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# insights

# INTEGRATION CASE BOOK

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# the editor's word

## *ESG deconstructed*

Amidst a storm of criticism and greenwashing allegations, ESG is quickly becoming one of the most controversial acronyms out there. "ESG is the devil," twitted Elon Musk just the other day. And he is hardly the only media-savvy populist eager to hijack and distort the concept to make it fit his personal or political agenda.

In these times of cheap rhetoric and sweeping generalisations, it is essential to recall the true meaning of ESG and its different components. In this year's ESG Casebook edition, we aim to do just that. Through concrete cases, we go beyond the general concept of ESG and highlight the many different ways that asset owners and asset managers work with the E, the S, and the G aspects of sustainability, individually or together.

We take a look at how Norwegian pension fund KLP has chosen to deconstruct ESG into specific actions targeting deforestation, climate inertia and tax avoidance. We examine the way Danish AkademikerPension, Norwegian Storebrand Asset Management, and Dutch APG Asset Management have pinpointed Toyota's climate lobbying as a concrete and meaningful case to tackle together.

Steward Investors urges us to avoid the pitfall of narrow carbon tunnel vision and zoom in on factors like income inequality and demographics to illustrate the importance of the human aspect of ESG. Meanwhile, UBS Asset Management showcases a different approach, deconstructing the ESG concept to its constituents in order to be able to integrate it into their factor index solutions.

We also consider the plight of a manager selector trying to integrate ESG into the complex equation of choosing the best external manager to partner with. Three organisations with ample experience in the field, Norway's sovereign wealth fund (NBIM), Kempen Capital Management, and Cardano, provide some useful guidance via the PRI. The experts at Global Fund Search (GFS) are also eager to provide help.

Last but not least, we dive deep into emerging markets and biodiversity to find out about the role of blended finance in the race to preserve endangered ecosystems.

It takes deconstructing the concept of ESG to find out it is not just an empty label and certainly not one that can simply be hung out and set on fire. The ESG is not the devil but it is in the detail!

Aline Reichenberg Gustafsson, CFA

Editor-in-Chief

NordSIP

# Integrating ESG into Factor Index Solutions

*by* Marcin Wojtowicz, PhD
ETF & Index Fund Investment Analytics, UBS Asset Management

Credit: AtlasComposer on Envato

Investors are increasingly looking to integrate ESG considerations into factor investing. This requires a balancing act between tilting the portfolio towards factor characteristics and meeting ESG objectives. Let us look at how investors can combine these two objectives with index-based factor strategies.

### Constructing factor indices

Before delving into ESG integration, we first provide a short overview on the construction of traditional factor indices. In this article, we will focus on quality and value factors.

The starting point here is to decide on the most appropriate metrics to capture a given factor exposure.

- **Value criteria:** Price-to-Book Value, Price-to-Earnings, Price-to-Sales, Price-to-Cash Earnings
- **Quality criteria:** Return-on-Equity, Debt-to-Equity, Earnings-Variability

By using these company-level metrics, we can assess the factor exposure of each company in the investment universe (e.g. MSCI USA index). To ensure comparability, it is typical to standardize these metrics by creating z-scores.

These can be further aggregated into composite z-scores corresponding to the specific factor (value, quality), which can be interpreted as factor loadings. The higher the value of the z-score, the higher the factor exposure.

In an index-based approach, a factor portfolio can be constructed by selecting only those companies from the parent universe which have relatively high factor loadings (e.g. including 25-30% by market capitalization). Furthermore, the weighting of portfolio constituents may be linked to market capitalization as well as factor exposures (z-scores) to further tilt towards the targeted factor.

### ESG integration

In our view, a comprehensive ESG overlay should include several components such as business activity exclusions, promotion of higher ESG rated companies, and a carbon footprint reduction. In particular, sustainability ambitions can be defined as follows (based on MSCI data).

- **Exclusions**: UNGC violations, tobacco, weapons (controversial, nuclear, military, civilian), thermal coal mining, unconventional oil and gas extraction, thermal coal power generation
- **Minimum ESG standards**: minimum MSCI rating of BB and minimum controversy score of 1
- ESG score improvement target of **+20%**
- Carbon footprint reduction by **30%**, potential emissions (fossil fuel reserves) reduction by **30%**

Applying business activity exclusions [1] and minimum ESG standards [2] is straightforward and typically reduces the eligible universe by single digit percentages as measured by market capitalization.

*Constructing a standard factor index is about defining the relevant factor metrics, which are then used for stock selection and tilting weights to increase factor exposure.*

Florian Cisana
Head of UBS ETF
& Index Fund Sales Nordics

### Interplay between factor exposure and ESG considerations

The key challenge lies in balancing at the portfolio level between:

- factor exposure
- an improvement in ESG score [3]
- a reduction in carbon footprint [4].

In essence, it is a multidimensional optimization problem.

We examine the relationship between the value factor exposure and ESG score for the MSCI USA universe (Figure 1), using MSCI ESG data. The most desirable companies are characterized by above average ESG scores and high value factor loadings (z-scores).

The bubble area represents the weights of companies in MSCI USA index. The horizontal blue line represents the average (industry-adjusted) ESG score of 6.3, while the vertical blue line represents the average value z-score by construction equal to 0.0.

### What are the two methods to create a factor ESG portfolio?

**Option 1. A two-step approach:** ESG integration followed by factor selection.

For example, ESG integration could aim to include the top 50% of highest ESG rated companies. The second step would be a selection of the top 50% of companies with the highest value loadings (z-score).

This selection is represented by the top right quadrant of Figure 1. In this quadrant, there are 124 companies (note that the MSCI USA has 625 constituents) with an aggregate weight of 13.7%. The caveat is that ESG score improvement reaches 13.9% compared to MSCI USA, while carbon intensity is actually 160% higher. A two-step approach would thus require further refinements to meet the previously outlined ESG ambitions.

The weakness of this approach lies in its inability to jointly assess companies based on the three criteria (factor exposure, ESG score [3], carbon footprint [4]). To illustrate the point: a company with a very high factor loading may be just below the ESG threshold, while a company having an insignificantly better ESG score may pass despite having a significantly weaker factor loading. It leads to unnecessary erosion of factor exposure that is required to meet a targeted ESG improvement.[1]

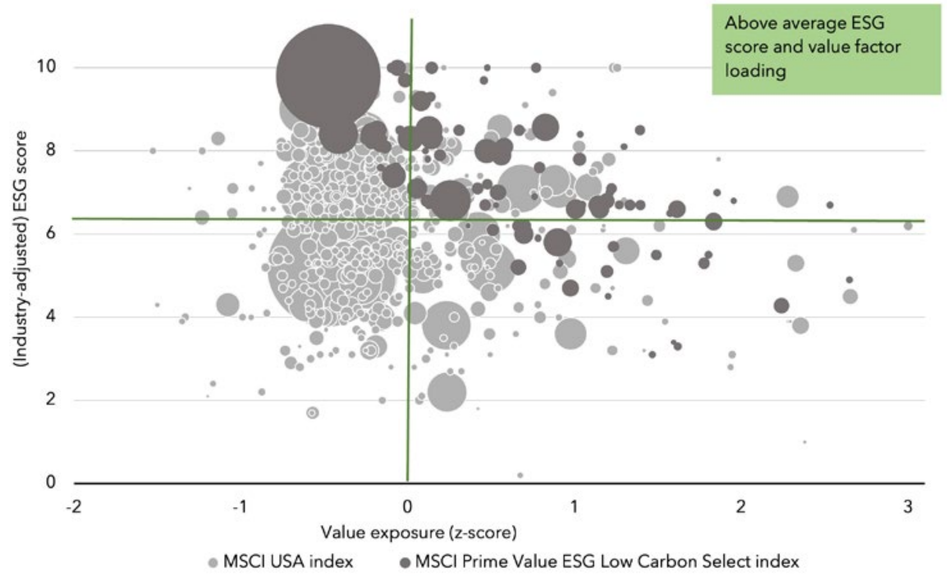
**Option 2. Optimized approach:** optimization procedure with the objective to maximize the portfolio exposure to the value factor (z-score), subject to the constraint of meeting the ESG improvement target (+20%) and carbon intensity reduction (-30%).

The optimizer not only selects a subset of companies, but also reweights portfolio constituents, while a number of conditions are imposed to ensure sufficient diversification.

[1] For a more detailed discussion on this topic, we refer to MSCI publication 'The MSCI Factor ESG Target Indexes' (September 2017).

**Figure 1: MSCI USA universe: ESG scores vs. value factor z-scores**

The bubble area represents the weights of companies in MSCI USA index. The horizontal green line represents the average (industry-adjusted) ESG score of 6.3, while the vertical green line represents the average value z-score by construction equal to 0.0.




Source: MSCI, UBS Asset Management. Data as of 28 April 2023.

- Tracking error limit: 10%
- Sector active weights: +/- 20%, country active weights: +/-20% but more stringent for smaller countries
- Number of constituents: minimum 100 or at least 25% of the number of constituents in the parent index rounded to the nearest 10
- Maximum overweight of a constituent by a factor of 10 vs. the parent index weight, but the overweight is not greater than by +2% in absolute terms
- Minimum constituent weight: 0.05%
- One-way semi-annual turnover: 20%

This approach provides a flexible framework that can be applied to different factors (e.g. quality, value, volatility) and across different universes (MSCI USA, MSCI EMU).

A framework like this is used in the MSCI USA ESG Quality Low Carbon Select [LCS] index and the MSCI USA ESG Prime Value LCS index.

The latter is a value index that additionally applies a quality pre-screen which removes one-third of companies with the lowest scores based on quality metrics. Its purpose is to avoid value traps, which are companies that exhibit strong value characteristics (e.g. low P/E) but for the very reason of questionable financial viability. Let us look at this portfolio in more detail.

### MSCI USA Prime Value ESG Low Carbon Select index

The MSCI USA Prime Value ESG LCS index portfolio is indicted in Figure 1 with dark grey colour; it includes 104 companies with an aggregate market cap weight of 17.0% vs its parent – the MSCI USA index. We can see the optimizer makes trade-offs between factor exposures and ESG scores: at times a company with a lower factor loading enters the portfolio because it has a high ESG score and vice-versa. Clearly, companies with below average ESG scores and below average value factor loadings are excluded (bottom left quadrant in Figure 1).

The portfolio fulfils all objectives; MSCI USA Prime Value index has a value exposure that is significantly higher compared to MSCI USA (z-score of 0.34[2] vs -0.13)[3], while it meets the ESG target improvement (+20%) and exceeds the carbon reduction target (-49%).

**Table 1: Comparison of selected metrics (averages weighted by market capitalization)**

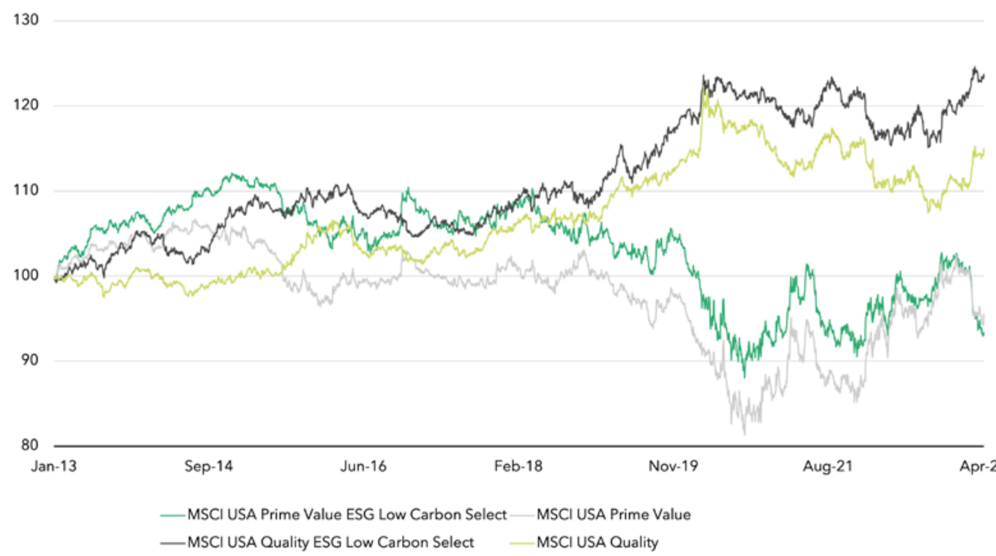
| | Value z-score | ESG Score (Industry adj.) | Carbon intensity |
|---|---|---|---|
| MSCI USA Prime Value ESG LCS | 0.34 | 7.91 | 73.71 |
| MSCI USA | -0.13[4] | 6.59 | 144.41 |

[2] This portfolio average value z-score is weighted by market capitalization

[3] The value is -0.13 because it is the market cap-weighted average. For arithmetic mean, the value is 0.0.

**Figure 2: Historical performance of selected factor indices relative to MSCI USA**

Index level data for factor indices contains live and back-tested data. Past performance, whether simulated or actual, is not a reliable indicator of future results. For illustrative purposes only.




Source: MSCI, UBS Asset Management. Data as of 28 April 2023.

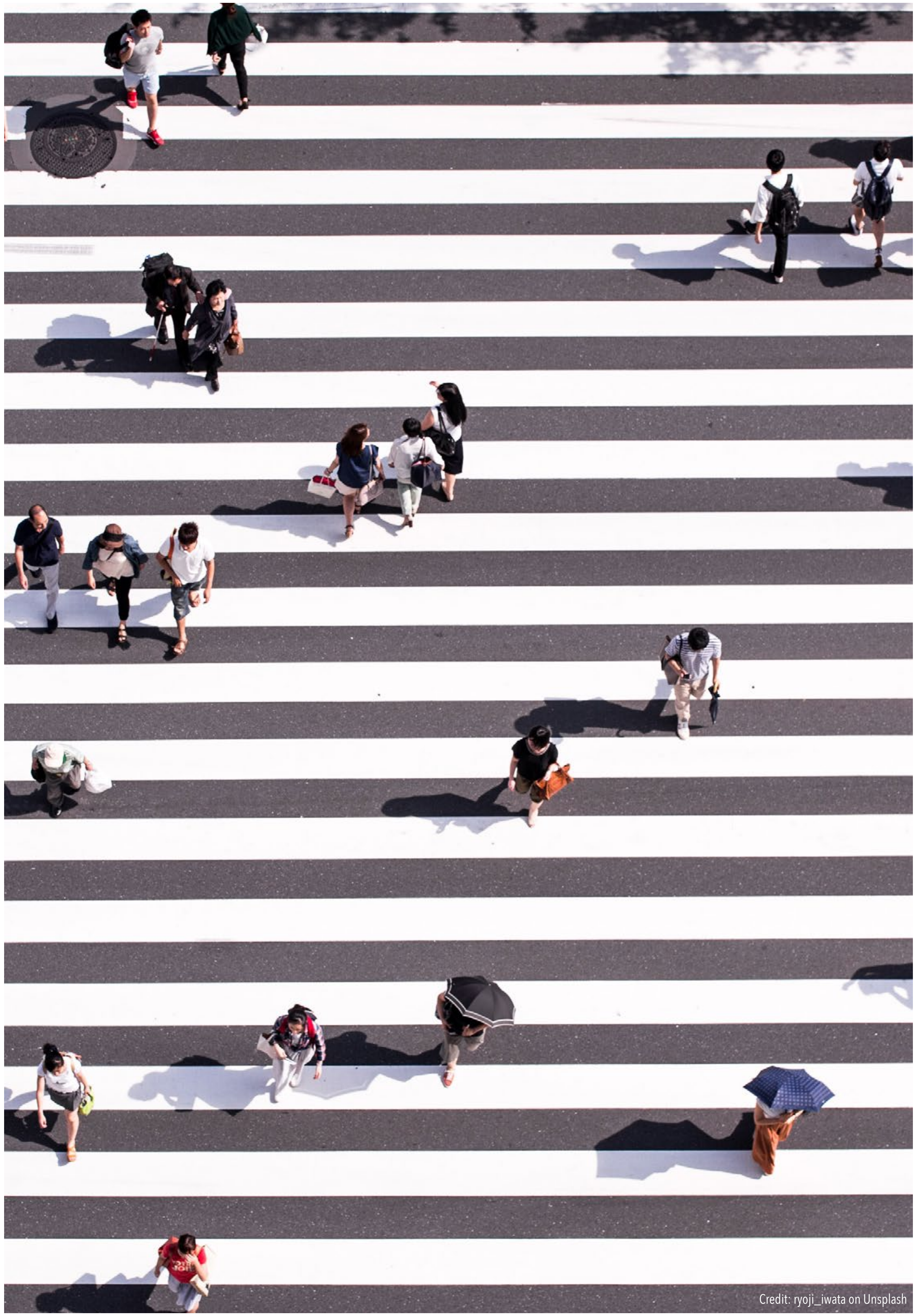
### Performance

The performance of the mentioned factor ESG indices has been similar to standard factor indices (Figure 2). Since 2013, the Value ESG index underperformed its standard Value equivalent by 25 bps per annum, while the Quality ESG index outperformed its standard factor equivalent by 81 bps per annum[5]. Also, correlations in daily excess returns between the two Value and Quality indices has been at 0.86 and 0.79, respectively, which further demonstrates similarity.

[5] The factor ESG indices are primarily based on backtested data.

### Conclusions

Integrating ESG into factor indices can be achieved with an optimized approach that efficiently balances between achieving factor exposures and sustainability objectives. Historical simulations demonstrate that factor ESG solutions can be considered as a good alternative to their traditional counterparts.




# *Sustainable Investing:* Don't Forget the Humans

*by* Stewart Investors

*"Climate change is one of our greatest threats. At Stewart Investors we consider it a key investment risk, and an investment opportunity."*

Morningstar identified 860 funds with a climate-related mandate in 2021 and estimates this number increased by more than a third in 2022[1] Financial regulators are calling for investors to increase their climate-risk disclosure and there is an increasing number of industry collaborations such as the Glasgow Financial Alliance for Net Zero. This increased attention to climate change by the financial community is both welcome, and understandable, given the frequency of record-breaking weather events and concerning levels of pollution and biodiversity loss we face.

Climate change is one of our greatest threats. At Stewart Investors we consider it a key investment risk, and an investment opportunity. However our definition of sustainability is broader than just climate change, and encompasses a wide range of environmental and human development considerations. Instead of viewing sustainability issues in isolation, we think of them as part of an interconnected and interdependent web of challenges.

Take income inequality as an example. It is usually linked to access to education, which is often linked to poverty, which can be linked to food insecurity, which is increasingly linked to climate change and biodiversity loss, which can link back to poverty and inequality, and so on. Efforts to improve human development will be limited if we don't address climate change, and efforts to address climate change will be undermined, if we don't improve human development.

Why? Let's consider demographic change. In 2022, the eight billionth person was born[2]. The world's population grew by one billion people over the last 12 years[3], mostly in Asia. It is currently growing by more than 200,000 people each day[4]. As things stand, 70% of the world's population live in countries running an ecological deficit while generating a below-world-average income[5]. If everyone is to live like the average Brit or American, we will need at least 3-5 planets worth of resources to sustain ourselves.[6]The Global Footprint Network illustrates this point well, and maps countries according to their human development and ecological footprint (see page 13).

The Human Development Index (horizontal axis) measures a country's life expectancy, education and income. The ecological footprint (vertical axis) measures the stock of natural resources it takes to sustain a country's economy and population.

As countries improve their human development, they also tend to increase their ecological footprint. Wealthy people and countries have a disproportionately large ecological footprint and some studies suggest they are responsible for a growing proportion of total global emissions.[7]

So it is clear we need to change, and find ways to improve living standards while staying within environmental limits. This requires governmental action and broad societal change, but the private sector has a crucial role to play too. This is our investment hunting ground, where we search for publicly-listed companies that are helping societies move to the bottom right-hand section of the chart above.

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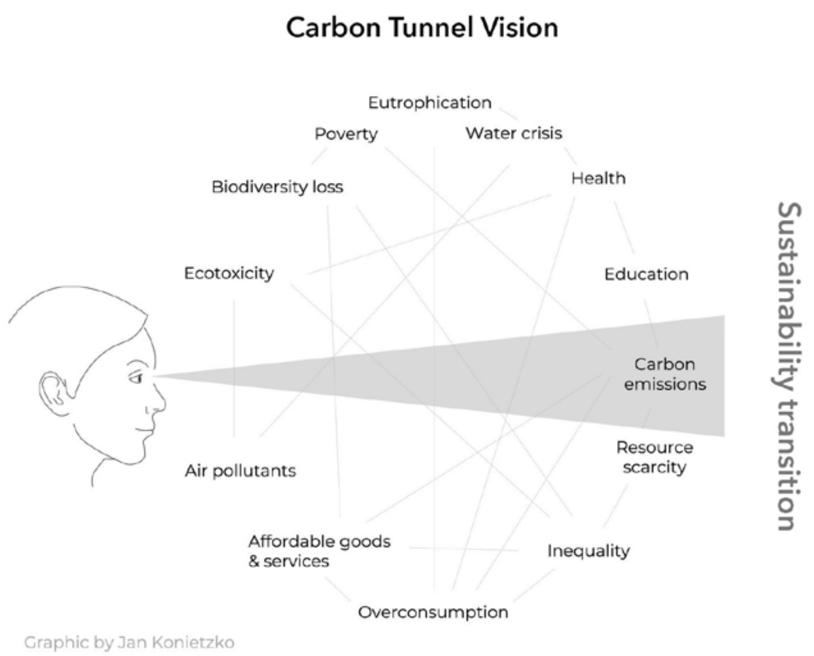
[1] Investment Week, November 2022
[2] United Nations News, November 2022
[3] United Nations 2022
[4] The World Counts
[5] Nature Sustainability, April 2021
[6] Overshootday.org
[7] The Guardian, February 2022

**Figure 1: Carbon Tunnel Vision**




### How do we invest?

Our investment philosophy is to only invest in high-quality companies that we believe are contributing to a more sustainable future. We look for companies that are helping to reduce our ecological footprint, or advance human development, or ideally both. Some companies are reducing healthcare costs, or providing financial services to lower income communities in emerging markets. Others are providing technologies for electrification, waste reduction and industrial process efficiencies.

Many companies are doing wonderful things for society or the environment, but we only invest in those that meet our high quality criteria. Equally, there are many high-quality companies in our investable universe that we avoid because they are not contributing to a more sustainable future.

When we refer to quality, we don't simply focus on high margins, profit growth and returns. We take a more nuanced and qualitative approach, and assess the quality of the people running the businesses, the quality of the franchises and the financials. Among other things, we look for companies led by outstanding, long-term focused stewards, who look after all their stakeholders. We look for franchises that are resilient, competitive and have pricing power. And we look for companies with simple and conservative financials, with strong balance sheets, that avoid financial shenanigans.

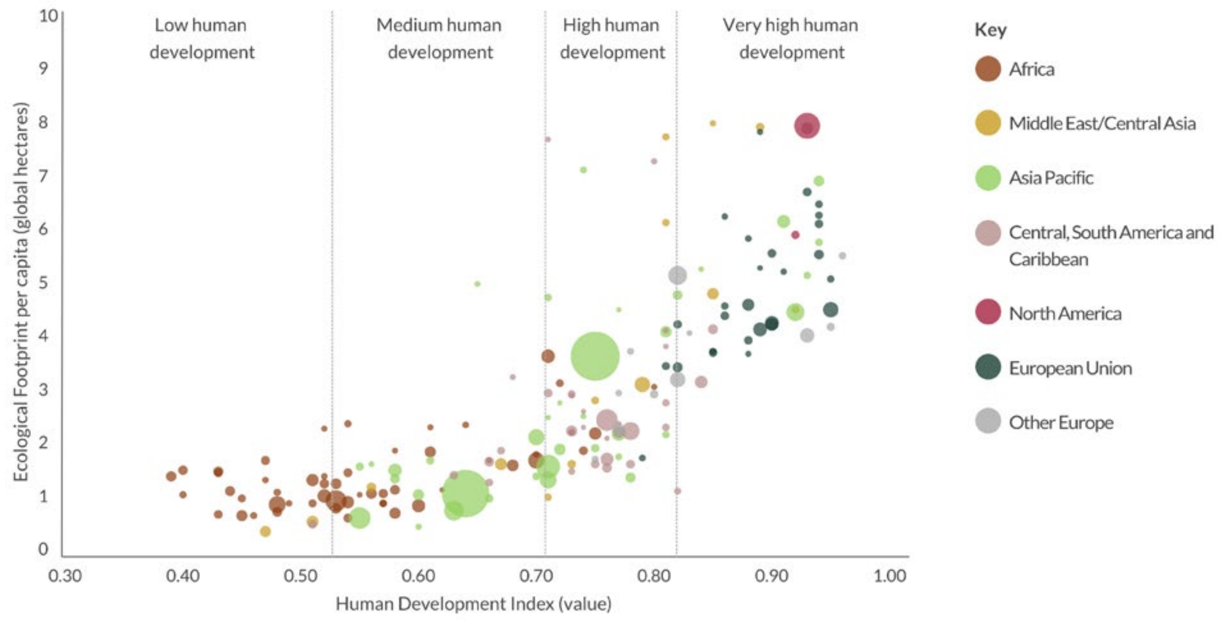
Similarly, for sustainability, we don't rely on simple Environmental, Social and Governance (ESG) scores, or carbon footprints. We focus on the societal impact of the products and services being sold; on how company leaders behave; on the operational impacts of the company, and on how well placed a company is to benefit from sustainability tailwinds.

We pay just as much attention to human development as we do to environmental issues, because both are equally important for a more sustainable future.

We believe this rounded approach to sustainable investment helps us avoid and mitigate risks, identify opportunities that are different from our peers, and above all, deliver strong returns.



**Figure 2: Sustainable Development**
**Global Footprint Network - Human Development Index and Ecological Footprint of Countries**




Source: Global Footprint Network, 2022 National Footprint and Biocapacity Accounts. Latest country data for the Ecological footprint is 2018.

**Company Case Study 1 – HDFC Corporation (HDFC)**

HDFC is the leading provider of housing loans in India and one of the most recognised and trusted brands in the country[1]. Around half of their loans are to new home owners and around a third to lower-income households. The company is benefiting from structural tailwinds as mortgage penetration in India is still only 11% of GDP , compared with 52% in the USA[2]; two-thirds of India's population is under the age of 35[3]; and the average age of a first-time home buyer is 38[4].

Mortgage demand is increasing as people migrate from rural areas to cities and as the nuclear family model becomes more commonplace. Since its founding in 1978, HDFC has financed over nine million housing units and the mortgage market is expected to more than double in the next five years[5].

[1] The Economic Times (India), September 2022
[2] The Economic Times (India), November 2022
[3] The Diplomat, January 2023
[4] Wall Street Journal, January 2022
[5] The Times of India, June 2022

**Company Case Study 2 – bioMérieux**

bioMérieux is a family-owned company providing instruments and consumables for diagnosing infectious diseases and detecting bacteria in food, pharmaceutical and cosmetic products. It is also the world leader in researching and providing solutions for antimicrobial resistance[1], which kills 700,000 people each year.

The business model is resilient, with 90% of revenues coming from the recurring sale of reagents and services, and the balance sheet is net cash[2].

The company is benefiting from the move towards personalised medicine, while combatting the increasing number of infectious diseases we face.

[1] bioMérieux 2023
[2] bioMérieux Universal Registration Document 2022

# The Case of Toyota and Climate Lobbying:

## *Engagement Beyond Dialogue*

*by* Julia Axelsson, CAIA



*"Toyota is missing out on profits from soaring EV sales, jeopardising its valuable brand, and cementing its global laggard status."*

Anders Schelde
Chief Investment Officer
AkademikerPension

On 11 May, three heavy-weight shareholders in Toyota Motor Corporation, Danish AkademikerPension, Norwegian Storebrand Asset Management, and Dutch APG Asset Management, announced they had filed a climate lobbying-related resolution ahead of the company's Annual General Meeting in June. According to the press release, the trio of institutional investors behind the proposal had been engaging "intensively and constructively" with Toyota on climate lobbying for a couple of years. As their continuous dialogue with the company's senior management has so far failed to yield the desired results, they are now changing tactics.

"We welcomed the dialogue and annual disclosure [published by Toyota], but we need concrete policy changes and a better annual review drawing on independent data to calm international investors," comments Anders Schelde, Chief Investment Officer at AkademikerPension.

"AGM proposals are a particularly important mechanism to raise issues in cases where other stewardship activities have failed to obtain a satisfactory outcome," explains Kamil Zabielski, Head of Sustainable Investment at Storebrand Asset Management. "AGMs provide the opportunity to raise the profile of the issue, in this case: corporate lobbying against global climate commitments," he adds.

**Why Climate Lobbying?**

Every year, publicly traded corporations spend hundreds of millions of dollars lobbying to block or delay regulations designed to avert the climate crisis. They can do this either directly or through support of and leadership in various trade associations and policy-focused non-profits. Moreover, many companies advocate against climate progress and policy through highly targeted and widespread social media persuasion.

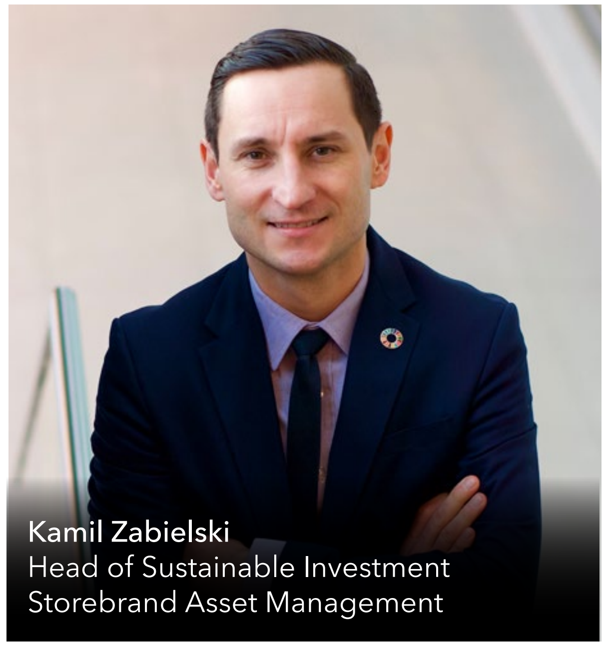
Last year, the IPCC report Mitigation of Climate Change identified "opposition from status quo interests" and "incumbent" fossil fuel interests exerting political influence as a key barrier to progress on global climate goals. The OECD and various political leaders have also highlighted the issue recently.

Addressing a conference at the White House last year, António Guterres compared fossil fuel companies lobbying against climate change to the tobacco companies that continued to push their addictive products while concealing the links between smoking and cancer. "For decades, the fossil fuel industry has invested heavily in pseudoscience and public relations – with a false narrative to minimise their responsibility for climate change and undermine ambitious climate policies," said Guterres.

It is, however, not only fossil fuel companies that are prone to engage in climate lobbying. Increasingly, several carmakers have emerged as the world's most aggressive anti-climate lobbyists. Their stubborn insistence on petrol-fuelled cars is holding consumers back from cleaner, more affordable transport.

**Why Toyota?**

Toyota's efforts to ensure continued manufacture and distribution of internal combustion engine vehicles has gained it a global reputation as an anti-climate lobbyist. The company has fought against government policies designed to reduce transport


Kamil Zabielski
Head of Sustainable Investment
Storebrand Asset Management

*"The Paris Agreement needs strong regulation at the national level. Companies and trade associations should not be using their political influence to block climate policies and slow the pace of urgent climate action."*

sector emissions, improve air quality and human health, and make electric vehicles more affordable across multiple jurisdictions.

"Independent analysts [] find that Toyota and its business associations such as Keidanren and JAMA still have a long way to go to be aligned with the goals of the Paris Agreement when it comes to their lobbying," points out Schelde. Indeed, InfluenceMap, the think-tank specialising in data-driven analysis on how business and finance impact the climate crisis, ranks the Japanese car manufacturer as one of the worst culprits globally.

According to Zabielski, ever since Storebrand introduced a new divestment criterion on climate lobbying in 2020, they have been screening companies systematically concerning this specific issue. "We have not singled out Toyota in particular; we engage with many other companies across various sectors on climate lobbying," he says. "Based on our screening, however, Toyota has singled itself out, as the company is lagging behind its peers, ranked tenth on the 'most negative and influential companies on climate policy' of 2022 by the independent think-tank InfluenceMap."

Schelde stresses the business rationale for urging Toyota to improve its climate lobbying practices. "Toyota is missing out on profits from soaring EV sales, jeopardising its valuable brand, and cementing its global laggard status," he explains.

Looking at the broader implications of this specific case, Herman Slooijer, CIO at APG Asset Management, calls Toyota Motor Corp "Japan Inc.", emphasising its importance for the country and the industry in general. "Since Toyota is the world's largest car maker, accelerating the company's EV transition is not only crucial for improving its business competitiveness, but also for giving a push to the decarbonisation of the entire industry," he says. "Toyota plays a pivotal role in the Japanese automotive-related industry, which leads the country's manufacturing and economy. We, therefore, believe that Toyota leading engagement with industry associations, regulators, and its supply chains is critical for decarbonising the Japanese economy as well as for sustainable economic growth and job creation in Japan."

**Why Now?**

"Despite over two years of intense investor engagement with Toyota, it has not been possible to reach common ground with the company on its lobbying activities, so this made it necessary to escalate the dialogue," explains Zabielski.

AkademikerPension and Storebrand Asset Management, alongside AP7 and Church of England, initiated the dialogue with Toyota back in March 2021. Right from the start, AkademikerPension flagged its intention to file a shareholder proposal on climate-related lobbying. However, the company's assurances that it would support the goals of the Paris Agreement and review its public policy engagement activities convicted the investors of withdrawing their proposal.

The engagement process intensified as Toyota's then-CEO, Toyoda, came out with some negative public statements on climate-related regulation. In an attempt to meet shareholders' criticism, in December 2021, the company published a paper, "Toyota's Views



*"We, therefore, believe that Toyota leading engagement with industry associations, regulators, and its supply chains is critical for decarbonising the Japanese economy as well as for sustainable economic growth and job creation in Japan."*


Herman Slooijer
CIO
APG Asset Management

on Climate Public Policies 2021". The investor group reconvened to discuss the quality of the report and deemed it to fall short of expectations.

In April 2022, AkademikerPension was once again prepared to file a shareholder proposal. The filing was, however, rejected by Toyota as, according to them, it arrived one day too late for an undisclosed deadline. A second iteration of the report, "Toyota's Views on Climate Public Policies 2022", has since failed to reassure the investors of the company's changing ways. "The report falls short of investor expectations expressed by, for example, the Climate Action 100+, and more importantly, the company has continued to lobby against climate-related regulation and policies in, e.g., the US, UK, Japan etc.," comments Schelde.

Fast forward to May 2022. This time around, the proposal has been filed within the legal timeframe, and Toyota's Board and management will have to consider it properly. "We encourage Toyota to enhance and increase the transparency of its sustainability disclosures based on our suggestions – especially considering recent emission misrepresentation issues at some of its affiliates," says Slooijer. "This is important to restore investors' confidence in Toyota's carbon reduction commitment and strategy," he adds.

**Why Do It Together?**

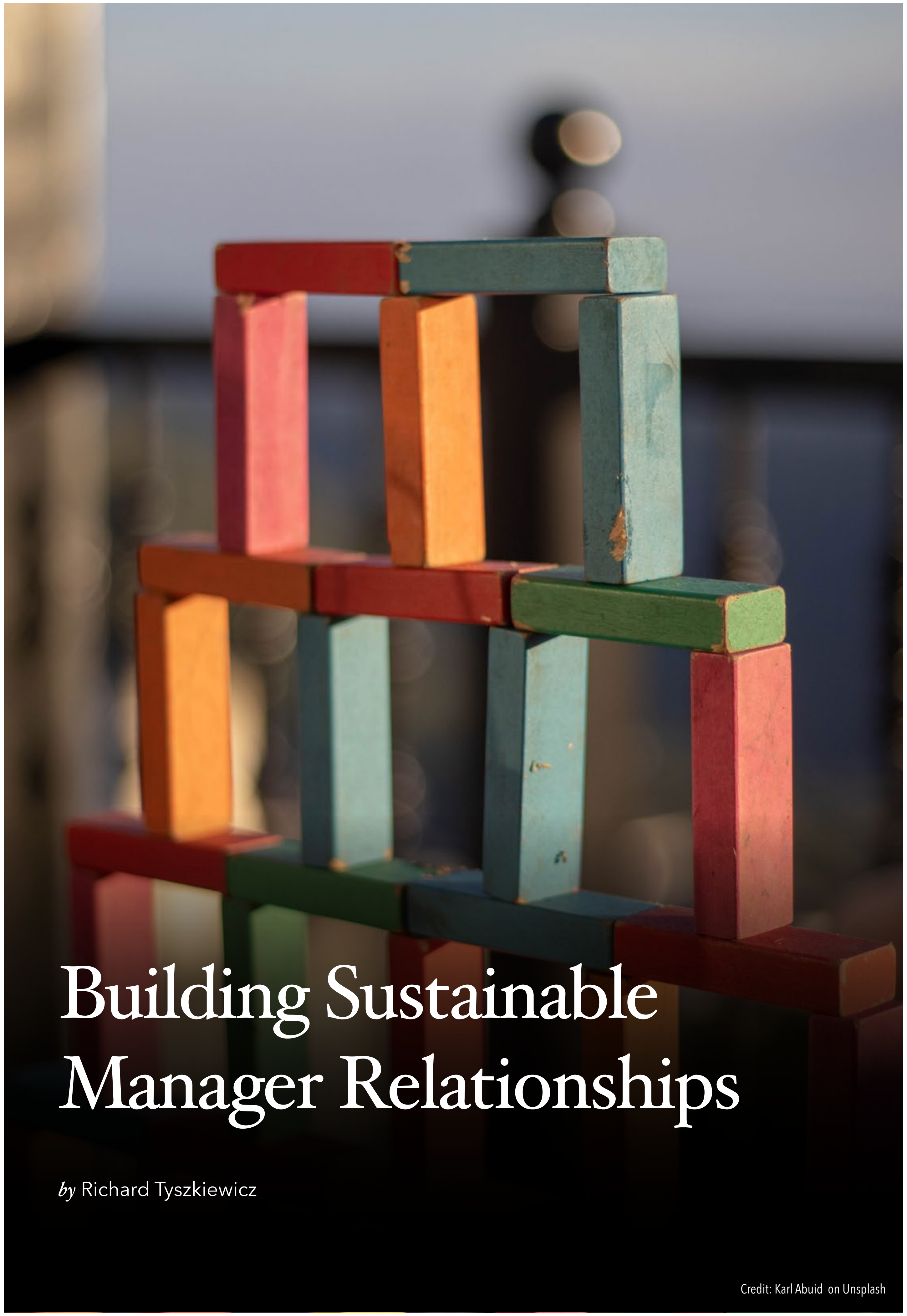
"Collaboration is key," stresses Zabielski. "Co-filing allows us to mobilise and leverage the voting power and influence of several like-minded investors. Our resolutions are made stronger with a diverse set of shareholders who bring different experiences and expertise to the table while sharing a vision of the impact a company should be having."

The joint effort of the three institutional investors has been facilitated by Climate Action 100+. "Platforms such as this are unique forums that allow investors to pool resources, share information and enhance their influence on ESG issues," says Zabielski. Alongside filing shareholder proposals, investors can use the collaboration platform to encourage collaborative investor engagement with companies between AGMs.

**What Happens Next?**

Toyota's Board has already recommended shareholders vote against the resolution at the AGM in June. Still, the institutional investors who filed it sound hopeful. "The best-case scenario would be a well-supported proposal to demonstrate the level of interest from investors, encouraging the company and its peers to reconsider its approach to managing and reporting on the issue at hand," says Zabielski.

"The Paris Agreement needs strong regulation at the national level. Companies and trade associations should not be using their political influence to block climate policies and slow the pace of urgent climate action. We believe that Toyota, as a leading automotive company in Japan, should be consistent in their policy engagement in all geographic regions and ensure any engagement conducted on their behalf or with their support is aligned with our interest in a safe climate, in turn protecting the long-term value in our portfolios across all sectors and asset classes," concludes Zabielski.



# Building Sustainable Manager Relationships

*by* Richard Tyszkiewicz

Credit: Karl Abuid on Unsplash

Björn Edlund-Persson
Head of Institutional Clients
Global Fund Search

The sustainability policies of institutional asset owners are a constantly evolving work-in-progress. Not only are regulators now expecting environmental, social and governance (ESG) criteria to be considered across all asset classes in the portfolio, but the requirements are increasingly complex as themes such as biodiversity and plastic pollution are added to the mix. The relatively small investment teams managing European pension funds, insurance companies and endowments have long had to rely on external managers for significant proportions of their portfolio investments. A decade ago, these external providers might be expected to be able to cater for client-specific norms-based or ethical exclusions and demonstrate their commitment to sustainability by signing the Principles for Responsible Investment (PRI).

These are now the most base-level requirements, and far more is expected from external managers in terms of ESG integration and their ability to support institutional clients with rapidly evolving sustainability-related needs. How can asset owners ensure that they can identify, screen, and appoint managers with genuine ESG credentials? Once in place, how best to monitor them to accurately gauge whether they are on track to deliver on their sustainability promises?

No amount of pre-screening of the manager universe can replace the potential revelations obtained via face-to-face meetings and on-site due diligence visits. "Managers need to show evidence that if they do indeed have an ESG strategy, is not only expressed in the marketing materials but also truly believed by the portfolio managers and analysts. The ESG message should be aligned within the organisation" says Björn Edlund-Persson, Head of Institutional Clients at Global Fund Search (GFS). Copenhagen-based GFS was formed in 2012 with the aim of providing a convenient online platform for asset owners to submit asset management requests for proposals (RFPs) to a broad universe of potential providers. GFS also maintains a proprietary list of ESG Leaders in equity, fixed income, and real assets, based on these firms' consistent results in previous sustainability themed manager searches.

"The ESG strategy must be embedded in the culture of the firm," adds Edlund-Persson, as there has been a trend over recent years for asset managers to jump on the sustainability bandwagon regardless of their track record of ESG integration. This poses a manager selection challenge far more complex than the quantitative and qualitative evaluation of people and processes that has been used historically. There is a need for a behavioural and cultural overlay to the evaluation process, aimed at rooting out any form of greenwashing.

### The investor's sustainability policy is key

The selection of specialists ESG managers should be preceded by the establishment of a robust and clearly communicated sustainability policy on the part of the asset owners. Nordic institutions are well positioned in that respect, according to Persson: "The ESG requirements are generally more detailed in the Nordic Region compared to Germany, for example. The Nordics definitely lead the pack in terms of ESG requirements." This prescriptive approach allows for

*"Managers need to show evidence that the ESG strategy is not only expressed in the marketing materials but also truly believed by the portfolio managers and analysts."*

a more effective screening of the manager universe from the outset, with only potentially suitable parties submitting proposals when the key ESG requirements are clearly laid out in advance. It is important in the early stages to signal to the managers which requirements are "dealbreakers" and which ones are softer, more subjective indicators.

Asset owners may be guided by international norms and sustainability frameworks as they seek to integrate ESG in their investment portfolios. Edlund-Persson explains: "Some investors use our platform to find managers with broad exposure to the Sustainable Development Goals (SDGs) and others use it to get exposure to specific SDGs that are of special importance to them, for instance to balance out their total SDG exposure. Others might want exposure to particular themes within ESG investing, for instance climate solutions or transition metals. These specialised searches are difficult to conduct using traditional databases, and our platform is a useful tool to communicate directly with the managers, without being too restricted."

## Narrowing the field with forethought and RFP design

Assuming the asset owner's sustainable investment policy and goals are well defined and communicated, it is worth them spending some time on defining the type of manager they would ideally like to work with on the long-term.

ESG specialists need to handle a more complex and less well-defined set of parameters in their investment process, hence the need for an understanding of their internal behavioural characteristics and company culture regarding sustainability. The PRI produced a set of 6 core attributes for ESG managers, distilled from the organisation's signatories' responses to the PRI Reporting and Assessment Framework. The PRI's core attributes can be summarised as follows:

1. Systematically integrate ESG factors in their investment analysis and decisions.
2. Assess materiality of ESG factors ex-ante and ex-post of an investment decision with a long-term view.
3. Embed ESG considerations in legal documentation.
4. Act as a good steward to implement and promote RI and engaged ownership practices.
5. Take a long-term view to assess the impact of investment decisions on the environment and society.
6. Undertake adequate public/transparent disclosure and implement accountability mechanisms.

These attributes can help with RFP design, with the addition of more probing questions as well as requests for case study evidence of positive practices. However, in some cases they can only be verified at the due diligence phase of the process. The same can be said for company culture.

## Finding the right cultural fit

Why is this important in ESG manager selection? Sustainable investing is a constantly evolving environment, and most asset owners would prefer to co-operate with external partners that can not only manage their share of the portfolio but also support them as they navigate the ever-changing risks and opportunities.

European managers have typically been at the forefront in this respect, but Edlund-Persson believes this is changing: "We no longer see that much of a difference between European and US managers. US managers have been catching up in recent years and some of the larger players have significant ESG resources and research and development capabilities." Some cultural aspects can be evaluated in advance through targeted RFP questions on ESG governance, the incentive structure and communication patterns between sustainability experts and the portfolio management team.

The gradual mainstreaming of sustainability can also be witnessed in the positive performance in ESG manager selection exercises of providers that do not explicitly label themselves as such. Certain asset managers have a long track record of considering a broad range of non-financial criteria when evaluating investee companies, and the market has effectively caught up with them in that respect. For this reason, it pays to look beyond strategy names or product labels.

Ultimately, company culture and the depth of ESG integration are best evaluated face-to-face with the individuals concerned towards the latter stages of the selection process, but valuable time can be saved at the outset with judicious RFP design.

## Selecting the short-list through art and science

The initial stages of the manager selection process should help ensure that speculative or unsuitable candidates are quickly screened out, and that the submissions are of a high average quality. GFS takes a back seat at this point, as Edlund-Persson explains: "Asset owners will use the platform to reach the widest range of managers anonymously at first. It is also possible for asset owners to only invite a few of their preferred partners.

The actual evaluation of managers will be done by them, sometimes with the help of a consultant. GFS will keep track of the process and provide feedback to unsuccessful candidates at the end." Larger, more sophisticated institutions may have their own selection criteria gleaned from their ongoing manager monitoring and experience of outsourcing. This can be complemented by third-party ratings and data, as well as a deeper-dive second phase RFP in the form of asset class specific due diligence questionnaires (DDQs).

For Edlund-Persson, the rapid evolution of ESG-related metrics helps to make this an increasingly structured process: "The word 'measurable' is the key, as going back a few years there were a lot of strategies making sustainability-related claims. Investors today are trying to identify the serious players and can look at a whole range of measures in terms of carbon or other types of positive impact."

Translating the analysis into graphic form can help decision makers home in the most well-rounded candidates, for instance with a colour-coded "heat map" score card. The deeper the buyers' understanding of the internal workings of short-listed managers, the more effective the final due diligence phase will be.

## Making the most of the due diligence phase

Armed with an in-depth analysis of each finalist's capabilities, asset owners are well-advised to take full control of the face-to-face due diligence meetings. Traditionally referred to as the "beauty parade," these may take place at the asset owner's premises and can be followed with on-site visits to the potential appointees. Asset owners can impose a strict agenda including targeted questions for each manager arising from the prior analysis.

This avoids potential time-wasting in the form of standard sales pitches. If possible, the finalists' presentation teams should include portfolio managers and analysts alongside any commercial representatives. This is where manager selection involves more art than science as the potential investor observes the interaction between individuals. These behavioural aspects can provide invaluable input on how genuinely sustainability is integrated at all levels of the manager's organisation.

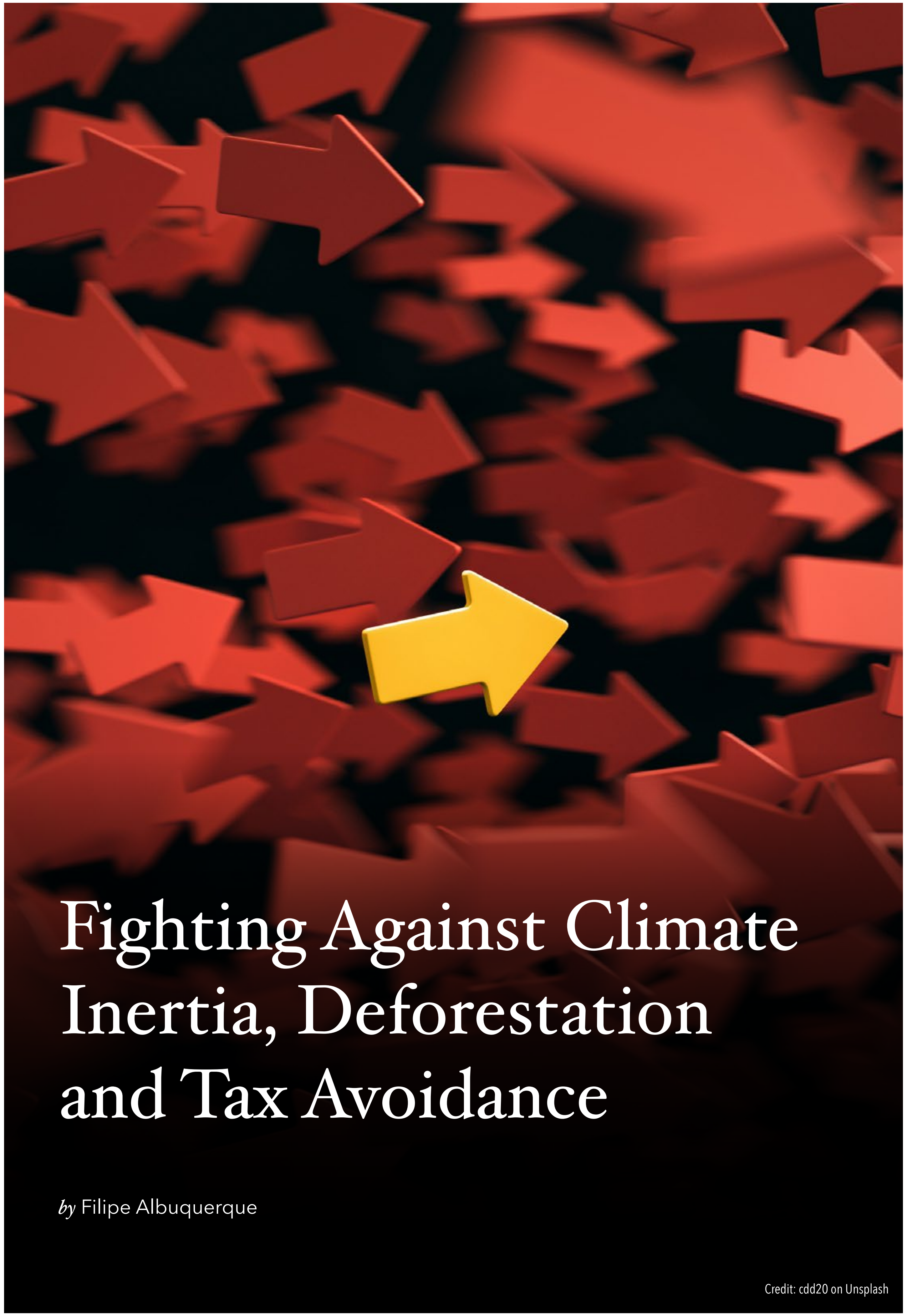
For Edlund-Persson, managers need to demonstrate their credibility through clarity and transparency: "What we hear from investors is that even the most sophisticated sounding ESG strategy needs to be measurable, and easily understandable. Managers should be able to clearly explain what they do within a half-hour conversation. They must also show evidence that the ESG strategy is embedded in the company culture and is not only expressed by the marketing department or the distribution teams but also, most importantly, by the portfolio managers and analysts. Lastly, investors would like to understand how the ESG strategy can help to improve performance over time".

## Manager appointment and monitoring

Final on-site due diligence visits can help verify the managers' claimed ESG-related capabilities, tools and processes. Having selected the most suitable provider, asset owners must ensure that the Investment Management Agreement (IMA) and related documentation incorporate all relevant ESG-related requirements.

Service level expectations should also be made clear from the outset. Sustainability-related reporting is expected to be greatly expanded over the short-term to include nature-related data and more granular value chain information regarding human rights or plastic pollution.

Appointed managers must be capable of keeping up with developments in that respect and supporting their clients in meeting new regulatory guidelines. Asset owners may also wish to establish agreed lines of communication with their external managers' sustainability experts to gain periodic input to their own ESG strategy. The manager selection process has had to swiftly adapt to ESG integration along with the rest of the industry. Successful external manager relationships may last for many years, so it is crucial for asset owners to identify the best partners from the start as they navigate their way towards sustainability. they navigate their way towards sustainability.



# Fighting Against Climate Inertia, Deforestation and Tax Avoidance

*by* Filipe Albuquerque

Credit: cdd20 on Unsplash

Kiran Aziz
Head of Responsible Investments
KLP

At a time when ESG investing has come under increased scrutiny, engagement in the continued pursuit of sustainable goals is crucial. From 2023 onwards, Norwegian pension fund KLP has decided to take a more staunch approach on deforestation risk, the inertia in the face of the climate transition and tax transparency.

"KLP considers climate change and nature loss as both a direct financial risk and an indirect system level risk to global society and the financial system at large. Disappointingly, after decades of climate warnings there are still large public companies in high emitting sectors that haven't gotten the message and still refuse to acknowledge the need for transition plans in order to align with global climate goals," says Kiran Aziz, Head of Responsible Investments at KLP. She adds on another literally burning topic: "Deforestation and other land conversion, mainly driven by agricultural expansion and forestry is a major source of climate emissions and the main driver of nature loss. Companies throughout the agricultural supply chain need to manage the risk of contributing to deforestation. Regrettably, some companies still prefer to ignore their role and responsibilities. We need speak out loudly against these companies, there is no time to lose on halting deforestation."

In parallel to these considerations, KLP is also pushing the boards of its investee companies to become increasingly transparent about their tax management arrangements. "Responsible tax practices are important from a risk mitigation and positive impact perspectives. Companies seeking to exploit legal grey areas in their planning of where they pay taxes face a regulatory, legal and reputational risks which ultimately will impact the financial return. This is quite simple: tax should be paid where the economic value is actually created," says Aziz.

In line with its views of the importance of these issues, KLP has warned it will vote against the board companies with deviating practices.

**Going against the board of companies with inadequate response to climate- and deforestation risks**

KLP's stance on climate change and its voting intentions are laid out in its new expectation paper "KLP's expectations for companies with respect to climate change and the natural environment", and "Voting policy 2023". Here, KLP lays out its intention to vote against the board of high-risk companies that do not have or do not report compliance with a no-deforestation commitment, as assess by the Forest 500 project by the NGO Global Canopy. Examples of companies where KLP has voted against the boards on the issue of deforestation include Kraft Heinz, Adidas, Thomson Reuters and Kikkoman.

KLP will take a similar hard line regarding the absence of climate transition plans. "Following the assessment

*"While legal tax avoidance – the act of reducing your liability – is still seen as a good business practice by many, a growing minority of asset owners and managers see taxation as an important driver of sustainable and inclusive growth."*

by the investor-led climate initiative Climate Action 100+, we will vote against the board of large climate gas emitters that still haven't presented a transition plan that explains how the company will reduce emission in line with the goal of the Paris agreement." Aziz describes. Among other companies, KLP has voted against the boards of Exxon Mobil, ConocoPhillips, Delta Air lines, Bunge, BMW, Honda on the issue of climate risk.

"Our 2023 voting policy is one example of how we operationalize our new expectation document on climate and the environment. KLP has been working to improve climate and environmental performance of companies for many years, with voting at AGM's as one of the tools we have been using. We have now clarified and strengthened our expectations and are following up with a broader and more systematic voting policy. The implication is that we are now telling many more companies that we are not satisfied with how they manage deforestation and climate risk by voting against their boards," says Aziz.

"The expectation paper sets the standard for our engagement activities and voting decisions and inform project analysis and investment decisions as we seek to do our part in the collective effort of shifting the global economy towards these common goals," Aziz adds.

### Fighting for Tax Transparency

KLP has also recently endorsed a number of proposals for increased tax transparency. The Norwegian pension fund co-filed such a motion for Conoco, Exxon and Chevron with Oxfam US and it voted in supported of similar proposals for Meta and Amazon.

The resolution proposed to the shareholders of ConocoPhillips requested that "the Board of Directors issue a tax transparency report to shareholders, at reasonable expense and excluding confidential information, prepared in consideration of the indicators and guidelines set forth in the Global Reporting Initiative's (GRI) Tax Standard. Peer companies, including Shell, BP, Hess, and Newmont, are already voluntarily embracing more detailed disclosures so should these major actors too," she explains.

According to Aziz, KLP expects companies to pay taxes where the economic value is generated and frowns upon tax evasion and speculative tax planning seeking to exploit legal gray zones. "KLP encourages companies to publicly disclose financial key figures, including tax paid, for all related companies using a country-by-country format. Companies benefits from both the physical infrastructure and societies investment in human capacities, health and safety nets, they should pay their contribution.

"Voting at a General Meetings is a shareholder's right and this is part of active ownership as grounded in our guidelines for responsible investments. We started a process of more systematic screening companies three to four years ago and has engaged with about 100 companies on tax transparency. Where we haven't seen progress, we are now escalating to the GM," Aziz explains. "Before taking this step, we always have an internal assessment in asset management on what we can achieve. For the shareholder proposal involving Conoco, Exxon and Chevron, we started to work in early autumn 2022 and initiated a dialogue prior to submitting the resolution. We met with the companies to discuss this issue and the fact that similar oil and gas companies disclose similar information. When Oxfam US reached out to us, we decided to co-file," Aziz says describing the decision-making process behind this proposal.

### Going Beyond the Law

For Aziz, the issue is not only about compliance with the law, but also a commitment to transparency as a good business practice. "There are a lot of grey zones and the company may say they are tax planning within the legal framework, but sometimes you have to go beyond the law on tax as it isn't perfect. The tax regulations that apply to large technology companies or pharmaceutical companies were made around 60 years ago and have not been modernized. Investors have come out in support of tax transparency because they know that if a company's competitive advantage lies in tax secrecy rather than the profitability of its commercial operations, that creates a material risk for everyone."

The GRI 207 Tax standard, released in December 2019, was introduced to meet stakeholder demands for greater transparency around tax. "It represents an example of the wider integration of tax with broader ESG topics. This is the most comprehensive tax standard as the key focus areas are approach to tax, tax governance, control and risk management, stakeholder engagement and management concerns related to tax and disclosure of Country-by-country reporting tax data," Aziz says.

According to KLP's Head of Responsible Investments, tech giants Meta and Amazon have published interesting tax policies. "META's 2023 approach to tax policy is quite 'light'. It does not mention "low tax jurisdictions" and makes no commitment to either paying taxes where economic value is generated although they do acknowledge that most of the R&D and operations are located in the US. Regrettably, there is no commitment to go beyond legal compliance and take into account both the spirit and the letter of tax regulations. Meanwhile, Amazon's 2023 tax principles mentions 'tax haven' and discloses that the intellectual property is held in the US. This is a good commitment, but more can still be done. Not all tax avoidance involves the use of tax havens, and the definition of tax havens can be very subjective," Aziz argues.

### Shareholder Support

Ultimately the tax transparency resolutions faced an uphill battle at this year's General Meetings and were not approved. In their response to the proposal, ConocoPhillips provided three rebuttals. "They stated that they are already transparent about their payments to governments. They disagreed with Oxfam, arguing that the peer companies mentioned do not actually report in line with GRI. Finally, they argued that added tax transparency would put them to a disadvantage," Aziz explains.

"While legal tax avoidance – the act of reducing your liability – is still seen as a good business practice by many, a growing minority of asset owners and managers see taxation as an important driver of sustainable and inclusive growth," Aziz continues. "We achieved over 17% at the Conoco AGM and 14% each at Exxon and Chevron – which is quite impressive at these companies, especially as we saw other shareholder resolutions only receive 2% of the vote. We are very pleased with the result as it shows that it is an increasing momentum on responsible tax practices," Aziz adds.

"The voting result shows that tax transparency is a growing concern and a clear signal to the board and management. We have a long-term perspective on these matters and we know that by engaging companies and other investors we can work towards a positive change," Aziz explains.

### The Way Forward

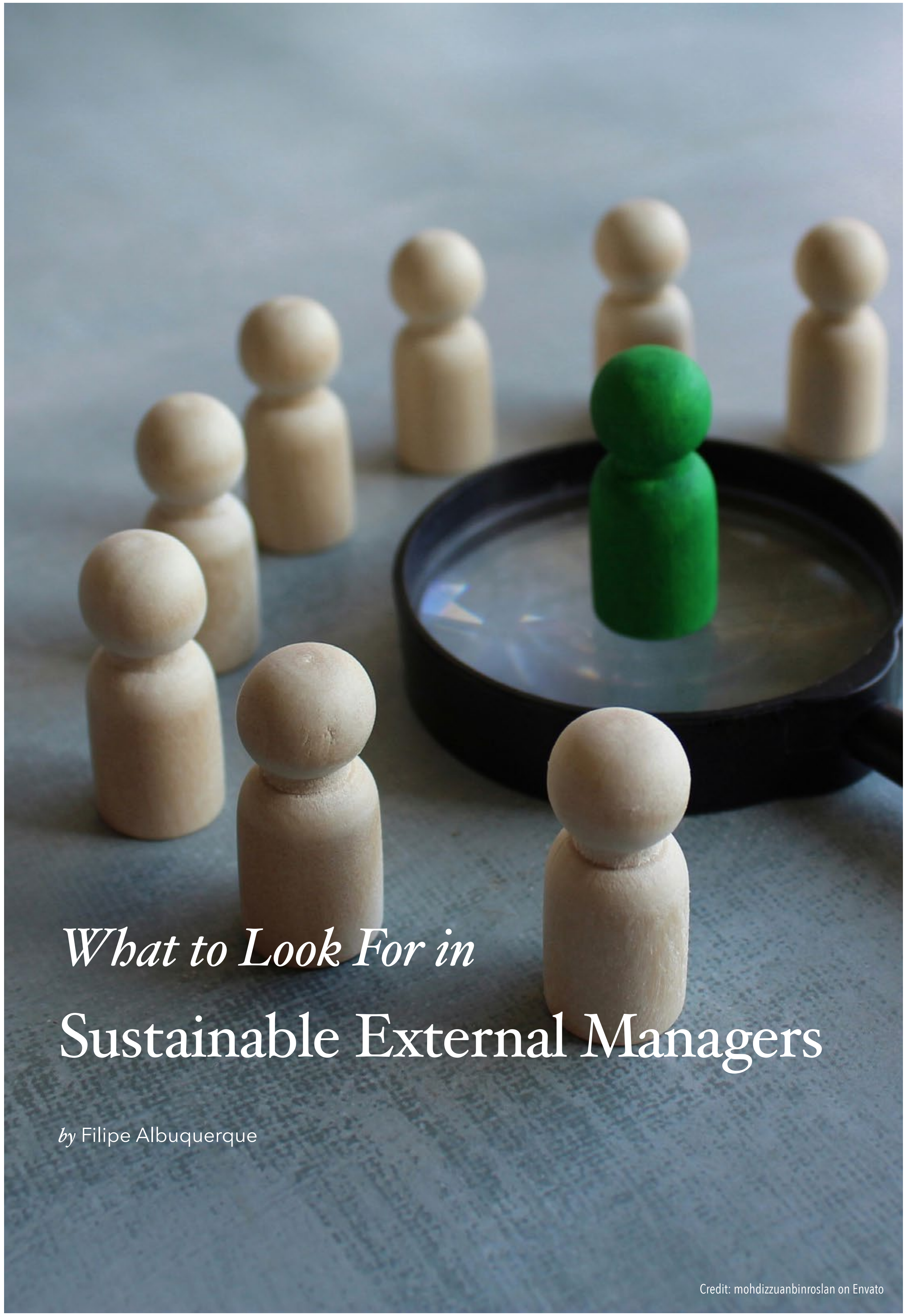
The work on tax transparency should not be left to sustainable investors alone: Regulators have an important role to play. The EU is taking the lead on this issue through the Sustainable Finance Disclosures Regulation (SFDR). "SFDR requires that Article 8 or Article 9 products do not invest in companies that do not follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance," Aziz says.

SFDR's requirement that fund managers report against Principal Adverse Indicators (PAIs) might also provide a useful channel to increase tax transparency. "There is a proposal by EU's financial markets regulator and supervisor (ESMA) to introduce new PAIs, including a requirement that large EU companies[1] should disclose the amount of accumulated earnings in. This would be a part of the EU's country-by-country reporting (CbCR) directive[2] from 2024 and the information should be made public from 2025 onwards," Aziz adds.

Looking ahead, it seems KLP will stay focused on sorting the wheat from the chaff. "The climate and biodiversity crisis are an existential threat that require urgent actions across societies and industries. Going forward KLP will contribute to more clearly separate companies that are committed to transition to a business model in line with the global climate and biodiversity goals from those who are in reality clinging to unsustainable models. We want to be a good partner to first and a constructive but clear and demanding owner to the later," Aziz concludes.

[1] Large companies in the EU would be defined as those businesses with €750 consolidated revenues or more, that are headquartered in the EU or have a significant EU branch.

[2] According to EY, "The rules set forth in the Directive will require both EU-based multinational enterprises (MNEs) and non-EU based MNEs doing business in the EU through a branch or subsidiary with total consolidated revenue of more than €750 million in each of the last two consecutive financial years to disclose publicly the income taxes paid and other tax-related information such as a breakdown of profits, revenues and employees per country."



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# *What to Look For in* Sustainable External Managers

*by* Filipe Albuquerque

*" Choosing the right external manager can make all the difference for an asset owner's ability to find the excess returns it needs without compromising its sustainability goals."*

Asset owners are not always able to manage all of their investments inhouse, be it for a lack of human or technical resources or for a lack of specialisation in specific markets or investment strategies. For these reasons, the task is often delegated to external managers, who are given a fiduciary responsibility for the management of a share of the fund's assets via a strategy or fund.

Over the last decade, ESG integration has become a crucial part of external manager selection. Nevertheless, striking the right tune that finds external managers capable of generating excess returns and sustainable or even impact opportunities can be a challenge. The experiences of NBIM, Kempen, Brunel and Cardano can help shed some light into what asset owners expect from sustainable managers and what the best practices in this evolving field are.

**20 Years of (Sustainable) Manager Selection at NBIM**

Norway's sovereign fund, Norges Bank Investment Management (NBIM), had allocated 4.6% of its capital (NOK569 billion, approximately US$58.2 billion) to 100 external managers at the end of 2022. NBIM awards investment mandates to external managers with expertise in clearly defined areas, that seek to beat the markets they operate in and generate excess returns thanks to a "deep understanding of companies and local market dynamics".

Beyond the traditional concerns about providing robust returns to asset owners, ESG integration has become an integral part of external manager selection. In its 20-year review of external managers, NBIM described how it developed an expectation that "specialist managers (...) invest in companies that deliver good returns, and at the same time not invest in companies with poor corporate governance or unsustainable business practices. We believe that companies in the latter category have a higher risk of underperforming in the longer term. When selecting external managers, we have focused on finding managers with this expertise," NBIM explains.

This approach is particularly relevant when applied to Emerging Markets (EMs), where governance issues can often be a problem that ESG integration can help tackle. According to the Norwegian sovereign fund, external managers should be prepared to answer ESG questions about their investments throughout their interaction with the asset owner as long as the partnership starts. "The research is continuous. The manager needs to continuously re-select the company, meaning that they need to constantly consider whether the factors driving its price are changing and whether the company is exposed to changes in sustainability and governance risks. (...) The questions we ask about sustainability and governance issues include how they are integrated into their investment process and decisions, confirmation of where the managers obtain information to assess company exposure to relevant governance issues, and a description of which issues are most relevant and common in the markets they operate in."

These issues are not a box ticking nor a purely window dressing exercise for NBIM, which finds sustainability to add value to the investment process. "Many of our managers have learned through cycles that, when operating in emerging markets, it is important in terms of returns to have a focus on sustainable business practices and quality of operations. We find that in markets with poor governance structure, and where the efficiency of regulatory enforcement is relatively weak, local managers are important in reducing the risk of investing in companies with unsustainable business practices," NBIM adds.


### Meaningful Authenticity

Beyond these concerns, there are soft skills that asset owners use to distinguish genuine sustainable managers from greenwashers. In a PRI case study, Brunel Pension Partnership argues that there are subtle ways in which an authentic commitment to sustainable practices and an internal culture of sustainability will make themselves known.

"When speaking with portfolio managers about responsible investment, we look at whether they talk about responsible investment in a generic sense, or whether they can demonstrate that they have integrated environmental, social, and governance (ESG) factors into the specific asset class or product they are showing us. We look at their PRI assessment reports; whether they are involved in initiatives such as Climate Action 100+; and ask for examples of engagements specific to the product."

"We also consider responsible investment at a fund management company level. We want to see some overlap between our philosophy and the manager's, as this can be an indicator of how willing they are to form a partnership with us, and the extent to which they will listen if we disagree on an issue. It is important to determine the culture of the company as that helps us to evaluate whether a manager lives out its stated commitments to risk, regulatory and decision-making standards and processes – and its responsible investment principles."

### Consistent and Clear ESG Assessment Criteria

Choosing the right external manager can make all the difference for an asset owner's ability to find the excess returns it needs without compromising its sustainability goals. While regulators are attempting to improve the ability of asset owners to sort the wheat from the chaff (e.g.: the EU's Sustainable Finance Disclosures Regulation – SFDR), the onus remains on the managers to argue for the sustainability of investment vehicles. This task is simplified when external managers have clear, consistent and transparent approaches to help asset owners understand the perceived ESG virtues and pitfalls of investment opportunities.

Kempen Capital Management, a UK-based asset manager, describes in a PRI-case study how it has implemented a number of processes to classify, score and monitor external managers so as to help it identify and track the funds that best fit its (asset owner) clients' preferences.

Kempen's "Sustainability Spectrum", allows it to classify funds along five levels of sustainability, namely: compliant, basic, avoid harm, do better, do good. In a sense, it is possible to see this spectrum as Kempen's inhouse manager-categorisation answer to SFDR's article 6, 8 and 9 classification.

"We expect our external managers and own internal funds to at least fulfil the level 3 criteria (avoid harm) and are aiming to move towards level 4 (do better) or beyond for a large number of our funds, to promote responsible business conduct," Kempen argues. This assessment is made with recourse to assessment criteria based on Kempen's six pillars: (i) Commitment to sustainability, (ii) ESG integration, (iii) Active Ownership, (iv) Transparency & Evidence, (v) Tailoring/Exclusion and (vi) Impact/SDG Investing.

Kempen assesses how funds perform based the performance of a fund in a matrix that matches the different categories on its sustainability spectrum with the elements characterising the dimensions of its six pillars. "For each of the pillars there are requirements that managers need to satisfy to qualify for the corresponding level," Kempen explains. Level 4 managers should meet the requirements of level 3 but also "have $CO_2$ reduction targets and a best-in-class or thematic approach that shows how they are benefiting stakeholders." Level 5 managers display intentionality and a solutions-driven approach.

While it is possible to simply look back and classify existing investments in line with the criteria of this framework, it is also possible to partner with clients and design new products based on this classification and its associated criteria. This was Kempen's experience when helping a pension fund design a sustainability index that rewards climate ambition and excludes "climate criminals". The 200-company index seeks to reach level 4 on Kempen's spectrum and focus on the SDGs, with a particular focus on the treatment of important illnesses, food security (nutrition) and the prevention of pollution.

### The Qualities of a Sustainable External Manager

In another PRI case study, Cardano, a UK-based asset manager describes the four qualities it is looking for in external managers, namely:

1. The existence of investment policies that demonstrate a sustainable intent (including corporate policies focused climate change, diversity/inclusion and governance);
2. ESG integration and participation in collective industry initiatives;
3. A focus on positive change through engagement; and
4. Reporting on policy implementation, and the disclosure of voting, engagement progress and ESG incidents.

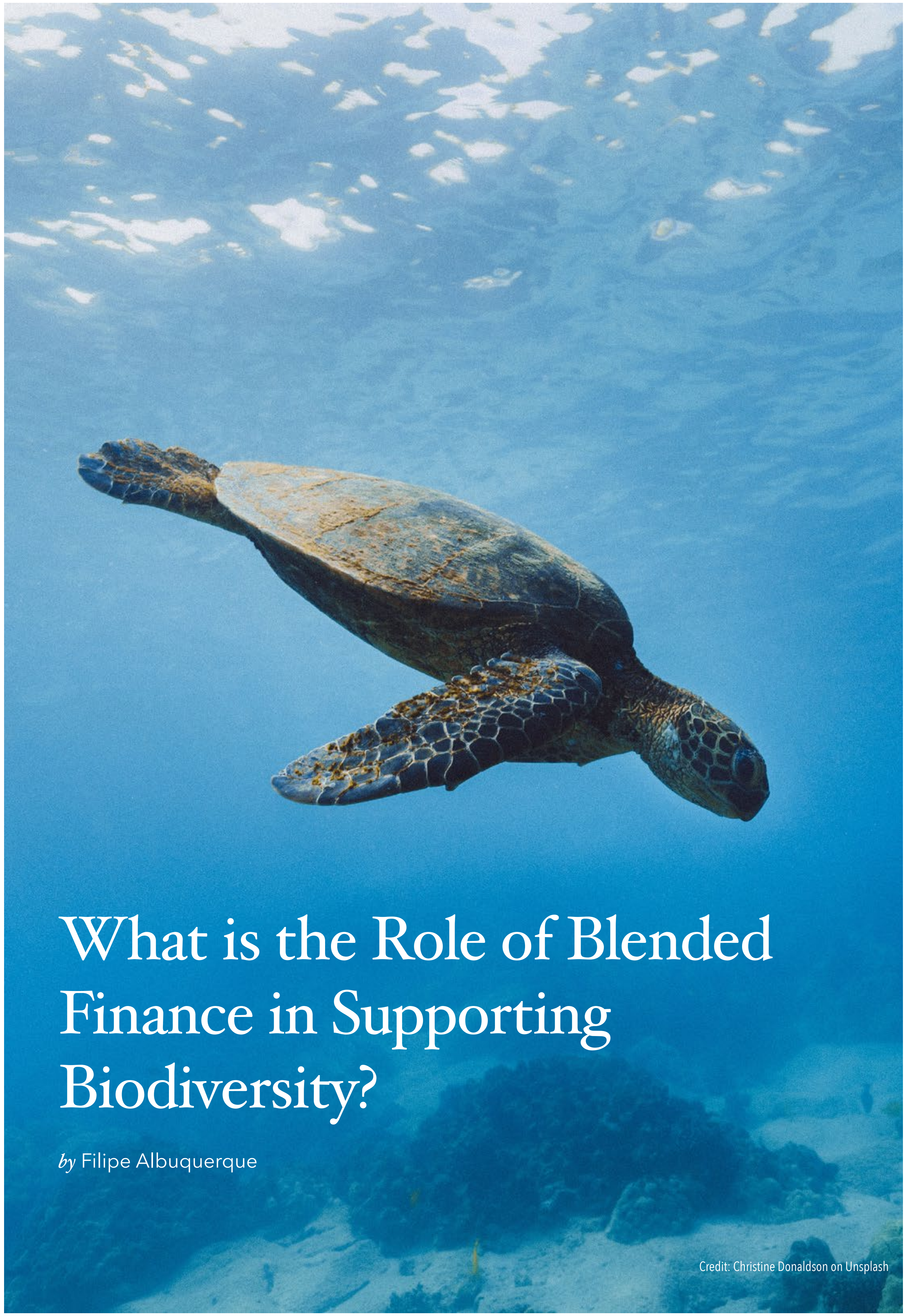
Cardano highlights the need to find external managers that are best suited to address clients' goals. "Our approach encompasses all investment strategies, but we recognise that ESG issues have a greater impact on some investment strategies than others and that some managers are able to exert a higher degree of influence and engagement than others," Cardano explains.

Brunel Pension Partnership also highlights the importance of engagement. Beyond its ability to pick investments consistent with its own net-zero emissions criteria, Brunel argues that external managers who recognise that borrowers are most responsive to engagement at strategically important times, such as during refinancing operations, are signalling both their competence and their commitment to ESG.

Describing the selection of an external manager, Brunel notes that its choice was strongly influenced by their willingness to go the extra mile by carrying out scenario modelling on physical and transitional risk and engaging on environmental protections with sovereign issuers. Another way to go the extra mile is to remain open and transparent in addressing shortcoming. For Brunel, transparency is crucial when dealing with complex issues such as limited data availability, a particularly common problem in private debt markets. However, instead of obfuscating the issue, Brunel notes that it is best to address this issue an open and frank dialogue where the external manager can explain how it attempts to overcome such hurdles.

### Finding the Right External Manager Fit

External manager selection is crucial for asset owners looking to find excess returns and to participate and even lead the sustainable transition. An ideal partner will be open to continuous development and transparency about its performance and investment assessments. Asset owners value sincerely commitments to ESG, participation in like-minded initiatives and cunning managers able to exploit the best time to make an impact. External managers are most valued if they can show that they are aligned with the interest of their clients but also if they have developed internal processes that show a clear and professional commitment to sustainable investments. Last but not least, openness to engagement with investee companies and transparency with asset owner clients are seen as crucial foundations for sustainable long term relationships.



Credit: Christine Donaldson on Unsplash

# What is the Role of Blended Finance in Supporting Biodiversity?

*by* Filipe Albuquerque

*"Philanthropic foundations in a blended finance structure can partner with development finance institutions and offer guarantees to reduce risk for private finance."*

Following the December 2022 COP15 and its "30x30" goal of protecting 30% of the planet's natural capital by 2030 agreed upon by 190 countries, the Kunming-Montreal Global Biodiversity Framework (GBF) is now in place to guide global biodiversity action.

Armed with tools and goals, it is nw arguably easier to protect the earth's natural capital. However, biodiversity is not like other sustainable investments, such as wind turbines or solar panels, which will generate profit as a matter of commercial activity. While the long-term benefits of biodiversity in terms of the sustenance of our ecosystem are well-known, there is no short or medium term financial incentive to invest in it. It would seem as though nature conservation is a goal best served by governmental policy, international cooperation, regulations and philanthropy.

However, that also leaves biodiversity exposed to governmental overreach, capture and mismanagement. Zimbabwe's recent decision to void carbon offsets seems to embody these concerns. However, other alternatives exist. A recent debt-for-nature blended finance transaction from Ecuador illustrates a potential alternative with regards to biodiversity protection, even if it is not without its critics.

## The Zimbabwe Shock

At the start of May, the Government of Zimbabwe released a national carbon credit framework outlining guidance on the compliance and voluntary carbon markets in the country. According to the new framework, all current carbon offset deals in the country are to be considered null and void. The government, seeking to maximise its share of these activities, declared it would take a 50% revenue cut of all future contracts, leaving a mere 30% and 20% to foreign and local investors, respectively. The announcement was seen to endanger several projects and could create a problematic precedent for other countries to extract similar concessions.

"The framework spells out the processes and institutions required to ensure that carbon credits assist the transformation needed to promote climate change mitigation and low carbon emissions in various sectors, among them, energy, and forestry," according to a statement by the Ministry of Information, Publicity & Broadcasting.

Underlying the decision is a recent controversy over the potentially exaggerated emissions avoided estimates of the Kariba Project in Zimbabwe run by carbon finance group South Pole. On top of its previous woes, South Pole's stake in the project appears to be threatened, following the announcement.

While there are well documented concerns about carbon offset schemes, this unilateral exercise of state power is very problematic and antagonistic of private foreign investors in biodiversity. In effect, this decision is tantamount to the expropriation via nationalisation of carbon credit asset in the country. Moreover, it is also questionable whether the government has the necessary resources to manage the natural resources it has now taken over.

## The Role of Blended Finance

Fortunately, despite the important role of that the public sector has to pay in supporting biodiversity, there seem to be channels through which private funds can be galvanised. According to Yabanex Batista, Deputy head, UN Global Team, Global Fund for Coral Reefs, "ensuring that private-sector finance flows into biodiversity and ecosystem conservation will be crucial to attain this ambitious [US$200 billion] financing target. Blended finance is a key piece of this recipe, as highlighted by the GBF and the Joint Donor Statement on International Finance for Biodiversity and Nature delivered in Montreal during CBD COP15."

The Global Impact Investing Network (GIIN) defines blended finance as "a strategy that combines capital with different levels of risk in order to catalyse risk-adjusted market-rate-seeking financing into impact investments. The providers of the risk-tolerant, 'catalytic' capital in blended finance structures aim to increase their social and/or environmental impact by accessing larger, more diverse pools of capital from commercial investors. (...) The core characteristic of blended finance approaches is that they allow two, or more, investors to invest alongside each other while simultaneously targeting their own objectives. One investor can pursue market rate returns, while the other can provide sub-market rate returns in exchange for social or environmental impact. Frequently these groups will be referred to as 'Private Capital', targeting market-rate or near market-rate returns, and 'Public/ Philanthropic Capital', targeting concessional, or more flexible/patient, capital returns. A unique offering of blended finance structures is their ability to expand the definition of what constitutes a feasible investment."

Given these characteristics, it is not surprising to find that philanthropy has an important role in blended finance. Dr Juvaria Jafri, and Di Kennedy, Centre Manager, at the University of Cambridge Centre for Strategic Philanthropy, explain that "funds and transactions that use blended finance seek to use development finance and philanthropic funds strategically to mobilise private capital flows to emerging and frontier markets. This type of approach has been used regularly in past for public-private partnerships — including in high income countries — for large infrastructure projects. More recently, impact investing has gained traction as a way to direct private capital to initiatives that have wider public benefits, particularly in terms of environmental, social, and corporate governance, commonly known as ESG."

"Philanthropic foundations in a blended finance structure can partner with development finance institutions and offer guarantees to reduce risk for private finance; they can also create strong incentives for the private sector to invest in strategic sectors and thus supplement grants and development finance; and they can also provide technical assistance to facilitate investment to plug finance gaps," Jafri and Kennedy add.

### Ecuador's Galápagos Debt-for-Nature Swap

Fixed income investments provide well-known impact opportunities that are not available in equity markets. A recent Debt-for-Nature blue bond swap by Ecuador provides a good example of how bonds can offer the opportunity to fund biodiversity protection

At the start of May, the government of Ecuador issued US$656 million in Galápagos marine conservation-linked bond (Galápagos Marine Bond). The bond was used to finance a debt conversion for Ecuador, exchanging $1.628 billion of Ecuador's international bonds for an $656 million loan (the Loan) maturing in 2041. This, in effect, means that the government was able to repurchase the debt at a near 60% discount. For holders of the sovereign bonds, the exchange provided a floor on their potential losses for a bond trading at a heavy discount. In exchange the government of Ecuador made a commitment to fund conservation efforts in the Galápagos islands. This deal was not the firs debt-for-nature transaction. Both Belize and Barbados had conducted similar transactions. However, Ecuador's bond is the largest such transaction so far.

The debt conversion will generate an estimated $323 million for marine conservation in the Galápagos Islands over the next 18.5 years, including approximately $12.05 million of new funding annually and around $5.41 million annually, on average, to capitalise an endowment for the Galapagos Life Fund (GLF). The endowment, which will be a source of permanent funding for the GLF to continue supporting marine conservation projects beyond the term of the transaction, is estimated to grow to more than $227 million by 2041. Combined, the debt conversion and endowment will generate more than $450 million for marine conservation in the Galápagos Islands.

The US International Development Finance Corporation (DFC) provided US$656 million in political risk insurance for the Loan, while Inter-American Development Bank (IDB) provided another US$85 million guarantee. The DFC and the IBD effectively cover the first six quarterly interest payments of the bond if necessary. A group of 11 private insurers, includes AXA XL, Fidelis MGU and Chubb, provided more than fifty percent reinsurance to facilitate the project. Pew Bertarelli Ocean Legacy Project, a charity, the Climate Fund Managers (CFM)'s Oceans Finance Company (OFC) and Aqua Blue Investments collaborated with the government of Ecuador on this deal. Credit Suisse acted as offeror for the international bonds.

OFC was one of the key advisors for the Galápagos Marine Bond. It developed the concept to fruition, led on the financial structuring and invested US$2 million in early-stage development capital via its Climate Investor Two (CI2) Fund, an innovative blended finance vehicle focused on oceans, water



and sanitation. The Dutch Fund for Climate & Development (DFCD) and the European Commission (EC), amongst others, provided the risk capital via CI2's development fund.

Local conservation funding allocation decisions will be made by the Galápagos Life Fund (GLF), a nonprofit trust established in 2023 as part of the debt conversion deal. The GLF will be governed by an 11-member board of directors that includes five Ecuadorian government ministers and six nongovernment representatives. According to the Pew Bertarelli Ocean Legacy Project , a seat reserved for a local nongovernmental organisation will be temporarily assigned to itself for two years, and possibly up to four years, so that Pew can share expertise on marine conservation and support the startup. It is understood that another seat was also allocated to CFM.

"Science shows that the effectiveness of marine protections often depends on securing the funding needed for implementation and ongoing monitoring, management, and enforcement. Driven by science, inclusion, and consensus, Ecuador's sustainable funding mechanism provides an extraordinary win for nature and people," said Giuseppe Di Carlo, Director of the Pew Bertarelli Ocean Legacy.

### Galápagos Marine Bond Pitfalls

The Galápagos Marine Bond deal is not without its critics. Daniel Ortega-Pacheco, Director of the Center for Public Policy Development (ESPOL), and a former Minister of Environment of Ecuador and a former member of the Advisory Council of the Green Bond Principles, and his coauthors[1] raised several concerns about the bond.

Ortega-Pacheco and his coauthors highlight several pitfalls of this transaction. For one, they express a concern for transparency. "The deal is structured by a private-led for-profit special purpose vehicle (the SPV), GPS[4] Blue Financing Designated Activity Company, established in Ireland. (...) Under the deal, the SPV lent the proceeds of the blue bond sale (US$656 million) to Ecuador, under partially known conditions.

Ecuador committed to make quarterly payments dedicated to conservation and linked to the debt exchange of initially US$ 4.5 million (average US$5.41 million per annum) to the SVP until 2041, which the lender has in turn committed to contribute to GLF, a foreign not-for-profit endowment fund. (...) The administrative costs structure of the endowment fund is unknown."

From a purely sustainability perspective, Ortega-Pacheco and his co-authors also criticise the spread underlying the Galápagos Marine Bond. "The loan to Ecuador carries a 11.04% rate whereas the blue bond was issued at 5.4%. This is a difference of 5.50 basis points of spread generating about US$450 million in 18 years. The US$450 million are distributed between transaction costs, SPV profit and resources for conservation. The bulk of the resources goes to transaction costs," the critics warn. On top of that, "the deal is insufficient to cover conservation funding needs and compromises strategic resources of Ecuador. Galapagos is fiscally underfinanced since 2020 with annual deficit amounting approximately to US$20 million. The deal attempts to mobilise up to US$18 million per year."

Last but not least, the critics argue that there were better alternative structures for this sort of financing deal. "Both a hypothetical UN-backed deal or the use of international reserves for buy-back show enhanced integrity. On governance, there is no critical need to use a SPV under a sovereign deal. (...) Other previous governance arrangements for managing conservation funding include the use of a Multi Donor Trust Fund administered by United Nations Development Program UNDP[28] and the active Fondo de Inversión Ambiental Sostenible (FIAS). In both cases, governance incorporates civil society as members of the Board without prejudicing the government's veto power," Ortega-Pacheco and his co-authors explain.

The authors also worry that there is no indication that the Galápagos Marine Bond is compliant with the Green Bond Principles, that the security is supported by a green or blue bond framework, nor that it is consistent with tany of the EU's environmental finance regulations, so that "bond buyers can be exposed to major reputational risks."

### Room for Improvement

These criticism should not be seen to be dismissing the role of private investors. "Blended finance, special purpose vehicles, thematic bonds and other sustainable finance instruments could have some potential to contribute to achieving a country's prioritised sustainability goals. However, there is a clear need for improved institutional arrangement, both domestically and internationally," they say pointing to the need to design a global regulatory framework to ensure robust governance, transparency and accountability.

[1] "Galapagos deal: an ignominious legacy", by Daniel Ortega-Pacheco, Director of the Center for Public Policy Development (ESPOL), and a former Minister of Environment of Ecuador and a former member of the Advisory Council of the Green Bond Principles; Iolanda Fresnillo, Policy and Advocacy Manager for Debt Justice at EURODAD; Patricia Miranda, Director of Global Advocacy and Director of the New Financial Architecture Area at LATINDADD; Rodolfo Bejarano, Finance for Development Analyst at LATINDADD; and Carola Mejia Climate Finance Analyst at LATINDADD, 25 May 2023, Latindadd – Red LAtinoamericana por Justicia Económica y Social.

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# ESG Integration Case Book 2023

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