of assets to cover these outflows.
- iv) Operational risk: The branch offices of this credit institution are also affected by the floods.
- v) Insurance risk: Homeowners' insurance claims rise as a result of storms, floods or hail. Business interruption insurance claims may also rise. The increasing intensity and/or frequency of such events should be appropriately reflected in the assessment of technical provisions or premium risk. In this context, it is also worth considering that insurance undertakings may be affected by the same sustainability risk on both the asset and the liability side.
- vi) Strategic risk: A credit institution specialised in financing coal mining loses the basis of its business.
- vii) Reputational risk: An investment fund is invested in a clothing factory owned by a well-known brand in East Asia. The building burns down as a result of inadequate national safety standards, hundreds of workers die, reports circulating in the media name the investor. The sale of allegedly sustainable financial products (known as greenwashing) to those seeking ESG-compliant investments may also represent a reputational risk.

3 Strategies of supervised entities

3.1 General information

3.1.1

In order to handle sustainability risks (and where applicable, opportunities), supervised entities should **either** develop stand-alone strategies, **or** adapt their existing strategies accordingly.

3.1.2

If entities have voluntarily agreed to abide by **external** sustainability standards, or to implement recommendations, these should be reflected in in-house strategies and organisational guidelines.

E.g.: "Principles for Responsible Banking", "Principles for Responsible Investment", "Principles for Sustainable Insurance", recommendations of the "Task Force on Climate-related Financial Disclosures", the German Sustainability Code (*Nachhaltigkeitskodex*), the "SD-KPI Standard 2016-2021", and the Berlin

CSR Consensus on Corporate Responsibility in Supply and Value Chains (*Berliner CSR-Konsens zur Unternehmensverantwortung in Liefer- und Wertschöpfungsketten*).

3.2 Review of the business strategy

The business strategies of supervised companies should be fully reviewed for sustainability risks. *Potential questions* entities may consider if relevant:

3.2.1

Which business areas are exposed to a physical risk? Is the risk material? Should the affected areas be continued, scaled back or adapted? Do sustainability risks require consideration across all business areas and processes on the basis of their materiality, or is it sufficient to focus on particularly exposed business





areas and processes? Are impact analyses over a period of several years required for informed decision-making on any (future) management measures that may be necessary? *E.g.*: real estate financing in areas at risk of flooding, insurance of certain risks or the introduction or expansion of underwriting limits or exclusions, and investments in water-cooled power stations in regions at risk of drought.

3.2.2

Which business areas are exposed to a transition risk? Is the risk material? Should the affected areas be continued, scaled back or adapted? Should sustainability requirements be set for third parties and communicated to them? Should stakeholders with material sustainability risks be contacted to discuss how such risks can be mitigated or reduced in the future? What is the policy on exercising voting rights with regard to equity investments? Are impact analyses over a period of several years required for informed decision-making? *E.g.*: restrictions on financing companies with business models based primarily on fossil fuels, or the real estate used by such companies; critical dialogue with companies that are directly or indirectly reliant on the production of combustion engines concerning their strategies for the future; and requirements for counterparties to

comply with the disclosure recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), the EU Commission's guidelines on non-financial reporting, the Sustainability Code or the SD-KPI Standard 2016-2021.

3.2.3

Are adjustments to the business model necessary or sensible in order to take account of physical or transition risks (energy transition) and investors' and counterparties' increased awareness of sustainability issues? Should concrete sustainability goals be followed, or sustainable financial products (green bonds, social bonds, green loans, sustainability investment funds, etc.) offered? What is the image that will be used to recruit future employees? *E.g.*: the expansion or reduction of insurance cover offered; cooperation with development banks to provide loans for sustainable construction; issue of green *Pfandbriefen*, certificates of indebtedness or products that are more innovative, for example as regards impact or sensitivity to risk; assumption of an advisory role vis-à-vis counterparties regarding the transition to carbon neutrality for their business operations or the financing of energy-efficient real estate as a lucrative new business field.

3.2.4

How can the availability of adequate numbers of appropriately qualified personnel and other resources to meet the new challenges posed by sustainability risks be ensured?

3.3 Review of the risk strategy

The risk strategy should be fully reviewed with regard to sustainability risks. *Potential questions* supervised entities may consider if relevant to their specific business model:

3.3.1

Would there be any detrimental impact on legally prescribed key ratios such as capital ratios if any sustainability risks (in the form of existing risk types that have been identified as material) were to occur? Which stress tests, including scenario analyses, have been carried out for sustainability risks? What are the implications of the outcomes?

3.3.2

Which risk types are affected by sustainability risks at the entity? Are the sustainability risks affecting these risk types implicitly and adequately reflected when defining risk appetite and risk limits? Are there any county, region, company or sector-specific issues?

3.3.3

Are there any risk concentrations? *E.g.*: a reinsurance undertaking accepting the storm risk of a number of insurance undertakings for the same region; within a financial conglomerate, a credit institution holding receivables from uninsured companies that are sensitive to weather damages, whilst an insurance undertaking within the conglomerate provides cover against natural disasters in the same region (see also 9.3 Risk concentrations).

3.3.4

How should the time horizon of physical and transition risks be handled? Are these risks addressed early or is a wait-and-see approach taken? Is (extended) cover for the risks possible using derivatives, insurance solutions or similar? Does the planning horizon for informed decision-making need extending to reflect sustainability risks and factors?

3.3.5

Can the processes for identifying, measuring, managing and reporting sustainability risks be systematically or selectively improved?

3.4 Communication

The handling of sustainability risks defined by the management board should be clearly communicated to the entity's managers, employees, counterparties and investors. In particular, it is recommended that any criteria for the exclusion or targeted management of certain risk positions be communicated externally, in order to make the approach transparent for stakeholders and dispel any uncertainty on the part of counterparties.



4 Responsible corporate governance

4.1 Responsibility for the strategy

The management board is responsible for the business and risk strategy and its communication and implementation within the entity (risk culture), as well as for institutionalising it through established process structures. Accordingly, senior management is also responsible for the strategic considerations described under section 3 Strategies of supervised entities; of course support may also be provided by experts, e.g. from the risk control function.

4.2 Understanding of sustainability risks

The management board is expected to develop an understanding of any material sustainability risks, including physical and transition risks, their characteristics and potential impact on the entity's business.

4.3 Responsibilities

The management board is responsible for allocating responsibility for managing risks (those under 2.7 Translation into known risk types), including

sustainability risks, within the organisation. The supervised entity may also take account of external sources when identifying potential sustainability risks. *E.g.*: data providers specialised in sustainability; publications of the Federal Environmental Agency (*Umweltbundesamt*) or the Potsdam Institute for Climate Impact Research.

4.4 Role model

The management board should provide a positive example to pre-empt any potential reputational risks. *Potential questions*: Are existing remuneration systems conducive to the appropriate management of sustainability risks (*e.g.* a link between bonuses and the management of sustainability risks), and in keeping with any existing concrete sustainability strategies of the supervised entity (*e.g.* the achievement of specific sustainability targets)?²³ How can the long-term success of the entity be ensured, which includes counterparty and employee acceptance of the conscientious handling of sustainability risks, and any potentially negative impacts of the entity's own business operations on sustainability issues?

²³ Based on the EU Regulation on sustainability-related disclosures in the financial services sector. As an example, please also refer to the "Principles for Responsible Investment".

5 Business organisation

5.1 Internal organisational guidelines or written directives

A comprehensive review should be carried out to integrate sustainability risks into the existing internal organisational guidelines. The contents, methods and level of detail are at the discretion of the supervised entities, within the framework of the minimum legal requirements. Internal ESG guidelines or directives may be introduced but are not compulsory.

5.2 Processes

A review should be carried out to determine: (i) if and how sustainability risks are integrated into existing processes for credit business/underwriting/investment decisions, risk management and risk control (including any proprietary ESG risk management system); or for the activities of the special functions within the meaning of MaRisk or key functions within the meaning of the VAG, and for outsourcing/spin-off; or (ii) separate processes are being set up, in which case the seamless integration of these separate processes must be ensured.

5.3 Responsibilities

Responsibilities should be defined in the organisational guidelines.

5.4 Resources

With regards for the principle of proportionality, we recommend that appropriate personnel and financial resources be made available to handle sustainability risks (in particular in the risk management system). It is important to ensure that personnel are adequately qualified. It may be advisable to strengthen the specific functions defined in MaRisk or the key functions defined in VAG by experts in sustainability

risks, or to set up a separate sustainability unit with responsibility for specific tasks. *E.g.*: developing specific processes or guidelines, ensuring consistent implementation within the entity and providing support with this, and internal and external reporting/communication).

5.5 Dedicated sustainability unit

If a supervised entity sets up or intends to set up a unit with special responsibility for sustainability risks, its integration with existing processes and interfaces with other functions must be clearly defined. The dedicated sustainability unit may be involved whenever the counterparty or investment belongs to an economic sector with high transition risks. In such cases in particular, misunderstandings regarding the extent of the assessment by the sustainability unit must be excluded, e.g. whether it is responsible solely for reputational risks or also for sustainability-related financial risks.

5.6 Front office/market/ portfolio management

The relevant information regarding any potential sustainability risks associated with a counterparty or an investment should be identified, analysed and included in the decision-making process at the start of the review process for the relevant counterparty transaction²⁴ or investment.

²⁴ Depending on the context, "transactions" within the meaning of this Guidance Notice may refer to granting credits, making investments and underwriting insurance risk, etc.

5.7 Back office

Where relevant to the specific sector, the back office should carry out an appropriate review of the front office assessment and monitor compliance with relevant sustainability-related limits or exclusions.

5.8 Risk control function

5.8.1

In carrying out its duties, the risk control function should take account of sustainability risks in conformity with decisions taken pursuant to sections 5.1 Internal organisational guidelines or written directives and 5.2 Processes.

5.8.2

In particular, the risk control function should provide comprehensive internal reports for the management board on the type and extent of material sustainability risks.

5.9 Compliance function

The compliance function should include the legal requirements regarding sustainability for financial sector entities when carrying out its duties under MaRisk, MaGo and KAMaRisk.

5.10 Internal audit function

Internal audit should also address the appropriate handling of sustainability risks as part of their audit activities. In particular, this should include an assessment of the appropriateness and effectiveness of the revised rules for the organisational and operational structure, risk management and the specific functions as defined by MaRisk and the key functions as defined by the VAG.

5.11 Contingency planning

The supervised entities should verify that sustainability risks are adequately reflected in contingency planning. In particular, it is recommended that contingency plans be extended if sustainability risks may threaten the continuation of the supervised entity's business operations. In addition to the obvious issues (related to buildings, employees, etc.), a communications strategy may also be developed e.g. in case of public discussions concerning the investment policy and/or strategy of the entity.

5.12 Special features for undertakings supervised under the VAG

5.12.1

Sustainability risks related to writing insurance policies may also be material. Reputational risk considerations and actuarial elements for the purposes of an appropriate premium and reserves calculation are both important. As regards potential reputational impacts, the key focus is business with commercial and industrial counterparties. The actuarial function must consider the actuarial relevance of sustainability risks.

5.12.2

The actuarial function should take account of sustainability risks in its evaluation of the appropriateness of the technical provisions and its opinion of the general underwriting policy. When assessing the quality and completeness of the underlying data used for this evaluation, the actuarial function should also take account of information that is available on sustainability risks. Historical analyses may not be sufficient to enable the appropriate calibration of premiums or reserves to reflect sustainability risks, in particular with regard to novel risks.

5.12.3

The actuarial function must gain an appropriate understanding of all risks, including long-term risks and novel risks. To ensure this, actuaries must be made aware of these risks, and where necessary, receive further training.



6 Risk Management

6.1 General requirements for the integration of sustainability risks into the risk identification, management and control processes

6.1.1

Tasks, responsibilities and the timelines for identifying, evaluating, managing, monitoring and reporting sustainability risks should be clearly defined within the framework of and with regards for identified risk types (see 2.7 Translation into known risk types) in the risk management system of the supervised entity.

6.1.2

Supervised entities should review their methods and procedures for identifying, evaluating, managing, monitoring and reporting sustainability risks at regular intervals. This should also include the quality of the underlying data.

6.1.3

Sustainability risks should be considered as factors of identified risk types (see 2.7 Translation into known risk types) in the written risk management guidelines. In particular, processes should be established for the early recognition of such risks, if this is justified by the assessment of the aforementioned characteristics of sustainability risks (see 2.6 Characteristics of sustainability risks).



6.1.4

Existing escalation processes should be used or extended to include management in the handling of any sustainability risks.

6.1.5

In assessing the extent and time horizon of sustainability risks, it may be helpful to define appropriate risk indicators (see NGFS recommendations²⁵) that take account of internal capital adequacy and risk appetite.

6.2 Methods

Methods should be defined for managing and/or limiting sustainability risks, which are consistent with the business and risk strategy and enable the supervised entity to appropriately manage sustainability risks. *Potential examples* (if relevant to the business model of the entity):

6.2.1

Exclusion criteria/limits. These may be based on the identification of companies, sectors, regions, countries, etc. that are excluded as investments or subject to investment limits, as a result of the extent of compliance with certain criteria. *E.g.*: exclusion of companies generating at least ___% of sales from mining, processing or burning fossil fuels. Heat maps²⁶ that highlight sustainability risks based on their relevance and urgency for individual (sub-) sectors in a chart, or on a scaling system may also provide an indication of this. These heat maps may be purchased externally or created internally; typically, they rank the transition risks for the economic sectors of land

and forestry, manufacturing, electricity (generation, storage and distribution), fossil fuels (extraction, processing and distribution), transport (road, sea and air traffic) and construction and real estate based on their relevance for political climate goals into different risk categories over a time axis. For company-specific exclusions, a decision may be necessary on whether affiliated or group companies should also be covered by the exclusion and any threshold levels.

6.2.2

Positive lists. These may be based on the identification of the companies, sectors, regions, countries, etc. that are preferred for investment, as a result of compliance with certain sustainability criteria.

6.2.3

Best-in-class approach. As in 6.2.2, but with the focus on identifying companies that outperform their peer group for the sustainability criteria chosen. This approach is sometimes criticised, and the risk of greenwashing should be taken into account. As this is a relative approach, the portfolio may include companies that are less sustainable when measured on an absolute basis.

6.2.4

Standards based screening/ESG integration. As in 6.2.1 to 6.2.3, except that the sustainability criteria are not determined in-house, but correspond to internationally recognised standards. *E.g.*: UN Global Compact. Taking a holistic approach is referred to as ESG integration. *E.g.* "Principles for Responsible Investment", "Principles for Sustainable Insurance" and "Principles for Responsible Banking".

²⁵ NGFS (2019), "Macroeconomic and financial stability implications of climate change", Annex 1. The risk indicators were developed for the purposes of supervisors and central banks, but in many cases are also appropriate for use in risk management by supervised entities.

²⁶ An example of heat maps can be found in "Climate Change – Managing a new financial risk" p. 20, Oliver Wyman, 2019.

6.2.5

A specific characteristic of the examples under 6.2.2 to 6.2.4 is investments in companies which have set the target of a positive environmental or social contribution.

6.2.6

Engagement. Exercising voting rights, engaging in dialogue with companies or exerting influence on sector organisations can be used to try and encourage targets of investment and counterparties to adopt a more sustainable approach. However, the provisions of stock corporation, company and antitrust laws must also be observed.

6.3 Use of risk analysis or classification procedures

6.3.1

Supervised entities may use risk analysis or classification procedures for the purposes of identifying and evaluating sustainability risks. These also serve to ensure compliance with legal²⁷ and in-house sustainability requirements (including any exclusion criteria/limits), and to assess the ability and willingness of the counterparty or investment target to introduce risk mitigation measures, including an evaluation of the quality of its sustainability management and any potential (contractual) agreement on corresponding risk mitigation measures. In this context, supervised entities can integrate sustainability risks into existing risk analysis or classification procedures, or set up new/specific procedures.

²⁷ *E.g.*: The EU Regulation on sustainability-related disclosures in the financial services sector in relation to sustainable investments and sustainability risks provides for disclosure of the due diligence process with regard to any material negative effects of investment decisions on sustainability factors, or a corresponding explanation of any non-disclosure.

6.3.2

Transactions (with business counterparties) should also be examined to identify companies belonging to sectors of the economy generating high emissions (if possible, including the upstream and downstream supply chain and other closely related economic sectors). Heat maps can also be used in this process (see 6.2.1 above). If external providers are used, we would suggest that appropriate plausibility checks be carried out on their rankings. The ranking of a sector on a heat map should only be used as a starting point for a more individual assessment of the actual risk position.

6.3.3

For transactions associated with a higher risk (for example, based on an initial ranking of the counterparty or investment on the heat map), more intensive analysis of the actual business model is required. *E.g.*: a review of current and projected greenhouse gas emissions²⁸, the market environment, supervisory requirements for the companies under consideration, the likely impacts on profitability and solvency, and future strategies. The risk analysis should take account of the fact that a company in an inherently high-risk sector may be subject to lower transition risk than other companies in the same sector as a result of its specific business model. (*E.g.*: the electricity sector is per se high-risk as regards climate goals, but if the actual counterparty or investment operates wind parks, it is subject to lower transition risk.) A sustainability rating for the counterparty may be useful as part of the risk analysis and assessment.

²⁸ Scope 1 emissions are direct emissions from owned or controlled sources. Scope 2 emissions are indirect emissions from the use of purchased electricity, steam, heat and cooling. Scope 3 emissions are all other indirect emissions occurring in the value chain of a company.



6.3.4

The examination should result in a risk classification for the counterparty or investment target that takes account of its sustainability risks. Based on the risk classification and depending on the situation, measures may include the following: Non-binding *examples* entities may consider if relevant:

6.3.4.1

Dialogue with the counterparty or investment to raise risk awareness, with a view to reducing the sustainability risks and developing a strategy for the future.

6.3.4.2

For participations with voting rights, exercising these voting rights at shareholder meetings of the company.

6.3.4.3

Identifying measures to manage or mitigate sustainability risks or the detrimental impacts on sustainability, culminating in a comprehensive action plan to eliminate such risks on a step-by-step basis; improve the sustainability rating or comply with particular sustainability standards.

6.3.4.4

A legally binding agreement on progress with a mandatory time horizon and reporting duties.

6.3.4.5

Advice regarding the financing of investments in order to reduce the sustainability risk, e.g. in cooperation with development banks.

6.3.4.6

Rejection of the transaction or application of a specific limit on the exposure. If the risk analysis and/or classification shows a high to very high sustainability risk, the organisational guidelines can ensure the involvement of the risk control function and, where applicable, management board.

6.3.5

If risk analysis or classification procedures are used, the risk classification should form part of the process to approve the transaction and, where relevant, to define its terms.



6.4 Tools for conducting a risk inventory or portfolio analysis

Tools already available in practice for establishing a risk inventory or portfolio analysis may be used by the supervised entity. Responsibility for the content and the technical and other aspects of these tools lies with the provider or operator, i.e. they should not be used as a substitute for an in-house risk assessment in supervised entities, but may be used for support with identifying risks.

6.5 Internal reporting

Sustainability risks should be adequately addressed within the framework of internal risk reporting if not already including in the reporting of other risk types. To this end, a review should be carried out to ascertain how sustainability risks can be included in current internal reporting as part of existing reporting channels, and whether the characteristics of sustainability risks indicate a need for specific reporting with a medium to long-term outlook.

6.6 Special features for institutions supervised under the KWG

In addition to the aforementioned recommendations, institutions that fall under the scope of the KWG and MaRisk should also comply with the following principles:

6.6.1

(Based on MaRisk AT 2.2 nos. 1 and 2) In the context of the regular risk inventory, institutions shall also examine which sustainability risks may materially impair their financial position (including their capital

resources), financial performance or liquidity position. However, in general, it should be possible to include such risks in the risk types already identified – specifically, credit risk, market risk, spread risk and operational risk (see also 2.7 Translation into known risk types). If additional material risks are identified under this framework, then the requirements of MaRisk should also be applied to these risks.

6.6.2

(Based on MaRisk AT 4.1 nos. 1 and 11) Based on the overall risk profile, institutions should also ensure that risks identified as material, including the sustainability risks included in the different risk types, taking account of risk concentrations, are constantly covered by the risk coverage potential, thus maintaining internal capital adequacy.

6.6.3

(Based on MaRisk BTO 1.2) Sustainability risks should also be included in the processes for credit business (the granting and further processing of loans) (see also *inter alia* 5.6 Front office/market/portfolio management, 5.7 Back office and 6.3 Use of risk analysis or classification procedures). To assess credit risk, institutions should form an opinion on counterparty default risk that incorporates future risks, including sustainability risks (as characterised above). The aspects material to the counterparty default risk of the loan exposure should be identified and assessed, whereby the intensity of such activities should depend on the risk content of the exposure (see also 6.3.3) Any sector and, where applicable, country risks, which may be increased as a result of sustainability risks, should also be considered. Critical aspects of an exposure should be highlighted and, where applicable, considered under various scenarios. Furthermore, even if using external credit assessments, the institution must form an opinion on counterparty default risk including its own knowledge and information in the credit decision. *E.g.*: a borrower's ability to service a loan used to finance a building that it has let to a company generating high emissions may be dependent on the future of this company, if the



rent is the borrower's primary source of income; if the building can be easily let to a third party, the future income stream of the borrower is less risky.

6.6.4

As part of the procedure to establish the value of collateral, factors affecting the value that are related to (future) sustainability risks should also be taken into account.

E.g.: a building with a "KfW Efficiency House 100" rating should be worth less than an identical building in the same position with a "KfW Efficiency House 55" rating; a building on the coast could lose its insurance cover in the event of a future rise in sea levels or an increase in the number of maritime storms.

6.7 Special features for asset management companies supervised under the KAGB

6.7.1

(Based on KAMaRisk 4.1 no. 3) In assessing the materiality of risks for the investment fund and the company on a regular and on an ad hoc basis, the senior management of the asset management company shall also include sustainability risks as a component of the known risk types (see also 2.7 Translation into known risk types).

6.7.2

(Based on KAMaRisk 4.3 no. 8) During the regular comparison of the overall risk profile of the company within the meaning of part 4.1 no. 3 of KAMaRisk with the risk coverage potential of the company, it should also be ensured that any risks identified as material are covered, including the sustainability risks included in the different risk types, taking account of risk concentrations.

6.8 Special features for undertakings supervised under the VAG

6.8.1

In the context of the regular risk inventory, undertakings supervised under the VAG shall also examine which sustainability risks may materially impair their financial position (including their capital resources), financial performance or liquidity position. However, in general, it should be possible to include such risks in the risk types already identified – specifically, market risk, insurance risk, credit risk, spread risk and operational risk (see also 2.7 Translation into known risk types).

6.8.2

When comparing the solvency needs with the supervisory own funds requirement as part of the Own Risk and Solvency Assessment (ORSA) by insurance companies, supervised entities should take account of the specific risk profile including any sustainability risks identified as material. For institutions for occupational retirement provision, material sustainability risks should also be addressed as part of the supervisory requirements of the own risk assessment (ORA).

6.8.3

The following risk management areas may be particularly affected by sustainability risks: asset-liability management, investment risk management, underwriting and reserving, reinsurance and other insurance risk-mitigation techniques, and reputational risk management.

6.8.4

As part of the underwriting process for the insurance of risks, any potential sustainability risks, including possible reputational risks (see 5.12.1), should also be identified and analysed, and only accepted if consistent with the risk strategy (see also 6.3 Use of risk analysis or classification procedures). The use of heat maps²⁹ and ESG scoring procedures may be helpful in this respect. Individual business areas or counterparty relationships may be the subject of a targeted analysis based on specific ESG criteria (*e.g.* environmental and air pollution, or human rights violations). Insurance undertakings should also consider new types of risk related to climate change when underwriting business (see also 5.12 Special features for undertakings supervised under the VAG) (*e.g.*, where applicable, liability risks arising as a result of amendments to the law or case law judgements). The insurance underwriting guidelines should be defined accordingly, in order to implement this approach in ongoing operations.

²⁹ *E.g.*: “Underwriting environmental, social and governance risks in non-life insurance business”, PSI Guideline.

7 Risk management: stress tests including scenario analyses

7.1 Internal³⁰ stress tests

Supervised entities should check whether the existing internal³¹ stress tests adequately reflect sustainability risks, or if new or modified internal³² stress tests should be created to address these.

7.2 Scenario analyses

Stress tests may include specific sensitivity and scenario analyses to examine the entity's ability to withstand adverse events or scenarios caused by physical and transition risks. Stress tests should therefore also take account of scenarios reflecting

plausible future developments, and make greater use of long-term scenario analyses³³. The NGFS, the European Systemic Risk Board, the European Central Bank and the Deutsche Bundesbank are currently working on scenarios for climate-related stress tests³⁴. These scenarios provide pointers for entity-specific³⁵ stress tests in the sustainability area.

30 Supervised entities managing portfolios on behalf of third parties should review whether existing stress tests appropriately reflect sustainability risks both at the level of the portfolios managed and at the level of the entity.

31 See footnote 31.

32 See footnote 31.

33 On the use of climate-related scenario analyses in entities, see also: TCFD (2017), "Technical Supplement: The Use of Scenario Analysis in Disclosure of Climate-related Risks and Opportunities", UNEP FI, April 2018; "Extending our horizons - PART 1: Transition-related risks & opportunities", UNEP FI, July 2018; "Navigating a new climate - PART 2: Physical risks and opportunities", Global Compact Network Germany, 2019; "Evaluating corporate climate risks".

34 However, these are scenarios for supervisory purposes, and may have a different focus to entity-specific stress tests, e.g. with respect to granularity and the regions considered. Supervisory scenarios can therefore at best be used as a starting point for entity-specific considerations.

35 See footnote 31.



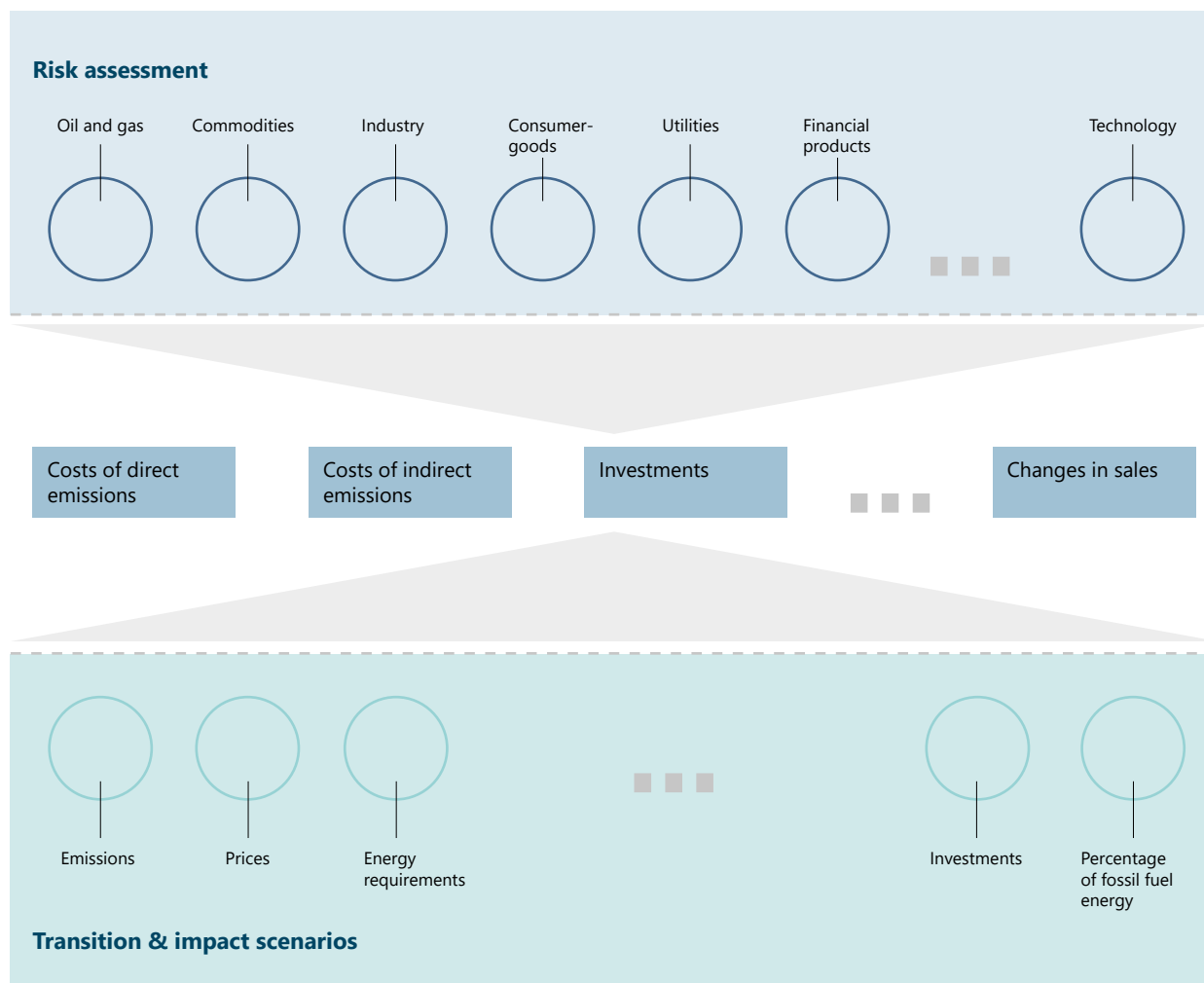


Chart Source: Potsdam Institute for Climate Impact Research/SENSES project.

7.3 Transition scenarios

Transition scenarios from integrated assessment modelling (IAM), *inter alia*, may enable an understanding of the time horizon and the sectors that could come under pressure as a result of the shift away from fossil fuels on the road to a low-carbon economy. These scenarios are not forecasts based on specific statistical probabilities, but describe coherent development trajectories for the achievement of a specific climate goal (e.g. carbon neutrality by 2050). The decarbonisation of sectors presented in transition scenarios describes one such coherent development trajectory; however in reality, events may occur in a different order, with a different level of intensity and greater turbulence.

Relevant costs and expenditures can be concretely identified (applying a consistent approach). For example, figures such as the energy requirements of

a specific company and the price per unit of energy enables conclusions to be drawn regarding values such as the (in)direct cost of emissions or expected sales fluctuations for this company. The analysis based on these values can be expanded to create an aggregated assessment.

Please note that certain types of IAM have been judged unsuitable for analysing transition risks, e.g. by the International Monetary Fund³⁶. Scenario analysis methods based on such IAM require scrutiny.

³⁶ See "Macroeconomic and Financial Policies for Climate Change Mitigation", IMF Working Paper No. 19/185 (2019).



7.4 Impact scenarios

The aim of impact scenarios is to improve global and regional risk management of the direct consequences of climate change on people and the environment: in concrete terms, they draw up consistent climate change impact projections taking into account the long-term planning horizon of the company in question and spanning economic areas and ranges, covering themes such as agriculture, water, biomes, healthcare and coastal infrastructure. The focus of these scenarios is on the impacts of physical risks (e.g. drought, flooding, etc.). Other themes considered include fishing, energy, permafrost, biodiversity and forestry.

7.5 Proportionality

The supervised entity defines the assumptions for stress tests and analyses based on its own business model risk profile, as well as individual specifications. The entity should consider several alternative scenarios, based on different combinations of assumptions.

7.6 Interpretation

The outcomes of stress tests and scenario analyses may be interpreted on a quantitative basis, and depending on the background of the supervised entity, on a qualitative basis. The outcomes of these methods may thus serve as the starting point for descriptive and narrative elements.

7.7 Special features for institutions supervised under the KWG

(Based on MaRisk AT 4.3.3) If sustainability risks have a significant impact on the risk types identified in accordance with section 2.7 Translation into known risk types, and contribute to the materiality of these risk types as part of the risk inventory, they should be included in the regular and ad hoc stress tests for material risks.

8 Outsourcing

8.1 Outsourcing guideline

Where relevant, the handling of sustainability risks should also be governed by the internal outsourcing guideline. *Potential questions:* Which business areas/processes/tasks are subject to sustainability risks? What standard arrangements should be agreed with service providers to cover this? Are the reporting obligations of the service providers sufficient to meet external sustainability reporting obligations?

8.2 Risk analysis

Sustainability risks should be included in the risk analysis to identify *material*³⁷ outsourcing arrangements and the risks related to outsourcing. *Examples:* outsourcing the identification of sustainability risks could be material if these sustainability risks have a significant impact on the risk types identified in accordance with section 2.7 Translation into known risk types; outsourcing activities to a service provider that regularly violates employment law standards may represent a reputational risk.

8.3 Outsourcing agreement

In the event of material outsourcing, the outsourcing agreement should include the following rules regarding sustainability risks:

8.3.1

If risk management activities are outsourced, the service provider should be given specific targets governing the identification, assessment, management, monitoring and reporting of sustainability risks.

8.3.2

If the supervised entity commits to compliance with certain sustainability standards (see 3.1.2), it should be checked whether the outsourcing agreement includes an obligation for the service provider to comply with these standards. If so, the outsourcing entity must be provided with the information required for the purposes of monitoring and reporting in accordance with these standards.

8.4 Centralised outsourcing management

Sustainability risks should also be included in the organisational guidelines for central outsourcing management, where relevant.

³⁷ In contrast to the KWG, the KAGB makes no distinction (see section 36 of the KAGB) between a material and non-material outsourcing arrangement.

9 Group issues

9.1 Organisational guidelines

Where applicable law does not provide otherwise, rules for dealing with sustainability risks should be consistently implemented across the group in the business and risk strategy, and in the organisational guidelines.

9.2 Sustainability unit

The competent parent undertaking should also decide whether a dedicated sustainability unit should be created at the group level. Given that the relevant data is often missing and difficulties arise in quantifying sustainability risks (see 2.6 Characteristics of sustainability risks), this sustainability unit could provide support to all relevant group entities.

9.3 Risk concentrations

One role of group-wide risk management is to establish whether the different activities of entities belonging to the group result in any sustainability risk concentrations. *Potential example:* E.g. various credit institutions within a group granting loans to companies in a floodplain that is no longer insurable.

9.4 Sustainability standards

If the decision is taken to comply with voluntary sustainability standards (see 3.1.2), their application across the entire group is encouraged. It may create reputational risk if some group entities apply non-binding sustainability standards that are violated by other entities in the group.





10 Use of ratings

10.1 Credit ratings

In accordance with the EU Credit Rating Regulation, traditional credit ratings only take account of the factors required to assess the creditworthiness of an entity or the credit risk of a financial instrument. These may, of course, include ESG factors. However, 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 rating. Otherwise, there is the risk of distorting the validity of a rating on default probability.

10.2 ESG ratings

Specialised ESG ratings can be used to determine the sustainability of financial investments and, where applicable, to infer additional information regarding sustainability risks. These already exist in the market and are offered by various companies. Some registered rating agencies also provide ESG ratings. 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.

10.3 Unified standards

There are currently no unified concepts or general standards for ESG ratings. The EU taxonomy for sustainable activities proposed by the Commission and worked out in detail by the Technical Expert Group may be used as a guideline (although it is currently still in development). The development of unified standards is a key requirement in the creation of long-term ESG ratings as a source of information for assessing the sustainability of financial investments.

10.4 Plausibility checks

Against the background of the aforementioned points, the users of ESG ratings should not simply accept these when assessing the sustainability of a financial investment, but should carry out appropriate plausibility checks in light of the principle of proportionality, and distinguish between sustainability aspects and creditworthiness or credit risk aspects, if these are not connected.