BVI¹ position on the consultative report of the Financial Stability Board (FSB):
Supervisory and Regulatory Approaches to Climate-related Risks

We welcome FSB’s initiative to assess the impact of climate-related risks in supervisory practices in improving the understanding of potential financial vulnerabilities. FSB’s final report will stimulate the discussion and sensitise the supervisory and regulatory authorities for developing their approaches to monitor, manage and mitigate risks arising from climate change. It is important to review processes to see how climate-related risks can be integrated into the existing supervisory processes. In view of the challenges of climate change, the entire financial sector must deal with the associated risks and opportunities. However, we focus our response on the impact on asset managers with the following key remarks:

1. **Germany is the largest market in the EU.** In the EU, a total of more than EUR 13 trillion is invested in investment funds by private and institutional investors. With assets of EUR 3,600 billion, Germany is the largest market (according to the ECB) with a market share of 27 percent. An annual growth rate of 9.6 percent makes Germany one of the fastest growing markets, surpassing, for instance, France, Italy, and The Netherlands.

2. **Managing investment funds differs fundamentally from business models of banks or other types of financial entities such as insurance companies and therefore requires separate consideration when assessing climate-related risks in supervisory practices.** Asset managers are neither banks nor insurance companies, but a separate pillar of the financial economy. They act as agents on behalf of their investors and are subject to fiduciary duties to act in the best interest of investors. They do not have custody over the assets, as these are ‘safe-kept’ by separate depositary institutions. Fund assets are thus never part of the asset manager’s own balance sheet. Own capital of asset managers is not required to bail out struggling funds. Importantly, the investment results of investment funds – whether positive or negative – are fully attributable to investors. Existing European sector-specific rules and additional national rules for asset managers provide a robust framework to address entity-specific vulnerabilities including the integration of sustainability risk in the internal governance structure (such as management of conflict of interests), in the risk management process (valuation of relevant risks in the managed portfolios) and in the investment process (such as pre- and post-purchase investment due-diligence).

Therefore, integration of climate-related risks in supervisory and regulatory approaches depends on the sector-specific requirements for asset managers and must be strictly separated from the approaches used in the banking or insurance sector. The differences are partly addressed in the interim report. Nevertheless, we recognise a clear focus on the banking business, whose prudential requirements (such as reporting to the supervisory authority) differ significantly from those of asset managers. We therefore recommend that the final report should more clearly elaborate on the differences between banks and asset managers: The main focus in the banking business lies on the risks to which the bank may be exposed to via the impact of environmental factors on its counterparties such

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¹ BVI represents the interests of the German fund industry at national and international level. The association promotes sensible regulation of the fund business as well as fair competition vis-à-vis policy makers and regulators. Asset Managers act as trustees in the sole interest of the investor and are subject to strict regulation. Funds match funding investors and the capital demands of companies and governments, thus fulfilling an important macro-economic function. BVI’s 116 members manage assets of some EUR 4 trillion for retail investors, insurance companies, pension and retirement schemes, banks, churches and foundations. With a share of 28%, Germany represents the largest fund market in the EU. BVI’s ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.
as the increase of credit risk of the counterparty due to higher probability of default and loss given default and its impact on the solvency or performance of the institution. In our view, the solvency risk is closely connected with the level of concentration risks (associated with the default of counterparties and with trading positions of the own balance sheet). Asset managers have a very low solvency risk which results more from professional liability and operational risks and not from their supervised activities. Their focus is more on the impact of climate-related risks on the portfolio managed on behalf of investors. Moreover, sustainability investing is a very broad field with many different investment approaches addressing various investment objectives. At a top level, we can break down climate-related investing into three main investment approaches: climate-related integration, in which the key objective is to improve the risk-return characteristics of a portfolio; second, values-based investing, in which the investor seeks to align his portfolio with certain norms and standards; third, impact-related investing, in which investors want to use their capital to trigger possible change for environmental purposes, for example, to accelerate the decarbonization of the economy.

3. **Common definitions:** In order to allow for implementation of consistent concepts for sustainable risk management across different business lines, the definitions of environmental or climate-related risk and factors should be fully aligned. Moreover, it is of utmost importance to clarify that sustainable risks materialise only through their potential significant negative impact on prudential risk categories.

4. **Climate-related risks should only be considered as a partial aspect of the already known financial risks and not as a separate type of risk.** It is important to understand that the concept of sustainability risk is not a new stand-alone risk management process, but rather a specific sub-set of financial risk. To put it differently: sustainability risk is financial risk inherent in a portfolio due to sustainability factors attached to the underlying investments of the fund. Therefore, as it stands, sustainability risk in fund investments is in general not identified and measured separately from other risks. Rather, it is included into the exposure to other relevant risks or considered part of the price valuation of portfolio assets.

Moreover, it should be clarified that environmental indicators are only relevant for the purpose of identifying and managing environmental risks if they flag issues that are material in terms of financial performance. In this regard, due caution should be used when pointing to the indicators for **principal adverse impacts (PAIs)** developed under the European framework for sustainable disclosure (SFDR). There is a clear conceptual difference between PAIs and the notion of sustainability risk (such as environmental risk). While sustainability risk is defined as a subtype of financial risks, i.e. the risk of actual or potential material negative impact on the value of the investment resulting from an environmental event, PAIs shall capture negative implications of investment decisions on environmental and social matters. This means that PAI indicators should only be used for identifying sustainability risks if they are systematically supplemented by an assessment of financial materiality. Sustainability risks can indeed materialise from adverse impacts on e.g. environment or people especially in the long term. For instance, an investment in a company from an GHG-intense manufacturing sector has an adverse impact in terms of GHG emissions in the first place. This adverse impact could also materialise as a risk for the financial performance in case of introduction of carbon-pricing mechanisms that would penalise highly emitting activities.

5. **It must be clarified that there is no obligation to use quantitative and qualitative indicators related to the identification of climate-related risks.** At the current stage, approaches in the market for the measurement of sustainability risk are not standardised so that the use of qualitative indicators only (such as descriptive considerations of interdependencies between indicators and financial risks) should be possible as a first step to identify sustainability risks. Consequently, standard quantitative
indicators, such as those used throughout the industry to manage market and counterparty risks, cannot be used at present. We assume that the supervisory authorities are aware of these de facto limitations; nevertheless, they should be explicitly emphasised. The capability of financial institutions to account for sustainability risk within their processes depends to a great extent upon the availability of public, transparent, relevant, and reliable data related to sustainability considerations. The metrics and methods used to assess environmental risks are neither compulsory nor do they have a specific ranking. Such a principle-based approach should be clarified more prominently in the final report.

6. We fully agree with the assumption provided by the FSB that climate scenario analysis and stress tests as system-wide approaches are not appropriate for the asset management sector. However, we see the need to further discuss about macro-policy tools that can be used by supervisors such as national competent authorities (NCA), the European Securities and Markets Authority (ESMA), the European Systemic Risk Bord (ESRB) or IOSCO for their own analysis to identify potential system-wide risk in the asset management sector. The German NCA (BaFin)\(^2\), for instance, has started a new central Data Intelligence Unit (DIU) and a digital supervisor cockpit to form the backbone of IT-driven supervision of the financial sector. ESMA introduced the STRESI solution (stress simulation for investment funds).\(^3\) In this regard, analyses of system-wide climate-related risks should be based on data reported by the supervised entities. Moreover, it is important to set up or improve the information sharing process between all supervisors.

7. All supervisory and regulatory approaches need a wealth of climate-related data and analytics. Comprehensive disclosure of consistent, comparable and reliable climate-related data is therefore needed. In this regard, we highly welcome the adoption of the new framework for corporate sustainability reporting (CSRD) at the EU level as well as ongoing discussions on common reporting standards in the EU and on a global scale. However, it will take some time before these reforms will show first effects in practice. Meanwhile, asset managers and other market participants have no other choice than to rely on commercial ESG data providers to cover their ESG data needs.

Competent Authorities and regulators should take into account the existing market practices in order to deal with conflicts of interests by disclosure of types of research received and the main counterparties. We believe that a uniform quality standard for the evaluation process for external data (such as ESG ratings) is necessary. However, supervisory authorities should be aware of the problems of licensing costs, the lack of transparency of the methodologies underlying the ratings and the disproportionate market power of individual US providers. This situation has implications for the quality and reliability of data, since investors and financial market participants need to rely on research and qualitative assessments of climate-related aspects as basis for ratings that might not fully incorporate and take into account the development of the sustainable finance regulations, enacted e.g., in the EU. This is particularly relevant in relation to investments outside the EU, where EU investors will also in the long-term have difficulties to rely on corporate disclosures, which do not meet the EU data and transparency requirements. With increased regulatory focus on sustainability also in the Americas and Asia this outcome cannot be deemed satisfactory from a global policy perspective. Therefore, the costs of sustainability data (data prices, licensing practices, definitions, verification procedures and connectivity fees) must be subject to regulatory oversight. Strict oversight of the entire business of ESG data is critical in order to maximise the resulting economic and social benefits.


\(^3\) Available under the following link: https://www.esma.europa.eu/sites/default/files/library/esma50-164-2458_stresi_report.pdf.