Sustainable Finance
Risk Management

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BDO FINANCIAL SERVICES

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BDO FINANCIAL SERVICES – SUSTAINABILITY AND ESG

Our clients seek specialist risk management advice in areas such as Sustainability and ESG. Sustainability and environmental, social, and governance factors have fast risen towards the top of the board agenda, both as a driver of financial performance and as a factor of social importance.
FOCUS ON SUSTAINABLE FINANCE

As of February 2020, 187 countries and the European Union have signed the Paris Agreement. Policy makers as well as regulators have stated to evaluate how they can encourage or require banks, insurance undertakings and pension funds, asset managers and institutional investors to adopt strategies that will support countries in meeting their commitments. In January 2020, Ursula von der Leyen, President of the EU Commission, set the “Green Deal” as a major political guideline for the development in the EU in the coming years.

In December 2017 central banks and supervisors established the Network for Greening the Financial System (NGFS). The networks purpose is to strengthen the global response required to meet the goals of the Paris Agreement and to enhance the role of the financial system to manage risks and to mobilize capital for green and low-carbon investments. The NGFS published in April 2019 its first comprehensive report “A call for Action” which proposes first recommendations aiming at facilitating the role of the financial sector in achieving the objectives of the 2015 Paris Agreement.

The ECB published a “Guide on climate-related and environmental risk” in May 2020. The principles and processes demonstrated in the ECB guide can be thought of as guidelines with which entities can align their in-house handling of sustainability risks. They formulated a set of thirteen aspects of supervisory expectations. In a summary, key tasks for supervised entities are:

- review of business strategy and risk strategy
- review of responsible corporate governance
- review of business organization
- Integrate sustainable risks into the risk identification, management and control processes as well as into stress tests including scenario analysis and into the use of ratings.
- Publish meaningful information and key metrics on climate-related and environmental risks.

A similar Guidance Note on Dealing with Sustainability

Sustainable Finance refers to the integration of environmental, social and governance aspects (ESG criteria) into the decision-making of financial players. The ESG criteria were first introduced by the United Nations’ ‘Global Compact’ initiative.

- Introducing sustainable finance into the business organisation and processes of the players in the financial sector will add value to the society and environment.

The term sustainability risks is defined on the basis of the UN ESG criteria and illustrates physical and transition risks that may unfold with increasing intensity through existing risk types.

- Dealing with sustainability risks is the future challenge for the financial sector.
HOW ESG AFFECTS FINANCIAL SERVICES

EXAMPLES OF INTEGRATION OF SUSTAINABILITY RISKS IN EXISTING RISK CATEGORIES

**STRATEGIC RISK:**
Risk of losing target customer segments in non-sustainable industries

**REPUTATIONAL RISK:**
Risk of losing reputation after selling “green washing”-products

**CREDIT RISK:**
Default risk due to new regulations, e.g. lower maximum carbon emissions, can weaken customer’s business model.

**MARKET RISK:**
Downturn risk of investments in non-sustainable activities

**LIQUIDITY RISK:**
Bank runs liquidity risks based on possible severe image problems of the institute due to non-sustainable actions or incidents.

**INSURANCE RISK:**
Risk of miscalculation of insurance costs

**OPERATIONAL RISK:**
Break-down risk of (outsourced) IT-systems due to extreme weather conditions
Handling risk related to ESG is a new component in risk management of financial institutions and the magnitude of the risk is growing rapidly. The current focus is on the letter “E” for environmental risk and in particular climate risk.

To assess climate risk two questions need to be answered:
- Does climate change trigger any transition risks?
- Does climate change trigger any physical risks?

Both terms, physical and transition risk, are new to risk management. For the time being financial institutions cannot apply any standardised risk assessment concepts to quantify or describe their climate risk, as those standards have not yet been developed and agreed upon.

The letters "S" for social and "G" for Governance in the ESG-term include more well-known issues like risks of failing working standards, fair wages, equality and diversity management, transparent reporting or anti-corruption management. The shift in the risk landscape related to “S” and “G” is more about increased expectations of a holistic and systematic risk assessment and less about absorbing new risks. Again, there is, with few exceptions, no standardised assessment concept to draw on. Each entity must develop their individual risk assessment.
**E FOR ENVIRONMENTAL**

The European Commission aims to become the world’s first climate-neutral continent by 2050. This, combined with the ongoing climate change, will affect the economy and generate massive climate-related risk. Beside the climate discussion, biodiversity may come up as the next big issue under E.

**S FOR SOCIAL:**

Risk related to how companies manage relationships with employees, suppliers, customers and the community is also receiving increased attention by investors. Goldman Sachs presented in Davos 2020 a new policy, refusing IPOs if their management is without diversity.

**G FOR GOVERNANCE:**

The governance dimension has already been assessed for a longer period of time in terms of corporate governance in general, codes of business conduct, tax strategy or anti-corruption and anti-money laundering. Beside these well-known topics you should be aware of ability to adopt to circular economy as a possible new governance risk.
SUSTAINABILITY RISK MANAGEMENT

Sustainability risk assessments are rather new to the financial industry and often conducted on a stand-alone basis. However, to obtain efficient risk management it is important to have an integrated approach. It is advisable to extend an existing risk framework and integrate sustainability risk management in risk policy and standards using already well-known risk categories.

ESG risk management is multifaceted and general knowledge only is no longer sufficient. Banks install more and more specialised sustainability resources. Often serving all aspects of sustainability within the company. The challenge for risk management is to combine sustainability and risk knowledge and to define roles and responsibilities without any overlap or vacuity.

Methods of risk assessments are not yet standardised. We expect financial authorities to publish more specific guidelines in the future and that the number of different methods in use will decline. Until then we recommend taking advantage of possible individual variations and gain better understanding of the own specific risk situation.
SUSTAINABILITY AND RISK ASSESSMENT IN THE CORPORATE CREDIT PROCESS

BDO combines four different workflows to assure an efficient development process.

**Workflow 1** defines sustainability risk assessment framework in corporate credit process

**Workflow 2** implements sustainability risk management in credit risk policy and standards, and defines the assessment process within the general credit

**Workflow 3** embeds sustainability credit risk data in internal and external reporting

**Workflow 4** develops concept for implementation activities and training
EXAMPLES OF RISK APPROACHES

- **Exclusion list and limits**: Listing industries, regions, nations or specific companies which are excluded or limited as customers or partners.

- **Favourite list**: Listing industries, regions, nations or specific companies which are preferred customers or partners.

- **Best-in-Class-Approach**: Based on best practice within industries, regions or nations minimum thresholds are defined and used as criteria for further engagement with customers or partners.

- **Norm based screening**: Implementation of international concepts like UN Global compact or GHG-protocol as screening criteria for customers or partners.

BDO MODULES FOR SUSTAINABILITY RISK MANAGEMENT

- **Green Bond Framework**

- **UN Principles for responsible banking**

- **Sustainability risk assessment in the Corporate Credit Process** – policy, framework, implementation and training activities

- **Risk approach framework**

- **External Sustainability Reporting**

- **Sustainability KPI dashboard - Identify the most relevant KPIs**

- **Management workshop – ESG- risk management: Where to go, what to do?**

- **Management table top workshop – Defining sustainability commitments**

- **Scenario analysis**

- **Recovery Plan, ICAAP and ILAAP adaption**

EXAMPLE OF REPORTING FRAMEWORKS

- **TCFD**
- **GHG-Protocol**
- **UN Global compact**
- **GRI**
- **SASB**
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