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FACTORING

Sustainability in the Financial Sector

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Sustainability in the Financial Sector

Insights from the factoring branch

For Germany, achieving climate neutrality means that billions of euros will have to be invested additionally in the next two decades. The financial sector is contributing to this transformation by providing the requisite financial resources. This piece sets out to define the so-called ESG criteria and outlines the work of the European Union towards increasing sustainability, a work leading to the creation of important markers for the fashioning of sustainable finance products while keeping an eye on prevailing regulatory provisions. (Ed.)

Sustainability is one of the major topics of our time. Germany is hoping to become climate neutral by the middle of the century. According to a study commissioned by the German Reconstruction Loan corporation (Kreditanstalt für Wiederaufbau (KfW)) “Green Finance's contribution to achieving climate neutrality in Germany”, investments in climate protection will have amounted to five trillion (million million) euros by 2050. Given the recently given closer date of 2045, increased investments of annually 72 billion euros are to be anticipated.1) A recently published study by McKinsey arrives at a still higher total figure of six trillion euros.2)


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The resulting investment requirements are especially high in certain industries. The energy intensive raw material sectors (gas, steel, chemicals) in particular face considerable challenges in switching to more climate friendly production technologies. Investments in more energy-efficient process and building technology are expected from the commercial, retail and service sectors especially. Given that both public and private investments are necessary to cover the cost of such transformation, the financial sector has a significant role to play in meeting the financial requirements arising from such investments.[3]

The process of transforming the German national economy also encompasses the changed requirements arising from digitalization and globalization. Every business affected will have to make massive investments in the years to come to ensure that production procedures and business models are fit for the future, and to take advantage of the opportunities which sustainable development offers. The financial sector, including the factoring branch, has a decisive role to play here, providing the necessary funding to make such demanding transformation efforts work.

To be clear: we are talking about "sustainable finance" whenever an institution involved in financial decision making takes ESG into account: Environment (E), Social(S), Governance(G).

The meaning of sustainable finance

The abbreviation ESG refers to the three column model of sustainable development and has established itself in the money market as the standard for assessing sustainable assets. According to the Climate Bonds Initiative, the global market in so-called green bonds amounted in 2020 to 269.5 billion (thousand million) dollars. A firm is deemed to be sustainable under the ESG model when it prioritizes economic, environmental and social aims in equal measure. The three letters E,S and G stand for the three focal points of responsibility around sustainability:

„E“ stands for Environment. This includes activities aimed at reducing or at least stabilizing the volume of greenhouse gases in the atmosphere.

„S“ stands for Social. This includes for example maintaining and enforcing recognized legal labor standards.4) In addition to labor norms, social aspects include the safeguarding of human rights and health and safety related issues. 5)

„G“ stands for Governance, that is to say, the way a business is managed. The safeguarding of employees' rights or measures to prevent corruption are cases in point.

A useful outline of the aspects included here is provided by the United Nations 17 Sustainable Development Goals.

The EU Commission has also turned its attention to ESG factors. In view of the goals of the Green Deal, a plan of action for sustainable financing has been put forward, one which includes the expectation that the financial sector incorporate ESG factors both into business strategy and into risk assessment.

The European Taxonomy for Sustainable Activities fits into this scheme too, among other things by linking investment activity to the goals of the Paris Climate Agreement (1.5°C./2.7°F.) Based on this, an economic activity is expected to contribute significantly to at least one of the named environmental goals without thereby causing notable damage to another (Do No Significant Harm – DNSH) while at the same time guaranteeing a given minimum level of social responsibility. Along with ESG ratings and ESG certifications, any experience and knowledge gained from reports on annual financial statements and sustainability as well as information gleaned from dialogues with customers and insights gained from press coverage are all aspects which need to be considered when conducting a proper due diligence testing.6).

The taxonomy is complex. It is nevertheless the first step, and an important one, towards more market standardization and is a benchmark in the creation of sustainable finance products. Furthermore, it enables factoring financing to be classified in terms of ESG criteria, such transparency showing customers which economic activities can be classified as sustainable.

The first factoring companies are already offering products to support customers in their efforts to transform. In a three cornered relationship between the three parties involved: factoring company, customer and debtor, the ESG classification is no easy matter, so the relevant products are mostly so-called ESG linked factoring products.

Example of the Application of an ESG linked product

In order to offer customers the kind of support already mentioned, PB Factoring GmbH, the factoring branch of the Deutsche Bank, offers for example the ESG-linked product called Sustainability Factoring.

The sustainability related structure of the factoring product in question is linked to specific sustainability goals, so-called sustainability performance targets, key performance indicators (KPI) in this case. The underlying KPI's thus link the most important branch-specific ESG challenges which the customer is facing, such as for example moving over to a less CO_2 intensive business model. The KPI's are regularly monitored and reported on (preferably by qualified third-party suppliers) and if the KPI's are sufficiently demanding, this can influence the pricing model.

Trained ESG experts are on hand from the supplier to provide the concrete structuring of such KPI's. There may be an agreement to achieve an ESG qualified rating issued by a rating agency and to reach one of the reduction targets for CO_2 emissions, ideally as the result of relevant initiatives undertaken by the customer. Examples include measures to raise the efficiency of the manufacturing plant or replacing the car fleet with vehicles with an alternative engine. There is considerable interest in this product because it addresses the customer's sustainability agenda and makes a contribution to the move to more sustainable business model.

Sustainable financial transactions can be a good starting point for the customer to build up a resilient reporting system in terms of sustainability. The EU Commission draft of February 2022 has found its way into the most recent regulatory developments, aiming at an EU wide supply chain directive (Corporate Sustainability Due Diligence) which examines major businesses with a view to the sustainability aspects of their operations.

Since many regulatory and entrepreneurial efforts are aimed at activating effective capital allocation linked to reliable risk management,7) processes developed around such product innovations can also play a role in including ESG factors in risk assessment. They can for instance assist in the application of regulatory requirements in dealing with sustainability risks.

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Sustainability Risks

In addition to their role in making the necessary means available for efforts on the part of customers to transform their businesses, institutions have to take regulatory requirements into account, especially those which address the risk aspects of sustainability.

Colony of honey bee leased from PB Factoring GmbH.

Contribution to Climate Neutrality

Sustainability begins at home, so PB Factoring GmbH has set itself the target of becoming more environmentally aware in its consumption of resources and of becoming climate neutral. In-house processes have been digitalized to save paper on a long term basis and initiatives have been introduced to compensate for unavoidable waste. The company also supports sustainability projects on a regular basis. Its most recent project is a commitment to the maintenance of an aviary which it leases, an action intended to be part of efforts to do something to counter the constant decline in honey bee numbers.

Germany's Federal Financial Supervisory Authority (BaFin, Die Bundesanstalt für Finanzdienstleistungsaufsicht) recently announced that it would be raising the issue of the appropriate approach to sustainability risks in supervisory discussions more often, and also in the future in the course of both on-site inspections and the supervisory review and evaluation process.8)

In its Guidance Notice on Dealing with Sustainability Risks, BaFin highlights the risks arising from environmental, social or managerial fields which have a real or potentially negative effect on the financial performance, position and cash flows and even the very reputation of a company under supervision were they to materialize. Such risks may include physical risks, which may arise in the form of a single extreme weather event and its aftermath or from long term changes in climate and environmental conditions, or they may be transitory risks, which are associated among other things with the transfer to a low carbon economy.9)
Further concretizations and the most recent developments in the matter of sustainability are to be addressed in the pending seventh version of the minimum requirements for risk management (MaRisk) including the Guidelines on Climate Related and Environmental Risks that was published by the European Central Bank at the end of 2020.

In view of the fact that regulatory requirements on the whole may be expected to increase, institutions will need to integrate more ESG aspects into their organizational and management procedures, and that includes internal control systems.10)

Since these kinds of risk could affect the business relationships of the sellers of receivables and their debtors, institutions are well advised to familiarize themselves with ESG aspects when evaluating risks. This could mean for example that natural catastrophes lead to the sellers of receivables and their debtors being given a lower rating while at the same time the physical losses are negatively affecting their balance sheets. The methods contained in the sustainable finance framework set up in an institution can be useful here and the construction of a risk classification can be the starting point for the the sustainability evaluation of vendors in the outsourcing process.

Setting the Course for the Future

Along with competency development, various measures are necessary to achieve a proper approach to sustainability risks. These include changes in strategies, duties, methods and operating processes, the concept of stress tests or their adaptation, taking sustainability risks seriously in in-house risk inventories and ICAAP processes and the further development of reporting with due regard for considerations of proportionality. The intended norm should be overseeing which areas harbour major ESG risks and whether guiding principles should be introduced, meaning for example an adjustment of the willingness to run risks or limitations imposed to confine them.11)

Many steps will have to be taken before climate neutrality and a sustainable future has been reached. Overall large transformative efforts and massive investments and the requisite means for that will make it possible to contribute to a sustainable world. According to the concluding report of the Sustainable Finance Advisory Council (Sustainable-Finance-Beirat) of the German government, the aim is to make Germany a leading leading sustainable finance location.12) The study first commissioned by the KfB (Reconstruction Loan Corporation) is encouraging the financial sector to develop green products and to establish Germany as a location for green finance.13) With its first ESG linked factoring products now on the market, the factoring industry is contributing to this trend.

Given the decarbonization targets, the supervisory lines of conduct, responsible behavior in business and the dangers of ESG risks, it is important to continue to deal intensely with all these issues and so put ourselves on the right course for the future.

1) KfW, 2021, 5 Bio. EUR klimafreundlich investieren – eine leistbare Herausforderung, (Climate friendly investing, an achievable challenge) Research Report Nr. 350.
2) Vgl. McKinsey, 2021, Net-Zero Deutschland – Chancen und Herausforderungen auf dem Weg zur Klimaneutralität (Net Zero Germany -Chances and Challenges on the way to Climate Neutrality) 2045.
3) KfW, 2021, 5 Bio. EUR klimafreundlich investieren – eine leistbare Herausforderung, Research Bericht Nr. 350 (5 trillion euro climate friendly investments an achievable challenge, Research Report Nr. 350)
4) Vgl. ILO-Kernarbeitsnormen bzw. UN-Leitprinzipien für Wirtschaft und Menschenrechte. (cf. ILO core labor standards and UN guiding principles for the economy and human rights)
5) Vgl. UNEP Inquiry 2016, S. 10. (cf. UNEP inquiry 2016, p.10)
6) Vgl. Europäische Zentralbank, 2020, Leitfaden zu Klima- und Umweltrisiken – Erwartungen der Aufsicht in Bezug auf Risikomanagement und Of- fenlegungen, S. 29. (cf European Central Bank 2020 Guide on climate related and environmental risks-Supervisory Expectations in relation to risk management and disclosures p.29)
7) Vgl. Sustainable Finance Beirat der Bundesregierung, 2021, Shifting the Trillions – Ein nachhaltiges Finanzsystem für die Große Transformation, S. 2–4. (cf. Advisory Body to the German government on sustainable finance 2021, Shifting the trillions: a sustainable financial system for the great transformation. pp 2-4)
8) Vgl. BaFin, 2021, Der deutsche Finanzsektor und die Nachhaltigkeitsrisiken: Eine Sachstandserhebung durch die BaFin, S. 24. (cf BaFin 2021, The German Financial Sector and Risks of Sustainability: a survey of the current situation by the BaFin, p.24).
9) Vgl. BaFin, 2019, Merkblatt zum Umgang mit Nachhaltigkeitsrisiken. (cf. BaFin 2019, Guidance Notice on dealing with Sustainability Risks)
10) Vgl. Institut der Wirtschaftsprüfer in Deutschland e. V., 2020, Positionspapier – Sustainable Finance als Teil der nachhaltigen Transformation, S. 7. (cf German Institute of Registered Auditors 2020. Position Paper Sustainable Finance as part of sustainable transformation, p.7)
11) Ibid. p.3
12) Vgl. Sustainable Finance Beirat der Bundesregierung, 2021, Shifting the Trillions – Ein nachhaltiges Finanzsystem für die Große Transformation.(cf. Sustainable Finance-Federal Advisory Commission, 2021 Shifting the trillions-a sustainable financial system for the great transformation.)
13) Vgl. Prognos/Nextra/NKI, 2021, Beitrag von Green Finance zum Erreichen von Klimaneutralität in Deutschland, Studie im Auftrag der KfW, S. 161. (cf. Sustainable Finance. (cf. Prognos/Nextra/NKI, 2021 contribution of green finance towards reaching climate neutrality in Germany. Study commissioned by the Reconstruction Loan Corporation, p.161)

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