CASE STUDY: ANNEX E

GERMANY - KREDITANSTALT FÜR WIEDERAUFBAU (KfW)

Background and Establishment

KfW was established in 1948 in Frankfurt, Germany, with the aim to reconstruct the German economy after World War II, with the Western Allies commissioning a central agency for that purpose. The initial investment financing was provided by the Marshall Plan, with funds amounting to the equivalent of EUR 1 billion[1].

While the original rationale for establishing KfW was to provide financing for the reconstruction of Germany, the bank has diversified extensively since. Even from as early as 1961, KfW was given a legal mandate to finance development aid. However, in the 1970s it refocused on domestic promotion. With reunification in 1990, KfW focused on accelerating the development of eastern Germany. It is regulated by the "Law concerning KfW" and exempt from corporate taxes. KfW has grown rapidly in recent years and, at the end of 2017, had EUR 366 billion outstanding in global capital and bond markets. It is also Germany's third largest commercial bank. Total assets were reported as EUR 472.3 billion at year end 2017.

KfW is the sixth largest global bond issuer - around EUR 80 billion per year – there is a statutory federal government guarantee and funders include institutional and retail sources, domestic and international. It acts as an agent and centre of technical expertise for both the federal and state governments. Beyond this, it provides a policy piloting and implementation, monitoring and dialogue platform directly with government. This strong and direct relationship with policymakers, combined with the ability to finance at scale and low cost, is a key characteristic and one of the main reasons why KfW is effective and efficient.

Mandate

The bank's mandate is to improve the economic, social and ecological living conditions around the world on behalf of Germany. It performs its tasks pursuant to state mandates in different areas.

KfW's work can be divided into domestic promotion; export and project finance; and development finance. The areas follow different mandates, as follows:

- **Domestic promotion:** Domestically, KfW's mandate is to sustainably support changes in the economy, ecology and society. The tasks are divided into three business sectors, where KfW finances SMEs, private clients, municipalities and organisations. In the 2017 Annual Report, the annual domestic promotional business activity was reported at EUR 51.8 billion.
- **Export and project finance:** The KfW IPEX-Bank GmbH focuses on international export and project finance for German and European companies and the promotion of developing countries, and emerging economies. Its mandate is to support German and European companies to preserve and increase their competitiveness in global markets. This includes medium- and long-term structured financing for the export industry; maintenance and expansion of German and European infrastructure, climate and environmental protection projects; and securing German and European raw material supplies. Total export and project finance activities in 2017 were EUR 13.8 billion.
- **Development finance:** On behalf of the Federal Ministry for Economic Cooperation and Development, the KfW Development Bank promotes initiatives in developing countries and emerging economies, with the objective of sustainably improving economic and social living conditions, reducing poverty and protecting the climate and the environment. It also executes mandates by the EU Commission and selected bilateral donors. It focuses on the finance and support of projects that primarily involve public sector players. KfW's subsidiary DEG focuses on

1 KfW at a glance – Facts and Figures. (April 2013). [Online]. <https://www.KfW.de/Download-Center/Konzernthemen/Kompass-und-Imagebrosch%C3%BCre/KfW-Zahlen-und-Fakten_en.pdf>

developmental finance aimed at expanding the private sector, supports sustainable development that creates qualified jobs and improves living conditions, promotes innovative business models, and introduces international standards in developing countries. For 2017, development finance totalled EUR 8.2 billion.

Other functions of KfW include granting loans and other forms of financing to territorial authorities and special-purpose associations under public law, as well as financing measures with purely social goals and for the promotion of education. KfW also has a mandate to grant other financings in the interest of the German and European economies. KfW supports the Federal Republic of Germany in the performance of special tasks, such as the privatisation of enterprises and the provision of local financing in other European countries.

Institutional Structure

KfW is owned 80 percent by the Federal Republic of Germany and 20 percent by the States of Germany. It is a public agency with unremunerated equity provided by its public shareholders. It is constrained by the mandate in the KfW Law and not allowed to compete with commercial banks.

Governance Structure

EXECUTIVE BOARD

The Executive Board has five members and conducts KfW's business, and administers its assets according to the Law Concerning KfW and the KfW by-laws. It is responsible for performing its assigned duties under this legislation, and sees to the implementation of resolutions taken by the Supervisory Board of Directors[2].

SUPERVISORY BOARD OF DIRECTORS AND ITS COMMITTEES

The Supervisory Board of Directors and its committees supervise the conduct of KfW's business and the administration of its assets. The main tasks for which it holds responsibility are the appointment and dismissal of members of the Executive Board, the approval of the financial statements, as well as the planning and selection of the auditor to be appointed by the Supervisory Authority. The board is chaired by the Federal Minister of Finance and the Federal Minister for Economic Affairs and Energy in alternation.

The board is composed of 37 members of both chambers of the German Federal Parliament, and representatives from banks (appointed by government), industry (appointed by government) and trade unions (appointed by government though likely officials from the trade unions). They all have equal voting rights and most decisions are based on majority votes[3].

There are four sub-committees:

- the Presidential and Nomination Committee;
- the Remuneration Committee;
- the Risk and Credit Committee, which deals with risk matters and approves large loans; and
- the Audit Committee.

MITTELSTANDSRAT (SME ADVISORY COUNCIL) AT KFW

The Mittelstandsrat (SME Advisory Council) controls the state mandate of KfW Mittelstandsbank. It deliberates and takes decisions on proposals for the promotion of small and medium-sized enterprises, taking into consideration the overall business planning of the Institution[4].

Capital Structure and Sources of Finance

The KfW funds its business almost entirely through international capital markets, with an annual issuance volume of around EUR 70-80 billion. As of December 2017, capital market financing accounted for 81 percent of KfW's financing, followed by nine percent raised through money markets; an additional six percent of its capitalisation is equity, while four percent constitutes other liabilities (primarily collateral from derivative transactions). Initially, the share in nominal capital supplied by the Federal Republic of Germany was largely attributed to the European Recovery Program (Marshall Plan) Special fund.

2 KfW Website. Executive Board. [Online]. <https://www.KfW.de/KfW-Group/About-KfW/Vorstand-und-Gremien/Vorstand/>.

3 KfW Website. Board of Supervisory Directors. [Online]. <https://www.KfW.de/KfW-Group/About-KfW/Vorstand-und-Gremien/Verwaltungsrat-und-seine-Aussch%C3%BCsse/>.

4 KfW Website. SME Advisory Council. [Online]. <https://www.KfW.de/KfW-Group/About-KfW/Vorstand-und-Gremien/Mittelstandsrat-bei-der-KfW/>,

The KfW has a Tier 1 ratio of 20.6 percent and a total capital ratio of 20.6 percent. The bank follows a three-pillar strategy to secure funding from international capital markets:

- The **Benchmark program** constitutes the first pillar, making up 71 percent of the KfW's bond volume as the bank's most important funding source. The program consists of large and liquid bonds, with at least three, five, seven and 10-year benchmark maturities each year and target benchmark issue sizes of EUR/USD 3-5 billion.
- The second pillar consists of **other public transactions**, which include large and liquid bonds in strategic markets and with non-benchmark maturities, plus green bonds, as well as other structured public bonds in various currencies. This pillar accounts for 25 percent of KfW's bonds.
- The third pillar consists of **private placements**, which are bonds customised for investor needs that are flexible in currency, structure and maturity (four percent of the issuance volume).

Banks and central banks account for the largest part of KfW's investors, followed by asset managers. As stated in the Law concerning KfW, the short-term liabilities of the KfW must not exceed 10 percent of the medium- and long-term liabilities. The Federal Republic of Germany guarantees directly, explicitly and unconditionally, all obligations of KfW, as stated in the Law concerning KfW. Based on this government guarantee, the KfW has been rated Aaa (Moody's) and AAA (Scope ratings, S&P), with a stable outlook.

Financing Activities

KfW does not have a branch network on its own, but works through on-lending mechanisms. Its financing partners enter into loan agreements with customers, and KfW refinances the loans at favourable interest rates. As noted earlier, in 2017, KfW's domestic promotional business had a volume of EUR 51.8 billion. Almost 60 percent of the financing was directed to municipal and private client bank/credit institutions, with the remaining financing being channelled through the KfW Mittelstandsbank – the SME bank. The majority of financing is directed at the housing sector (18.9 percent), followed by environment and start-ups and general corporate financing support. Infrastructure accounts for only 3.9 percent of the 2017 domestic promotional business. KfW has stated that, in 2017, EUR 3.9 billion was spent on investments in the communal and social infrastructure of Germany. Investments in hospitals, institutions for the elderly or disabled, schools and kindergartens account for the majority of loans. Investments in traffic infrastructure, city and village development and sewage disposal constitute smaller but significant parts of the credit volume[5].

More generally, Germany – at the federal and state level – has never had a long-term structural problem in fiscal space or project management or procurement to constrain finance for network infrastructure from direct budgets; this traditional public sector model still covers some 95 percent of contracts. PPPs are small in number and declining. The need for a national infrastructure bank is, therefore, less obvious than in other countries. What KfW offers is a coherent, public policy-driven set of businesses that have excellent credit ratings and appropriate sector and financial expertise, linked into domestic, European and Global DFI and private networks. It has been catalytic particularly in the establishment of domestic renewable energy generation.

Below is an overview of domestic financial products related to infrastructure investment. The products are focused on particular types of borrowers:

Most relevant to these guidelines, are products offered to municipalities for infrastructure projects:

- **Loan 208 "IKK - Investitionskredit Kommunen".** These loans support investment in municipal and social infrastructure of up to EUR 150 million per year and applicant. The applicant has to be a municipality or one of their bodies (i.e. a sewage disposal operator fully owned by the municipality)[6]. Examples include schools, kindergartens, telecommunication distribution networks, transport infrastructure, etc. The loans can be used to buy real estate if intended for development purposes. Conditions are based on the amount and length of the loan but, in general, the loans allow municipalities to borrow at close to wholesale market rates (with fixed terms for the first 10 years – ranging between 0.41 percent and 0.85 percent depending on the length of the loan)[7]. The loans can be taken out for up to 30 years.

5 KfW. Abschlussbericht zu den Programmen der Investitionsoffensive Infrastruktur. (February 2012). [Online]. <https://www.KfW.de/Download-Center/Konzernthemen/Research/PDF-Dokumente-Sonderpublikationen/Abschlussbericht-Investitionsoffensive-Infrastruktur.pdf>.

6 KfW Website – Credit 218. [Online]. <https://www.kfw.de/inlandsfoerderung/%C3%96ffentliche-Einrichtungen/Kommunale-soziale-Basisversorgung/Finanzierungsangebote/Investitionskredit-Kommunen-(208)/>

7 Will finance only 50 percent of projects that cost more than EUR 2 million, but up to 100 percent below.

- **Loan 233 "IKK – Barrierearme Stadt".** These loans support investment into changes to existing infrastructure to make it more elderly- and family-friendly[8]. Areas supported include public transport, public spaces and public buildings. There is no limit on the size of the individual loans and the full project can be financed through such a loan. The interest rates offered on these loans are again dependent on tenor but are extremely low, currently ranging between 0.05 percent and 0.2 percent. Applicants need to show how they have used the loan two years after disbursement.
- **Loan 201 "IKK – Energetische Stadtsanierung".** These loans support sustainable investments in energy efficient municipal heat, water and sewage systems. There is no limit on the size of the loan and the whole project can be funded. The interest rates offered are extremely low (0.05 percent) and up to five percent (or EUR 2.5 million) of the loan does not have to be repaid if it is successfully shown how the funds are used. Applicants need to show how they have utilised the proceeds of the loan within nine months after disbursement.

Other relevant products for municipal and social organisations (i.e. companies that are owned at least 50 percent by municipalities, not-for-profit organisations such as churches, and any private companies that are part of public-private partnerships) include the following:

- **Loan 148: "IKU – Investitionskredit – Kommunale and soziale Unternehmen".** These loans support any investments in municipal and social infrastructure in Germany of up to EUR 50 million per year and applicant[9]. The complete project can be financed through this loan. Security needs to be provided similar to commercial banking. The conditions of the loan depend on the risk category of the lender and the project, the tenor of the loan and, thus, the loans tend to be offered at a rate above wholesale market rates (i.e. starting at 1.41 percent interest rate). The loans can be taken out up to 30 years, with an ability to fix interest rates for up to 10 and 20 years.
- **Loan 234: "IKU Barrierearme Stadt".** These loans support investments in projects designed to make existing infrastructure more elderly- and family-friendly[10]. Up to EUR 50 million can be financed and the whole project can be founded through the loan. Areas supported include public transport, public spaces and public buildings. Applicants need to show how they have spent the loan within three years after disbursement.

Lastly, there are also direct loans for companies and private people that invest in renewable energy (domestic and international):

- **Loan 270: "Erneuerbare Energien – Standard".** These loans support investments in renewable energy projects, including solar, wind, demand response and heat networks[11]. Up to EUR 50 million and full project costs can be funded. Conditions are based on risk factors, quality of insurance provided and location for the investment. Interest rates range from one percent to around 7.4 percent. There is also a "premium loan" that is available for investment that aims to use the heat from renewable energy investments. Size can be up to EUR 25 million, but with up to 25 percent not having to be repaid if inefficient heating systems are replaced.
- **Loan 230 "BMU-Umweltinnovationsprogramm".** These loans support innovative pilot projects that have a sustainable impact and have been scientifically proven, but where finance cannot be raised through market mechanisms[12]. Activities supported are development, investment in equipment, costs for launching/running the project and the measuring of success indicators. Qualifying areas include water/sewage, rubbish collection and climate change initiatives. Up to 30 percent of project costs are paid for by the KfW and, for the remaining 70 percent, a loan is available at a reduced interest rate (ranging between 1.8 to 8.2 percent). There is no upper limit on the loan.

8 KfW Website - Credit 233. [Online]. <https://www.kfw.de/inlandsfoerderung/%C3%96ffentliche-Einrichtungen/Soziale-Kommunen/Finanzierungsangebote/Barrierearme-Stadt-Kommunen-(233)/>

9 KfW Website – Credit 148. [Online]. <https://www.kfw.de/inlandsfoerderung/%C3%96ffentliche-Einrichtungen/Kommunale-soziale-Basisversorgung/Finanzierungsangebote/Investitionskredit-kommunale-Unternehmen-(148)/>

10 KfW Website – Credit 233. [Online]. <https://www.kfw.de/inlandsfoerderung/%C3%96ffentliche-Einrichtungen/Soziale-Kommunen/Finanzierungsangebote/Barrierearme-Stadt-Kommunen-(233)/>

11 KfW Website – Credit 270. [Online]. <https://www.kfw.de/inlandsfoerderung/Unternehmen/Energie-Umwelt/F%C3%B6rderprodukte/Erneuerbare-Energien-Standard-(270)/>

12 KfW Website – Credit 230. [Online]. <https://www.kfw.de/inlandsfoerderung/Unternehmen/Energie-Umwelt/Finanzierungsangebote/BMU-Umweltinnovationsprogramm-(230)/>

Most of the loans can be combined, as long as they do not go above any specified limit of KfW financing or above the overall costs of the project.

In 2009 and 2010, the KfW facilitated a special program initiated by the government offering credits for infrastructure at lower rates than the standard KfW products.

Following the financial crisis, the German Government decided to introduce two economic stimulus packages. The government instructed KfW with the implementation of the so-called investment plan for infrastructure ("Investitionsoffensive Infrastruktur"), one of the main pillars of the first stimulus package. Within the scope of this plan, KfW offered loans for economically and financially underdeveloped municipalities (Loan 207), not-for-profit organisations (Loan 211), and municipal companies (Loan 212) in order to finance additional infrastructure investments in the respective regions between 2009 and 2010.

Interested parties were able to obtain loans at lower rates than KfW's usual programs[13]. Loans could be taken out for up to 30 years, with interest rates starting from 0 percent p.a. (first and second year of loan 207), 1.10 percent p.a. (Loan 211) and 1.2 percent p.a. (Loan 212), respectively. Fixed interest rate conditions were granted for five years[14].

The uptake was largest for Loan 207, accounting for 50 percent of the credit volume (EUR 1.885 billion). As in KfW's standard programs, the largest share of the credit volume benefited schools and kindergartens (EUR 485.5 million), followed by hospitals and institutions for the elderly and disabled (EUR 424.3 million).

13 KfW. Abschlussbericht zu den Programmen der Investitionsoffensive Infrastruktur. (February 2012). [Online]. <https://www.KfW.de/Download-Center/Konzernthemen/Research/PDF-Dokumente-Sonderpublikationen/Abschlussbericht-Investitionsoffensive-Infrastruktur.pdf>.

14 https://www.regierung.oberbayern.bayern.de/imperia/md/content/regob/internet/dokumente/bereich3/infobrief12_energieeffizienz_und_bauen.pdf

Project Preparation and Technical Assistance Activities

While KfW offers extensive technical assistance internationally, this is more limited domestically. For example, KfW offers loans that also cover the costs for on-site energy advice; and advice for start-ups and young businesses in order to promote start-up activity in Germany.

Performance Monitoring

KfW does not publicly report project- or loan-specific indicators. Its portfolio guidelines distinguish between different products and types of counterparties. KfW defines risk guidelines for countries, sectors and products that allow reactions to existing or potential negative developments. Various risk committees, as well as a comprehensive risk management policy, have been established to monitor and limit risk. However, KfW does report on its impact on environmental sustainability, including the extent to which its financing supports improvements in energy efficiency.

Key Lessons Learned

KfW has been a major strategic player in the transformation of the German economy, particularly in supporting exports, renewable energy and energy efficiency, as well as SMEs, innovation and social infrastructure, such as housing and communal facilities.

KfW reports and is organised on a thematic rather than sectoral basis. It is programmatic and iterative; often working through intermediaries, with the latter taking any credit risk on projects. It is not a major financier of domestic infrastructure at the municipal level except in regard to its thematic priorities, such as renewable energy and energy efficiency.

It has have evolved in line with public policy priorities: post war recovery, exports, restructuring, clean energy and public goods. Strong governance and legal arrangements are in place and a group strategy reflects the public ownership interests. Its domestic banking operations are regulated so as not to compete with the private sector.

This political and regulatory framework is very context-specific to Germany. KfW is an instrument of government policy and its Ministerial stakeholders include Finance, Energy, Environment and Development Cooperation. This diversity fits closely with its programmatic and thematic modes of operation. It is also an independent centre of expertise and technical advice for government, and can provide innovation and experimentation platforms.

It is flexible in how it operates, either via commercial or mortgage banks, or by providing direct loans using standard loan products. Government may provide budget subsidies for selected areas like innovation or SMEs.

In international operations, KfW keeps to the same set of environmental standards and policies as for the domestic projects that it finances; this demonstration objective directly flows from government policy. This is seen as facilitating technical quality and replication, improving impact and making monitoring easier.

Due to its legal tax-free status, public ownership, unremunerated equity and competitive positioning, it is an efficient and effective mobiliser of long-term resources from global capital markets; this, coupled with federal budget funds, allows large-scale lending at below-market rates. This provides an impressive and sustainable financial investment platform.