



SUSTAINABLE FINANCE

A NEW GENERATION OF FINANCIAL LITERACY

FEBRUARY 2019



INTRODUCTION: ABOUT BDO

BDO: PROFILE AND POSITIONING

BDO is one of the world's leading auditing and consulting firms.

We are an entrepreneurial network and a professional partner for regional companies and global groups alike.

We aim to provide auditing and consulting services and support of the highest quality. We act with foresight, create added value and proactively approach our clients.

BDO FINANCIAL SERVICES

BDO's strategy is ambitious: To further expand its strong market position in the financial services industry.

Today, BDO's industry specialists provide consulting and auditing services to leading banks, investment managers and insurance companies.

More than 1,000 employees focus on financial services, including auditors, tax consultants, lawyers and other specialists, for example in the fields of compliance, IT, M&A and business valuation.

High quality, strong motivation and independence serve as a benchmark for everything we do.

BDO INTERNATIONAL

US \$ 9.0 billion
2018 REVENUE

162 Countries
1,600 offices
80,087 Staff



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FOCUS ON SUSTAINABLE FINANCE

At the Paris Conference in 2015 where the Accord de Paris (Paris Agreement) was negotiated, the developed countries reaffirmed the commitment to align financial flows with a pathway towards low-carbon and climate-resilient development. As of November 2018, 183 countries and the European Union had signed the Paris Agreement.

As a result of the Paris Agreement, policy makers worldwide have started to evaluate how they can encourage or require banks, asset managers and institutional investors to adopt strategies that will support countries in meeting their commitments.

In the EU, the European Commission established a High-Level Expert Group on Sustainable Finance in 2016. The expert group's two main tasks were: to improve the **contribution of the financial sector** to sustainable growth, with particular focus on environmental sustainability; and to **protect financial stability** from risks related to environment, social and governance (ESG) dimensions.

- In its final report published in January 2018, the expert group stresses the importance of institutional investors and asset managers' fiduciary duties (i.e. care, loyalty and prudence) as they are already embedded in EU regulations including UCITS, AIFMD, MiFID II, Solvency II and IORP II.
- Such obligations include the duty to act: in the best interest of beneficiaries/ investors; with due care, skill and diligence, including the identification and management of conflicts of interests; with honesty.
- In 2018, the European Commission published an Action Plan on Financing Sustainable Growth. Further, the Commission set up a technical expert group (TEG) to assist in the development of a unified classification system for sustainable economic activities, a green bond standard, methodologies of low-carbon indices and metrics for climate-related disclosure.
- To help integrate ESG considerations and preferences into investment advice and portfolio management, the European Commission in January 2019 published draft rules on how investment firms and insurance distributors should take sustainability issues into account when providing advice to their clients. Such rules would amend delegated acts under MiFID II and the Insurance Distribution Directive (IDD).

Long before the Paris Conference of 2015, the concept of sustainability attracted attention from firms and stakeholders with regard to its benefits and what it is.

- With the aim of developing guidelines for sustainability reporting, the Global Reporting Initiative (GRI) was formed, with the support of the United Nations Environment Programme (UNEP), in 1997.
- In the EU, the CSR Directive (2014/95/EU) introduced measures that strengthen the transparency and accountability of firms. Under the CSR Directive, large listed firms, banks and insurers with more than 500 employees are required to describe their business model and to report on environmental, employee and social-related, human rights, anti-corruption and bribery matters as well as on their diversity policy. Firms are encouraged to rely on recognised frameworks such as GRI's Sustainability Reporting Guidelines. The first non-financial reports under the EU Directive were published in 2018.
- Sustainability reporting affects firms of all industries, but can financing by banks make an impact on overall sustainable development?

'ESG' stands for Environmental, Social and Governance, the latter meaning corporate governance. The term and ESG criteria were first introduced by the United Nations' 'Global Compact' initiative

- ▶ By applying ESG criteria in asset allocation, the financial sector may contribute to sustainable growth

The acronym 'CSR' stands for Corporate Social Responsibility. CSR can be defined as the ethical principle that a firm should be responsible for how its behaviour might affect society and the environment

- ▶ Introducing CSR into a bank's process will add value to the society and the environment

A SHIFT IN THE INVESTMENT LANDSCAPE

Institutional investors and fund managers owe specific 'fiduciary duties' to their end-investors/scheme members:

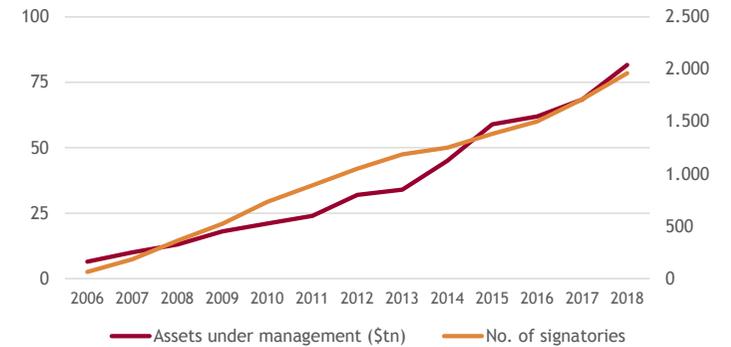
- Pension funds and insurers in the EU use the guiding 'prudent person principle' as stipulated in the Solvency II Directive. This principle encompasses a duty to act in the best interests of the beneficiary and to act prudently: 'All assets [...] shall be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole' (article 132(2) Solvency II Directive). The IORP II Directive goes one step further and explicitly refers to ESG factors: 'Within the prudent person rule, Member States shall allow IORPs to take into account the potential long-term impact of investment decisions on environmental, social, and governance factors' (article 19(1) IORP II Directive).
- Duties similar to the 'prudent person principle' apply to investment firms which are required to adhere to conduct rules. Such rules are embedded in AIFMD (article 12), UCITS (article 25) and MiFID (article 24) and include a duty to act in the best interests of clients (duty of loyalty) and a duty to act professionally, and with due care and skill (duty of prudence).

Principles for Responsible Investment (PRI), the international network of investors founded in 2005 by then UN Secretary-General Kofi Annan, has developed six Principles, promoting a fuller consideration of ESG factors by institutional investors. At the beginning of 2019, nearly 2,000 signatories, from over 50 countries, representing approximately \$80 trillion assets under management had signed up to the Principles (see graph).

Today, ESG factors are more and more **part of the investment process**:

- Recognition among regulators, institutional investors and individual scheme members has grown that the interests of future beneficiaries are as relevant to the governance of pension funds as those of current members.
- Rating agencies are looking at integrating ESG factors into their credit assessments and overall rating processes.
- In today's global and complex economy, managing environmental and social factors is part of sustaining competitive advantage. As a consequence, professional investors regard ESG factors as being integral to assessing the quality of a company.
- In recent years shareholders have suffered substantial losses following ESG risk events (see table).

Growth of Principles for Responsible Investments (PRI) Investor signatories



Source: PRI

Stock price performance one year following ESG risk event

ESG risk event	Date	Loss
Upper Big Branch Mine explosion	5 April 2010	-53%
Deepwater Horizon oil spill	20 April 2010	-28%
Automobile airbag recall	21 January 2014	-54%
Pharmaceutical accounting scandal	5 August 2015	-92%
Automobile emissions scandal	20 September 2015	-26%
Average loss to shareholders after 1 year		-50%

Source: Morgan Stanley

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BDO CASE STUDY 1

Client description: A Roman Catholic Diocese based in Europe. The client had decades of experience in responsible investing as ESG factors are embedded in its mission and values.

Client objective: The client was looking for long-term capital preservation in a low interest rate environment. Specifically, the Diocese wanted its investments not only to fuel future pensions but to also have a positive environmental and social impact.

BDO solution: We worked with the client to assess the investment guidelines in-force and recommend a set of strategies dedicated to increasing the level of disclosure on ESG factors as well as to defining an asset manager selection process. Furthermore, the client implemented new investment guidelines.

BDO CASE STUDY 2

Client description: An alternative investment firm, signatory to PRI and committed to providing institutional investors with alternative investment solutions, including photovoltaic, wind power, hydropower and similar ESG-relevant asset classes.

Client objective: The client's expertise, built across the entire value chain, enables it to identify and manage attractive ESG investments for investors. For certain asset classes, the client seeks due diligence and valuation assistance.

BDO solution: The client regularly engages BDO to assist its investment process with due diligence and valuation expertise. BDO's corporate finance specialists understand the challenges of business cases in alternative energy and can add value to the client's value chain.

RESPONSIBLE LENDING AND GREEN FUNDING

REPORTING ON CSR

- In response to increasing questions regarding how sustainability impacts their business (and vice versa), many companies have implemented CSR programmes, participate in voluntary initiatives and report on CSR standards. Today, more than 6,000 companies worldwide communicate on progress each year.
- Under the CSR Directive, large EU firms, banks and insurers with more than 500 employees are now required to publish a non-financial report annually. In preparing their non-financial report, financial institutions need to evaluate and present to which degree their responsible lending and funding add value to society and environment.

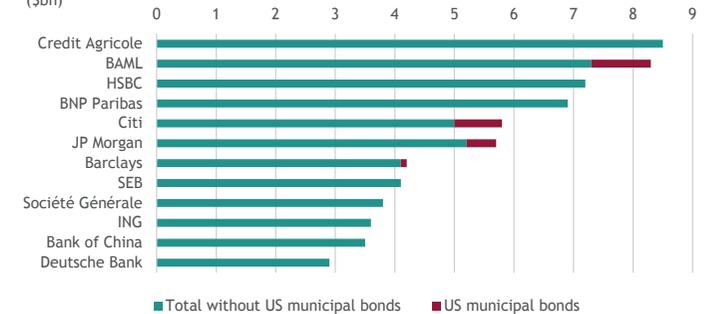
RESPONSIBLE LENDING

- Banks are increasingly aware of the corporate responsibility in all financing projects and have implemented mandatory in-house review processes and a comprehensive set of rules that reputation and sustainability risks relating to the environment, society or ethics are identified, analysed, and assessed early in the process of deciding on extending credit such as export financing, corporate loans or project financing.
- See the illustrative example of a bank's ES policy framework.

GREEN FUNDING

- Green bonds were created to fund projects that have positive environmental impact. Proceeds from these bonds are earmarked towards green projects but are backed by the issuer's entire balance sheet.
- According to the green bond underwriter league table of 2018, Credit Agricole has climbed to the top from second place in 2017 and third place in 2016. BAML and HSBC are also in the top three (see graph). As the only Chinese institution, Bank of China made its way into the top ten global underwriters in 2018.
- In November 2018, ING came to the market with a green bond issuance totalling €2.6 billion, the largest green bond deal yet from a European bank. The bond's dual € and \$ tranches were certified under the Wind, Solar, Marine Renewables (offshore wind) and Low Carbon Buildings Criteria of the Climate Bond Standard, the labelling scheme for bonds developed by the Climate Bond Initiative.

2018 green bond underwriter league table (\$bn)



Source: Climate Bond Initiative, Refinitiv

EXAMPLE: ES POLICY FRAMEWORK

Deutsche Bank has implemented an Environmental and Social (ES) Risk Policy Framework that specifies the approach to defined sensitive sectors with high potential for significant ES impacts (e.g. energy utilities, infrastructure projects in certain countries, monocultures in agriculture and forestry). The framework defines responsibilities, processes and requirements for ES due diligence.

For example, as a result of an ES risk evaluation, the bank declined the opportunity of co-financing a hydro power plant because the project involved resettlement, but no resettlement plan was provided.

Source: Deutsche Bank

BDO CASE STUDY 3

Client description: A development bank providing debt and equity finance to private sector enterprises operating in developing and emerging-market countries, including long-term loans, mezzanine finance and equity capital to financial institutions.

Client objective: The client was considering acquiring a minority stake in an insurance company serving SMEs and retail clients in Southeast Asia.

BDO solution: BDO was engaged to carry out a financial and actuarial due diligence to assess the risks associated with the acquisition of a minority share. Our work highlighted strengths and weaknesses of the target company as well as potential measures contributing to advancing developmental broad-based and structural effects and help further professionalisation.

BDO CASE STUDY 4

Client description: A financial institution based in the EU with a business model focused on supporting SMEs, corporates and private equity clients with loans.

Client objective: Due to its size, the client is required to prepare a non-financial report under the CSR Directive. The client had started the process of collecting, analysing and collating information in order to prepare the report.

BDO solution: BDO was commissioned as independent assurance services provider to verify the non-financial report. The work also covered the client's core lending and funding functions. Based on the non-financial report, the client highlights its business integrity and improves its social, environmental and economic impacts. By engaging BDO, the client increased the credibility of its non-financial reporting.

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HOW BDO CAN ASSIST THE FINANCIAL SERVICES INDUSTRY

Sustainable investments as well as responsible lending and funding may add value to society and environment.

The relevance of sustainable finance goes beyond pure corporate reporting as it should be embedded throughout the business model, including a bank's core investment, financing and funding processes.

BDO's Corporate Finance practices assist financial institutions throughout the M&A and investment process, encompassing services around:

- Strategic advice to pension funds, insurers and investment firms in relation to ESG-relevant investment guidelines and processes
- Valuation and M&A transaction assistance (financial, regulatory, tax, legal due diligence) with special focus on financial institutions
- Asset valuation and transaction assistance on investments in ESG-relevant asset classes including
 - Photovoltaic
 - Wind power
 - Hydropower
 - Healthcare
- Debt and equity private placement advisory services (DCM, ECM)
- Advice on compliance with regulatory requirements

BDO as a leading global audit and consulting firm also provides services in relation to CSR reporting:

- Independent assurance on non-financial reports
- Advice on CSR reporting processes (i.e. engaging with stakeholders, revising materiality assessments, managing risks, managing performance, implementing continuous improvements)

BDO CASE STUDY 5

Client description: A bank focused on financing projects and businesses including independent schools and kindergartens, organic farms, institutions using therapeutic pedagogy, health-food stores, communal living projects and sustainable businesses.

Client objective: For its private banking customers, the client was preparing the issuance of a green bond exclusively funding wind power projects.

BDO solution: BDO was engaged to assist the client with the preparation of the private placement, including the offering prospectus documents. The combined BDO and BDO Legal team was comprised of seasoned financial services professionals, especially corporate finance experts and securities attorneys.

"A dramatic expansion in creative financing is going to be crucial for catalysing the transition to a low-carbon, sustainable world. It is happening, but needs to happen with greater urgency, speed and scale."

Patricia Espinosa
Executive Secretary, UN Climate Change

Source: HSBC

"In this race against time, the banking and financial sector must be at the forefront of building a low-carbon economy."

Jean-Laurent Bonnafé
CEO, BNP Paribas

Source: BNP Paribas

"The world is changing for the better, and we stand with our clients as they imagine, create and build a broader transition to a low-carbon future."

Michael L. Corbat
CEO, Citigroup Inc.

Source: Citigroup

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