Green and Sustainable
Finance Cluster
Germany

TCFD Think Tank

Regulatory developments in the wake of the TCFD recommendations

Potential impacts on
Banks and Asset Managers

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Abbreviations

BdF	Banque de France
BoE	Bank of England
CFRF	Climate Financial Risk Forum
EBA	European Banking Authority
EIOPA	European Insurance and Occupational Pensions Authority
ESG	Environmental, Social and Governance
FCA	Financial Conduct Authority
NGFS	Central Banks and Supervisors Network for Greening the Financial System
PRA	Prudential Regulation Authority
SFSG	G20 Sustainable Finance Study Group
SREP	Supervisory review and evaluation process
TCFD	Task Force on Climate-related Financial Disclosures

Foreword Green and Sustainable Finance Cluster Germany

Transparency is fundamental to evaluating risks and allocating capital efficiently. For this purpose, the consistent disclosure of financial results, the handling of opportunities and risks, the status and the making of forecasts are indispensable. This also applies to understanding the effects of the climate crisis.

The analysis of climate-related risks is challenging, as neither the exact path towards a world compatible with the Paris Agreement nor the exact timing and extent of the physical effects of the climate crisis can be predicted. Many actors are only slowly recognising the significance of the climate crisis for their future economic success. In fact, changes due to the climate crisis affect all parts of the global economic system. The associated changes not only represent a considerable risk, but also open up new business opportunities for companies that strategically consider the climate crisis.

Risk-return profiles in the lending business and in asset management will change considerably as a result of the climate crisis. They are a result of the physical effects of climate change, climate policy and regulation, changing demand structures and new emerging technologies. Avoiding climate-related risks will prove difficult in certain asset classes or sectors, which may lead to a revaluation of such activities.

The Financial Stability Board has set up an industry-led Task Force on Climate-related Financial Disclosures (TCFD) to assess information relevant to climate-related risk. The TCFD has issued recommendations for the voluntary and consistent disclosure of climate-related financial information. These are intended to help investors, lenders and insurance companies understand significant climate-related risks and opportunities. Globally, the TCFD recommendations are now understood as a guideline and numerous companies have committed themselves to their implementation.

The Green and Sustainable Finance Cluster Germany e.V. (Cluster) showed in its Baseline Report published in August 2018 that the TCFD recommendations seem too abstract for German financial institutions. There is little understanding of practical implementation approaches of the TCFD recommendations. In cooperation with experienced financial market practitioners, the Cluster has therefore established a think tank for overcoming practical implementation issues. This is supported by the in-depth knowledge of the Frankfurt School of Finance & Management, PwC Deutschland, d-fine and right. based on science.

Within the framework of the TCFD Think Tank, four workshops with selected financial market practitioners were held. In the course of this process, a deeper understanding of the TCFD recommendations was built up. The findings are now made available to the interested public, in particular financial institutions, in the form of short briefs. They are tailored to the needs of practitioners in order to independently advance the implementation of the TCFD recommendations.

1 INGREASING REGULATORY PRESSURE

The issue of sustainability and consideration of the financial risks of climate change is increasingly moving in the focus of regulatory attention. In 2017, the Central Banks and Supervisors Network for Greening the Financial System (NGFS) was established by eight central banks and supervisors with the aim of contributing to the understanding and development of climate risk management in the financial sector. The NGFS has now grown to over 30 members [1] and 6 observers[2] from around the world, including the BaFin (German Federal Financial Supervisory Authority), Deutsche Bundesbank, European Banking Authority (EBA) and European Insurance and Occupational Pensions Authority (EIOPA).

The first interim report of the NGFS, published in October 2018, stresses that climate risks represent a financial risk. The consideration of climate risks requires an approach that is both forward-looking and includes a long-term time horizon. The NGFS worries that financial risks related to climate change are not fully factored into the valuation of financial products. It is therefore the task of supervisory authorities and central banks to ensure the resilience and stability of the financial system against climate-related risks through appropriate supervisory measures.[3]

The first comprehensive NGFS report was published in April 2019. It sets out six non-binding recommendations for central banks, supervisors, policy-makers and financial institutions to address climate-related risks in line with the best practices of NGFS members:

1. Integration of climate-related risks in the supervision of individual financial institutions (micro level) as well as in the monitoring of the stability of the financial system (macro level)
2. Integration of sustainability factors into the own portfolio management
3. Bridging data gaps
4. Awareness raising and development of expertise and encouragement of technical support and knowledge exchange
5. Robust and internationally consistent disclosure in relation to climate and the environment

1 On 11 February 2019, the NGFS consisted of the following members: Banca d'Italia, Banco de España, Banco de México, Banco de Por tugal, Al Alamhrib, Bank of England, Bank of Finland, Bank of Greece, Bank Negara Malaysia (Central Bank of Malaysia), Bank of Thailand, Banque centrale du Luxembourg, Banque de France / Authority of the Federal Republic of Germany Prudentiel et de Résolution (ACPR), Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), Central Bank of Hungary, De Nederlandsche Bank, Deutsche Bundesbank, European Banking Authority (EBA), European Central Bank, European Insurance and Occupational Pensions Authority (EIOPA), Financial Inspectorates (Swedish FSA), Finanstilsynet (Norwegian FSA), Japanese FSA, Monetary Authority of Singapore, National Bank of Belgium, Norges Bank, Austrian National Bank, People's Bank of China, Reserve Bank of Australia, Reserve Bank of New Zealand and Sveriges Riksbank

2 Several institutions have joined the NGFS as observers: the Bank for International Settlements, the European Bank for Reconstruction and Development, the Organisation for Economic Cooperation and Development, the Sustainable Insurance Forum, the World Bank and the International Finance Corporation

3 First Progress Report, NGFS, October 2018: https://www.banque-france.fr/en/financial-stability/international-role/network-greening-financial-system/first-ngfs-progress-report

6. Support for the development of a taxonomy for economic activities[4].

Recommendations 1 to 4 are addressed to central banks and supervisors, NGFS members and non-members, but parts of these recommendations may also apply to financial institutions. Recommendations 5 and 6 do not fall directly within the remit of central banks and supervisory authorities, but point to measures that can be taken by policy-makers to facilitate the work of central banks and supervisory authorities. Parts of these recommendations may also apply to the private sector. To some extent, Recommendations 1 to 4 require the implementation of Recommendations 5 and 6, but this does not prevent central banks and supervisory authorities from working towards full implementation now.

The NGFS will continue its work and plans to develop:
(i) a guide on climate and environmental risk management for regulators and financial institutions;
(ii) voluntary guidelines on scenario-based risk analysis;
(iii) best practices for incorporating sustainability criteria into central bank portfolio management (in particular with regard to climate-friendly investments).

Further reading
After the editorial deadline, the NGFS submitted its first technical report;
https://www.banque-france.fr/sites/default/files/media/2019/08/07/ngfs_report_techical_supplement_final.pdf

2 DEVELOPMENTS IN THE EU

The supervisory authorities of some Member States of the European Union are beginning to request information on climate-related risks.

With the introduction of the obligation to report climate risks under Article 173-VI of the French Energy Transition Law in 2015, France is taking on a pioneering role. The reporting obligation has been binding for French asset managers and institutional investors since 2017. The article also includes an obligation to integrate ESG factors into the investment strategy, which was previously only required of asset managers. This should include both the impact of the investment on ESG factors and the impact of ESG factors on the investment. The means to support the transition to a low-carbon economy should also be described. The latter only applies to investors and asset

4 First comprehensive report, NGFS, April 2019: https://www.banque-france.fr/en/financial-stability/international-role/network-greening-financial-system/first-ngfs-progress-report

managers with an investment volume of more than EUR 500 million. The regulation affects all asset classes from bonds to physical assets. For implementation, the regulations must either be followed or it must be explained in which points and for what reason deviations are made („comply or explain“ model). [5,6] Based on the provisions of Article 173 of French law and the TCFD recommendations, the Banque de France (BdF), in its „Responsible Investment Report“ of 2018 sets out further steps towards achieving 2°C compliance by creating consistency between the investment approach and the financial stability mandate of the BdF. For this purpose, the „Responsible Investment Charter“ introduced in March 2018 is to be implemented. For implementation, the BdF has defined a strategy based on three pillars and five objectives (for a complete list see further literature). Some of the objectives are the alignment of own funds with the 2°C trajectory by 2020, the consideration of ESG criteria in equity portfolios, as well as the exercise of the right to influence issuers, e.g. in the area of non-financial transparency.[7]

The Bank of England (BoE) is actively involved in the investigation of climate-related financial risks. It is a founding member of the NGFS and a supporter of the Task Force on Climate-related Financial Disclosures (TCFD). In October 2018, the Prudential Regulation Authority (PRA; part of the BoE) published the consultation paper „Enhancing banks‘ and insurers‘ approaches to managing the financial risks from climate change“, which discusses effective governance, risk management, scenario analysis and disclosure to manage the financial risks of climate change. The expectation of the PRA is that companies will find a strategic approach to managing climate-related financial risks. Companies should integrate the financial risks of climate change into their governance and existing risk management practices; a scenario analysis should be used to support the strategy and for risk assessment and identification. In addition, an approach for the disclosure of the financial risks of climate change is to be developed. Thus, the PRA expectations are very close to the TCFD recommendations. According to PRA, climate-change-related physical and transition risks can be expressed, for example, by rising credit and market risks [8]
The consultation ended in January 2019, the corresponding statement of the PRA followed in April 2019. In many detailed questions PRA refers to the individual respon-

5 France, Article 173: https://www.legifrance.gouv.fr/eli/loi/2015/8/17/DEVX1413992L/jo/article_173

6 Article 173-VI: Understanding the French regulation on investor climate reporting, Oktober 2016: https://www.frenchsif.org/isr-esg/wp-content/uploads/Understanding_article173-French_SIF_Handbook.pdf

7 Responsible Investment Report, Banque de France, 2018: https://www.banque-france.fr/sites/default/files/media/2019/03/26/banque-de-france-responsible-investment-report-2018_0.pdf

8 Consultation Paper 23/18, PRA, Oktober 2018: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2018/cp2318.pdf?la=en&hash=8663D2D47A725C395F71FD5688E5667399C48E08

sibility of the companies and the iterative character of the solutions. The future work of the Climate Financial Risk Forum (CFRF) and NGFS is referred to as a support for companies[9].

In March 2019, the first meeting of the CFRF took place under the chairmanship of the PRA and the Financial Conduct Authority (FCA). The aim of the forum is to develop practical approaches in the areas of risk management, scenario analysis, disclosure and innovation.

The Dutch central bank De Nederlandsche Bank (DNB) stressed in its report „Waterproof? An exploration of climate-related risks for the Dutch financial sector“ (2017) that financial institutions must take into account the consequences of a changing climate and the transition to a carbon-neutral economy. As a supervisory authority, DNB intends to embed climate-related risks more strongly in financial supervision in order to ensure sustainable financial stability. For example, DNB is already working on the implementation and further development of climate stress tests for both physical and transition risks. In their report, they also make recommendations for financial institutions and political decision-makers to address climate risks as early as possible. Financial institutions are particularly recommended to model the uncertain course of the energy system transformation and climate change by means of forward-looking risk management using scenario analysis. They should also be aware of the risks they face in carbon-intensive sectors. Policy-makers are advised to define a clear transition path to ensure financial stability. In addition, the government should also work to improve disclosure standards for climate-related risks. In this context, it is explicitly stressed that DNB supports the recommendations of the TCFD on climate-related financial disclosure.[10]

Developments on climate-related disclosure are also taking place at EU level. One of the main topics of the Banking Package agreed within the framework of the EU Trilogue is the requirements for the disclosure of ESG risks (see CRR II Draft Article 4 ESG risks) for large institutions. This includes explicitly physical and transition climate-related risks[11] as listed in the TCFD recommendations.

9 Policy Statement 11/19, PRA, April 2019: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2019/ps1119.pdf?la=en&hash=CD95D958ECD437140A4C7CF94337DAFD8AD962DE

10 An exploration of climate-related risks for the Dutch financial sector, De Nederlandsche Bank, 2017: https://www.dnb.nl/en/binaries/Waterproof_tcm47-363851.pdf?2017110615

11 Text of the political agreement on the Own Resources Regulation (EU) No 575/2013: https://data.consilium.europa.eu/doc/document/ST-6288-2019-INIT/en/pdf

In addition, EBA should examine the consideration of ESG risks in the supervisory review and assessment process (SREP) and develop appropriate guidelines depending on the outcome[12]. In particular, a uniform definition of ESG risks, including physical risks and transition risks, is to be developed. In addition, qualitative and quantitative assessment criteria for the short-, medium- and long-term impact of these risks on the financial stability of institutions are to be developed. This also includes stress testing procedures and scenario analyses[13], which are recommended by the TCFD to measure the impact of climate-related risks. In addition, the arrangements, strategies, processes and mechanisms to be used by institutions to identify, assess and manage ESG risks and the related analytical methods and tools will be developed[14].

Further reading

Article 173-VI: *Understanding the French regulation on investor climate reporting* (Oktober 2016): https://www.frenchsif.org/isr-esg/wp-content/uploads/Understanding_article173-French_SIF_Handbook.pdf

Responsible Investment Report (Banque de France, 2018): https://www.banque-france.fr/sites/default/files/media/2019/03/26/banque-de-france-responsible-investment-report-2018_0.pdf

Consultation Paper 23/18: Enhancing banks' and insurers' approaches to managing the financial risks from climate change (PRA, Oktober 2018): https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2018/cp2318.pdf?la=en&hash=8663D2D47A725C395F71FD5688E5667399C48E08

An exploration of climate-related risks for the Dutch financial sector (De Nederlandsche Bank, 2017): https://www.dnb.nl/en/binaries/Waterproof_tcm47-363851.pdf?2017110615

12 Text of the political agreement on the Own Resources Regulation (EU) No 575/2013: https://data.consilium.europa.eu/doc/document/ST-6288-2019-INIT/en/pdf

13 13 Text of the political agreement on the Own Funds Directive 2013/36/EU: https://data.consilium.europa.eu/doc/document/ST-6289-2019-INIT/en/pdf

14 Text of the political agreement on the Own Resources Regulation (EU) No 575/2013: https://data.consilium.europa.eu/doc/document/ST-6288-2019-INIT/en/pdf

3 POSSIBLE ANCHORING OF REGULATIONS IN GERMANY

In addition to approaches at EU level, developments are also taking place at the German level. For some time now, BaFin has been working in all business areas on anchoring climate, environmental and social factors in the financial sector in order to strengthen and systematically take account of sustainability in supervision[15]. In his lecture of March 2019, Raimund Röseler described Sustainable Finance as one of the „hot spots" of the German banking landscape. He drew attention both to the effects of climate change and to the financial industry's ambitious climate targets. Under its supervision, BaFin will raise companies' awareness of the issue and demand that sustainability risks be integrated into risk management[16]. For example, it would be possible for the issue of sustainability to be emphasised more strongly by a supplementary letter to MaRisk (legally binding minimum requirements for risk management in Germany) or even by an adaptation of MaRisk by BaFin. Deutsche Bundesbank also calls for greater attention to the risks arising from climate change. At the Bundesbank Symposium on 19 March 2019, Prof. Dr. Wuermeling explicitly stressed in his speech that new sources of risk, including climate change, should be identified and considered as early as possible[17].

It is to be expected that the TCFD recommendations will be fully or partially incorporated into regulatory requirements within the EU and also at national level. German companies should start integrating the TCFD recommendations in order to benefit from their knowledge in dealing with climate-related risks and opportunities and to secure long-term economic success.

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15 Sustainable Finance: Changes in Environment and Society - BaFin's Dealing with Risks, BaFin, 2018: https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Fachartikel/2018/fa_bj_1805_sustainable_financial_economy.html

16 Lecture by the Executive Director Banking Supervision, Raimund Röseler, March 2019: https://www.bafin.de/SharedDocs/Veroeffentlichun- gen/DE/Reden/re_190322_quo_vadis_bank supervision_ed_ba.html

17 Speech by Prof. Dr. Joachim Wuermeling, Bundesbank Symposium, 19.03.2019: https://www.bundesbank.de/de/presse/reden/what-goes-what-remains-what-committed-perspectives-for-the-German-bank-sector-782894

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