

# For a future-proof financial system as a mainstay for competitiveness and employment in Germany – elements of a policy roadmap

## Transformation as an opportunity

Germany, Europe and the world face a fundamental transformation, posing a challenge that will need to be mastered by all spheres of policy, business and society. In view of global warming, change is inevitable in order to secure the livelihoods of some ten billion people by the mid-21st century on a sustainable basis. Designing such change will ensure a transition into a climatically compatible and sustainable social order.

What has hardly arrived in the public debate so far is that the financial system as a mainstay of the economic system is similarly affected by the transformation in fundamental terms as the manufacturing enterprises of the real economy, the transformation of which today keeps appearing in the headlines under such buzzwords as decarbonisation and digitalisation. Already when dealing with the transition itself, which will continue for at least a complete generation, the issue is securing prosperity, competitiveness and jobs because the transformation would otherwise fail due to its internal contradictions long before it has run its course.

Security in transformation – that is the challenge facing policymakers, the business community and the financial system, particularly after the experiences of the global economic crisis triggered by the financial system after 2008. Security in transformation calls for decision-makers to control the transformation themselves by a step-by-step orientation of their priorities that will ultimately need to be fundamentally changed, however. It is no alternative to wrestle for change in a disorderly process between politics, society, the real and the financial economy and the expected and increasingly dramatic results of climate change.

Despite all the complexity of the details, the questions to be answered are simple and, this much is clear: they are easier to answer if the players in the financial and the real economic system undertake to do so jointly from the outset, and not against one another. It is important to note that the relevant political framework conditions provide for clear and interpretation-free orientation in line with the economy and the financial sector. Proactive transformation design opens up the opportunity to foster innovative entrepreneurship within Germany as an economic location in a targeted fashion, to develop new fields of activity, to secure existing jobs and create new ones – relying for guidance on the objective of bringing growing prosperity into harmony with the planetary borders and thus securing human livelihoods.

### ***Transformation as an opportunity to reposition the financial sector***

Without credible participation by central players, societal change is hardly possible in principle. This also applies to the financial sector which, as a key cross-sectional industry, plays a supporting role of prosperity in society. Sensible interaction of the financial industry with the real economy, policymakers and civil society will make it possible to implement objectives within society at large. It cannot be ignored that the financial sector as a whole has been under increasingly strict public scrutiny since the financial crisis. With the forthcoming reorientation towards the positive objective of a climate-compatible, future-proof economy, the players of the financial system now have the opportunity to drive and enable developments assessed as positive and to grow into socially accepted roles.

### ***Affirming Germany's role as a proponent of sustainable development in Europe***

For a long period of time, the federal German government was an essential orchestrator of a policy of climate-compatible redesign focusing on sustainability in particular of the energy system, even beyond its own borders. Being a large economy and a key member state of the European Union, for decades Germany has played a weighty role in international forums, negotiations and agreements in order to firmly entrench the aim of sustainable development. Unfortunately, in recent years the level of ambition and readiness to tackle central challenges has noticeably declined in many fields. And this comes during a time in which the implementation of the global Sustainable Development Goals (SDGs) and the Paris Climate Agreement call for exactly the opposite: more commitment, more political willpower and an in-depth understanding of the urgency and implementation of the transformation process in politics, the economy and in the financial system. Not only, but also in Germany. The federal government must become the engine of transformation once again, along with other European governments, supervisory authorities and the Commission.

### ***Policymakers as a robust framework provider***

Against the backdrop of the consequences of the financial crisis that have not yet been resolved everywhere and the escalating climate crisis, the federal and other allied governments are jointly called upon to finally take action again. This is no formality; instead, it serves the cause – and the recovery of trust and confidence in the political system. Robust, challenging and targeted regulatory parameters constitute the framework for designing and organising the forthcoming transformation. They are the key foundations for the transformation and foster sustainable business models, innovative product ideas, transparent process control as well as informed consumer behaviour. The task of policymakers is to give the unfolding paradigm change clear guidance and to drive it with the support of all relevant interests and stakeholders. At the same time, this will serve to accomplish central political goals such as securing budget stability, risk mitigation and stability in the system as well as the avoidance of misallocations of capital.

To make its contribution towards enabling the financial system to change, Germany must take up and support European and international processes, identify own fields of action and use these as a basis for proposed measures and to assume a leading role in the implementation. The guideline in this context must be Germany's firm commitment based on scientific findings to keep global warming below 2 degrees Centigrade if possible and to guarantee that social and human rights standards are safeguarded. The increasing physical consequences of the global climate crisis in the form of speedier sequences of extreme weather conditions constantly keep proving anew that inaction certainly does not produce immediate consequences, e.g. with regard to property damage, injury or loss of human lives.

# Sustainability as a guideline of the renewed financial system

## ***Prerequisites: Dialogue and strategy***

“Sustainable finance” is defined as a financial system that is geared to sustainability, a financial system that underpins the transformation. The manufacturing industry has begun in isolated cases to trigger deep-seated transformation processes in order to secure the future viability of its own core business operations. It is the opportunity and task of the financial sector to support and make these initiatives available to the public at large.

Sustainable finance comprises the targeted development of the transformation and innovation powers of the finance industry, simultaneously guaranteeing the stability of the financial system. However, the financial system needs to be enabled to successfully co-design and organise the transformation. This is why it is of fundamental importance to consider all player and investment classes as well as the product and service offerings available. Modern opportunity and risk profiles need to be established and transformed into sustainable strategies. In doing so, future scenarios and their impacts and general societal objectives must be systematically taken into account. Designing these tasks calls for positive commitment by large parts of the financial system. Banks, institutional investors, insurers, rating agencies, public officials and supervisory authorities will each contribute different perspectives and resources.

The federal government needs to take these up systematically and in a coordinated fashion for the purpose of formulating a political roadmap. Large parts of the finance industry are hitherto not prepared for these challenges. Accordingly, the need to build up structured capacities, the establishment of a far-reaching dialogue structure on the topic of the “importance of the financial system for the future viability and success of our society” is a key field of action. An open and knowledge-based, efficiently designed and participative exchange of information between the finance sector, the manufacturing industry, ministries, supervisory authorities, the scientific community and civil society is indispensable in this regard. This process must tie in with European and international approaches in order to actively utilise and co-design these. The process must lead to a political strategy governing action to be taken and a roadmap that is coordinated with the regulatory framework of the real economy and focuses on efforts to achieve milestones to be reached and serves to secure (interim) results.

## ***Orientation of the financial system of the future***

Corner points:

- ***Ensuring relevant information flows*** and, where necessary, newly establishing these in order to make the ***depth of the forthcoming transformation*** comprehensively identifiable and useful for capital commitment decisions, particularly in the manufacturing industry.
- Orientation of the capital allocation along the new ***leading yardstick of future requirements***. Scientifically robust scenarios as well as action and assessment frameworks derived from them serve as evaluation benchmarks and foundations.
- Orientation of risk management in companies and in the finance industry comprehensively along ***sustainability and transformation-related risks*** and making them transparent to all those concerned.

- Making **precise information on repercussions of financial services on societal goals** available to all market participants at an early stage.
- In doing so, ensuring that **fundamental financial market regulatory principles are not compromised**. System and individual counterparty stability are central, leading values. The existing framework for action is to be rendered appropriately specific and further developed.
- Where necessary, **system-compatible incentive solutions should be implemented**. Incentives, promotional or subsidisation concepts must always be subject to time limits in the interests of the transformation and regularly reviewed for their (continued) existing necessity.
- A stop must be put to the trade-off of **sustainability against return opportunities** by pricing in sustainability risks. The interpretation of duties of care and consideration of sustainability must be clearly settled in legal terms when it comes to investment decisions and the allocation of loans.
- **Scientific findings** must be developed with regard to requirements necessary in future to safeguard action being taken within the planetary borders as the foundations for steering-related interventions.
- **The regulatory framework must refer to all players** in the financial system and their product spectrum and establish clear criteria for non-use.

### **Elements of a policy roadmap for the financial system**

Against the backdrop of the current dynamism on the market and the many and various initiatives at EU and G20 levels on the subject of sustainable finance, the federal government is called upon to develop objectives of its own without delay, to engage in positioning and make contributions to the ongoing processes. The development of a roadmap that initially provides national guidance and orientation is a necessary prerequisite in order to speedily leverage the potential of the financial system and its players and take them on the road towards a sustainable financial system. In addition, this is a key element and impetus for Germany to regain its lost role as a trailblazer in the international arena.

Against the backdrop of processes that have already been initiated in the international and European environment, the requirements and – also taking account of differences in terms of urgency – recommendations are given below for a time schedule and sequence of events.

### **Transparency & disclosure**

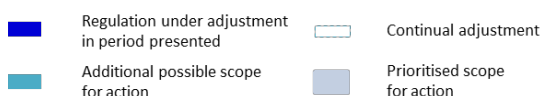
Transparency is the key prerequisite for gaining credibility and establishing reliability. Germany needs to actively become engaged in key current developments dealing with the improvement of transparency & disclosure:

- Transparency presupposes a common, centrally embedded understanding of fundamental definitions by the market players. This is fundamentally necessary to acquire an appropriate understanding of cause & effect situations and a shared basis for identification and assessment of risks. In order to guarantee this, a process for definition and classification of a transformative sustainability taxonomy is indispensable. This taxonomy serves as the framework for action and assessments that market participants can jointly refer to and rely on. Once it has been established, it must be continually further developed.
- Creation of an EU-uniform legal framework for transparency & disclosure for players and products in line with the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD).

- Establishment of transparency criteria for the evaluation of target definitions, for appraisal of the degree of target achievement as well as related processes, such as the creation of disclosure requirements.
- Assessments of sustainability and transformation effects must be based on a clear and legally certain understanding as to how evaluations on essentials and materiality are to be prepared both for risk & return as well as for transformation success stories. In doing so, in particular the time horizons collapsing today for the financial and transformation risk need to be associated. This applies to the identification and selection of relevant aspects and the execution process in making assessments. Moreover, clarity must be established regarding the extent to which there is a corresponding need for systematic fulfilment of duties and obligations imposed (duties of care and disclosure).
- In future, the duty to make pre-contractual information available for finance products of every description must systematically include sustainability impacts and aspects. The proposals by the Commission with regard to consultation processes are welcome but still too ineffective. Striving for implementation with minimal effort.
- Deficiencies relating to data foundations such as availability, quality, meaningfulness and content-related orientation need to be remedied to include forward-looking and future-oriented effects.

Political options for action to implement the aspects indicated will fall within the course of the current legislative period in Germany and Europe. These are specifically detailed in the following table:

Transparency & disclosure	2018	2019	2020	2021	2022	Objective	Central participants
Active assistance and design EU process for implementation of the Disclosure Policy						Creation of a uniform EU legal framework for transparency and disclosure for participants and products in line with TCFD	EU institutions BReg (participation)
Assistance with and design review CSR guideline with regard to sustainable finance (target definitions and focus)						Integration of TFC-compliant disclosure obligations in CRS Directive	BReg
Establishment of taxonomy (scope for action at EU level; active support of sustainable finance-legislative process; ensuring definitions on materiality/legal interpretation/duties)						Taxonomy takes account of sustainability goals SDGs, Paris-compatible	Breg EU institutions
Creating and improving data foundations Implementation of Shareholder Rights Directive in relevant legislation						Beschriftung Ensuring sustainable finance-compliant information obligations	Beschriftung BReg
Adjustment to Landesbank legislation						TFCD-compliant disclosure obligations of Landesbanken	State govt.
Establishment, <b>integration and pre-contractual disclosures</b> of forward-looking climate and sustainability aspects for compliance with duties of care (IDD, EbAV/IORP II, MiFID II, KAGB et al., PRIIPS, PEPP)						Ensuring sustainable finance-compliant regulations	EU institutions <b>FOR DISCUSSION</b> <b>DRAFT</b>
Adjustments to additional regulations, e.g. Old-age Income / Old-age Assets Act						Ensuring sustainable finance-compliant legal regulations	BReg



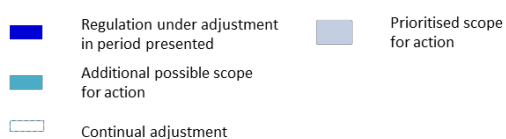
## Stability & risk management

In order to secure the stability and guarantee robust risk management in a sustainable financial system, numerous supplementary measures are necessary within an existing regulatory framework and partly also within one still to be newly established. Specifically, e.g.:

- Need to create standardised processes, particularly for medium- to long-term risk identification and evaluation.
- Establishing data-based risk scenarios and taking these into account in investment analysis and financing decision-making processes. It is important to define central corner points for scenario selection and use so that they can become standard instruments for medium- to long-term forecasts and targeted risk transparency in value added chains.
- Need to define and implement clear requirements regarding the steering and management of risks identified.
- Content relating to fulfilment of obligations such as duties of care and disclosure (also in the field of risks analyses) as well as all relevant aspects of credit and investment audits must be adequately clarified.
- Need to coordinate existing policy goals on the subject of sustainability with the aim of ensuring stability.
- Need to augment the mandates of supervisory authorities to include questions relating to sustainability impacts and transformation compatibility.
- Corresponding integration of risk and effect criteria in central areas of access to capital, such as stock exchange access criteria.
- Need to take account of climate risks in terms of equity capital requirements (CRR and CRD) – a robust risk connection is key in this respect.

Political opportunities for action will be available in Germany and Europe until 2022 in:

Stability / risk management	2018	2019	2020	2021	Next BReg	Objective	Central participants
Setting up workgroup on capacity establishment of climate-related scenario analyses and stress testing. Focus on dealing with timing conflicts. Associating effects with risk analyses, stability and other political objectives	FOR DISCUSSION DRAFT					Stronger weighting of climate / sustainability in stress tests for banks, Establishment of capacities for Scenario analyses; integration into mandate Bundesbank and BaFin	Bundesbank BaFin
Definition and entrenchment of climate risks e.g. in MaRisk (based on Section 25a KWG)						Reinforcing resilience of financial system	BReg
Augmenting the mandates of supervisory authorities to include questions regarding sustainability impacts						Entrenching holistic risk analysis in supervisory practice	BReg BaFin Bundesbank
Taking account of climate risks in equity requirements (CRR, CRD)						Reinforcing resilience of financial system	BReg EU institutions supervisory authorities
Guidance in harmony with climate risks in KAGB						Mandatory TFCO-compliant disclosure obligations on insurers / pension funds	BReg Insurers Pension funds
Adjustments to stock exchange access criteria						Beschriftung	Beschriftung











## Location policy and supporting framework-setting

The financial system will be placed in the service of the planned structural change of Germany as an economic location. Supportive measures should be carried out in a targeted fashion and when considered to be justifiably necessary in order to successfully shape the transformation process.

- The need to secure the successful performance of the manufacturing industry and the planned location-based differentiation is to be supported in future within the scope of the German and European financial system. A policy roadmap must develop focal points and priorities for action that take account of and integrate European activities.
- The federal government actively intervenes where the market does not fill gaps or does so too slowly and has difficulties in developing innovative solutions. This may include guarantee facilities and targeted risk takeovers where public roles exist on the basis of robust analyses because market-related solutions cannot be implemented (as yet). The role of the KfW will focus on the innovative areas and necessary market developments in harmony with the climate target level defined in Paris.
- One example is the provision of capacities for use in scenarios or forums for the development of best practices, e.g. in the field of reporting, verification of climate goals, the establishment of structural formats regarding the discussion concerning transitional plans for enterprises and corresponding reporting formats and parameters.
- Within the scope of public tasks and authorities, consistency will be created via mandates, e.g. OECD guidelines and a whole lot more.

The following political opportunities for action will be available in Germany and Europe until 2022:

Location policy and supportive framework	2018	2019	2020	2021	Next BReg	Objective	Central participants
Active incentive-setting in cases of existing gaps (e.g. availability of scenarios, best practice reporting, access to data, establishing forums for dialogue)	<div style="border: 1px solid black; padding: 5px; display: inline-block;"> <p style="margin: 0;">FOR DISCUSSION</p> <p style="margin: 0;">DRAFT</p> </div>					Active filling of gaps for enabling participants	BReg
Consistent financing strategy Of KfW (KfW Act), incl. IPEX and DEG						Paris-compatible overall strategy and contributions by market development	BReg, KfW
Active participation, processing and design of discourse plans at EU and international level on sust. finance						Setting up and designing policy scope	BReg
OECD environmental guidelines on export insurance agreements						Paris-compatibility	BReg, OECD
Targeted guarantee and promotional programmes						Designing transformation	BReg, KfW

-  Regulation under adjustment in period presented
-  Additional possible scope for action
-  Continual adjustment
-  Prioritised scope for action

## **Responsibility**

The federal government is responsible for ensuring that the wide range of partly completely new tasks will be comprehensively structured within the scope of creating a sustainable financial system. The objective must be to establish fields for action, to initiate and follow up the necessary processes and finally to achieve the formulated goals within appropriate periods. Where the federal government has scope of its own for decision-making, it will act with the appropriate understanding and consistency. Specifically:

- Institutionalisation of the process for determining competences and establishment of an advisory body of experts. Both will initially serve to document the seriousness of the planned transformation process and, therefore, also the political credibility. In particular, they are indispensable in terms of their content for developing overarching solutions and, therefore, the success of the measures adopted. The body of experts engages all groups of relevance in this connection from society, the financial market, the scientific community, policymakers and supervisory institutions.
- The federal government will use public assets as exemplary vehicles for transformation of the financial system. In the process, no benefit commitments will be risked and no irresponsible risks will be taken. Voting rights will be actively exercised in the interests of the transformation, the course and final point of which are defined in the climate protection targets of the Paris Agreement on Climate Protection.
- Public-sector facilities and closely associated institutions (such as the KfW Group, Euler Hermes) must likewise realise a strategy and capital provision in consistency with the policy goals. This applies, for example to the field of export credit insurance, the promotional programmes and the assumption of public mandates in multilateral institutions. This will turn these market participants into multipliers.
- The federal government will consistently position itself in international forums and institutions, it will provide guidance and take part in setting essential standards. This will also mean increasingly seeking an exchange of views with others, such as via the Network on Greening the Financial System. Within the scope of G7 and G20, common resolutions and dialogues with individual states or groups thereof will be observed in order to coordinate implementation strategies.



The following political opportunities for action will be available in Germany and Europe until 2022:

Responsibility	2018	2019	2020	2021	Next BReg	Objective	Central participants
Establishment of coordination body for sustainable finance within BReg (StS/AL level)						Elaborating a common, progressive government position	BReg
Establishing advisory body for sustainable finance						Multi-stakeholder body to support the transformation	BReg
Entrenching finance as a cross-sectional field of action for climate protection measures 2030 and in the Climate Protection Act						Recognition of the role of finance in implementing climate policy and designing structural change	BReg
Adjustment to investment guidelines for disposal fund and other public investment vehicles						SBT as an investment criterion	BReg
Reinforcement of sustainable finance for next EU budget (MFR post-2020)						Priority of sust. finance in InvestEU; Reinforcement in all instruments	Breg EU institutions
Sustainable orientation of federal state and sector strategies of multilateral development banks						Paris compatibility of federal state and sector strategies	Breg, WB
Establishment of sustainable finance in G7, G20, NGFS and other institutions						Sustainable finance as part of the agenda	BReg
Adjustment to export finance and insurance						Paris compatibility	Breg, Euler, KfW
Establishment/design of the institutionalisation process at EU level (e.g. platform for sustainable finance)						reinforcement of the platform for further development of sustainable finance process	Breg EU institutions

- Regulation under adjustment in period presented
- Continual adjustment
- Additional possible scope for action
- Prioritised scope for action