DWS

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Consideration of sustainability risks: ESG | Mandatory or optional?

"Net zero economy" is the highly ambitious economic strategy of the European Union with the aim of reducing greenhouse gas emissions to "net zero" by 2050.

Revolution of the financial industry

According to the new EU Commission head Ursula von der Leyen, the European Union is to become the driving force in climate policy. The goal should be to make the EU climate-neutral by 2050. According to the EU Commission, this requires not only annual investments of **at least EUR 180 billion**, but also a range of instruments for reallocating capital. The function of the financial industry is exciting: Banks, asset managers and institutional investors will play a decisive role in the realignment of capital flows in favour of sustainable investments. We have summarized for you what foreseeable effects the regulatory agenda will have on you and what measures already affect you today.

One thing is clear, the topic of "sustainability" is currently receiving more and more attention, both socially and politically. The topic is also currently being intensively discussed on the capital markets. Investing in ecological, social and corporate governance aspects is becoming massively more important. The magic formula here is ESG (Environmental, Social & Governance). This rapid development now receives prominent support from Brussels. With the help of a holistic strategy for financing sustainable growth, the EU Commission wants to anchor sustainability as a permanent and integral component of the European financial market.

Based on the Paris Climate Convention 2015, in which the EU and governments worldwide committed themselves to the goal of a more sustainable economy and society, the course has been set for limiting global warming to significantly less than 2 degrees by 2030 compared to pre-industrial levels. To promote a green and sustainable economy that tackles climate change and resource scarcity, Brussels officials, MEPs and member states are currently rolling out plans for a gold standard for green investment, with the aim of diverting private capital. This will help finance the transition to a more sustainable world. The project, which is highly complex in regulatory terms, has an unassuming name – **EU Action Plan to finance sustainable growth** – but the implications are revolutionary. The EU wants to be the first supranational regulatory authority to establish rules that oblige **banks and institutional investors, such as insurance companies and pension funds**, in particular, to take sustainability into account in their investment decisions. This is intended to make the capital market greener and support the Paris climate targets.

EU financial market strategy for the long-term reduction of greenhouse gas emissions

To achieve the ambitious goals, the EU Commission is building its strategy on three pillars.*

1. **Redirecting captial flows** towards sustainable investment in order to achieve sustainable growth

2. **Management of financial risks** arising from climate change, resource depletion, environmental degradation and social problems

3. **Promoting transparency and a long-term perspective** in financial and economic life

Source: DWS International GmbH, January 2020
*BaFIN: Information sheet on dealing with sustainability risks

EU action plan

The EU action plan is a broadly based instrument package which is to be incorporated step by step into European legislation. With its help, the financial industry should make a holistic contribution to achieving the Paris climate targets. The following areas are to be covered:

1. **Taxonomy**
   Creation of an EU classification system for sustainable activities
2. **Standards**
   Introduction of standards and labels for "green" financial products
3. **Sustainable projects**
   Promotion of investments in sustainable projects
4. **Investment advisory**
   Integration of sustainability into investment advisory
5. **Benchmarks**
   Development of sustainable benchmarks
6. **Sustainability ratings**
   Integration of sustainability aspects in ratings and research
7. **Obligations for asset managers and institutional investors**
   Consideration of sustainability parameters in the investment decision process
8. **Regulatory requirements**
   Integration of sustainability into regulatory obligations
9. **Disclosure and accounting**
   Strengthening of disclosure requirements
10. **Corporate governance**
    Promotion of sustainability in corporate policy

Obligations for asset managers and institutional investors

Some of the future regulatory requirements resulting from the EU action plan are already very concrete today. In particular, the obligations for asset managers and institutional investors are already existent in the form of legislative proposals. Some of them will become binding as early as 10.03.2021; such as the recently published regulation in Brussels on the disclosure of information on sustainable investments and sustainability risks.

Investment products, such as investment funds, life insurance, portfolio management services or pension products, are usually designed with the intention of pooling investors' capital and investing it collectively through a portfolio of financial instruments. Existing guidelines already oblige institutional investors and asset managers to act in the best interests of their customers. However, the consideration of sustainability principles has not yet been consistently taken into account on the market. To this end, the European legislator has launched the regulation on the disclosure of information on sustainable investments and sustainability risks (Disclosure Regulation).

The purpose of the socalled "Disclosure Regulation" is to make it mandatory for certain financial market participants, such as **insurers, asset managers, banks, investment firms and institutions for occupational retirement provision**, including pension funds, to integrate certain transparency regulations regarding the consideration of sustainability risks into their investment decision process. In the future, all financial market players with more than 500 employees will therefore have to disclose how they take sustainability opportunities and risks into account during their investment decisions.

What effects do the planned provisions of the Disclosure Regulation have on financial market participants?

- **Consideration of sustainability risks**
  In the future, the financial market participants concerned will be obliged to publish whether or what strategy they pursue with regard to the consideration of sustainability risks in investment decision processes.
- **Publication on the website**
  Furthermore, financial market participants will be obliged to publish this information on their own website and to keep it up to date.
- **Expansion of pre-contractual information**
  Financial market participants must explain in their pre-contractual information how sustainability risks are taken into account. (e.g. advertising adjustments in the sales prospectus).
- **Effects on returns**
  In particular, financial market participants will have to indicate which procedures and conditions are applied with regard to the extent to which sustainability risks affect the return on investment decisions.

Source: DWS International GmbH, January 2020
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_**Remuneration policy**
In the future, financial market participants will have to indicate in their remuneration policy to what extent it is consistent with sustainability risks.

In precise words, each of the above-mentioned financial market players with more than 500 employees will have to ask themselves whether the money they invest or manage can have negative environmental or social effects. This means that by March 2021 at the latest, the issue of sustainability will be introduced throughout the European financial market.

How are sustainability risks to be defined?

The technical regulatory standards and methods for the concrete implementation of the disclosure regulation will be developed and presented by the European supervisory authorities in the coming months. The German Federal Financial Supervisory Authority (BaFin) provides an initial non-binding orientation on what concrete standards could look like. To this end, it published a first leaflet on dealing with sustainability risks in December 2019.

> "Sustainability risks within the meaning of the Code of Conduct are events or conditions in the environmental, social or corporate management fields, the occurrence of which can have actual or potential negative effects on the assets, financial position, earnings and reputation of a company."

Source: BaFin – Merkblatt zum Umgang mit Nachhaltigkeitsrisiken

Sustainability risks in the area of climate and the environment are divided into physical risks and transition risks. The consideration of sustainability risks is not only about environmental protection, but also about the consideration of material financial and strategic impacts on companies. The following examples impressively illustrate that it makes sense to include sustainability risks in investment decisions.

Physical risks can arise both from the inclusion of extreme weather events (e.g. heat and drought, flooding, forest fires, etc.) and from long-term changes in climatic conditions (e.g. frequency and intensity of precipitation, sea-level rise, etc.).

Examples:

_**Low water level**
in the Rhine restricts ship deliveries of petroleum products. This leads to higher freight costs for the Netherlands, Switzerland and Germany. (Nov. 2018).

_**Heavy storms**
in Japan and North America burden a large American insurance company with a net loss of USD

Transition risks can arise in particular from the transition to a low-carbon economy. Political decisions can lead to a future shortage or increase in the price of fossil fuels (e.g. coal exit, exit from nuclear energy, CO_2 taxation, etc.). Furthermore, old technologies can be replaced or superseded by new innovations (e.g. electric mobility, etc.)

Dealing with sustainability risks

The central point of the Bafin leaflet is the consideration of sustainability risks in the risk management of supervised companies. BaFin expects sustainability risks to be identified, documented and appropriately taken into account in the investment and risk strategy. Sustainability risks are not defined by BaFin as a new or separate type of risk. Instead, the leaflet stresses that sustainability risks can have a significant impact on known risk types. These risk types include credit risk, market price risk, liquidity risk, operational risk, underwriting risk, strategic risk and reputational risk. The general purpose of the information sheet is to provide credit institutions, insurance companies and capital management companies with guidance on how to consider and translate sustainability risks into known risk types. The expectations of BaFin are clear: analyse the sustainability risks of the portfolios, manage and limit their impact on existing investments.

Why is it important to consider sustainability risks?

The consideration of sustainability risks is demanded both politically and socially. At the same time, there is a growing awareness among companies and investors that sustainability risks can have a direct and non-negligible impact on companies' earnings.
As a consequence, investors are increasingly paying attention to how companies can reduce risks and opportunities through sustainability and integrate their own corporate strategy. The future changes in profits and costs due to sustainability risks are increasingly taken into account in valuation models for companies and thus ultimately have a direct influence on the purchasing decisions of institutional investors.
Investors who fail to analyse companies for sustainability risks run the danger that these risks may be unintentionally and unconsciously included in the investment. If these risks materialize, the investor suffers the financial losses associated with them.

Source: DWS International GmbH, January 2020
*BaFIN: Information sheet on dealing with sustainability risks

As with all risks that affect the future financial characteristics of companies, early identification of sustainability risks helps to avoid long-term losses arising from them.

Need for investors to act

In order to address sustainability risks efficiently, it is essential for investors to first define a long-term sustainability strategy for their own assets. This means developing a strategy to protect their assets from risks by integrating sustainability factors.
The definition of a sustainability strategy thus goes hand in hand with the identification of the sustainability risks relevant to the investment strategy. As described in the section above, such risks include not only physical climate risks, but also all risks arising from a lack of environmental protection, social aspects or poor corporate governance, as well as serious financial and strategic implications for companies. The extent of potential losses that arise when sustainability risks materialise can be assessed by means of scenario analyses and stress tests. The analysis of sustainability risks and the resulting loss potential must inevitably become an elementary part of any stringent risk management. By assessing companies on the basis of pre-defined sustainability criteria, companies or sectors with relatively pronounced sustainability risks can be identified and separated from companies with relatively low sustainability risks.

Summary and outlook

Due to the pressure of disclosure requirements, institutional investors will have to meet a significant degree of transparency. This transparency will make it more obvious which investors take a consistent sustainability strategy into account in their investment process and which ones pursue it less consistently. DWS already supports its clients in developing and implementing a sustainable investment strategy across all steps of the investment process. We are able to measure sustainability risks with the DWS ESG Engine and analyse the impact on all key financial market figures of our client portfolios (benchmarks and multi-asset portfolios). In our in-house investment processes, especially in risk management, we take climatic risks and ESG risk ratings in every investment decision into account.

We assume that the implementation of the EU action plan will continue to be driven forward politically in the upcoming years and that further regulatory requirements will follow. With regard to the issue of sustainability and regulatory developments, we would like to continue to help our investors and advisors as sparring partners to understand and take advantage of the challenges and, above all, the opportunities of the rapidly changing ESG landscape.

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