



Module Responsible Investment & Climate Risk – Responsible Investment

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Nice to meet you, my name is Adrie Heinsbroek, member of the Responsible Investment Committee of CFA Society VBA Netherlands and Chief Sustainability Officer at NN Investment Partners.

In this session we will discuss 3 topics related to Responsible Investment. The first is Sustainable Development, the second is the European classification system ('green taxonomy') and last one is the role of ESG scores in the investment portfolio.

Sustainable Development; concepts and connotations

Sustainability and its economic dimension

The concept of Sustainability was originated by Hans Carl von Carlowitz, an inspector of mines in Saxony over 300 years ago. His book, "Sylvicultura Oeconomica" ("Silviculture and Economics") of 1713 - considered to be the first work on forest management – brings the concept or term "sustainability" to the forefront of efficient forestry and continuation of mining as known in those times.

In his work Von Carlowitz was directly confronted with the greatest problem of the then flourishing Saxon mines and smelting works: lack of wood. He developed a concept intended to ensure a lasting supply of wood for the mining industry. In his book, he suggested only as much wood should be logged as could grow back in the same time.



Early signs of sustainability

Original idea of sustainability: **Only cut as much wood so it can grow again.**
(Hans Carl von Carlowitz, 1713)



Another important moment was 1972, when a report for the Club of Rome was published. Founded in April 1968, The Club of Rome consisted of academic and government officials, diplomats, scientists, economists, and business leaders from around the world. It looked at issues or problems, as interrelated and interdependent, and not in isolation.

The Club of Rome stimulated considerable public attention with its first report **“The Limits to Growth”**. In the book, scenarios or simulations suggested that economic growth could not continue indefinitely because of resource depletion. The Limits to Growth can be regarded as a scenario analysis of 12 possible futures from 1972 to 2100. One could state that the main conclusion was that if policies or practices are not put into effect, then the human economy would overshoot planetary limits. Once in so-called unsustainable territory, human society would be forced to reduce its rate of resource use either through regulated reductions or by an unregulated “collapse” induced by nature or the market.



According to The Limits of Growth, the only thing that could not happen was for world society to remain in unsustainable territory on a permanent basis - using more of nature's resources every year than nature produces during that time. There is a striking resemblance between this and the suggestion of Von Carlowitz on the amount of wood that could be logged.

15 years later, another report was published. "A global agenda for change" - this was what the World Commission on Environment and Development (WCED) was asked to formulate. In 1987, the Commission issued a report called "**Our Common Future**", also known as the 'Brundtland Report', in recognition of the role of Gro Harlem Brundtland, the former Norwegian Prime Minister, as Chair of the commission.

In this report the concept of Sustainable Development was defined as "Development that meets the needs of the present without compromising the ability of future generations to meet their own needs".

This is one of the most influential ways in which sustainability has been understood in recent years. This conception of sustainability is a function of three intersecting concerns: economic growth, social development and environmental preservation.

In this description of Sustainable development, there is no mutual exclusiveness, but it's about combined inclusion. As the picture shows, Economic, Social and Environmental dimensions can be drawn as circles that overlap each other; combinations can reinforce each other as overlaps mean that both dimensions are part of the equation.



Description and Dimensions

Sustainable Development

"Sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs"
Brundtland Commission
"Our common future" 1987



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Another illustration of sustainability, in environmental terms at least, can be thought of in terms of planetary boundaries, a concept introduced in 2009 by a group of Earth system and environmental scientists led by the Stockholm Research Institute. The group created a framework recognizing that human actions have become the main driver of global environmental change and that in order to thrive, humanity had to develop and thrive within certain limits. Out of nine defined boundaries, four have already been crossed – where we have breached a tipping point, or safe operating space – these are climate change, biodiversity loss, biogeochemical processes and ocean acidification.

Link to Responsible Investing

Allow me to elaborate on some elements of sustainable development that relate to Responsible Investing (RI):

Integration connection: In RI there is also the combination of both financial and economics next to social and environmental factors. One could even state that Sustainable Development and the Social, Environmental and Economic (SEE) dimensions are a different way of regarding ESG



(Environmental, Social, Governance) factors within Responsible Investments. It is important to note here that meeting essential needs requires, according to the Brundtland report, an assurance that the current and future generations and population all get their fair share of the resources required to sustain and experience economic growth. This requires political systems that secure effective citizen participation in decision making and, *mutatis mutandis*, transparent decision making at corporates. This leads into the Governance dimensions of ESG.¹ The combination of these factors provides a broader view which we will discuss later in the module.

Economic connection: Sustainability is connected to business continuity as the example of the Saxon mining and forestry illustrated earlier. Business continuity is also explicitly part of the description of the three dimensions of the Brundtland report as these dimensions ensure continued development and economic activity. Implicitly, sustainability is the factor enabling continued economic activity, when social and environmental dimensions are not respected, economic development will not be able to sustain over time as social development and environmental destruction will diminish continuous economic progress. The concept of planetary boundaries also points to this.

Risk and opportunities connection; While Limits to Growth started from a risk perspective, the Brundtland report also helped generate a view on opportunities as development and growth could remain possible, as long as it was done with respect, an eye for social development and ensuring environmental protection. Therefore, it provides corporates with a license to operate when they take up their corporate responsibility.

Long term perspective connection; RI usually has a longer term investment horizon and the description of sustainable development is clearly also aimed at the longer term as it describes conditions to ensure ongoing economic activity. It also puts the accent on future generations and implicitly builds on a moral case to ensure that future generations will also be able to be economically and social active. RI seeks to help address the challenge of inter-temporal decision making – limiting short term gains if they have long term negative impacts that outweigh them.



¹ Derived from paragraph 28 of the WECD report “Our Common Future”; “Meeting essential needs requires not only a new era of economic growth for nations in which the majority are poor, but an assurance that those poor get their fair share of the resources required to sustain that growth. Such equity would be aided by political systems that secure effective citizen participation in decision making and by greater democracy in international decision making.”



Stakeholders connection; RI puts emphasis on the role and responsibility of companies and governments in their policies and practices of economic behavior. This is aligned with the interconnection of sustainable development as here the dimension of environmental protection and social development is connected to economic growth. Hence economic actors must be aware of stakeholder relations and not only have eye for the needs of share and bondholders.

Allow me to also bring two other topics to your attention;

Our Common Future was both practical as well as radical. The radical aspect emerged from the explicit linkage made between environment and development issues. The report argued that ecological sustainability cannot be achieved if the problem of poverty is not successfully addressed around the world. This is reflected in the Sustainable Development Goals (SDG), adopted by the United Nations in 2015 where poverty and ecology are part of several goals. Here there is a strong connection with impact investing as these types of investments often refer to the SDGs. The practical element was that the report did not oppose economic growth and economic activity as such and was not advocating economic downsizing.

There was also criticism of the report. There is, for instance no formal guarantee that economic development will parallel social and institutional development (accountable governmental and corporate governance) or that economic development will not come at the expense of environmental degradation. As the report provides room for economic growth, the major concern is that environmental concerns will remain subordinate to economic development concerns and that economic actors are only paying lip service to the idea of sustainability.

The EU taxonomy

The EU taxonomy is a classification system, establishing a list of environmentally sustainable economic activities.

The European commission expects, by providing appropriate definitions (and descriptions) to companies, investors and policymakers on which economic activities can be considered environmentally sustainable, to create security for investors, protect private investors from



greenwashing, help companies to plan the transition, mitigate market fragmentation and eventually help shift investments towards sustainable projects and activities in order to make European economies, businesses and societies more resilient against climate and environmental shocks and risks.

For now, the taxonomy has an environmental dimension, in the near future social objectives will also be established by the European commission.

The Taxonomy Regulation was published in the Official Journal of the European Union on 22 June 2020 and entered into force on 12 July 2020.

The Taxonomy Regulation establishes six environmental objectives

1. Climate change mitigation
2. Climate change adaptation
3. The sustainable use and protection of water and marine resources
4. The transition to a circular economy
5. Pollution prevention and control
6. The protection and restoration of biodiversity and ecosystems

An economic activity will be considered to be environmentally sustainable if it complies with all four of the following criteria:

- substantially contributes to one or more environmental objectives;
- does not significantly harm (DNSH) any environmental objective;
- complies with minimum safeguards based on certain human rights standards; and
- complies with the Technical Screening Criteria (TSC), which are the detailed conditions for the first two limbs above.

The Taxonomy Regulation describes the actual list of environmentally sustainable activities by defining technical screening criteria (TSC) for each environmental objective through delegated acts.

The European Commission has published in April 2021 a text of the EU Taxonomy Climate Delegated Act on Climate Change mitigation and on Climate Change adaptation. A second delegated act for the remaining objectives will be published in 2022, where in 2021 the consultation will be expected where feedback can be provided. This moves us closer to a green classification framework.



Climate change mitigation and adaptation

Under the taxonomy, an activity will qualify as substantially contributing to the climate change mitigation objective via the avoidance of emissions of greenhouse gases¹ (GHGs), reduction of GHG emissions or removing GHGs from the atmosphere. Where there is no technologically and economically feasible low carbon alternative, the EU Taxonomy also recognises that certain activities can qualify as making a substantial contribution to the transition to a net zero economy. Specific transitional activities will be specified in the technical screening criteria; these must represent best-in-sector/industry GHG emissions performance, not hamper the development and deployment of low carbon alternatives and not lead to a lock-in of carbon intensive assets considered over their lifetime.

An activity will qualify as substantially contributing to the objective of climate change adaptation where it includes adaptation solutions that substantially reduce the risk of adverse impact of climate change on that activity or, subject to certain additional criteria, on people, nature or assets. In both cases, this must be without increasing the risk of adverse impact on people, nature or assets more broadly.

Do note that the detail of how this is determined for specific activities is set out in the technical screening criteria.

Due Diligence

It is important to add that minimum requirements have been built into the methodology to prevent significant harm to the other objectives. The consequence is that investors need to conduct an ESG-due diligence when making an investment and on a regular basis on their portfolios. As the due diligence is focused on (preventing) '**significant harm to others**', the process consists of six steps.

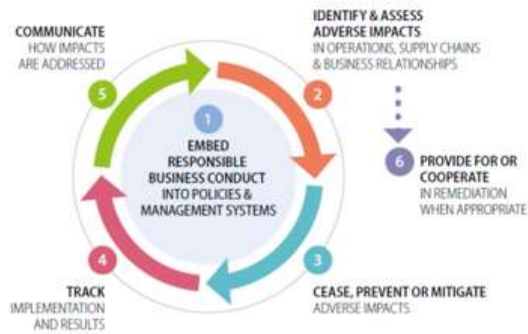


These steps deal with (see the figure):

- integrating responsible business conduct into policy and management systems
- identifying and analysing risks to society and the environment
- preventing and mitigating potential and actual negative impact by using influence
- monitoring implementation and monitoring results
- communicating on the approach and results;
- providing access to remedy, as in encouraging the investee company to provide remedy when negative impact has occurred.

Due Diligence

FIGURE 1. DUE DILIGENCE PROCESS & SUPPORTING MEASURES



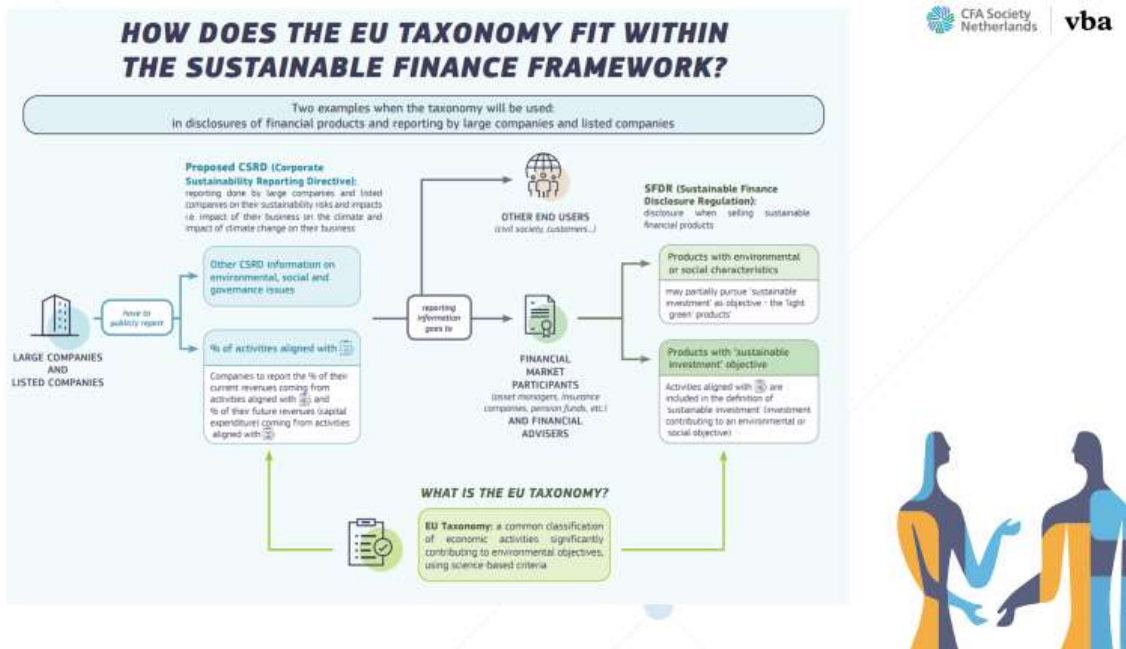
MiFID II

Stay Compliant Program



Connection

The taxonomy is linked with other parts of the EU Sustainable Finance Action plan as can be seen in this overview.



Important for investors is that as the taxonomy describes environmentally sustainable economic activities, this helps companies to disclose relevant and needed information on their contribution to these activities. The taxonomy also assists investors as the activities aligned with the taxonomy are included in the definition of sustainable investment which is part of article 9 financial products under the SFDR.



Environmental, Social and Governance factors in the investment decision making process

Integrating Environmental, Social and Governance (ESG) factors in the investment decision making process has become mainstream. It is even fair to say that integrating Environmental, Social and Governance factors enhances the decision-making process, when not only financial performance and outlook is considered but also the performance on ESG dimensions. ESG aspects can be relevant to assess both the resilience of an investment to risks as well as the opportunities to create value and an investment return. ESG aspects can have a material impact on the long-term growth and profitability of companies, the competitive edge of their business model and hence the valuation.

The recent EU Sustainable Finance regulation (SFDR) also recognizes the importance of ESG factors in investment decision making by emphasizing sustainability risk, environmental and social characteristics and good governance practices.

Building on the concept of ESG factors being important in the investment decision process, ESG scores of investments are also becoming more widely used. ESG scores are a quantified metric (number or letter) and can tell an investor how a company or issuer is performing on environmental, social or governance aspects, both from an absolute level as well as relative to other investments.



ESG factors



Allow me to describe some roles of ESG scores or performance in the investment process and portfolio decisions.

ESG factors add to the insights of investors when assessing an investment as both financial information and information on ESG performance (non-financial information) are two sides of the same coin so to speak. ESG factors can relate to both policies and to practices and therefore can be used as an element to analyse the ability of a company, for instance to execute on its strategy. The score of an investment on a specific ESG factor might also provide investors with information to engage with a company or issuer to share either concerns or compliments on that specific performance. For instance on board diversity or board independence. Therefore they can be considered a tool or instrument for active ownership (engagement).

ESG scores or performance also have a link with materiality. Materiality is about determining those issues and opportunities that companies in a certain sector might face to create value for all stakeholders. Materiality enables you as an investor to view the specific importance of a specific ESG factor for an investment according to your investment views or beliefs. Not every factor is as



important for every sector or company. For instance, an environmental factor such as waste disposal will be less material for the full ESG score of a financial institution than it will be for a company active in the mining sector. The example of the collapse of a tailings dam in Brazil has clearly shown this. Assessing this is helpful in linking the specific ESG factor in terms of its role in value creation or preventing value destruction. Hence, ESG factors can be seen as financially material as they relate to the financial outlook of a company.

From the perspective of materiality, this allows you as an investor to weigh the risk or opportunity of an ESG factor's value creation. ESG factors and scores can be used as a metric for expressing risks or for underlining opportunities to invest in. ESG scores or performance are nowadays also used as a reason for divestment if an investment is no longer in line with the ESG criteria of an investor.

On environmental metrics, you can see that portfolios are managed accordingly to specific environmental scores on metrics such as carbon emissions. For instance the portfolios are managed to be aligned with specific carbon benchmarks or to be Paris-aligned where the carbon emissions of a portfolio are in line with the scenarios as agreed upon according to the reduction targets and timelines of Paris Agreement.

Another role nowadays for ESG factors in the investment process is their explicit role in the EU Sustainable Finance regulation. Companies are obliged to disclose (CSRD regulation) ESG information such as carbon emissions and asset managers are obliged to disclose (SFDR regulation) which ESG indicators are used to mitigate negative impact of portfolios on society. ESG factors and scores can help to comply with the regulation and to report on how a portfolio is performing. It is also increasingly seen that companies conduct ESG roadshows and want to demonstrate their performance on specific metrics, mostly environmental, as well as show their transparency on these factors and even on the Sustainable Development Goals.

It is also remains important to note that there are aspects to be aware of in the ESG scores of companies and issuers as well as of investment portfolios.

Due to the emphasis on environmental scores it should not be ignored that Governance factors also play an important role, as can be witnessed at annual shareholding meetings (AGM) of companies where topics such as remuneration and board diversity are mentioned in conversations and in



exchanges with board representatives and even voted on. Investors should be aware that the integral value of ESG is also in the combination and connection of the three domains. This was also described in the session on Sustainable development where both environmental and social topics have a connection to the economic outlook. Having portfolios geared towards only one dimension or specific factors might not reflect the full ESG performance of an investment and can include unintended sustainability risks and even financial risks.

There might be biases in data, notably a size bias as larger public companies have on average better scores compared to smaller companies. This can be the result of larger companies having more resources allocated to develop policies and report on practices. There is also a time lag in data especially for sovereign data as objective, statistical data has a tendency to be available after some time has gone by.

One should also be aware that due to underlying differences in methodology or parameters that are measured, correlation of ESG scores of different rating agencies can be low. This can lead to different outcomes of a similar kind of ESG due diligence due to the use of parameters from different sources and combination with the investors own methodology or materiality framework. The weighting of different parameters and even broad categories (Environmental, Social, Governance) across frameworks can also widely differ. One of the results is that investors tend to use multiple sources or construct with the input of ESG research providers their own ESG scores. Also rating agencies such as Morningstar have constructed an average ESG score for portfolios based on a specific methodology. Being aware of underlying methodologies and used ESG data is important.

A final point to consider is the timing of applying ESG scores in investment selection process. For example, if investments are screened for performance in advance of ESG factors, the initial filter of performance can result in the exclusion of companies that score well in ESG terms. This could lead to missed opportunities to generate gains through companies that focus on long term performance.