# SUSTAINABLE FINANCE RISK MANAGEMENT

## Banks should take the lead on sustainable finance

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*We believe banks should take the lead in devising suitable solutions to the challenges associated with sustainable finance. Such proactive efforts will create new business opportunities. We strongly recommend bankers start reviewing their business models and strategies with this in mind.*

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# INTRODUCTION

Climate protection and sustainable business practices have risen significantly on the agenda of bank boards. This partly has to do with the onset of the COVID-19 pandemic. It has become all too readily apparent just how rapidly - and with previously unimaginable force - societies and economies can be impacted by severe health and environmental risks. The world is changing with astonishing speed, and in ways that are quickly reshaping today's cultural consciousness and business environment.

While the development of many industries, such as of the transport and real estate sectors, are already affected by the need to achieve climate targets, we are now seeing the advent of  consumers and investors demanding a shift towards sustainability from the financial industry as well.

# A SHIFT TOWARDS SUSTAINABILITY IN THE FINANCIAL SERVICES INDUSTRY

To its credit, the banking industry also recognises this need. A recent survey by the Association of German Banks concludes that the vast majority of financial institutions expect to see noticeable and possibly serious effects from climate change on their businesses in the next 10 years[1]. Politicians[2] and banking regulators[3] have also taken notice.

Bank regulators are beginning to require the integration of sustainable finance into risk management as well[4]. If a business model changes - which is foreseeable in more or less all industries - then banks must keep this in mind when considering risk in the short run. In the long term, governments will also intervene to ensure sustainable capital flows. In response, we expect banks to adjust their capital requirements as needed. In Europe, this will take some time. The European Banking Authority (EBA) has been granted until July 2025 to create an actionable basis for this transformation[5].

[1] Sustainable Finance, Der Beitrag der privaten Banken, November 2020.

[2] UN, The Paris Agreement, 2015.

EU Commission, A European Green Deal, 2018,EU Commission, Action Plan on Financing Sustainable Growth, March 2018.

EU Commission, Consultation on the renewed sustainable finance strategy, July 2020.

EU Commission, Legislative proposals on sustainable finance.

[3] EBA, Action Plan on Sustainable Finance, December 2019.

ESMA, Sustainable Finance,

EIOPA, Sustainable Finance.

[4] EBA Discussion paper, On management and supervision of ESG risks for credit institutions and investment firms, October 2020,

ECB, Guide on climate-related and environmental risks, May 2020,

BaFin Merkblatt zum Umgang mit Nachhaltigkeitsrisiken.

[5] Art. 501c CRR II (Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019).

## SUSTAINABLE FINANCE RISK MANAGEMENT - STATUS OF STANDARDS AND REGULATIONS

However, many important fundamentals for comprehensive risk management in sustainable finance do not yet exist. Concrete standards for the classification of assets from a sustainability perspective have not yet emerged, nor have sustainable taxonomies[6] been specified in sufficient detail. Similarly, there are not as of yet any established market standards for measuring the relationship between sustainable business models of customers and credit risks[7]. In addition, we lack reliable data for statistically valid credit spread calculations[8]. Dealing with "hard facts" when it comes to sustainability in risk management is hardly possible at this time - or only with restrictions, even if there are initial analyses about the effects of climate change. And yet, due to the lack of time series data, even these aren't currently specific enough[9].

In our opinion, to begin managing environmental, social and governance (ESG) risks, companies must start with the "soft" factors in risk management. (Banking supervisors have pointed this out as well and urge companies to begin as soon as possible[10]. ) We don't know of an existing model blueprint for risk management geared towards sustainable finance.

## ADAPTING TO THE CLIENT'S CONSIDERATIONS OF THE IMPACT OF SUSTAINABLE FINANCE ON FUTURE BUSINESS AND PROCESSES

Banks have different options as they design the size and structure of an ESG project. Their decisions will mainly be influenced by expectations about how much their business will be affected by ESG in the future. With this in mind, we feel it is important for banks to quickly develop estimations of how individual customer segments, regions, and even products will appear - now and in the future - when viewed through the lens of sustainability. In this context, transitory developments, such as new decarbonation norms for certain industries and customer segments, are increasingly a major influence. These key considerations should be included in the development of risk strategies.

Some clients are already going a step further to discuss the need for changes to their business processes. Such forward-thinking dialogues can lead to timely reforms[11]. When it comes to lending procedures[12] for example, the chain of processes - from lending and approval, to the evaluation of collateral assessment and the associated documentation, as well as the management of portfolios or the expansion of stress test considerations - are all put to the test.

> ***Best-practice approaches will emerge gradually and only over time. Nevertheless, it's time for banks to make necessary preliminary considerations regarding the scope of sustainable finance projects.***
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[6] Framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088, Sustainable finance: Parliament adopts taxonomy regulation.
[7] NGFS, Overview of Environmental Risk Analysis, September 2020.
[8] NGFS, September 2020.
[9] E.g. World Disasters Report 2020.
[10] BaFin Merkblatt zum Umgang mit Nachhaltigkeitsrisiken,
IDW, Sustainable Finance als Teil der Nachhaltigen Transformation, Oktober 2020.
[11] E.g., EBA, Guidelines on loan origination and monitoring (EBA/GL/2020/06).
[12] BDO Global Financial Services. Sustainable Finance, March 2020.

## ARE YOUR EMPLOYEES READY FOR THE SHIFT?

This push for new risk assessment is causing an enormous across-the-board need to make employees fit for sustainable finance. As we know, continued success in business development often depends on this. It is important for employees to develop a high level of analytical and advisory skill in these matters. This is the only way for a business to keep up with sustainability in the long term - a necessary aspiration also from a risk perspective.

## THE ISSUE OF DISCLOSURE

The issue of disclosure is another important emerging area in risk management and sustainable finance. Both the banking supervision[13] and the EU Commission[14] emphasise in numerous guidelines and regulatory reforms that banks in particular are obliged to provide meaningful information in this regard, be it by means of "non-financial disclosures" and/or reports from Pillar III. Information regarding real estate portfolios is in particular focus due to its understood correlation with climate change. These requirements are in the process of being made more concrete. As of yet, there are still no fixed market standards for such reporting.

> *It would serve the interests of banks to set up their own solid reporting systems for dealing with sustainability as soon as possible. Excellence in providing concrete information regarding the ramifications of sustainability will most certainly be recognised as a very real competitive edge in the near future.*
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[13] ECB, Guide on climate-related and environmental risks, May 2020,
EBA, Survey on credit institutions' disclosure of information related to ESG risks, October 2020,
ESA, Joint Consultation paper on ESG disclosures, April 2020.
[14] EU, Non-financial reporting directive,
EU Commission, Review of non-financial reporting directive,
EU, Regulation on sustainability-related disclosures in the financial sector, November 2019.

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