KfW Bankengruppe

Direct – Fixed Income Sovereign

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)

We largely adopt the same approach to incorporation of ESG issues in our sovereign fixed income assets as we do in our corporate fixed income assets.

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 (sovereign) 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%					

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 of the sovereign issuers in KfW's liquidity portfolio. The sustainability ratings are based on ESG data and 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. Details of this contract are confidential.

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

Coverage of research					
✓	Environment	✓	Social	✓	Corporate governance

Type of ESG research	
✓	Raw data
✓	Ratings
✓	Analysis at a country level
✓	Analysis of specific ESG issues
✓	Analysis in relation to 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 FIS 02:
http://nachhaltigkeit.kfw.de/EN_Home/Sustainable_investment/KfWs_sustainable_investment_approach/Strategies_for_Sustainable_Investment/Integration_of_ESG_criteria/Portfolio_Optimisation.jsp

Outputs and outcomes

Measuring impact of ESG incorporation

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

Process to measure the impact of ESG incorporation on financial performance

Due to KfW's specific investment approach, performance can be described by the following criteria: a) Ratings are relative, upgrades or downgrades can happen although a specific issuer‘s

score has not changed ipsum
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 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	ESG rating upgrade
Explanation of issue	rating upgrade due to improved ESG rating score
Impact on investment view	Limit reduction of 30% is reduced to limit reduction of 10%
Number of Countries/municipalities affected	5
Proportion of fixed income sovereign internally managed holdings affected	2.7%
Addressed in	Portfolios with ESG integration

Example 2	
ESG issue name	ESG rating downgrade
Explanation of issue	rating downgrade due to worsened ESG rating score
Impact on investment view	limit reduction of 10%
Number of Countries/municipalities affected	3
Proportion of fixed income sovereign internally managed holdings affected	2.2%
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
Impact on investment view	limit reduction of 10% is increased to limit reduction of 30%
Number of Countries/municipalities affected	3
Proportion of fixed income sovereign internally managed holdings affected	1%
Addressed in	Portfolios with ESG integration

Engagements

Overview

In addition to our public policy engagements reported in the Overarching Approach supplement, we do not engage with the issuers of sovereign bonds on ESG issues.

Explanation of why we do not engage with the issuers of sovereign bonds on ESG issues

KfW is owned by the German Federal government and the Federal states. Therefore, it does not consider itself mandated to engage with other sovereign entities.