Deutscher Fondsverband

BVI Research

BVI SURVEY ON THE INTEGRATION OF SUSTAINABILITY RISKS IN RISK MANAGEMENT

Survey summary

According to its guidance notice of 2019, the Federal Financial Supervisory Authority (BaFin) already expects that supervised entities ensure that sustainability risks are also considered and that this process is documented. Legally binding requirements will apply to both investment fund management companies licensed under the AIFMD or UCITS Directive and investment firms such as portfolio managers with a mere MiFID license under Level 2 of the corresponding Directives from August 2022. Accordingly, sustainability risks must be systematically integrated in internal processes. This concerns the investment process, risk management and the internal organisation.

In August 2021, BVI conducted a survey that aimed to ascertain the status on how market participants currently integrate sustainability risks in the German asset management industry identifying any weaknesses and need for action at an early stage. The results of our survey will be used to provide practical support and to develop industry standards. Our survey focuses exclusively on the risk management process, in particular which data bases, methods, and procedures that market participants use to identify and assess sustainability risks.

The starting point is the definition of sustainability risk within the meaning of the EU Regulation on sustainability-related disclosures in the financial services sector (SFDR) as an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment. In this context, we proceed from the BaFin understanding that sustainability risk is not a separate type of risk, but it may have rather a significant impact on all of the existing risk types such as market price risk, credit risk or liquidity risk, and is a factor that contributes to their materiality.

The questionnaire was addressed to all BVI members, regardless of which license they hold or in which country they manage portfolios or distribute funds. The survey was conducted at the group level which covers all the assets of the companies within a group. The sample of 61 companies accounts for 94 percent of the assets under management in BVI's Statistics, which is representative of the whole German asset management industry. Moreover, all kinds of managers are represented in the sample, from investment securities companies (29), real estate investment companies (21) to portfolio managers licensed as investment firms (11).

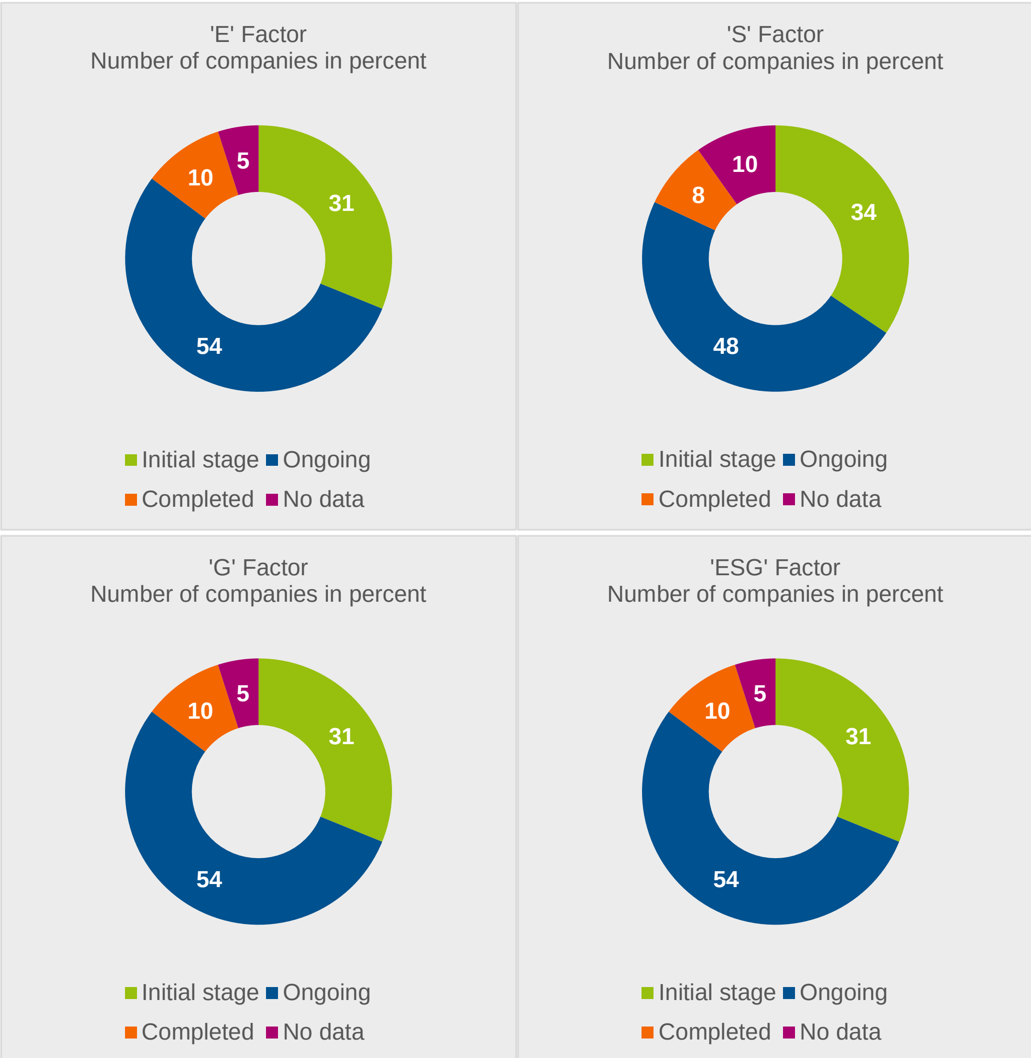
Results obtained from the survey show that most of the market participants have started the process of integrating sustainability risks into their risk management process and 10 percent of them have already fully accomplished this task. The most important challenges that asset managers and investment firms face at the present stage in this process is the lack of consistent ESG data and the diffuse regulation. To overcome this drawback, market participants have already built internal capabilities and source data from more than one data provider or from multi-vendor sources. Data challenges are most pronounced for small caps, derivatives, and alternative assets. Sustainability risks are not treated as separate risk factors, but they are additional risk factors that contribute to the well-known financial risks.

Survey results

1. Integration of ‘E’, ‘S’, ‘G’ and ‘ESG’ factors

Regarding the integration of the ‘E’ factor (environmental event) in the risk management process, 10 percent of the companies have already completed the integration process, whereas 85 percent are still working on the process or are in the initial stage. The ‘S’ factor (social event) has been integrated by 8 percent of the 61 questionnaire’s participants, and 82 percent of the companies are still working to complete it.

What is the current status of integration?



Similar to the numbers above, 10 percent of the companies have already completed the integration process of the “G” factor (governance event) and ESG factors, whereas 85 percent are still working on the process or are in the initial stage. Note that only between 5 and 10 percent of the participants do not provide any information regarding the status of integration of the mentioned factors, which shows that the majority of the participants have already taken some measures to deal with the integration of sustainability risks in the risk management process.

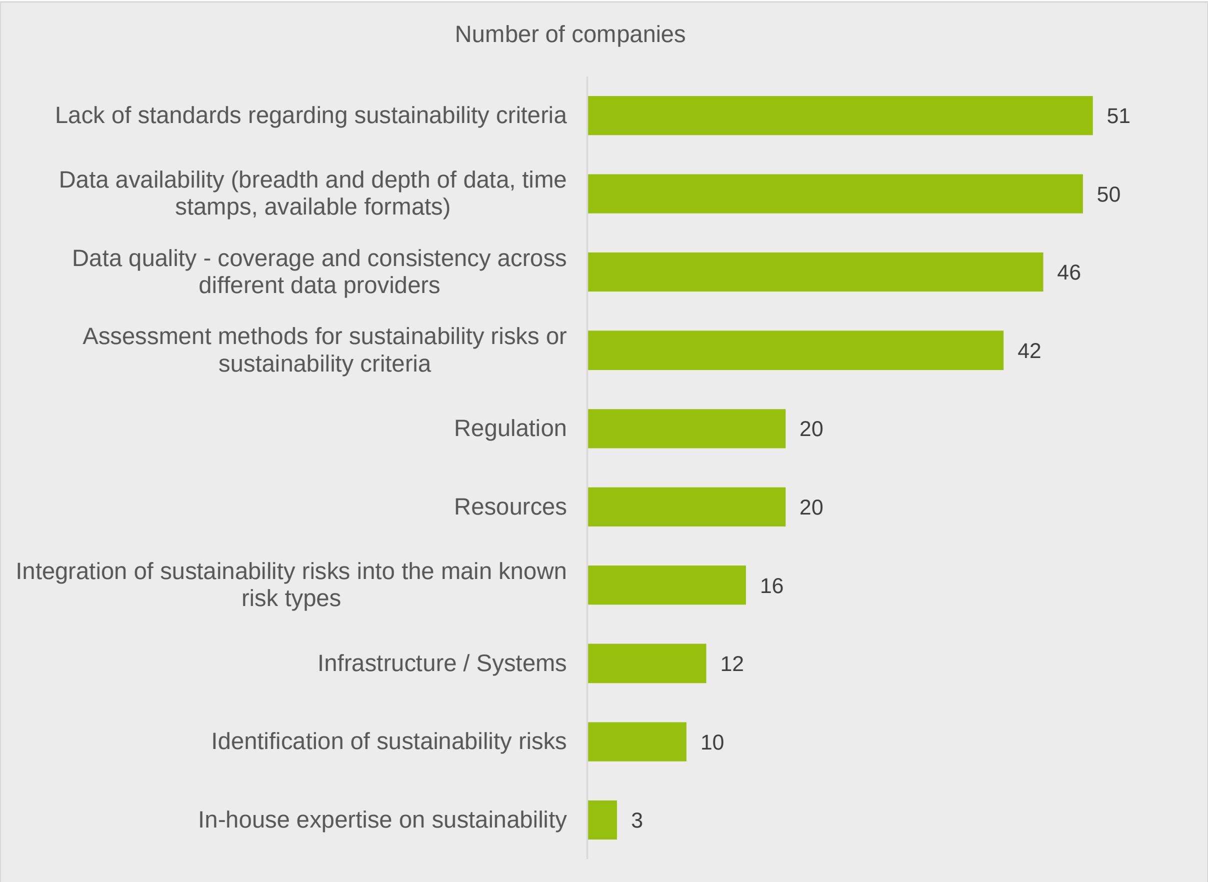
Key findings:

- *90 to 95 percent of the market participants have started the process of integrating sustainability risks in their risk management process. 10 percent of the companies have already completed this process.*
- *Environmental and governance issues have been largely integrated, whereas social issues are slightly lagging. Difficulties in integrating social issues, probably stem from the subjective nature of these factors which suggests the need of definitions particularly in this area.*

2. Greatest obstacles hindering the integration of sustainability risks

Most of the questionnaire's participants (50 out of 61) mention a wide range of data issues as being the main obstacles hindering the integration of sustainability risks. Data issues range from the lack of concrete sustainability criteria, coverage, and consistency of data among data providers to the availability and accessibility of the data sources. Other obstacles mentioned are the lack of appropriate methods and assessment procedures, unclear regulation, and the lack of internal resources and infrastructure.

What are the greatest obstacles hindering the integration of sustainability factors?



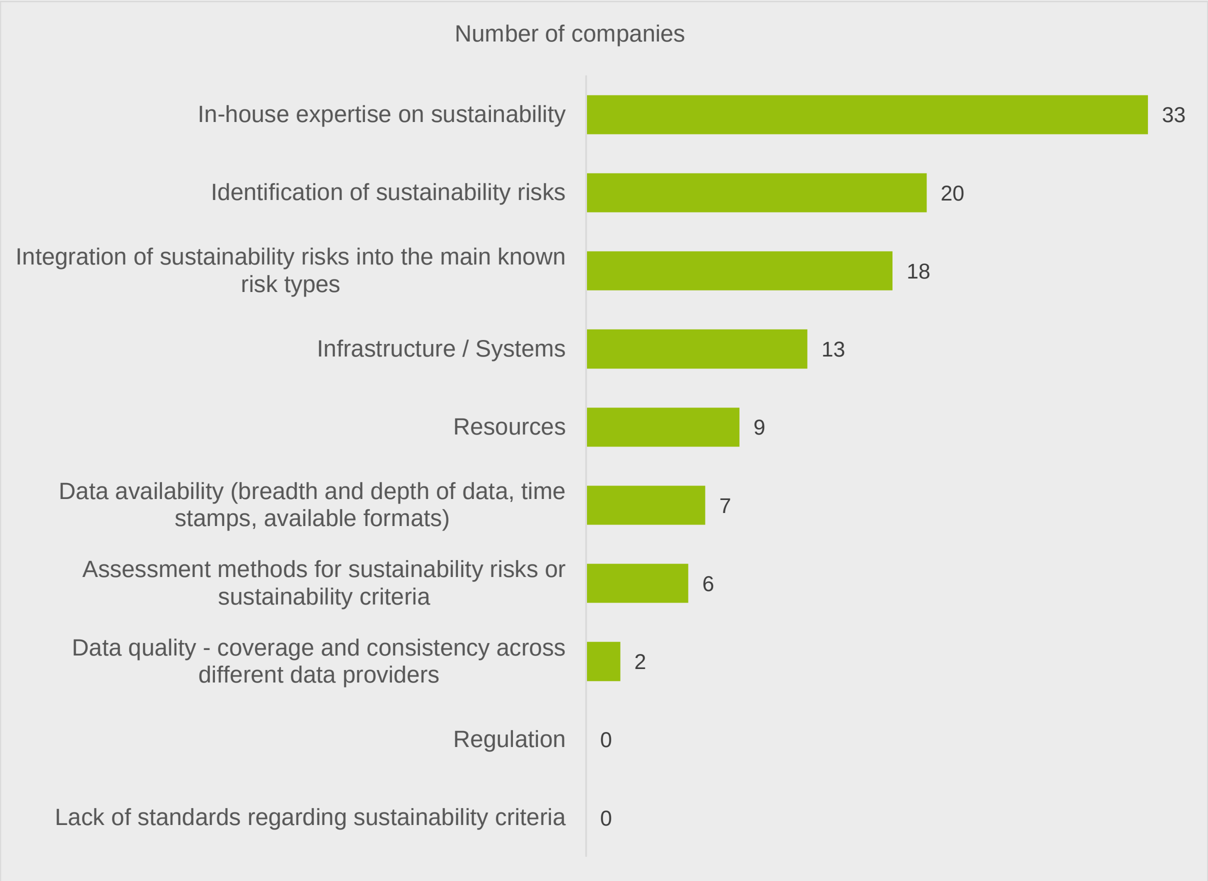
Key findings:

- *Most market participants (at least 46 out of 61) point out the lack of standards and the quality and coverage of data as the main difficulties in assessing sustainability risks.*
- *Most market participants seem to have developed internal expertise in dealing with ESG issues in the last year. Likewise, they appear to have the needed infrastructure and resources.*

3. Well-functioning processes

In the questionaire we did not ask just about the most troubling issues that hinder the integration of sustainability risks. We also asked what are the processes that are working well in order to identify particular strenghs and be aware of the advances in the industry. Most of the participants pointed out that they have established in-house expertise regarding the assessment of sustianability factors so that they are able to identify and classify them within the cathegories of well known financial risks. Consistent with responses to the previous question market participants note that the lack of data and standards as well as vague regulation are conditions that are dragging down the process of integration of sustainability factors in the risk management process. Given the dichotomy between this section and the previous one, answers to the question on well-functioning processes reinforce the results from the previous question referring to the greatest obstacles for integration.

What processes for integrating sustainability risks are functioning well?



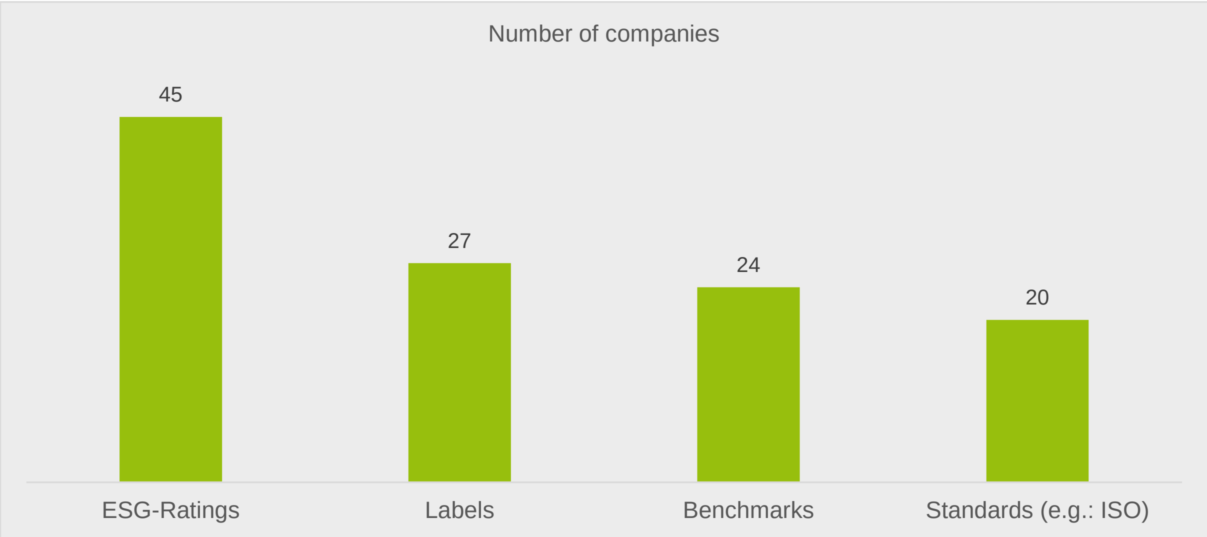
Key findings:

- *Market participants point out that they have built internal capabilities for dealing with sustainability risks.*
- *Lack of standards and diffuse regulation are the main sources of complexity in dealing with sustainability risks.*

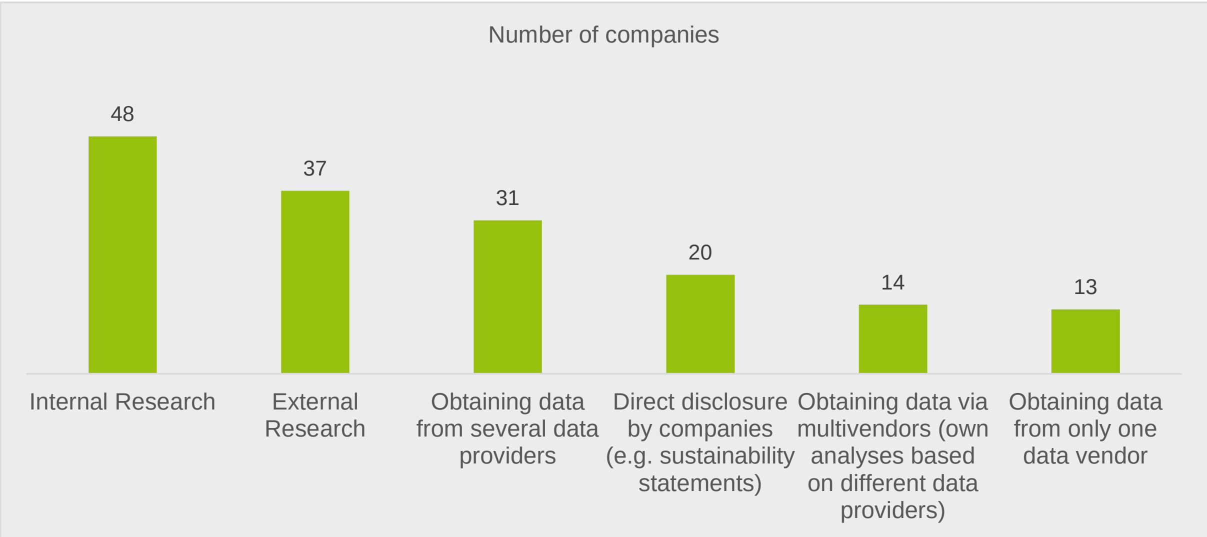
4. Most commonly used data – Data types and data sources

The most common data types used by the market participants are ESG ratings followed by sustainability labels, benchmarks and standards.

What are the most used data types used to assess sustainability risks?



What are the most used data sources while assessing sustainability risks?



Consistent with the results from previous questions, it seems that in recent years market participants have built up internal capabilities in order to deal with sustainability factors. This is reflected by the fact that 48 out of 61 companies report having proprietary research. Another tendency identified in the industry is that market participants obtain ESG data from more than one data provider on the basis of which they do their own assessment. This appears to be the consequence of this in dealing with ESG data caveats that were reported in the previous sections such as unavailable and inconsistent ESG data.

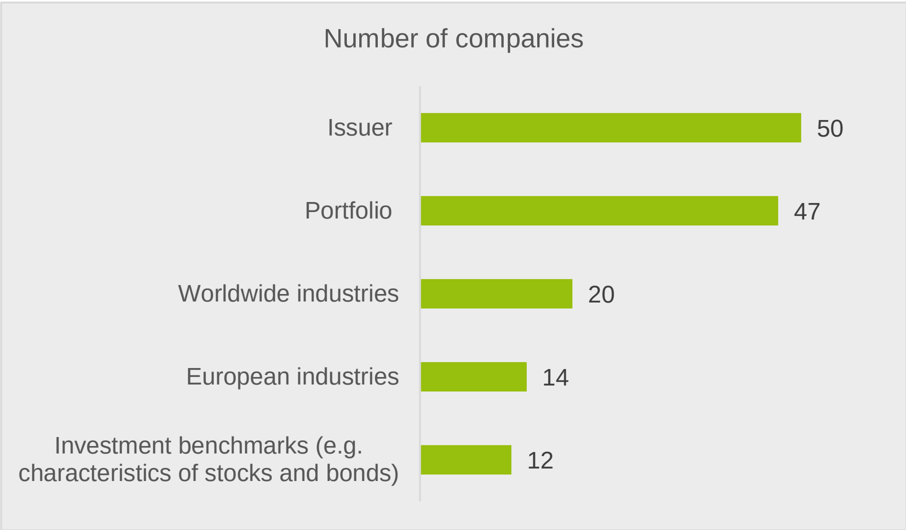
Key findings:

- *Most of the investment companies in the survey use ESG ratings for dealing with sustainability issues.*
- *Most of the investment companies obtain data from more than one data source and process it within the framework of its own research.*

5. Identification of sustainability risks by aggregation level

The next question asked was at which level are sustainability risks identified. Most of the respondents to the questionnaire pointed out that they identify sustainability risks at the issuer as well as the portfolio level and less at a higher level of aggregation such as country, industry or global level.

At which level do you identify sustainability risks?



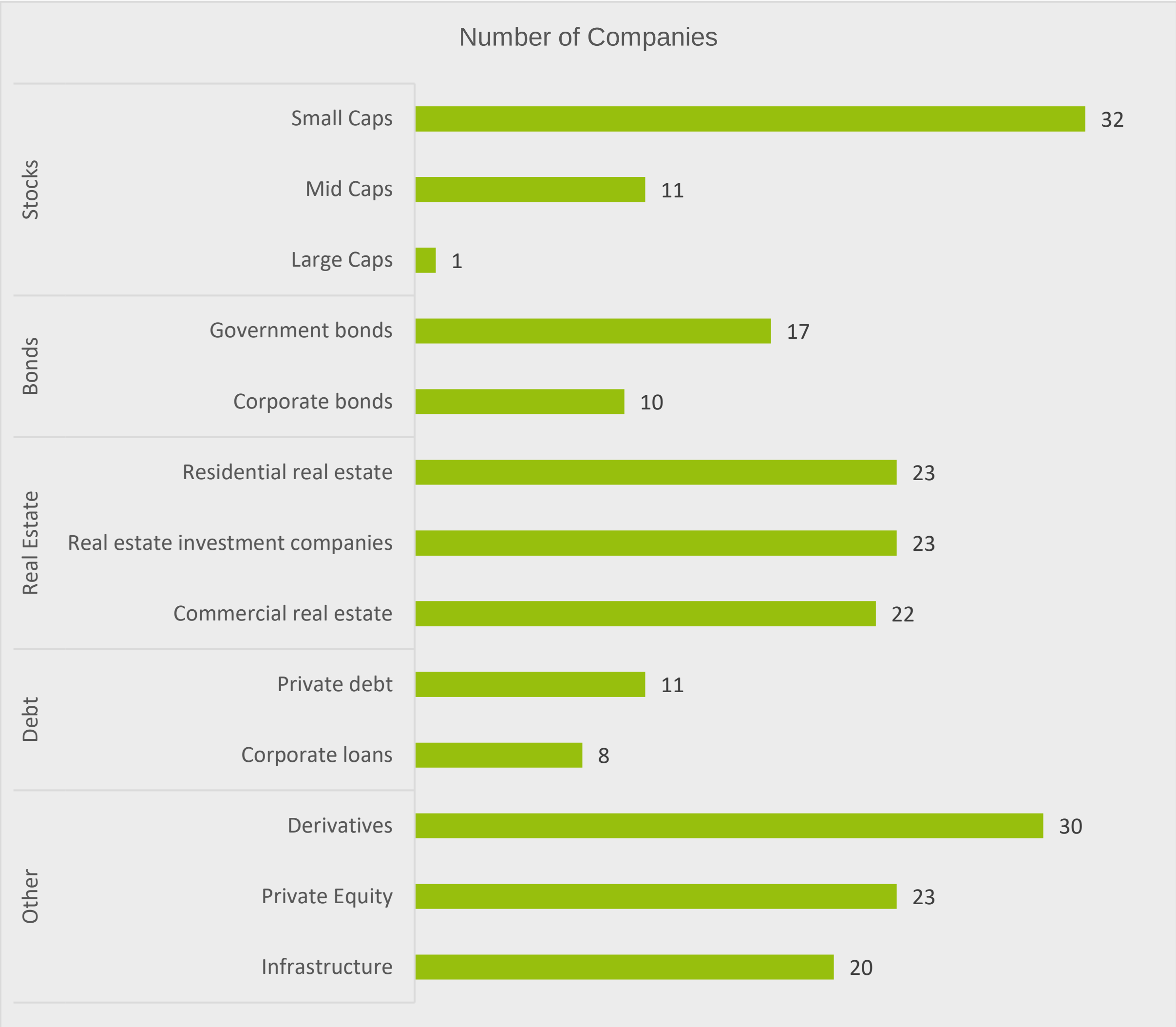
Key finding:

- *Most of the investment companies process the information at a low aggregation level: issuer or portfolio level. This emphasizes the importance of the quality and consistency of ESG data at the issuer level in order to obtain consistent output.*

6. Asset classes that present the greatest challenges in identifying sustainability risks

For most of the participants, the greatest challenges in identifying sustainability risks are present when dealing with small caps, derivatives and illiquid asset classes like private equity, real estate and infrastructure.

For which asset classes do you see difficulties in the identification of sustainability risks?



Key finding:

- *Difficulties in integrating sustainability risks are found mostly when dealing with small caps and derivatives as well as illiquid assets: real estate, private debt, private equity and infrastructure.*

7. Most commonly used assessment methods for sustainability risks

The most established methods for assessing sustainability risks are implicit methods: negative screening or exclusion lists, principles-based screening, as well as investment limits and positive screening as well as best-in-class approach. Negative screening refers to the practice in which certain sectors, companies or practices are excluded from a fund or portfolio based on specific ESG criteria. Principles-based exclusions refers to the screening of investments against minimum standards of business practice based on international norms. The best-in-class approach consists in selecting the best issuers of an industry or sector in terms of sustainability performance.

Which methods do you use to assess sustainability risks at portfolio level?

More sophisticated methods that identify sustainability risks on portfolio level are less widespread than implicit methods. These embrace the exposure method, sensitivity analysis, the portfolio alignment method, stress tests and other individual methods like proprietary factor models. The portfolio alignment method describes the extent to which portfolios are aligned with global sustainability goals and what changes are required to achieve these goals. The exposure approach consists in a direct assessment of individual issuers and exposures. It is a scoring approach in which the performance of an engagement with regard to sustainability aspects is evaluated. The risk framework methods analyse by means of stress tests or scenario analysis how sustainability risks affect the risk profile of the portfolio and their standard risk indicators. Stress tests consist in building a wide range of scenarios to assess risks. Sensitivity analysis is a simplified approach for simulation of individual risk parameters under the assumption of specific ESG developments.

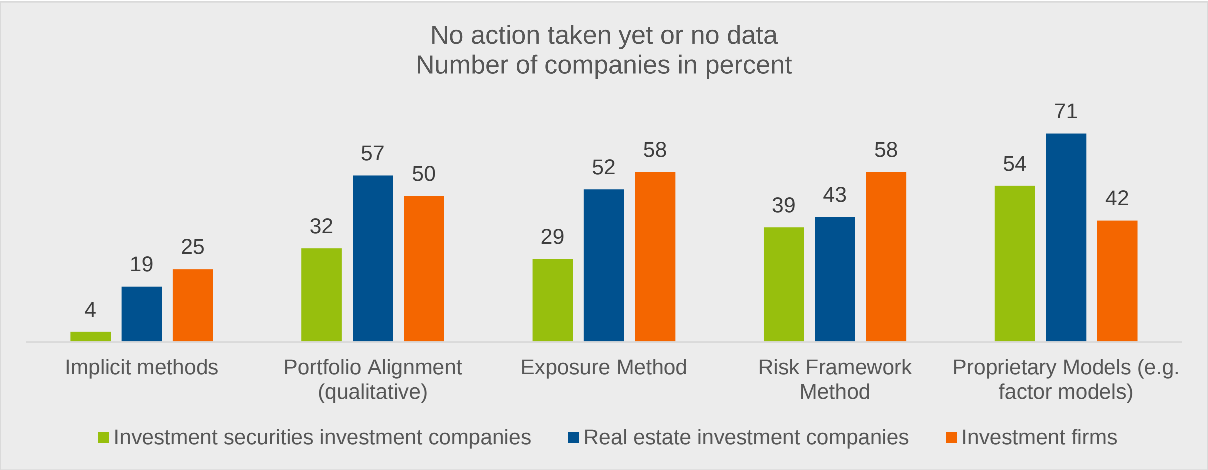
An interesting feature of the results gathered when focusing on different types of companies is that a large number of investment firms and real estate investment companies have not yet taken action or deliver no answers regarding the implementation of more sophisticated models, which implies a major potential for the industry to further develop a toolbox of assessment methods. .

Another interesting observation when focusing on the size of the investment companies is that small and medium investment companies have more difficulties in developing more complex assessment methods such as stress tests, scenario analysis or factor models. It seems to be easier for large companies to adapt to the new requirements regarding sustainability risks, and a large number of them have built up the necessary infrastructure and capabilities to deal with sustainability risks.

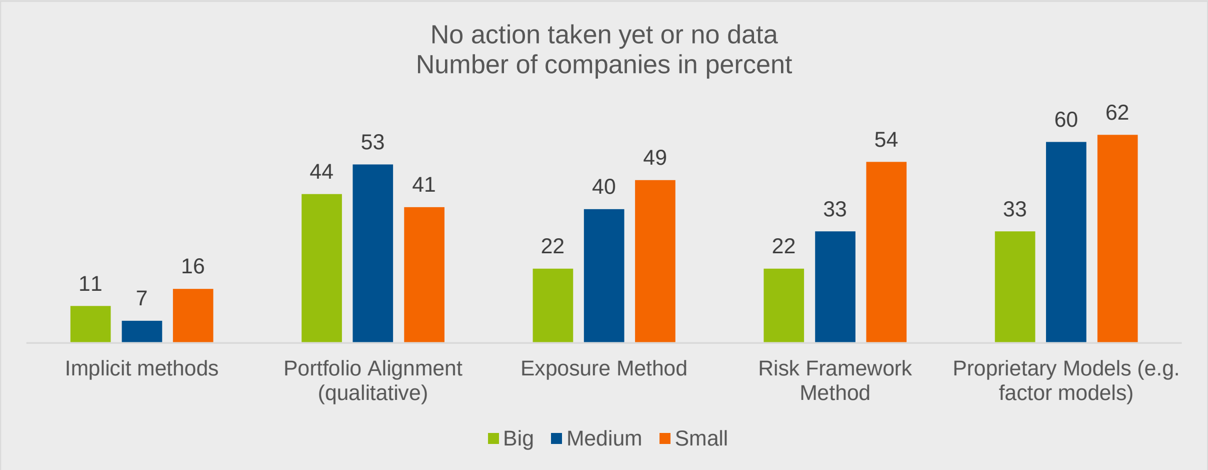
Another interesting observation focusing on the size of the investment companies is that small and medium investment companies have so far been more reluctant to develop more complex assessment methods such as stress tests, scenario analysis or factor models as shown in the following figure.

What is the current implementation status of the integration of valuation methods in your internal processes?

Selected results by type of investment company



Selected results by size of investment company



Notes:

- These figures focus on results in which participants answered that they have not yet taken action/no data has been delivered. The other answers are at an initial stage, ongoing and completed.
- Small companies have been defined as companies with less than EUR 20 billion assets under management, medium companies have between EUR 20 and 300 billion assets under management and big companies are the ones with more than EUR 300 billion assets under management. This figure focuses on results in which participants answered that they have not taken action yet or no data has been delivered regarding the status of implementation of risk assessment methods. The other answers are at an initial stage, ongoing and completed.

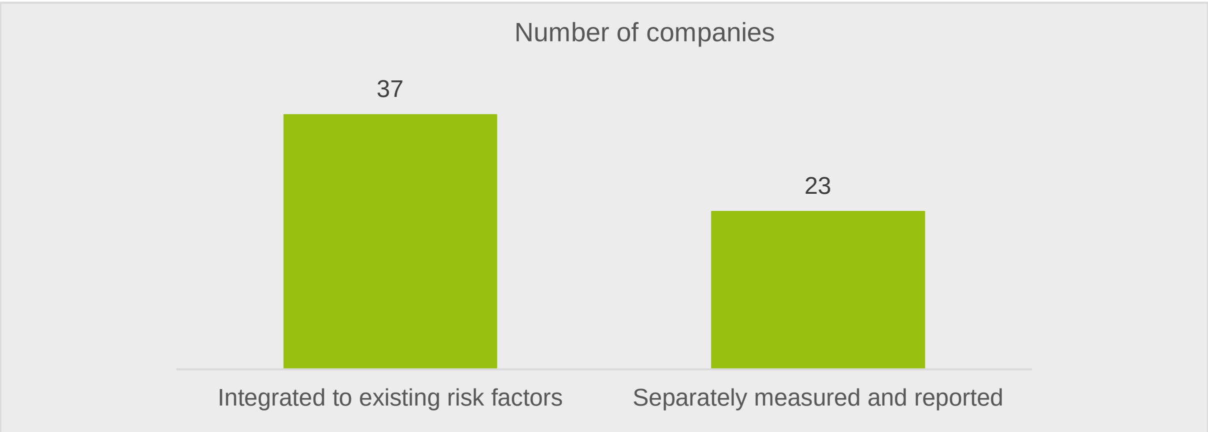
Key finding:

- *Regarding methods to currently assess sustainability risks, market participants focus on rather simple approaches like exclusionary approaches. More sophisticated methods like stress tests and factor models have upside potential for development. Small and medium investment companies as well as real estate companies and investment firms have so far been more reluctant in implementing more complex methods to assess sustainability risks.*

8. Are sustainability risks independent risk factors?

The last question refers to how sustainability risks are assessed and reported with respect to the overarching types of financial risks: market, credit or liquidity risk. Most of the participants point out that sustainability risks are integrated into the existing risk factors, with a minor number of participants who explain that sustainability risks are measured and reported separately as an independent risk factor. This is consistent with the German supervisors' best practice for the integration of sustainability risks, which suggests that sustainability factors should be integrated to the well-known financial risks: market price risk, credit risk or liquidity risk.

Do you integrate the sustainability risks into the existing (overarching) risk factors, or do you measure and report them separately?



Key finding:

- *Sustainability risks are mostly integrated into the existing risk factors: market, credit or liquidity risk.*

9. Summary of the key findings

- *Regarding the integration of 'E', 'S', 'G', and 'ESG' 90 to 95 percent of the market participants have started the process of integrating sustainability risks in their risk management process. 10 percent of the companies have already completed this process.*
- *Environmental and governance issues have been largely integrated, whereas social issues are slightly lagging. Difficulties in integrating social issues, probably stem from the subjective nature of these factors which suggests the need of definitions particularly in this area.*
- *Most market participants (at least 46 out of 61) point out the lack of standards and the quality and coverage of data as the main difficulties in assessing sustainability risks.*
- *Respondents have overwhelmingly developed internal expertise in dealing with ESG issues in the last year. Likewise, they have the necessary infrastructure and resources.*
- *Market participants point out that they have built internal capabilities for dealing with sustainability risks.*
- *Lack of standards and diffuse regulation are the main sources of complexity in dealing with sustainability risks.*
- *Most of the investment companies in the survey use ESG ratings for dealing with sustainability issues.*
- *They typically obtain data from more than one data source and process it within the framework of its own research.*
- *Most of the investment companies process the information at a low aggregation level: issuer or portfolio level. This emphasizes the importance of the quality and consistency of ESG data at the issuer level in order to obtain consistent output.*
- *Difficulties in integrating sustainability risks are found mostly when dealing with small caps and derivatives as well as illiquid assets: real estate, private debt, private equity and infrastructure.*
- *Regarding methods to currently assess sustainability risks, market participants focus on rather simple approaches like exclusionary approaches. More sophisticated methods like stress tests and factor models have upside potential for development. Small and medium investment companies as well as real estate companies and investment firms have so far been more reluctant in implementing more complex methods to assess sustainability risks.*
- *Sustainability risks are mostly integrated into the existing risk factors: market, credit or liquidity risk.*