New geopolitical challenges for ESG transformation

An action plan for banks

Content

ESG transformation – A growth story for banks

It is perhaps the largest project in human history: converting the industrial society into a "green economy". **The financial sector – and the banks in particular – have been assigned a key role in this transformation.** This is because, on the one hand, incentives for socially desirable changes can and need to be set through the financial flows that are managed substantially by financial institutions.[1] On the other, it is estimated that investments totalling six trillion euros are required in Germany alone for the conversion to a climate-neutral economy.[2]
A major part of these investments will (have to) be financed by banks or conducted with the help of banks in the capital markets.

In the context of ESG transformation (environmental, social, governance), the greatest attention is being paid at the moment to the goal of climate neutrality. Other "E" aspects, such as biodiversity, conserving forests and woodlands or combatting ocean acidification, are only slowly attracting more notice. The same is true for "S" and "G" aspects.[3] It can be expected that interest in these aspects will soon increase considerably as a result of the development of corporate social responsibility reporting obligations and a general public that is becoming increasingly sensitive to ESG issues.

Studies have shown that a euro invested in green transformation generates more growth than one that is invested in other areas.[4]
ESG transformation is therefore not only an ecological necessity, it is also a growth story – both for the real economy and for the financial sector. Which impacts, however, will the **Ukraine war** and the accompanying **turning point** have on the progress of ESG transformation? And what new **challenges and courses of action** will result from this **for banks in Germany?**

[1] Article 2 of the Paris Agreement
[2] Calculation: McKinsey 2021
[3] "ESG Risk – Market view Survey", KPMG 2022
[4] "Greenovate for a better environment and economy", KMPG 2021

Ukraine war a turning point: A new economic canon

As has been repeatedly stated in the political public sphere, Russia's invasion of Ukraine marks a turning point. Not only because it has shaken the European security order that has been maintained for decades, but also because it has **at the same time destroyed several basic assumptions underlying the globalised economy:**

The world's leading economic nations are primarily interested in their own prosperity and in **growing levels of affluence.**

A **division of labour** that is motivated primarily by economics and optimised and focused globally on efficiency criteria is possible and desirable.

Increasing **economic interconnectedness** and the resulting mutual dependence are increasing global security and leading to an alignment of values.[5]

The trend towards **dismantling barriers** to global flows of goods and services, as all of the countries involved benefit in the development of their prosperity from a globally optimised allocation of labour.

[5] "The illusion of 'change through trade'", Börsen-Zeitung (23 April 2022, paywall, in German)

These assumptions, which have characterised the international exchange of capital, goods, commodities and services for many years, are now being replaced by a **canon of new basic assumptions**:

- Increasing their power is so important to some of the world's leading economic nations that they are prepared to accept temporarily significant declines in their prosperity and economic well-being in return.

- The security of a nation's economic prosperity is even greater the more there are economic dependencies exclusively on countries that pursue similar objectives in global power politics.

- In addition to economic motives and efficiency criteria, the geostrategic interests of countries are once again at the heart of the considerations of economic activities when decisions concerning a global allocation of labour are discussed.

- As a result of the massive rise in the importance of geostrategic and political aspects, countries are actively and continually intervening in the economic system, for example in the form of subsidies, regulations, sanctions, punitive tariffs and other measures.

It can therefore be expected that security considerations will play a greater role in shaping economic relations in the future and that **supply chains** will be **reorganised and repatriated.** As a result, the world will be increasingly divided into separate economic security zones, each with their own technologies and standards.[6] This development marks **new geostrategic challenges for the mega topic of ESG** that banks will now have to consider in a new context.

[6] "Ukraine Conflict", Global Data (24 March 2022)

Impacts on ESG transformation

The watershed that the Ukraine war represents will have an impact on ESG transformation in a variety of ways. Both catalytic trends on the one hand and dampening trends – or at least trends that will drive costs – on the other can be foreseen. In the near future, this will also have an impact on risk scenarios of banks and the range of services they offer.

Catalytic effects

Trends that will act as catalysts can be expected particularly in the development of renewable energies and also in technologies for improving energy efficiency. As energy represents a directly effective instrument for exercising power because of its importance for growth and prosperity, nations have a high level of ambition to break free from the dependency on countries that do not belong to the same community of values.

Current events provide clear evidence of this:

- The German federal government announced that it intends to become largely independent of Russian oil in the late summer of 2022 and of Russian gas by the middle of 2024. The plan to achieve this includes new supply structures, the expansion of LNG terminals, the continuing development of renewable energies and a major energy efficiency programme.[7]

- Intensive discussions are taking place on whether the objective formulated in the coalition agreement to phase out fossil fuels as early as 2030 instead of 2038 should be suspended. A postponement of the phase-out

[7] Federal Ministry for Economic Affairs and Climate Action "Energy security progress report" (25 March 2022) and press release (1 May 2022)

of nuclear energy planned for the end of 2022, which was classed at the beginning of 2022 as climate-friendly in the EU taxonomy under certain circumstances, is also under consideration.

- The European Raw Materials Alliance (ERMA) has been founded on the initiative of the EU Commission in order to make Europe less dependent on the procurement of rare earths and other metals – especially from China. The mission of the alliance is to outline ways in which the required raw materials can be extracted and made suitable for the market in Europe in the future.[8]

Ensuring the supply of energy and raw materials will also mean working together – at least for a transitional period – with countries that do not share the same values. Examples of this include the recent contracts for gas supplies entered into by Germany and Qatar as well the contracts between Italy and the Republic of Congo and Angola.[9]

In addition to energy transition, the **circular economy** will also benefit from current events. As the procurement of raw materials from geostrategically questionable countries will become more difficult, companies are increasingly incentivised to process and recycle these materials themselves. This is the case with metals and certain other substances such as indium, vanadium, graphite and lithium for example. They are of key importance for the global energy transition, but are mined by only a few countries. The People's Republic of China is thus the main supplier of indium, while cobalt, which is required for batteries for example, is mined primarily in the Democratic Republic of the Congo.[10]

The turning point triggered by the Ukraine war will additionally have positive effects on digitalisation and connectivity. This is because the reconfiguration and repatriation of supply chains will increase the pressure to develop highly efficient value-added processes in order to remain competitive. **Technologies that have been gaining in importance at a rapid rate in banks for some time will have to be integrated even more quickly,** including artificial intelligence, the cloud, blockchain and many others.

Finally, it can be expected that – in addition to the other environmental aspects such as biodiversity, conserving forests and woodlands or combatting ocean acidification – the importance of social and governance aspects will also continue to grow. This is because the "S" and "G" criteria reflect the value of companies and countries – and these are increasingly determining the intensity of economic exchanges. Social and governance aspects are not only an expression of desirable goals for a more liveable world, but are also increasingly becoming elements of a more sober calculation of risk.

[8] ERMA: Ensuring access to the raw materials for the European Green Deal: A European Call for Action (erma.eu), report "Rare Earth Magnets and Motors: A European Call for Action"

[9] Italian Ministry of Foreign Affairs press release

[10] "Resourcing the Energy Transition: Making the World Go Round", KPMG 2021

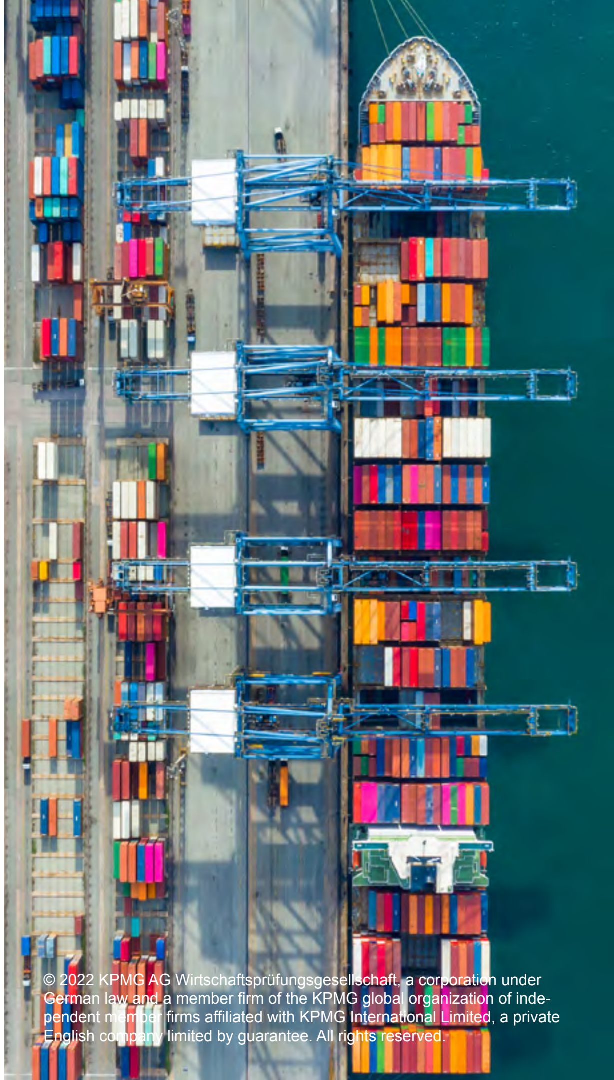
Dampening effects

The catalytic effects are, however, also counterbalanced by dampening effects, or at least effects that drive costs, in ESG transformation. This is because any division of the world into different economic security zones will adversely impact global prosperity. And this will have a wide range of consequences. It will, for example, become even more challenging, particularly for emerging and developing countries, to shape ESG transformation. This is because this transformation requires extensive investments, not least in digitalisation.[11] The price of these investments is increasing as a result of the continuing rise in the price of raw materials and food, while the share of indispensable consumer goods as a proportion of GDP is growing.

Moreover, a **fragmentation of the world into different economic security zones** will impede the transfer of knowledge and expertise that is essential for transformation. A topical example of this is the zero-Covid policy in China: in order to use the country's own vaccines as a geopolitical instrument, the significantly more effective vaccines from the US and Europe have not been authorised. The consequences have been and continue to be strict lockdowns in China, which are adversely impacting global supply chains and thus the performance of the global economy.

Primarily, however, all national economies are affected by the fact that restrictions on economic relations for geopolitical – and not economic – reasons significantly reduce the possibilities for organisation, optimisation and growth. The resulting negative economic consequences diminish the potential to drive ESG transformation forward at the expected pace and increase the costs of transformation.

[11] "The new technology frontier for developing economies", KPMG 2022



New opportunities for banks

A number of opportunities arise for banks in Germany from the changes described above:

1

Opportunity 1: As **supply chains are shortened and repatriated** in the next few years, strategically important industries will be located in the home country or in countries that share the same values. This will also result in numerous new investment projects in Germany that would have taken place abroad under other circumstances and, with them, requirements for financing.

2

Opportunity 2: The reorganisation of supply chains will additionally enable and encourage a further increase in the digitalisation and connectivity of processes. It can be expected that the **pressure to digitalise the economy** already present will gain in intensity as a result of the shortening and repatriation of supply chains and will lead to an increased and accelerated **need to finance relevant investments.**

3

Opportunity 3: The **accelerated development of renewable energies** and the continuing rise in importance of energy efficiency in Germany and abroad is accompanied by significantly **increased demands for suitable financing.**

What results from all this for banks is not only **possibilities for growth in the lending business,** but also **opportunities in investment banking** and the capital market business from bond financing and securitisation as well as in asset and wealth management from an increased supply of investments in green infrastructure financing projects. It can be expected that **additional growth effects in the retail business** will result in the course of this, as the population’s awareness of climate-friendly technologies increases as a result of public discourse.

New risks for banks

These opportunities, however, are also counterbalanced by several risks:

Credit risks: The reorganisation of supply chains in many industries will lead to lower economic growth and a decrease in the profitability of certain business models. The consequences could be reduced consumption as well as increasing bankruptcies among companies and private households, which would lead in turn to declines in the lending business. In addition, the credit risks in the business with corporate customers and with retail clients will also increase as global uncertainty grows. This may lead to an increased need for capital and subsequently to a decline in returns on capital.

Non-financial risks: If countries become more prepared to enter into conflicts, **cyber risks** (on account of more frequent cyber attacks) as well **compliance risks** (on account of increasing **sanctions and regulations**) will also gain importance. Operational resilience, i.e. the ability to continue to perform critical operations despite disruptions, will also become imperative. Furthermore, non-compliance with the values required by society will also be more intensely monitored and discussed by the public in the future. Any misconduct perceived by the entirety of the stakeholders will therefore lead to **reputational risks** more quickly.

Business risks: As a result of the creation of separate economic zones that can be expected, banks in Germany will no longer be able to serve certain countries and regions as was the case in the past. It can thus also be expected that **business relationships with numerous companies and industries will have to be restricted in the long term** or even abandoned on account of an increase in sanctions. As business activities undergo a realignment, greater complexity will also produce a risk of increased costs.

5

An action plan for the management agenda in banks

In order to take advantage of the opportunities described in section 3 and to be able to mitigate risks appropriately, banks have to take action in a variety of respects today. The most important measures can be summarised in ten action points. Many of these are not new to banks. It is only in the way that they interact, however, that they will produce a response appropriate to the new situation.[12]

[12] See also "The future of the European Banking Sector", KPMG 2021

Adapt the top management agenda for the new challenges ahead

1 2 3 4 5 6 7 8 9 10

1 **Action Point 1:** Systematically reflect and swiftly anchor the change in the importance of general geostrategic conditions **in all business decisions,** in the assessment of business potential, in the design of operational processes (outsourcing, resilience) and in the entire risk management. This applies in particular to a **geopolitically and comprehensively defined ESG agenda that is adapted** to the new circumstances. This agenda is assigned greater importance here, especially with regard to elements not related to the climate, than had previously been the case.

2 **Action Point 2:** Engage in a dialogue with political decision-makers, as government activities will take on greater importance in the future on account of the geopolitical changes. The **plans and measures undertaken by government** should play a central role in top management and in industry associations.

Make targeted use of the opportunities to develop the business

3 **Action Point 3: Develop the expertise** in subject areas involving **"renewable energies and energy efficiency", "digitalisation and connectivity" and the "circular economy"** in order to take advantage of the increasing need for financing in these fields. This also concerns the already increasingly challenging **search for talent** and also touches on internal training programmes.

4 **Action Point 4:** Expand competence in capital markets and structuring, as it is not feasible for the financing requirements to be completely covered by bank's balance sheets. **ESG-compliant banking increasingly also requires elements of investment banking.** Accordingly, the sales skills required for capital market products and relevant markets will need to be expanded.

Make targeted adjustments to credit and compliance risk management

5

Action Point 5: Develop credit management systems to identify and analyse geostrategic dependencies. This applies not only to large corporations, but also to small and medium-sized enterprises. Examples of aspects that have to be taken into account here include energy supply in production or the geostrategic vulnerability of supply and sales channels. **ESG aspects have to be more extensively interpreted and consciously analysed as credit risks** – in all of their breadth and depth. Country risk analyses will be necessary to a much greater extent in order to take the risk of many borrowers into account.

6

Action Point 6: Professionalise compliance systems. This means particularly further developing technological solutions for the **compliance function** by using enhanced, learning algorithms so that they are commensurate with the complexity, occasional inconsistency and variability of diverse **global sanctions rules** and so that the number of false positives is reduced – this furthermore helps to keep the costs of the compliance function under control.

Place special focus on the management of non-financial risks

7 **Action Point 7:** Integrate IT risk management systematically in the overall risk management and link up the monitoring of IT security with risk management as a strategic discipline. Regulatory requirements, such as the Supervisory Requirements for IT in Financial Institutions (BAIT), should be implemented promptly and diligently.

8 **Action Point 8: Review the dependence on global supply chains** that exist in the bank's own processes and **eliminate outsourcing risks.** At the same time, the processes have to be automated even further in order to enhance the quality and speed of service provision and to reduce costs.

9 **Action Point 9:** Integrate **non-financial risks** extensively in modelling, examinations of scenarios, simulations and planning, take them into account systematically during the Supervisory Review and Evaluation Process (SREP) and **interpret them as key factors for the success of the bank's management**.

10 **Action Point 10:** Professionalise communications with all stakeholders in order to be able to counter the **growing threat of reputational risks** effectively. A requirement for this is **strategically focused communications** that can swiftly provide consistent messages across all relevant communication channels.

Contact

KPMG AG Wirtschaftsprüfungsgesellschaft

Dr Matthias Mayer
Partner, Financial Services
T +49 173 5764262
matthiasmayer@kpmg.com

Dr Daniel Sommer
Partner, Financial Services
T +49 172 6767927
dsommer@kpmg.com

www.kpmg.de

www.kpmg.de/socialmedia