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INFORMATION NOTE

SUSTAINABILITY IN FINANCE

What is sustainable finance?

The widespread awareness of the impact of economic activities on different social and environmental aspects has highlighted the demand for greater consideration of these same factors in the selection of financial investments by both private and institutional investors.

The evaluation of the long-term impacts of investment decisions has historically always been considered a niche approach, sometimes reflecting the personal values of the individual investor concerned (Ethical Investments, Socially Responsible Investments, or others). However, the visibility and importance that sustainable development has acquired in recent years have led to a strong evolution and diffusion of these trends, both in terms of approach and of strategies and composition of assets, to the point that Sustainable Finance has now become one of the main themes of consultancy and asset management activities.

So, Sustainable Finance now means an approach to the selection and monitoring of investments that takes into account not only long-term financial and economic objectives, but also the positive or negative effects that such investments may have on the environment and society. Seen in this light, investments must also be analysed on the basis of their contribution to the sustainable development of human activities at both the local and global levels.

Thus, taking into consideration ESG factors, on the one hand, allows investors to align their preferences and aspirations in terms of sustainability with the investments in which their assets are put and, on the other, in the ongoing dialogue between investors and the factors of economic production, it allows the generation of a virtuous circle that encourages companies to be more attentive to their own sustainability strategy.

Far from being a monolithic and immutable methodology, Sustainable Finance continues to develop and adapt as the concepts of sustainability and sustainable growth evolve. Technological development and its accompanying ethical-philosophical debate ensure that sustainable investment is constantly evolving and improving.

Following this perspective, the Swiss financial industry has now adopted standards that make sustainable finance a practice that is transparent, solid and suited to the needs of its clients and investors. In particular, the Swiss Bankers Association (SBA), the trade association of banks in Switzerland, has issued a directive for financial service providers concerning the inclusion of ESG preferences and risks in investment and asset management advisory activities. These directives are binding on all members of the association.[1]

ESG analysis

From a methodological standpoint, in the analysis of sustainable investments, three factors are identified which comprehensively include all the aspects that are most important for sustainability: the Environmental factor, the Social factor, and the Governance factor, which in English correspond to the acronym ESG.

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[1] https://www.swissbanking.ch/en/topics/sustainable-finance/self-regulation-in-sustainable-finance

The first two factors indicate the two macro-categories on which the effects of economic growth have the greatest impact: the Environment, understood as both use of natural resources and pollution and waste of these resources, and the Social sphere, understood as both the community involved in the production activity (workers, shareholders, suppliers, etc.) and those who are affected by this activity (customers/consumers, inhabitants of the places where these activities are carried on, etc.), that is to say, more generally speaking, the so-called *stakeholders*.

Governance, on the other hand, is the key factor that guarantees that objectives are pursued in an ethical manner and in full compliance with current behavioural regulations as well as with the true spirit of the applicable laws.

This type of analysis is valid especially with regards to investments linked to the asset class of Stocks and Bonds. As regards the latter, keeping in mind that bondholders have less control over the activity of their creditor company, the offer of Green Bonds and Social Bonds or, more generally speaking, Sustainability Bonds is also increasing. These are debt securities containing explicit clauses that refer to the sustainability objectives that the issuing company aims to achieve or towards which the proceeds of the issue are to be directed.

ESG analysis is also fundamental for other asset classes, ranging from Real Estate to Private Assets to Certificates and Structured products, and is also used in the context of collective investment products, funds and Exchange Traded Funds (ETFs), as a methodology for identifying the sustainable approach to the selection of investments.

ESG risks

In recent decades we have seen how the effects of economic growth and access to the benefits of globalisation have both positive and negative sides. The negative effects, the so-called *negative externalities*, have an impact on both the investments themselves, that is to say the companies and their related economic operators, and the environment and society as a whole. In the financial context, this risk is defined as the ESG risk, i.e. the investment risk linked to ESG, Environmental, Social and Governance themes.

According to the SBA definition: *"ESG risks" are events or situations in the Environmental, Social and corporate Governance areas that are currently having a negative impact on economic, cost or reputation factors, for example, and thus also on the value of a company or the market price of financial instruments or could potentially do so in future.*[2]

ESG risks are present in all investment products and, although they are identifiable, they are difficult to predict in terms of magnitude and timing. To manage these risks, it is necessary first of all to identify the factors that determine them and then to identify possible mitigation or reduction measures. Ideally, to achieve this result, it is therefore necessary to carry out a detailed analysis and, where possible, to encourage the investor in turn to be proactive. The next section lists some of the approaches most commonly used for this purpose.

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[2] SBA document "Risks involved in Trading Financial Instruments" published by the Swiss Bankers Association, ed. June 2023 - Chapter 1.6: "Sustainability-related financial risks (ESG Risks)"

Examples of the risks we are talking about are *the consumption or contamination and pollution of the natural resources necessary for economic activity, unfair treatment of workers, which can lead to operational risks or reputational damage, or business practices which are not transparent or that can lead to disputes with suppliers or customers*.

These risks are material, as the adverse event caused can have a serious impact on the company's income statement (fines, loss of customers, reputational damage, etc.) or it can even jeopardise its corporate survival (withdrawal of licenses, failure of its business model, corporate bankruptcy, etc.). *It is important to point out that this list could be extended almost infinitely, as the analysis of ESG factors is constantly evolving.*

In certain cases, these are risks that do not reflect directly on companies, but rather they represent an externality that impacts society as a whole, the communities in which the economic activity involved is carried on, the workers engaged in the production and supply chain, or the environment in general, not forgetting the effects on future generations.

The different approaches to sustainable investment

Over the years, various strategies have been developed with the objective of taking into consideration and mitigating ESG risks, as well as of directing investments towards more sustainable development models. The most basic approach is that of ***Exclusion***, which means that certain economic activities are directly excluded from the investable universe, as they are not consistent with the sustainability objective or because they are intrinsically exposed to an unmanageable ESG risk. Examples are the exclusion of activities related to pornography and gambling[3] or arms, or limitation in the case of activities related to the consumption of alcohol and tobacco or the production of Genetically Modified Organisms (GMOs), or the production of nuclear energy. Although some aspects are common, the definition of the list of activities excluded from investments is part of the process of defining the strategy itself and, as such, it depends, or may depend, on the investor's preferences regarding sustainability.

For a more proactive approach, over the years analysis metrics have been developed that allow us not only to exclude the most controversial activities, but also to understand how the various companies involved are positioned in relation to the three ESG factors. To do this, we analyse various static quantitative parameters, such as the production of polluting substances and the composition of the workforce, or dynamic quantitative parameters, such as the constant improvement of these indicators, as well as qualitative parameters, such as the production processes and decision-making processes, commitments entered into with stakeholders, or even reputational aspects. These indicators are often summarised with an evaluation that can be expressed as a ranking. Of course, not all aspects are equivalent, and a part of the analysis involves understanding which factors have the most impact on the sector and company analysed. By selecting the best candidates in this ranking, we choose the approach referred to as ***Best in Class***, which allows us to build an extremely well positioned portfolio as far as the mitigation of ESG risks is concerned. Depending on the approach used, the Best in Class selection may present greater exposure in certain sectors which by their intrinsic nature allow for greater sustainability.

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[3] Excluding gaming establishments holding a specific authorisation issued in the context of the applicable laws in force in the countries concerned.

The development of sustainability analysis as described above allows us to take a further step forward and, instead of applying a simple positive filter, that is to say one which selects the best investments in assets at any given moment, it is now widespread practice to integrate this analysis into the broader process of investment, thus considering ESG factors not as an element extraneous to the financial evaluation, but rather as an integral part of it that actively contributes to the determination of the investment judgment. Among other things, proceeding in this way, the analysis is not static, but rather it allows investment in companies that have room for improvement in their sustainability profiles. These strategies are referred to as ***ESG Integration***.

For a more active approach

The approach to improvement becomes even more evident and radical when a policy of sustainability activism is chosen. As shareholders, and in some cases also as bondholders, investors have means at their disposal to influence the strategic decisions of the company in which they have invested. An increasing number of investment products allows the votes of minority shareholders to be cast in support of the cause of sustainability within the company's own strategies. This practice is often referred to as ***Stewardship***, which represents the combination of two approaches. On the one hand, the exercise of voting rights through which shareholders express their will in periodic votes that determine the various company strategies. On the other hand, ***Engagement***, that is to say the active dialogue between the shareholders and the company's management, with the aim of directing the corporate strategy in such a way as to ensure that ESG factors are taken into consideration.[4]

Lastly, when the selection of investments is done with the declared objective of favouring a positive change and is subject to measurable metrics in some areas of sustainability, we talk about ***Impact Investing***. This type of investment can be limited to the holding of shares in companies that have clear positive social or environmental externalities or to the use of activism to define the sustainability strategies of the companies in which we invest, with the aim of obtaining measurable results on the environment and society. This second case is much more effective in the case of *private assets*, because the possibility of intervening is greater. In this case, what is involved is a high-risk, non-liquid investment suitable for professional clients only. Often, in this approach, the economic return, although taken into consideration, is secondary to sustainability and impact objectives.

Sometimes sustainable investments also fall into the category of so-called ***thematic investments***, i.e. those collective investment instruments that concentrate the portfolio in the securities of companies that are exposed to a specific theme or business. In this case, this may be a typical sustainability theme, such as clean energy or social inclusiveness.

It is important to consider that these different approaches are not mutually excludable. Indeed, it is widespread practice for those who propose sustainable investment strategies to use different approaches, with the objective not only of providing an adequate financial risk-return profile, but also of contributing in the manner which they deem to be more efficient for the environmental and social sustainability of the investment portfolio.

[4] See, for example:
https://www.sustainablefinance.ch/upload/cms/user/EN_2020_06_16_SFAMA_SSF_key_messages_and_recommendations_final.pdf

Effect of ESG investment strategies on the portfolio

It should be kept in mind that an investment activity that chooses a strategy that mitigates ESG risks, in addition to positive long-term effects, can also have an impact on the portfolio. In particular, too stringent constraints in the selection of investments can reduce the investable universe by reducing diversification. It can thus put the return-on-investment objective at risk if it is linked to a financial index, because it may not be able to replicate the desired or most optimal sector exposure. Lastly, certain ESG strategies require the use of instruments, such as *private assets*, which are not very liquid and are thus suitable only for professional investors.

Whatever the choice of the sustainable investment approach, the typical risks of financial investments remain, and they must be adequately calibrated based on the investor's own risk profile. Academic studies do not show substantial differences in long-term returns between investments made using traditional strategies and those made using ESG strategies.[5]

Reporting and the risk of "*Greenwashing*"

The development of technology, international policies and regulatory frameworks mean that there is no single standard, and they make the selection and evaluation of sustainable investments a process subject to continuous evolution and exploration, as are the definition and proposal of sustainable financial products.

Data transparency and reporting are therefore fundamental in sustainable finance, even more than in traditional investment approaches, because they allow the investor to verify that the sustainability objectives are in fact aligned with their own, to monitor trends, and to be more aware of their own investments.

This also helps to limit the so-called *Greenwashing* phenomenon, which, according to the FINMA definition, consists in **intentionally or unintentionally deceiving clients and investors regarding the sustainability properties of financial products and services**.[6] Regulators, and FINMA in particular, are very sensitive to this issue and have the objective of trying to prevent and combat activities that claim to be eco-sustainable, for example through the use and communication of sustainability concepts for purely commercial purposes and without any true sustainability objective or without implementing the processes deemed to be necessary in order to achieve that objective. This incorrect practice takes advantage of the objective difficulty of defining an operational standard and the lack of transparency, by leveraging a widespread and strongly felt theme. *Greenwashing* phenomena are unfortunately known both within individual companies and in the marketing of sustainable investment products in general. For this reason, periodic reporting adequate for the set objectives and regulations that are attentive to the issue are both essential.

[5] Consider, for example, the meta study: *Atz, Ulrich and Van Holt, Tracy and Liu, Zongyuan Zoe and Bruno, Christopher, Does Sustainability Generate Better Financial Performance? Review, Meta-analysis, and Propositions (July 22, 2022). Journal of Sustainable Finance and Investment*

[6] See https://www.finma.ch/en/documentation/dossier/dossier-sustainable-finance/investor-protection,-c-,-preventing-greenwashing/

Client profiling and preference

In the context of financial services transparency, it is important not only to recognise and inform clients about the investment risks and opportunities linked to ESG factors, but also to collect any preferences from them regarding the theme of sustainability. This is done primarily in order to meet their specific needs and their desire to limit the risks related to ESG factors or to promote certain sustainable development objectives. Through correct profiling, it is possible for the financial services provider to propose the most suitable financial product or service among those available or to provide the necessary information with sufficient transparency in the event that it is not possible to satisfy the client's requests.

SBA Directive

Swiss banks, through their SBA trade association, have also equipped themselves with a self-discipline system in the area of sustainable finance. In particular, the new directive contains minimum requirements for the consideration of sustainability in investment and asset management consultancy with the aim of preventing "*Greenwashing*" practices and promoting the reputation of the Swiss financial marketplace. These requirements commit the members of the Association to inform their clients about the ESG risks and characteristics of proposed investment solutions, to profile their clients according to their preferences in terms of sustainability, and to take these preferences into consideration when developing their proposals, provided that such preferences are not in conflict with the investment objectives defined by the client's risk profile in accordance with the FinSA [Federal Act on Financial Services]. The financial services provider must ensure that clients' preferences are in line with the ESG characteristics of the recommended financial instruments and, if these instruments deviate from the expressed preferences, the provider must communicate this to the clients.

Further information, in particular on the documentation, reporting and effective date of the regulations, is available on the website of the Swiss Bankers Association.[7]

GLOSSARY[8]

CSR: Corporate Social Responsibility. This term refers to an organisation's commitment, beyond what is required by law, to ensure that the social, economic and environmental impact of its actions creates a net benefit for communities and society. It is based on the belief that all companies have a "duty of care" to all their stakeholders in every area of their business operations and that being a responsible citizen improves the long-term business success of a company.

ESG: Environmental, Social and Governance. ESG stands for Environmental (e.g. energy consumption, water usage), Social (e.g. talent attraction, supply chain management) and Governance (e.g. remuneration policies, board governance). ESG factors form the basis for the different SI approaches.

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[7] https://www.swissbanking.ch/en/topics/sustainable-finance/self-regulation-in-sustainable-finance
[8] Extracted and translated from https://www.sustainablefinance.ch/en/resources/what-sustainable-finance/glossary.html

ESG Engagement: Engagement is an activity performed by shareholders with the goal of convincing management to take account of environmental, social and governance criteria. This dialogue includes communicating with senior management and/or boards of companies and filing or co-filing shareholder proposals.

Successful engagement can lead to changes in a company's strategy and processes so as to improve ESG performance and reduce risks.

GREEN BONDS: Green bonds are broadly defined as fixed-income securities that raise capital for a project with specific environmental benefits. The majority of green bonds issued to date have raised money for renewable energy projects, energy efficiency measures, mass transit and water technology. Most green bonds have been either plain vanilla treasury-style retail bonds (with a fixed rate of interest and redeemable in full on maturity), or asset-backed securities tied to specific green infrastructure projects.

IMPACT INVESTING: Investments intended to generate a measurable, beneficial social and environmental impact alongside a financial return. Impact investments can be made in both emerging and developed markets, and target a range of returns from below-market to above-market rates, depending upon the circumstances. Swiss Sustainable Finance (SSF) considers impact investments as those having three main characteristics: intentionality, management and measurability.

SUSTAINABLE INVESTMENT (SI): Sustainable investment (analogous to responsible investment) refers to any investment approach integrating environmental, social and governance factors (ESG) into the selection and management of investments. There are many different approaches of sustainable investing, including best-in-class, ESG integration, exclusion screening, thematic investing and impact investing. They are all components of sustainable investing and have played a role in its history and evolution.

Information Note prepared by the ABT Sustainable Investments Working Group.

Vezia, July 2023