# APPLYING AN ESG METHODOLOGY TO A EUROPEAN INFRASTRUCTURE DEBT FUND

**SIGNATORY TYPE**

Investment Manager

**OPERATING MARKET**

Europe

**AUM**

$450 billion[1]

**AUTHORS**

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Our commitment to sustainable investing began in 2002 with the launch of our first socially-responsible investment (SRI) fund. We joined the Institutional Investors Group on Climate Change (IIGCC) shortly after, and in 2006 became a founding signatory to the Principles for Responsible Investment (PRI). In 2012, we implemented the Ten Principles of the UN Global Compact as a standard across our investment funds, and in 2015 we committed to aligning our portfolios with the goals of the Paris Agreement.

As part of our Global Sustainability Strategy, in 2019 we committed to systematically integrating sustainable investment practices across the full range of our investments. We also introduced an enhanced coal policy, with the aim of phasing out thermal coal from our investments by 2020 – a significant step towards the alignment of our energy mix with the IEA Sustainable Development Scenario.

We acknowledge the importance of our role in representing clients' interests to the management teams of our investee companies. Being a long-term investor enables us to form deep relationships and engage on the issues that are most relevant to our investment cases.

At the core of our investment processes, analysts and portfolio managers integrate material ESG factors into their company, asset and sovereign evaluations, and investment decision-making processes. As reflected in our investment beliefs[2], this process allows us to identify and assess areas of risk or opportunity which may not be understood by all market participants, and which can therefore provide a relative advantage.

This case study is focused on ESG integration in our European Infrastructure Debt fund. We have two ESG analysts dedicated to private debt strategies. One analyst is invited to all Investment Committee meetings and has the right to veto a proposed investment.

1 $604 billion advised and managed at 31 December 2018 (source: BNP Paribas Asset Management)

2 https://docfinder.bnpparibas-am.com/api/files/1FC9FC6C-0DA8-468E-90B3-016DDB5CD270

**Assessments of ESG risks and opportunities are structured around four steps:**

PRELIMINARY ESG REVIEW → ESG ASSESSMENT → IMPACT ASSESSMENT → PORTFOLIO REVIEW AND REPORTING

# STEP 1: PRELIMINARY ESG REVIEW

## ESG RISK ANALYSIS AND SCREENING

The first step in the ESG review process is based on our standard and sector policies for controversial activities, which apply to all our strategies. There are two types of sector policies: one excludes certain activities (such as tobacco, coal, asbestos and controversial weapons) and the other outlines mandatory requirements. The latter are absolute conditions for any transaction or deal, as well as criteria for assessing how responsibly the companies in these controversial sectors behave. Through this screening, we identify risks early in the deal cycle which allows us to avoid projects with potential controversies and/or negative social and environmental impacts.

Similarly, and as part of our Responsible Business Conduct[3], if the sponsor or the project does not meet our requirements with respect to human and labour rights, protecting the environment and ensuring anti-corruption safeguards[4], the project will not be eligible for investment.

An ESG analysis of the operational aspects of the project is then performed, with two main aims:

- To guard against exposure to particularly controversial projects and/or significant negative social and environmental impacts.

> We do not invest in projects related to the nuclear industry, the thermal coal industry and controversial hydrocarbon extraction methods, such as shale gas and oil. Oil sands and oil projects in the Arctic zone[5] are also ineligible. These exclusions[6] cover processing and transportation facilities related to hydrocarbon extracted by unconventional methods such as refineries, pipelines, liquified natural gas terminals and storage units.

- To target opportunities that generate positive environmental impacts and influence future macro-economic trends.

By applying several exclusion policies to our investment decisions, we tend to decline transactions that do not align with our philosophy early in the process before looking at the specifics of the transactions. As an example, we have rejected infrastructure debt investments such as coal-fired power generation or transactions with links to mining and oil sands.

## ESG VALUE CREATION AND OPPORTUNITIES

Our Sustainability Centre has created a taxonomy for infrastructure investments to identify the nature of the activity and its impact on energy, ecological and social transition. The taxonomy is based on the work of the Climate Bonds Initiative and the French government's Transition Energy and Ecology for Climate label.

By defining and implementing a taxonomy for each asset class, we are able to refine our ESG analysis and identify the energy and environmental impact of each sub-sector. Therefore, the European infrastructure debt strategy's objective is to invest mainly in projects with net positive environmental or social impacts. The remainder of the portfolio will consist of projects that, despite not specifically considered as green according to BNPP AM's taxonomy, meet our eligibility criteria for ESG best practice.

3 https://docfinder.bnpparibas-am.com/api/files/D8E2B165-C94F-413E-BE2E-154B83BD4E9B

4 Wherever it operates and in line with the UN Global Compact Principles and OECD Guidelines for Multinational Enterprises.

5 Arctic zone defined as permanent ice zone.

6 https://docfinder.bnpparibas-am.com/api/files/D8E2B165-C94F-413E-BE2E-154B83BD4E9B

## STEP 2: ESG ASSESSMENT OF THE UNDERLYING ASSET

An ESG assessment of the underlying asset and how it is managed is performed by the Sustainability Centre team. It considers qualitative criteria – namely the sponsor's ESG management system, ESG policies and standards – and quantitative criteria on environmental and social performance.

We have a list of standard indicators or KPIs, see below, that we adapt according to the nature of the assets financed. Analysts then provide an ESG-related recommendation for each project and present their analysis to the investment committee. Projects with low ESG performance will not be eligible.

These ESG assessments enable us to make better decisions during portfolio construction. For example, when we finance a data centre, all other things being equal, we would choose the asset for which its electricity consumption comes from renewable energy sources. The same type of decision would apply for a rolling stock company – we would favour the company with the highest proportion of electric locomotives.

**ESG KPIs**

| ENVIRONMENT | SOCIAL | GOVERNANCE |
|---|---|---|
| ▪ Quality of the environmental management system<br>▪ Energy consumption, actions against climate change<br>▪ Waste management<br>▪ Water management<br>▪ Biodiversity management<br>▪ Air pollution (NOx, SOx and dust)<br>▪ Greenhouse gas emissions | ▪ Evolution of the employment<br>▪ Social climate (number of days of strike, absenteeism, work-related accidents)<br>▪ Social standards in the supply chain<br>▪ Existence of consultation mechanisms with local populations<br>▪ Existence of mechanisms for complaints by residents | ▪ Independence of the oversight council and board of directors<br>▪ Existence of dedicated committees<br>▪ Internal audit, fines and debate |

## STEP 3: ENVIRONMENTAL AND CLIMATE IMPACT ASSESSMENT

To finalise our selection process, an environmental and climate impact assessment is performed for each investment opportunity by the independent consulting firm I-Care & Consult. I-Care's assessment is based on a proprietary climate impact methodology suitable for all infrastructure assets across sectors.

It focuses on four metrics:

- indirect emissions linked to construction, operation, maintenance and asset use;
- avoided emissions through asset optimisation and when compared to a reference scenario;
- alignment with a 2°C trajectory based on the Sectoral Decarbonisation Approach method; and
- contribution to the energy and ecological transition based on a -100 percent to +100 percent scale (with 0 percent representing the sectorial mean and 100 percent the best available solution).

## STEP 4: ESG PORTFOLIO REVIEW AND REPORTING

We regularly review the ESG performance of our infrastructure debt portfolio by:

- Sending ESG questionnaires to sponsors: Questions asked include whether any measures or actions have been taken during the reporting year.
- Assessing KPIs at the project level: This includes assessing the carbon footprint, avoided emissions and 2°C alignment, and the Net Environmental Contribution[7].
- Producing an annual portfolio report: We compile quantitative elements such as ESG evaluations of all portfolio positions, the percentage of investments that have a positive environmental or social impact, and portfolio-level climate and environmental impacts. This is complemented by a year-on-year analysis of each asset's ESG practices.

The infrastructure debt fund is a buy-and-hold strategy given the illiquidity of the portfolio's assets, meaning no divestment would be considered. Therefore, our pre-investment ESG due diligence process is crucial to avoid ESG-related risks or controversies. Our annual post-investment engagements are intended to monitor the ESG performance of our portfolio, and to encourage sponsors to improve the ESG performance of the assets we financed.

7 https://securities.bnpparibas.com/news/calculating-the-environmental-im.html