Volksbanken Raiffeisenbanken
cooperative financial network

DZ BANK Spotlight:

ESG against the backdrop of the world's new geopolitical reality

24 February 2022 was a major inflection point for the global sustainability agenda and thus for discussions around ESG.

The war in Ukraine has a massive impact on all four dimensions of sustainability: economic, environmental, social and governance. It has already cost the lives of thousands of civilians and displaced millions of people from their homes. Hence, health, education and housing systems are facing a new test of endurance. Rising commodity prices and trade disruptions are exacerbating inflationary pressures. Higher food prices could push millions of people especially in the poorest and most vulnerable countries further into poverty. Given the "weaponization of gas", the war in Ukraine is also a "wake-up call" to expedite the global transition to a more secure and cleaner energy future. It also makes clear that a successful development agenda requires inclusive partnerships – at global, regional, national and local levels.

And the past has taught us one thing: negative external shocks widen the sustainability financing gap, making it even more important to mobilise private capital and allocate it through the capital market to sustainable projects with positive impact. Even before the Russian invasion, the world was not on track to achieve most of the UN Sustainable

Content

- **DZ BANK Spotlight: ESG against the backdrop of the world's new geopolitical reality**
- **DZ BANK Spotlight: European Green Bond Standard – Status Quo**
- **Guest Commentary: BayernLB – on the green track**
- **DZ BANK Spotlight: The EU Sustainability Reporting Directive – Current Status**
- **DZ BANK Save the Date: DZ BANK Sustainability Day 2022**

Dear Reader,

We are pleased to present the latest edition of our Sustainable Finance Bulletin.

Even though this year is only a little more than half over, it has already shown that old certainties will have to be reconsidered in 2022. Rarely before has the term „turning point" been used so often in politics as this year. This also applies to the global sustainability agenda and thus also to discussions about ESG. The war in Ukraine has massive implications for all four dimensions of sustainability: economic, environmental, social and governance. Mitigating and addressing the economic, environmental, social and governance impacts will require the help of the capital market – and this must be done in a sustainable way. In the meantime, the European Commission, the Parliament as well as the Council have presented their drafts for an EU Standard for Green Bonds and are currently negotiating them in trialogue. Detached from the sustainable bond market, a large part of the companies will have to fulfil certain reporting obligations regarding their sustainable positioning in the future against the background of the CSRD.

Enjoy reading! Stay healthy!

Marcus Pratsch
Head of Sustainable Bonds & Finance

Tim Buchholz
ESG Originator

David Marques Pereira
ESG Originator

Bianca Schneider
ESG Originator

Johannes Trautwein
ESG Originator

DZ BANK

Development Goals. Unfortunately, many targets will be set back by the new geopolitical situation, so even more capital will be required in the future.

The ongoing war in Ukraine is hence becoming increasingly a test for the SRI investor movement. It will inevitably lead to a reassessment of ESG investment approaches and sustainable portfolios as it not only reveals Europe's high energy dependence on Russia and shows how vulnerable the global food system is, but also raises the question of geopolitical sustainability. Therefore, it is not surprising that the first sustainability rating agencies have recently revised its ESG risk assessment methodologies and added new geopolitical criteria.

The war in Ukraine has renewed the question how sustainable and safe is invested capital in countries with autocratic governments? In the past, the "G" has always been a critical element for SRI investors. However, in the future a rethinking of ESG sovereign risk will take place and sovereign governance as well (geo)political risks will gain in importance. Because in the past, poor performance on the „G" was too often compensated for by good performance on the „E" and „S".

In principle, an investment in government bonds and an investment in a company based in or conducting business with authoritarian countries should be considered separately. But the boundaries are often not clear. Corporates operating in authoritarian states are typically more exposed to sustainability risks than others operating only in democracies. Examples include human rights, corruption and reputational risks. Irrespective of a moral evaluation, such ESG risks have a negative impact on a company's performance. Hence, there is the question how to treat companies that resume trading with Russia as going concern becomes a source of systemic risk. The last few weeks have shown that more and more SRI investors are now excluding Russian companies as well as issuers with significant ties to Russia.

In this context, SRI investors will also continue to gain greater visibility into supply chains. Where will goods and components come from? How strict should one be regarding social factors in the extraction and purchase of raw materials? Under what conditions, including political conditions, is production taking place?

In addition, there is no question that the disruption of global energy markets has caused SRI investors to rethink energy strategies. Does the pace of fossil fuel phase-out need to be adjusted until renewables, hydrogen and storage technologies can fill the gap reliably and affordably? Will nuclear energy and natural gas gain importance as bridging technologies? Without a doubt, in the end this new thinking should focus on renewable energy sources, energy infrastructure and sustainable technologies to support the transition away from traditional energy sources.

Finally, the war in Ukraine has also brought a controversial discussion in the ESG context back onto the front pages. How should the issue of security and defence be interpreted in a sustainability context? Is defence ESG-compliant? Is „Security the mother of all sustainability", as the Federation of the German Security and Defence Industries argues? How should SDG 16 („Peace, justice and strong institutions") be interpreted in this context? There is already a large pension fund that has surprisingly changed its investment policy to include even certain defence companies in selected ESG funds.

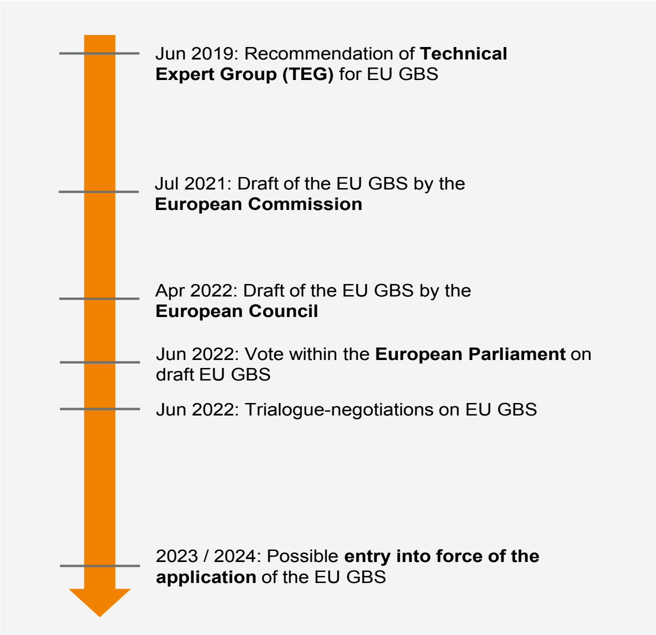
To sum it up: Although the conflict has revealed some flaws in ESG investing and shifted priorities, it is too early to say if it will lead to a total rethinking of ESG in the long-term. But one thing is certain: Mitigating and combating the economic, environmental and social consequences of such negative external shocks requires the help of the capital markets - and this must be done in a sustainable manner.

DZ BANK Spotlight:

European Green Bond Standard – Status Quo

After the European Commission already published its proposal for a European Green Bond Standard on July 12, 2021, both the European Council and the European Parliament have now published drafts for the standard within the last few months. Accordingly, the negotiations between the European institutions within the so-called trialogue have now begun, which are likely to prove difficult due to the partly very different positions of the participating parties. Although the drafts agree on the conformity of the use of proceeds with the EU Taxonomy and on increased transparency through publication obligations both before and after the issue of a European Green Bond, there are in some cases considerable differences in the more precise formulation. These must be overcome over the next few months to enable the standard to be applied within the next few years.

In this text, we look at a selection of the most important aspects of the European Green Bond Standard and highlight the different positions of the three parties in an overview.



Taxonomy conformity of the use of proceeds

The Commission's draft stipulates that 100% of the proceeds of the issue be used for activities that are already in compliance with the EU Taxonomy either at the time of the issue or within five or, in exceptional cases, up to ten years. The latter case will be described within a taxonomy adaptation plan. In contrast, the Parliament's draft explicitly still mentions, in addition to the activities compliant with the EU taxonomy, the issuing costs of the bond, for which the proceeds of the issue may be used. Again, activities can be funded that will take up to ten years to be in compliance with EU Taxonomy, which in turn will be described in a CapEx plan. Interestingly, the proposal provides for a list, to be established by the Commission, of activities that qualify for up to a ten-year extension of the taxonomy compliance to be achieved. The first part of the European Council's proposal is essentially the same as that of the Parliament, but without mention of issue costs and the list to be drawn up by the Commission. A key difference, however, is the ability to use up to 20% of the proceeds for activities that must comply with the „do-no-significant-harm" and "minimum safeguard" requirements, but not the „technical screening criteria". In cases where the issuer makes use of this, this shall be described accordingly in a transparent manner in the „factsheet". The topic of transition activities, on the other hand, is only explicitly addressed by the Parliament, which defines a transition period in which compliance with the Taxonomy requirements must be achieved, of a maximum of two years.

Grandfathering

Also with regard to how long, in the event of a change in the delegated acts, the requirements for sustainable activities prevailing at the time of issue may still be used for the European Green Bond, all three proposals differ, at least at first glance. The Commission's draft provides for a transitional period of 5 years during which an issuer may continue to apply the „old" delegated acts in force at the time of issuance for the use of the proceeds. Parliament defines this identically but adds the clarifying addition that funds already allocated do not have to be reallocated. However, there is an understanding that this was also the desired reading on the part of the Commission. The Council's version no longer provides for such a definition of grandfathering, thereby creating more certainty for the issuer in which the delegated acts applicable to a European Green Bond are those that existed at the time of issue. This is probably the most pragmatic and, at least for the issuers, the most desirable too because it is also the most stable solution.

Review of mandatory application

The Commission as well as the Council do not foresee a review of the European Green Bond Standard. In contrast, the Parliament's draft defines that the Commission should report to the Parliament and the Council two years after entry into force and every three years thereafter, based on an impact analysis, to what extent an application of the standard should become mandatory and what the time horizon of such an approach might be.

Disclosure requirements

In terms of disclosure requirements, one of the biggest differences between the three drafts is the scope of application. While the proposals of the Commission and the Council only provide for disclosure obligations for issuers of European Green Bonds, the draft of the Parliament defines reporting obligations for issuers of all types of environmentally Sustainable Bonds and Sustainability-Linked Bonds in order to make them as comparable as possible for investors. These issuers should disclose a whole range of information in this regard, such as a clear and reasoned explanation of how the bond takes into account the principal adverse impact (PAI) on sustainability factors, information on how the bond's environmental characteristics are met, or information on the proportion of expected Taxonomy-compliant use of proceeds. While the last point would help promote some granularity in the market, the first two requirements still need some clarification (e.g. to what extent PAIs need to be reported at the bond or issuer level).

Also with regard to the reporting for European Green Bonds, the draft of the Parliament provides for a decisive tightening for many issuers compared to the proposals of the Commission and the Council. While the Commission and the Council allow that a reporting on allocation and environmental impact can refer to a single as well as to several European Green Bonds (i.e. a portfolio solution), the Parliament requires that each European Green Bond has to be reported individually (bond-by-bond approach). By way of derogation, an allocation and environmental impact report of a portfolio of European Green Bonds to a portfolio of financial assets may refer to several European Green Bond issues.

Activities related to nuclear energy or fossil gases

With respect to the financing of activities related to nuclear energy and fossil gas, the Commission and the Council make no explicit comments. Only the Parliament provides for disclosure of the amount and proportion of proceeds earmarked for activities related to nuclear energy and fossil gas.

For more details, the three-column table to commence trialogue published by the Council of the European Union can be found under the following link: **https://data.consilium.europa.eu/doc/document/ST-9834-2022-INIT/en/pdf.** The EU Framework Directive is now subject to the EU's ordinary legislative procedure. When an agreement will be reached within the trialogue negotiations is naturally not clear. However, the application of the European Green Bond Standard is not expected to come into force before 2023. In any case, all drafts provide for entry into force of the Regulation on the 20th day after publication in the EU Official Journal.

Guest Commentary:

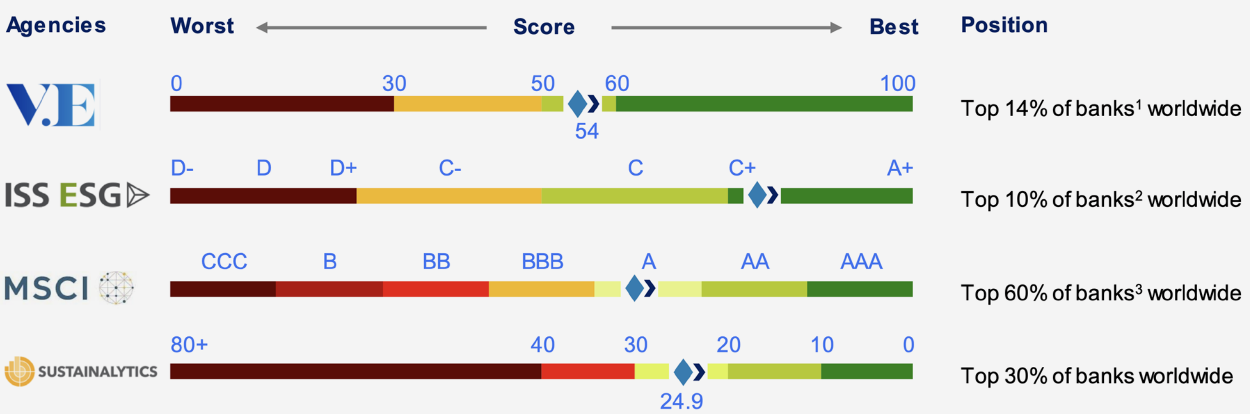
BayernLB – on the green track

Paul Weber
Group Treasury BayernLB

As part of its strategic realignment announced at the end of 2019, BayernLB decided to place an even greater focus on sustainable issues in its business activities. The objective is to evolve into a streamlined, specialised bank by 2024. It will consistently focus on sustainable, innovative sectors of the future, namely energy, mobility, technology, mechanical and plant engineering, construction and basic materials. As part of its realignment towards sustainability, BayernLB also developed a clear mission statement that allows it to benefit from new business potential, a stronger funding basis, improved portfolio quality and an enhanced corporate identity.

With regard to customers, BayernLB's Sustainable Lending Framework provides the guidance and parameters for its sustainable financing activities, which are aligned with the sustainability strategy from the outset. This makes BayernLB's range of sustainable credit finance products transparent, thereby serving also as a seal of quality. BayernLB's Sustainable Lending Framework is based on the Loan Market Association (LMA) guidelines, which are the standards commonly used on the international market for sustainable lending at present. In addition, every new loan is subject to a comprehensive sustainability assessment. Alongside exposure related to

BayernLB's current ESG ratings



As at: 18 February 2022
[1] Banks = Retail & specialised banks [2] Banks = Public & regional banks [3] Banks = MSCI ACWI Index constituents, banks

Source: BayernLB

Portfolios and impact at a glance

2.9 EURbn

The **renewable energy portfolio** consists of solar and wind projects across the globe with more than 200 EURm in net new volume in 2021

- 2,800 MW installed capacity
- 6.5m MWh energy production
- 1.6m t C02 avoided CO2 emissions

2.6 EURbn

In total, BayernLB has 2.6 EURbn sustainable financing instruments outstanding. As one of the first European Banks, BayernLB implemented a Green Commercial Paper program at the start of 2021.

- 2.0 EURbn outstanding Benchmark Green Bonds including two very successful Green T2 transactions as well as a Green Rail Covered Bond

1.6 EURbn

This year, BayernLB added its **rail portfolio consisting** of 100% electric rail projects for interurban passenger transport in Germany and Switzerland. All projects are aligned with the EU-Taxonomy according to ISS ESG SPO

- Aligned with the Climate Change Mitigation Criteria
- Aligned with the Do No Significant Harm Criteria
- Aligned with the Minimum Social Safeguards requirement

Source: BayernLB

environmental risk, the ESG impact is also examined, meaning the contribution of investments to achieving climate and sustainability goals. These criteria are based on the Bavarian Sustainability Strategy and the climate and environmental goals of the EU Taxonomy. Ultimately, this results in an ESG rating that allows for the preparation of detailed ESG reportings and lending management. For example, BayernLB's Treasury department offers attractive terms and conditions for sustainable projects.

On the liability side, the bank secures funding via sustainable debt instruments issued by all three units of the Group (DKB, BayernLabo and BayernLB). The latter published its first Sustainable Financing Framework for this purpose in 2020. At the heart of this Framework is a sustainable loan pool comprising the bank's most sustainable assets. Overall, around €4.5bn of such assets are currently included.

We started with worldwide funding of solar energy and wind power plants. At the beginning of this year, the pool was expanded to include financing for the electric train projects against the background of the update of the Sustainable Finance Framework. This included construction financings for train manufacturers and follow-up financings for the operation of the respective rail network. As an example, BayernLB financed the manufacturing of 18 KISS-type double-decker multiple units from the rail vehicle construction company Stadler for the Electronic Railroad Network Schleswig-Holstein East. From December 2022, 810 seats per connection will be available. Each day, around 24,000 passengers travel on the 175km route between Lübeck and Hamburg. Both renewable energy and electric rail transport are highly sustainable fields. In its current Second Party Opinion, the rating agency ISS ESG confirmed the alignment with the strict requirements of the EU Taxonomy for the bank's rail transport portfolio.

On this basis, BayernLB is very successful in issuing sustainable debt instruments with different formats. For ultra-short maturities, the bank was one of the first to launch its green commercial paper programme with a volume of up to €1bn. Alongside non-preferred senior (NPS) bonds for retail investors, an NPS benchmark bond and two subordinated benchmark bonds were very successfully issued.

At the end of June 2022, BayernLB successfully placed its first public sector Pfandbrief backed by its rail assets aligned with the EU Taxonomy. This once again demonstrated the appeal of Sustainable Bonds for investors. Despite a difficult environment due to great macroeconomic uncertainty and the resultant volatility and restraint on the primary market, the 10-year bond was successfully placed and very well received. However, at the same time, investors are now demanding much more from frameworks and reportings. The Framework will therefore no longer be viewed in isolation but in connection with group-wide ESG figures and goals, such as Scope-3-CO2 emissions, and in accordance with the sustainability strategy of the issuer. The recent proliferation of greenwashing controversies has led to investors having higher expectations of issuers with regard to the provision of relevant ESG figures. Issuers who do not meet this investor need should expect no orders from dedicated ESG investors, who might even sell outstanding bond issuances.

BayernLB will continue to be an active issuer of ESG debt instruments. Both its Sustainable Financing Framework and reporting will be developed on an ongoing basis to meet future requirements. This includes expanding the sustainable loan pool to add other relevant categories. As one of the largest real estate financiers in Germany, BayernLB will soon include financing of green building projects in its sustainable loan pool. This all falls under the bank's stated commitment to make a contribution in the transformation towards a sustainable economy.

DZ BANK Spotlight:

The EU Sustainability Reporting Directive – Current Status

Sustainable reporting for companies is currently mostly found under the unwieldy term „non-financial reporting". Since 2017, large and capital market-oriented companies have been subject to the obligation to publish this report in accordance with the Non-Financial Reporting Directive (NFRD). Currently, this includes approximately 11,000 companies in Europe that perform disclosures on non-financial topics using external frameworks such as the SASB standards or the Global Reporting Initiative. In doing so, they report on sustainability, social responsibility, compliance with human rights and diversity. For example in Germany, currently, there is only a check whether an NFRD report is available, but there is no examination of the report's content. Furthermore, the report can be published as part of the management report or separately.

What will now change under the new planned EU Directive on Sustainability Reporting, which was first presented as a draft in April 2021? The most important thing first: the name. To give sustainability the prominence it deserves, the Non-Financial Reporting Directive will become a Corporate Sustainability Reporting Directive, or CSRD. The plan was for this to be rolled out starting in 2025 for fiscal year 2024 and applicable to a larger number of companies before being extended again to smaller companies two years later. However, after several discussions and negotiations at EU level, the original plan was abandoned. Thus, the directive is expected to continue to be implemented in 2025, but then only for companies already subject to the NFRD. One year later, it will be extended to companies with more than 250 employees, a balance sheet total of more than EUR 20 million and sales greater than EUR 40 million – two of these three criteria must be met. This extends the reporting requirement to over 50,000 companies that account for more than 75% of total sales in the EU. For small and medium-sized enterprises (SMEs) that are stock market-oriented, the obligation will apply from the 2026 financial year. However, through the mandatory consideration of the entire supply chain, indirectly affected SMEs will have a transition period until 2028. In addition to reporting EU Taxonomy-eligible sales, operating and capital expenditures, there are other significant differences from current reporting. Companies must report from two perspectives. These are the outside-in perspective, which states which sustainability aspects represent opportunities and risks for the business model, and the inside-out perspective, i.e., which business activities have an influence on sustainability aspects. Furthermore, companies must disclose their materiality assessment processes, publish forward-looking information in addition to historical information, and address immaterial issues.

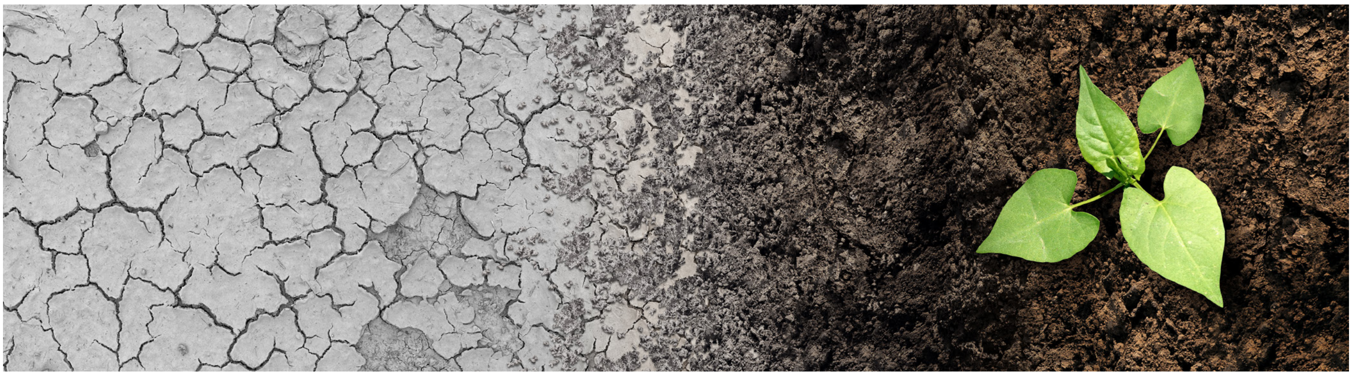
One innovation that will make it easier for smaller companies to implement their sustainability strategy in financial instruments is the mandatory external audit of the limited assurance report at launch. Whether the report will have to be audited with reasonable assurance in the future remains to be seen at this point in time. Furthermore, the report must be published both in the management report and in electronic and thus easily readable form. This will present many companies with logistical and resource-related challenges but should also be seen as an opportunity to take an in-depth look at their own positioning on the issue of sustainability and thus to review their business model for future viability.

What is the current status on implementation?

On 21 June 2022, the European Council and the European Parliament reached a political agreement on the new EU Directive. Therefore, on 30 June 2022, the text of the directive was published on the EU website. Once the agreement has been approved by the Council and Parliament and passed through the adoption procedure, the directive will enter into force on the twentieth day following its publication in the Official Journal of the European Union. As this is a directive, it must then be implemented into national legislation by the EU countries. However, the new directive will empower the European Commission to adopt reporting standards by means of delegated acts - similar to the EU Taxonomy. Overall, the directive is another part of the European Green Deal to encourage investment in sustainable activities and facilitate the transition to a sustainable economy. However, similar to the EU taxonomy, the effort will be enormous for many affected companies and financial institutions, especially at the beginning.

DZ BANK Events:

Save the date – DZ BANK Sustainability Day 2022



Time to network in person again! Make a note of our **DZ BANK Sustainability Day 2022 on 29 September 2022 in Frankfurt am Main.** Exchange views with other sustainable finance experts live on site about current trends and drivers in the sustainable capital market.

You can already register today via the following link:
https://sustainability-day.events.dzbank.de/