



## MiFID II stay compliant program: Responsible Investment and Climate Risks

Hello everyone, my name is Pim Lievense, Senior Responsible Investment Specialist at NN Investment Partners.

Responsible investing has been on the rise over the past decade for institutional as well as retail investors globally. Regional differences in terms of width and breath of implementation exist. European, and more specifically northern European institutional investors are generally recognized to be thought- as well as practice-leaders in the field of Responsible Investing. European Policy and lawmakers have also directed their attention to the field of RI. For example the 2013 Dutch legislation "wet marktbeschrijving", prohibits institutional investments in manufacturers of cluster bombs. Therefore, it shouldn't come as a surprise that the European Commission in 2018 has launched the *EU action plan on sustainable finance*. In this part we will address the goals and objectives of the Action Plan, the various elements which the Action Plan comprises, and the supposed impact as well as time-lines the Action Plan will have on institutional investors.

The EU Action Plan was adopted by the European Commission in March 2018. The recommendations of the *High-level expert group on sustainable finance* form the basis of the plan. The High Level expert group consisting of 20 experts members, has provided advice to the European Commission on three key objectives:

Firstly, advice on how to direct, both public and private capital flows towards sustainable investments;

Secondly, advice on the steps that financial institutions and supervisors should take to protect the stability of the financial system from risks related to the environment;

Thirdly, advice on how to execute the policies on a pan-European scale

The EC has identified 5 key challenges in relation to sustainable finance and has defined actions that should overcome the challenges. The key challenges are:

KEY CHALLENGES	ACTIONS	
No common definition of 'sustainable investment'	EU classification (taxonomy) for sustainable activities	RELIABLE INFORMATION
Risk of 'greenwashing' of investment products	Standards and labels for 'green' financial products give investors certainty	
Banks and insurers often give insufficient consideration to climate and environmental risks	Study if capital requirements should reflect exposure to climate change and environmental risks	SUSTAINABILITY AND RISK MANAGEMENT
Investors often disregard sustainability factors or underestimate their impact	Clarify institutional investor duties to consider sustainable finance when allocating assets	
Too little information on corporate sustainability-related activities	Enhancing non-financial information disclosure	LONG-TERMISM IN GOVERNANCE



Based on the advice multiple actions have been identified which will either result in new legislation or in the development of new standards and labels. Let's focus on the actions that have the highest direct impact on an institutional investor, namely new regulation:

In May 2018, the European Commission adopted a package of measures implementing several key actions announced in its action plan on sustainable finance. The package includes:

***A proposal for a regulation on the establishment of a framework to facilitate sustainable investment***

This regulation establishes the conditions and the framework to gradually create a unified classification system ('taxonomy') on what can be considered an environmentally sustainable economic activity. This is a first and essential step in the efforts to channel investments into sustainable activities.

In June 2019 the TEG has published its Taxonomy-report, which was open to consultation until the end of 2019. The key take aways from the work that the TEG has undertaken are that 67 economic activities have been identified that can make a substantial contribution to one of the following environmental objectives:

1. Climate change mitigation
2. Climate change adaptation
3. Sustainable use and protection of water and marine resources
4. Transition to a circular economy, waste prevention and recycling
5. Pollution prevention and control
6. Protection of healthy ecosystems

A methodology has been developed for evaluating substantial contributions to either of these goals. It is important to add that minimum requirements have been built into the methodology to prevent significant harm to other objectives.

Now what classifies as an economic activity that contributes substantially to climate change mitigation? Three set of activities have been identified. Firstly, activities that are compatible with a 2050 net zero carbon economy. Secondly activities that contribute to a transition to a net zero economy in 2050, but are not currently operating at that level. An example is this type of activity is the production of a car with emissions below 50 grams of CO<sub>2</sub> per kilometer traveled. Thirdly: activities that contribute to both set of activities as mentioned above. As an example, the manufacturing of wind turbines.

***A proposal for a regulation on disclosures relating to sustainable investments and sustainability risks***

This regulation will introduce disclosure obligations on how institutional investors and asset managers integrate ESG- factors into their risk management processes. Delegated acts will further specify requirements on integrating ESG factors into investment decisions, as this is part of institutional investors' and asset managers' duties towards investors and beneficiaries. The current proposal stipulates the following ESG- requirements for asset managers:

- 1) explicitly requiring the integration of ESG risks in the investment decision or advisory processes as part of duties towards investors and/or beneficiaries;
- 2) introducing mandatory disclosures on how ESG risks are integrated in the investment decision and advisory process;
- 3) in addition, where financial market participants and financial advisors advertise and sell financial products or services claim that such products or services pursue sustainable investment objectives, obliging them to disclose information on the contribution of the investment decisions to the sustainable investment



### **A proposal for a regulation amending the benchmark regulation**

The proposed amendment will create a new category of benchmarks comprising low-carbon and positive carbon impact benchmarks, which will provide investors with better information on the carbon footprint of their investments.

In the third quarter of 2019 the TEG published its final report on climate benchmarks and benchmarks' ESG disclosures. The reports details the construction criteria for two types of climate benchmarks, namely the so called EU Climate Transition Benchmark and the EU Paris-aligned benchmark. It also details the disclosure requirements that shall be applicable to all investment benchmarks.

The EU Climate Transition Benchmark has an explicit CO2-reduction target of 30% compared to the investable universe. This must be based on scope 1 + scope 2 emissions i.e. direct and outsourced emissions initially, but will bring scope 3 emissions, which are the emissions of the produced end-product during the lifetime of the product, into scope within a maximum period of 4 years. Next to this the benchmark should exclude producers of controversial weapons as well as norm violators. The EU Paris aligned benchmark has a 50% CO2-reduction target and will exclude coal, oil and natural gas producers, as well as energy utilities that use these fossil fuels, all subject to a maximum % of revenues derived from those fossil fuels. This means that this benchmark will have a risk-return profile that may deviate substantially from traditional benchmarks.

Finally, a last key feature of the Action Plan is to create EU ecolabels for financial products. The Ecolabel would cover a variety of green financial products, including green bonds. Moreover, the Ecolabel will provide information to retail investors on whether a financial product respects a green standard.

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### **ESG Scores & the investment process**

Hello everyone, my name is Jeroen Bos, Board Member at CFA Society VBA Netherlands and Head of Specialised Equity & Responsible Investing at NN Investment Partners.

In this part we will address the role of ESG scores in the investment process. The role of Environmental, Social and Governance aspects in the investment process has clearly become more prominent in recent years and rightly so. ESG aspects can have a material impact on the long-term growth and profitability of companies, the sustainability and longevity of its business model and therefore also its valuation. As a result, ESG can influence the investment performance of securities like stocks, bonds, real estate and other assets in financial markets. Therefore it is important to integrate these in one's investment process. You can even argue that if you haven't looked at ESG yet, you haven't really finalized your investment analysis and due diligence and you are likely not yet ready to make the best informed investment decision.

One of the ways one can look at ESG aspects of companies is to look at ESG scores from research providers. There are a range of providers in the market offering ESG research, data and scores including firms like Sustainalytics, MSCI, Refinitive, RepRisk, TrueValueLabs, to name a few.

ESG scores can tell you something about how well a company is doing on environmental, social and governance aspects both from an absolute level as well as relative to comparable companies. This can help investors judge if the companies in their investment portfolios score well on ESG or maybe score poorly and therefore have ESG risks that may warrant further investigation. ESG scores are for example driven by features such as the strength of the company's governance, how well the company is treating their workers or for example how well the company is treating the environment they are active in.

You can also calculate the ESG score of an investment portfolio. You can do this by calculating the weighted average of ESG scores of all the individual investments in the portfolio. The ESG score of a portfolio can in turn be compared to other portfolios to see which portfolios have higher or lower risks from an ESG perspective.

So a portfolio scoring better on ESG could have lower environmental risks and exposures, for example when looking at CO<sub>2</sub> emissions. The same logic holds for Social and Governance aspects where portfolios with better ESG scores could have less risks in the area of governance or on certain social aspects like supply chain risks.

It is however important to note that ESG scores of companies and investment portfolios have some angles to be aware off when using these scores to assess the ESG quality and sustainability profile.

Firstly, at some of the ESG rating providers there is often still a size bias in the data, meaning that larger companies have, on average, better ESG scores compared to smaller companies. This doesn't always necessarily mean that larger companies or portfolios with larger stocks in it are more sustainable in terms of business model or treat the environment or society better. This is often the result of larger companies having more resources to develop and maintain a range of policies in the area of ESG.

Secondly, most ESG scoring methodologies often include some kind of sector-neutrality, meaning that the best companies in a sector will have above-average ESG scores. A clear conflict with sustainability could arise as companies active in for example weapons, tobacco and traditional energy can still get high, above market-average ESG scores driven by its policies and this sector-neutrality feature.

Thirdly, do note that the correlation between the ESG scores of different rating agencies is low, sometimes even as low as 0.3. The low correlation of ESG scores of the different rating providers was again confirmed by recent research done by MIT University in the US. This means that ESG ratings on the same companies can be very different at different ESG rating providers. This actually shows that methodologies of the different providers differ and sometimes change through time as well, and therefore one could argue there is no universal truth when it comes to ESG. As a result, ESG scores can be a good starting point when judging the quality and sustainability of companies and portfolios but to get a better and more complete insights it is recommend to look beyond the simple ESG scores and to the reasoning behind these scores.

So to summarize, ESG scores can help give better and more complete insights into the risks and opportunities of securities and investment portfolios and lead to a more complete approach to investing. Portfolios that scores better on ESG usually having a lower risk profile compared to investment portfolios that score worse on ESG. At the same time, it is important to realize that although ESG scores can provide some good insights into risks and opportunities they can still have some biases. It is therefore recommended to always look beyond the standard ESG scores and ratings and use these as simply the starting point to improve the overall decision-making process.

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### Responsible Investing and the concept of Greenwashing

When talking about responsible investing it is important to define what we actually mean. In the market, there is still no clear straightforward definition and for different investors investing responsibly has a different meaning. For some investors this would mean excluding or divesting specific assets, for others it means doing investments which contribute to the environment or society. For others it is to take non-financial aspects in the areas of environmental, social and governance (so ESG) into account when making investment decisions. When looking at the latter, adding ESG insights to the investment process should improve the quality of the process and lead to better investment decisions as it is simply a more complete approach to investing.

It is clear that investing in a responsible way is gaining in popularity and becoming the new normal, which ever specific definition you use. However, with the rising popularity of ESG and responsible investing there is an increasing risk of “Greenwashing”. Simply put, with greenwashing we mean a situation in which one actually pretends to do much more with ESG aspects in their operations or investment processes than actually is the case in practice. Greenwashing can be done by both companies and investors. Companies can for example do great marketing about how sustainable they are by using examples that maybe only represent a very small portion of their activities. By doing this they create the illusion of being a very sustainable company but could actually be doing poorly on ESG in the rest of their business. On the investor side we could see the same in terms of greenwashing. Doing well on ESG is great marketing these days hence almost all asset managers and asset owners claim to do a lot on ESG integration. In practice, however, an asset manager could do very little when it comes to ESG and responsible investing. So it is important to investigate what asset managers or asset owners are actually doing in this area in practice and don't take the marketing stories for granted. As a result of greenwashing we now also see European and local regulators developing standards for Sustainability and ESG integration and this should increasingly help counter this phenomenon.

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### The impact of Climate risks on Investment Portfolios under IORP II

The costs associated with climate change are huge under all likely climate change scenarios. For investors this means that specific climate change related investment risks should be identified. The risks associated with climate change are generally referred to as either physical risks, technological risks, or regulatory risks. And there is always a flip side to it, meaning that risks related to these topics can be opportunities as well of course.

Physical risks associated with climate change relate to business operations that are impacted by extreme weather events resulting from global warming, such as hurricanes, water scarcity or flooding. Business operations can be negatively impacted by these type of risks and can cause direct physical damage to buildings or indirect damage relating to down time of operations as a result of extreme weather events.

The technological risks associated with climate change relate to risks and opportunities as a result of the transition to a green economy. In the light of the energy transition existing techniques can become obsolete or may incur significant impairments. An example of transition risks is visible in the automobiles industry, where conventional combustion engines are being replaced by electric engines. The additional investments that conventional car manufacturers will have to make are huge, and competitors that have exclusively focused on electrification have a competitive advantage.

Regulatory risks associated with climate change stem from changing rules and regulations around the cause of climate change, being carbon emissions. Placing a hard or soft cap on emissions, and rising prices for emission rights pose risks for high emitting businesses. Some national or local governments are banning diesel fueled cars, others are closing down thermal coal powered energy plants. These are examples of regulatory risks that relating to climate change.

Ultimately existing techniques, resources and assets can become obsolete as a result of technological or regulatory developments. When this occurs assets may become stranded, in other words worthless.

Institutional investors apply a myriad of policy instruments to mitigate these risks. Engaging investee companies on climate change related risks as well as bringing down the CO2-footprint of the investment portfolio are actions that are frequently taken. This is likely to be driven even further by the new European law on pension funds (IORP II). The new directive that was published in January 2019 requires European pension funds to conduct periodic risk assessments that should where relevant include risks related to climate change,



use of resources and the environment, social risks and risk related to the depreciation of assets due to regulatory change.

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### **Legal Risks for Corporates from Climate-related topics**

Running a business means taking and managing risks. Businesses in all industries run ESG-risks, such as the risk of fraud, human rights violations in the supply chain, or violating environmental norms. Ideally, these risks should be mitigated by management, in order to protect employers, local community and shareholders from negative consequences. When these risk are not managed well enough, the company and its shareholders are exposed to financial risk in the form of fines and legal compensation payments.

These type of financial risks are now starting to materialize in relation to corporate activities and behavior relating to climate change, so called climate litigation. A number of lawsuits have been filed against oil and gas companies as well as energy utilities over their contribution of their business activities to climate change. In the US, two states have filed lawsuits against a well known oil-major over their role in climate change. Faced with the possibility of devastating consequences brought by rising sea levels, eight cities and counties in California, along with New York City and municipalities in Colorado and Washington state, have filed civil lawsuits against several oil and gas companies.

In Europe a large German energy utility has been sewed by a Peruvian mountain guide in their role of global climate change and the effects it has on the Peruvian community of Huaraz and their property. A local German District Court has taken on this lawsuit which is currently in its fourth year running. This makes clear that fossil fuel companies now and in the future are exposed to risks of climate change related lawsuits.

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### **Carbon Footprint & Investment Portfolios**

In this part of the webinar we will go into the topic of the carbon footprint of companies and the impact it can have on investment portfolios. Carbon emissions of companies, or also expressed as the carbon footprint of companies, are becoming increasingly in focus given the debates around global warming. This gained even more momentum after the Paris agreement of 2015.

Like ESG scores of portfolios one can also look at the carbon footprint of investment portfolios. The carbon footprint of a portfolio can basically be calculated by looking at all the different holdings of a portfolio and calculate the weighted average to get insights into the overall carbon emission of the portfolio.

The greater the carbon footprint of portfolios, the bigger the potential negative impact and risk from this high exposure to carbon emissions. One could think about the risk of increasing involvement of regulators to drive carbon emissions down. This could be done through for example higher carbon taxes, regulatory fines or cancellation of permits, all of which could negatively impact companies with higher carbon emissions.

Furthermore, we could see the financial markets shifting financial allocations towards carbon light firms at the expense of carbon intensive industries which could see demand for lower carbon intensive firms increase and demand for high-carbon intensive securities decrease, thereby potentially affecting the prices for these securities. All these factors increase the financial risk for carbon intensive companies. Therefore, it is important to be aware of the carbon intensity of investment portfolios.

Investors can reduce risks stemming from a high carbon footprint by for example focusing on investing in industries and companies that have lower carbon emission instead of ones that emit above average emission or invest in companies that have a strong ambition to reduce their emissions. Furthermore, one could also focus on investing in companies that facilitate the transition to a lower carbon intensive economy. Lastly,



through engagement, so discussing with management teams of the corporates, investors can help push the companies towards a lower carbon intensive future.

So, as discussed there are several ways in which investors can actually steer their portfolios away from high carbon intensive investments and therefore lower the risks that the transition to a lower carbon economy can have on their portfolio.

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### Green Bonds

In the following part we will have a look at the concept of green bonds. One of the ways of integrating carbon emissions in the asset allocation as well as supporting the energy transition is investing in green bonds.

Basically a green bond is a bond for which the proceeds are specifically earmarked to be used for climate and environmental projects. These include projects that are aimed at energy efficiency, pollution prevention, sustainable agriculture, fishery and forestry, clean transportation, sustainable water management, just to name a few.

One of the key questions when thinking about green bonds is often around the impact on the spread. In other words, is the spread of green bonds different compared to the spread of mainstream bonds.

From a fundamental perspective the difference between a green bond of a company and a traditional bond issued by the same company is very limited. Only the goal for which the proceeds of the bond is being used will often be the key difference with the green bond proceeds only being allowed to be used for "green" projects we discussed earlier. The overall risks of the underlying issuer are of course the same and hence the credit spread should normally be very similar as well.

In general the spreads between green bonds and traditional bonds are therefore fairly comparable, although we did see some tighter spreads in recent years in some instances. The explanation for this could simply be the strong interest in green bonds in combination with still limited supply of green bonds. As a result, these issuers were able to offer a tighter spread for their green bonds when issuing these as investors were willing to pay a small premium. In these cases, the question for investors would be if they should be willing to pay this small valuation premium for a green bond versus a comparable traditional bond.

With the strong growth in supply of green bonds in the market it is the expectation that spread should converge further, limiting the spread difference between traditional bonds and green bonds. This of course makes a lot of sense as the risk profile regarding the issuer is almost always the same for both bonds.

Furthermore, it is important to assess how green a green bond itself or the corporate issuer of the bond actually is. As there is no exact regulation around when an issuer can call their bond a green bond, it is important as an investor to make sure one feels comfortable enough around the intentions of the issuer. For example, can a traditional coal company also issue a green bond and if so, are we confident enough that these proceeds will go to green projects. Given the lack of regulation every investor needs to decide this for themselves and hence it is important to be aware of these dynamics.

So to conclude, green bonds are a relatively new asset, providing financing that is really focused on climate and environmental projects. From a spread perspective there is no strong reason why longer term the spread should be different versus more traditional bonds although in the near-to-medium term supply and demand dynamics could still result in slightly tighter spreads for green bonds.