

FIDUCIARY DUTY IN THE 21ST CENTURY

GERMANY ROADMAP

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This roadmap is prepared by the PRI, UNEP FI and The Generation Foundation and does not necessarily represent the views of interviewees and reviewers.

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GERMANY ROADMAP

THE PROJECT

[Fiduciary duty in the 21st century](#) concluded that failing to consider long-term investment value drivers, including environmental, social and governance (ESG) issues, in investment practice is a failure of fiduciary duty.¹ Despite significant progress, many institutional investors have yet to fully integrate ESG issues into their investment decision-making processes.

In January 2016, the PRI, UNEP FI and The Generation Foundation launched a three-year project to implement the report's recommendations, including the preparation of [country roadmaps](#). The roadmaps enable the PRI and UNEP FI to work with national

stakeholders to implement clear and accountable policy and practice that embrace the modern interpretation of fiduciary duty.

This roadmap was developed through industry consultation and sets out recommendations to ensure that the modern interpretation of fiduciary duty is adopted by German investors. It also presents German capital markets in a broader international context, as regulators and investors respond to a rapidly changing investment landscape. In particular, many of the concepts relevant to this project are subject to regulatory attention from the European Union.

¹ In common with other civil law jurisdictions, the exact term *fiduciary duty* is not used in German law. However, the term is well understood and equivalent obligations are set out in various statutory instruments.

SUMMARY RECOMMENDATIONS

To encourage full integration of ESG issues across German capital markets, we have made recommendations based on four priority themes:

1. Government leadership

The Federal Government should send strong signals on the importance of sustainable finance, including:

- a. Germany's financial regulator, BaFin, and the Federal Ministry of Finance should clarify that investors and other organisations in the investment system must take account of ESG issues in their investment processes and decision-making, encourage high standards of ESG performance in the companies or other entities in which they are invested, and support the stability and resilience of the financial system.

Government-related funds should also demonstrate leadership:

- b. The Federal and Länder civil service schemes should publicly commit to responsible investment and publish details of their approach.
- c. Given the importance of Germany's banking system for inter-bank and inter-company financing, commitments to responsible investment should also extend to state-owned Landesbanken.

2. Institutional investors

- a. **Legal clarity and consistency:** The Prudent Person Principle embedded in the Pension Insurance Act (Versicherungsaufsichtsrecht – VAG) will be amended as part of the transposition of the revised EU Institutions for Occupational Retirement Provision (IORP II) Directive. As part of this transposition, the Ministry of Finance should propose to amend the Pension Insurance Act to clarify that all institutional investors should consider financially material ESG issues.
- b. **Preparation for upcoming EU Directives:** Tools, education and best practice case studies should be provided to German IORPs (Pensionfonds, Pensionkassen) to help them prepare for the ESG aspects of the IORP II and Shareholder Rights Directive (and, if relevant, the CSR Directive). Interviewees indicated a preference for this to be developed by BaFin in collaboration with industry associations.

Occupational pension fund reform:

- c. New defined contribution (DC) schemes should publicly commit to responsible investment and ensure that ESG risks are considered as part of investment decision-making across all funds.
- d. Such schemes should also consider, and respond to, the ethical preferences of their members. This should not be confused with the management of financially material ESG risk.

3. Fund managers

- a. BaFin should issue guidance to fund managers clarifying that the Capital Investment Code (Kapitalanlagegesetzbuch – KAGB) requires consideration of material ESG issues.
- b. The impact of this guidance should be monitored: If this is not successful in encouraging widespread adoption of ESG, the Federal Ministry of Finance should propose to amend the Capital Investment Code.

4. Implementation of the CSR Directive (covering institutional investors and fund managers)

- a. The German Federal Ministry of Justice and Consumer Affairs (BMJV) should issue guidance to public interest entities complying with the new requirements, including that:
 - i. For financials, investments are in scope for their reporting. Where possible, this should be aligned with upcoming reporting requirements under the IORP II and Shareholder Rights Directives.
 - ii. For non-financial corporates, investments such as pension schemes and contractual trust agreements are in scope for reporting.
- b. The German Parliament should monitor the implementation of amendments to the Handelsgesetzbuch (commercial law code) to: Ensure high-quality disclosure of ESG factors with clear links between ESG factors; a company's business model and risk factors; and to allow for investor comparability by industry, portfolio and across time-series.

FIDUCIARY DUTY IN GERMANY

CONTEXT FOR ESG

Many industry experts involved in this study indicated that while some investors actively pursue ESG integration, the practice in Germany is on average less advanced than neighbouring France, the Netherlands, the UK and Scandinavia. However, it was also noted that Germany's financial system and investment culture is in many ways different from its peers.

Germany's financial culture is often characterised as a "savings" rather than "investment" culture, with a preference for stability and security². Correspondingly, German investors hold relatively little equity compared to their European counterparts³. Progress is being made across all asset classes, but responsible investment techniques are most widespread and sophisticated in listed equity.

ESG integration is often pursued as a way to enhance investment returns or mitigate risks, while some interviewees felt that the investment case for ESG in fixed income was less advanced. By contrast, some industry studies are encouraged by current levels of ESG integration in this field⁴.

Indeed, industry initiatives related to ESG issues have become more prevalent, with a recent survey from Union Investment identifying a significant increase in the adoption of sustainable finance strategies. Forum Nachhaltige Geldanlagen (FNG) – the German, Austrian and Swiss Sustainable Investment Forum – now has over 170 members from the banking, fund management and NGO sectors. Meanwhile, the Society of Investment Professionals (DVFA) now runs training courses on ESG integration and this year a coalition of investors launched the Frankfurt Declaration⁵, a commitment to collaborate on the development of Frankfurt as a sustainable finance hub.

2 This may be due in part to the fact that life insurance companies as well as many Pensionskassen are subject to the Solvency I or II regime, which require significant equity capital coverage for risky assets.

3 Figures provided by GDV indicate that, on average, 4.4% of an insurer's portfolio is equity, while estimates from the IBA suggest that Pensionskassen, on average, hold less than 10% of their assets in equity.

4 ESG & Corporate Financial Performance: Mapping the global landscape (2015). [institutional.deutscheam.com/content/media/K15090_Academic_Insights_UK_EMEA_RZ_Online_151201_Final_\(2\).pdf](https://www.institutional.deutscheam.com/content/media/K15090_Academic_Insights_UK_EMEA_RZ_Online_151201_Final_(2).pdf)

5 [deutsche-boerse.com/blob/3031308/6d8e47815720a97c638b9f2906922e0b/data/Frankfurt_Declaration-1.pdf](https://www.deutsche-boerse.com/blob/3031308/6d8e47815720a97c638b9f2906922e0b/data/Frankfurt_Declaration-1.pdf)

GOVERNMENT ACTION ON ESG

The Federal Government has taken several actions:

- The Federal Ministry of Finance (Bundesministerium der Finanzen – BMF) has published the results of an analysis on financial stability risks relating to climate change⁶.
- The Federal Government's advisory body, the High Tech Forum, has published an FNG report on ways to enhance sustainable capital flows⁷, which has also been a reference for this roadmap.
- The German Council for Sustainable Development, an advisory body to the Federal Government, released a discussion paper to help form consensus around a new German hub for sustainable finance⁸.

These are supported by international developments:

- The G20's Green Finance Study Group made a number of policy recommendations in its [synthesis report](#). The study group will continue under the German presidency.
- [The Financial Stability Board's Taskforce on Climate-related Disclosures](#) has compiled an initial set of recommendations for consistent and comparable climate risk disclosure.
- In addition to reforms embedded in several directives, the EU has established a [High Level Expert Group on sustainable finance](#), which includes DEKA Investment. This group will recommend policy options for the EU to promote sustainable finance.

6 See full report: shar.es/1RhMBR and associated news reports: www.bundesfinanzministerium.de/Content/EN/Standardartikel/Topics/Financial_markets/Articles/2016-09-19-Climate-change-and-financial-markets.html

7 www.hightech-forum.de/fileadmin/Bilder/Publikationen/green_economy_kurzanalyse.pdf

8 www.nachhaltigkeitsrat.de/fileadmin/user_upload/dokumente/beitraege/2017/20170315_Living_document_RNE_Green_Finance_EN.pdf

RECOMMENDATIONS

A common theme in interviews was that Germany's finance industry is compliance-oriented. Investors will seek to comply fully with regulation, but are unlikely to go beyond it. Many of the recommendations therefore focus on regulation and policy.

1. GOVERNMENT LEADERSHIP

STRONG POLICY SIGNALS

The G20 Green Finance Study Group concluded that country authorities should provide clear strategic signals to investors. Such signals would build confidence, conviction and ultimately help to drive assets towards more sustainable outcomes. The PRI's 2016 [Global guide to responsible investment regulation](#) reinforces the need for this, noting that investors globally often question government commitment to ESG, which in turn undermines their progress.

Throughout the interview process, respondents agreed that strong signals on the importance of sustainable finance were essential. Respondents also noted that Germany's 2017 presidency of the G20 is an opportunity to take a leadership position.

The PRI has also asked governments to endorse the FSB Taskforce on Climate-related Financial Disclosures.

Next steps

- a. Germany's financial regulator BaFin and the Federal Ministry of Finance should clarify that investors and other organisations must consider ESG issues in their investment decision-making processes, as well as encourage high standards of ESG performance in the companies or other entities in which they are invested, and support the stability and resilience of the financial system.

Leadership from Pillar 1 Funds

Both the Federal Government and Federal State (Länder) have funds to fulfil their liabilities regarding civil servants' pensions. Many interviewees also noted considerable interest in ESG issues at the Federal State level and in local government. Examples include responsible investment embedded in coalition agreements and divestment campaigns, such as the Federal State of Berlin and cities like Stuttgart and Münster.

Research from UNEP FI and the PRI finds that large government funds can have a transformative effect on market practice⁹. By adopting ESG integration approaches, they therefore send a strong signal of government support. They can also share techniques and tools to help educate and inform other investors.

ESG issues were debated during the revision of the Pension Provision Act (Versorgungsrücklagengesetz – VersRücklG), but were not mentioned in the final draft. The law came into force on 1 January 2017.

Next steps

- a. The Federal and Länder civil service schemes should publicly commit to responsible investment and publish details of their approach.
- b. Given the importance of Germany's banking system for inter-bank and inter-company financing, commitments to responsible investment should also extend to state-owned Landesbanken.

⁹ See the PRI's Global Guide to Responsible Investment (2016) and Investor Obligations and Duties in six Asian markets (2016).

2. INSTITUTIONAL INVESTORS

OCCUPATIONAL PENSION SCHEMES

Occupational pension schemes, which have been the focus of much of the PRI's and UNEP FI's work on fiduciary duty, are comparatively small in Germany¹⁰. They are voluntary to offer and participate in. Industry estimates suggest occupational pensions represent 13% of Germany's GDP (with half of these schemes funded through book reserves), compared to 112% in the UK and 184% in the Netherlands¹¹.

At the heart of the existing system is the pension promise, which in Germany currently takes the form of a defined benefit or hybrid scheme. Employers may choose from five possible vehicles to help fund the promise. German pension funds do not have trustees¹² – the relationship between the employer and employee is governed by labour law. As such, there is little incentive for an employee to engage with how pension assets are invested, though social partners and employee representatives on supervisory boards (Aufsichtsräte) can theoretically influence ESG strategies.

Of the five current legal structures available to employers, two – Pensionkasse and Pensionfonds – are designated “institutions for occupational retirement provision” (IORPs), meaning they are subject to EU occupational pension legislation and to supervision by BaFin. As of 2015, there were 171 IORPs registered in Germany.

Some German pension schemes have demonstrated considerable leadership on ESG issues. However, they remain in the minority. Key barriers include scepticism of the value of ESG factors in investment decision-making, conceptual blurring between ESG and ethical issues¹³, and practical challenges including resourcing, skills, capacity and process.

Insurers

Most large insurers have made statements of commitment to ESG issues to the PRI and the Principles for Sustainable Insurance (PSI)¹⁴, though challenges related to implementing ESG considerations across large, complex organisations remain. Collaboration between large insurers is almost entirely prevented by fear of breaching anti-trust/acting in concert rules. However, collaboration can reduce costs and make engagement more effective – particularly for smaller funds. Interviewees indicated that smaller insurers have engaged less on the topic, struggling with capacity.

In March 2015, the insurance association GDV produced non-binding notes on sustainable investment for their members. This sets out possible actions for incorporating ESG factors into its investment criteria¹⁵.

Legal framework

Considering ESG issues is permitted by the German legal framework for regulated occupational pension funds and insurers. However, there is no explicit requirement to do so, and many investors choose not to. Altersvorsorgezertifizierungsgesetz AltZertG § 7a and Versicherungsaufsichtsgesetz VAG § 144 require basic and occupational retirement provisions to include information (before signing and then on an annual basis) about whether and how ethical, social and environmental concerns are addressed in pension fund management.

Fiduciary duties on regulated occupational pension funds and insurers are set by [section 124 of the Pension Insurance Act \(Versicherungsaufsichtsgesetz – VAG\)](#) – including the duty to invest according to the Prudent Person Principle¹⁶ – to maximise security and investment profitability, and promote liquidity and diversification. Pension providers are also required to disclose to pension beneficiaries details on how ESG issues are considered.

10 The state pension, which operates on a pay as you go basis, provides benefits to the majority of workers (though some occupations – notably civil servants – have separate pillar 1 pension arrangements).

11 Source: www.willistowerswatson.com/en/insights/2016/02/global-pensions-asset-study-2016

12 The function “Treuhandler” is sometimes translated as “Trustee” but is different, relating to securing guarantee assets for use in cases of insolvency.

13 Responsible investment techniques in Germany first developed in faith-based investing. As such, there is still a widespread misconception that ESG integration is the same as ethical investment.

14 Launched at the 2012 UN Conference on Sustainable Development, the UNEP FI Principles for Sustainable Insurance (PSI) serve as a global framework for the insurance industry to address environmental, social and governance risks and opportunities.

15 www.gdv.de/2015/03/gdv-veroeffentlicht-hinweise-zu-nachhaltigen-kapitalanlagen/

16 See Article 132 of the Solvency II Directive: “Insurers shall only invest in assets whose risks they can properly identify, measure, monitor, manage, control and report, and appropriately take into account in the assessment of their overall solvency needs.”

Forthcoming EU Directives

German financial regulation is substantially influenced by EU Directives and regulation. In addition to the recently transposed CSR Directive, other directives discuss ESG issues in more depth and are due to be incorporated into German law within the next two years, and therefore subject to BaFin oversight.

With the transposition of the revised EU Directive for [Institutions for Occupational Retirement Provision \(IORP II\)](#) into German law, IORPs will be required to publish their position on ESG issues in their Statement of Investment Policy Principles, and consider them in their own risk assessment as well as in their governance structure. The directive entered the official journal of the EU in December 2016. The revised IORP II Directive further clarifies that the Prudent Person Principle does not preclude funds from considering the impact of their investments on ESG issues.

With the transposition of the [EU Shareholder Rights Directive](#), institutional investors (insurers and IORPs) will be required to create an engagement policy. Institutional investors will also be required to disclose how the main components of their equity strategies align with their long-term liabilities.

The level of ESG awareness among German pension funds suggests that complying with the new requirements – under IORP and SRD II – will be a challenge.

Next steps

- a. **Legal clarity and consistency:** The Prudent Person Principle embedded in the Pension Insurance Act (Versicherungsaufsichtsrecht – VAG) will be amended as part of the transposition of the IORP Directive. The Ministry of Finance should propose to amend the Pension Insurance Act to clarify that all institutional investors should consider financially material ESG issues. This will:
 - i. Remove ambiguity in the wording around ESG and better align with global equivalents.
 - ii. Clarify that pension funds are obliged to take material ESG factors into account when making investment decisions.
- b. **Preparation for upcoming EU Directives:** Tools, education and best practice case studies should be provided for German IORPs (Pensionfonds, Pensionkassen) to help them prepare for the ESG aspects of the IORP II and Shareholder Rights Directive (and, if relevant, the CSR Directive). Interviewees indicated a preference for this to be developed by BaFin in collaboration with industry associations.

Occupational pension reform

To date, all German occupational pension payments have been guaranteed to employees by their employer. Proposals have now reached tentative agreement on a proposed law to reform occupational pensions (Betriebsrentenstärkungsgesetz). This law will allow the first pure DC occupational pension schemes, when agreed on by the employer and trade unions. These reforms will apply only to new pension promises. The current draft law does not mention ESG issues.

DC schemes shift investment risk – and opportunity – to employees. A full consideration of ESG issues is therefore in their best interest. Several jurisdictions outside of Germany have bolstered their governance efforts to help ensure value for money, good risk management and transparency for employees in DC schemes¹⁷.

Some interviewees also noted that German citizens have a strong preference for environmentally sustainable activity and more sustainable investments. Some interviewees noted that the previous system left little incentive for an employee to engage with how their pension assets are invested. These reforms have the potential to positively alter the relationship between employees and their occupational pension, with greater engagement in the types of assets into which their pension is invested, for example.

Next steps

- a. New DC schemes should publicly commit to responsible investment and ensure that ESG risks are considered as part of investment decision-making across all funds.
- b. Such schemes should also consider, and respond to, the ethical preferences of their members. This should not be confused with the management of financially material ESG risk.

The PRI and UNEP FI, in collaboration with other stakeholders, will continue to engage on this topic and share international examples of best practice for the DC sector.

17 Examples include the EU's revised IORP Directive, which had explicit aims of enhancing pension fund governance and transparency, and recent UK reforms on establishing independent governance committees for defined contribution scheme providers, tasked with ensuring product suitability and controlling fees.

3. FUND MANAGERS

Market practice continues to evolve to reflect a more modern understanding of the relationship between ESG issues and fiduciary duty. The German Investment Funds Association ([BVI Rules of Conduct](#)), which came into force in January 2017, contain a principle on good corporate citizenship. This further clarifies that financially material ESG issues should be considered to ensure an investor fulfils their fiduciary duty, and that fund managers should exercise shareholder rights where it is considered in the best interests of the end investor to do so. The rules of conduct are “comply or explain”.

Germany’s mutual fund market is dominated by the largest five fund managers, representing 94% of assets¹⁸. All of the large fund managers have at least some resources dedicated to ESG factors. Still, ESG-related practice continues to evolve, with some interviewees sensing that domestic client demand for ESG strategies is weak, but increasing nonetheless. Internationally, Article 173 of the French Energy Transition Law¹⁹ has spurred demand from French clients.

Duties of loyalty and prudence are codified in conduct rules for fund managers in [Section 26 of the Capital Investment Code](#) (Kapitalanlagegesetzbuch – KAGB). These include a duty to act honestly, in the best interests of investors and to support market integrity. As with institutional investors, the rules require financially material issues – including ESG factors – to be considered. However, the rules are not explicit on this point, and, consequently, many fund managers may not consider ESG risks systematically.

Two forthcoming EU initiatives will influence the regulatory framework for fund managers:

- In addition to requirements on engagement and voting, the Shareholder Rights Directive will require that fund managers disclose to clients how the main components of their equity strategies align with the client’s long-term liabilities.
- The Packaged Retail Insurance and Investment Products (PRIIPs) regulation includes a requirement to disclose any environmental and social objectives a fund holds within a Key Information Document.

Next steps

- a. BaFin should issue guidance to fund managers clarifying that the Capital Investment Code (Kapitalanlagegesetzbuch – KAGB) requires consideration of material ESG issues.
- b. The impact of this guidance should be monitored; if unsuccessful, the Federal Ministry of Finance should propose to amend the Capital Investment Code.

Fund manager engagement and voting

The revised [EU Shareholder Rights Directive](#) will require fund managers to establish an engagement policy, or provide a clear explanation for why they have chosen not to. However, existing regulation and market practice in Germany means that most managers will be well prepared for these requirements, assuming they are implemented in a way that is consistent with existing law. Fund managers are already required to create an engagement policy²⁰ and casting proxy votes is widely understood to be part of a fund manager’s fiduciary duty. The BVI rules of conduct also indicates that fund managers should undertake engagement and voting.

However, two issues remain:

- Cross-border voting remains complicated and, in some cases, expensive. As part of the Shareholder Rights Directive, the European Commission will work to improve vote transmission across the EU. The PRI has previously engaged the EU on the importance of this work and will continue to do so.
- Despite guidance issued by the European Securities and Markets Authority (ESMA)²¹ in 2014, many German investors remain concerned about possible legal consequences in relation to anti-trust/acting in concert in collaborative engagements. This prevents collaboration between investors on company engagement in relation to ESG issues. The concern remains because of strict requirements to notify BaFin of voting rights, with substantial penalties if these are not filed correctly. Furthermore, the ESMA guidance is not considered binding on member state competent authorities.

18 See Fig 51: www.efama.org/SitePages/homepublications.aspx

19 A briefing from the PRI can be found here: www.unpri.org/download_report/14573

20 See Art. 37 AIFM-Regulation 231/2013 also in connection with Section 3 Kapitalanlage-Verhaltens- und Organisationsverordnung – KAVerOV.

21 This guidance established a “white list” of permitted activities, including entering into discussions with other shareholders about matters to raise with the company’s board, and making representations to company boards around company policies, practices or actions: www.esma.europa.eu/sites/default/files/library/2015/11/2014-677.pdf.

4. GUIDANCE TO INVESTORS COMPLYING WITH THE CSR DIRECTIVE

This review focusses on capital markets – a challenge for Germany because it is dominated by non-listed, often family-owned companies (some 3.4 million, compared to just 711 companies listed on Deutsche Börse as of July 2014)²². Financing is mainly provided by banks rather than sought through capital markets.

Shareholder engagement and corporate governance

Shareholder dialogue has been a topic of considerable debate in recent time. In 2016, the [Developing Shareholder Communication initiative](#), led by Hermes and EY, produced guiding principles for dialogue between investors and supervisory boards. This document recognises a trend towards more active shareholder engagement and defines principles to enhance communication, transparency and trust – without undermining entrepreneurial freedom.

The findings were reflected in the 2017 update of the [German Corporate Governance Code](#). The preamble to the code now states that institutional investors should exercise their ownership rights “actively and responsibly” and in accordance with transparent principles that also respect the concept of sustainability. It also contains a provision that the chair of the supervisory board be prepared to engage with shareholders on issues directly related to the supervisory board’s remit.

The code also uses the term “honourable businessperson” (“Ehrbarer Kaufmann”), and the updated code notes that this is to reflect the fact that good governance is defined by legal, ethical and self-responsible conduct.

Interviewees noted that many corporates, including much of Germany’s DAX index, have adopted the UN Global Compact Principles, or made similar commitments. However, few apply these principles to their pension funds.

Non-financial reporting

Since 2013, listed companies are required to comply with Deutsche Börse’s guidelines on sustainability communication²³.

In early 2017, the German Parliament finalised amendments to the Commercial Code/Handelsgesetzbuch (HGB) to implement the EU’s Non-Financial Reporting Directive (also known as the CSR Directive). This requires public interest entities of above a certain size to report on their sustainability policies, due diligence processes and KPIs on matters including environmental, social and employee matters, respect for human rights, anti-corruption and bribery.

Several interviewees noted that many of the largest banks and institutional investors in Germany are required to comply with the directive. In addition, many of the non-financial corporates have substantial investments in occupational pension funds or contractual trust agreements (not subject to BaFin oversight). Several have started to assess the impact of their investments to ensure they comply with new requirements, but this is not yet a systematic process.

Next steps

- a. The German Federal Ministry of Justice and Consumer Affairs (BMJV) should issue guidance to public interest entities complying with the new requirements that BMJV should issue guidance to public interest entities complying with the new requirements including that:
 - i. For financials, investments are in scope for their reporting. Where possible, this should be aligned with upcoming reporting requirements under the IORP II and Shareholder Rights Directives.
 - ii. For non-financial corporates, investments such as pension schemes and contractual trust agreements are in scope for reporting.
- b. The German Parliament should monitor the implementation of amendments to the Handelsgesetzbuch to: ensure high-quality disclosure of ESG factors with clear links between ESG factors, a company’s business model and risk factors; and to allow for investor comparability by industry, portfolio and across time-series.

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²² This is slightly misleading. Listed companies include many of the largest German companies. A better estimate of scale is that 90% of workers are employed by privately owned companies.

²³ deutsche-boerse.com/dbg/dispatch/en/binary/gdb_content_pool/imported_files/public_files/10_downloads/33_going_being_public/10_products/Communicating_sustainability.pdf

