Note (June 2023):
Section 1.6 supplements the November 2019 edition. It therefore brings it into line with the updated June 2023 edition.

1.6 Sustainability-related financial risks (ESG-risks)

ESG stands for **environmental** (e.g. energy and water consumption), **social** (e.g. employer appeal and supply chain management) and **governance** (e.g. remuneration policy and company management).

ESG-risks are events or situations in these three areas that are **currently having a negative impact on economic, cost or reputation factors, for example, and thus also on the value of a company or the market price of financial instruments or could potentially do so in future.**

Environmental risks are commonly divided into two categories: physical risks and transition risks. Physical risks include, for example, damage and costs arising from extreme weather events caused by climate change, such as storms, flooding and heatwaves, which threaten or harm a company's economic activities or assets. Transition risks include regulatory risks, changes in consumer behaviour and liability or legal risks. One example of a transition risk would be the introduction of a tax on carbon dioxide emissions, which could negatively affect a company's profitability and thus its enterprise value.

Social risks can arise, for example, from violations of employment standards, a lack of attention to occupational health and safety, poor product safety, failure to address social issues, unfair treatment of staff or high staff turnover.

Governance risks, meanwhile, can arise from unequal treatment of shareholders, inadequate risk management or control mechanisms, inappropriate remuneration systems or rule violations (e.g. corruption), among other things.

ESG-risks can affect specific asset classes, regions, economic sectors and/or companies in different ways. For instance, climate change, environmental destruction and the need to adopt more sustainable business practices can lead to changes in the real economy that might create new risk factors for investors. Investors, therefore, should always incorporate ESG-risks into their risk diversification decisions.

ESG-risks and characteristics can be integrated into asset management and investment advisory processes using a range of different ESG-approaches, all of which are evolving rapidly. It is important for investors to understand that these approaches have different aims and that not all of them are geared to a measurable positive impact on ESG-factors such as reducing pollution.