Update on Sustainable, Responsible Investing (SRI)

ECB Bond Market Contact Group

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Drivers for ESG: an irreversible trend

- General concerns about sustainability
- Wealth transfer to gen. Xers & millennials
- Institutional demand for RI as best practice
- Investor buy-in for ESG ‘business case’
- Better corporate reporting → availability of ESG data
- Rapid growth in ESG policy instruments
ESG objectives and actions

Objectives

Avoid

- Apply negative screens
  - Exclusions based on:
    - Product or behaviour
    - Sector / sub-sector
    - UN Global Compact
    - Norges Bank IM list

Improve

- Invest with + impact
  - Create positive outcomes:
    - Best-in-class / best-in-sector overlay
    - ESG themed investing
    - ‘Impact first’ investing

Change

- Engage issuers on ESG
  - Apply stewardship for:
    - ESG transparency
    - Seeking to mitigate downside risk
    - Optimising positive ESG outcomes

Evaluate

- Integrate ESG into investment decisions
  - Consider relevant ESG risks & opportunities:
    - In financial modelling
    - To price externalities
    - To identify hidden risks / red flags

Actions

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Addressing climate change as investors

Are companies exposed to climate risk?

- Carbon tax
- Policy support for low carbon
- Low carbon transport
- Low carbon energy
- Low carbon subsidies
- Branding
- Product innovation
- Changing consumer tastes
- Stranded assets
- Greenhouse gas emissions
- Impact on agriculture
- Land degradation
- Deforestation
- Energy inefficiency
- Climate legislation
- Insurance costs
- Public health
- Adaptation costs
- Physical risk to property

Are companies part of the cause or the solution?

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ESG Research

Overcoming the ESG data gap and low correlations between ESG rating providers

- Rating correlations: 0.9 - credit rating agencies | 0.32 - MSCI / Sustainalytics
- Largest ESG data gaps: high-yield / private companies
- Muzinich commissions c. 20 new ESG ratings per annum
- Results of new ratings are shared with all Sustainalytics subscribers
- Lack of ESG data can be both a challenge and an opportunity (particularly for active managers)

Example: cyber security

Cyber security risks
- Poor understanding of risks
- Under investment in infrastructure
- Poor accountability

Financial outcome
- Litigation costs
- Revenue loss
- Unexpected capex

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ESG analysis, ratings and certifications

Proliferation of types and providers of ESG information available to investors

Types of ESG information available:

- Asset management certifications and fund ratings
- ESG data, ratings, rankings
- Specialist & bespoke thematic and sector research
- Sell-side research incorporating ESG elements
- Thematic product (e.g. green bond certification)
- EC ‘green taxonomy’ and ‘ecolabel’
- ESG (custom) benchmarks

ESG data providers

- MSCI
- TruValue Labs
- RepRisk
- SUSTAINALYTICS
- vigeo eiris
- Trucost
- Moody’s
- EthiFinance
- S&P Global

ESG themed research

- Morningstar
- LUXFLAG
- PRI
- SASB
- CFA Institute
- CDP
- BEYOND RATINGS
- South Pole
- Sedex

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Responsible investing, returns and fiduciary duty

“Failing to consider long-term investment value drivers - which include environmental, social and governance issues - in investment practice is a failure of fiduciary duty.”

UN-supported Principles for Responsible Investment

- Deutsche AM (2016) study of 2,000 papers - 90% non-negative correlation ESG and corporate performance
- ESG should not be seen as a ‘barrier’ but rather a ‘duty’ of investors
- Policy makers play a key role to:
  - Clarify the status of ESG integration in relation to fiduciary duty
  - Strengthen implementation of legislation and codes to refer to ESG
  - Clarify expectations of trustees’ competence relating to ESG
  - Harmonise legislation on ESG globally
- BUT... in the US policy makers are not necessarily progressing


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Network for Greening the Financial System

**Key recommendations for central banks (NGFS members)**

1. Integrate climate-related risks into financial stability monitoring and micro-supervision
2. Integrate sustainability factors into own-portfolio management
3. Bridge the data gaps
4. Build awareness and intellectual capacity and encourage technical assistance and knowledge sharing
5. Achieve robust and internationally consistent climate and environment-related disclosure
6. Support the development of a taxonomy of economic activities
7. Tax incentives
8. Innovation (e.g. equity tranche on green CLO)

**Central banks as regulators**

1. Carbon reduction mechanisms: cap & trade or tax
2. Harmonise ESG regulation globally
3. Clarify investor (fiduciary) duties on ESG
4. Ensure executives’ accountability for climate risk
5. Innovation - positive incentive loans, green CLOs etc.
6. Green supporting factor / regulatory capital


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Negative screening

Zero-tolerance

- Production of controversial weapons (e.g. cluster munitions)
- Evidence of child labour in company operations

Industry

- Adult entertainment
- Alcohol
- Conventional weapons
- Fur & specialty leather
- Gambling
- Military contracting
- Nuclear power generation & services
- Tobacco

UN Global Compact

UN Global Compact requires companies to follow ten principles encompassing:
- Human rights
- Labour standards
- Environment
- Anti-corruption

Specialist ESG research provider determines compliance quarterly.

NBIM

Determined on a name-by-name basis by Council on Ethics. Criteria:
- Controversial weapons
- Tobacco
- Mining and energy companies using coal
- Human rights and environmental
- Gross corruption
- Human rights contraventions
- Severe environmental damage

Custom screens

Muzinich provides options for clients to determine custom screens for separately managed accounts.

Threshold:
- Zero-tolerance for involvement
- Zero-tolerance for non-compliance
- Zero-tolerance for names on list
- Determined with client

Threshold:
- >5% revenues derived from related criteria

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Best-in-class: identify ESG leaders

Source: Sustainalytics.

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Integrating ESG into credit assessments

Fundamental bottom up research combines ESG and traditional financial data

- Credit risk assessment
- Fundamentals
- Long term ESG macro risk factors (climate)
- ESG commentaries
- Short term earnings news
- ESG sector research
- ESG controversies and product involvement
- ESG Risk Ratings

Integrated investment signals feed into research, portfolio construction and risk management

- Fundamental research
- Portfolio construction
- Risk management
- Global macro

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Engaging & monitoring issuers on ESG

Why does Muzinich engage on ESG?

• Actively manage downside risk
• Encourage transparency on material ESG issues (hidden risks)
• Drive positive change relating to specific ESG issues
• Communicate rationale for not participating on ESG grounds
• Part of ongoing cycle of monitoring and research

How does Muzinich engage on ESG?

• Engagements done by investment team directly or via banks
• Investment team raises concerns about ESG verbally in meetings with issuers, at roadshow events and other opportunities
• Automatic engagement whenever not participating on ESG grounds
• Feedback from engagements shared among investment team members

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Addressing climate risk at Muzinich

Trucost is a leading provider of specialist environmental research and data. Muzinich has access to:

• Carbon emission reporting at portfolio level
• Detailed company level carbon assessments
• Stranded assets assessments
• Green/Brown revenue share for corporates
• Alignment with 2 degrees warming scenarios
• Private company carbon footprint modelling

Incorporating climate risk into research

• Muzinich analysts will be able to conduct carbon intensity and “carbon value at risk” assessments across holdings
• 2 degrees scenario analysis gives forward looking insight into corporate climate transparency and readiness

Reporting portfolio carbon intensity

• Muzinich able to report to clients on
  • portfolio carbon footprint
  • portfolio preparedness for 2 degree scenarios and climate policy shifts
• Muzinich will further integrate portfolio carbon intensity into investment decisions to reduce climate risk exposure

Muzinich as a firm

• Muzinich is undertaking a full greenhouse gas emissions assessment of its own operations including:
  • CO₂ emissions / US$mn
  • Estimated damage cost equivalents
  • Impact ratios

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Mainstreaming ESG - the role of the official sector

Policy overview

• Almost 300 individual policy tools or initiatives*
• Over half since 2012
• Requirements grouped into:
  • Asset owners: insurance & pension regulation
  • Asset managers: disclosure & stewardship codes and
  • Investees: corporate disclosure on ESG (climate)
• Paris Climate Agreement (2015)
• UN Sustainable Development Goals (2015)

Policy activity

• Network for Greening the Financial System
• FSB - Task Force on Climate-related Financial Disclosures
• EU - High-Level Expert Group on Sustainable Finance
• French Article 173 of French Energy Transition Law
• CRISA code (SA), Ontario Pension Benefits Act (Can)
• De Nederlandsche Bank & Hong Kong Monetary Authority signed Principles for Responsible Investment (2019)
• Banque de France ‘ESG charter’

European Commission: Sustainable Finance Action Plan

High-Level Expert Group on Sustainable Finance (HLEG) established to advise on:

1) **Sustainable taxonomy**: develop a universal classification system for sustainable economic activities
2) **EU Ecolabel**: criteria for labelling of sustainable retail financial products
3) **Green bond standard**: to address barriers and promote ‘additionality’ of green bonds
4) **Promoting sustainable finance**: mapping investment gaps for sustainable projects
5) **Investment advice**: MiFID II Directive to include ESG considerations in investor and insurance distributors advice
6) **Clarification on investor duties**: with regards to ESG and fiduciary duty
7) **Low-carbon benchmarks**: amend benchmark regulation, create new category of low-carbon benchmarks

Source: European Commission
Important Information

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