THE EUROMONEY
INTERNATIONAL DEBT CAPITAL MARKETS HANDBOOK
2014

EUROMONEY
HANDBOOKS
Part of Euromoney Trading Ltd

This chapter was originally published in:

THE EUROMONEY **INTERNATIONAL DEBT CAPITAL MARKETS HANDBOOK** 2014

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Responsible investing cares about who you are investing in

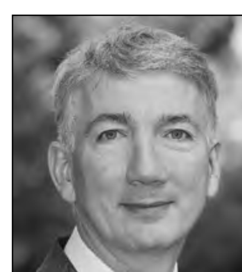
by Dr. Frank Czichowski, KfW Bankengruppe

Socially responsible investors (SRIs) want to make sure that their funds are appropriately used and, in most cases, will be invested in green or sustainable projects. That is why SRI bonds, and green bonds in particular, have steadily been attracting more attention in capital markets and media in recent years. Since sustainable corporate behaviour can also be an indicator of the future credit quality of a company, SRIs shall care even more who they are investing in. A holistic approach can improve SRIs' risk-return ratio and facilitate even more investment while improving global living conditions at the same time. Germany's flagship development agency KfW, one of the largest and most frequent international bond issuers, has fully committed itself to a rigorous sustainability approach.

A growing market for green bonds and sustainable investments

Being praised to increase investment in green and sustainable projects, the market for green bonds still finds itself in an early stage of development and presents investors with some challenges. Despite its recent gain of advertence, the market for green bonds remains to be in parts a rather illiquid and a small segment of the global bond market. In addition, the number of issuers of these debt securities is still small and issuers, investors and intermediaries alike seem to enter this market in order to benefit from its positive reputation. However, supranational/sovereign/agency borrowers, and development agencies in particular, seem to be ideal for this market niche, as those institutions have a specific mandate to support sustainable development and they can create asset pools big enough to match respective liabilities.

A general market standard for green bonds has yet to emerge. This is due to both the size of the market and the



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fact that green bonds are still considered to be a recent innovation in fixed income capital markets. Due to a lack of standardisation, the structure of these instruments differs from issuer to issuer. Investors in these securities require the ability to track where their money is being spent, whereas the issuers mainly set the criteria for the projects they may engage in with the raised funds. This inevitably increases the need of co-ordination between the parties involved in such transactions and, additionally, bears legal and reputational risks when it comes to the implementation of the aforementioned investment criteria. Being able to track and ring-fence the flows of funds internally may require issuers to set up separate accounting procedures which can further increase the operational costs of such bonds. This can in fact be detrimental to an issuer's ability to promote green and sustainable investments, as higher costs imply higher lending rates which negatively impact demand for loans. Unless SRIs are willing to forgo some yield over conventional funding, green bonds may not achieve their ultimate goals.

The relatively small size of both the market for green bonds as a whole and the individual securities issued often do not offer a sufficient degree of liquidity for large asset managers. This is why the market for green bonds is still regarded as a niche in the universe of fixed income securities. Moreover, green bonds do not take into account who the issuers of specific securities are and how responsible they act in their daily overall business. In order to extract positive effects on the environment from green investing, investors should be more cognisant of whom they are investing in.

Rigorous focus on the sustainability of bond issuers

A rigorous focus on the overall sustainability approach of bond issuers may help to overcome the handicaps of green bonds. Common credit analysis mainly focuses on financial figures and often excludes other important factors that can have an impact on the creditworthiness of a borrower. These factors can be described using environmental, social and governance (ESG) criteria which analyse these aspects. For example, the case of Enron has demonstrated the importance of corporate governance, as the firm had to file for bankruptcy in 2001 due to a systematic accounting fraud that led to massive losses for investors. Nowadays, law-makers plan to make corporations responsible for any environmental pollution caused, which may possibly lead to high additional costs for upgrading outdated production sites in the future. All this shows, that a certain degree of foresight with respect to ESG criteria is beneficial not only for investors, but also for the broader public.

Specialised rating agencies analyse and rate ESG aspects of equity and bond issuers for institutional investors. Such ratings take into account a number of other factors in addition to environmental management and the company's products and services. These aspects include, among others, working-time models for employees, organisational measures to combat corruption, and principles of corporate governance and business practice. This approach is holistic and takes into account an issuer as a whole and not only the purposes of investment decisions. At the same time, ESG ratings provide a significant level of standardisation that adds additional transparency and comparability for all investors without negatively affecting the liquidity of respective securities. When sustainable corporate behaviour is rewarded by rating agencies and investors alike, this will induce additional issuers to engage in this practice, which will eventually increase green and sustainable behaviour in general.

As one of the world's leading and most experienced development agencies, KfW Group has for decades been committed to improving the economic, social and environmental conditions in Germany and around the globe. Responsibility is KfW's core business and this is confirmed by independent ESG rating agencies that specialise in the sustainable investment sector. KfW has been rated 'very good' by several of these sustainability rating agencies for many years, and has been assigned a top ranking by each in their international sector comparisons.

The international rating agency, Sustainalytics, confirms that KfW shows a strong performance with respect to all three ESG pillars of its rating. As of September 2013, KfW ranked second out of 192 listed and non-listed banks covered by Sustainalytics. KfW's reporting on ESG issues is considered strong.

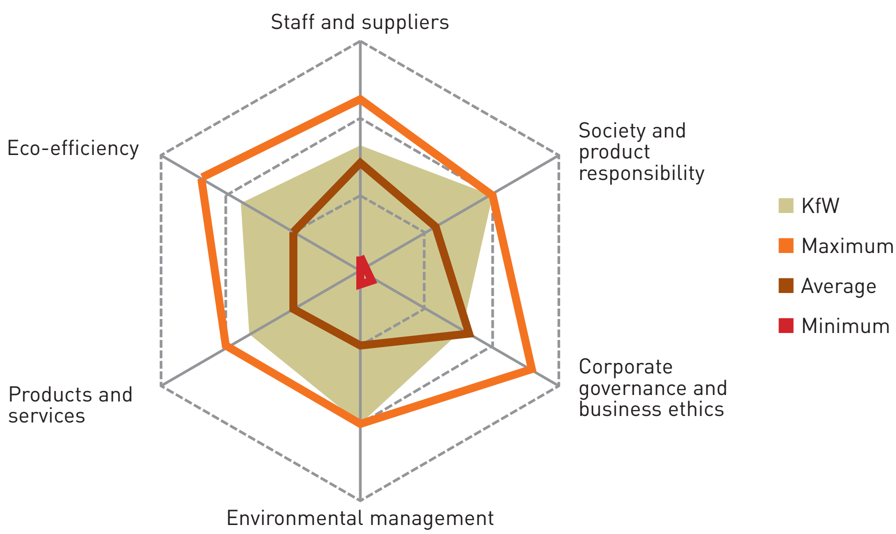
In the sustainability assessments of 127 international bond issuers in the financial sector conducted by the Germany based agency Imug, KfW is among the top four institutions. Furthermore, KfW ranks first among all German financial institutions.

Oekom research, another leading Germany based ESG rating agency, states: "'Prime' mark-up among the group of best-rated financial institutions." KfW currently ranks third among 23 analysed financial institutions.

Exhibit 1 shows how comprehensively bond issuers are analysed by ESG rating agencies, here by oekom research. The Exhibit also demonstrates KfW's current performance in different areas compared to its peers. While KfW is best in class in the areas of environmental management as well as society and product responsibility, oekom research still sees room for improvement especially in the field of corporate governance and business ethics.

The eligibility and inclusion of bonds in ESG specialised indices give the SRI community further third party opinions on the quality of bonds and issuers in their portfolio. For example, KfW bonds are included in Barclays MSCI ESG Fixed Income Indices. These indices set standards for ESG investing and represent rules-based fixed income benchmark indices which incorporate measures of ESG risk and involvement. Eligible fixed-rate benchmark bonds possess an investment grade rating, are issued in a freely convertible currency and mature in more than one year. The rebalancing of the indices follows predetermined rules and is for example based on ESG ratings of involved issuers. Being included in these indices confirms that the ESG activities of KfW are regarded favourable by investment professionals and we at KfW are pleased to be able to participate in setting standards in the field of green and sustainable investments.

KfW's ESG rating performance



Source: oekom research

KfW's mission: Responsible banking in all aspects

KfW has not entered the market for green bonds yet, because we are truly aware of the caveats that come with these financial instruments. Nevertheless, we are clearly focused on sustainability and social responsibility. At the same time, we rely on a broad range of funding instruments that cater to a wide variety of investors that do not only require the money to be spent on green projects, but also strive for a high degree of liquidity and tight bid-ask-spreads for example. With respect to the large scale funding volume of around €65bn-€80bn that KfW raises in the capital markets every year, this approach enables us to realise our extensive lending schemes by offering liquid SRI eligible bonds. But why do we think that KfW's bonds can be considered a green and sustainable investment without being green bonds in the narrower sense?

In recent years, KfW has oriented its business activity even more strongly on socially relevant developments and sustainability criteria. In order to achieve these objectives in an optimal way, the group's strategic focus for its core business is based on two aspects. Firstly, the promotional portfolio is being adjusted to the major challenges of our time:

i. combating climate change and protecting our natural environment;
ii. ensuring competitiveness in a globalised world while fostering technological progress; and
iii. coping with demographic change.

In addition to these three megatrends, KfW sees fundamental promotional themes such as reducing poverty, general corporate financing with an emphasis on small and medium-sized enterprises and promoting start-ups.

Secondly, the quality of promotional products is being continually improved. Large sections of KfW's product portfolio are subject to ongoing evaluation based on standardised quality criteria. High quality products are enhanced, while lower quality products are gradually phased out. As a responsible development agency that operates via intermediaries, the quality of our business is a priority.

Climate change and the environment are of core importance for the group's activities. With around €29bn, commitments in this area comprised 40% of the group's promotional lending in 2012. In order to accommodate the special importance of this focal area and maintain recent years' success for the long term, KfW aims to dedicate around 33% of its new financing activities to environmental issues over the next years.

An environmental and social impact assessment (ESIA) is a major component of the assessment of projects we help finance in developing and transition countries as well as for export and project financing mainly in countries outside the EU or the OECD. The assessment systematically analyses the projects for any potential negative impacts. The ESIA determines protection and mitigation measures which are overseen by a monitoring programme.

Since 2012, KfW IPEX-Bank and DEG, two wholly-owned subsidiaries of KfW that focus on international project and export financing and private sector investments in developing countries respectively, have assessed their lending practises using the amended provisions of the International Finance Corporation for environmental and social impact assessment. This also applies to public private partnership projects. Moreover, KfW is participating in the process of revising these provisions for analysing environmental and social impact by providing specialist support.

KfW recently adopted a comprehensive package to strengthen its sustainability engagement and make it more visible to stakeholders. A new guideline for responsible procurement at KfW Group ensures that all procurement processes both in Germany and abroad take special account of environmental and social aspects. As well as the systematic integration of environmental and social aspects, the new guideline ensures that the implementation is assessed as needed and ensures the implementation of the relevant processes throughout the bank. By coming into effect, the specifications of the guideline are also reflected in KfW's general terms and conditions of purchase.

Our employees are the cornerstone of the current and future success of the entire KfW Group. Important components of personnel policy include fair wages, equal opportunities, work life balance and a number of professional and health benefits. The figures in these areas remained at a high level in 2012. Severely disabled employees constituted 5% of staff. The proportion of staff working part-time increased slightly to 21%, as did the proportion of women in managerial positions, which reached 28%. The training rate at KfW was unchanged from the previous year at just under 6%. Since 2001, KfW has regularly been certificated as part of the 'work and family' audit by the charitable Hertie Foundation. DEG joined for the first time in 2012 with its own certificate. KfW IPEX-Bank again received an award in 2012 in the 'Top Employer' competition.

KfW is committed to making significant and continual reductions to its CO_2 emissions in accordance with the worldwide two-degree climate change target. This is not achievable through energy savings and use of green electricity alone. Since 2006, KfW has offset all remaining carbon emissions attributable to energy consumption of buildings or business travel by staff, making them climate neutral. According to KfW's most recent Sustainability Report, CO_2 emissions fell over 5% year on year. In order to contribute to electromobility in Germany, KfW participates in expanding the respective infrastructure in Germany. For example, several charging stations were set up in Frankfurt, Berlin and Bonn. As KfW only uses electricity from renewable energy sources, the carbon neutrality of the charging stations is guaranteed. As a further contribution to carbon reductions, over 50 meeting rooms are available for virtual meetings at KfW equipped with video conference technology.

As a large asset owner with a rigorous focus on sustainability, KfW was one of the first German companies to join the UN's Principles for Responsible Investment (PRI) initiative in 2006. Consequently, KfW incorporates social responsibility in its own investments in fixed and floating rate securities and over 90% of KfW's securities in a narrow sense met these criteria at the end of 2012.
This refers to KfW's liquidity reserve, which amounted to €21.1bn as of year-end 2012.

PRI in KfW's portfolio management are implemented in three steps: in addition to general credit analysis, ESG criteria are included in investment decisions. There are also exclusion criteria for non-government issuers. Finally, KfW communicates its methodology and the outcomes to the issuers of the securities in its portfolio. In KfW's view, SRIs on the capital market play an important role in overcoming global challenges. The bank therefore participates in a PRI working group, which deals with ESG risks and the integration of ESG criteria in bonds. KfW also supports a project by the UN (ERISC), which highlights the necessity of integrating environmental risks into country valuations.

KfW bonds are liquid, safe and sustainable investments

Although KfW is not an issuer of green bonds in the narrower sense, we are convinced that KfW's rigorous focus on sustainability makes all KfW bonds an equally attractive investment opportunity to those investors who consider a company's sustainability performance in their investment decisions. KfW bonds combine the best credit quality with an exceptional sense of responsibility.
The leading agencies for sustainability ratings continue to rate KfW very highly. However, we are closely monitoring the current developments around themed bonds, such as green bonds, and we are willing to enhance stakeholders' awareness with respect to sustainable corporate behaviour. So what are the next steps?

Our primary goal is to further expand our responsible business model and to make it even more appealing to investors and issuers alike. The holistic approach that KfW uses to incorporate its focus on sustainability and responsible banking in its daily operations may help influence others. Therefore, we seek to increase the dialogue with investors, issuers, intermediaries and rating agencies likewise. This will contribute to reinforce the awareness of green investing by pointing out respective benefits in the broader public and will specifically cater to those socially responsible investors that currently focus on green bonds when making their investment decisions. Finally, we intend to contribute to the process of setting general market standards for green bonds to support the further development of this segment.

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