

Update on Sustainable, Responsible Investing (SRI)

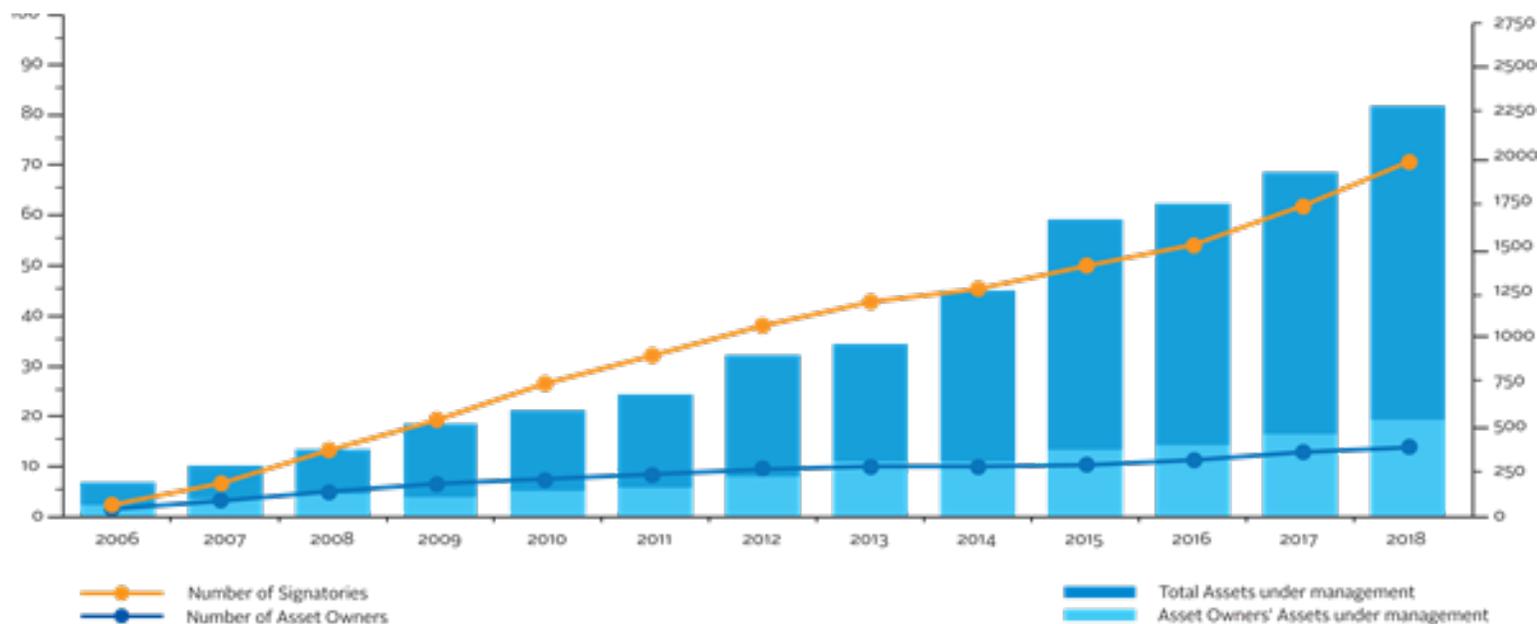
ECB Bond Market Contact Group

12 June 2019

Drivers for ESG: an irreversible trend

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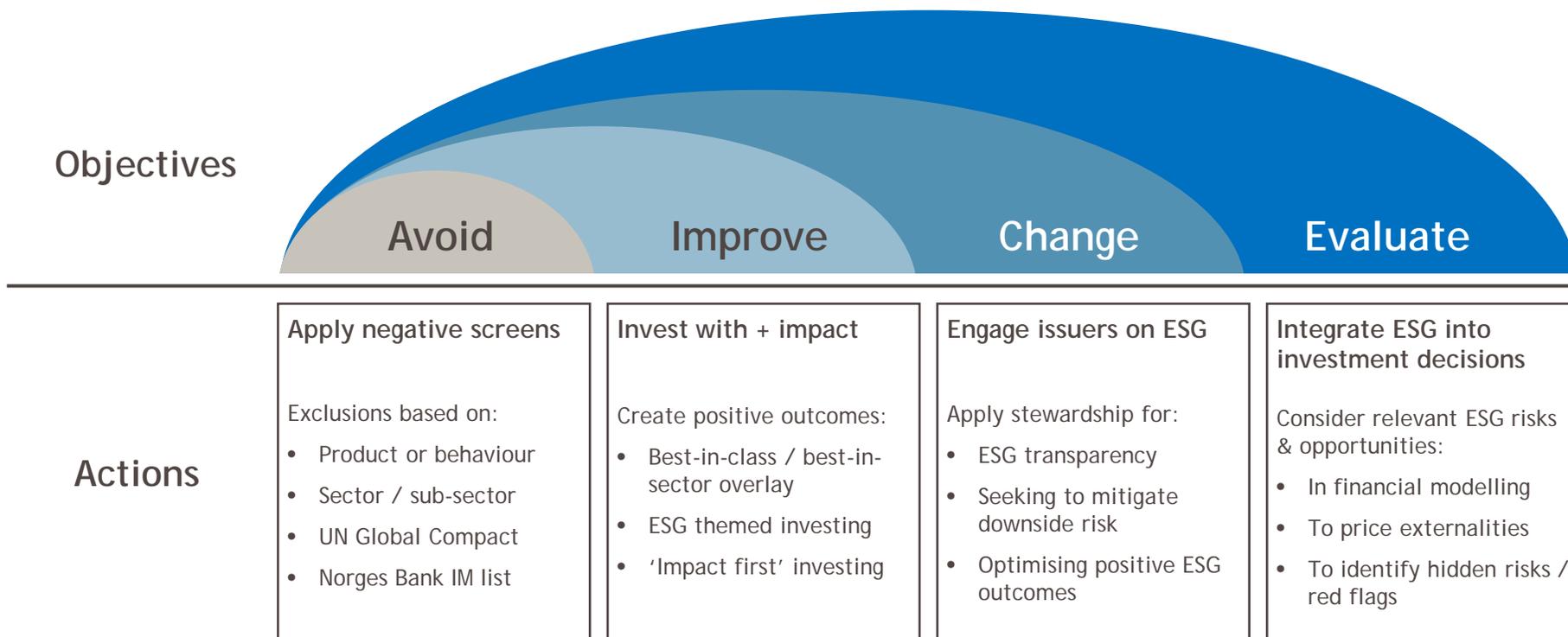
- General concerns about sustainability
- Wealth transfer to gen. Xers & millennials
- Institutional demand for RI as best practice
- Investor buy-in for ESG 'business case'
- Better corporate reporting → availability of ESG data
- Rapid growth in ESG policy instruments



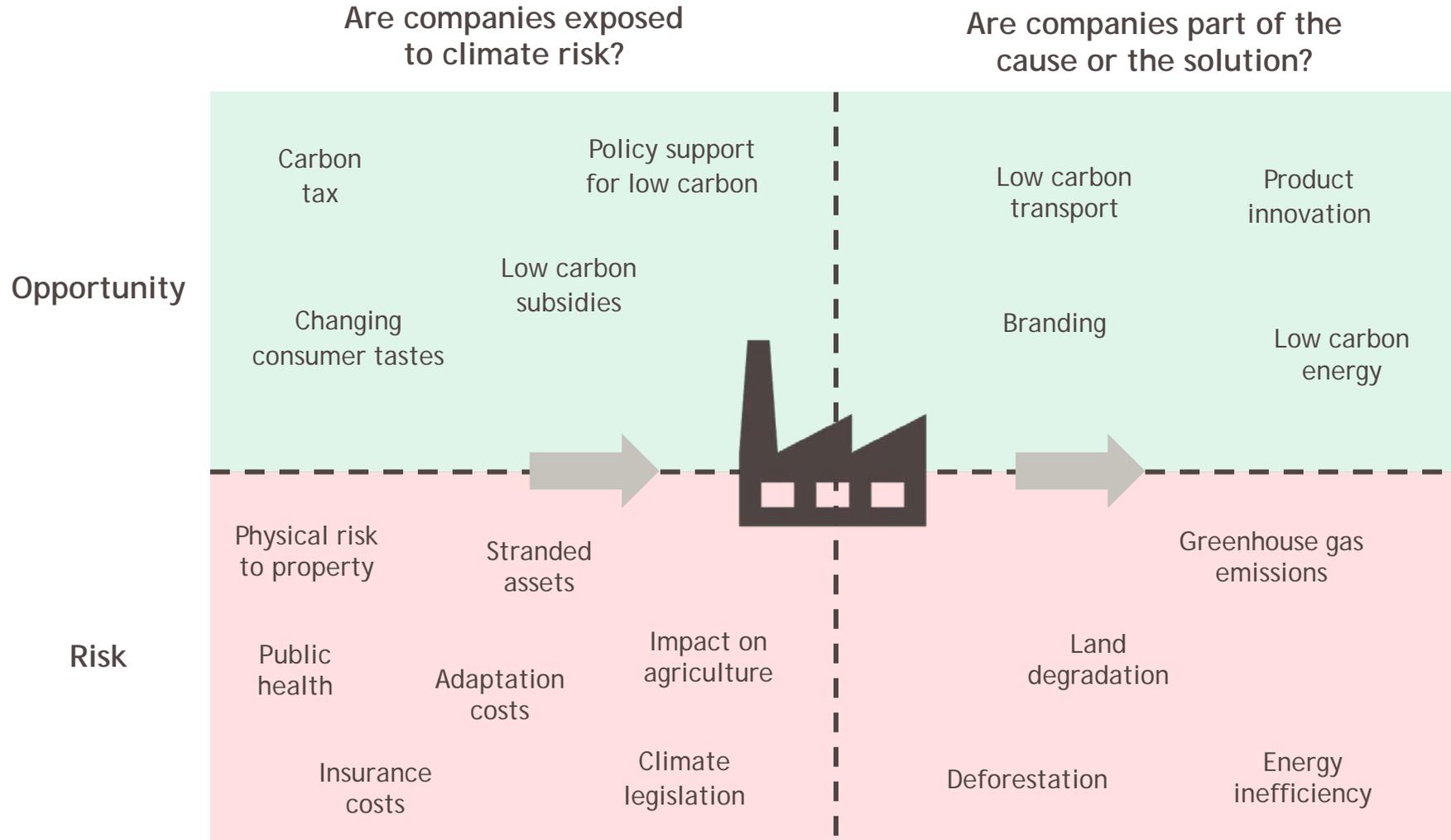
Source: UN-supported Principles for Responsible Investment (PRI) website as of 5 April 2019

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ESG objectives and actions



Addressing climate change as investors



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

- 
- Data breach
 - Corporate espionage
 - Sabotage
 - Extortion

Financial outcome

- Litigation costs
- Revenue loss
- Unexpected capex

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



Responsible investing standards, certifications etc.

ESG themed research



Responsible investing, returns and fiduciary duty

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“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

- Freshfields (2005) *A legal framework for the integration of ESG issues into institutional 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

Sources: UNPRI (2015) Fiduciary Duty in the 21st Century.

Freshfields (2005) A legal framework for the integration of ESG issues into institutional investment.

Deutsche Asset and Wealth Management (2015) ESG and Corporate Financial Performance: Mapping the global landscape.

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Network for Greening the Financial System

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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



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

7) Tax incentives

8) Innovation (e.g. equity tranche on green CLO)

Central banks as investors

1. Integrate ESG into investment decisions
2. Apply ESG tilt to bond buying
3. Soft engagement (messaging to corporates)

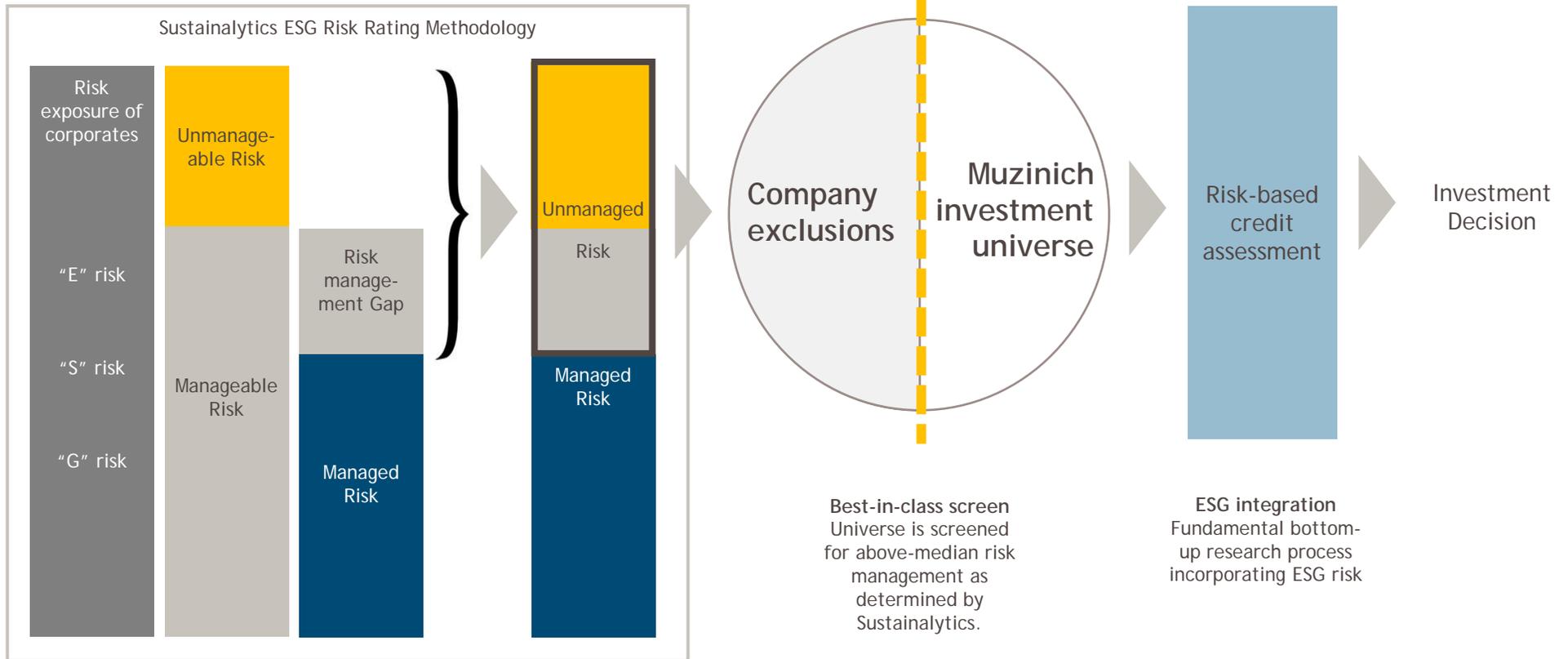
Appendix

Negative screening



| Zero-tolerance  | Industry  | UN Global Compact  | NBIM  | Custom screens  |
|--|---|--|--|---|
| <ul style="list-style-type: none"> • Production of controversial weapons (e.g. cluster munitions) • Evidence of child labour in company operations | <ul style="list-style-type: none"> • Adult entertainment • Alcohol • Conventional weapons • Fur & specialty leather • Gambling • Military contracting • Nuclear power generation & services • Tobacco | <p>UN Global Compact requires companies to follow ten principles encompassing:</p> <ul style="list-style-type: none"> • Human rights • Labour standards • Environment • Anti-corruption <p>Specialist ESG research provider determines compliance quarterly.</p> | <p>Determined on a name-by-name basis by Council on Ethics. Criteria:</p> <ul style="list-style-type: none"> • Controversial weapons • Tobacco • Mining and energy companies using coal • Human rights and environmental • Gross corruption • Human rights contraventions • Severe environmental damage | <p>Muzinich provides options for clients to determine custom screens for separately managed accounts.</p> |
| <p>Threshold: Zero-tolerance for involvement</p> | <p>Threshold: >5% revenues derived from related criteria</p> | <p>Threshold: Zero-tolerance for non-compliance</p> | <p>Threshold: Zero-tolerance for names on list</p> | <p>Threshold: Determined with client</p> |

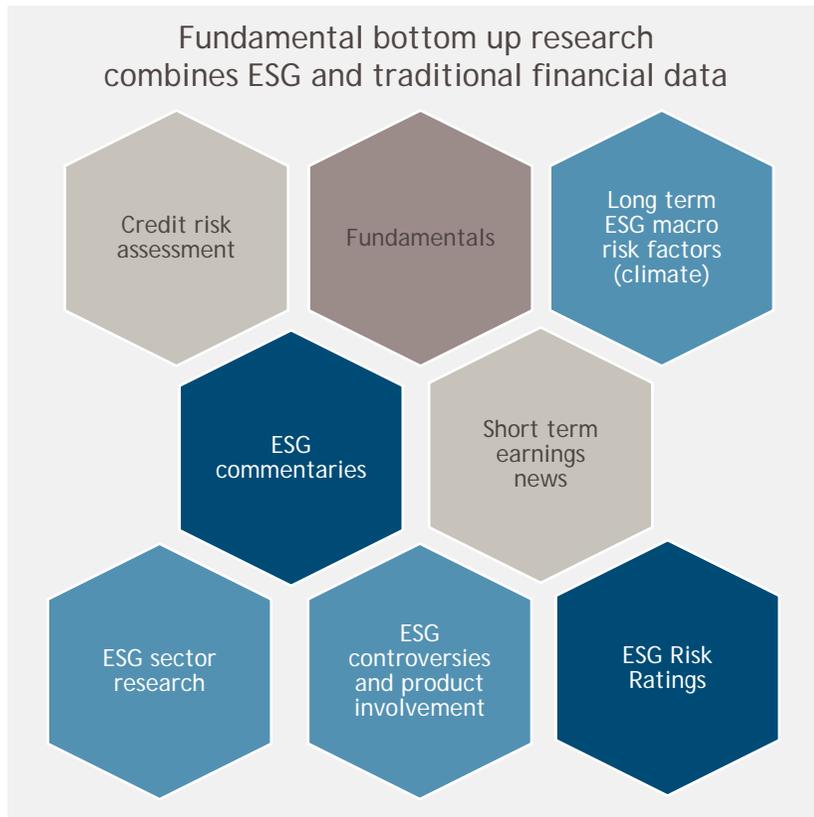
Best-in-class: identify ESG leaders



Source: Sustainalytics.

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Integrating ESG into credit assessments



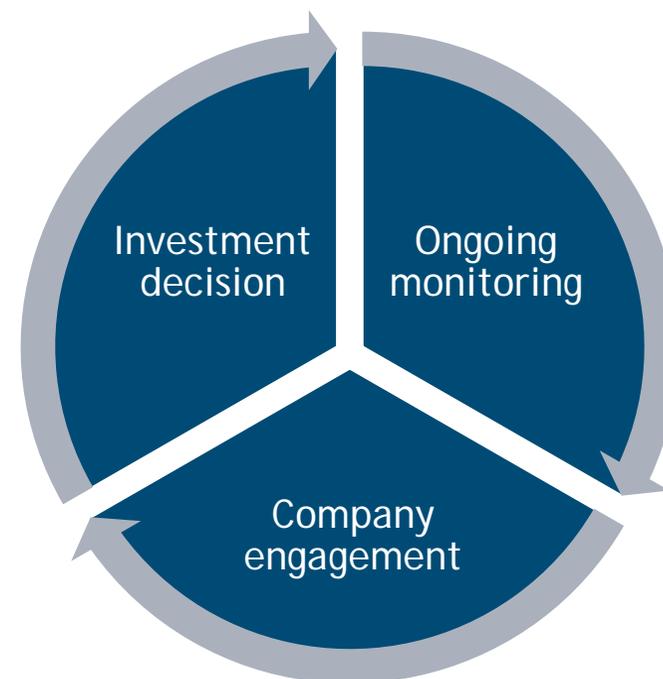
Engaging & monitoring issuers on ESG

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



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\$m
 - Estimated damage cost equivalents
 - Impact ratios

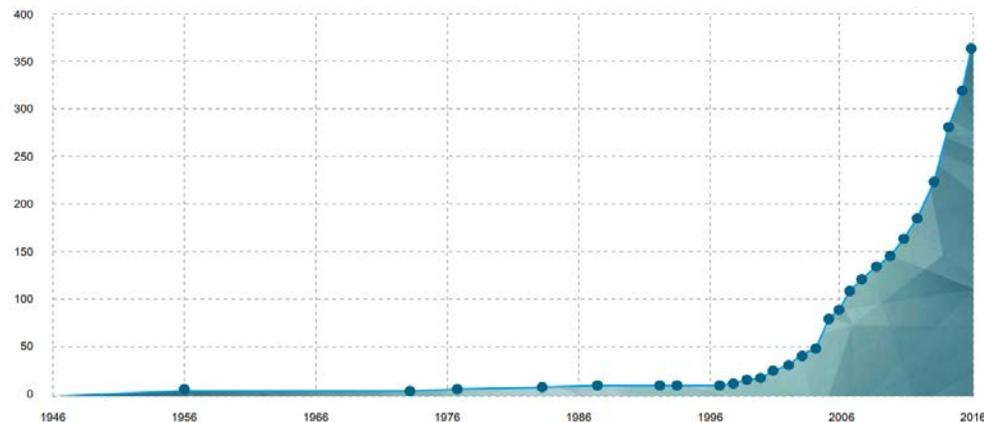
Mainstreaming ESG - the role of the official sector

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'

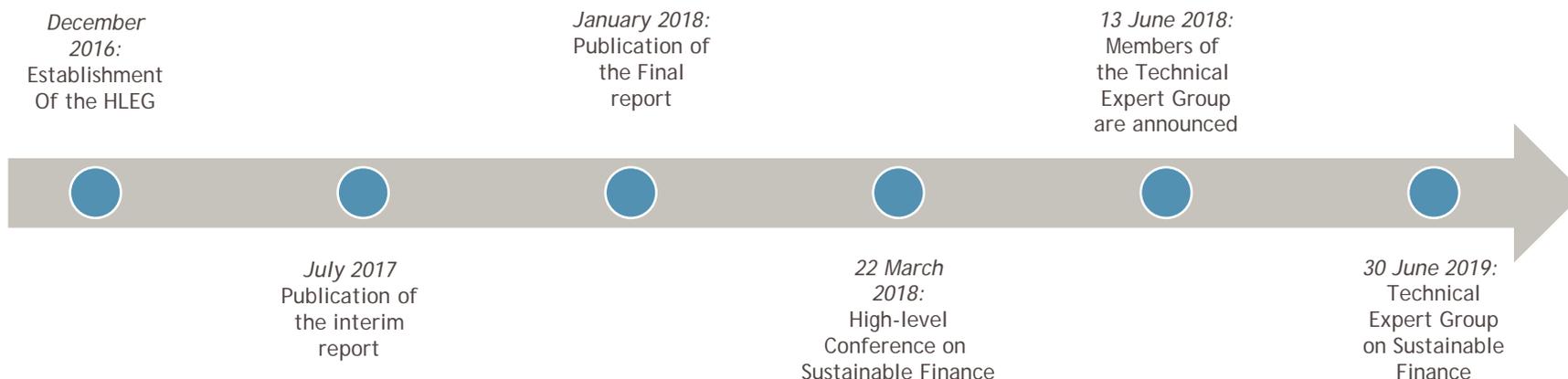


* Source: PRI (2018) Global Guide to Responsible Investment Regulation. Data shows the cumulative number of ESG policy interventions per year. Source: PRI (2016) The Global Guide to Responsible Investment Regulation.

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



Important Information

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