KfW Bankengruppe

Direct – Fixed Income Corporate

Responsible investment report 2012

Public report

February 2013

PRI disclaimer

The contents of this report are being piloted this year for signatories and stakeholders to provide feedback. The reports will be updated for the 2013/2014 reporting cycle to reflect the comments we receive on design, structure and usability.

Moreover, due to the pilot nature of the 2012 Reporting Framework, certain indicators are undergoing further changes. These changes will also be reflected in the reports for the next reporting cycle.

This document is based on information reported by signatories and responses have not been independently audited by the PRI Secretariat, PRI working groups, or any other third party. While this information is believed to be reliable, no representations or warranties are made as to the accuracy of the information presented, and no responsibility or liability can be accepted for any error or omission.

ESG Incorporation (actively managed)

Overview

Description of how our organization accounts for ESG issues in investment strategies and processes

After signing the PRI, KfW discussed different strategies to implement a sustainable investment approach for its liquidity portfolio. In this process, the adherence to the objective of the liquidity portfolio was of paramount importance!

The liquidity portfolio is part of KfW's overall liquidity management activities. It is a pure fixed income portfolio. The portfolio's asset allocation includes sovereign issuers, supranationals, financials and covered bonds. KfW adopts a buy-and-hold strategy, which means that the bonds are held to maturity. Risk is managed on the one hand through strict minimum credit requirements for issuers, a broad regional distribution of issuers and bond duration targets. Furthermore, the maximum investment amount for each bond issuer, the so-called limit, is set according to the bank-wide single borrower limit framework.

Considering the characteristics of the liquidity portfolio and its investment guidelines, KfW decided in 2008 to integrate ESG criteria in the current investment approach. This implies that in addition to the credit assessment of the issuers their sustainability rating is also included in the limit assessment. More recently, KfW introduced an engagement approach in 2010 and exclusion criteria for financial service providers in 2011.

Integration of ESG criteria into KfW's investment approach for the liquidity portfolio:

For the integration of ESG criteria in the investment approach for the liquidity portfolio of KfW, the concept of 'sustainability' had to be operationalised first. The sustainability strategy of the German federal government, in-house environmental and social guidelines, the KfW mission statement and its core activities serve as the basis to accomplish this. The three main criteria, 'environment', 'social' and 'governance' are described and defined more precisely using a variety of individual criteria (http://nachhaltigkeit.kfw.de/EN_Home/Sustainable_investment/Latest_news/PDF_files/Examples_for_ESG_criteria_E_072011.pdf.)

Since KfW defines itself as an "environmental bank", KfW weights "environment" with 60% in the overall sustainability rating for non-governmental issuers. The two other criteria are weighted at 20% each. The three ESG criteria are equally weighted for sovereign issuers as overweighting the criterion environment is considered inappropriate.

Portfolio optimization:

The inclusion of each issuer in KfW's liquidity portfolio depends first and foremost on its financial credit standing, which is assessed in the context of assigning bank-wide single borrower limits. This in-house limit procedure defines the maximum limit volume available for each issuer. In a second step, the sustainability ratings described below are applied. Put another way, aside from his financial credit standing, the inclusion of an issuer in one of the three sustainability rating categories determines the possible investment amount in his bonds or, in other words, the maximum limit volume.

Based on KfW's definition of sustainability described before, the sustainability rating agency, Sustainalytics, generates sustainability scores for all issuers in the liquidity portfolio. These are not produced in the form of absolute ratings - as in conventional credit ratings - but in the form of rankings. In other words, a rating always has to be interpreted relative to the rest of the respective industry. Using this methodology, KfW obtains a respective ranking for all sovereign and non-governmental issuers in its portfolio universe sorted by their level of sustainability. Based on these sustainability scores, the portfolio universe - separated into sovereign and non-governmental issuers - is broken down into three groups: issuers with a good sustainability rating, those with an average sustainability rating and issuers with a relatively poor sustainability rating. The sustainability scores and ratings are updated on a monthly basis.

Based on these ratings, KfW then defines whether to maintain or to reduce the maximum limit volume for an issuer. The 20-60-20 rule determines the breakdown of the liquidity portfolio universe into the 20% top issuers, the 60% issuers with an average rating and the 20% issuers with a relatively poor rating. For the top 20%, the predetermined limit volume remains in place. The limit volume of the 60% issuers with an average rating is reduced by 10%, while that of the 20% issuers having a relatively poor rating is reduced by 30%.

This approach optimizes the portfolio and prevents it from including investments that are less sustainable. The approach promotes competition among issuers and encourages them to improve their sustainability rating in order to prevent limit reductions or to increase limits that have been reduced and once again to facilitate new investments in their bonds by KfW. This competition is addressed by KfW's engagement activities.

In addition to integrating the so-called ESG criteria in its responsible investment approach, KfW also started to consider exclusion criteria in its investment decisions in the beginning of 2011. The objective of the exclusion criteria is to prevent possible negative environmental, social and governance impacts that may be generated by the use of the debt capital provided by KfW. Details concerning the application of the exclusion criteria can be found in KfW's sustainability portal:
(http://nachhaltigkeit.kfw.de/EN_Home/Sustainable_investment/KfWs_sustainable_investment_approach/Strategies_for_Sustainable_Investment/Exclusion_Criteria.jsp).

Approaches to ESG incorporation in fixed income (corporate) portfolio

As a % of internal actively managed assets					
ESG integration	Overarching ESG exclusions	Fund/mandate specific ESG exclusions	ESG themed investments	ESG positive screening	Other
100%	100%				

ESG integration – actively managed

Description of ESG research obtained reviewed and made available to investment professionals

Sustainalytics, a sustainability rating agency, is KfW's external provider for the sustainability ratings for all issuers in KfW's liquidity portfolio. The sustainbility ratings are based on ESG data/research of each individual issuer.

http://nachhaltigkeit.kfw.de/EN_Home/Sustainable_investment/KfWs_sustainable_investment_approach/Strategies_for_Sustainable_Investment/Integration_of_ESG_criteria/Definition_and_Weighting_of_Sustainability.jsp

Use of ESG information and research

✔	ESG information and research are used in investment decision making.
✔	Records are kept highlighting discussions or research/reviews of ESG information undertaken.
✔	Records are kept on how ESG information and research has influenced investment decisions.

Resources allocated to the purchase and development of ESG-related research

KfW has a contract with the sustainability rating agency Sustainalytics GmbH. Details of this contract are confidential.

ESG research (internally or externally produced) used in investment processes

Coverage of ESG research		
✔ Environment	✔ Social	✔ Corporate governance

Type of ESG research	
✔	Raw data
✔	Ratings
✔	Analysis at a company level
✔	Analysis at a sector level
✔	Analysis at a country level
✔	Analysis of specific ESG issues
✔	Analysis in relation international initiatives, declarations or standards
✔	Positively or negatively screened investment universes
✔	Credit rating agencies

Process of reviewing and integrating ESG ratings/scores provided by credit rating agencies into our investment process

see FIC 02;
http://nachhaltigkeit.kfw.de/EN_Home/Sustainable_investment/KfWs_sustainable_investment_approach/Strategies_for_Sustainable_Investment/Integration_of_ESG_criteria/Portfolio_Optimisation.jsp

ESG exclusions – actively managed

Overarching ESG exclusions and their implementation

In addition to integrating the so-called ESG criteria in its sustainable investment approach, KfW also started to integrate exclusion criteria in its investment approach in the beginning of 2011.
In its liquidity portfolio, KfW invests in government bonds, covered bonds, bank bonds and bonds of supranational organizations. The exclusion criteria in KfW's portfolio management exclusively apply to financial services providers. Exclusion criteria are not applied to bonds of sovereign issuers because KfW, being a promotional bank that is owned by the Federal Republic and the federal states, does not consider itself mandated to assess other states.
The process of indirectly applying exclusion criteria:
KfW does not purchase bonds issued by producing enterprises for its liquidity portfolio. Therefore, the exclusion criteria essentially can only be applied indirectly, for example by identifying banks

that hold a share of 10% or more in an enterprise which, for its part, generates at least 5% of its annual turnover on the basis of one or more of the products listed below or exhibits a controversy factor of 4 or 5. KfW's research partner, Sustainalytics, assesses enterprises with controversies on a scale of 1 to 5. A controversy factor of 4 or higher means that controversies or serious violations have been repeatedly identified in an enterprise. As a general principle, the indirect application of the exclusion criteria only considers equity participations that account for a share of at least 0.5% of a bank's total assets.

The motivation for applying exclusion criteria:

Through the purchase of bonds, KfW provides debt capital for issuers. The objective of the exclusion criteria is to prevent possible negative environmental, social and governance impacts that may be generated by the use of the debt capital provided by KfW. Providers of debt capital usually cannot control the compliance of projects financed with this capital with environmental, social and governance criteria. Applying exclusion criteria ensures that, as a matter of principle, no funds provided by KfW to the issuers through the purchase of their bonds for the KfW liquidity portfolio can flow into projects which, from the perspective of KfW, are likely to have unacceptable negative environmental, social and governance impacts from the outset.

The exclusion criteria of KfW:

The exclusion criteria for financial services providers are based on the "IFC Exclusion List" and are intended to ensure that excluded projects are not supported with funds provided by KfW to the issuers through the purchase of bonds for KfW's liquidity portfolio. The "IFC Exclusion List" is already being applied in the provision of funds to financial intermediaries that promote developing and transition countries and in financing activities of KfW's subsidiary DEG.

List of exclusion criteria:

1. Production or activities involving harmful or exploitative forms of forced labour or child labour as defined in the ILO core labour standards.
2. Production, use of or trade in pharmaceuticals, pesticides/herbicides, chemicals, ozone depleting substances and other hazardous substances that are subject to international bans.
3. Trade in animals or animal products that are subject to the provisions of CITES (Convention on International Trade in Endangered Species of Wild Fauna and Flora).
4. Production of cosmetics etc. involving testing on animals.
5. Commercial logging operations for use in primary tropical moist forests.
6. Production of wood or wood products other than from sustainably managed forests (enterprises with less than 50% FSC-certified production are excluded, FSC - Forest Stewardship Council).
7. Production or trade in controversial weapons or important components for the production of controversial weapons (anti-personnel mines, biological and chemical weapons, cluster bombs, radioactive ammunition, nuclear weapons).
8. Production or trade in tobacco.
9. Drift net fishing in the marine environment using nets in excess of 2.5 kilometers in length.
10. Controversial forms of gambling: operation of casinos, production of devices or other equipment for casinos or betting offices or companies that generate turnover via online betting. (So-called "short odds" are defined as "controversial forms of gambling").
11. Any business activity involving pornography.
12. Production or distribution of racist, anti-democratic and/or neo-Nazi media.

Outputs and outcomes

Measuring impact of ESG incorporation

- **We measure the impact of ESG incorporation on financial performance.**
- **We measure the impact of ESG incorporation on ESG performance.**

Process to measure the impact of ESG incorporation on financial performance

Due to our specific investment approach, performance can be described by the following aspects:
a) Ratings are relative – upgrades or downgrades can happen although a specific issuer's score has
not changed
b) Average approx. 10 monthly rating border crossings
c) Limits can be exceeded: no forced selling language, but investment stop
d) overall portfolio effect: total limit volume is reduced by approx. 8%, i.e. KfW does not use available limit volume of more than € 3 bn

Process to measure the impact of ESG incorporation on ESG performance

KfW's own sustainability ratings are a measure of its overall ESG performance. In the continuous process of updating KfW's own sustainability rating with different sustainability rating agencies, KfW's sustainable investment approach is one important aspect of KfW's overall sustainability strategy.

ESG issues that affected investment decisions in the reporting year

Example 1	
ESG issue name	exclusion criteria: controversial weapons
Explanation of issue	company holds a share of >10% in an enterprise that generates > 5% of its annual turnover on the basis of controversial weapons
Sector (s) affected	non-governmental issuers
Impact on investment view	investment stop
Number of holdings affected	1
Proportion of holdings affected	
Addressed in	Portfolios with ESG integration

Example 2	
ESG issue name	ESG rating upgrade
Explanation of issue	rating upgrade due to improved ESG rating score;
Sector (s) affected	non-governmental issuers
Impact on investment view	limit reduction of 10% is waived
Number of holdings affected	3
Proportion of holdings affected	1.5%
Addressed in	Portfolios with ESG integration

Example 3	
ESG issue name	ESG rating downgrade
Explanation of issue	rating downgrade due to worsened ESG rating score
Sector (s) affected	non-governmental issuer
Impact on investment view	limit reduction of 10%
Number of holdings affected	2
Proportion of holdings affected	1%
Addressed in	Portfolios with ESG integration

Engagements

Overview

Engagement activities' objectives	Direct	Service provider(s)
To monitor ESG activities of the company	✓	N/A
To influence company behaviour on ESG issues	✓	N/A
To monitor and influence companies on business strategy not directly related to ESG issues	–	N/A

Engagement with issuers on ESG issues

Our approach to engagement with issuers on ESG issues does not differ with regards to pre and post bond issue. It also does not differ between private and public assets.

Engagements for monitoring

Organisational approach

A key component of the Principles for Responsible Investment (PRI) and, consequently, of a sustainable investment approach is engagement. The term in this context refers to all actions designed to promote the acceptance of sustainable investment practices among market participants, to demand an open attitude concerning ESG issues and to support the implementation of the PRI by adopting appropriate disclosure and reporting practices. The ideal of investor engagement is that of an active owner. Since KfW does not own any shares as part of its own securities investments, but does intend to fully meet its obligations arising from the PRI, KfW's engagement primarily involves dialogue with the bond issuers included in its liquidity portfolio.

Due to the specific sustainable investment approach for KfW's liquidity portfolio, we have also tailored our engagement activity accordingly. Our engagement approach combines two objectives: to monitor issuers on ESG issues and to influence issuer's behavior on ESG issues. At the heart of KfW's approach to sustainable portfolio management is the idea that an issuer's sustainability rating should be ranked in relation to the sustainability ratings of all other issuers. Depending on the degree of an issuer's sustainable business practices, his sustainability rating can improve or deteriorate relative to the rating of all other issuers. Based on this classification, KfW then decides whether to retain or reduce the investable limit volume for an issuer. On this background, in KfW's view it is essential to inform the issuers about their current sustainability rating on an ongoing basis and to encourage them to maintain or strengthen their commitment to sustainability.

The dialogue is initiated by contacting the issuers in writing, drawing their attention to KfW's sustainable investment approach and to the fact that KfW only fully commits to investing in issuers with a good sustainability rating. KfW appreciates the active dialogue with many issuers and the diverse activities the issuers start in order to improve their sustainability assessment. Furthermore, KfW also communicates with market participants on the issue of sustainable investment in international conferences and via activities in collaboration with the newly founded German PRI Network.

Tracking engagement for monitoring activities

We track our engagement for monitoring activities

Method of tracking

The engagement activity is conducted on an annual basis. Records concerning issuers' sustainability ratings and feedback are maintained and analysed internally. Records are kept in a database solely created for engagement activities of KfW.

Engagement numbers – For monitoring

Engagements for Monitoring		
	Internally run	**Service providers**
Engagement cases	N/A	N/A
Companies engaged with	90	N/A
(% of the number of our fixed income investment portfolio companies)	100%	

Engagements for monitoring influencing our investment views and decision-making

ESG engagements for monitoring that are run directly have influenced our investment views and decision-making in the reporting year.

Illustrative examples of how ESG engagements that are run directly have influenced our investment views and decision-making in the reporting year

Our engagement activities are based on the issuers' individual sustainability ratings with KfW. Therefore, any changes in their behaviour that results from KfW's engagement initiative can lead to a rating change.

Engagements for influence

Organisational approach

KfW does not separate between engagement for monitoring and engagement for influence (cf. FIC 19).

Tracking engagement for influence activities

We track our engagement for influence activities.

Method of tracking

The engagement activity is conducted on an annual basis. Records concerning issuers' sustainability ratings and feedback are maintained and analysed internally.

Engagement numbers – For influence

Engagements for Influence		
	Internally run	**Service providers**
Engagement cases	N/A	N/A
Companies engaged with	90	N/A
(% of the number of our fixed income investment portfolio companies)	100%	

Process for engagements for influence run internally

We have a formal process for identifying and prioritising our ESG engagements for influence.

Description of process for identifying and prioritising our ESG engagement for influence
KfW engages with all corporate issuers that constitute our portfolio universe and that are investable at that point in time (cf. FIC 19).

Monitoring and evaluating the progress of our ESG engagements for influence

When initiating ESG engagements for influence, goals are defined systematically across ESG engagements.

Process to monitor whether companies have made desired changes following our engagement is set systematically across ESG engagements.

Description of how we monitor and evaluate the progress of our engagements for influence
Companies that change their business behaviour will get better sustainable rating scores and, in turn, will get a more positive engagement letter. KfW's sustainability scores and ratings are updated on a monthly basis. Records are kept internally.

Robustness of engagement process and progress forms part of performance appraisal of:	
✓	Specialist responsible investment/ESG staff
–	Investment management staff

Engagement for influence influencing our investment views and decision-making

ESG engagements for influence activities has affected our investment views and decision-making in the reporting year.

Illustrative examples

Our engagement activities are based on the issuers' individual sustainability ratings with KfW. Therefore, any changes in their behaviour that results from KfW's engagement initiative can lead to a rating change.

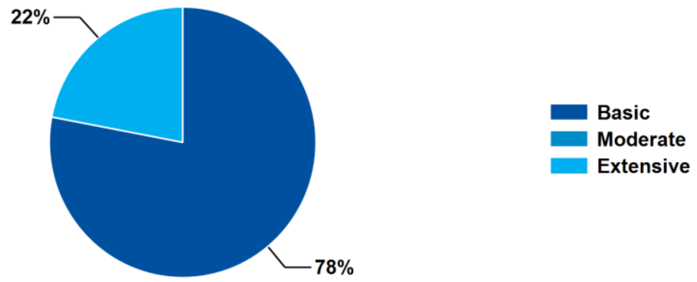
Outputs and outcomes from the engagement for influence activities

As described before, KfW's engagement acitivity with the issuers of its liquidity portfolio is an important element of its overall sustainable investment approach. By applying this approach, all issuers in the liquidity portfolio compete with each other concerning the sustainability of their business activities. Therefore, in KfW's view it is essential to inform the issuers about their current sustainability rating and the existence of exclusion criteria on an ongoing basis and to encourage them to maintain or strengthen their commitment to sustainability. In 2011, 90 letters have been sent to issuers. Approx. 20% of the issuers responded to these letters via direct communication, phone confererences and information about their respective sustainable business practices.

Engagements by extent of interactions with companies

Direct engagements

Total number of direct engagements for influence:	90
Extent of interaction held with companies	

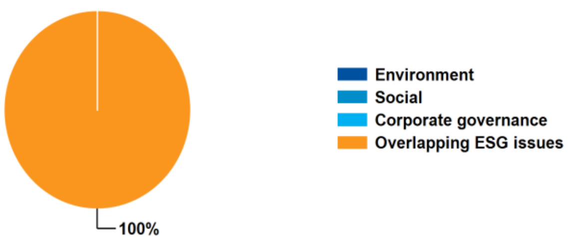


- Basic: A single letter (and no calls or meeting) to the issuer in which action is requested
- Moderate: A single meeting or call with the issuer at which action is requested
- Extensive: Multiple letters, meeting and calls with the issuer in pursuit of change objectives

Breakdown of E, S and G issues covered in our engagements

Direct engagements

Breakdown by topic of engagements



Geographic focus of our engagements	
✔	Developed
–	Emerging. Frontier and other

Changes in companies following engagements

We can provide a reliable estimate of the number of companies where changes or change commitments followed our engagement in the current year.

Through direct engagements	Through collaborative engagements	Through service provider(s)
20		N/A

Communication and reporting

Beyond the PRI Reporting and Assessment, our organisation provides information on fixed income corporate ESG engagement for influence-related activities to the public.

Publicly available documents

http://nachhaltigkeit.kfw.de/EN_Home/Sustainable_investment/Latest_news/PDF_files/-NH_Master_2011-08_E.pdf

The levels of disclosure are not different between public and clients/beneficiaries.

Disclosed to public	
✓	Number of engagements for influence
–	Names of the companies engaged with
–	Breakdown of engagements by type
✓	Breakdown of engagements by topic
–	Breakdown of engagements by region
✓	Details of the selections, priorities and specific goals of engagement
–	An assessment of the current status of the engagement
–	Outcomes that have been achieved from the engagement
Frequency of provision of engagement information	
✓	Disclosed annually

Examples of individual ESG engagement for influence during the reporting year

Example 1:	
Engagement topics and rationale	engagement with the issuers of KfW's liquidity portfolio
Engagement goals	inform them about their current sustainability rating and the effect on their limit volume
Engagement approach	Extensive
Number of companies engaged	90
Proportion of holdings engaged	100% (of total fixed income corporateinvestments)
Engagement outcomes	20% feedback from issuers

Example 2:	
Engagement topics and rationale	engagement with one issuer concerning their sustainable business practices; meeting with deputy head of group corporate sustainability
Engagement goals	better understanding concerning our definition of sustainability; discussion of sustainability rating generation
Engagement approach	Extensive
Number of companies engaged	1
Proportion of holdings engaged	1% (of total fixed income corporateinvestments)
Engagement outcomes	improved communication; dialogue with sustainability rating agency

Additional information on collaborative ESG engagement for influence during the reporting year
KfW did not participate in collaborative ESG engagement activities.

Process of engaging with companies where we are both a bondholder and an equity holder

not applicable