

The Sustainable Finance Advisory Board of the German Federal Government

Mission, ambition and objectives

Due to the established production and consumption patterns of our time, our livelihoods and the very basis of our existence are under great pressure. If we do not succeed in implementing the necessary structural changes to the extent required, ecosystems will fundamentally change in ways difficult to imagine today. The financial system can play a vital role in making structural changes a success and in ensuring that all actors systematically adjust their behaviour. For example, as long as systematic consideration of risk and impact continues to focus on the short term even though they are of a medium to long-term nature, today's decisions will diminish the chances of a good life for the world's population and raise the potential for catastrophic consequences in the future.

Germany, Europe and the world are thus facing fundamental upheaval which poses an equal challenge to politics, the economy, and society. In view of the long-term effects on global (eco)systems by today's actions, it is thus vital to recognise the urgent need to set the right course now. The successful shaping of this structural change will secure the transition to a climate-friendly and sustainable society – it therefore also holds an enormous opportunity.

The level of ambition of the sustainable finance strategy recommendations of the Sustainable Finance Advisory Board (SFB) to the Federal Government is based on the aspiration to establish Germany as a leading location for sustainable finance.

The objective is therefore to provide the Federal Government with concrete and practicable recommendations in shaping the necessary transformation in the real and financial economy. In the process, existing conflicts of objectives, barriers and inconsistencies within the existing regulatory framework and practice will be addressed in equal measure. In addition, the particularities of Germany as a financial centre and the interaction of its financial market players with the real economy are taken into account.

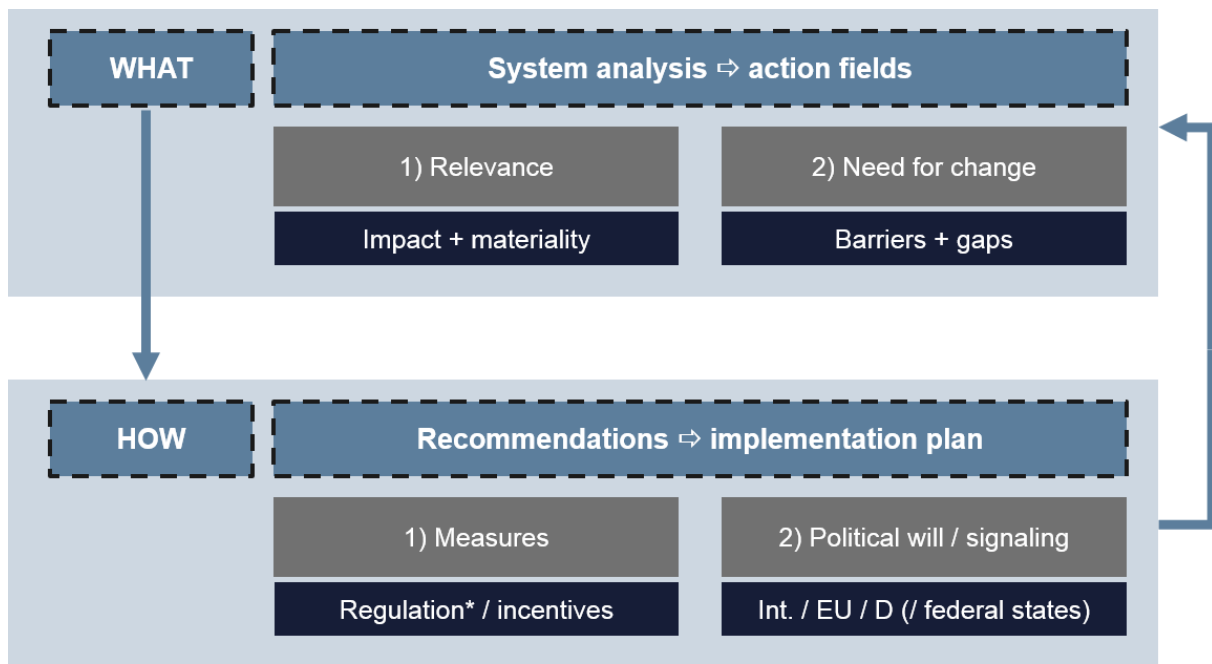
The recommendations should be coherent, supportive and formative in relation to the dynamics of the developing European and international financial systems and the resulting political framework conditions, in particular in terms of climate protection.

Our sustainable finance strategy recommendations intend to help ...

- achieve the internationally agreed sustainability and emission reduction targets as specifically the Sustainable Development Goals (SDGs) and the CO₂ reduction targets agreed at the Paris climate negotiations and within the EU.
- secure competitiveness and employment in Germany as an economic and industrial centre in the long term and thereby secure prosperity within an environment and society worth living in.
- prepare the German financial system for the future and enable it to efficiently fund the necessary transformation of the real economy without endangering financial market stability.

The sustainable finance strategy recommendations should therefore take into account the central aspects and mechanisms of the financial system as well as all parties involved (all types of credit institutions, insurers, company pension institutions, asset managers, rating agencies, stock exchanges, private customers), their business purpose and the traditional characteristics of the German economy (importance of credit and capital market financing as well as of small and medium-sized enterprises (SMEs)).

To us, the SFB, leadership means that financial market players and governments worldwide recognise the German sustainable finance strategy as pro-active, ambitious in its goals, successful in achieving them as well as relevant to their own decisions. To this end, the systemic integration of a sustainable finance strategy into existing economic structures is a basic necessity, opening up material fields of action which in turn can be put into practice and further developed through concrete measures. As a result, internationally trend-setting sustainable finance standards and measurable competitive advantages for Germany as a financial centre and business location are established:



* Options for regulation: hard / soft regulation / voluntary commitments

Conflicting objectives, e.g. with regard to financial market stability and supervisory requirements, must be made transparent.

Fields of action (WHAT):

- Enable and support structural change in the real economy, taking into account necessary sectoral developments. Work towards risk tolerance and resilience, take advantage of opportunities, and support the transformation of the real economy.
- Transformation within the financial system to support macroeconomic objectives, including the identification of central barriers and gaps within the financial system and areas in need of change.
- Focus on fields of action and regulatory areas that have a leverage effect across the entire financial system.

Implementation recommendations (HOW):

- Financial market regulation should be specifically devised to combine the required target levels with the basic principle of ensuring stability. A neat balance of rules/regulations and incentives must be maintained. Solutions and process changes must be developed in a way for them to be realised and scaled-up within a clearly defined timeframe. They must cover all areas of the financial system without unilaterally burdening its participants.^{1 2}
- Leading role of the public sector:

¹ For the financial system to reach its full potential, parallel developments in the real economy are necessary, such as the provision of data and new investment options.

² European and international regulatory frameworks need to be taken into account, including central bodies and institutions such as the Basel Committee and the IAIS.

- Investment criteria of the Federal Government and the federal states
 - Alignment of development bank strategies with policy objectives
 - Consideration and inclusion of regional needs and requirements for the implementation of sustainability-oriented infrastructure projects in Germany and development of adequate implementation capacities
 - Ensuring a competition-neutral, exemplary alignment of the German savings bank sector (i.e. savings banks and affiliates), which is committed to the common good, with the sustainability and climate objectives
 - Export financing and export credit insurance
 - Economic cooperation with other countries
 - Advancement of the European sustainable finance strategy, the EU action plan and the pending processes, in terms of content and cooperation with other member states
 - Making use of multilateral political processes (such as G20, G7, Mandates of the German Federal Government within multilateral institutions and organisations)
 - Institutionalisation wherever necessary, i.e. when it is systematically/systemically efficient
- Differentiation from other financial centres when appropriate, in active cooperation and application of best practices
 - Inclusion of all participants and product classes as well as financial market regulatory and supervisory provisions and bodies. Incentive systems can be an important element to success
 - Materiality and proportionality must be maintained in legislative and supervisory practice and implementation
 - The real economy should provide material sustainability information that meets the information needs of financial market players and offers a comprehensive picture of their impact on the economic development of companies as well as on the environment and society. This information must be integrated and continuously assessed by the financial sector in order to ensure active support in transforming the real economy's value creation
 - To estimate future effects, the principle of foresight needs to be strengthened, both with regard to the assessment of sustainability-related risk implications and the achievement of sustainability goals
 - In addition to developing relevant standards for the entire financial market, we must ensure that innovation and existing pioneering roles have room to thrive

The question whether procedures or actions must be mandatory or can remain voluntary should be judged in view of the likely impact of the measure in question. Legally binding provisions do not guarantee an intended outcome, nor are voluntary approaches per se ineffective.

The following theses present the initial considerations of the advisory board. They are to be further specified, refined and concretised into recommended actions. Regulatory requirements and other prerequisites for implementation will also be taken into consideration. Following a structural logic, the overarching theses of Work Group 1 frame the issues at a higher level. These were taken up and dealt with more specifically by the subsequent Work Groups.

WG 1 Objectives / strategy / communication³

Thesis 1

The guiding principle of every decision in investment and lending needs to be a science-based and future-oriented approach taking into account systemic effects. Resilience arises where medium to long-term sustainability risks are adequately recorded, assessed and controlled. Investment and lending decisions must be aligned accordingly.

Thesis 2

The prerequisite for resilient portfolios and an allocation of capital in line with the policy objectives and the balance of economic, ecological and social criteria is sufficient transparency with regard to the relevant sustainability effects, opportunities and risks. Today's reporting practice does not yet provide the necessary database. Improvements are particularly necessary when it comes to applicable future-oriented approaches such as scenario analyses.

Thesis 3

The necessary transparency must be generated in line with bureaucratic requirements. Ability and feasibility must take the SME level into account. The aim should be to obtain meaningful data and information on material aspects.

Thesis 4

³ Numbering of the theses does not prejudice prioritisation.

The public sector plays a key and exemplary role in the sustainable transformation of the financial system and the real economy. Actions and budgetary policies of the Federal Government, the individual states and all associated institutions must therefore be attuned to this role. Germany can only fully unleash its potential as the largest European economy if a coordinated strategy on sustainable finance exists between the Federal Government and the federal states.

Thesis 5

The SDGs can only be reached if they are incorporated into behavioural standards.

Thesis 6

Adequate information and a broad and easily accessible range of financial products from across the financial sector must be available to institutional and private clients, enabling them to make informed financial decisions and thus support the transformation.

Thesis 7

The capital available within the global financial system can make a decisive contribution to limiting climate change if appropriate allocation and targeted management of financial flows are ensured. Suitable framework conditions in the financial system can facilitate an efficient re-orientation of capital flows into sustainable activities/projects. As a prerequisite, the number of sustainable and investable projects must be increased, for example via incentive systems or effective public-private financing models.

WG 2 Financial market stability / risk

Thesis 1

The risk management systems (including risk inventory, risk models, solvency requirements) applied in the three areas of the financial system which are relevant from a regulatory perspective (in accordance with the European supervisory authorities EBA, EIOPA, ESMA) do not reflect relevant sustainability parameters in a way that allows recording and assessment of long-term future risks arising from the (above described) transformation.

The risk management systems and models of the individual actors/groups of actors therefore require further development/supplementation appropriate for the respective group of institutions with regard to:

- Systematic consideration of sustainability parameters (instead of lacking or merely implicit consideration)
- Application of scenario analyses (rather than purely historical data)

When defining ESG⁴ stress tests and ESG scenario analyses, participants should have the freedom of individual implementation under principle-based supervision.

Thesis 2

Comprehensive and reliable data are essential for the effective functioning of risk management systems, which ensure the stability of the financial system. A database can only be built if companies in the real economy, as the parties seeking loans or capital market financing, make meaningful, comparable and forward-looking sustainability data available to lenders or investors as part of their financial reporting.

Companies' accounting and reporting standards must therefore be amended accordingly, placing sustainability data in plausible context with their business strategy and financial reporting. Future-oriented climate data based on scenario analyses should be positioned as a main priority. Standardised reporting frameworks (e.g. Integrated Reporting, TCFD recommendations, Sustainability Code) ensure the necessary comparability and facilitate implementation in the risk management systems of the financial industry.

Thesis 3

⁴ ESG = environment, social and governance

A number of regulatory financial market risk management provisions currently in place are in conflict with a long-term sustainability perspective, for example by focusing on short-term liquidity, the maintenance of solvency, and volatility. This, in turn, is likely to impede the mobilisation of capital for long-term transformation projects in the real economy. In addition, long-term sustainability risks on financial market stability may be receiving insufficient attention.

In collaboration with financial market stakeholders, the supervisory authorities should therefore explain to what extent these contradictions actually exist and in what ways they could be resolved to avoid endangering and in fact promote financial market stability. The desire to avoid a climate-induced impairment of financial market stability must not lead to measures that are in themselves capable of jeopardising it. The European Supervisory Authorities (ESAs) study for the EU Commission on the short-term nature of decisions in the financial system shall be taken into account for the German context.

Thesis 4

Today's risk management systems focus heavily on the (empirically derived) quantifiability of risks. However, a consideration of risks that is appropriate to the individual case and forward-looking both within the larger business strategy and in financial market players' everyday business also requires an appropriate risk culture among management and employees to meet these demands. To do so, comprehensive knowledge and awareness of sustainability risks are crucial. Qualification and training requirements must therefore be adapted accordingly.

A responsible, sustainability-oriented corporate management with suitable incentive and sanction mechanisms should be anchored within the financial market players' governance system as an important contributing factor to the desired risk culture. For the necessary transformation to be effective, this enhanced governance system of the financial industry should be mirrored in companies of the real economy.

WG 3 Transparency / disclosure / effect

Thesis 1

Presently, sufficient comparable, material ESG information from companies to allow for reliable statements on actual sustainable development effects is not available. It is therefore necessary to require companies to provide a core set of key sustainability information in accordance with internationally recognised standards, both across sectors and for specific industries.

Thesis 2

Reporting with regard to the fulfilment of minimum requirements on essential past and future-oriented sustainability information should be established in the corporate landscape by means of suitable legal and voluntary means (analogous to financial information). A raw database for ESG criteria of investment objects, accessible to all financial market players and standardised throughout Europe, provides the basis for a targeted management of capital flows for the necessary funding of sustainable growth.

Thesis 3

There is currently no agreement on exactly which key ESG data should be provided by the real economy and the financial sector for investor processing. Common ground is, however, necessary to meet the challenges of a transformation towards sustainable (and in particular climate-neutral) economic activities. The prerequisite is that both the real economy and the financial sector focus on the essential transformation paths relevant to their respective sector or company. They should also take into account the influencing factors and framework conditions, which are developing dynamically.

Thesis 4

Meanwhile, large parts of the financial sector are non-transparent: to date, the necessary information indicating the degree of sustainability of investment and lending activity by banks, insurance companies and pension funds remains unavailable.

The disclosure of ESG policies as well as of key data on ESG issues and CO₂ emissions would fill this gap and enable both private and institutional investors to make sustainable investment decisions.

Thesis 5

There is no investment without effect. Investments have a social and ecological impact which companies and financial market players must disclose in order to promote long-term positive effects on sustainable development and to prevent any negative ones.

WG 4 End customers

Thesis 1

For an economic transformation towards sustainability in the sense of the SDGs and the Paris Climate Agreement to take hold, all forms of financing must be included in the considerations. Private and institutional clients must be offered transformation-compliant, sustainable and responsible financial products in all categories – especially investment, banking and insurance products.

Thesis 2

Transformation will only be successful if the entire financial services industry – rather than a limited number of specialist providers – adapts its product range accordingly. The best possible integration of the existing offering into the product development process should therefore be ensured (even if it is not yet fully compliant with the transformation or the SDGs).

Thesis 3

Client access must be as easy as possible. Labels can be used in support of the effort. Incentives for customers and suppliers should facilitate compliance with transformation goals when making investments or raising capital.

Thesis 4

Publicly subsidised financing and investment products (KfW programmes and comparable products as well as capital-forming benefits (“vermögenswirksame Leistungen”), Riester-Rente and Rürup-Rente pension schemes; company pension schemes) play a pioneering role.

Thesis 5

On the path to transformation, the training and qualification of employees in the financial industry plays a key role. Only with the necessary awareness and understanding of sustainable and responsible financial products can they be made properly available to meet clients’ needs. Above all, it is necessary to foster mindfulness across society as a whole.