



Sustainable Finance: Challenges and Opportunities for German SMEs

Sustainable Finance regulation poses a challenge for German medium-sized businesses. This article addresses these concerns, but also highlights opportunities and outlines prospects for an implementation, which supports German SMEs in their role as the engine of the climate and sustainability transformation.

In its new guiding strategy, the European Green Deal of December 2019, the European Commission laid down how the sustainability transformation of national economies can succeed. Following this, the Commission published its Renewed Sustainable Finance Strategy in early July 2021, which also included a draft regulation for an EU Green Bond Standard. A week later, the Fit for 55 package was presented, which displayed a number of legislative proposals to achieve an EU-wide greenhouse gas reduction of 55% by 2030 (compared to 1990). At the national level, the Federal cabinet approved the Federal German Government's Sustainable Finance Strategy and an amendment to the Federal Climate Protection Act at the beginning of May 2021.

What does this mean for companies? German businesses are obliged to integrate environmental, social and governance (or ESG) criteria¹ and thus a consideration of these three dimensions into their structures and processes and sustainable finance hence has significant implications for competitiveness, with winners and losers. Against this backdrop, it is essential to provide the right incentives for the private sector to embark on and ultimately achieve the sustainability transformation while ensuring competitiveness. In order to unleash market forces that channel the necessary financial resources into sustainability-oriented investments at an early stage, one indispensable prerequisite is needed above all: good data availability.

Information asymmetries and uncertainty lead to adverse selection² and increase transaction and financing costs. Standardized and meaningful disclosure of material information reduces market failures and enables a more effective capital allocation. Efficient aggregation and risk adjustment of financed economic activity by market participants is enabled by available sustainability data. The demand for expanding and improving the availability of sustainability data is therefore primarily a finance- and capital market-driven effort to reduce market failures, which regulators have taken up in the form of a corresponding harmonised framework.

A uniform taxonomy and disclosure for more transparency

The Taxonomy Regulation and the corresponding disclosure requirements for companies represent central instruments within the framework of EU sustainable finance regulation, with the following overarching objectives: (i) the efficient allocation of capital, taking into account all material risks (both long-term and sustainable) and (ii) greater consideration of investor (and stakeholder) preferences (in terms of sustainable or long-term investment impacts).

In this context, an expansion of information, reporting and disclosure obligations is intended to make the ESG performance of companies and thus risks in the financial system and the real economy

¹ The acronym "ESG" is now well established and describes the three central areas of "environmental", "social" and "governance".

² Market information is usually not distributed equally. Akerlof (1970) was the first to show that this can lead to market failure. Due to a lack of information, purchasers on the market cannot see the quality of the product in demand. Therefore, they are only willing to pay an average price. This leads to adverse selection, a negative selection of products with good quality.



transparent. So-called taxonomies, which are increasingly being developed at the global level, are intended to provide clarification of terms, greater transparency and harmonization³. The EU taxonomy is a classification system for a uniform EU-wide definition of sustainability. It is thus an important reference framework for sustainable product and investment regulation in the private sector as well as for financial market supervision.

For the German market, the taxonomy specifically aims at companies that are required to publish a non-financial statement (now: sustainability statement) in accordance with the European Non-Financial Reporting Directive (NFRD) of 2014, which is to be revised as part of the Corporate Sustainability Reporting Directive (CSRD) proposed by the European Commission at the end of April 2021. Financial companies are also addressed by the Sustainable Finance Disclosure Regulation (SFDR). For these, the initial disclosure requirements have already been in force since 10 March 2021.

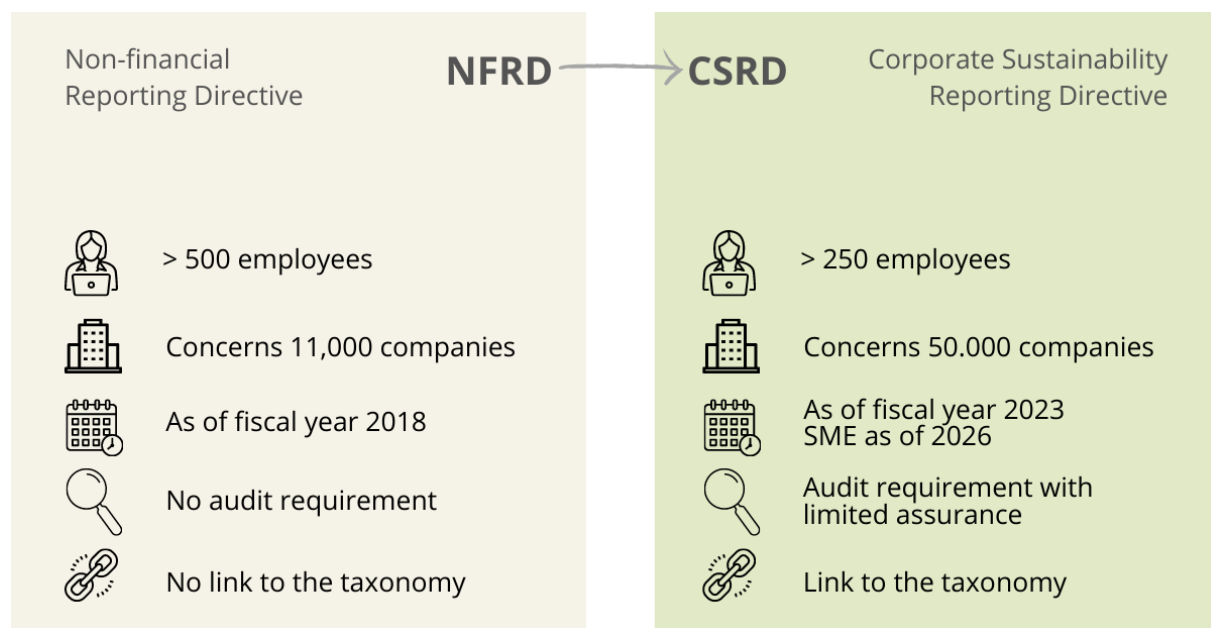


Figure 1: Differences between NFRD and CSRD (own illustration)

The planned CSRD will affect all large⁴ limited partnerships with more than 250 employees and all listed companies with the exception of micro-enterprises⁵. Companies already covered by the NFRD⁶ will have to apply the initial sustainability-related reporting requirements in terms of the EU Taxonomy from 2024 for the reporting year 2023. Small and medium-sized capital market-oriented companies that were not subject to reporting requirements under the NFRD will have to comply with the reporting requirements from the 2026 financial year.

Article 1 of the Taxonomy Regulation, which entered into force in July 2020, requires companies to report on the extent to which their own economic activities meet the taxonomy criteria. The first

³ See, e.g. [2020 Annual Report](#) of the "International Platform on Sustainable Finance".

⁴ Companies with a total balance sheet of more than € 20 million or an annual turnover of more than € 40 million.

⁵ For micro-enterprises, no more than one criterion may be exceeded: 1) 10 employees, 2) € 350,000 in total assets or 3) € 700,000 in net turnover.

⁶ Listed EU companies with more than 500 employees as well as banks and insurance companies.



criteria for the contribution of an economic activity to climate change mitigation and adaptation were adopted by the Commission in the form of a delegated act in early June 2021⁷.

In particular, Article 8 of the Taxonomy Regulation requires non-financial companies to disclose in their sustainability reporting the proportion of sales revenue, capital expenditure and operating expenditure that is considered sustainable.

In order to make sustainability measurable in a tangible and standardised way for the private sector, further delegated acts to the Taxonomy Regulation and the CSRD are currently being discussed in the context of the EFRAG Working Group⁸ and the Sustainable Finance Platform (SFP) - an advisory body of the European Commission. In this context, sustainable finance regulation will also be expanded, technically specified and standardised with regard to further environmental and sustainability objectives. These go beyond climate protection and adaptation to climate change. Figure 2 shows an overview of the six environmental dimensions and the number of ESG criteria that have been or are being developed. The economic activities for which these assessment criteria (Technical Screening Criteria) will, eventually, be adopted (through additional delegated acts) will be subject to corresponding reporting requirements.







Environmental dimensions		Number of economic activities	Examples
Climate change mitigation		79	Economic activities covering the majority of EU emissions, e.g. retail and wholesale trade are missing
Climate change adaptation		75	
Sustainable use of water and marine resources		20	Individual economic activities from agriculture, mining, the manufacturing industry or wastewater disposal
Circular economy		24	Individual economic activities from the manufacturing, mining, wastewater and waste management sectors.
Pollution prevention		26	Individual economic activities from agriculture, mining, the chemical industry, transportation or wastewater disposal
Biodiversity		23	Individual economic activities from agriculture, forestry, mining, or the manufacturing industry

Figure 2: Overview of the six environmental dimensions and the number of economic activities. (own illustration) * According to the current status of the consultation⁹

⁷ Commission, [Delegated Regulation to establish the technical screening criteria: climate change mitigation and climate change adaptation](#), 4 June 2021.

⁸ [EFRAG Homepage](#)

⁹ [Consultation on preliminary recommendations for technical screening criteria for the EU taxonomy](#)



The focus of the ESG criteria developed in the past has been on climate change mitigation and adaptation, but the SFP is currently developing criteria for the other four environmental dimensions. In the first round, these comprise of 20 to 26 economic activities each; the corresponding report is in public consultation from the beginning of August until the end of September 2021. For a medium-sized company that engages in animal husbandry, for example, ESG criteria and thus future reporting requirements are in place or are specifically planned for the following environmental dimensions: Climate change mitigation (existing), pollution prevention and control, and biodiversity (in public consultation by the editorial deadline). Companies that carry out economic activities for which there are no ESG criteria are not subject to reporting requirements.

Challenges and opportunities

The challenge is obvious: what level of granularity is appropriate when companies collect new data points? On the one hand, a certain level of data is necessary for funding partners to make informed decisions. On the other hand, too much data and the resulting need to aggregate it can cause substantial costs and slow down decision-making.

Since the requirements presented affect non-financial corporates' financing partners, the taxonomy also affects the financing conditions of companies. Through the reporting and disclosure requirements, the taxonomy has a direct impact on the behaviour of (institutional) investors and financing partners of SMEs. Accordingly, sustainable finance will change the way companies access finance. In principle, standardisation and transparency of business activities can improve companies' ability to access the capital market. In this respect, the legislative standardization of a supply-side sustainability orientation in the financial market represents an opportunity.

By changing the framework conditions for lending, sustainable finance regulation also has a significant impact on small and medium-sized enterprises, which rely almost exclusively on bank financing - especially the lower Mittelstand consisting of micro-enterprises and small and medium-sized enterprises (SMEs) with annual sales of less than €50 million. In all likelihood, this will increase the risk of bottlenecks in corporate financing for those parts of the commercial sector that do not fulfil the additional information requirements on ESG criteria. Medium-sized companies that can already demonstrate compliance with the taxonomy will benefit, for example, from additional financing opportunities under KfW's "Climate Protection Offensive for SMEs" launched in 2020. Since the taxonomy has so far focused on sectors with high environmental relevance, some sectors are not affected by the taxonomy at all and thus cannot demonstrate taxonomy compliance. For companies in these sectors, the currently discussed "no significant impact" (NSI) taxonomy¹⁰ could be helpful to demonstrate to financing partners that they are not "green" in the sense of the environmental taxonomy, but still do not cause significant harm. Also, the development of a "significant harm" (SH) taxonomy would provide an opportunity for companies with better ESG performance to differentiate themselves from their "significantly harmful" peers - with corresponding advantages in accessing financing.

Access to finance for SMEs depends in particular on the implementation of the disclosure obligations of financial institutions. According to Article 8 of the Taxonomy Regulation, the latter must publish a Green Asset Ratio (GAR). This describes how large the scope of activities is, which is compatible with the taxonomy. Since no materiality limits apply to financing for the time being, there is a general

¹⁰ Commission, [Call for feedback on the draft reports by the Platform on Sustainable Finance on a social taxonomy and on an extended taxonomy to support economic transition](#), 12 July 2021.



incentive for financial companies to optimize their portfolios in an ESG-compliant manner: not only capital market-oriented but also deposit-oriented banks are competing for the "best" GAR due to the supply-side sustainability orientation. The implementation of NSI and SH taxonomies could counteract this competition, which could otherwise lead to the divestment of parts of the commercial economy within the assets of financial companies.

Opportunities for sustainable finance regulation materialise if proportionate and trustworthy implementation succeeds and access to finance is preserved.

Companies already collect many data points that cover certain aspects of sustainable finance regulation. In this context, it is crucial that companies have legal certainty regarding the disclosure of material information with regard to their sustainability-oriented disclosure. Harmonising the respective reporting obligations and data requirements in the relevant regulation could make a significant contribution to alleviating the burden on companies.

In order to support the German SME sector as a key driver of the transformation, it must be examined to what extent proportionality of the requirements can be preserved in relation to the size of the company. In its new Sustainable Finance Strategy, the Commission is seeking to reduce the administrative burden, especially for SMEs, with various measures. For example, a taxonomy compass was recently published to make the contents of the taxonomy more accessible. In addition, the Commission plans to develop separate and proportional reporting standards for SMEs. While listed SMEs would be obliged to apply these proportional standards, non-listed SMEs are to do so on a voluntary basis. Moreover, the Commission intends to support member states in providing more comprehensive advice to SMEs in order to promote voluntary reporting on sustainability risks and impacts in general. To facilitate access to data, the Commission launched a consultation on the European Single Access Point (ESAP) in February 2021. This instrument is intended to bundle sustainability-oriented information from companies and make it accessible to investors and other stakeholders in a structured form. In addition to the Commission's efforts, international standards and guidelines aim to improve the standardisation and comparability of corporate data¹¹.

Another helpful tool can be the EU Green Bond Standard, which holds opportunities for SMEs if implemented adequately. Green bonds can be part of the financing of the low-carbon transformation process, as they typically have long maturities and bullet repayment structures that fit well with large infrastructure projects. SMEs will also be able to benefit from this investment activity. The standard will also define a reference framework for ESG-compliant investments in the capital markets, in particular due to the mandatory verification by an independent third party. With regard to long-term financing of transformation, the securitisation market can also play a significant role. In the context of ABS securities, investors - primarily banks and regulated institutional investors - will pay attention to sustainability transparency on their own initiative. Long-term SME financing in particular could benefit from liquid ABCP markets - if it were possible to launch ESG-compliant ABCP programmes. However, this raises not only the question of the reference variable (asset, debtor or originator?), but in particular again the question of the appropriate granularity of the data, e.g. in the securitisation of very short-term trade receivables.

Another important lever for a trustworthy implementation of the sustainability finance regulation would be an expanded accounting and sustainability-related reporting by companies, which is anchored in corporate governance through obligations of the executive board and supervisory

¹¹ For example, from the Global Reporting Initiative (GRI) or the Task Force on Climate-related Financial Disclosure (TCFD).



board as well as internal and external audit mechanisms. Through such a commitment, transparency of ESG data can be achieved that can represent reliable information from a third party perspective. Due to the effort involved in setting up such structures, appropriate transition periods should be provided.

Conclusion

The transformation of the German economy offers medium- and long-term opportunities for market penetration, new business areas and additional sources of financing. It can thus secure and enhance the future international competitiveness of Germany as a business location.

With regard to the German SME sector as a driver of the transformation towards more sustainability, it will be important to examine (within the framework of the taxonomy) to what extent proportionality in reporting can be maintained for companies of a certain size. For the implementation of the transformation, it is important that sectors with high negative environmental impacts are included in the reporting obligations of the sustainable finance regulation - irrespective of the capital market orientation of the companies concerned. However, SMEs may have little indication of which sustainability aspects are important to them and which requirements they have to fulfil in order to access financing. The support offered by the Sustainable Finance Regulation for directly or indirectly affected companies is currently insufficient.

With sufficient support, there could be an opportunity for European financial markets to positively differentiate themselves from the rest of the world - especially if investors outside the EU take the taxonomy into account with regard to their ESG criteria for investment decisions within and outside the European financial market. The prerequisite for this is a sufficiently large or liquid market segment for ESG-compliant investments. In view of the financial resources required for the sustainability orientation of the economy, growth in ESG-compliant investments appears desirable and possible. However, this process requires that German SMEs are appropriately integrated into the national and European discourse and included in the further design of the application of the taxonomy. Only then can the sustainability transformation succeed.

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