

# ESG Integration in Sustainable Bonds

Assessment process

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## Introduction into Sustainable Bonds

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Starting 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, Sustainability Bonds and more recently, Sustainability-Linked Bonds. Also, labels such as Blue, Climate (Action) and SDG Bonds are used. The common ground of Green, Social and Sustainability Bonds are the different categories for which the use of proceeds are allocated to defined eligible projects. For Sustainability-linked Bonds, there is not a direct link between the use of proceeds and the eligible projects, but sustainability is enhanced through a set of pre-defined issuer-wide sustainability targets that may result in financial consequences for the bond when the targets are not met.

ACTIAM sees it as its mission to deliver relevant investment solutions by maximising long-term financial, environmental and social returns. ACTIAM recognizes that it is its 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, ACTIAM invests in companies that operate in line with this adaptive space or entities that 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. This can be bonds with specific purposes or linkage to projects that contribute to a more sustainable society, such as Green, Social and Sustainability Bonds. Or via investing in bonds that are linked to the issuers' overall sustainable strategy and targets, as defined by Sustainability-Linked Bonds. Within ACTIAM, all these bonds are referred to as Sustainable Bonds as there is no distinction made in the assessment between the different nomenclature of these bonds and the overall same criteria apply 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 of the total bonds we invest in.

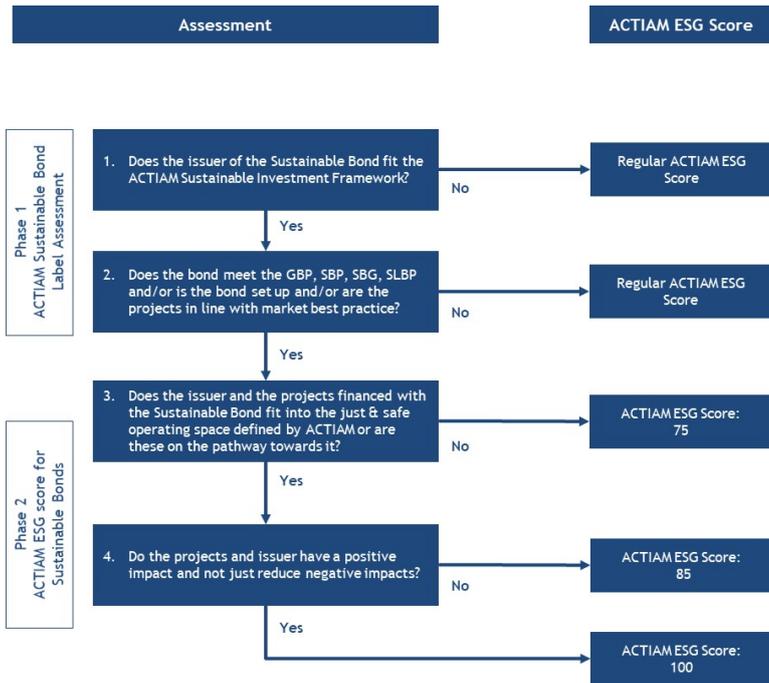
To prevent potential green or social washing, stimulate comparability of investment strategies and eliminate barriers for (new) issuers of Sustainable Bonds, ACTIAM wants to contribute to clear and indisputable definitions of Sustainable Bonds. That is why ACTIAM supports the Green Bonds Principles (GBP), Social Bond Principles (SBP), Sustainability Bond Guidelines (SBG) and the Sustainability-Linked Bond Principles (SLBP). All together referred to "The Principles". The aim of the Principles 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 Sustainable Bond. ACTIAM is a member of the Principles and is active in various workgroups supporting the Principles. 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. Hereafter, the process of integrating sustainable bonds in our investment process is presented, for example through the ESG score.

# ACTIAM Sustainable Bond Assessment Framework

To ensure ACTIAM invests in bonds that are actually addressing the goals of a sustainable society, ACTIAM assesses whether bonds comply with our definition of Sustainable Bonds. These bonds can be newly issued or purchased on the secondary market. 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.

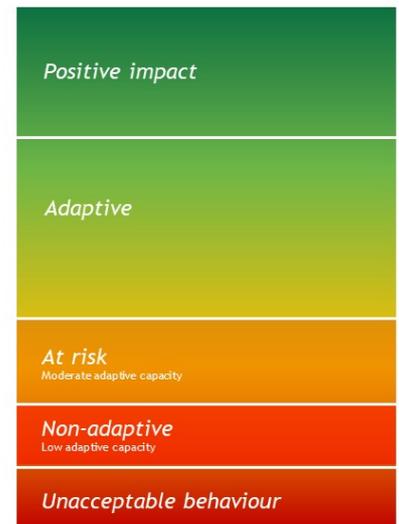
The ACTIAM Sustainable Bond Assessment Framework is presented in the Figure below before more details are given.



The ACTIAM Sustainable Investment Framework forms the basis for the assessment of Sustainable Bonds. That is, issuers are screened on their compliance with the 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 these, so also not in the Sustainable Bonds issued.. 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 is classified as Sustainable Bond, the next step is to 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 set on the entities level and linked to the bond. Based on this, 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 with its specific projects or predefined targets would help the issuer to make the transition towards the ‘adaptive or positive impact zone’. Here, both the profile of the issuer as well as the underlying projects or targets are assessed. Based on the total outcome of these steps, an ACTIAM ESG score is allocated to each Sustainable Bond. The allocation of Sustainable Bonds is to the Positive Impact zone. Please note that this does not automatically applies to the issuer of the Sustainable Bonds; this entity could be labelled as at-risk or adaptive as well.

ACTIAM Sustainable Investment Framework



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

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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 or more of the Material Sustainability Drivers do not qualify for a Sustainable Bond. Issuers classified as "at-risk" may issue a bond which qualifies as a Sustainable Bond if the positive contribution of its projects becomes a substantial part of their core activities and sufficiently supports their transition towards an "adaptive" or "positive impact" classification or when the KPI is significantly improving the performance of the issuer on its lacking material driver. We believe that when the targeted activities underlying the bond are increasing in substance and are becoming a more substantial proportion of the overall profile of an issuer, the issuer is becoming eligible to move from at-risk towards adaptive or positive impact. 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 judge whether the controversies affect the chances of the bond's goals being achieved and do not undermine its credibility. A result can be that resultantly 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.
- for Sustainability-Linked Bonds, the KPIs set should be financially material and of significantly importance for the overall profile of the issuer. By this, ACTIAM differs between investing in SLB which follow regulatory defined targets and real ambitious issuers. For example, an waste processor aligning a target on avoided carbon emissions within regulation but leaving out a KPI on manners to reduce waste will not be classified.

**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. When fully developed, also the EU Taxonomy can provide additional guidelines. 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

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

To determine the ESG score, two additional topics are assessed. 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 adaptive or positive impact zone 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 the fitness of issuers 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. Also, it is considered whether there is no significant adverse impact on any of the other drivers and/or whether the potential for such impact is sufficiently mitigated. 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 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 or the targets set. 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. In case an issuer has not included specific outcome or impact indicators on Bond level, the corporate sustainability policy of the issuer is assessed. Targets set on corporate level can be taken into account under the assumption that the use of proceeds of the bond are being put to use for the achievement of corporate strategies and related sustainability targets.

### **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 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 adaptive or positive impact zone, 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. Also, targets and ambitions aligned with science-based targets are preferred. Further, ACTIAM assesses the progress made by an issuer. That is, when a bond is issued under a certain framework and this is labelled as a Sustainable Bond by ACTIAM another issuance under the same framework does not automatically lead to the same label. For example, a

framework with basic impact and limited proved progression over time is expected to be updated according to the current standards.

#### 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. While ACTIAM believes that Sustainable Bonds fit into this categories when these pass the assessment process described here, the same does not automatically apply to the issuer. For example, a heavy polluting mining company could be issuing a Green Bond to finance an onshore solar plant. Where this project can be seen as positive impact, the issuer itself is not.

Through positive contribution, entities go beyond the adaptive zone and are creating a positive impact by their business model or operations. 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 reforestation or the protection of endangered species which have a pure positive impact.

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

By 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 or output 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, and therefore will not be 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.

ACTIAM N.V.

Postal address

P.O. Box 679  
3500 AR Utrecht



+31-(0)10-206 1300  
marcom@actiam.nl  
www.actiam.com