

ESG Integration in Sustainable Bonds

Assessment process

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Introduction into Sustainable Bonds

Started in 2007 by the issuance of bonds with eligible projects mainly focussing on green activities, such as renewable energy and energy efficiency, the Green Bond market has broadened its focus to also include Social Bonds and Sustainability Bonds. Also, definitions as Blue Bonds and Climate (Action) Bonds are used. The common ground of these different categories is that the use of proceeds has to be allocated to defined eligible projects. The Green, Social and Sustainability Bonds were followed by the introduction of Sustainability-linked (or KPI-linked) bonds in 2019. In this case, there is not a direct link between the use of proceeds and the eligible projects, but sustainability is enhanced through the set of pre-defined issuer-wide sustainability targets that may result in financial consequences for the bond.

ACTIAM sees it as its mission to deliver relevant investment solutions, by maximising long-term financial, environmental and social returns. We recognize that it is our fiduciary duty to support the transition to a sustainable society. This consideration is incorporated in the ACTIAM Sustainable Investment Framework and stipulates that companies and countries should operate within the planetary boundaries and respect the social foundations of society. For that reason, we invest in companies that operate in line with this safe and just space or are making the transition towards it.

Investing in Sustainable Bonds is one of the tools to achieve this goal, contributing to ACTIAM's mission and vision. These are bonds with specific purposes and/or linked to projects that contribute to a more sustainable society, such as Green, Social, Sustainability, Blue, Climate and Sustainability-linked Bonds. We refer to these bonds as Sustainable Bonds as we do not make a distinction in our assessment between the different nomenclature of these bonds and apply the same criteria to all. It is our conviction that investing in these types of bonds, contributes to our mission and vision.

ACTIAM does not only invest in Sustainable Bonds for their sustainable character, but also because we believe that focusing on the societal impact of investments results in higher long-term financial returns. Given the age of the market, there is no hard (academic) proof for long-term financial returns of Sustainable Bonds yet. However, the market expectation and results seen so far indicate that in a more pressured market, Sustainable Bonds will be less volatile and outperform plain vanilla bonds. This is considered to result from the fact that these bonds are in the hands of more longer-term investors. For these reasons, ACTIAM prefers investing in Sustainable Bonds to so called "grey bonds", all else being equal. This is reflected in ACTIAM's investment solutions, which include targets for the share of Sustainable Bonds out the total bonds we invest in..

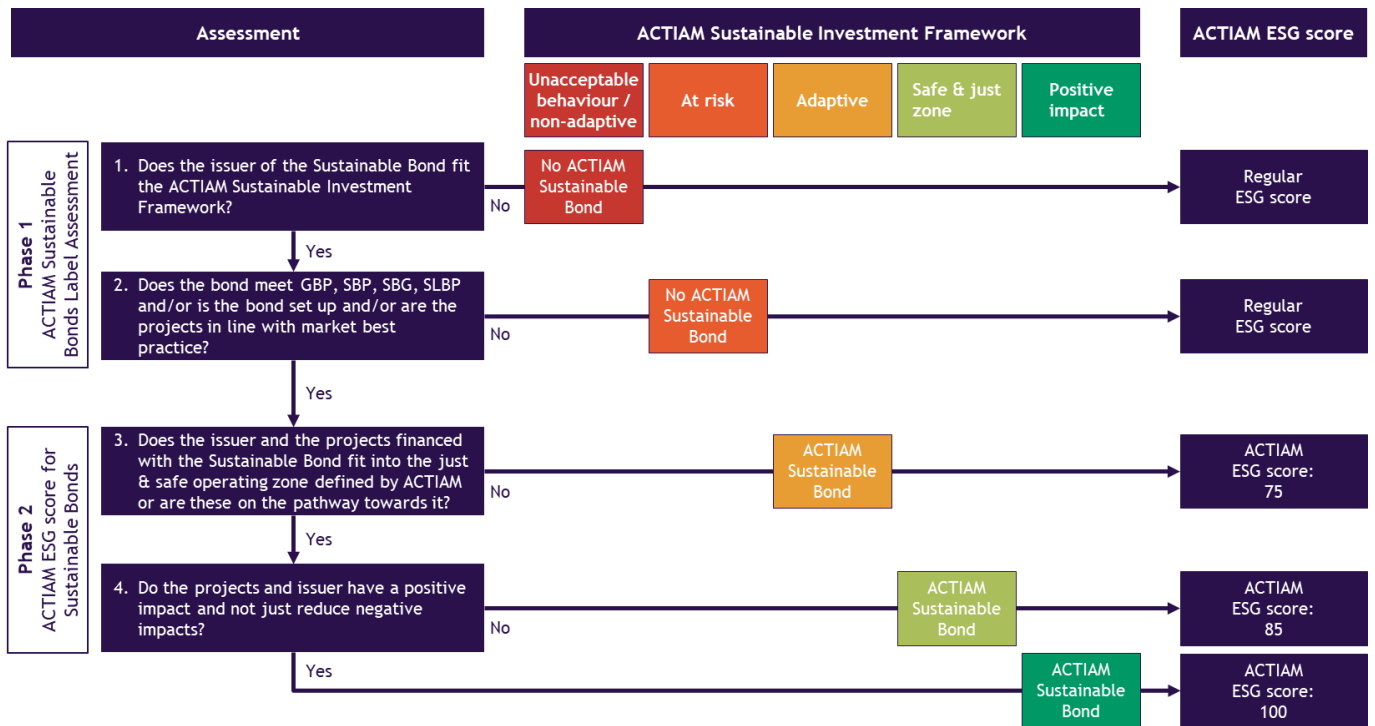
To prevent potential greenwashing, stimulate comparability of investment strategies and eliminate barriers for (new) issuers of Sustainable Bonds, ACTIAM wants to contribute to clear and indisputable definitions of Sustainable Bonds. That is why ACTIAM supports the Green Bonds Principles (GBP), Social Bond Principles (SBP), Sustainability Bond Guidelines (SBG) and the Sustainability-Linked Bond Principles (SLBP). All together referred to as "GBP". The aim of the GBP is to provide guidelines that recommend transparency and disclosure while promoting integrity in the development of the market by clarifying the approach for issuance of a Green Bond. ACTIAM is a member of the GBP and is elected in the Executive Committee to represent investors in 2020 for the second time in a row. In this way, ACTIAM plays an active role in all matters relating to the Principles and wishes to especially focus on reporting of comparable elements, such as performance indicators and sustainable targets.

This document describes the assessment performed by ACTIAM of every Sustainable Bond it considers purchasing. The document will then zoom in on the process of integrating sustainable bonds in our investment process, for example through the ESG score.

ACTIAM Sustainable Bond Assessment Framework

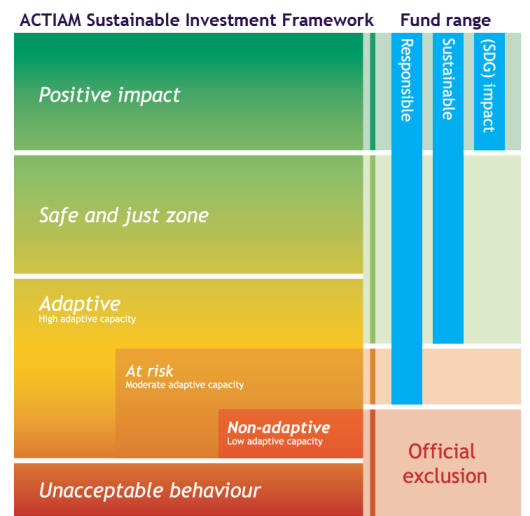
To ensure we invest in bonds that are actually addressing our goal of a sustainable society, ACTIAM assesses whether newly issued bonds comply with our definition of Sustainable Bonds. This assessment is not arbitrary and follows well-recognized principles, as well as ACTIAM’s own view on the perceived impact of the bond, the underlying projects or targets and the credibility of the issuer.

The ACTIAM Sustainable Bond Assessment Framework is presented in the Figure below before more details are given.



The ACTIAM Sustainable Investment Framework forms the basis for the assessment of Sustainable Bonds. That is, issuers are screened on their compliance with our social-ethical investment principles and our view on companies’ adaptiveness towards a sustainable society. If companies violate these principles or are deemed non-adaptive, we do not invest in Sustainable Bonds issued by them. In case issuers are deemed investable, we also require them to follow the market standard for their Sustainable Bond as set by the Green, Social and Sustainability-linked Bond Principles and the Sustainability Bond Guidelines. In case a bond is issued based on these principles and it is in line with our own Sustainable Investment Policy, we can classify the bond as a Sustainable Bond.

When a bond can be assessed as a Sustainable Bond, we evaluate the issuer’s adaptive capacities, its preparedness to mitigate sustainable transition risks, its positive impact and sustainable business opportunities. To assess this, we research the issuer’s exposure to and management capabilities in seven financially material sustainability issues. These range from fossil fuel, water and land use to chemical & waste management, social and human capital and organisational behaviour & integrity. In addition, we analyse the underlying projects financed by the use of proceeds or the pre-defined targets. Based on that, we evaluate whether the bond would reduce the issuer’s exposure to and/or enhance its management of the seven sustainability topics. Additionally, we assess whether the bond would help the issuer to make the transition towards the ‘safe and just zone’. Based on these latter two steps, an ACTIAM ESG score is allocated to each Sustainable Bond.



The final decision to invest in the bond is also subject to credit criteria and the view of the Portfolio Manager. After the assessment is finished and the Sustainable Bond is bought, ACTIAM has the ambition to track these bonds on their actual social and environmental impact. We are working on ways to collect information about eligible projects in which bonds invest, such as avoided carbon emissions or number of people affected by improved health care facilities. Since so far there is no standardized and verified way to calculate impacts of projects and allocate these to investors, the work here is still ongoing. Also the measurement of projects with a social impact, such as beneficiaries from unemployment programs, is still being developed. As member of the GBP, we have an active role in this field and strongly encourage issuers to be transparent on their reporting methodologies and impact calculation methods.

Phase I: Sustainable Bond Label Assessment

The first phase of Sustainable Bond assessment is based on questions regarding the sustainable credentials of the issuer (see question 1) and regarding the degree of transparency and assurance of the bond issuance itself (see question 2). With this, we test whether the issuer and bond align with ACTIAM's beliefs of sustainability. For this, we use the ACTIAM policy screening framework and our knowledge of the Green, Social, Sustainability and Sustainability-Linked Bond market to analyse the environmental and social profile of the issuer and the alignment of the bond with market practises. If a bond fulfils the criteria, it is labelled as an ACTIAM Sustainable Bond.

Question 1: Does the issuer of the Sustainable Bond fit the ACTIAM Sustainable Investment Framework?

ACTIAM verifies whether the issuer of the Sustainable Bond is compliant with ACTIAM's Sustainable Investment Policy. Issuers that are officially excluded because of non-compliance with the Fundamental Investment Principles (FIP) or because they are classified as "non-adaptive" for one of the Material Sustainability Drivers do not qualify for a Sustainable Bond. Issuers classified as "at-risk" may qualify for a Sustainable Bond if the positive contribution of their projects become a substantial part of their core activities and sufficiently support their transition towards an "adaptive" classification. We believe that when the activities of an issuer become a more substantial proportion of the overall profile, the issuer is becoming eligible to move from at-risk towards adaptive. In this transition, a Sustainable Bond can be a useful instrument. As ACTIAM, we believe in financing the required transition towards a more sustainable future and therefore we would support issuers in this category.

In addition, we check:

- the issuer's involvement in major controversies connected with the project categories defined in its Green, Social or Sustainability framework or related to its predefined targets in a Sustainability-linked bond. For example, the issuer is found to have controversies connected to labour rights and one of the categories defined in the Social Bond is employment generation. In this case, we do not consider the bond to be a Sustainable Bond.
- its contribution to incremental improvements in sustainable performance, to assure that issuers truly focus on making their business model more sustainable and do not just (re)finance existing projects. With this, ACTIAM ensures to not finance running business operations instead of investing in bonds with true improvements and impact. For example, an issuer completely changing its business strategy and operations in order to become more sustainable is preferred over an utility company solely refinancing an onshore wind farm.

Question 2: Does the bond meet the Green Bond Principles (GBP), Social Bond Principles (SBP), Sustainability Bond Guidelines (SBG), Sustainability-Linked Principles (SLBP) and/or is the bond set up and/or are the projects in line with market best practice?

In this step, ACTIAM verifies whether a Green, Social or Sustainability bond meets the four core components of the GBP, SBP, SBG or the five categories of the SLBP. These voluntary initiatives define guidelines on transparency requirements for the issuance of a bond. That is, is the process for transparency aligned with

1. use of proceeds,
2. process for project evaluation and selection,
3. management of proceeds, and
4. reporting.

In case of a Sustainability-Linked Bond, these components are defined as:

1. selection of Key Performance Indicators,
2. calibration of Sustainability Performance Targets,
3. bond characteristics,
4. reporting, and
5. verification.

In line with the last components of the SLBP, we expect a Green, Social or Sustainability Bond to also get an external verification in the form of a Second Party Opinion (SPO). In case the above is not fulfilled, ACTIAM does not classify the bond as a Sustainable Bond as there is insufficient evidence of process transparency.

Next to the alignment with the GBP, SBP, SBG and/or SLBP, the criteria of the eligible projects are compared to those defined by available market best practice. For example, the Climate Bond Initiative (CBI) has developed a taxonomy to classify activities and technologies that have a positive, environmental impact. Besides, we highly support the further development of standards, such as the EU Green Bond Standard, to increase the level of transparency in this market.

Phase II: ACTIAM ESG Score for Sustainable Bonds

In the second phase, the ACTIAM ESG score of the Sustainable Bond is determined. The bonds that pass the first phase get a minimum ACTIAM ESG score of 75. In case the bond has a material positive contribution to sustainability, it can be upgraded to 85 or 100. By upgrading the score, the Sustainable Bond is more attractive to invest by ACTIAM.

To determine the ESG score, two additional questions are raised. If the Sustainable Bond is positively assessed in question 3 the score is upgraded to 85. If it is also positively assessed in question 4, it is upgraded to 100. With this score, we pronounce our confidence in the Sustainable Bond and believe there is a true alignment with ACTIAM's beliefs on sustainability.

Question 3: Does the issuer and the projects financed with the Sustainable Bond fit into the just & safe operating space defined by ACTIAM or are these on the pathway towards it?

A. Are the eligible projects defined in the framework of the issuer and are the predefined goals or targets positively contributing to the relevant drivers as set in the ACTIAM Sustainable Investment Framework?

For assessing how issuers comply with the ACTIAM Sustainable Investment Policy, their exposure and management capabilities are monitored for seven Material Sustainability Drivers. For each Sustainable Bond, we assess to what extent the eligible projects or predefined targets reduce exposure or improve management capabilities of the issuers. For example, when a Green Bond aims to contribute to energy efficiency in buildings, we assess how the projects impact the metrics used in the Fossil Fuel Use and the Chemicals & Waste Management drivers. Or when a Social Bond aims to contribute to (access to) education, its impact on the Social Capital driver are considered. At this moment, it is not possible to quantify these criteria. Especially for the more social sustainability themes, this asks for a case-by-case assessment.

B. Are there ambitious and/or innovative outcome indicators defined for the eligible projects?

In this step, ACTIAM checks whether the Sustainable Bond issuer pre-defines specific outcome or impact indicators at issuance. With this, the issuer should illustrate the expected environmental and/or social impact (in qualitative and/or quantitative terms) made possible by the projects to which the proceeds have been allocated. ACTIAM supports the development of new, innovative and ambitious indicators and encourages the evolution of standard parameters such as carbon emissions avoided. Also, transparency about the calculation methods and used methodology to come to outcome or impact indicators is appreciated.

For the Sustainability-Linked Bonds, this question is not relevant.

C. Is the issued bond a one-off or does it fit into an overall and ambitious sustainable program/framework/strategy of the issuer?

ACTIAM believes in investing in responsible and sustainable investment strategies as these create attractive and enduring financial value to clients as well as sustained social value to society. In order to do so, ACTIAM invests in entities operating within the planetary boundaries and respecting the social foundations. We believe that companies should be transparent about this and explain and/or define their operations, activities and sustainable policies. In case an issuer is not yet operating according the ACTIAMs safe & just operating space, we expect it to be transparent on its transition towards this space. The issuer can do so via its sustainability framework, an ESG strategy or another relevant policy. By this, the entity shows that the Sustainable Bond is not only a one-off activity but fits into an overall sustainable vision where the issuer is adequately managing its risks, its exposure to material risks, its impact on society and its opportunities to become (more) sustainable. As we want to invest in Sustainable Bonds with the largest impact, we do expect the sustainability ambitions of the issuer to be best-in-class and fit with ACTIAM's beliefs on sustainability. That is, are the targets set by an issuer in line with those defined by ACTIAM.

Question 4: Do the projects and issuer have a positive impact and not just reduce negative impacts?

A. Does the issuer meet the criteria defined by ACTIAM as “positive impact”?

In the ACTIAM Sustainable Investment Framework, the highest level of sustainability is defined as “positive impact”. Companies in this category take the opportunities to make a positive and intentional contribution to the Sustainable Development Goals, while operating within the planetary boundaries.

Through their positive contribution, they go beyond the safe and just zone and are creating a positive impact. In this question, the issuer and/or the eligible projects are verified against ACTIAM definitions for positive impact. This means, the issuer is creating a positive impact and is not solely preventing or limiting its negative impact. For example, this differs

projects regarding energy efficiency which reduce carbon emissions, being a negative impact, whilst projects allocated to afforestation have a positive impact as they store carbon emissions.

B. Is the business model, product and/or services provided by the issuer believed to be future proof?

In this question, ACTIAM assesses whether the Sustainable Bond issuer defines new and/or innovative business models, products and services which are underpinned by transformational leadership, which disrupt existing industries and are realigned with the Sustainable Development Goals. For example, this applies if a utility company replaces its fossil fuel investments in line with the reduction in carbon emissions that is needed for the transition to a world in which the global average temperature to well below 2°C the pre-industrial levels and pursuing efforts to limit the temperature increase to 1.5°C. So, we assess structural change on the issuer level that is required for a sustainable future.

C. Does the issuer set targets for the impact indicators?

When defining output, outcome or impact indicators, the issuer has the possibility to link these to its sustainability strategy and speak out its ambition by setting targets on these metrics. For example, if a sub-sovereign issues a Social Bond related to affordable housing, it is encouraged to set a target on the amount of people helped by this investment. Or, in case of a Green Bond the issuer can set ambitions to reduce CO₂ emissions, an upfront and ambitious target on this reduction increases the likelihood of receiving an ESG-score of 100.

In case a bond is not classified as Sustainable Bond by the assessment above, it will receive the regular ACTIAM ESG score (0-100) of its issuer. ACTIAM may start engagement with these issuers to encourage further development of their sustainable policies and practices, or on a specific topic (e.g. impact reporting or target setting for certain projects). Furthermore, in case a bond is classified as a Sustainable Bond by ACTIAM given a certain framework and potential other information, this does not guarantee the same label will be given to other bonds issued within the same framework at a later date. For example, an issuer may fail to comply with its promised targets, reporting and/or transparency, being therefore not labelled Sustainable Bond for its next issuance. Also, technology, innovation and market developments can catch up with the eligible projects and set criteria. For example, the category “energy efficiency in green building” of a certain framework may be considered as a Sustainable Bond by ACTIAM at certain date, but with the passing of time and advancements in the market, the eligible project category may have insufficient definition and criteria in order to receive the ACTIAM Sustainable Bond label again.

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