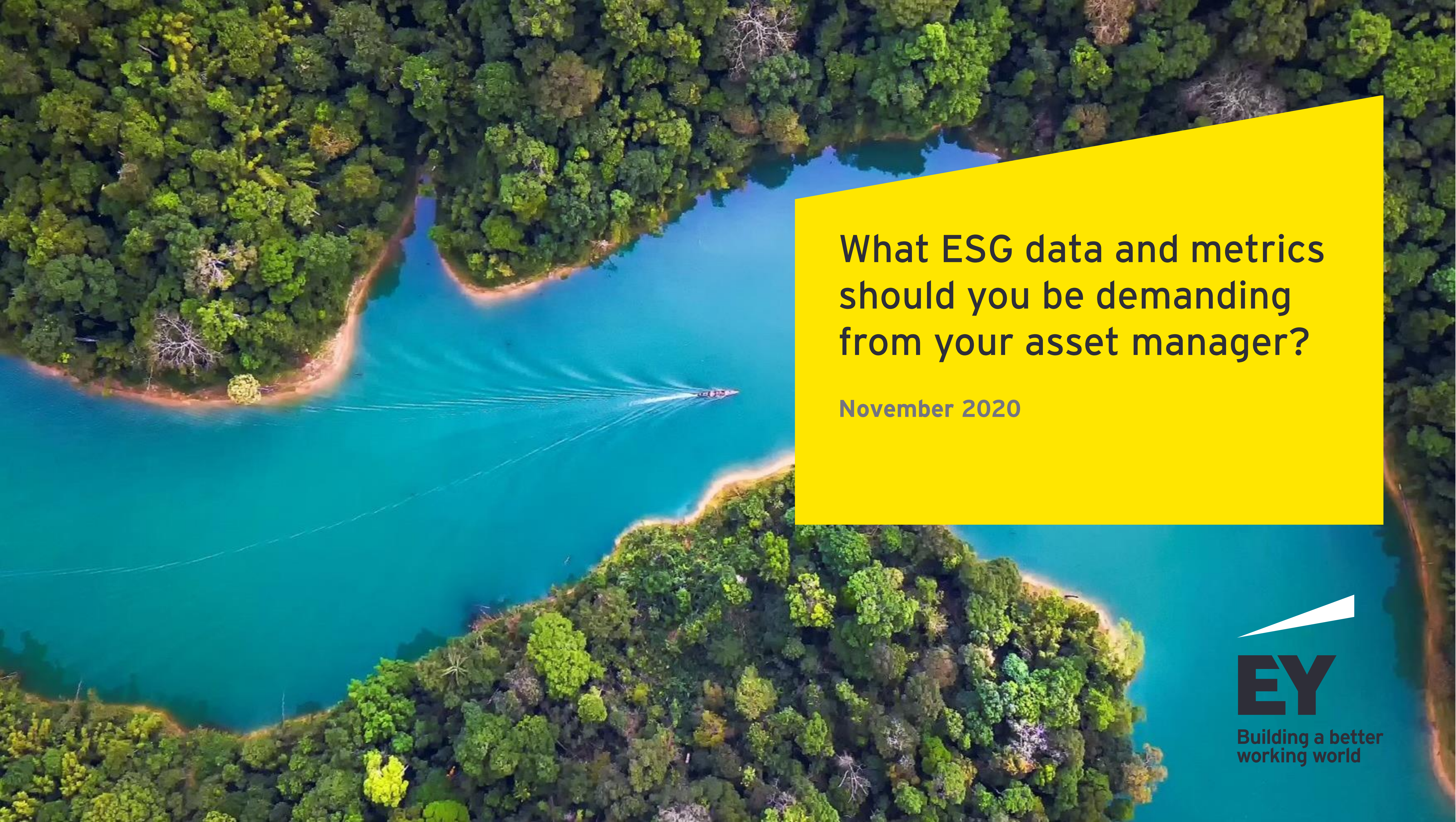


What ESG data and metrics should you be demanding from your asset manager?

November 2020

Building a better working world

Presenters introduction

Jack Bowles

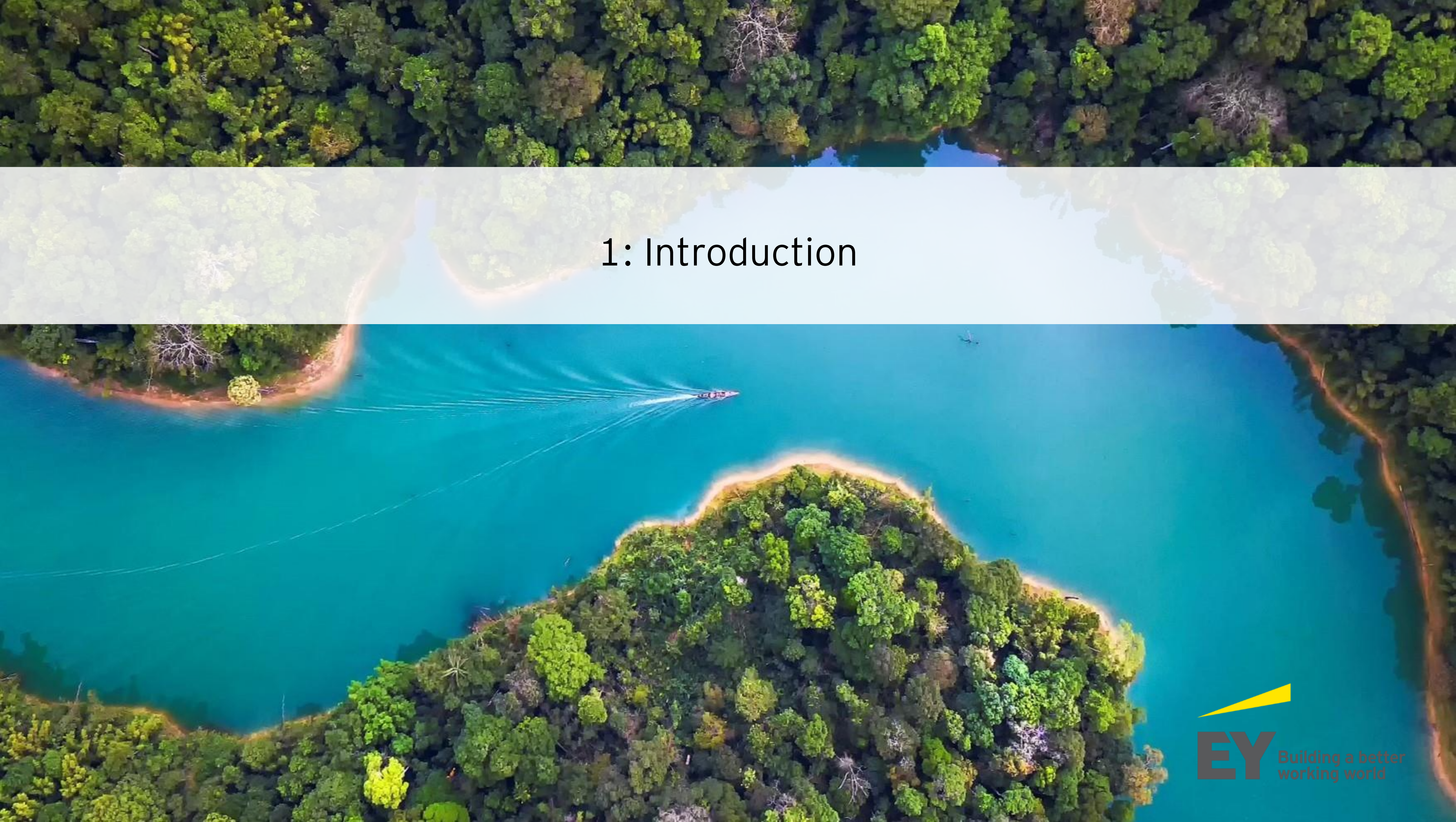
Senior Consultant
Sustainable Finance, UK FSO

Jo Young

Senior Consultant
Sustainable Finance, UK FSO

Agenda

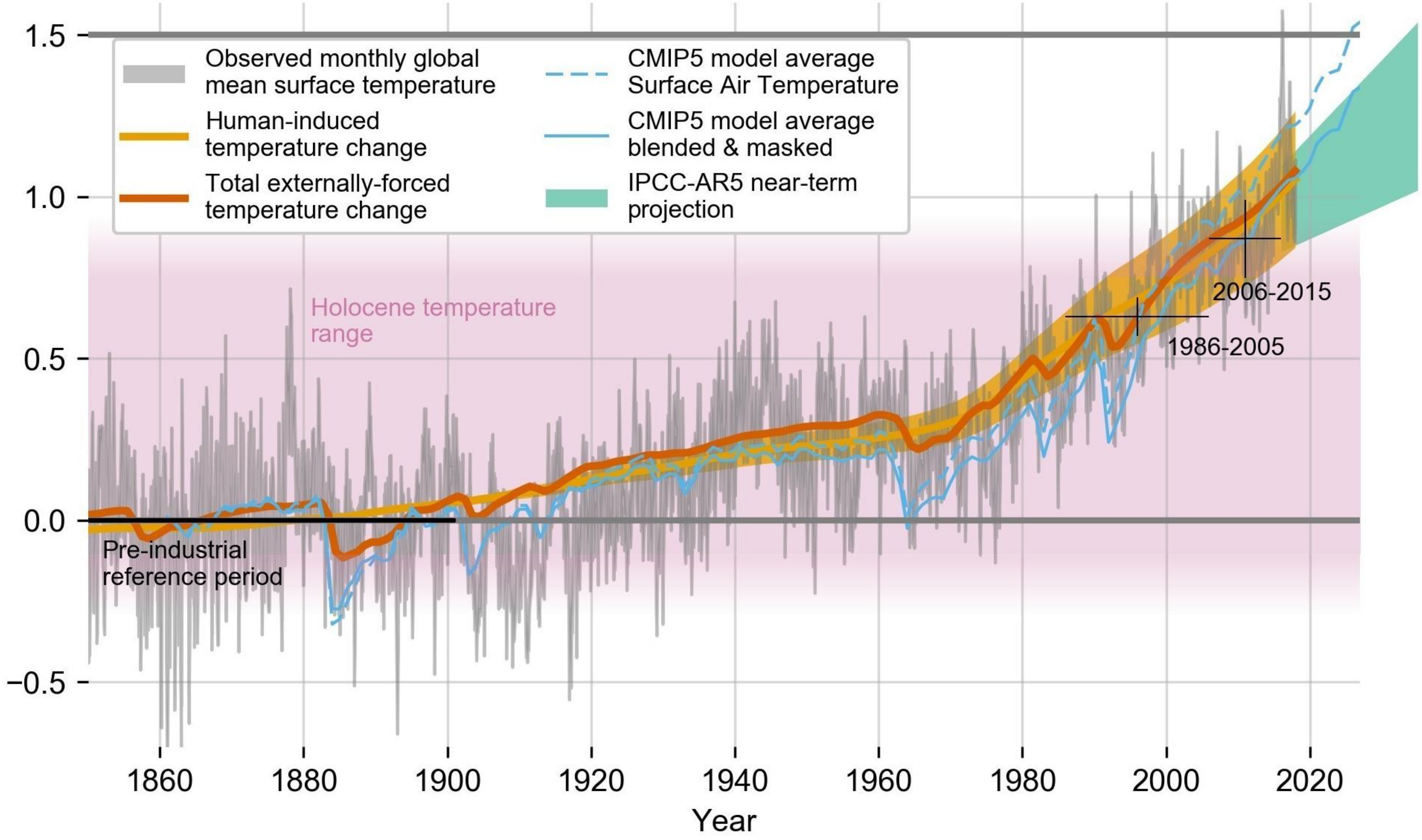
1. Introduction
2. The evolution of the relationship between institutional investor and asset manager in the context of climate change
3. Overview of the levels of maturity with respect to ESG data and metrics in the asset management industry
4. What are the emerging industry standards with respect to ESG data and metrics, which metrics are actually useful, and what is the direction of travel?
5. Example institutional investor reporting portal with possible metrics which you could demand from your asset manager



1: Introduction

The world, and its climate is changing, and it is due to humans

Global average temperature is now more than 1ºC warmer than the pre-industrial era (before 1850).

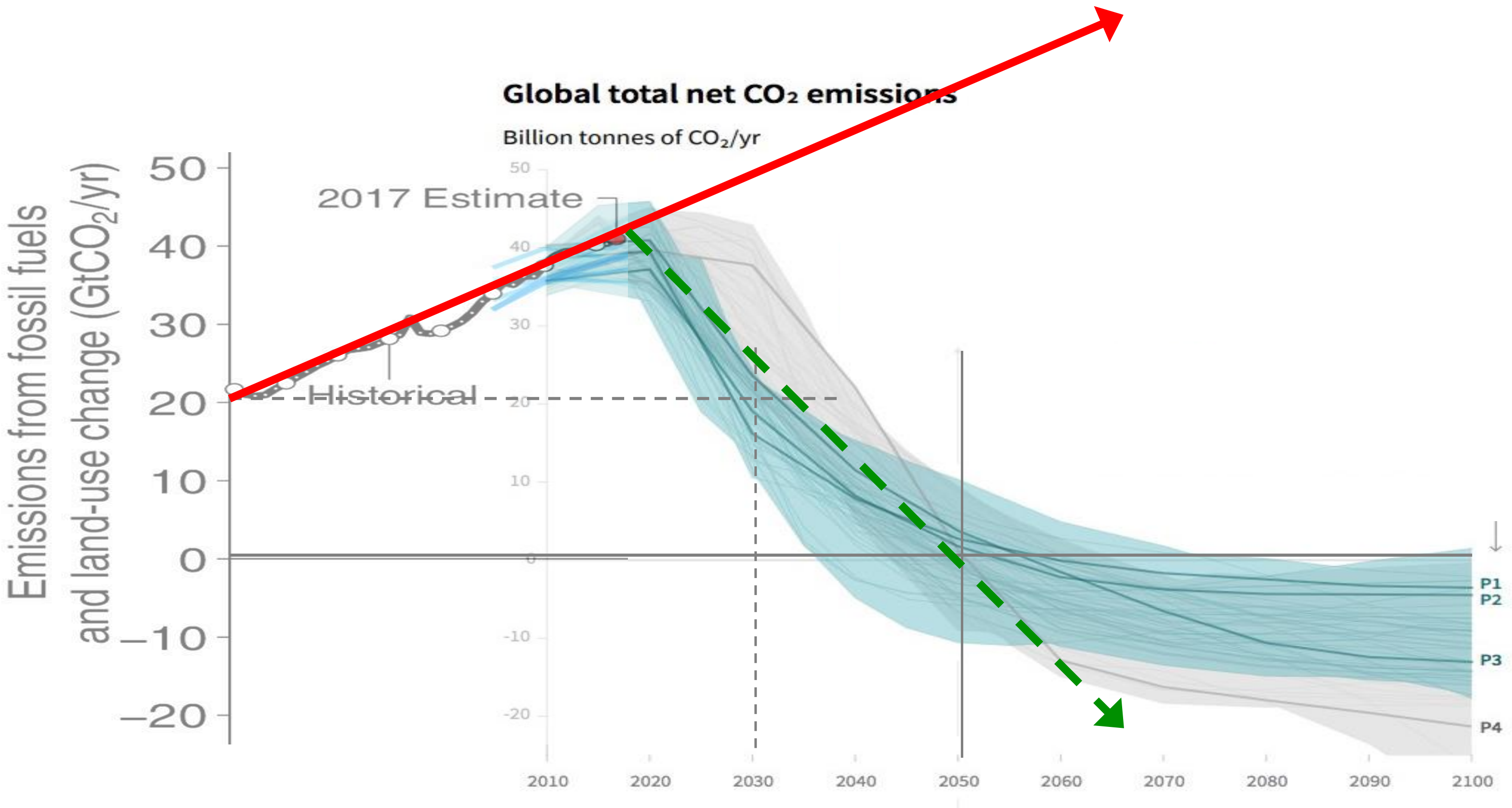


Source: IPCCC.ch

We are currently on track for 3 degrees of warming by the end of the century

This temperature rise is predominantly due to the additional Greenhouse Gas (GHG) emissions being released into the atmosphere as a result of human activities such as farming, transport and industry. If this trend continues it will leave large parts of the globe uninhabitable.

Global total net CO2 emissions



Source: IPCCC.ch

Financial institutions are using climate data, alongside other non-financial information, to measure investment sustainability

Environmental, social and governance (ESG) refers to the three key non-financial factors used to measure the sustainability of an enterprise. The objective is to build a picture of the financial risk based on the internal and external operating environment of a company.

Defining Sustainable Finance

Any form of financial service that incentivises integration of long-term **environmental, social and governance** (ESG) criteria into business decisions to provide more **equitable, sustainable and inclusive benefit** to all stakeholders.

What is ESG?

Environmental, social and governance (ESG) refers to the three central factors in measuring the **sustainability and ethical impact** of an investment via a financial instrument. **Changing socio-economic factors are fuelling growth in ESG strategies**

Environmental	Social	Governance
How do you influence the environment and what ability do you have to mitigate risks that could cause it harm?	What relationships do you have with other businesses and communities and what is your attitude towards equality, diversity and human rights?	How do you manage your internal affairs to ensure accurate and transparent accounting method and the avoidance of conflicts of interests and illegal practices?
Climate change Pollution Resource Management Water Usage Energy Efficiency Nuclear Energy	Equality & diversity Human rights Supply Chain Management Community Relations Data Protection and Privacy Product Safety and Liability	Management structure & Compensation Accounting and Auditing Standards Board Leadership, Diversity and Independence Succession Management Shareholders rights

Main drivers

Key statistics

£4.4bn was invested in ESG funds in 2019 (70% inflows into active funds).

Source: FT Advisor, 2019

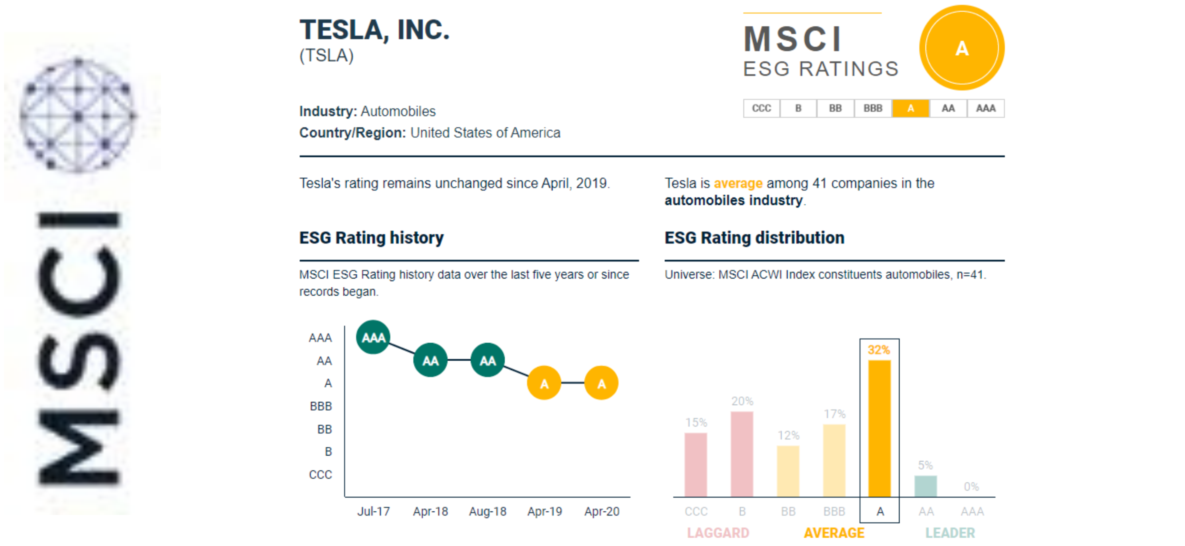
$31T

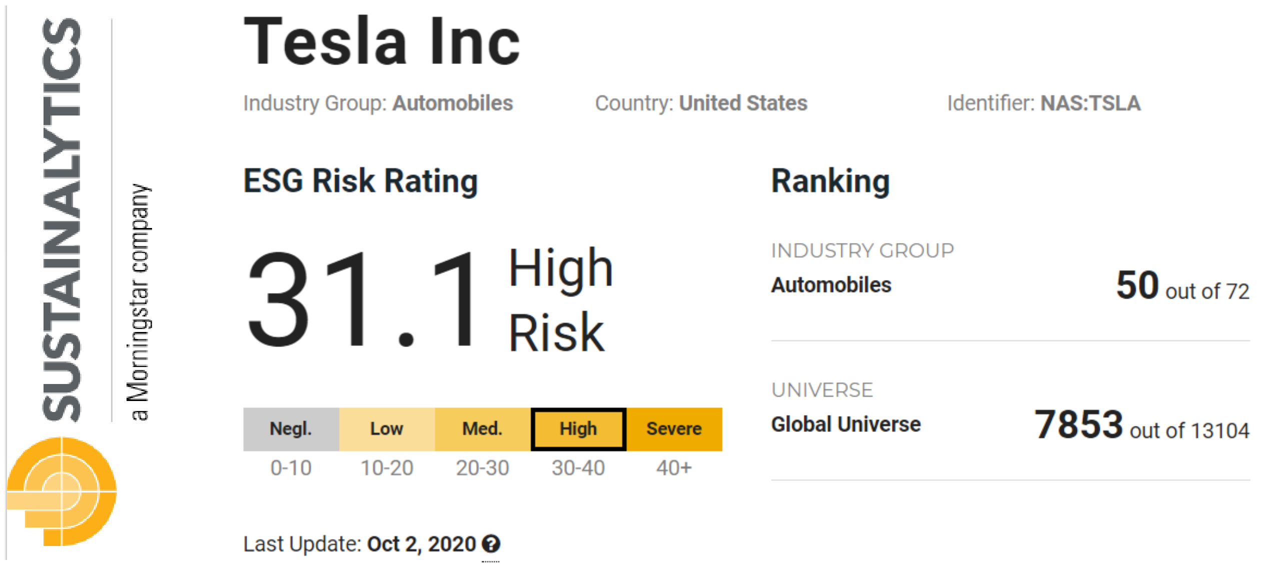
Global sustainable investing assets stood at $30.7 trillion at the start of 2018

Source: Global Sustainable Investment Review, 2018

Despite increased adoption, there is considerable fragmentation in ESG data

The Asset Management industry has seen a considerable increase in the incorporation of ESG factors into the investment process. However, given the data challenges, there is significant fragmentation in the approach adopted by individual managers.





80% Of asset managers rate individual assets against an ESG scorecard*

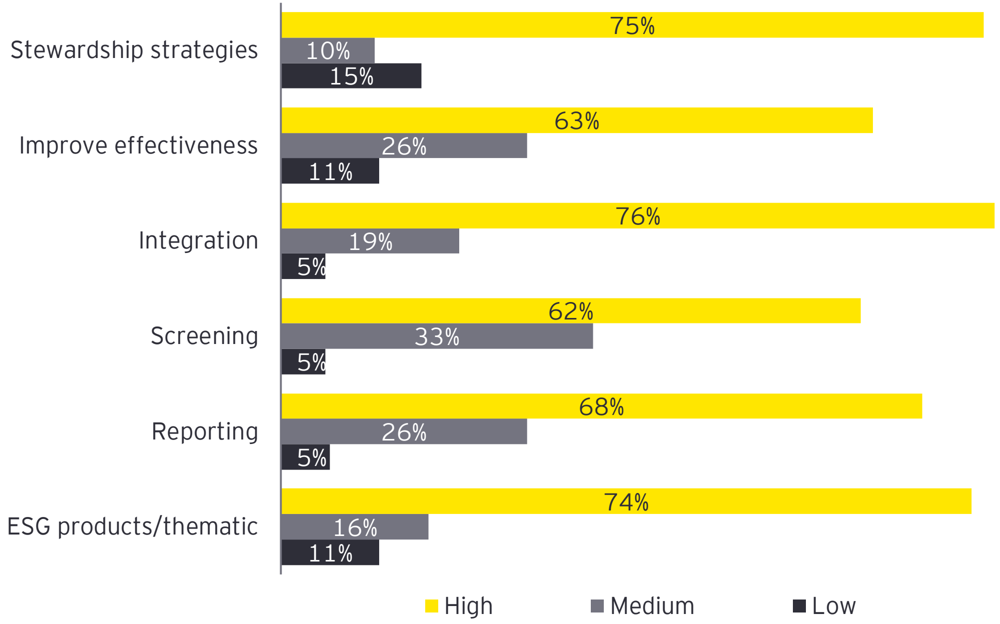
82% Investment managers adopt their own ESG screening criteria*

* *Source: EY's Asset Management survey (2020)*

Causing asset managers to focus on Integration, Stewardship and Product*

The UN's Principles for Responsible Investment (PRI) are prioritised to varying degrees by Asset Managers in anticipation of meeting increased Asset Owner demand.

Principles of responsible investing are prioritised ...



Stewardship strategies: Ensure that shareholder votes are used and that the investor takes governance seats on Boards of invested firms to conduct appropriate decision-making when implementing policy

Improve effectiveness: Ensure any standard is sufficient for the aims of the ESG business strategy and enhance implementation of ESG practises against that standard

Integration: Consider ESG risks at the appropriate stages of the investment process

Screening: Improving criteria to limit investments with negative societal, environmental or ethical outcomes

Reporting: management information for internal monitoring of any emerging ESG targets, external disclosure as required by regulators, and raising awareness amongst a broader group of stakeholders

ESG products/thematic: Offering products with distinct environmental and social objectives.

Industry trends

1. Integration of an ESG is the highest priority item among asset managers.
2. We expect asset owners to increase screening of risk factors for undesirable exposures as global participants become increasingly ESG conscious.
3. Further regulatory guidance around reporting requirements will likely strengthen in the coming years as an industry-wide standard emerges for investment taxonomy, disclosure and reporting.

* *Source: EY's Asset Management survey (2020)*

Alongside investor demand, regulation is driving ESG adoption

In March 2020, the EU Technical Expert Group (TEG) on Sustainable Finance published the EU Taxonomy which aims to support companies, issuers and other relevant players transition to a low carbon, resilient and resource-efficient economy by requiring the disclosure of robust environmental data, in the hope that this will increase the rate of investment into green and sustainable activities.

Overview of the EU Taxonomy:

The Taxonomy sets performance thresholds* for economic activities which make a substantive contribution to one of six environmental objectives:

- Climate change mitigation
- Climate change adaption
- Sustainable & Protection of water & marine resources
- Transition to a circular economy
- Pollution prevention and control
- Protection and restoration of biodiversity and ecosystems

As well as evidence contribution to one of the environmental objectives, the taxonomy requires that the solution should:

1. Do no significant harm (DNSH) to the other five objectives, where relevant; and
2. Meet minimum safeguards (e.g., OECD Guidelines on Multinational Enterprises and the UN Guiding Principles on Business and Human Rights)

In-scope entities:

Large companies that are already required to provide a non-financial statement under the Non-Financial Reporting Directive

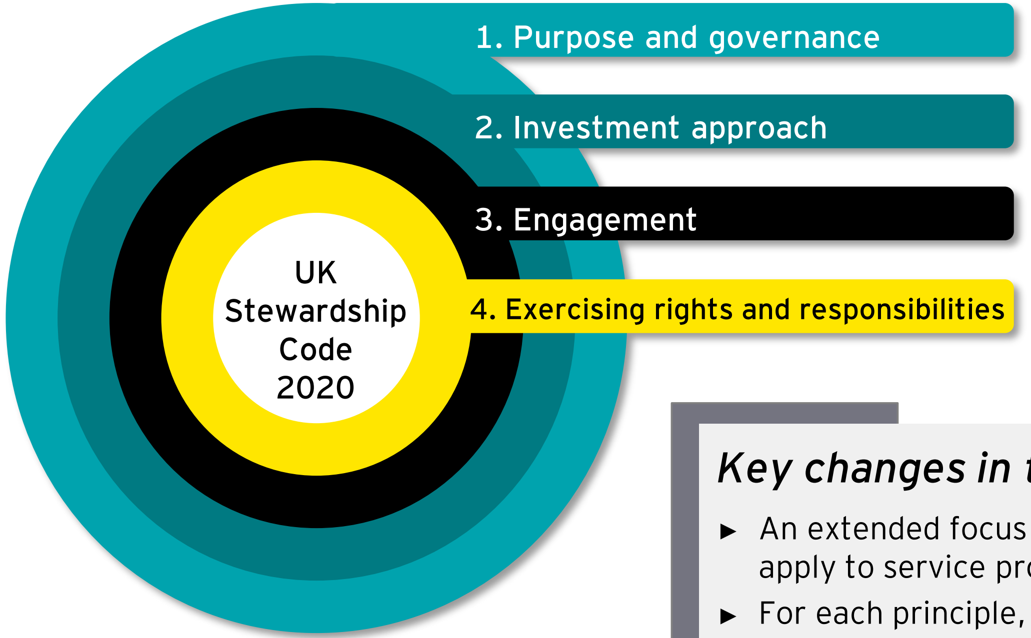
Financial Market Participants offering financial products in the EU, including occupational providers

The EU and its member states when setting public measures, standards, or labels for green financial products or green bonds

** Thresholds are established at industry level.*

With the UK stewardship code driving significant change between AO's and their AM's

4 primary areas of focus, with 12 Code principles for asset managers and asset owners



1. Purpose, strategy and culture
2. Governance, resources and incentives
3. Conflicts of interest
4. Promoting well-functioning markets
5. Review and assurance
6. Client and beneficiary needs
7. Stewardship, investment and ESG integration
8. Monitoring mangers and service providers
9. Engagement
10. Collaboration
11. Escalation
12. Exercising rights and responsibilities

Key changes in the new Code include…

- An extended focus including asset owners in addition to asset managers; 6 separate principles apply to service providers
- For each principle, a requirement to report annually on stewardship <u>activities</u> and <u>outcomes</u>, not just policies
- The expectation that signatories integrate ESG factors into their investment decision-making
- A requirement that signatories explain how they exercised stewardship across asset classes beyond listed equity, and in investments outside the UK
- A requirement to explain the organisation's purpose, investment beliefs, strategy and culture as enablers for stewardship

Moving from "comply <u>or</u> explain" to… "apply <u>and</u> explain"

2: The evolution of the relationship between institutional investor and asset manager in the context of climate change

There are a number of megatrends driving increased Asset Owner adoption of ESG

The impetus of the impending climate crisis compounded, by new regulation, is driving increased asset owner integration of ESG factors.

Net Zero

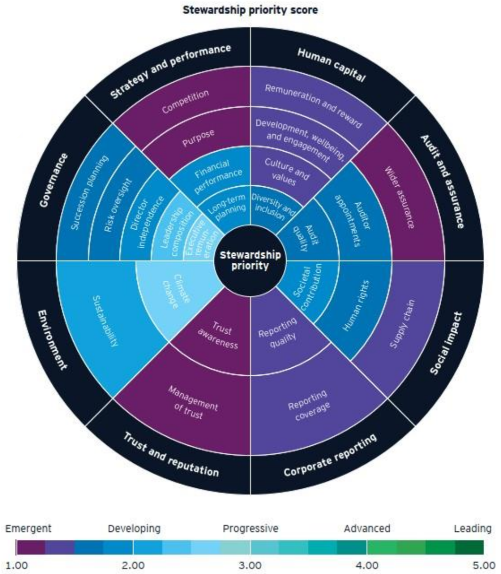
Increased public awareness of the climate crisis is pressuring the investment industry to take action.

The launch of the UN-backed Net-Zero Asset Owner Alliance is a significant step by global Asset Owners in making this change.

Stewardship

The inclusion of Asset Owners in the 2020 update to the UK Stewardship code has removed their ability to delegate Corporate engagement.

Coupled with campaigns such as ‘Make My Money Matter,’ Asset Owners need to evidence how they create Long-Term-Vale for their customers.



ESG Asset Allocation

Asset Owners long-term investment horizon provides a unique opportunity to make positive socio-economic impact alongside risk-adjusted returns.

L&G Affordable Homes and Nationwide’s new environmentally friendly housing development are two examples of Leading propositions informing this Maturity Matrix.

Legal & General Affordable Homes

Legal & General invests £750m into developing new affordable housing

Nationwide Building Society

- **Committing to building environmentally-friendly new homes:** the Oakfield housing development in Swindon, funded by Nationwide, aims to build homes of the highest environmental standards – with an ambition to create 239 EPC A-rated homes

This is moving the industry away from a delegated authority model

There is a general shift towards 'Advanced' and 'Leading' status amongst larger asset owners, as firms continue to develop capabilities in this area to satisfy public, regulatory and wider stakeholder expectations. A summary of the matrix* is shown below, with arrows indicating the range of market practice from a group of seven major international asset owners, primarily based in Europe.

		LOW	MODERATE	ADVANCED	LEADING	PIONEERING
Responsible Investment strategy and governance	Corporate strategy and purpose	High-level RI strategy in place but with limited application	Establishment of targeted RI strategy applied at high-level	Align social impact programme to RI strategy for maximum impact	Commitment to be Net-Zero prior to 2050; member of the Net Zero Asset Owners Alliance	Visionary corporate purpose with a clear articulation of how change initiatives lead to impact goals
	RI Policy and Governance	High-level RI policy in place but with limited application	RI policy covers understanding of RI and investment beliefs	RI policies and process for ESG integration for all asset classes	RI strategy engrained in the firm's strategic priorities	Risk appetite, tolerances and limits established for net zero
ESG integration	Strategic asset allocation (SAA)	Little to purely exclusions based integration only	Climate risk starting to be considered in SAA process	SAA incorporates climate risk - informed by climate stress testing	SAA incorporates climate and a small number of other ESG factors	SAA incorporates a comprehensive ESG factors linked to UN SDG's
	AM expectations	Little to no expectations of asset manager (AM) to integrate ESG factors	AM to integrate ESG factors across core asset classes only	Require AM to integrate ESG factors across all asset classes	Require AM's to demonstrate alignment to Net-Zero Asset Owner Alliance targets via the ESG integration process	Classification of 100% of investments into RI categories, that at least meet a minimum of impact-driven investment criteria Fair value integration of real assets
	AM oversight	Little to no monitoring of AM ESG integration	High level monitoring of AM ESG integration via questionnaire	Monitoring of AM's ESG Integration via questionnaire and interviews	Monitoring of AM's ESG Integration includes data review.	Assets held by best in class AM's, with outcomes based monitoring
Voting, stewardship engagement and advocacy	Voting	No requirement for AM to vote on holdings	Limited requirement for AM to vote on holdings	Requirement for AM's to vote on all eligible shares	Publicly commit to voting against chair of the board	Publish clear escalation policy for voting against chair of the board
	Stewardship engagement	No stewardship activity at an asset owner (AO) level	Limited activity at an AO level, with reliance placed on AM activity.	Committed to the stewardship code in relevant jurisdictions	Policy clearly communicated and supported by clear outcomes;	Commitment to UN PRI Active Ownership 2.0
	Advocacy	No advocacy at an AO level	Limited advocacy activity at an AO level, reliance placed on AMs	AO involvement in investor coalitions	Leadership actively seek further legislation for RI and Climate	Outline objectives to influence policy makers
Communication and reporting	Reporting	Limited to no public statement on RI	Extensive qualitative statement on RI	A small number of quantitative RI targets reported	Comprehensive number of quantitative RI metrics reported	Embedded RI commitments with robust, measurable controls
	Customer engagement	No explicit communication covering the ESG approach adopted	High-level communication covering ESG approach	Periodic communication to beneficiaries;	RI integrated into customer engagement, funds and marketing	Real time comprehensive RI information available digitally

** Risk Management, described and assessed across both Sustainable Insurance and Responsible Investments, is covered on the previous page.*

Key:
Range of maturity observed in benchmarked companies

3: Overview of the levels of maturity with respect to ESG data and metrics in the asset management industry

EY Building a better working world

Overview levels of maturity

1 Purchasing Data

The data purchased tends to cover equities and to some extent corporate bonds. Depending on the business, this may only give limited coverage. For example, private equity firms and banks will have large portfolios of unlisted equites and alternative assets.

These firms tend to be buying in a single data set from a single provider, in order to meet basic regulatory expectations.

There is a need to understand the underlying methodology behind ESG scores or stress testing scenarios to assess the fit to the business and therefore be in a position to make meaningful decisions.

There is a lack of consistency/correlation between ESG ratings, due to differences in the underlying factors used to derive the scores and the way in which each is weighted. For example, some scores penalise firms for not publishing TCFD disclosures, even if their underlying sustainability performance is good.

This makes it difficult to compare like-for-like, especially if asset managers are using a different set of scores to asset owners.

The correlation between ESG ratings across different providers is around 0.3. This contrasts with credit ratings, where the correlation between ratings by S&P and Moody's is around 0.99.

2 Using multiple data sets

This provides a broader perspective and also meets a wider range of data needs. For example:

- Physical risk modelling for property assets or mortgage lending books
- Sentiment analysis to calibrate ESG scores and assess reputational risk
- Top down risk analysis for climate informed economic scenario generators
- Range of metrics to inform on investment beliefs and stewardship

The introduction of multiple data sets reflects the fact that the firm now has a better understanding of which types of data serve different requirements and that ESG considerations are being integrated across a range of business functions.

But; the methodology is still bought in, so it is important to understand how well the results fit to the business, in order to be able to apply actuarial judgement to strategic decisions.

3 Using raw data and quant teams

These firms may still use third-party providers to supply raw data or to enhance internal experience data and publicly available disclosures.

Scoring or risk modelling methodologies are then developed, based on assessment of key exposures, so a better fit to the risk profile of the business is achieved.

Building your own models also allows you to build in consistency with existing systems and take into considerations mitigating actions already in place such as reinsurance

It requires significant investment and a depth of knowledge. Those with quant teams have been working on ESG risks for in excess of 10 years. There is however an open question around whether there is a risk that those who do not start to build the capability could be come laggards over the coming 10 years.

What data is useful?

That depends on your need.........

Stewardship

- Specific data needs will depends on your stated priorities
- e.g. carbon emissions, female/BAME representation, UNGC violations
- Many of these metrics are found in the underlying data used to generate ESG scores and can be accessed from these providers

Investment management/ALM

- Top down analysis, that models impacts of ESG risks on sectors and the real economy will support SAA
- For tactical asset allocations a bottom-up analysis will be required, which looks at the risk associated with entities in a portfolio and aggregates to a portfolio and enterprise level.
- Data underlying ESG scores and other metrics such as UNGC violations can be used to assess whether asset holdings are in breach of exclusions policies.
- Sentiment analysis will identify any reputational risk associated with entities.

Risk management and stress testing

- Scenarios that model balance sheet impacts on both assets and liabilities due to the impact of physical and transition risks.
- Could be either top-down (systemic and sector level risks) or bottom up (portfolio exposures)
- Supports TCFD reporting

Net Zero Alignment

- Many 'warming potential' indicators are backward looking; assessing current carbon intensity and mapping these onto warming pathways provided by IPCC or TPI.
- Some offer additional 'indicators' such as whether scope 3 emissions are included or if the emissions trend is generally downward.
- True insights require models to be forward-looking; taking into consideration alignment targets, transition plans and capital expenditure#
- These methodologies are just beginning to emerge but can be found in the CA100+ alignment framework and the open source alignment tool developed by the Science-Based Targets initiative and Ortec Finance.

4: What are the emerging industry standards with respect to ESG data and metrics, which metrics are actually useful, and what is the direction of travel?

EY Building a better working world

Emerging Industry Standards

100% Of asset managers are a signatory to the UN PRI

84% Of asset managers produce a TCFD report

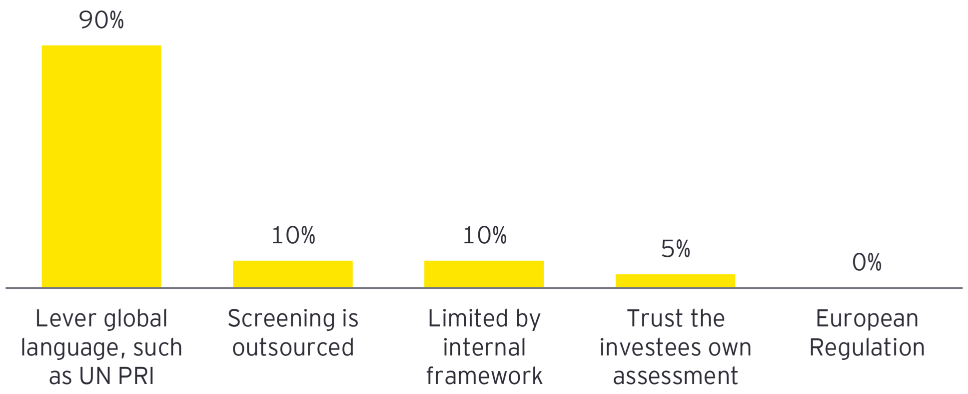
81% Of asset managers perform an active stewardship role

76% Of asset managers perform “impact investing” (based on own internal definition)

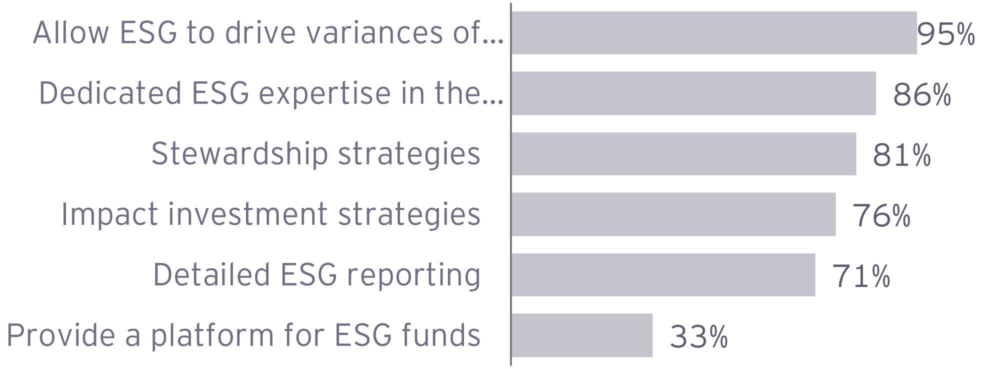
19 Years estimate average age of existing responsible investment funds

With the introduction of Taxonomy Regulation, we expect a change in favour of EU regulatory standard.

How do asset managers interpret definitions of ESG?

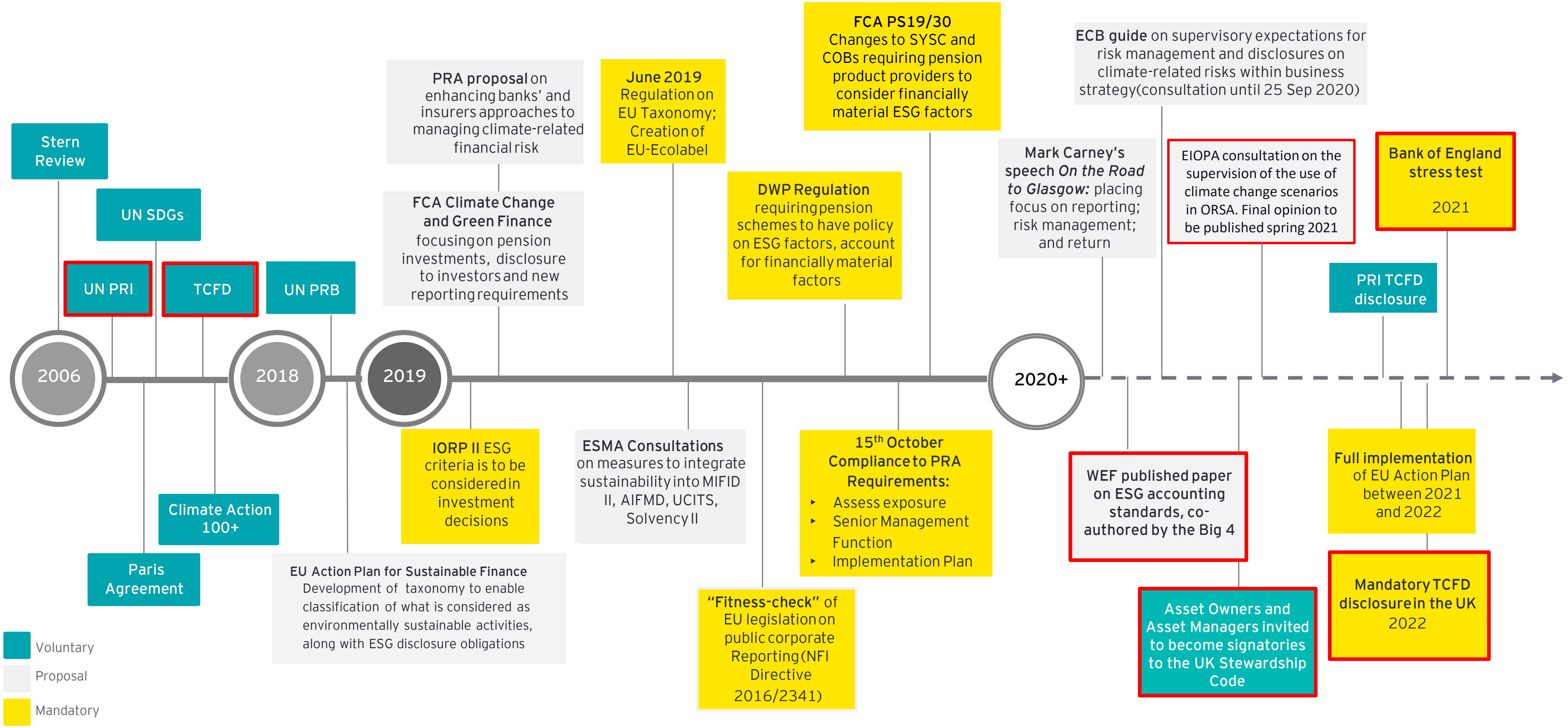


Which of the following offerings do you provide?

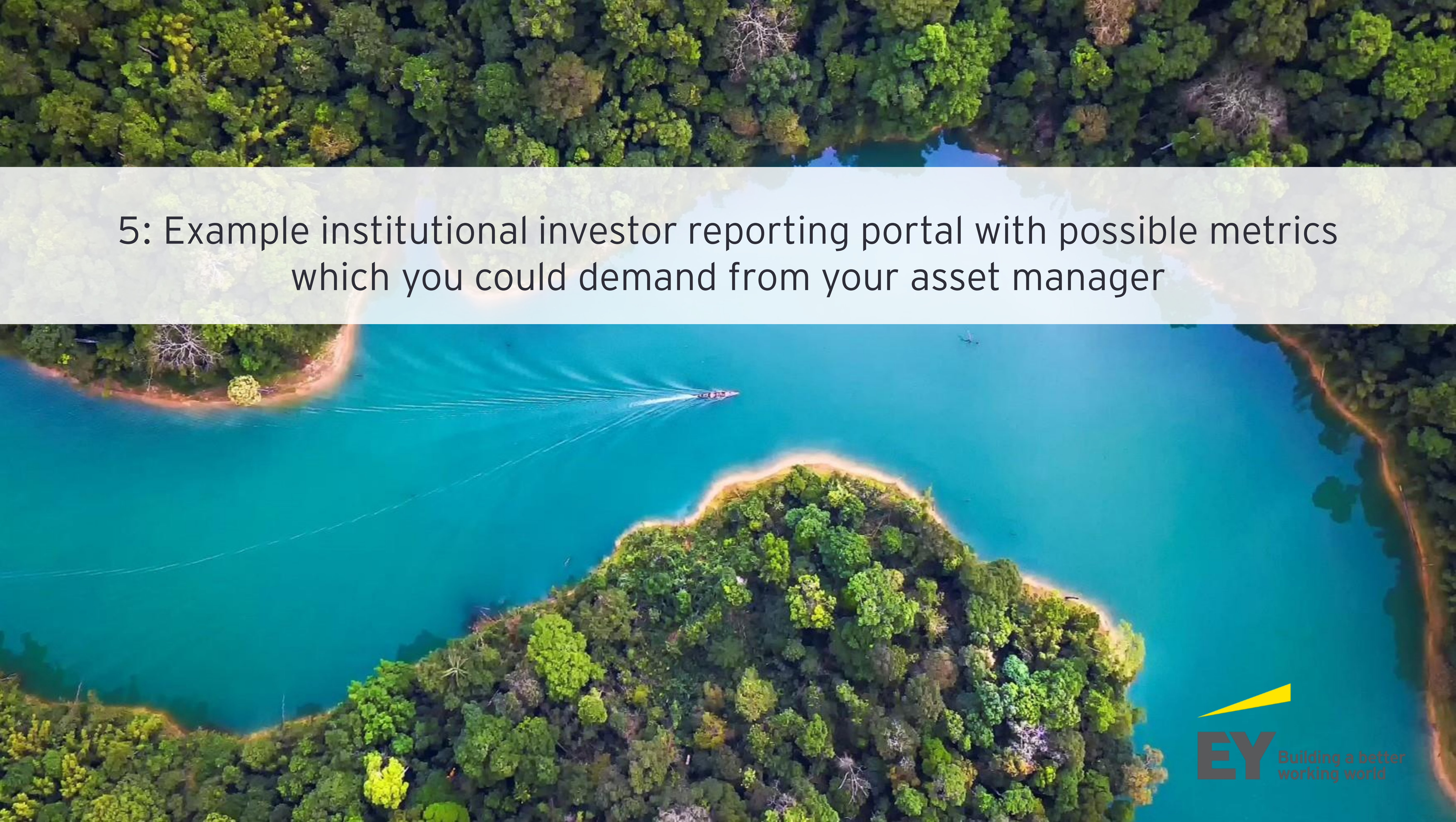


The changing landscape of ESG data needs

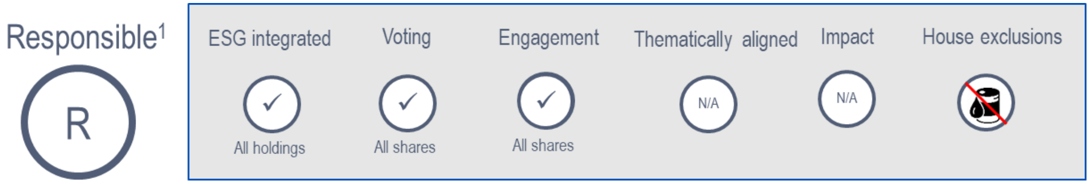
ESG reporting has been in existence for a number of years. The introduction of regulation has since accelerated its adoption in recent years. We now anticipate a move to mandatory reporting in the near future and the requirement for structured audits, to ensure accounting standards.

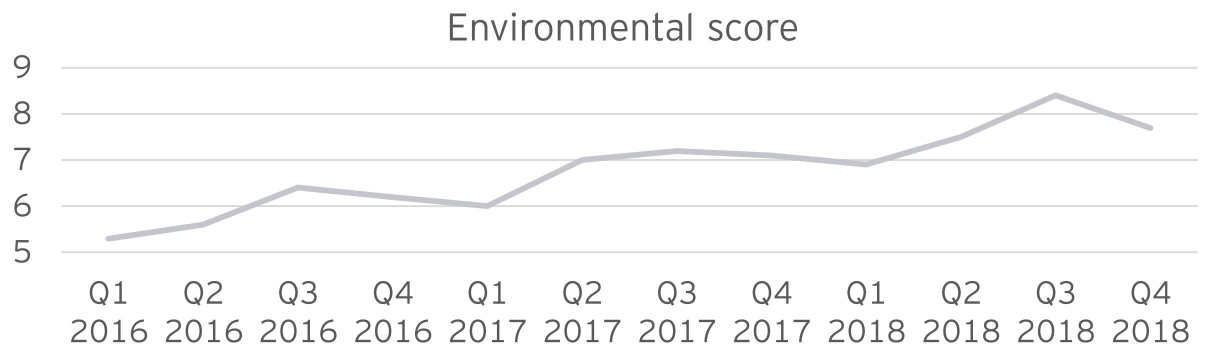


5: Example institutional investor reporting portal with possible metrics which you could demand from your asset manager



Reporting example: Environmental performance in a responsible equities fund





Proprietary Environmental score X/10

Proprietary methodology paper

MSCI methodology paper

[Narrative on how ESG scores have influenced investment decisions]

Please click the options below to deep dive into the relevant sub-factors of interest, which combine to make up the environmental score.

Climate change

Natural resources

Pollution and waste

Environmental opportunities

Top 5 avoiding companies				
Company	tCO2/M£	Weight in fund	Weight relative to benchmark	% of avoided
Exelon group	-883	0.66%	+4.3%	5%
Duke Energy	-675	0.29%	+3.7%	4%
Boeing CO	-615	0.17%	-6.9%	3%
Waste Mgmt Inc	-945	0.42%	-3.4%	2%
Airbus SE	-878	0.14%	+5.1%	2%

Top 5 emitting companies				
Company	tCO2/M£	Weight in fund	Weight relative to benchmark	% of induced
BT Group	883	0.65%	+4.3%	5%
Centrica	675	0.79%	+3.7%	4%
Experian	615	0.57%	-6.9%	3%
Just Eat	945	0.32%	-3.4%	2%
Rightmove	878	0.34%	+5.1%	2%