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ESG Masterclass

Lead the Future of Sustainable Finance

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Photo: TECA “Blue Economy” venture building wave, Kenyan coast, Feb 2023

Terms

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ESG AND IMPACT INVESTING

ESG Investing

- Mainly about "value".
- Looks at a company's environmental, social and governance practices, alongside more traditional financial measures.
- Objective is to improve the overall investment performance.
- Increase financial returns or reduce risks
- Mostly public market investments.

Impact Investing

- Mainly about "values"
- Looks at positive outcomes associated with an investment beyond financial outcomes (e.g., to contribute UN Sustainable Development Goals).
- Objective is to help accomplish goals
- May intentionally come with lower financial returns.
- Mostly private market investments.

Sometimes referred to as
responsible investing, sustainable investing, or corporate social responsibility (CSR) investing

Terms

ESG AND IMPACT INVESTING: EXAMPLE FROM GOLDMAN SACHS

Source: Goldman Sachs Asset Management

Terms

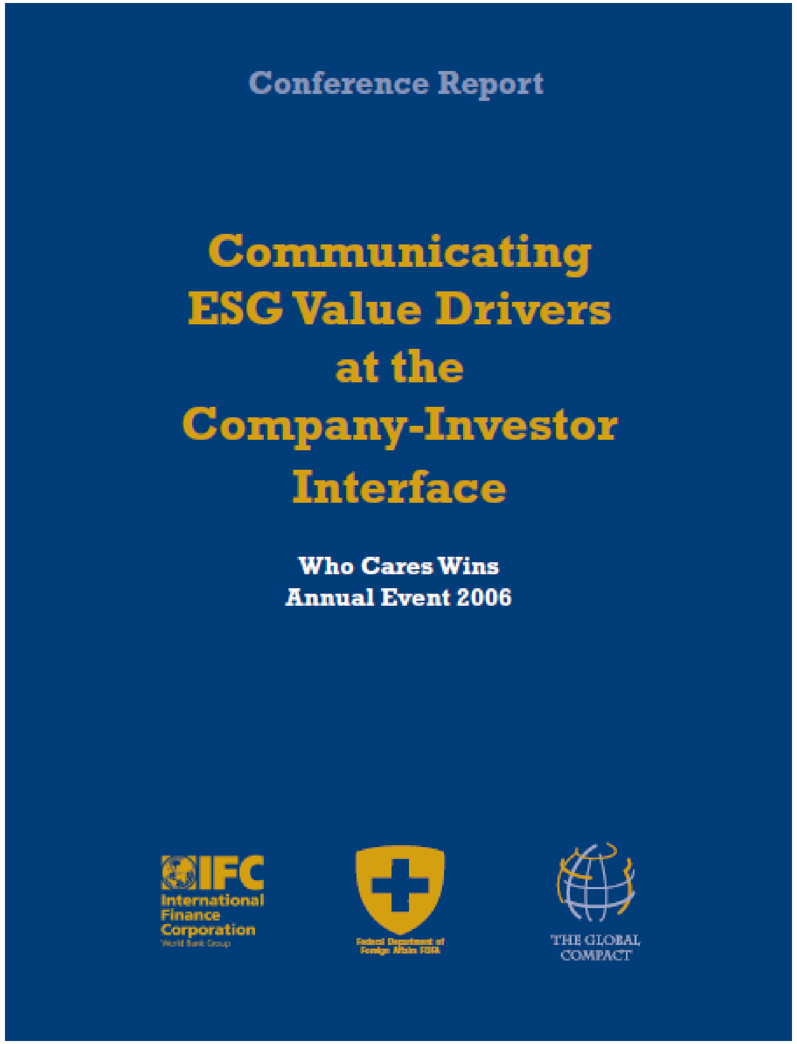
ESG INVESTING TOPICS: EXAMPLES

Source: Anevis Solutions

Terms

ORIGIN OF THE TERM "ESG"

- Publication of report "Who Cares Wins" by the UN Global Compact in 2006.
- *"This report is the result of a joint initiative of financial institutions which were invited by United Nations Secretary-General Kofi Annan to develop guidelines and recommendations on how to better integrate* ***environmental, social and corporate governance issues*** *in asset management, securities brokerage services and associated research functions."*



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IMPACT INVESTING TOPICS: EXAMPLES

Terms

IMPACT INVESTING TOPICS: EXAMPLES

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ESG investing aims to achieve better investment performance by considering environmental, social, and governance issues. Better investment performance can be achieved by reducing risks or increasing returns.

Impact investing aims to achieve positive environmental or social outcomes through investment decisions, even if this comes with lower returns.

In general, there are several, and at times competing definitions of ESG and Impact Investing.

Importance

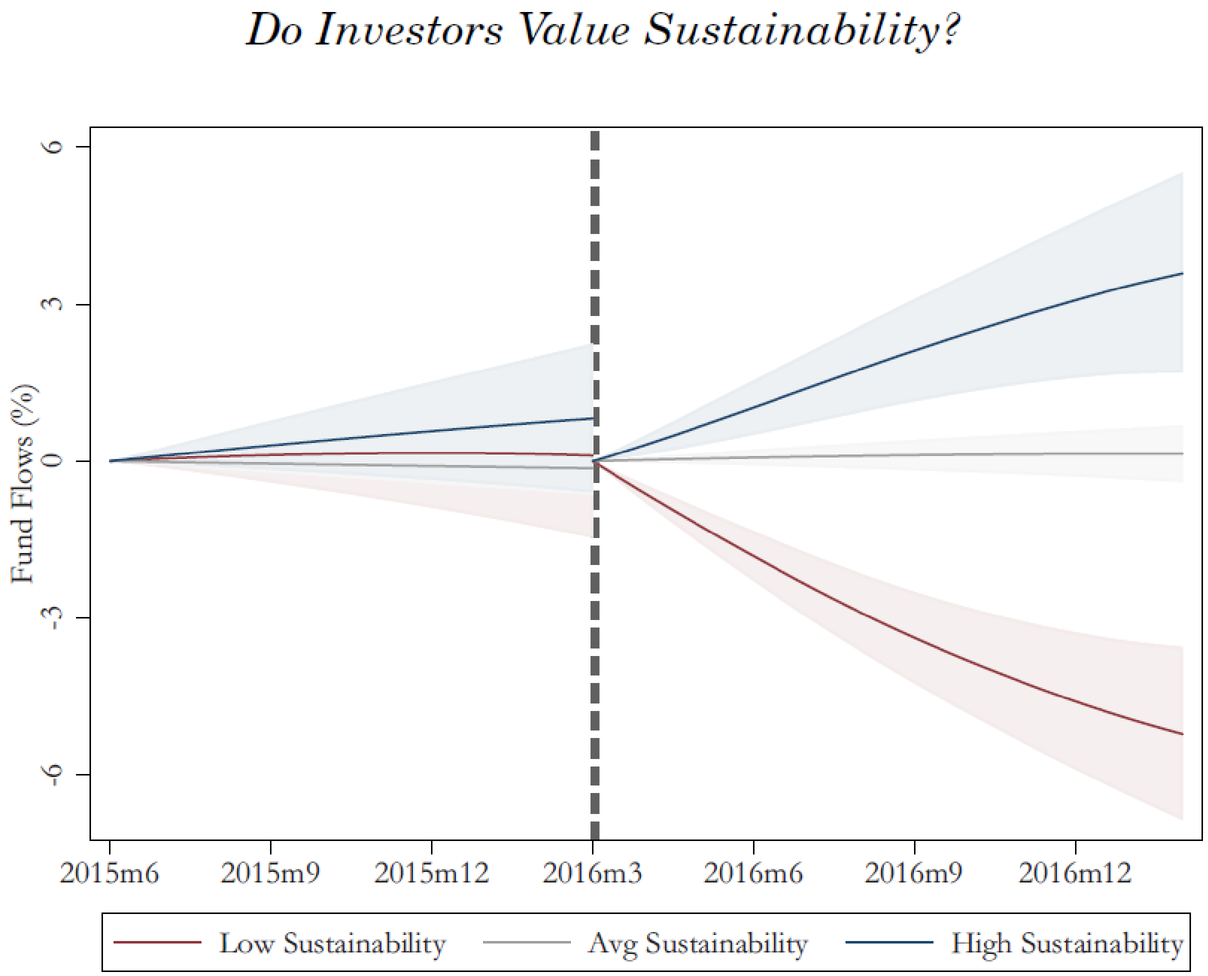
BLACKROCK LETTERS TO CEOS

- Largest asset manager in the world, with USD 7.8 trillion AuM in 2020.
- Letters from Larry Fink, Chairman and CEO, to CEOs of their portfolio companies.

  - *2016: "Over the long-term, environmental, social and governance (ESG) issues ranging from climate change to diversity to board effectiveness - have real and quantifiable financial impacts."*
  - *2017: "Environmental, Social and Governance (ESG) factors relevant to a company's business can provide essential insights into management effectiveness and thus a company's long-term prospects."*
  - *2018: "As a fiduciary, BlackRock engages with companies to drive the sustainable, long-term growth that our clients need to meet their goals..." "Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes positive contribution to society."*

Importance

ESG AND MUTUAL FUND FLOWS



Source:
Hartzmark and Sussman , 2019, Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows, Journal of Finance 74, 2789 2837

ESG and Impact Investing is no longer a “niche subject relevant only for tree-huggers”.
Instead, it positions you at the forefront of skill development for a revolutionary trend in mainstream finance.

Drivers of ESG Investing by the investment industry :

- Greater awareness of global risks such as climate change.
- A recognition that ESG investing does not equate to forfeiting returns, but instead is associated with better risk-return relationships.
- Regulatory requirements.
- Demographic shifts to millennials and women

Investment Strategies

ESG AND IMPACT INVESTMENT STRATEGIES

- Negative screening
  - Exclusions (Divestment)
  - Norm-based screening
- Positive screening
  - Sustainability-themed
  - Best-in-class
  - ESG integration
- Engagement & voting (shareholder activism)
- Impact investing

- Differences across ESG
  - Environmental issues
  - Labour and human rights issues
  - Business practices
  - Governance issues

Investment Strategies

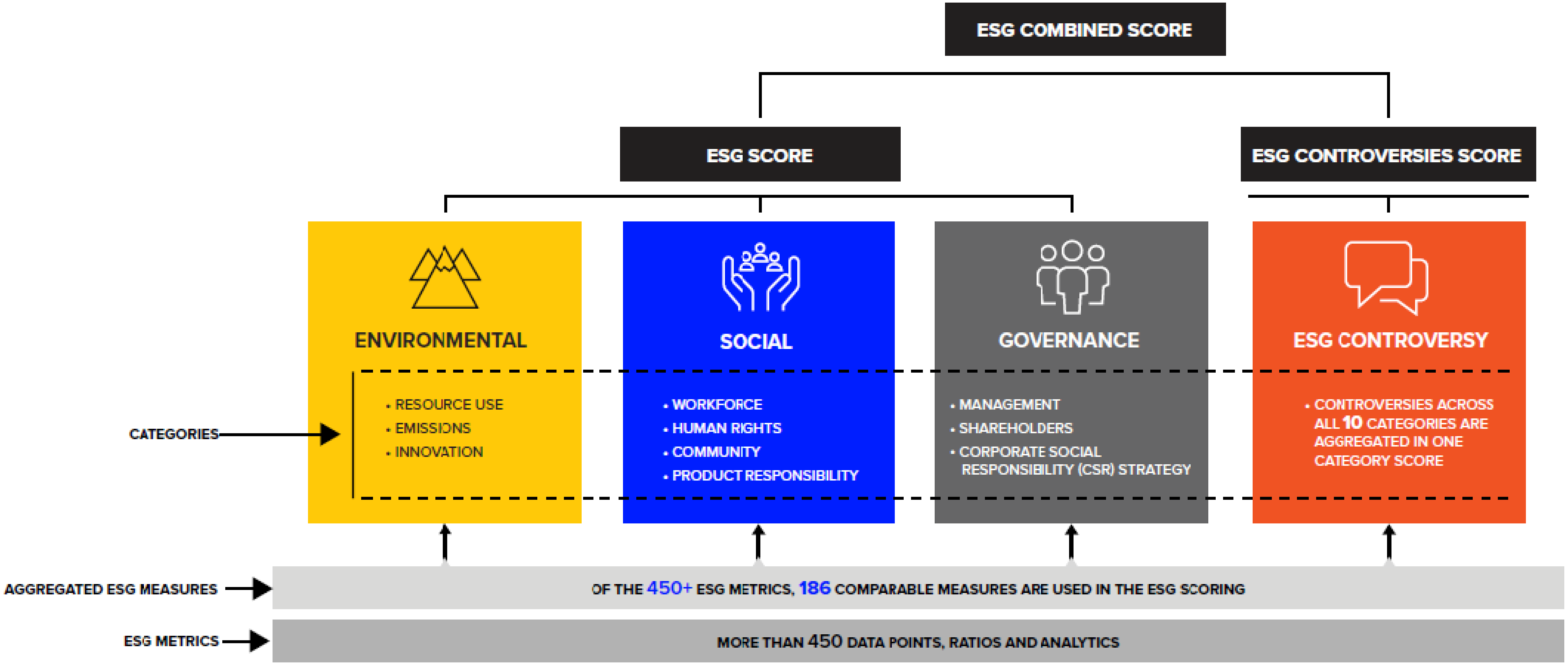
ESG AND IMPACT INVESTMENT STRATEGIES

Positive screening

Negative screening

Landscape

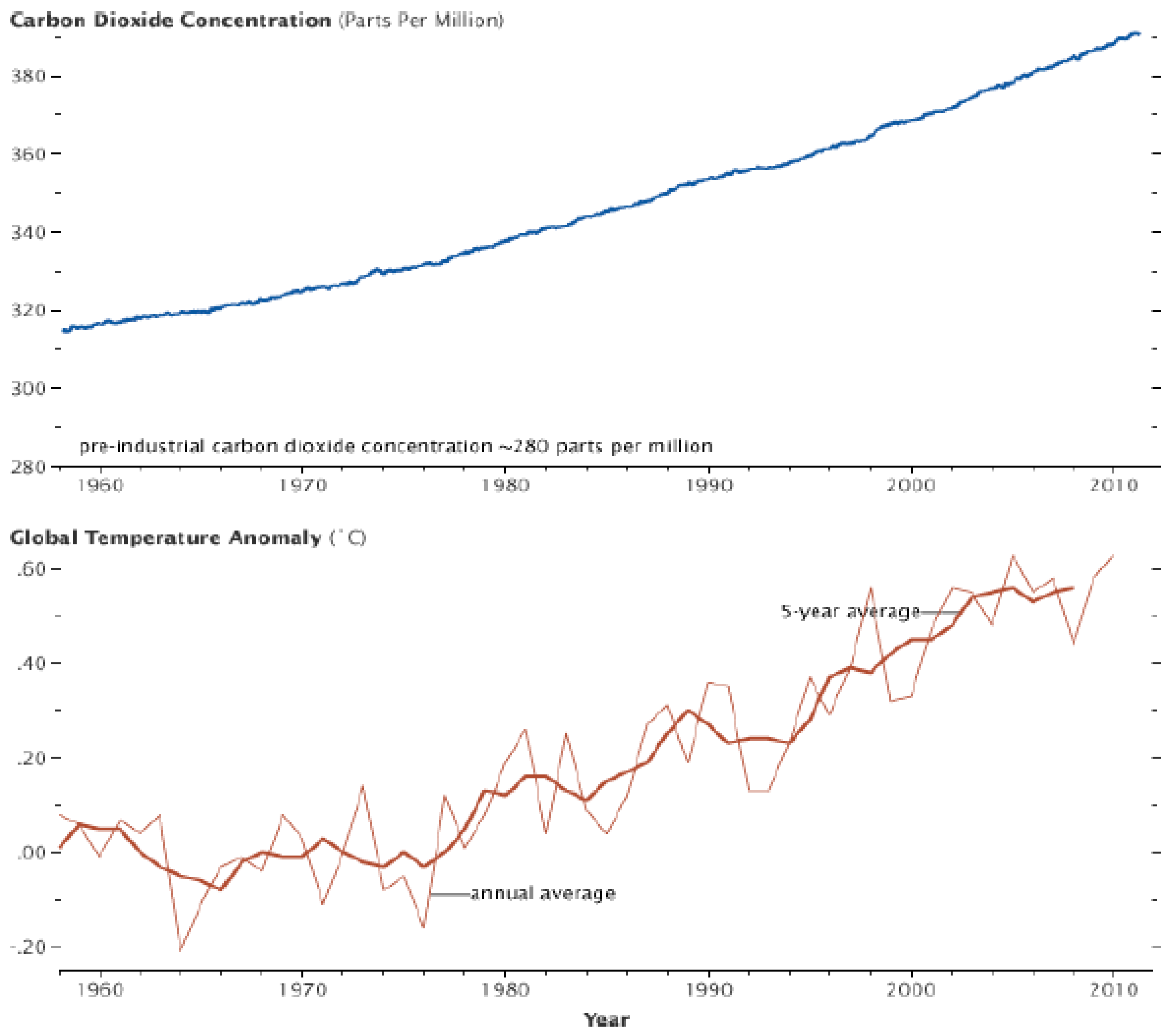
ESG RATING FIRMS : EXAMPLE FROM REFINITIV ESG RATINGS



Source: Refinitiv, April 2020

Climate Change

CARBON EMISSIONS AND GLOBAL WARMING



Source:
https://earthobservatory.nasa.gov/features/CarbonCycle/page5.php

Article 2

1. This Agreement, in enhancing the implementation of the Convention, including its objective, aims to strengthen the global response to the threat of climate change, in the context of sustainable development and efforts to eradicate poverty, including by:

(a) Holding the increase in the global average temperature to well below 2°C above pre-industrial levels and pursuing efforts to limit the temperature increase to 1.5°C above pre-industrial levels, recognizing that this would significantly reduce the risks and impacts of climate change;

(b) Increasing the ability to adapt to the adverse impacts of climate change and foster climate resilience and low greenhouse gas emissions development, in a manner that does not threaten food production; and

(c) Making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development.

Climate Change

WHY RELEVANT FOR ESG AND IMPACT INVESTING?

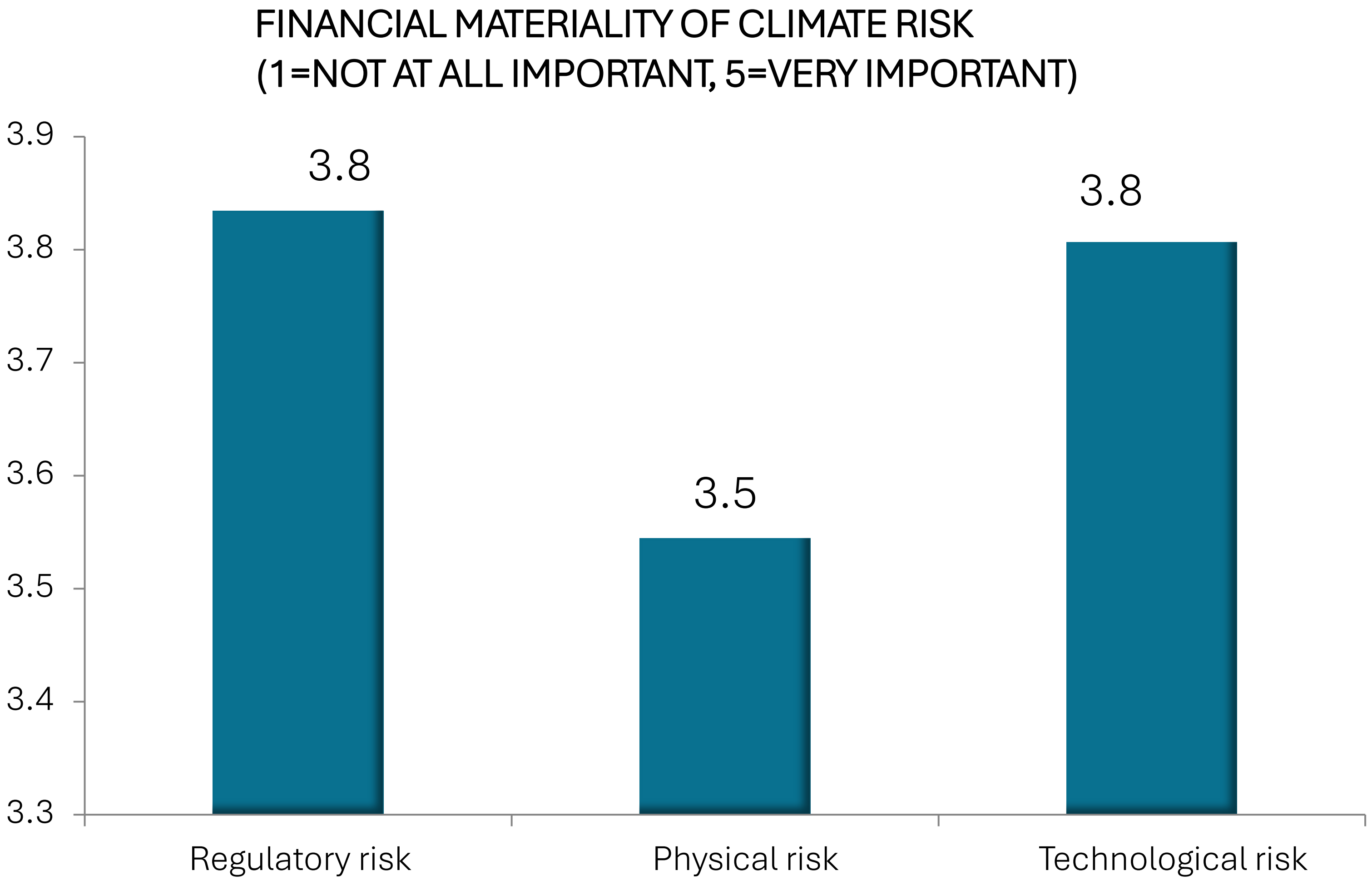
- Possibly huge effects on financial markets.
  - To meet the 2 degrees Celcius target, huge capital reallocations needed.
  - 80% of coal reserves should remain unused from 2010 to 2050.
  - 33% of oil reserves.
  - 50% of gas reserves.
- Climate change will have a major impact on financial markets.
- Financial markets will have a major impact on climate change.

Importance of Climate Risks for Investors

IMPORTANCE OF CLIMATE RISKS

- Study by Krueger, Sautner, and Starks (2020).
- Climate risks adversely affect asset values, especially for long term investors.
- Climate risks are difficult to price and hedge.
  - Systematic nature.
  - Lack of disclosure by portfolio firms.
  - Difficulty in finding suitable hedging instruments.
- Climate risks become a first order topic for policy makers.
- Climate risks can also provide potential opportunities.

Importance of Climate Risks for Investors



Source: Krueger, Sautner, and Starks, 2020, The importance of climate risks for institutional investors, *Review of Financial Studies* 33, 1067–1111

Carbon Tail Risk

THE ROLE OF CARBON TAIL RISK

- Study by Ilhan, Sautner, and Vilkov (2020).
- Climate change imposes large risks on companies (Litterman 2016).
    - Increased regulation needed to meet the Paris Agreement (e.g. carbon taxes, emission trading schemes).
    - Regulatory climate risks likely most severe for firms with large carbon emissions: "carbon risks"
- Climate policy uncertainty has heterogeneous effects across firms in the economy.
- Climate policies can lead to
    - Stranded assets, increase in the cost of doing business, financing constraints.
- Financial impact of future climate regulation is difficult to quantify, investors face tail risk and variance risk.

Carbon Tail Risk

MEASURES AND DATA: CARBON EMISSIONS

- Carbon emissions data from CDP.
- Reporting to CDP is voluntary, so need to account for potential selection bias.
- CDP data is widely used by institutional investors and ESG data providers (MSCI ESG Research, Bloomberg, Sustainalytics).
- Three sources of carbon emissions from a company's operations.
  - Scope 1: Direct emissions from production.
  - Scope 2: Indirect emissions from consumption of purchased electricity, heat, or steam.
  - Scope 3: Other indirect emissions from the production of purchased materials, product use, waste disposal, outsourced activities, etc.

Carbon Tail Risk

EFFECT OF TRUMP ELECTION

Dependent variable:	*SlopeD*	*SlopeD*	*SlopeD*	*SlopeD*	*SlopeD*	*SlopeD*
Event window:	[−250; +250]	[−250; +250]	[−250; +250]	[−250; +250]	[−250; +250], excl. [−50; +50]	[−250; +250], excl. [−50; +50], excl. Healthcare
	(1)	(2)	(3)	(4)	(5)	(6)
Post-Trump election x Scope 1/MV industry high	−0.025**	−0.029**	−0.025***	−0.020**	−0.037***	−0.035**
	(−2.18)	(−2.43)	(−2.88)	(−2.20)	(−2.63)	(−2.45)
Scope 1/MV industry high	0.041*	0.043*			0.046*	0.043*
	(1.67)	(1.77)			(1.88)	(1.72)
Post-Trump election	−0.025***			−0.022***	−0.036***	−0.041***
	(−4.63)			(−4.33)	(−5.97)	(−6.13)
Model	DiD	DiD	DiD	DiD	DiD	DiD
Controls	Yes	Yes	Yes	Yes	Yes	Yes
Day fixed effects	No	Yes	Yes	No	No	No
Firm fixed effects	No	No	Yes	No	No	No
Industry fixed effects	No	No	No	Yes	No	Yes
Level	Firm	Firm	Firm	Firm	Firm	Firm
Frequency	Daily	Daily	Daily	Daily	Daily	Daily
Obs.	200,897	200,897	200,897	200,897	159,041	139,635
Adj. R^2	.062	.091	.294	.184	.061	.060

The importance of ESG integration

Enhancing competitiveness and creating a sustainable, resilient future

Photo: TECA "Blue Economy" venture building wave, Kenyan coast, Feb 2023

Overview and objectives

Embracing ESG principles, to unlock significant Africa's green opportunities, enhance its competitiveness, and create a more sustainable and resilient future...

OVERVIEW

- Understanding ESG (Environmental, Social and Governance).
- Importance of ESG principles globally and in the African context.

OBJECTIVES

- Explore the "why" and benefits of ESG Integration.
- Identify opportunities for sustainable growth.
- Discuss mechanisms for integration.

Understanding ESG

Environmental, Social and Governance


United Nations

Report of the World Commission on Environment and Development

Our Common Future

United Nations
1987

Sustainability

Meeting our own needs without compromising the ability of future generations to meet their own needs.[1]

- Covers natural, social and economic resources needs
- Embeds environment, health, social equity and economic development

Understanding ESG

refers to the three central pillars for measuring the effectiveness of the sustainability agenda of a business:

Environmental
Impact on natural resources, climate change, and environmental stewardship.

Social
Focus on community relations, labour practices, and human rights.

Governance
Emphasis on ethical management, transparency and corporate governance.

[1] Definition provided by the United Nations General Assembly, 1987, p.43 of the Brundtland Commission Report ***Our Common Future***

Global risks ranked by severity over short and long term

2 years

1st	Misinformation and disinformation
2nd	Extreme weather events
3rd	Societal polarisation
4th	Cyber insecurity
5th	Interstate armed conflict
6th	Lack of economic opportunity
7th	Inflation
8th	Involuntary migration
9th	Economic downturn
10th	Pollution

10 years

1st	Extreme weather events
2nd	Critical change to Earth systems
3rd	Biodiversity loss and ecosystem collapse
4th	Natural resource shortages
5th	Misinformation and disinformation
6th	Adverse outcomes of AI technologies
7th	Involuntary migration
8th	Cyber insecutity
9th	Societal polarisation
10th	Pollution

Risk categories: Economic Environmental Geopolitical Societal Technological

Source: World Economic Forum ***Global Risks Perception Survey 2023-2024***

Africa: Risks, challenges and/or opportunities for sustainability?

LARGE STOCK OF NATURAL CAPITAL

- 30% of the world's minerals (UNEP)
- 65% of world's arable land (UNEP)
- 25% of global diversity
- World's second largest rain forest

HIGHLY DEPENDENT ON NATURE

- 62% of Africa's GDP is dependent on nature (WEF, 2020) 30% of the world's minerals (UNEP)
- Over 70% of people living in sub-Saharan Africa depend on forests and woodlands for their livelihoods (UNEP)
- Most African countries, natural capital accounts for between 30-50% of total wealth (UNEP)

DISPROPORTIONATE IMPACT OF CLIMATE CHANGE

- Less than 3% of the world's energy-related emissions to date and lowest emissions per capita of any region
- Experiencing dipropionate negative effects of climate change, including water stress, reduced food production, increased frequency of extreme weather events and lower economic growth - fuelling mass migration and regional instability
- Estimated climate change would reduce African GDP by around 8% in 2050

RAPID DEPLETION OF NATURE ACROSS THE CONTINENT

- Each year, Africa loses an estimated $195bn of its natural resources
- Between 2001 and 2020 several African countries lost up to 30% of their tree cover, compared to 11% globally

Africa: Risks, challenges and/or opportunities for sustainability?

ACCESS TO ENERGY

- 600 million people, or 43% of the total population, lack access to electricity, most of them in sub-Saharan Africa
- 970 million people lack access to clean cooking. Achieving universal access to clean cooking fuels and technologies by 2030 requires shifting 130 million people away from dirty cooking fuels each year

STANDARDS OF LIVING AND POVERTY LINE

- Over 40% of Africa's population lives on less than $1.90 a day, which is the international threshold for extreme poverty
- Deficiencies in education, health and living standards

HOME TO TOMORROW'S GENERATION

- Currently equivalent to 18.3% of total world population
- More than 50% of growth in global population between 2015 and 2050 will be in Africa

SIGNIFICANT RENEWABLE ENERGY CAPACITY

- Africa accounts for over 40% of global reserves of cobalt, manganese and platinum – key minerals for batteries and hydrogen technologies. Africa is home to 60% of the best solar resources globally, yet only 1% of installed solar PV capacity.
- Renewables, including solar, wind, hydropower and geothermal account for over 80% of new power generation capacity in Africa to 2030.
- Huge potential to produce hydrogen using its rich renewable resources.
- Significant resources of natural gas

Why is ESG adoption important for the insurance sector?

ESG is of interest to the insurance industry for several reasons. We have tried summarizing them below:

Key stakeholders, including major institutional investors, are demanding greater ESG accountability from insurers whose reputations could be affected

ESG presents a business opportunity for developing sustainable insurance products

Global regulators are integrating climate-related issues in routine supervisory review tools, such as insurers' own risk and solvency assessment (ORSA)

Regulatory requirements to enhance ESG disclosure are gaining popularity globally, such as the EU Taxonomy Regulation and the Task Force in Climate-related Financial Disclosures (TCFD)

The importance of ESG in ensuring the sustainability of the insurance industry is gaining global attention, for example through the United Nations Environment Programme Finance Initiative (UNEP FI) Principles for Sustainable Insurance

Why is ESG important?

Not just about meeting global standards but about addressing local challenges and creating a more sustainable and equitable future for Africa

Africa: Importance of ESG integration

Each organization could have a different combination of why ESG is important

Why is ESG relevant to Stakeholders?

Stakeholders are demanding transformational change

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1	**Capital Providers** *Incl. Insurers*	ESG is linked to financial out-performance	Up to 5% out-performance by top quintile on material sustainability issues over bottom quintile over a 20-year period; Nervousness in D&O insurance around "event-driven" litigation against boards such as diversity, climate and ESG.
2	**Regulators**	Regulation on ESG topics is tightening	Over 1,800 climate-related laws and policies are already in place globally.
3	**Customers**	Customers are favoring companies with a good ESG story	76% of consumers would refuse to purchase a product if the company supported an issue contrary to their beliefs.
4	**Employees**	Good ESG helps win the competition for talent	16% higher productivity, with measurable impact on shareholder value.
5	**Partners/ Suppliers**	Businesses are requiring ESG adherence from vendors	Setting emissions standards for supply chain helped capture US$12.4 billion in savings for group of major companies.

How are ESG and Sustainability connected?

Sustainability

ESG is a measure of sustainability

- **Environment**
  - Nature loss
    Pollution, etc.
  - Climate Change
    - Increased frequency and severity of climate-related events
    - Climate Risk
      - Demand to reduce emissions
      - Net-Zero Targets
- **Social**
- **Governance**

ESG risk management can be grouped into three types of actions for organizations to take

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CONTROLS

Do they have robust policies, procedures, and practices in place to comply with ESG-related laws, regulations, and/or standards?

REPORTING

Can the organization publicly report ESG metrics around their exposure to risks and how they are managing those risks?

RESILIENCE

Is the organization able to anticipate, forecast, and manage ESG-related risks?

Real life examples of climate risks

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Physical Risk

Physical risks: losses from changing patterns of extreme weather (e.g. floods, heatwaves).

Example: **Storm URI Texas, Feb 2021**

- Cold weather led to spike in electricity demand which exceeded demand.
- More than **4.5 million households without electricity.**
- **Economic losses** estimated at **US$130 billion** for Texas alone (Accuweather, 2021).

Transition Risk

Transition risks business impact due to the transition to a low-carbon future (e.g. changing demand preferences, technologies or regulation)

Example: impact of changing consumer preferences on fashion industry

- Potential for buying patterns to change as consumers become more aware of the environmental and human costs of apparel production.
- Over next 10 years **fast fashion industry** could see **10%-30% revenue decline** (UBS, 2021).

Liability Risk

Liability risks failing to avoid or minimise adverse impacts on the climate, or failing to adapt to climate change.

Example: So far, around **1,850 climate-related lawsuits** have been brought before the courts **around the world.**

Organizations conscious of both their impact on the planet and the emerging risks they face

An "inside out" view

What is the impact of my organization on the planet?

Feeds into ESG policy, climate friendly commitments, measuring carbon own footprint, etc.

An "outside in" view

What is the potential impact of climate risk on my organization?

Integration of climate-related considerations (including governance and scenario analysis) into risk management framework to build resilience

Focusing on key priorities

“Boards are having to wake up and better understand their responsibilities on ESG – but this can become complicated by the sheer volume of issues to address under this umbrella. Companies that try to do too many things, instead of **focusing on key priorities**, will struggle to get much done.”

One of the key points from an exclusive interview by Critical Resources with Chad Holliday *(Chair of Shell) – January 2021*

The discussion was on building resilience in the face of interlinked crises, the need for impactful corporate action on climate change, addressing inequality and strengthening board capabilities on ESG issues.

Integrating ESG into the business

What role can INSURERS play in ESG integration?

RISK ASSESSMENT AND MANAGEMENT
- Quantifying ESG risks
- Model future scenarios

INCORPORATING ESG FACTORS INTO FINANCIAL MODELS
Enhance valuation models
Stress testing

SUPPORTING INVESTMENT DECISIONS
ESG scoring and analysis
Portfolio management

REGULATORY COMPLIANCE AND REPORTING
Regulatory analysis
Disclosure and reporting

CLIMATE RISK MANAGEMENT
Climate risk assessment
Adaptation strategies

EDUCATION AND ADVOCACY
Training and development
Thought leadership

Incorporating of sustainability risks into investment policy

Limiting investment in non-sustainable activities/companies

- **Best-in-Class strategy** consists in selecting companies engaged in the reduction of their carbon footprint

Stewardship and impact investing

- **the inclusion investment strategy**, i.e. investments directed at economic activities aiming to achieve social and/or environmental goals (e.g. through sustainability-themed investments, best-in-class investment selection, norm-based screening, impact investing)

Introduction of ESG criteria in the investment decision

- An **ESG rating** can be considered together with the financial criteria usually taken into account in an investment decision. Such a rating can be developed internally (based on information publicly available but also possibly through questionnaires sent to the investees) or externally (by ESG ratings agencies, standards or assets managers).

Incorporating sustainability risks into underwriting practices

Re-pricing of risks

- This occurs traditionally for non-life short term business, annual repricing takes place based on claims experience over the past 12 months

Integrating ESG into the underwriting standards and guidelines

- Develop guidelines and risk assessment tools for major infrastructure projects and integrate ESG factors in client/project assessment and approval as part of insurance underwriting processes and decisions

Product development

- Insurance products and services that encourage renewable energy infrastructure. Insurance products and operations that encourage 'green' consumption behavior, such as products that use pricing mechanisms that favour low-carbon emissions

Sustainable/Green Insurance Products

Sustainable products are those products

- **that provide environmental, social and economic benefits**
- **that cover the design, production and use of these sustainable products, or the liability associated with their production and use**

Personal Lines

- Green Property Rebuilding -Environmentally friendly or more energy-efficient materials when making repairs
- Pay As You Drive/Low Mileage Discount insurance products inherently give incentives to drive less
- Fuel Efficient/Low Emission Vehicle Discount for hybrid or electric passenger vehicles

Commercial Lines

- Insurance for Renewable Energy Projects - insurance products and services are designed to cover all stages of a project from design to distribution
- Insurance for Green Building - insurers offer help to customers to build sustainably
- Insurance for Carbon Capture & Storage/ Emission Reduction Projects
- Global Weather Insurance

Specialty Lines

- Insurance for Pollution/Enviromental Liability

Full Universe of Credits (and Quality of Them)

Source: Ecosystem Marketplace, 2024

ESG aspects of the Insurance Business cycle

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Strategy & Business Development	Client Appraisal	Underwriting & Contracting	Insurer Selection (by brokers)	Portfolio Management
Exclude harmful sectors or goods Exclude certain clients Include impactful clients	Screening & Categorisation Determine ESG exposure across clients and insurance lines Discuss and monitor ESG issues	Adapt policy terms (e.g. insured value) Requests to clients (e.g. ESG standards) Risk advisory function of insurer	ESG aspects in policy terms Preference for insurers with ESG advisory function	Claims acceptance contingent on relevant ESG practices Investments consider ESG issues and impact

Call to action

Understand our 'why?'

Reflect on the risks, impacts and opportunities of ESG - what are your priorities?

Invest in the right integration mechanism.

Accept it's a journey; and not one to be taken alone.

As we open the floor to questions

reflect on some of these questions...

Is sustainability a key consideration for your current or target clients?

Could the effects of climate change (environmental, social and economic) impact your business' supply chain?

What business opportunities could the components of the ESG provide?

How reliable are your governance and internal control structures?

Could you manage your costs or schedule better if you improved on any of the ESG areas?

Could your organisation benefit from better diversity?

Are any of the components of ESG potential risks to the business?

Are there specific sustainability regulations or disclosure requirements you need to meet?

Does the business need further financing (debt or institutional investors)?

Does the business have any (potential) areas of conflict with the neighbouring community and other key stakeholder?

Does your current CSR projects provide real sustainable impacts?

How aware or engaged are your employees about sustainability?

Does the operating environment of the business provide for real positive sustainability impacts opportunities?

What are the key value-adding sustainability KPIs for your business?

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