Sustainable finance in Germany – what are we waiting for?

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Germany is lagging behind other countries when it comes to developing a sustainable financial sector, despite the fact that major shifts – such as energy and transport reforms – are in the pipeline and need considerable capital. The Hub for Sustainable Finance Germany (H4SF), initiated by the RNE and Deutsche Börse AG, was created to help wake German players from their slumber.

The German Council for Sustainable Development (RNE) put sustainable finance on its agenda twelve years ago, tentatively examining the financial market for the first time back in 2006. Its theory was that balance sheets based on shareholder value no longer adequately reflected the value of a company. In its CSR recommendation, the RNE accordingly proposed to the Federal Government that state-subsidised private and company pensions – the so-called Riester and Rürup pensions – should take long-term sustainability factors into account as well as traditional investment criteria such as the financial return. If the state set a good example, the RNE suggested, the market for sustainable investment in Germany could close the gap and reach the level already attained by other countries. Even back then, the RNE identified the capital market as an independent player which would have to be incorporated into the process. It advocated the use of a sustainability index like those which stock exchanges and financial service providers have been developing for 20 years now (see infobox). At an early stage, the RNE encouraged shareholders and asset managers to adopt the Principles for Responsible Investment (PRI) and report on their use. Unfortunately, looking back on these efforts also serves to illustrate how little has changed since then – despite the financial crash which triggered a global economic crisis over ten years ago.

Delivering impetus for change: "Making a start is better than doing nothing"

At the behest of a number of financial market players and investors, the RNE revisited the subject in 2008 and developed the Sustainability Code. The Code combined financial market players' need for information with the increasingly widespread practice of corporate sustainability reporting.

Developing the Code marked a milestone in the RNE's work: it was one of the first projects with which the RNE attempted to bring about change itself. This proved successful in the case of the Code – particularly because it was drawn up in conjunction with stakeholders who work with reporting systems and are searching for relevant information. Initially launched as a voluntary minimum standard, it developed further thanks to companies' good reporting practices and triggered learning processes at organisations. If it continues to be cultivated as a constantly evolving standard at the interface between regulators, firms and financial market players, it will yield good results in the future as well. Germany has had legislation in place to regulate reporting on certain sustainability issues since the end of 2016. Following the transposition of the corresponding EU directive into German law, there has been an obligation for financial market players, banks and insurance companies in particular to disclose non-financial information in their reporting. The Code has proved to be an effective tool in this context as a source of pragmatic guidance. It helps companies to produce meaningful reports which also meet the reporting obligation.

Even after it had developed the Sustainability Code, the RNE kept returning to the topic of sustainable finance. In 2010, the RNE once again broached the subject of financial markets in a new recommendation. The 2013 peer review of the German Sustainable Development Strategy also placed an emphasis on finance – one which the new edition of the peer review took up in 2018 as well.

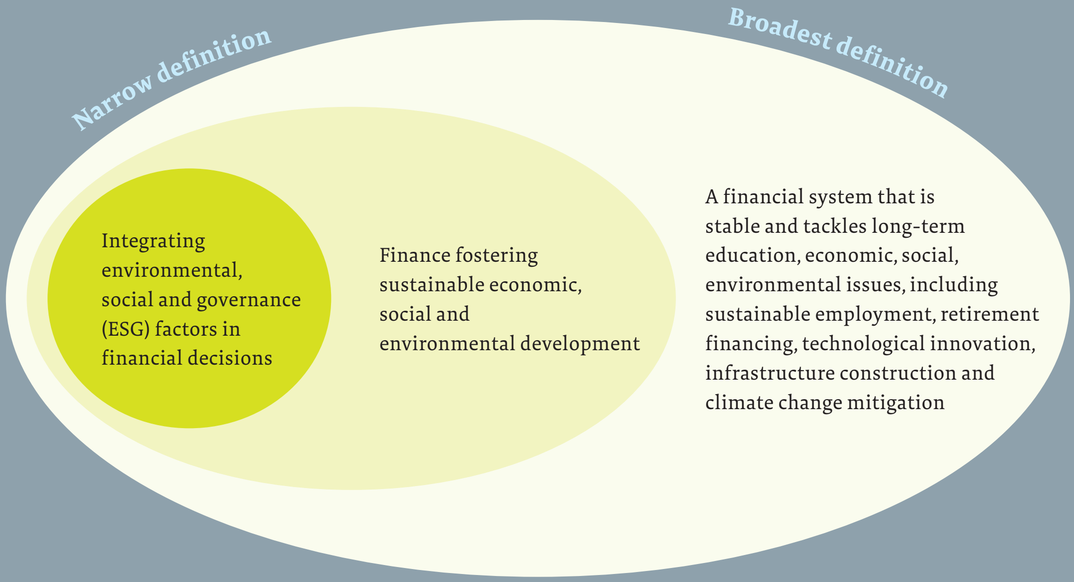
However, none of this can hide the fact that when it comes to sustainable finance Germany compares lamentably with other European countries. At first glance, the trend looks promising. Since 2014, Germany has recorded continuous growth in the volume of responsible investments[1] – i.e. products and investment vehicles which take environmental, social and governance (ESG) criteria into account – from 437 billion euros in 2014 to 1,409 billion euros in 2017. Between 2016 and 2017, sustainable investment funds and mandates jumped by no less than 17 per cent (Sustainable Investment Forum [FNG], 2018).

Above-average growth – but the market is small

This growth is largely attributable to institutional investors, who account for a predominant market share of 91 per cent. Their investment volume is increasing by an average of 32 per cent each year. By contrast, private investors – whose market share stands at the remaining nine per cent – are fairly

1 As defined by the FNG (FNG market report 2018, p. 10), sustainable investments are: "[…] the general term for sustainable products and investment vehicles which explicitly incorporate ethical, social and ecological considerations into their investment criteria." Furthermore, the FNG also includes those investments that are based on "an explicit, written investment policy on the use of ESG criteria." By contrast, the term "responsible investment" is defined as follows: "Responsible investors and asset managers take ecological, social and governance-related aspects (ESG criteria) into account in their investment processes and use corresponding investment strategies. They comply with public standards and principles, put their responsible investment strategy in writing, and provide information about their activities, investment strategies and ESG principles."

THREE DEFINITIONS OF SUSTAINABLE FINANCE



insignificant. Since 2012, the volume of private investors has grown by a modest seven per cent on average. Alongside the legislative framework, the strong demand for sustainable investments from institutional investors is therefore a key criterion for the market's development (FNG, 2018).

Although Germany's sustainable investment market experienced above-average growth of 17 per cent between 2016 and 2017, the overall volume remains low: the proportion of sustainable investment funds and mandates makes up just three per cent of the total market (German Investment Funds Association [BVI], 2018).

This growth may appear impressive at first sight, but a European and international comparison quickly puts it into perspective: according to the European SRI Study 2016 by Eurosif, France leads the field by a considerable margin. However, the markets in the Netherlands, the UK and Switzerland are also developing fast and Germany cannot keep up. Even if the German market for sustainable finance continues to experience above-average growth, it will be unable to close the existing gap to other European countries.

Sustainable finance – a term with many definitions

Those who believe that sustainable finance means incorporating ESG considerations into investment decisions take too narrow a view. Any-one who wants to know whether sustainable financial markets can contribute towards sustainable development must use a broader definition of the concept.

The first step towards establishing a sustainable financial system is funding sustainable development in economic, social and ecological terms. A sustainable financial system can only emerge if the financial markets systematically integrate economic, social and ecological challenges – such as education, sustainable employment, pensions funding or climate protection – into their logic long-term.

A great deal of funding is needed. There is an estimated shortfall of 1.77 thousand billion euros to finance the EU climate and energy policy alone, which aims to bring about a 40 per cent reduction in CO_2 emissions by 2030. The European Fund for Strategic Investments (EFSI) and other initiatives are trying to mobilise funds to compensate for this weak investment. However, this will not be enough. Closing the gap completely requires the financial sector to change its focus. It has a key role to play in bringing about sustainable development.

The first steps have already been taken. Based on an action plan developed by the EU High-Level Expert Group on Sustainable Finance (HLEG), the European Commission presented a package of measures with three legislative proposals in May 2018. These cover: 1.) a uniform classification system to determine sustainability in the financial system, 2.) legislation on how institutional investors should disclose the way in which ESG criteria are integrated into investment processes, and 3.) a CO_2 benchmark to make an investment's CO_2 footprint transparent.

Germany once again trailing behind

If investors are to disclose how they integrate ESG criteria into their investment decisions in the future as per the second legislative proposal, it is essential to acquire an overview of the various sustainable investment strategies. Experts currently distinguish between eight investment strategies.[2] Popular investment strategies throughout Europe are negative screening, norms-based screening, engagement and the exercise of voting rights (Eurosif, 2016). Other investment strategies are best in class, impact investing, integration and sustainable thematic funds (FNG, 2017).[3] With the help of sustainable investment strategies, private or institutional investors can identify potential risks, such as environmental or health impacts, associated with

2 Eurosif – and FNG in Germany – have defined eight investment strategies. Cf. investment strategies identified by GSIA, PRI or EFAMA as well.
3 Explanation of the different strategies: one of the first steps when applying sustainable investment strategies is often negative screening. Negative screening systematically excludes investments or investment classes on the basis of specific criteria. Examples include ruling out investments in the arms industry, tobacco and alcohol, nuclear power or fossil fuels. The criteria most commonly used for negative screening in Germany are weapons (production and trading), human rights violations and labour law violations (FNG, 2017). Norms-based screening also excludes certain investments by using international norms and standards. This means that investments may not be made in companies which do not comply with the selected norms and standards. The UN Global Compact, the OECD

financial products and subsequently take them into account in their decision-making.

A comparison of the volume invested within Europe using the above-mentioned strategies shows that:

» Only Switzerland and the UK are ahead of Germany in the use of negative screening for investment decisions.
» However, it is virtually impossible to catch up with France in the use of norms-based screening. The Netherlands are strong performers here too, while Germany is not worth mentioning.
» The UK is leagues ahead in the use of engagement and the exercise of voting rights as strategies. Much could be learned from the EU exit candidate on this score.

Sustainable investment is attracting more and more attention in Germany and demand is constantly rising. However, sustainable finance remains a niche topic. There is no sign of it becoming mainstream, even though more than half of studies examining how ESG criteria affect corporate and portfolio performance reveal a positive correlation, with only about one in ten suggesting a negative link. In particular, no studies whatsoever have found a negative connection between green building and financial performance (cf. Friede/Busch/Bassen, 2015). The academic research therefore also begs the question as to why Germany is so far behind other countries with regard to sustainable finance.

The banks postulate sustainable behaviour more and more, but the message is not being heard by clients, partners and policymakers. It is difficult to gauge how relevant sustainability issues are for banks' core business; many investors still know too little about the consequences of their decisions. Now, the CSR Directive Implementation Act is targeting precisely these players. It is important to consider the reporting obligation alongside the urgently needed overhaul of the financial markets and their orientation. Entrepreneurs in the real economy are not least among those demanding reliable framework conditions and partners – and these include the financial backers who set the tone with their incentive structures.

All of these observations make it clear just how crucial dialogue with investors and companies is. The market can only develop from trend to mainstream if it is debated more strongly by the public and knowledge about it is shared more widely. The HLEG action plan is one such move to deliver important impetus in this regard. Initiatives like this draw attention to the issue and provide a space for debate.

Guidelines for Multinational Enterprises and the ILO's core labour standards are particularly popular in Germany (FNG, 2017). Engagement involves raising awareness of ways in which companies could improve their sustainability performance in dialogue with firms, while the exercise of voting rights means that investors actively use their voting rights at AGMs to influence company policy in relation to ESG criteria. In practice, the popularity of exercising voting rights as an investment strategy can be gauged by looking at the number of shareholder proposals relating to sustainability issues. For instance, a study by the auditing firm Ernst & Young (2017) shows that around the world there has been a rise in shareholder proposals relating to environmental risks and CO_2 emissions.

Depending on how much attention is paid to sustainable finance and how investors exercise their influence, firms will make sustainability a routine part of their corporate behaviour and bring additional investors on board in turn. It is important to reduce (bureaucratic) complexity as much as possible in order to minimise barriers for organisations. Furthermore, initiatives need to create a space in which discussion, knowledge sharing and the urgently needed skill building can take place.

H4SF: impetus, initiatives, innovation

This is precisely where the Hub for Sustainable Finance Germany (H4SF) comes in. To take sustainable finance to the next level in Germany, the RNE and Deutsche Börse AG joined forces in summer 2017 and combined their activities. The aim of the Hub is to raise awareness of sustainability as a relevant issue for the financial market and to integrate ESG criteria into investment behaviour across the board.

The Hub's work is oriented on the 17 UN Sustainable Development Goals (SDGs), the UN Guiding Principles on Business and Human Rights, and the Paris Agreement, in which heads of state and government jointly agreed to strive to keep climate warming well below two degrees Celsius.

SDG 17 is entitled "Partnerships for the Goals". As an open network of financial market players and other stakeholders, this is the essence of the H4SF's mission. It brings all the players together, including some who were not previously part of the dialogue: businesses and financial sector stakeholders – those who are sustainability pioneers and those who are not – political and non-governmental organisations, and academia. By pooling numerous initiatives and players, the Hub makes space for innovation. In this way, it aims to contribute to a broad social discussion of the purpose and objective of a sustainable financial sector. The idea is for the players themselves to develop solutions of a transformational nature in conjunction with practitioners, such as solutions developed by the financial market for the financial market which help to achieve the climate target.

The RNE itself has developed over the last few years from a political advisory body to a proactive, enabling facilitator. Making a start is better than doing nothing – as the RNE proved with its Sustainability Code project. In line with this philosophy, the RNE is now setting out via the Hub to motivate market players to finally make their good intentions known widely. It will also lobby at the political level for smart co-regulation processes.

Ten recommendations for a sustainable financial system

The ten recommendations describe the most important fields where action is needed to make a sustainable financial system a reality (see infobox). These recommendations are based on a host of papers and reports: the HLEG interim report, the PRI Roadmap for Germany, the RNE's Living Document Sustainable Finance, the Accelerating Sustainable Finance Initiative of Deutsche Börse, and the recommendations of the Task Force on Climate-related Financial Disclosures of the Financial Stability Board. The points at which they intersect delineate the content of the Hub's activities. Interested parties can choose the way in which they work on contributions relating to these ten recommendations freely. Parties invited to contribute are institutions representing either the financial sector, the world of business, politics or academia who are planning a contribution relating to one of the ten recommendations. The activity must enhance knowledge or make a constructive, objective or academic contribution towards the discussion of a controversial topic.

A start has been made: the first German Sustainable Finance Summit took place in Frankfurt in October 2017 under the aegis of the German Federal Ministry of Finance (BMF) as the H4SF's

TEN RECOMMENDATIONS FOR SUSTAINABLE FINANCE IN GERMANY

Recommendations from the members of the Steering Committee of the Hub for Sustainable Finance on sustainable finance in Germany

1. Policymakers must take an active role in shaping and guiding these structures to a greater extent than has thus far been the case.
2. The state must fully embrace its function as a role model and guiding force behind the concrete realisation of a sustainability strategy.
3. Sustainable finance requires an entirely new relationship between the state and the financial sector – a relationship that serves societal goals and common integrity. This demands a strategic orientation and management on the basis of indicators and targets.
4. Suitable instruments need to be identified and developed with a view to financing future infrastructure.
5. Knowledge and competence with regard to fiduciary duty and the specific responsibility of the financial sector must be cultivated further.
6. Germany's financial sector should make a visible contribution to reaching the global sustainability goals.
7. Integrated sustainability management as a component of entrepreneurial practice on the part of all market players should be a matter of course.
8. Good reporting is a key foundation for assessing the societal contributions of the business sector and finance industry. The quality, availability and comparability of the data must be expanded considerably.
9. Sustainability aspects must become a component of the financial sector's risk culture.
10. Institutional investors should actively and responsibly exercise influence on shareholders.

For further information, please see **www.h4sf.de** inaugural event. One year later, in autumn 2018, the second Sustainable Finance Summit was held under the joint patronage of the BMF and the German Federal Ministry for the Environment. The European Commission and the European Parliament were also involved in the event. The summit showed that sustainable finance has finally made it onto the political agenda. The participants – representatives of the financial sector, politics, industry, academia and civil society – drafted a sustainable finance roadmap for the coming months. This roadmap now serves as a guideline for well-intentioned institutions which recognise that there is an urgent need to adopt a sustainable approach swiftly and consistently and that this issue can no longer be kicked into the long grass. In other countries, such as France, further-reaching regulations are already in place which make for a clear picture of the climate scenarios that form the basis for investment portfolios. By contrast, sustainable finance pioneers in Germany still have a lot of convincing to do. If it is possible to bring business representatives on board with the SDGs out of their own conviction, financial market players could deliver a convincing sustainability performance within the space of two to three years and prove themselves as enablers and supporters. It remains to be seen whether Germany needs to use the strong arm of the law to achieve this or whether the principle of voluntary commitment still has a future.

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THE SUSTAINABILITY CODE

The Sustainability Code is a standard that enables companies and organisations to report on their sustainability performance on the basis of 20 criteria. They outline their sustainability strategy, their sustainability management and the opportunities and risks in the areas of the environment and society. A Sustainability Code declaration of conformity addresses, for example, general norms of behaviour, concrete sustainable development goals and their implementation, energy efficiency and waste management, anti-corruption measures or employee health care.

The Code criteria help companies become more sustainable. The declarations of conformity are published in a publicly accessible database, allowing them to be compared. This makes them relevant to the public and, above all, the capital market as this makes it possible to identify companies in which an investment can be made in the interests of sustainability.

The RNE developed the Code together with the business and finance sectors in 2011 and it has since been adapted to various other industries. There are guidelines for banks, the housing industry, the food industry, waste management and municipal sanitation, and higher education institutions. The Sustainability Code is available in a number of languages and is compatible with international standards such as the Global Reporting Initiative (GRI). Anyone who uses the Code also meets the EU's CSR reporting requirements, which stipulate that as of the 2017 financial year companies of a certain size must publish non-financial information.

A total of 403 companies and organisations have now published one or more declarations of conformity (as at June 2018).

For further information, please see www.deutscher-nachhaltigkeitskodex.de/en