Sustainability in the financial industry

Why the time to get involved with ESG is now

Europe is expected to become climate-neutral by 2050. Financial service providers have their share of responsibility in ensuring sustainable action, since they are the ones who provide the resources needed for transformation efforts. Answers to the question as to what criteria must be met by sustainable behaviour can be found, to name a few sources, in the United Nations Sustainable Development Goals, the ESG criteria defined by Ivo Knoepfel, the Federal Financial Supervisory Authority fact sheet on dealing with sustainability risks, and the recommendations of the Sustainable Finance Advisory Council of the Federal Government. (Ed.)

Sustainability is becoming increasingly important for governments, companies, investors and civil society. The European Green Deal has set the goal of making Europe the first climate-neutral continent by 2050.

In addition, in view of the provisions of the Climate Protection Act of 12th December 2019 on national climate protection targets, the First Senate of the Federal Constitutional Court has recently ruled that the quantities of greenhouse gas emissions permitted until 2030 are incompatible with constitutional rights, to the extent that taking on a higher emission reduction load would be irreversibly postponed to periods after 2030. (1)

Against such a background, efforts nationally to achieve climate protection goals and more overall sustainability may be expected to continue to intensify. When it comes to translating "sustainability" into daily business activities, the 17 United Nations Sustainable Development Goals (SDGs) provide valuable guidance. The SDGs set out aspirations and goals for economic development, social and environmental sustainability– they can be applied in both developed and developing countries. These objectives are increasingly shaping regulatory measures and market standards, such as the EU Taxonomy (2) for sustainable activities. The latter provides a first framework linking investment activities to sustainability policy objectives.

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What is ESG - an overview

For many years, climate risks have shaped debates on sustainability, with aspects S and G gaining in importance, among other reasons owing to the coronavirus pandemic and cases such as Wire Card. (3) The three letters E, S and G stand for descriptions of the central sustainability-related areas of responsibility:

- "E" stands for "Environment". This includes activities that reduce or stabilise greenhouse gases in the atmosphere.
- "S" stands for the social element "Social". This includes for example compliance with recognised labour standards (4) such as no child or forced labour, no discrimination, etc.
- "G" stands for "Governance", i.e. the management of a company. Examples include measures to prevent corruption and to guarantee workers' rights.

The German Federal Financial Supervisory Authority (BaFin) has taken up this ESG approach. In its fact sheet on sustainability risks within ESG risks, published for the first time in

2019, it refers to events or conditions in the environmental, social or corporate governance fields, the occurrence of which could actually or potentially negatively affect net assets, the financial position, the earnings performance and also the reputation of any business being supervised.

Behaviour that is in line with ESG requirements can thus be understood as responsible action that addresses consequences for the environment, society and one's own company in the present and in the future, supports clients' transformation efforts and complies with political and regulatory guidelines in this area.

Significance for the national and financial economy

The future viability and success of the national economy depends on the sustainable actions of financial market players and companies. The financing of economic transformation is decisive for competitiveness. With its help, not only can the Paris Climate Agreement of 1.5 degrees Celsius and the 17 Sustainable Development Goals of the United Nations be achieved, but a good future global market position can be secured as well. Today the national economy is undergoing a fundamental transformation process in the face of changing demands posed by the climate crisis, digitalisation and globalisation. Companies need to make massive investments to make production methods and business models fit for the future and to benefit from the opportunities of sustainable development. The financial sector has a crucial role to play here, as it is an important building block for providing the necessary funds for these transformation efforts. Regulatory and corporate efforts are therefore aiming at effective capital allocation along with resilient risk management. (5)

A look in the rear-view mirror: between 2000 and 2016 the number of worldwide weather-related disasters per year increased by 46%. The financial losses from extreme weather events increased by 86% between 2007 and 2016 (129 billion US dollars in 2016) (6). Bearing in mind that almost 50% of the risk exposure of banks in the euro currency area during the period under review was directly or indirectly associated with climate change-related risks, (7) the far-reaching importance of ESG measures for a sustainable orientation of business models is clear. The importance of other environmental issues and the threat they pose to business models is being increasingly recognised too. (8) Not only environmental issues, but also social aspects, such as increasing inequality and poor working conditions, can have tangible effects on institutions and contain risks. Legal and reputational damage can ultimately lead to financial losses. (8)

»The Future of the Economy depends on the sustainable action of the Financial Market Players.«

All this poses numerous challenges in the day-to-day life of an institution, challenges which affect the entire organization. In addition to building up competencies, it is necessary to change strategies, guidelines, methods and operational processes, with due regard in every case to considerations of proportionality.

ESG measures in risk management

The national and European regulators have formulated their expectations of the institutions with the guidelines in the BaFin fact sheet dealing with sustainability risks, and the European Central Bank's published guide to climate and environmental risks published at the end of 2020.

Sustainable transformation is therefore essentially a matter of business and risk strategy and institutional governance, which means that supervised companies should develop their own approaches to dealing with sustainability risks or anchor them in their existing strategies. According to external regulators, one way would be to transform any optional standards of sustainability to become internal company requirements. The norm is principally aimed at checking which business areas are exposed to significant ESG risks and whether guidelines, for example in the form of adjusting risk appetite or limitations, need to be drawn up, in order to limit such risks. (10) In order to meet these expectations, it is important to make sustainability a management priority, for management to lead by example, to anchor sustainability in the organization and in the corporate culture and to create understanding and ability in the company, whereby sustainability risks and opportunities can be properly taken into account as part of management control.

In its fact sheet on addressing sustainability risks, BaFin identifies which ESG risks can arise It mentions by way of example physical risks. These may occur as a result of individual extreme weather events and their consequences or may be risks in respect of long-term changes in climatic and ecological conditions, or be transitory risks, the causes of which include the shift to a low carbon economy.

They are risks which fall under the provisions for Minimum Requirements for Risk Management (MaRisk). (11) which includes counterparty risk and operational risk. Natural disasters, for example, can trigger rating downgrades for the institutions' affected counterparties and debtors, and physical damage can put a strain on the balance sheet. In factoring, this could affect the economic circumstances of the seller of the receivables and their debtors.

The European Banking Authority had already put forward an action plan on sustainable financing on December 6th 2019, in which it expressed the view that institutions must be able to measure and monitor sustainability and ESG risks in order to be able to deal with both transition risks and physical risks.

»ESG Data are required for an appropriate sustainability assessment.«

Sustainability assessment

ESG data are nevertheless required for an appropriate sustainability assessment; they might for example, be derived from a specific ESG rating. There are already some offers on the market, but there is currently no uniform classification system. The current regulation at EU level (taxonomy and disclosure ordinance) is an important step in the right direction, one which can already be used today.(12) Based on this, an economic activity should make a significant contribution to at least one environmental goal, not have a notably negative effect on other goals and should guarantee a minimum level of social welfare. In this way it is possible to determine whether the institution is on the whole committed to sustainable financing. For a corresponding "proper due diligence review" formulated by the ECB as what to be expected, the following are taken into consideration: ESG ratings and ESG certifications, findings from annual financial statements and sustainability reports, information obtained in the course of dialogues with customers, and the contents of press coverage.

This approach is not only suitable for the risk classification of individual debtors, but can also serve as the starting point for the sustainability assessment of sellers in the outsourcing process and as the basis for the designing or adaptation of those stress tests in which sustainability risks must be into account. The supervised institution could build on this and develop methods suitable for the purposes of overall bank management, for example for assessing sustainability risks in the institution's own risk inventory or ICAAP process (Internal Capital Adequacy Assessment Process). Alternative procedures for the designing of stress tests might be simulated shifts in the probabilities of default, and loss ratios of debtors in sectors particularly affected by ESG risks.

The examples shown are intended to highlight what influence the expectations expressed by the regulators concerning the management of ESG risks have on the properly regulated business organization of a supervised institution. BaFin sees its guidelines on dealing with sustainability risks as a "compendium of non-binding procedures (good practice approaches), which, taking into account the principle of proportionality, can be used by the supervised companies in the area of sustainability risks to implement the legal requirements for a proper business organization and an appropriate risk management system. "

Owing to the increasing regulatory requirements, however, it is to be expected that institutions will (have to) increasingly incorporate ESG aspects into their overall organization and business processes, including the internal control system (ICS). (13)

Application example for ESG-linked products

In order to commit themselves to more sustainability, to a more environmentally compatible and socially inclusive world and to support their customers transformation efforts, some providers have already begun to offer the first ESG - linked products and such products already exist in factoring. In addition to the orientation framework from the European taxonomy, (14) it is also possible to fix the sustainability-related structure of a factoring product to specific sustainability performance targets, so-called Sustainability Performance Targets (SPTs) or Key Performance Indicators (KPIs). The underlying KPIs link the most important industry-specific ESG challenges that the customer is facing, for example the transition to a less CO2-intensive business model. These KPIs are regularly checked and reported on - preferably by qualified third-party providers - and can influence pricing if these KPIs are sufficiently demanding.

With a view to future regulatory requirements, sustainable financial transactions can be a good starting point to build a robust reporting system in terms of sustainability for the customer. At the same time, they take up the customers' sustainability agenda and help them to switch to a sustainable business model.

Set the course

It is generally expected that regulation will become more specific and more stringent in the years to come. In its recently published final report, the Federal Government's Sustainable Finance Advisory Council also drew up over 30 recommendations that are now being examined by political actors and taken into account in the forthcoming development of the Federal Government's Sustainable Finance strategy. The aim is to make Germany a leading location with sustainable financing.

The recommendations of the Advisory Board relate to five areas of action:

− Policy framework in Germany and in the EU for sustainability-oriented decisions in the financial and in the real economy.

− Integrated and future-oriented corporate reporting based on transparency and comparability , aimed among other things, at holistic risk management.

−Research efforts and systematic knowledge building with a view to the changing skills required of all the stakeholders involved.

− Products with effective sustainability.

− Institutional stabilisation for continuous support in the context of the transformation process. (15)

Not only with a view to the political and regulatory guidelines, but also in terms of responsible action with regard to the dangers of ESG risks for the environment, society and

for any company being supervised, it is important to continue to be intensively involved in these issues and to decide on the right courses of action.

Footnotes

1) See press release of the Federal Constitutional Court No. 31/2021.

2) See Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment and amending Regulation (EU) 2019/2088.

3) See Institut der Wirtschaftsprüfer in Deutschland e. V., Position Paper - Sustainable Finance as Part of Sustainable Transformation, 2020, p.3.

4) See e.g. ILO core labour standards or UN guiding principles for business and human rights.

5) See Sustainable Finance Advisory Board of the Federal Government, final report “Shifting the Trillions - A Sustainable Financial System for the Great Transformation ”, February 25, 2021, pp. 2-4.

6) See Lancet Report 2017, p.7.

7) See Battiston et al, A climate stress test of the financial system, Nature Climate Change, Vol. 7, No. 4, April 2017, pp. 283–288.

8) According to the World Economic Forum (Global Risks Report 2018), biodiversity loss, water scarcity and the collapse of eco-systems are among the top ten global risks.

9) See European Commission, Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, Action Plan: Financing Sustainable Growth, 8.3.2018, p. 4.

10) See. Institute of Chartered Accountants in German-country e. V., Position Paper - Sustainable Finance as Part of Sustainable Transformation, 2020, p. 3.

11) See BaFin, circular 09/2017 (BA), October 27, 2017.

12) See Sustainable Finance Advisory Board of the Federal Government, final report “Shifting the Trillions - A Sustainable Financial System for the Great Transformation”, February 25, 2021, p. 100.

13) See Institut der Wirtschaftsprüfer in Deutschland e. V., Position Paper - Sustainable Finance as Part of Sustainable Transformation, 2020, p. 7.

14) See Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment and amending Regulation (EU) 2019/2088.

15) See Sustainable Finance Advisory Board of the Federal Government, final report “Shifting the Trillions - A Sustainable Financial System for the Great Transformation”, February 25, 2021, pp. 2–5.