ENVIRONMENTAL, SOCIAL AND GOVERNANCE IN INVESTMENT AND BANKING

June 2020
THE AUTORS

Anaïs Dudout
Consultant

“After several years of interest for hiking and snorkelling, Anaïs made sustainability her main professional interest”

Anaïs is Consultant with 3 years of experience including 2 years as an ESG analyst by supporting investors in their sustainable portfolio strategy and by developing scoring methodologies. She has a solid academic background on sustainability risk management and regulation and wrote her final master degree dissertation on environmental prejudice and risk assessment.

Sébastien Gillet
Senior Consultant

“Nature photographer and passionate about travel, Sébastien is concerned about ecology and eco-management.”

Sebastien is a Senior Consultant with 7 years’ experience in the banking industry and financial services. He has a significant experience on several topics, and is currently working on new subjects, like sustainable finance. His project experience over the years has given him a high level of competence at managing projects through a combination both in a project management and business analyst role.

ABSTRACT

A growing number of stakeholders, from governments to individuals, pension funds and asset managers, have realised that the application of ESG criteria is in line with their financial objectives. Around the world, investment strategies based on sustainability criteria are growing to become a new service line tending to the needs of the stakeholders: supervisory bodies, financial institutions and all customers.

The European Union (EU), which wants to become a neutral-carbon continent by 2050, has launched its own initiative called the “European Green Deal” to address the environmental needs necessary to achieve the targets of the Paris Agreement. At the same time, the European Green Deal Investment Plan was created to facilitate investments for the transition to a climate-neutral, green and competitive economy.

The main objective of this briefing note is to present the ESG criteria in our Belgian financial and investment system, but also the awareness of financial institutions and society’s need to respond to the current crisis and carbon neutrality agreements.
OVERVIEW

'Sustainable finance' generally refers to the process of taking into account environment and social considerations when making investment decisions, leading to increased investment in longer-term and sustainable activities.

More specifically, environmental considerations refer to climate change. Social considerations may refer to issues of inequality, inclusiveness, labour relations, investment in human capital and communities. The governance of public and private institutions, including management structures, employee relations and executive remuneration, plays a fundamental role in ensuring the inclusion of social and environmental considerations in the decision-making process.

All three components – environmental, social and governance (ESG) – are integral parts of a sustainable economic development and finance.

ABSOLUTE AND RELATIVE GROWTH OF SUSTAINABLE FINANCE

Over the last years, we have observed a growing development of both “sustainable” financial products and regulatory as well as “soft” standards in the market. Initiated both by the governments and by the sector itself, the markets have consolidated earlier in Europe than in the rest of the world. The relative decrease of sustainable investment relative to total assets in Europe, showed in second graph below, is explained by initiatives and filters put in place by all stakeholders to offer high-quality of products and reliable green portfolios. The demand for green investment has become more qualitative in order to meet the requirements of stakeholders and investors.

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<tbody>
<tr>
<td>Europe</td>
<td>€9,885</td>
<td>€11,045</td>
<td>€12,306</td>
<td>12%</td>
<td>11%</td>
<td>60%</td>
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<tr>
<td>United States</td>
<td>$6,572</td>
<td>$8,723</td>
<td>$11,995</td>
<td>33%</td>
<td>38%</td>
<td>16%</td>
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<tr>
<td>Canada</td>
<td>$1,011</td>
<td>$1,505</td>
<td>$2,132</td>
<td>49%</td>
<td>42%</td>
<td>21%</td>
</tr>
<tr>
<td>Australia / NZ</td>
<td>$203</td>
<td>$707</td>
<td>$1,038</td>
<td>248%</td>
<td>46%</td>
<td>50%</td>
</tr>
<tr>
<td>Japan</td>
<td>¥804</td>
<td>¥57,055</td>
<td>¥231,852</td>
<td>6692%</td>
<td>307%</td>
<td>308%</td>
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Source: 2018 global sustainable investment review, global sustainable investment alliance

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1 Definition of European Commission
2 2018 global sustainable investment review, global sustainable investment alliance
KEY ESG DATA AND METHODOLOGY

Rating companies, index providers and investment strategy companies are specialised in producing a screen of listed companies according to ESG criteria, but also of all banks and all banking activities, e.g. bankwijzer3. Indeed, there is an existing demand from the customers of the bank to perform these ESG ratings; and not only from the shareholders of listed financial institutions.

Some companies are specialised in the advising of retail and investing banks on sustainability matters. Their targets are not only directed at shareholders, but also customers.

ESG criteria differ from one sector to another. Banks are rated for a great part based on the below topics:

- Data protection and privacy of their customers;
- Responsible customer service; and
- Controversy occurrence and reaction4.

The criteria, above, are particularly screened to measure the ESG performance of financial institutions as the consequences of “misbehaviour” by these actors on these criteria are the greatest for the society and the financial institutions themselves according to several top-companies of this sector. Vigeo-Eiris states: “In May 2016, the European Central Bank (ECB) estimated that cumulative legal costs (including damages, fines, settlements and litigation costs) at a sample of 26 global banks […] have reached almost USD 275 billion between 2008 and mid-2016. In the case of European banks, provisions for legal costs amounted to USD 160 billion, which represents almost half of European banks’ net income earned between 2008 and 2015”.

The “misconducts” also have non-financial implications: “Misconducts could damage confidence in financial markets and institutions, discouraging “users of financial services from utilising the system” and “limiting the potential of finance to serve real economies and foster global economic growth”. Likewise, misconduct by banks

3 https://bankwijzer.be/fr is a platform where is disclosed a screening analysis and a scorecard of Belgium banks. More precisely, the collective analysed the investment policies of the banks, not internal ESG performance.
4 http://vigeo-eiris.com/wp-content/uploads/2019/06/Key_Findings_Retail-and-Specialised-Banks.pdf This study of Vigeo-Eiris shows the performance indicators chosen by several actors of the market in their screening methodology.
imposes costs on society. “For example, mis-selling of financial products leads to a suboptimal allocation of investments and risks (as witnessed in the years preceding the financial crisis) and manipulation of financial markets distorts the proper functioning of these markets, allowing banks to profit from undue rents. Misconduct related to tax evasion has a direct impact on state revenues and misconduct related to money laundering undermine the efforts of states to enhance global security”.

REGULATORY FRAMEWORK

Sustainable finance aims at integrating Environmental, Social and Governance (ESG) criteria into financial services. It also aims to mitigate ESG risks via an appropriate management, considering in particular the longer-term nature of such risks and the uncertainty on their valuation and pricing.

Sustainability and corporate behaviour towards the environment and people has been an increasing topic on the governments and regulators agenda for several years. After the development of non-binding standards, initiated by the European institution, the member countries started implementing reporting and disclosure requirements over the years. Therefore, several financial institutions are now bound to build a sustainability strategy and to report on their performances in order to fulfil those regulatory requirements, on top of the traditional financial reporting.

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1 Vigéo Eiris – Responsibility and ethical culture in banking and finance – June 2017
European Central Bank (ECB) - Financial Stability Review. Special Features - May 2016
European Systemic Risk Board (ESRB) - Report on misconduct risk in the banking sector - June 2015
### BELGIAN LAW OF THE 4TH OF APRIL 2012

<table>
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<tr>
<th>Context</th>
<th>Scope</th>
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<th>Sanction</th>
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<tr>
<td>Transposition of directive 2009/65 of the European Parliament.</td>
<td>Collective Investment Funds.</td>
<td>In the prospectus addressed to its clients, the organization must disclose a clear description of how the social, ethic and environmental aspects are taken into consideration into the investment policy. This report must be transferred to and approved by the FSMA. Publication of an annual and a semi-annual report disclosing an information on how social, environmental and ethic criteria have been taken into consideration for the management of financial resources and in the exercise of the rights related to portfolio titles. This requirement applies, if needed, by compartment.</td>
<td>The FSMA is responsible for setting the sanctions.</td>
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### BELGIAN LAW OF 19TH OF APRIL 2014

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<th>Context</th>
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<tr>
<td>Transposition of directive 2011/61 of the European Parliament.</td>
<td>Alternative Collective Investment Organizations and their Managers.</td>
<td>Publication of an annual and a semi-annual report disclosing an information on how social, environmental and ethical criteria have been taken into considerations in the financial resources management and in the exercise of the rights related to portfolio titles. This report must be transferred to FSMA. In the prospectus addressed to its clients, the organization must disclose a clear description of its risk profile and how the social, environmental and ethical criteria have been taken into considerations in the investment policy of the company.</td>
<td>The FSMA is responsible for setting the sanctions.</td>
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### BELGIAN LAW OF 3RD OF SEPTEMBER 2017

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<td>Transposition of directive 2014/95 of the European Parliament.</td>
<td>Public interest companies with an average of 500 employees, and either a revenue of € 34M or a balance sheet of € 17M.</td>
<td>A report on non-financial information must be attached to the annual report with the following information: Business model description - Applied processes and due diligence policies - Results of these policies - Main risks tied to addressed issues - Extra-financial KPI The Law also includes requirements related to the equality and diversity policy of the company: Target disclosure - Policy of application and strategy - State of progress of the policies and results</td>
<td>Sanctions relative to non-publication of annual report applies (article 126 C. Soc.).</td>
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BELGIAN LAW OF 11TH OF JULY 2019

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<td>Transposition of</td>
<td>Professional Pensions</td>
<td>ESG factors must be taken into consideration during financial investments decisions. ESG risks of financial investments must be evaluated, notably risks related to climate change, use of the resources and the environment, social risks and risks related to the loss of value of goods linked to evolution of regulatory framework. These considerations must be integrated into the governance of the institutions and are subject to reporting requirements: organisational structure, internal control, measures ensuring the continuity and the compliance of the process, risk management process. Compulsory requirement at least annually to FSMA, EIOPA and BCE.</td>
<td>The FSMA is responsible for setting the sanctions.</td>
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SUSTAINABLE FINANCE PART OF THE GREEN DEAL

In December 2019, the European Union launched the European Green Deal to become the first climate neutral continent by 2050. This strategy aiming to adopt measures that will enable individuals and companies to change their way to operate, to consume and to invest by becoming carbon neutral.

In January 2020, as part of the Green Deal, the Commission presented the European Green Deal Investment Plan, which will mobilise at least €1 trillion of sustainable investments over the next decade. It will facilitate public and private investments needed for the transition to a climate-neutral, green, competitive and inclusive economy.

Already in March 2018, the commission implemented an action plan proposing several measures and key actions to connect Finance with Sustainability.

The key actions are:

- establishing a clear and detailed EU classification system – or taxonomy – for sustainable activities. This will create a common language for all actors in the financial sector;
- establishing EU labels for green financial products. This will help investors to easily identify products that comply with green or low-carbon criteria;
- introducing measures to clarify asset managers’ and institutional investors’ duties regarding sustainability;
- strengthening the transparency of companies on their environmental, social and governance (ESG) policies. The Commission will evaluate the current reporting requirements for issuers to make sure they provide the right information to investors; and
- introducing a ‘green supporting factor’ in the EU prudential rules for banks and insurance companies. This means incorporating climate risks into banks’ Risk Management policies and supporting financial institutions that contribute to fund sustainable projects

In February 2020, the COVID-19 crisis appeared that significantly impacted the global economy. The European Green Deal has been impacted and the effort of the recovery from the economic consequences will also increase across all sectors.
This is why the European Green Deal has announced a Renewed Sustainable Finance Strategy, which aims to provide the policy tools to ensure that the financial systems support the transition of businesses towards sustainability in a context of economic recovery. The strategy will create an enabling framework for sustainable investments by private investors and the public sector.

The importance of this strategy is highlighted through the ongoing COVID-19 crisis, which underscores links and risks associated with human activity, climate change, and biodiversity loss, as well as the subsequently critical need to strengthen the sustainability and resilience of our societies and economies.

The actual Renewed Sustainable Finance Strategy is currently under consultation until mid-July.6

**NEXT STEPS: WHAT ARE THE KEY CHALLENGES?**

Sustainable investment is gaining ground and attention. Perhaps because the market is beginning to realise that environmental and social issues related can penalise economies and companies. To prevent these adverse effects, we need to think about the financial, social and ecological impacts of our investment strategies. The emerging regulatory framework in Europe now creates requirements from financial institutions, making sustainability both a matter of private initiative and public oversight.

The next months will be a time of answers for the COVID-19 crisis for financial actors; but also the continuity of the regulatory footsteps of sustainability.

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ABOUT AVANTAGE REPLY

Avantage Reply (a member of Reply Group) is a Pan-European specialised management consultancy delivering change initiatives in Risk, Compliance, Finance, Treasury and Operations within the Financial Services industry.

Within our core competencies, we have extensive experience in implementing changes driven by:

- Regulatory Advisory (e.g., MIFIR, EBA, NBB, BASEL)
- Strategic & business change (e.g., customer journey, credit ‘re-invention’)
- IT change (e.g., risk and finance systems)
- Data management & reporting