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Guidance Notice on Dealing With Sustainability Risks

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The German Federal Financial Supervisory Authority (BaFin) recently published a Guidance Notice on Dealing with Sustainability Risks (the Guidance Notice). The binding German version was published on December 20, 2019, and later editorially modified, on January 13, 2020. Further, BaFin has now also made a version available in English.

According to BaFin, the Guidance Notice provides entities supervised by BaFin (e.g., 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) with detailed guidance on dealing with the issue of sustainability risks. The Guidance Notice also applies to the branches of third-country entities, provided that they are supervised in Germany similarly to domestic entities. It does not immediately apply to significant institutions directly supervised by the European Central Bank (ECB) or to the German branch offices of entities from the European Union (EU)/European Economic Area (EEA); however, given the advisory nature of this Guidance Notice, such entities may also consult it for orientation purposes.

Sustainability risks are defined as environmental, social and governance (ESG) events or conditions that may potentially have negative impacts on the asset, financial and earnings situation or reputation of an entity. Notably, the Guidance Notice defines the term "sustainability" on the basis of ESG criteria, and illustrates physical and transition risks that may come in place with increasing intensity through existing risk types. BaFin regards sustainability risks not as a separate risk type, but rather as a component of risk types that have already been dealt with in the existing guidance on risk management, like credit risk/counterparty default risk, market risk, liquidity risk, operational risk, insurance risk, strategic risk and reputational risk. The Guidance Notices states various examples and potential questions for the purposes of illustration for such risks.

BaFin intends the 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 organization and an appropriate risk management system. This includes reviewing their business strategies for sustainability risks and asking appropriate questions to determine whether a particular type of risk is material and whether adjustments to the business model are necessary to take account of physical or transition risks amongst others. Supervised entities should review their risk strategies again via asking questions in order to determine how risks can be better measured, managed and excluded. The strategy for handling sustainability risks should then be clearly communicated to the entity's managers, employees, clients and investors.

In this regard, the Guidance Notice considers details of strategies, responsible governance and business organization. Further, BaFin recommends a strategic assessment of sustainability risks. It is BaFin's understanding that 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 organization with the responsibilities, processes, resources and functions to address the risks.

In this regard, supervised entities should review the methods and procedures for identifying, evaluating, managing and monitoring sustainability risks at regular intervals. BaFin also encourages the defining of methods for managing and limiting sustainability risks consistent with the business and risk strategy. BaFin requires supervised entities to conduct stress tests in which they take into account adverse events caused by sustainability risks, including transition scenarios. Traditional credit ratings in line with the EU Credit Rating Regulation only take account of the factors required to assess the creditworthiness of an entity or the credit risk of a financial instrument and may or may not include ESG factors. BaFin, therefore, also encourages the use of ESG ratings to assess the sustainability of investments. However, users of ESG ratings should carry out appropriate plausibility checks and distinguish between sustainability aspects and creditworthiness or credit risk aspects, if these are not connected.

Additionally, BaFin has pointed out that the Guidance Notice neither reduces nor extends any binding legal or supervisory requirements as regards sustainability risks. This shall apply in particular to pending European action on the integration of sustainability risks for insurance undertakings, investment firms and asset management companies, and credit institutions. According to BaFin in this context, adjustments will also be made to this Guidance Notice where applicable. There, BaFin is keen to highlight the fact that the Guidance Notice does not change the already existing legal requirements contained in the various BaFin Circulars and that the relevant risks should continue to be adequately considered and documented appropriately by concerned entities.

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