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A journey through Green Bonds, Microfinance, Impact Investing and ESG

4TH DESTINATION: ESG

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Sustainability is like a heartbeat that goes on, stronger every day: human resources are becoming literally meaningful as "human"; whereas certain economic and financial concepts are to be rethought forever.

Hopefully in five to 10 years-time, we won't even be discussing ESG, since all investment funds will be socially responsible.

Marco Vernia, Sperling & Star

I can't change
what has been
But I can change
what will be...
It's time for action!

Luca Bruni, BZZ Advisory

Impact investing is not
just about green bonds,
microfinance and climate
transition solutions, it also
requires engagement by
voting and creating a
dialogue with the company
in which the industry is
investing.

Jean-Philippe Donge,
BLI - Banque de Luxembourg Investments S.A.

Introduction

By Marco Vernia, Sperling & Star
Luca Bruni, BZZ Advisory
Patricia Kaveh, Crédit Mutuel Investment Managers*

Every long journey begins with a first step.

Lao Tzu

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This ancient and concise proverb perfectly summarises our journey.
It started in April 2019 over a coffee. Over the last two years we have witnessed an incredible proliferation of articles, posts and initiatives around sustainable finance, ESG, socially responsible investments, impact investing, green finance and other assimilable topics.

Our team was already at a point where this was part of our reflection process, although primarily driven by personal considerations and convincement. Then something changed. While brainstorming about the opportunity to concretely contribute to the positive momentum of sustainable finance to the widest extent, we had the idea to join our energies and to channel those towards the realisation of a professional journey through the composite universes of **Microfinance, Green Bonds, Impact Investing** and **ESG.**

Conscious of the existing problems surrounding the definition of sustainable investment – and in this respect we refer to the recent report published by IIF SFWG – The case for simplifying sustainable investment terminology (October 2019) - we therefore decided to avoid slippery disquisitions around what exactly sustainable finance is and, thus, to align with the broad agreed conclusions drawn by this Report: "Exclusion, Inclusion and Impact have been used here for illustrative purposes, as they are the most commonly cited industry terms to describe the respective investment approaches".

This document aims to provide something different. The focus has been brought to the little voices of a plethora of diversified and international market players, their experiences on the ground, their daily challenges, their stories, their successes and their failures. Without imposed terminological guidelines, all of them have been able to freely express themselves, so to share authentically their passion, their joy, their frustrations and their hopes for a brighter future where the maturity of the "macro" organisations (i.e. international, intergovernmental bodies, etc.) better match the "micro" playground, made by an appreciable biodiversity of market players of different sizes and backgrounds. Theory and practice coming together - possibly hand in hand.

We have therefore privileged a pragmatic approach broken down into four **workshops**, each one is organised around a specific topic, with external speakers drawn directly from the financial industry, internal speakers working at BLI - Banque de Luxembourg Investments and attendees coming from all sectors of the financial universe. We had an agile format of around 60 minutes, a limited number of attendees to facilitate and incentivise the interaction with the speakers and between the attendees themselves, freedom to ask unplanned questions – but also freedom not to respond "live" if too tricky. This allowed us to collect incredibly rich and diversified feedback and opinions. For each of the four workshops the debate proved to be spontaneous, real, wide and always relevant.

This paper is therefore designed to illustrate the main conclusions reached for every session, without any pretension to draw universal truths applicable to the whole universe of markets and market players.

While we fully accept the intrinsic limits of our exercise, we also recognise the value and interest of the debates triggered by our four workshops. Some of the attendees decided to remain anonymous, whereas some others accepted to be named. Some were convinced supporters of sustainable finance (to the widest meaning of the term), while others were focused on the "green-washing" risks and attitude. Some invested time, money and energy to boost the sustainable economy, others declared waiting for more convincing evidence. Both positions are equally respectable and valuable to us, since they both contributed the harmony of opposites and made this paper possible.

We did not try to force consensus around the topics discussed, and genuinely accepted all views and positions, by only asking participants to remain – at all times – respectful of the opinions of others - even in cases of disagreement. We constantly sought a constructive exchange supported by personal experiences, all valuable. Luckily, we succeeded.

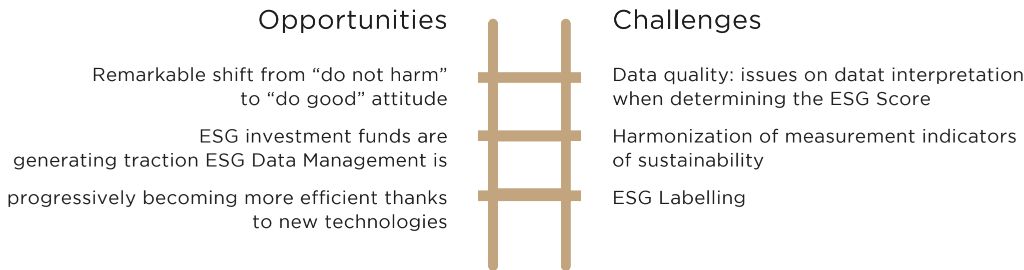
In addition, we decided to include in each of the four sections of this paper four specific "views": the **expert's corner**, the **lawyer's corner**, the **millennial's corner** and **BLI's corner –** as main sponsor of the entire cycle of workshops.

Thank you all, speakers, attendees, thank you to the supporters, but also to the detractors and the undecided. Each of you played an important role and we hope this document will also be "yours".

**Crédit Mutuel Investment Managers is in charge of the distribution of BLI products.*

Executive summary

Opportunities



Remarkable shift from "do not harm" to "do good" attitude

This top opportunity could be well summarised by a quotation from Blackrock's CEO Larry Fink's open letter to shareholders, back in January 2020: "The evidence on climate risk is compelling investors to reassess core assumptions about modern finance".

As it was well shown in our workshop, ESG has importantly evolved in the last couple of years, dynamically shifting from a "do not harm" attitude to a "do good" principle.

In fact, the previous approach to ESG was more about exclusion of those "bad" players harming the community, by screening those companies which were allegedly involved, for instance, in breaches of international law and norms on environmental protection, human rights, labour standards and anti-corruption; or whose business was connected to certain "bad" activities (e.g. production and sale of weapons).

The current attitude driven by investors is instead more directed towards producing a positive impact to the environment, to the society or the governance, always in line with the SDGs created by the UN.

However, even if it is intended for positive and sustainable purposes, it would never leave aside the return aspect, which remains a top item of any Asset Manager's agenda in this space – no matter the ESG approach adopted.

At OneLife, the big insurance business player, and speaker at our workshop, they recognise there is more and more demand for ESG investment funds with an impact investing attitude, and focusing on ESG and SRI principles.

At present such demand comes particularly from the asset manager, rather than from the client. However, there are sound reasons to believe that perhaps in 5 or 10 years, ESG will not be even a topic to discuss about, since all funds might be socially responsible.

ESG investment funds are generating traction

In the European context, Nordic countries and France are quite advanced when it comes to ESG funds. Even though Germany was a bit behind over the last two years, they are picking up quickly. Currently AMs find a lot of the requests from institutional clients from Germany involve ESG.

Ossiam, part of Natixis and speaker at our workshop, displayed how they are combining ETF and ESG.

They started out thanks to a French top-tier institutional client that, by appreciating one of Ossiam's ETF equity strategy and performances, asked if they could replicate the same approach by also integrating ESG in the equation.

In order to do so, Ossiam worked on integrating data from external providers (e.g. data bought from Sustainalytics) into their system and strategy through algorithms. This resulted in a fund whose performance and reduction of volatility proved to be even better than funds without ESG integration.

This made sense as the exclusion of "bad" companies reduced the ESG risk that in turn reduced the overall risk of the invested portfolio. Given this positive outcome, they decided to ensure most of their ETFs would incorporate that ESG component.

It must be noted ETFs are particularly well suited for this type of exercise, since they could replicate ESG indices (e.g. S&P ESG or the MSCI Indices) and such combination could be efficient to either reduce the risk or to increase the overall performance.

ESG Data Management is progressively becoming more efficient thanks to new technologies

When determining the ESG profile, a lot of key qualitative and quantitative factors must be taken into account.

In particular, asset managers participating in our workshop, including BLI - Banque de Luxembourg Investments reported that especially the Environmental and Social scores might depend on plenty of other specific and detailed indicators (in certain contexts up to 150 small indicators for every single company).

On the purpose of summarising the relevant ESG KPIs, a few Asset Managers have started introducing Artificial Intelligence machine learning algorithm, which would allow to detect the appropriate relationship between such small indicators and the performance, leading to the determination of an ESG profile. Accordingly, the machine would select stocks of companies capable of outperforming the benchmark.

Challenges

Data quality: issues on data interpretation when determining the ESG Score

Asset Managers underlined data management (and especially in the context of the ESG score's design) is one of the main challenges for ESG practical application.

ESG score could be defined as that ranking determined – as much transparently and objectively as possible – to measure a company's relative ESG performance across different themes and categories including Environmental, Social and Governance based on company reported data.

More than a few third parties in the market provide ESG scoring, whereas certain AMs are trying to produce ESG scoring internally.

In practical terms then, the ESG score represents the average of the Environmental, Social and Governance scores for a given company. The approach of using such average score risks to generate a loss of information, especially when benchmarking companies from different sectors.

In fact, two companies might show the same ESG score, yet still being hardly comparable as the E, S and G variables could have a different weight in the equation.

For banks for instance, governance is very important, whereas the environment might be less relevant; on the other hand, for an oil company the environment would be more significant.

This means certain indicators for certain stocks would never have the same impact. Hence, the risk of information mismatching is still relevant, and more than a few developments must be made in this space.

Sometimes data quality might be at stake also for the frequency of data, which most of the time is about two years old. One could observe ESG evolves on a weekly basis, according to news that are circulated progressively. Thus, utilising data that are two years old might jeopardise the accuracy of information for the purpose.

This latter issue would be solved by ensuring in-house teams focusing on ESG. But at present this is not always the case, and it is the reason why companies still rely on external providers' data quite much.

Harmonisation of measurement indicators of sustainability

During our workshop, BLI - Banque de Luxembourg Investments displayed their methodology over data management for ESG purposes, highlighting the relevance of the Country Sustainability Analysis in this process.

When conducting such an analysis, it is paramount to offer a credit risk measurement approach enhanced by new factors reflecting sustainability as a new and increasingly important facet of the economy.

And properly on these grounds, besides the quality of the data collected, another challenge the ESG analyst must take into account is the harmonisation of measurement indicators for sustainability – even more importantly across different fixed income sub-asset classes.

They are working on solutions to tackle such issues, by ensuring the risk measurement tool would reflect a transparent and rigorous approach, leading to an enhanced durability.

In particular at BLI - Banque de Luxembourg Investments, they apply such approach when analysing emerging countries, firstly by verifying the current level of development of policies positively impacting ESG (over the 3 components, Environment Social and Governance).

This is done via an ESG Score displaying the E, S, and G fundamentals of a country through an aggregation of quantitative factors specific to three analysed angles (i.e. E, S, and G), ranging from 0 to 10.

In order to determine such ESG scores, different techniques are adopted, such as selecting indicators according to different sources of data, lag and frequency of update and publication of such data.

ESG Labelling

One of the most reputable players within ESG labelling internationally, LuxFLAG, took part in our workshop and shed light on how labelling represents a challenge in the ESG space currently.

As an independent label agency, LuxFLAG provides labels for microfinance, environment, climate finance, and broad ESG funds.

Their labels are available for investment funds domiciled in an EU member state or any other jurisdiction with similar supervision to the European Union. In terms of methodology, LuxFLAG labels take into account review of portfolio holdings as well as incorporation of ESG factors in the investment process and decision-making.

They emphasize the need of looking forward rather than backwards when it comes to ESG. Rather than only debating about performance or "do not harm", players should focus on the effective ESG risk – that is one of the aspects labels' relevance relies on.

Being labelled is definitely a marketing tool, an evidence of compliance with certain criteria, and a benchmark for smaller firms that would see their reputation enhanced if it is certified their ESG policies are in line with those of bigger players.

LuxFLAG stressed the paramount features of a good label:

- Independency;
- Internationality/supranational approach; and
- Voluntary guidelines with strict criteria.

Even if besides LuxFLAG, there are quite a few other labels within ESG globally with a decent development, there is still a sort of political component at the basis of the discussions and it is mainly due to local pressure.

In order to increase labels' efficiency, LuxFLAG underlines the importance of extending an eco-labelling not only to consuming products but also to financial products.

It is an idea they have been working on for two years already. They believe this would require a stricter approach at European level as it seems to be still quite light at the moment. For instance, in fact, a firm with some 80% of activities which are "non-green" could still be classified as "green" and would obtain a European Eco-label currently. This is a challenge ESG practitioners must be facing in the near future.

Also, labels should be market-driven and provide visibility to those players who are effectively strong performers in this space according to market practices. Hence, a fair degree of objectivity would be required.

It should be pointed out the relevance of the voluntary disclosure and the fact there should be voluntary guidelines, not imposed by regulators who are not always in the position of determining what is right or wrong in ESG matters.

Several participants to our workshop agreed fund promoters, market players, practitioners, and fund associations should come together as decision-makers in this voluntary market-driven (rather than regulatory-driven) exercise of fixing guidelines.

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The lawyer's corner

By Edouard d'Anterroches, Stibbe Avocats

ESG Value Chain — A liberal legislative approach?

In line with its Action Plan on Sustainable Finance of March 2018 [1], the European Commission is currently preparing a wide action to:

- promote a financial transition to a more sustainable and inclusive growth;
- manage the risks arising from climate change and resource depletion and
- foster transparency.

In this regard, the European Commission recently issued a proposal for a regulation on the establishment of a framework to facilitate sustainable investments [2]. The Draft Regulation defines criteria for determining whether an economic activity is environmentally sustainable for the purposes of establishing the degree of environmental sustainability of an investment (taxonomy). It does not, however, define mechanisms to verify and monitor the compliance with such criteria. In parallel, the Draft Regulation provides stringent obligations as to the disclosure and reporting that financial products should comply with.

- **Reporting** and disclosure requirements: Any undertaking which is subject to the obligation to publish non-financial information shall include in its non-financial statement a report with information on how and to what extent the undertaking's activities are associated with environmentally sustainable economic activities.
- **Taxonomy**: According to the Draft Regulation, an economic activity must fulfil all of the following conditions to qualify as environmentally sustainable [3]:
  - Substantially contribute to at least one of the six environmental objectives defined by the Draft Regulation i.e., (i) climate change mitigation; (ii) climate change adaptation; (iii) sustainable use and protection of water and marine resources; (iv) transition to a circular economy; (v) pollution prevention and control; or (vi) protection and restoration of biodiversity and ecosystems [4];
  - Cause " no significant harm" to any of the other environmental objectives [5];
  - Comply with robust and science-based technical screening criteria [6]; and,
  - Comply with minimum social and governance safeguards [7].

This Draft Regulation should enter into force progressively in 2021 and 2022. However, considering the current situation and the impact Covid-19 has had on the financial markets, the adoption of this Draft Regulation and its entry into the industry may be postponed.

1 / *Communication of the European Commission of 8 March 2018 on Action Plan: Financing Sustainable Growth, COM (2018) 97 final.*

2 / *Proposal for a Regulation of The European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment on the establishment of a framework to facilitate sustainable investment, COM (2018) 353 final, 17 December 2019 (the "Draft Regulation").*

3 / *Draft Regulation, Article 3*

4 / *Draft Regulation, Article 5*

5 / *This concept is defined under article 2(17) of Regulation 2019/2088 on sustainability-related disclosures in the financial services sector that defines what a "sustainable investment" is.*

6 / *Draft Regulation, Article 14*

7 / *As defined in article 13 of the Draft Regulation by reference to the OECD Guidelines for Multinational Enterprises and UN Guiding Principles on Business and Human Rights, including the principles and rights set out in the eight fundamental conventions identified in the International Labour Organisation's declaration on Fundamental Rights and Principles at Work and the International Bill of Human Rights.*

This initiative, limited to environmental sustainability and referred to as the "**new green deal**" [8] illustrates a recent change in the European legislative's paradigm towards a more liberal approach, less stringent rules and to consider the variety of definitions as to what ESG actually covers. This approach is characterised by a set of recommendations and mandatory disclosure rules.

"Tell what you do, do what you tell", should be the new motto and the new basis for a more efficient prudential supervision allowing regulators and investors to assess whether managers are really able to achieve the promises of their investment thesis.

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Communication of the European Commission of 11 December 2019 on the new green deal, COM (2019) 640 final.

The expert's corner

By Marc Fohr, CFA - Investment Industry Professional

ESG — A real data issue

In recent years, sustainable investing has become more and more popular. UN PRI, the initiative for responsible investments of the United Nations, has grown from 51 in 2006, to almost 2,500 signatories of its charter in 2019. This is while the assets under management of its signatories have grown from less than USD 10 trillion to over USD 80 trillion in 13 years. This shows that this trend of responsible investing does not only concern institutional asset owners, but also active and passive investment managers and retail investors. Sustainable investing could be considered as an advancement of traditional investment management, where financial metrics have been put forward in the past, by adding non-financial factors, such as environmental, social and governance aspects in the investment process. Luxflag, the independent and international non-profit association created in Luxembourg in 2006, has seen a one-year growth of more than 80% in the number of labelled products at the end of the first quarter of 2020 to almost 200 labelled products. This shows that more and more funds have been issued or relabelled, or have changed investment objectives to adjust to the changing situation.

For the security selection part there are several approaches that lead to a sustainable investment process: exclusion, best-in-class, ESG-integration and thematic investing. Just as for traditional non-ESG investment processes, the ESG approach relies on information as well. As shown by Bender, Bridges, He, Lester and Sun [1], the sustainability rating for a single company can vary widely across different data providers. The authors show that the cross-sectional correlation of ESG data providers like Sustainalytics, MSCI, RobecoSAM or Bloomberg ESG for constituents of the MSCI World, a global equity index, ranges from 0.47 to 0.76 across aggregated scores. One reason is the source of the information used.

While some data providers use company reports, others pull their data from policy statements and/or news articles. Another factor that is responsible for these different results is the rating methodology. Some data providers have hired large teams of human analysts and others rely on artificial intelligence and machine learning. In the end, the investment management company has to decide what methodology it prefers.

Another issue is data availability. Not all demanded metrics are provided by ESG data suppliers. Therefore, ESG scoring can be challenging. An asset manager that focuses on climate change issues will be rather lucky, as non-financial figures, such as carbon emission volumes, are supported by a number of providers. Other data, such as gender equality, is not widely available and can be harder to find. Sometimes, the research providers are constrained to produce a subjective qualitative evaluation of the security issuers.

In order to solve this data issue and to limit the large universe of ESG matters, investment managers have to define the items they want to concentrate on in their investment process. In fact several different topics are on the table at

1/ *A Blueprint for Integrating ESG Into Equity Portfolios" (Journal of Investment Management, Volume 16, No. 1, 2018)*

present, such as climate change and carbon emissions, air and water pollution, energy efficiency, gender and diversity, human rights, labour standards, bribery and corruption, as well as executive compensation. However, it is rather difficult for an investment manager to limit the large universe of ESG issues, as all issues are important in the long run. As well as this, investors may not want to participate in companies or industries due to ethical reasons or risk motivations. Therefore, the demand for specific ESG metrics belongs to the focus on sustainable issues by the investment manager.

Depending on the budget for implementing non-financial factors in the existing investment process, the asset manager might opt not only for one single data supplier but for multiple sources in order to create a proprietary ESG score for the companies in the security universe. A combination of non-financial data can lead to superior results as some data outliers or missing numbers can be checked and corrected.

As long as governments do not have a common regulation of non-financial data reporting of companies, companies will be free to publish the ESG figures they define as important for their ESG performance. So, underperforming companies will not publish ESG data on deteriorating or weak issues. A global taxation of ESG information disclosure to investors is important and required in the future to give investors the necessary data set they need for their investment decisions.

Only consistent and complete data will lead to a more comprehensive and reliable ESG investment process in the future and it will require effort from a whole host of participants, such as governments, issuers and investors in order to be successful.

The millennial's corner

By Fabrice Ishimwe, MSc Sustainable Finance student at Kedge Business School
Sustainable Finance Analyst intern at Novethic

Attracting individual savers towards Responsible Investments

Today we are witnessing an awakening of populations for environmental and social issues coupled with a desire for meaning in terms of individual investments and savings. However, a lack of information and communication on how to achieve this goal of meaning and responsibility is palpable. The purpose of this note is therefore to provide concrete **guidance** on how to attract individual savers towards responsible investments.

Personal savings

In France, in 2019, the public depository fund (CDC) accounted EUR 293,6 [1] billion in Livret A savings accounts [2] and EUR 560,7 billion remained in giro accounts according to the French Central Bank [3]. Individual savers choose these types of low, or even non-remunerative savings products because of their lack of confidence in the financial industry. At the same time, more than two-thirds of savers believe that responsible investment products can boost their confidence in the management of their savings, but only 21% [4] say they have invested in such products. This is due partly to a **lack of communication and understanding**. Here are two solutions that could solve these issues:

- Training of bankers and advisors in direct contact with individual savers. This can be done by including SRI product training duties in the AMF's MIF II regulation (continuous training's section) for banking professionals. So, it would be easier to catch up with individual savers' SRI expectations;
- Following the FIR [5] in the absence of a contrary choice by the saver, savings products offered by retail or private banks should by default be a responsible savings product. Let's take Dutch bank ABN Amro as an example, that has announced that from 2018 responsible investing will become the norm for new retail customers [6].

Employee savings

According to the French Association of Financial Management (AFG), at the end of 2019, outstanding employee savings amounted to EUR 140 billion. Overall within the employee savings scheme and excluding employee shareholding, one out of three euros is socially responsible. The objective is to shift these savings towards SRI-labelled funds and **aim for 100% of employee savings invested in SRI-labelled funds** (excluding shareholder savings).

Trade unions have a major role in the security councils of companies (or other bodies) regarding the choice of management and investment of employee savings. We need to go further than the CIES (Comité Intersyndicale de l'Épargne Salariale) [7] project. The CIES label is awarded to employee savings schemes that include ESG criteria in their management.

1/ https://www.caissedesdepots.fr/sites/default/files/medias/cp_et_dp/cp_collecte_avril_2019.pdf

2/ Very popular savings account, with over 60 million accounts held in France (interest rate is 0.50% in 2020)

3/ https://www.banque-france.fr/search-es?term=epargne+des+menages

4/ Deloitte - Savers and Responsible Investment - 1st edition l April 2019.

5/ French SIF (Sustainable investment forum), founding member of the European network Eurosif in charge of promoting socially responsible investment

6/ https://www.frenchsif.org/isr-esg/wp-content/uploads/Position-FIR-Assurance-vie-et-climat-2018-28-mai-2018.pdf

7/ CIES (Comité intersyndicale de l'épargne salariale): inter-union employee savings committee.

Two ways to apply pressure:

- On employees during conferences or seminars into companies, this could be organised either by public speakers - as union trades during their communication campaigns (e.g. union elections) or private speakers as asset owners/managers or SRI-oriented speaker agencies that specialise in company conferences;
- Directly with trade unions by including votes in the security council (or other bodies) in the general doctrine of trade unions in favour of 100% SRI employee savings schemes.

Retirement savings

According to the results of the 2019 edition of the Eres European Pensions Observatory, EUR 880 billion is the amount of money French people had in retirement savings in 2018. However, dedicated products only represented 220 billion euros in 2018 [8]. Thanks to the PACTE law [9], the French government aims to increase the outstanding amount of retirement savings from EUR 220 billion to EUR 300 billion by 2022, by creating a new Retirement Savings Plan (RSP) with more attractive tax benefits than the existing schemes. So, the upcoming pension reform, moving to a funded, point-by-point pension, will open up a huge market in which **SRI asset managers have an interest in positioning themselves**.

Just as big asset managers like Black Rock, which strengthens its SRI ambition through Larry Fink's (Chairman and CEO of BlackRock) recent statements [10] on the prominence of ESG criteria in the investment arena, other SRI asset managers must offer solutions to capture these retirement savings. To do so, the asset managers must take the bend of these reforms in order to adapt their formulas to the latest developments.

To conclude, we realise that there are many ways to **raise awareness** and capture the savings of civil society. We know that they involve multiple mechanisms and stakeholders. These approaches are essential, because they affect a colossal mass of savings spread throughout the savings cycle, from personal savings to retirement savings and employee savings. Finally, one thing to keep in mind is that all these options have to follow one core objective, which is to promote **SRI into a non-financial area** with the aim of reconciling the financial world and the real economy.

8 / https://www.eres-group.com/etudes-et-enquetes/observatoire-retraite-eres-epargne-retraite/

9 / The Plan d'Action pour la Croissance et la Transformation des Entreprises (PACTE – Action Plan for Business Growth and Transformation) is a new step in France's economic transformation.

10 / https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter

BLI's corner

By Maxime Smekens, BLI - Banque de Luxembourg Investments S.A.

ESG — Optimisation

The bond management team worked to define a relevant investment strategy to include ESG factors.

Thus, issuers are subject to extra-financial analysis resulting in an ESG score that will be taken into account by the management team during its analysis and selection process for individual issuers. The objective is to obtain an average ESG score within each pocket, including sovereign bonds and corporate bonds, that is higher than that of an index representative in this universe.

This optimisation approach is carried out within both the sovereign and corporate bond pockets. The difference is the methodology used to establish the ESG score.

The choice was therefore made to not consolidate the economic fundamental score and the ESG score. Indeed, as an asset manager, our primary responsibility remains our fiduciary responsibility towards our clients. We therefore aim first and foremost to invest in issuers with strong and/or improving economic fundamentals.

For example, for a similar fundamental economic score, we will favour an issuer with a higher ESG score. However, we will never favour an issuer with a high ESG score if its economic fundamentals are not sufficiently strong.

The following focuses on the ESG optimisation strategy for sovereign issuers, based on a proprietary approach, to be implemented in 2020.

Background

It is not easy to understand and compare the levels of sustainability in a country; indeed, different parts of the analysis are subject to many constraints, the main one being the long delays in providing and updating data. While there is a significant amount of data available on the ESG criteria of countries, the data is often not up to date at the global level. The aggregation of public indicators takes time; the data may be two to ten years out of date and is not updated frequently (usually every two to four years).

The proprietary approach developed at BLI aims to overcome this major handicap by integrating, in addition to the analysis of available quantitative data, a study of the ESG dynamics in the different countries.

Methodology

The approach used to calculate the ESG score is to combine a fundamental score that remains relatively stable over time with a momentum score aimed at reflecting the ESG dynamics in which the countries under analysis are involved.

By comparing the proprietary financial data rating and the ESG rating, the strategist is able to identify quality issuers from both a financial and an ESG perspective. With similar fundamentals and performance, the management team will favour the issuer with a superior ESG rating.

- **Fundamental ESG Score**

Through this analysis, the management team determines a country's relative position in ESG terms.

This score, which can vary from 0 to 10, combines an independent analysis of the three factors E, S and G, issues and is based on the aggregation of publicly available quantitative data.

The data analysed (aggregated or raw) was selected on the basis of the reliability of sources, their relevance in terms of ESG analysis and how often it is updated.

The sources vary according to the purpose of the indicator. The most frequently used are: United Nations Office for Disaster Risk Reduction; Food and Agriculture Organisation of the United Nations; International Labour Organisation; WHO-UNICEF Joint Monitoring Programme for Water Supply, Sanitation and Hygiene; Global Health Observatory, WHO; World Development Indicators Database, World Bank; Skills for Employability and Productivity (STEP), World Bank; National Bureau of Statistics.

As this sovereign rating should also reflect possible future risks, when aggregating the three E/S/G ratings, the management team decided to assign a higher weighting to governance while social and environmental issues are equally weighted. This overweighting is explained by the fact that, at the country level and mainly in emerging countries, political stability remains an essential element for the creation (and maintenance) of the infrastructure necessary for the implementation of sustainable social and environmental policies.

As mentioned above, the limitation of this score is that the available information is not updated frequently.

Yet, to get a complete picture of a country's ESG profile and the risks associated with it, it is necessary to be able to take into account the different dynamics in place, whether positive or negative.

- **ESG Momentum Score**

Thus, in order to compensate for the lack of recent quantitative data, a systematic and continuous analysis of a carefully selected (relevance, reliability) flow of information relating to each country (news, articles, etc.) is carried out.

In order to streamline this analysis process and, above all, to be able to objectively compare data concerning news, reforms, and the feelings of the population, the management team relies on advances in artificial intelligence and language processing technologies.

Each week, country analyses focusing on the ESG criteria are incorporated into the model, which then ranks them as more or less positive depending on the strategist's view of his or her assessment of the ESG criteria.

This second, more dynamic level of analysis allows the management team to continuously monitor the relative sustainability of (mainly emerging) countries and to see whether a sustainable trend - positive or negative - in a given country can lead to an improvement or deterioration in fundamentals over the medium term.

A score for each of the three factors is calculated for each country and then combined to give an overall ESG Momentum Score (-2 to +2).

This method allows the management team to better understand why a

country has a better or worse ESG score and gives them the opportunity to build their own interpretation of the situation in each country analysed and to make a documented and considered decision to invest or divest in the medium term.

- **Confronting the country allocation with the Sustainable Development Goals (SDGs)**

Comparing the country allocation of the bond portfolios to the analytical framework defined by the SDGs allows the management team to put asset allocation decisions into perspective and assess their impact in ESG terms.

The scores mentioned in the example above can be seen as the percentage share of the path already taken to achieve the 2030 SDGs. A score of 100 indicates that the target for this indicator has been fully achieved.

While this is a posteriori analysis of the portfolio's positioning, it nevertheless provides an interesting basis for comparison and an objective account of the ESG impact of the country allocation defined using the internal rating methodology.

Furthermore, this framework cannot be used as a primary tool for developing an ESG investment strategy since it suffers from the same problem of data lag or mismatch that was discussed earlier.

ESG/SRI — The contrarian

By Giuseppe Sorge, Portfolio Management Expert

The aim of the following is to provide a different point of view on ESG/SRI investments, so as to stimulate reflection about what it could mean under the investment perspective. This is not to say that ESG/SRI investments are not a good choice.

ESG and SRI investments, due to their nature, are strategies which exclude possible investments. These kinds of stocks have, quite often, a longer time horizon, and may not be suitable for some investors.. If you focus solely on socially responsible investments, you could be leaving other, and in some cases, stronger investments on the table. For example, what happens if you come across a company (like Microsoft) that has a social performance score below average (due to the way it operates versus its competitors), but has a history of creating innovative products and services that improves lives and generates jobs? If you decide to pass on this attractive investment opportunity because of the social responsibility factor, you may lose a very strong and powerful investment. Are you sure you want to exclude companies like these that could boost your portfolio?

Another point I would like to draw attention to is what is happening around us today. The attention paid to the environment over the last few years brings even more consideration to green investments, which have significantly increased their weight in the portfolios of investors. This trend will probably continue in the future and now, thanks to new regulations which will become live in the coming years, investors and asset managers alike will be encouraged to have more ESG and SRI investments in their portfolios. This situation, on one hand, is great because it will push companies to become more compliant with ESG and SRI regulations, but on the other hand, it could bring companies to cheat on their numbers or on their future investments in order for them not to be excluded or sold (i.r. risk of Greenwashing). During recent years there have been many examples of companies in the United States that have greenwashed, i.e. General Electric, American Electric Power, Exxon, DuPont and Archer Daniels Midland among others. In Europe, Volkswagen is a well-fitting example of this practice.

Its commercials - along with its general image portray social responsibility. For many years the company put a hefty amount of marketing into its “clean diesel” campaign as a safer option for the environment, however they were cheating the controls of the US Environmental Protection Agency (EPA). The software used was able to recognise when the cars were in “test mode” so that the emissions were artificially reduced by 40 times when not being tested. This practice was discovered in 2015, giving life to the scandal known as “Dieselgate”. Back in October 2018, Rupert Stadler, CEO of Audi (owned by Volkswagen), was forced to resign as he was implicated in criminal investigations related to this scandal.

The final point I would like to highlight is how different criteria should be used to either exclude or include a company from an ESG or SRI investments.

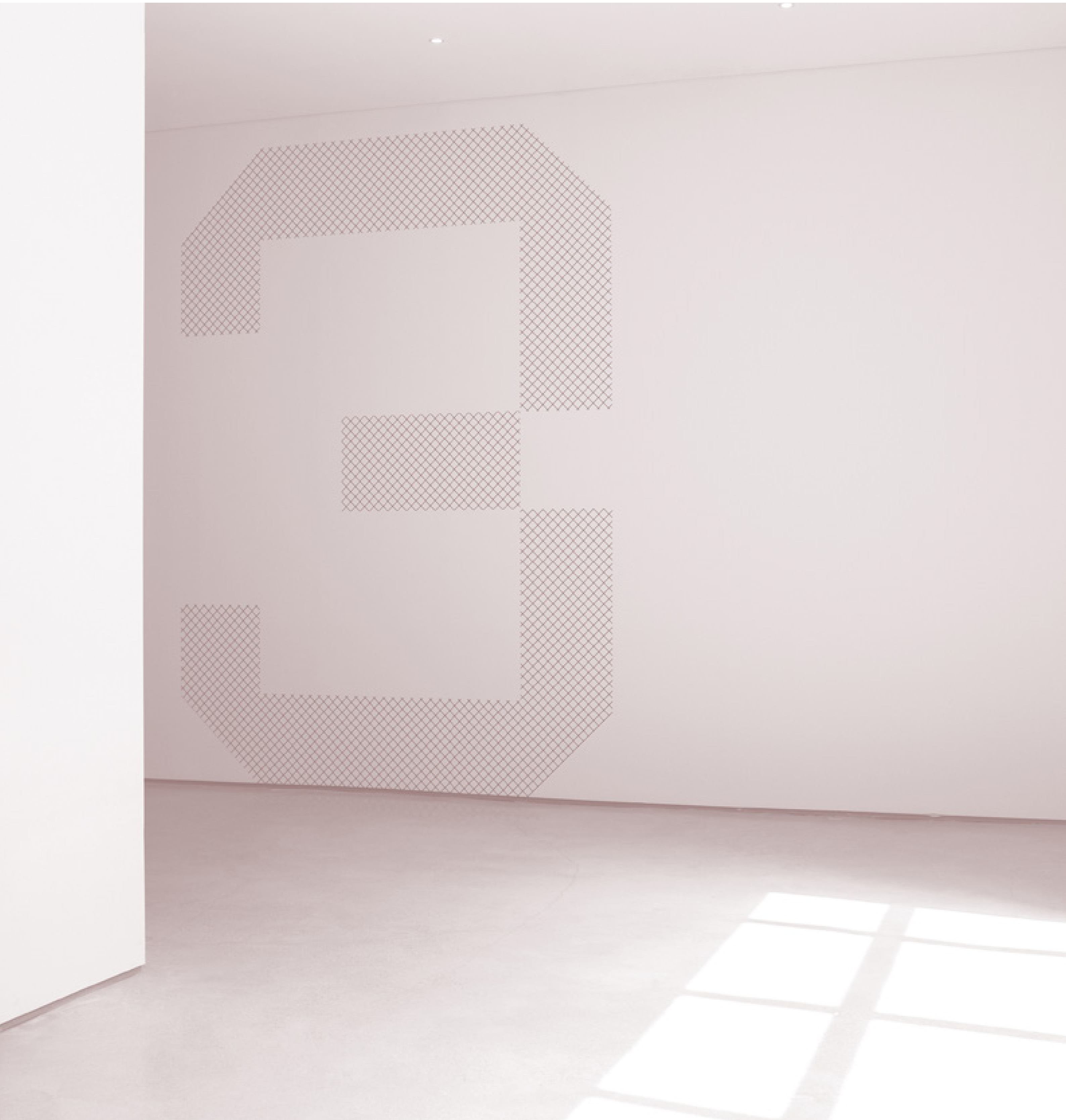
What constitutes as socially responsible investing is not always universal. Here, the best example is nuclear energy. If we just consider the perspective of damages from nuclear accidents and nuclear wastes, it might be seen as one of the worst investments ever. However, if we consider nuclear energy as a possible substitute for fossil fuels, it could constitute a socially responsible industry.

When you invest you should consider this factor, because some ETFs labelled as ESG or SRI are investing in many companies like ConocoPhillips, Occidental Petroleum, McDonald's (which has been accused of unfair labour practices) and Aramark (same thing). These stocks, it can be argued, go against traditional SRI guidelines.

During recent years, ESG investments performed in line or even better than "normal" investments. This is while among ESG investments, higher rated ESG companies performed better than lower ESG rated ones. It's certain that ESG and SRI factors are changing the way to invest and the way to allocate investments. Moreover, ESG and SRI companies are strongly benefitting from huge flows as testified in Morningstar's 2019 year-end report where it was highlighted that in Q4 2019 there were estimated inflows of USD 7.1 billion, setting a new record (the old one was Q2 2019USD 4.8 billion), with a total in the year of USD 20.6 billion - almost four times the previous record [1] set in 2018.

For the time being flows are on these investments and their growth looks consistent, stronger and supported by a change of mentality from the new generation of investors - but only the future will tell us if the growth of this market is due only to trendy flows, or if it will also be supported by fundamentals.

1/
Morningstar based its data on 300 mutual funds that integrate ESG factors into their investment processes, pursue sustainability-related investment themes, and seek to measure sustainable impact alongside financial returns



ESG/SRI — A new HR perspective

Marco Vernia, Sperling & Star

It has been many years now that ESG has been a widespread trendy topic globally and the recent official EU Commission's stance – reflecting ESG requirements into the main EU Directives impacting asset management (e.g. UCITS, AIFMD and MiFID II) – seems to prove it is going to be a concrete game-changer.

Also, the definite increased sensitivity over sustainability from younger generations has led to a shift from a "do not harm" principle to a "do good" approach, connecting ESG to impact investing quite closely.

This is changing the way we do and will be doing business for years to come.

The role of HR and recruitment specialists in these challenging times: supply and demand of new talent

In light of the above, due to their crucial position in this transition and especially in the wake of COVID-19, the role of Human Capital and the Human Resources function must be rethought.

The direct connection of HR's role to the ESG strategy management of any healthy company is even more evident if benchmarked with the UN's Sustainable Development Goals [1].

HR's role in connection with the UN Sustainable Development Goals' achievement

- Securing equal treatment to all workers — **SDG 10** (reduced inequalities);
- Safeguarding well-being across the workforce — **SDG 3** (Good health & well-being);
- Collaborating in the setting-up of learning & development tools to enhance productivity — **SDG 4** (Quality education);

1/ https://www.un.org/sustainabledevelopment/sustainable-development-goals/

- Preserving jobs — **SDG 8** (Decent work & economic growth);
- Working on solutions for infrastructure supporting – inter alia – smart/virtual working — **SDG 9** (Industry, innovation & infrastructure);
- Partnerships with different third parties (including government as well as private sector) so as to effectively react to contingent issues (e.g. COVID-19's consequences) — **SDG 17** (Partnerships).

The function of HR is going to be essential in this process since they will be called to interpret the inclusion of ESG strategies within the current corporate culture.

More importantly, HR professionals must support top management in order to review their modus operandi when it comes to recruit new ESG-compliant resources.

In fact, if on one hand an ever-growing number of professionals are seeking careers in ESG-related domains, organisations may struggle to find professionals with a new **skill set** in a field that is increasingly in demand.

According to the 2019 Global Report from the Global Impact Investing Network ("GIIN") [2], with a sample of 270 Impact Investing firms, requested to share their views on what motivates individuals to work in impact investing, respondents mainly cited a willingness to work for a mission-driven organisation (80%) and to align their careers with their personal core values.

However, about half of respondents indicated that the availability of ESG-skilled professionals remains a challenge for the industry. More than half indicated the number of professionals with Impact Management and Measurement ("IMM") skills is insufficient, whereas 41% believe there is an inadequate supply of professionals skilled in deal making and structuring applied to ESG.

The current picture also reveals a significant challenge for investment firms to attract and retain investment management and IMM staff, particularly at senior or executive levels.

Besides the compensation and current growth opportunities, companies claim that there is still a limited awareness on ESG and impact investing domains, with a limited track record in the field, which generates a small pool of qualified professionals.

Such urgent need for talent is consistent with the outcome of another important analysis: the ESG Global Survey 2019 from BNP Paribas [3], which surveyed 347 Asset Managers ("AMs") and Owners on ESG and sustainability.

The concerned AMs already have contingency plans in place to solve this issue within a short timeframe.

More specifically, 39% of the respondents plan to reinforce their sustainable strategies and practices across their own operations within 12 months. This is while 29% look to hire ESG talent in the broad sense, with a non-traditional financial background within 12 Months; whereas 34% will use or increase ESG/sustainability consultants; and 40% will train their team on matters of sustainable principles and practices.

Long story short: an average of one third of the organisations surveyed are going to take strong action to integrate sustainability-skilled Human Capital in 2020!

2 / https://thegiin.org/research/publication/impinv-survey-2019

3 / https://securities.bnpparibas.com/global-esg-survey.html

New skill sets: non-traditional financial backgrounds with no real benchmarking yet

The ongoing ESG development into business practice reveals that one of the prominent requirements to become a compelling ESG and impact investing specialist is a subtle mixture of financial and non-traditional financial skills.

The current situation is quite similar to the one experienced back in the early 90s, in the wake of the private equity boom.

After a solid period of leveraged buyouts, the rapidly increasing popularity of new strategies like venture capital funding, angel investing, and turnaround endeavours brought with them a steep demand of skilled professionals on such specific new trends. And even more critically, organisations found themselves searching for talent without the correct benchmarking.

ESG and impact investing today is experiencing the same challenge: as from 2015, the inflow of money in this investment space is increasing exponentially [4] and the demand for specific talent is increasing at the same rate.

Such rapid development makes it more challenging for organisations to set proper standards for the talent pool as there is no real benchmarking currently available.

However, based on diversified experiences in the field, we recognise the following three main features coming into play quite importantly when hiring a senior professional within ESG and impact investing investment management.

- **A true motivation**: working within ESG is not a mere business exercise but is connected with certain requested core values of a professional. Before hiring new professionals in the field, organisations start assessing whether a real alignment between a potential candidate and the ESG values of their corporate identity is present;
- **Learning flexibility**: ESG and Impact Investing requires a professional to juggle with different types of financial and non-financial information that might vary from project to project and sometimes with a high degree of diversity (e.g. implying different frontier economies with diverse qualitative and quantitative KPIs to take into account alike); and
- **Multidisciplinary expertise**: especially when dealing with investment and project management within ESG, the level of complexity is enhanced and the areas of expertise impacted are multiple – for instance:
    - **Business & financial services acumen**: it is necessary in order to establish the appropriate investment structure and to follow up on its implementation throughout the lifecycle of a multi-faceted project;
    - **Measurement strategies for the social impact of the ESG project and related activities**: this entails a deep understanding of (i) Impact Investment and Management strategies, of (ii) the economics dynamics in a specific region of a given emerging market, and of (iii) the related governmental approach to business;
    - **Relationship management skills**: this professional will be dealing with multiple parties (internally and externally – e.g.

4 / https://www.investmentnews.com/esg-funds-ride-perfect-storm-record-inflows-176396 ; https://www.internationalinvestment.net/news/4015493/esg-fund-flows-increase-fold-research

with independent valuation specialists of social impact indicators over a specific emerging market) and within different business ecosystems – covering the private sector but also, possibly, NGOs and governmental bodies.

Where does Luxembourg stand currently?

If Anglo-Saxon countries have shown to be pioneers – as often happens when it comes to new global business trends – Luxembourg is swiftly picking up the pace.

Our workshops provided a fair picture of how Luxembourgish business practitioners take ESG and impact investing seriously by deeming them as a potentially disruptive business strategy rather than a “trendy topic”.

I believe the Grand Duchy will implement ESG strategies rapidly, also on the heels of the upcoming concrete amendments to the main EU Directives impacting asset management legislation. After all, Luxembourg has historically demonstrated that it is one of the fastest EU member states to transpose EU Directives into domestic law.

Currently, I see a good share of AMs starting to fine tune their talent management to ESG strategies, even according to the solidity of their presence in Luxembourg and depending on their brand’s sensitivity in terms of ESG at the level of their head offices.

In a sort of “wait and see” approach, others still prefer outsourcing ESG analyses to external consultants, keeping open the possibility of hiring in-house human capital specialised in sustainable finance at a later stage, For example once ESG business practice is successfully up and running, this may allow for the hiring of further in-house teams..

Regardless of any firm’s selected strategies, I advise business players to start their journey to ESG talent management as from the design of the appropriate skill sets (as required), to the completion of the talent acquisition’s process.

There are some really exciting times ahead!

Conclusions

By Guy Wagner, BLI - Banque de Luxembourg Investments S.A.

ESG impact on the investment fund industry and distribution: a new paradigm?

For a long time, SRI and ESG investments have been seen by the industry at best as niche and thematic investments, and at worst as a "fad" that will not last.

The performance of SRI investments has regularly been called into question. Some question whether or not it is still possible to generate alpha if you are looking for "virtuous behaviour" in the investment field – this is also fortified by some philosophical debates in the background about liberalism and the purpose of capitalism.

Now, the very rapid growth of "mainstream" ESG investments is a fact and is underpinned by a key question from the European regulators: how is it possible to achieve sustainable and inclusive growth? This structural trend is forcing the asset management industry to act quickly and adapt its way of investing. The challenges of integrating ESG into investment funds has led to important organisational changes that impact people, tools, data and processes – at a huge cost, of course. However, there is now also a demand for cultural change in terms of the asset management company's social responsibility. Impact investing isn't just about green bonds, microfinance and climate transition solutions, but it also requires engagement by voting and creating a dialogue with the company in which the industry is investing.

An important effect on distribution

This ESG impact is not limited to investments: it also has an important effect on distribution. Whereas, initially, ESG was driven by institutional investors' demands, it is now clearly taking root in the wholesale and retail segment, a trend which is being accelerated by the regulations. The ESMA project on integrating sustainability risks and factors in MiFID II, with the final report published recently, is a good illustration. The end recommendations to a client must reflect both financial objectives and ESG preferences. The same goes for insurance intermediaries and insurance undertakings distributing insurance-based investment products; they will be required to include ESG investment objectives in the suitability assessment.

This has direct and multiple consequences for investment managers:

- The importance of defining the underlying principles as the advisers integrate ESG in their investment advice;
- The capacity to deliver transparency, accurate reporting and documentation on ESG – in itself is also clearly related to the data to which the investment firms have access;
- And finally, the question of the fund “label”.

On this last subject, the existence of different local ESG labels, such as the implementation of the Belgian sustainability label this year, is also a challenge for an industry that has taken the cross-border route with products registered in several countries. How can local demand be reconciled with a more European approach to ESG?

For the asset management industry, the integration of ESG criteria in investments is not a project, but the beginning of a “journey”. Significant challenges both on the investment and distribution side and on organisational implications should not be underestimated. On the other hand, this journey could also be seen as an important growth driver for the industry and a source of dynamism in terms of new solutions offered to different types of investors, as well as an opportunity for innovation through new tools and products.

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I can do things you cannot,
you can do things I cannot.
Together we can do
great things.

Mother Therese of Calcutta

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