How have investors met their ESG and climate reporting requirements under Article 173-VI?

Perspectives on the implementation of Article 173-VI of the French “Energy Transition for Green Growth” law

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In August 2015, France took a ground-breaking step by becoming the first country in the world to impose ESG and climate reporting requirements on asset owners and managers.

The implementation decree of Article 173-VI of the French “Energy Transition for Green Growth” law, dated January 2016, sets three requirements: i) providing a general description of the investor’s ESG policy, ii) disclosing the resources allocated to ESG analysis, and iii) explaining the methodology and the results of the climate risk analysis.

Thought leaders around the world will closely observe how the Article is implemented, capitalizing on the latter to develop similar national and transnational initiatives. The publication in June 2017 of the G20 Financial Stability Board’s Task Force on Climate-related Financial Disclosure (TCFD) was a strong indicator of the increasing demand for non-financial information and data. The Climate Finance Day to be held in France at the end of 2017 will most likely build upon this momentum.

This report aims to assess the first year of implementation of the Article and provide an overview of how ESG and climate topics are being taken into account by investors.
The focus of this study is the implementation of Article 173-VI. The study will draw on four key criteria, based on the TCFD’s recommendations concerning the disclosure of climate-related information on “Governance”, “Strategy”, “Risk Management” and “Metrics and Targets”. The implementation of these recommendations will provide an opportunity to carry out a similar study on a global scale.

Assessment indicators for each of the key criteria are based on the methodology developed by the “2°C Investing Initiative” and the French Ministry for Ecological and Inclusive Transition, as part of the International Award on Investor Climate-related Disclosures.

1. Governance and strategy
2. Management of ESG and climate risks
3. Integration of ESG and climate factors into investments
4. Quality of ESG and climate performance metrics

Methodological approach

This study is based on data provided by a panel of 23 entities subject to the ESG and Climate reporting requirements of Article 173-VI of the French “Energy Transition for Green Growth” law.

The panel is comprised of 15 insurance groups, six asset management companies and two pension funds, representing total assets of approximately EUR 4.500 billion.

The data collected as part of this study are publicly available ESG and climate information disclosed by entities that have met their reporting obligations.
Most asset owners and managers acknowledge the relevance of incorporating ESG and climate-related criteria into their investment processes.

1 - Governance and strategy

Participation in voluntary initiatives on the integration of ESG and climate-related topics into investments and the building of dedicated internal and external resources constitute decision support tools for top-level managements. The review of such indicators demonstrates that the maturing process is ongoing, especially for climate-related topics. Moreover, while investors have a sound understanding of their vested interests in being involved in the integration of ESG and climate-related topics, they still have difficulty setting quantitative objectives with a clear timeframe.

2 - Management of ESG and climate risks

Investors appear to have progressed further in their acknowledgement of climate risks than of other ESG risks. However, they only seem to be at the initial stages of implementing risk management measures, with just a few investors having assessed their exposure to climate risks. Measures need to be taken to improve the understanding of the correlation between portfolio carbon footprint and climate risk management.

3 - Integration of ESG and climate factors into investments

The level of disclosure of ESG criteria considered in our analysis is higher for private issuers than for sovereign issuers. A few investors referred to third-party analysis methodologies without describing their underlying ESG criteria. In addition, they did not give the reasons motivating their selection of ESG criteria, as required. In terms of engagement activities, a number of investors still do not actively engage with the companies they invest in via impactful meetings. Furthermore, asset owners should specify their ESG and climate requirements more clearly to their asset managers.

4 - Quality of ESG and climate performance metrics

Investors disclosed metrics linking investees’ GHG emissions to key financial indicators and assessing alignment of these emissions with a 2°C scenario. Methodological limitations make any comparison of these metrics impossible. Investors should improve the transparency and robustness of their methodologies in order to convert the metrics into key performance and risk management indicators.
Governance and strategy

Recent and long-term commitments to ESG and climate

By signing the UN Principles for Responsible Investment (UN PRI), investors commit to six principles, the main one being the integration of Environmental, Social and Governance (ESG) issues into investment analysis and decision-making processes. 82% of the reporting entities are signatories of the UN PRI, of which 26% are the founding members. 47% of them signed the UNPRI within the last three years.

As the fight against climate change continues to gain momentum, having reached a milestone with the Paris climate agreement in December 2015, the investment industry is committed to playing its role to the fullest. 17% of the reporting entities are signatories of the Portfolio Decarbonization Coalition, while 40% are signatories of the Montreal Carbon Pledge. Both of these voluntary initiatives constitute decision support tools for top-level managements, as they encourage investors to assess, disclose, and reduce their portfolios’ carbon footprint.

With the implementation of Article 173-VI, investors in France are further encouraged to take into account ESG and climate topics via the publication of dedicated ESG and climate information. One third of them were endorsed by a member of top management, while the majority of them made references to dedicated investment committees.
Academic literature on the raison d’être and relevance of integrating ESG topics into investment processes is dense and has allowed investors to form their own opinions. Among the reporting entities, 13% expressed the belief that ESG is not only a matter of responsibility, but can also be used to supplement fundamental analysis to mitigate portfolio risks. The remaining 87% considered that ESG is also a source of opportunity (e.g., capitalizing on megatrends or preventing impairment of financial performance).

Demonstrating the coherence between their voluntary commitments and positive opinions about ESG, 91% of the panel investors have built internal capabilities (e.g., ESG and climate analysis methodology, rating models, a dedicated team of analysts) and external capabilities (e.g., broker research papers, third-party analysis methodologies). The remaining 9% are investors who did not provide evidence of dedicated resources for the integration of ESG and climate criteria, or who are currently building capabilities.

Respectively 52% and 22% of the panel investors distribute or invest in funds which have been awarded the labels SRI (Socially Responsible Investment) and EETC (Energy and Ecological Transition for the Climate). Both labels receive support from the French government and aim to direct savings to funds integrating ESG and climate criteria. They bring more market visibility to clients’ of such funds.
Governance and strategy

**Difficulties in setting clear objectives and envisioning the future**

Despite various commitments to incorporating ESG and climate topics into their investment processes, only 57% of the panel investors provided information about the actions they intend to take based on their objectives. 69% have set qualitative objectives and 46% quantitative ones.

62% of the objectives are qualitative and mainly consist of general declarations without clearly defined time limits for their achievement. About **two thirds** of the disclosed qualitative objectives relate to the financing of the energy and ecological transition (e.g., investments in green bonds and companies offering green products and services) and to the intention of aligning portfolios with a 2°C scenario.

38% of the objectives are quantitative, thereby demonstrating a more proactive attitude. 75% of these quantitative objectives relate to divestment targets for coal-related activities, with pre-determined thresholds (percentage of revenue from coal-related activities).

The difficulties envisioning the future via clear strategies can be explained by the fact that performance indicators are still being developed or perfected (e.g., the carbon intensity of investment portfolios).

**Distribution of qualitative objectives by type**

- Portfolio decarbonation: 15.4%
- Divestment from coal: 23.1%
- Alignment with a 2°C scenario: 23.1%
- Financing the energy and ecological transition: 38.5%

**Distribution of quantitative objectives by type**

- Portfolio decarbonation: 12.5%
- Financing the energy and ecological transition: 75.0%
- Divestment from coal: 12.5%

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**Suggestions for next year**

Investors must capitalize on the indicators they have developed as part of their carbon footprint and 2°C alignment assessments in order to set appropriate quantitative targets that have clear time limits and are adapted to the different asset classes. They should commit to reducing the carbon footprint of their portfolios, divest from carbon-intensive activities (e.g. coal) using pre-determined thresholds (e.g. percentage of global turnover derived from coal-related activities), or invest defined amounts in the energy and ecological transition.

Moreover, investors who have developed green share and brown share assets, and have disclosed reduced CO2 emissions, should also set corresponding quantitative targets and estimate the extent to which they are ready to commit. This would involve metrics being tracked over time and on a regular basis.
ESG risks are non-financial risks which can have direct and/or indirect adverse impacts on an issuer’s value. Climate risks, which are ESG risks, relate to physical and transition risks resulting from climate change mitigation and adaptation (e.g. extreme weather conditions, carbon pricing).

Investors appear to have progressed further in their acknowledgement of climate risks than of other ESG risks, given the current context of efforts to mitigate climate change. 61% of the panel thus referred to both physical and transition risks in their report.

However, investors only seem to be at the initial stages of implementing risk management measures. 87% of the reporting entities have taken a first step in this respect by disclosing their portfolio carbon footprint. Yet only 22% have assessed their exposure to the physical risks of climate change (real estate and infrastructure assets only) and only 9% to transition risks.

For next year, investors may need to identify and contribute to the development of physical and transition risk assessment models in order to bridge the current methodological gaps.

Assessing exposure to physical risks borne by corporations would involve a better understanding of their geographical locations. Investors can learn from the insurance industry, which appears to be leading the way in measuring climate risks for real estate and infrastructure assets by relying on models existing in the market. This year, some insurance firms were able to predict financial losses due to extreme weather conditions and to create heat maps in order to obtain an initial understanding of potential transition risks.
Respectively 26% and 43% of the panel did not disclose the ESG criteria that they take into account to analyze private issuers and sovereign issuers. In most cases, investors provided details of their general approach and process used to integrate ESG criteria. Additionally, 9% of the panel referred to third-party methodologies developed by extra-financial rating agencies or asset managers, without describing the underlying ESG criteria taken into account for equities, corporate bonds and sovereign bonds.

Environmental criteria used to analyze private issuers typically cover carbon and toxic emissions, biodiversity, water, waste and opportunities offered by green products and services. Under the environmental pillar or as a supplement to it, a few investors have also developed specific “energy transition” analysis methodologies to better incorporate the ins and outs of climate change.

As for social criteria, these typically include, but are not limited to human capital development, community investments and philanthropic activities, supply chain management, and occupational health and safety.

Corporate governance criteria are designed to examine the size and composition of boards of directors, executive remuneration, potential conflicts of interest, the protection of minority shareholders’ interests, etc.

Whether relying on third-party or proprietary asset-specific ESG analysis methodologies, investors should improve disclosure of the criteria they take into account and justify their choice.

For the next year of implementation, investors should consider their efforts towards compliance with Article 173-VI as an opportunity to ensure that they disclose sufficient methodological information to their clients. In addition, they should give concrete examples of industry-specific ESG approaches and provide more insight into the relevance of the ESG criteria they select.

Finally, investors should develop additional analysis methodologies for other types of asset classes such as sovereign bonds, real estate and infrastructure.
Integration of ESG and climate factors into investments

*ESG and climate engagement activities with issuers are often limited to exercising voting rights*

As shareholders, investors can influence the behaviors and strategies of the companies they invest in by establishing regular dialogue with them. Such shareholder engagement vis-à-vis issuers ranges from exercising voting rights to frequent discussions on strategic topics, including ESG and climate-related issues.

Regarding ESG topics, 83% of the panel provided data on the resolutions they supported or rejected, while 65% also provided the reasons and motivations for their votes. Additionally, 61% of the panel went further by establishing dialogue with issuers. 43% provided detailed information and examples demonstrating the impact of their meetings with companies.

The above figures are slightly lower for climate-related topics, yet the trend has been positive over recent years. While climate-related resolutions at annual general meetings still remain rare in Europe, pressure on companies in the United States has increased. Furthermore, 52% of the panel appear to discuss climate change with issuers.

**Level of involvement in engagement activities with issuers (as a percentage of the panel)**

<table>
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<th>Level of involvement in engagement activities</th>
<th>General voting and engagement policy</th>
<th>Data on approved/rejected resolutions</th>
<th>Justification of the votes</th>
<th>Dialogue with issuers</th>
<th>Impact assessment of dialogue with issuers</th>
</tr>
</thead>
<tbody>
<tr>
<td>ESG</td>
<td>100%</td>
<td>83%</td>
<td>65%</td>
<td>61%</td>
<td>43%</td>
</tr>
<tr>
<td>Climate</td>
<td>100%</td>
<td>70%</td>
<td>61%</td>
<td>52%</td>
<td>35%</td>
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**Suggestions for next year**

In order to better understand the companies they invest in and protect their interests as shareholders, investors must perform engagement activities. They should describe their voting policy and procedures, disclose the number, share and type (E, S, or G) of resolutions they support or reject, justify their actions and positions (e.g., votes cast, shareholder resolutions), and provide concrete examples of failed or successful engagement initiatives.

For next year, investors who have published annual engagement and voting reports should capitalize on such documents, and place greater emphasis on assessing their impacts on companies’ behaviors and strategies.
Integration of ESG and climate factors into investments

Asset owners need to clarify their requirements to asset managers

Institutional investors’ compliance responses show that their concern for ESG and climate-related topics remains limited when it comes to their relations with asset managers.

The majority of the reporting entities do not include ESG or climate requirements in their requests for proposals (57% and 86%, respectively). When implemented, the asset manager selection process remains unclear. ESG and climate considerations are used as final selection criteria in the event of a tie between short-listed bidders.

Once contracted, asset managers tend to be subject to very limited scrutiny by their asset owners with regard to ESG and climate-related topics. Only 26% of asset owners with externally-managed assets reported on ESG engagement vis à vis their asset managers. Climate-related engagement vis à vis asset managers appears to be even less common, concerning only 22% of asset owners with externally-managed assets.

Asset owners must ensure that existing mandates assigned to asset managers duly comply with their ESG and climate requirements. In this respect, regular dialogue must be established to carry out checks, discuss expectations, and set objectives for key indicators.

Regarding new mandates, only a few investors have set ESG and climate requirements in their requests for proposals, with different levels of stringency compared to other considerations. While ESG and climate requirements may not be relevant for all RFPs, asset owners should specify their importance in the decision-making process for the award of new mandates.

Examples of ESG and climate requirements include, but are not limited to, whether the asset manager is a signatory of the UN PRI, whether its investment process and approach are robust (e.g. stringency of ESG rating selection), or whether it already manages SRI or EETC-certified funds.

For next year, institutional investors who have failed to report on these topics should clarify their RFP approach and provide concrete examples of engagement vis à vis asset managers for existing mandates.
Quality of ESG and climate performance metrics
Performance management requires improved accounting for scope 3 emissions

Of the 87% of panel members who completed a portfolio carbon footprint assessment, half of them included their equities, corporate bonds and sovereign bonds in the assessment.

Of the panel members who completed a portfolio carbon footprint assessment, 65% acknowledged the shortcomings of the carbon footprint method. These mainly concern the lack of accurate data on investees’ indirect emissions (i.e., scope 3 emissions of public issuers, and, to a lesser extent, of private issuers), and the fact that the method is not sufficiently forward-looking, without any estimation of future GHG emissions.

Additionally, 90% of the disclosed carbon footprint assessments went beyond scope 1 and 2 GHG emissions. However, 10% purposely decided not to incorporate scope 3 GHG emissions in order to avoid data biases.

Due to data gaps, indicators developed as part of carbon footprint assessments (e.g., tons of CO2 equivalents emitted per million euros invested or per million euros of revenue) are barely comparable, and cannot be used to successfully drive a strategy to align portfolios with the 2°C goal.

Suggestions for next year

A significant proportion of investors disclosed carbon performance metrics, which may be used in the future to set performance and risk management standards.

For next year, investors could continue to increase transparency on these metrics, i.e., detailing the calculation methodologies and assumptions used, and acknowledging the shortcomings of the calculations (e.g., data availability for scope 3 emissions). Moreover, investors could participate in working groups in order to bridge current methodological gaps.

Investors could also explain more clearly how these metrics may impact their investment process. For instance, asset owners could use carbon metrics to drive the climate performance of their externally-managed portfolios.
52% of the panel performed assessments of alignment with a 2°C scenario.

Two thirds of the 2°C alignment assessments performed by the panel relied on sectoral decarbonization scenarios developed by the International Energy Agency, for sectors such as utilities, automotive, and the oil & gas industry. 50% of the 2°C alignment assessments using this approach were carried out based on a single industry scenario, while 25% used three scenarios.

Investors chose various time horizons and asset class coverages when assessing the alignment of their portfolios with a 2°C scenario.

25% of the investors who performed a 2°C alignment assessment acknowledged the shortcomings of their approach.

Suggestions for next year

The existing methodologies used to assess climate risks cannot cover all asset classes and sectors. These shortcomings should be duly acknowledged.

Moreover, investors should anticipate bridging the current methodological gaps by taking part in dedicated working groups. This holds true especially for the assessment of industries where decarbonization scenarios and science-based targets have not yet been developed.

In terms of transparency, as stated in some of the compliance responses reviewed, investors should provide clearer disclosure on the extent to which their portfolios and investments are aligned with a 2°C scenario, and explain how this alignment can lead to better performance and risk management.
“Article 173-VI is a chance for investors to better manage climate risks and to identify opportunities for growth”

Caroline Delérable, EY Partner
Questions to consider for the next year of implementation

**Governance and strategy**

Do you explain the extent to which the integration of ESG and climate considerations into your investment process is relevant to your core activities and business model?

Is there sufficient management support to better integrate ESG and climate considerations into your investment processes?

How do you position yourselves compared to your peers in terms of adhesion to national and international industry initiatives?

Have you built sufficient capabilities to match your ambitions?

Capitalizing on developed metrics, do you plan to set ambitious quantitative targets with clear time limits? What will the expected concrete outcomes of achieving your targets be in terms of portfolio carbon footprint and 2°C alignment?

**Management of ESG and climate risks**

Do you categorize the different types of risks borne by issuers (e.g., regulatory, financial or reputational)?

Do you provide insight to those who bear ESG and climate risks (e.g., issuers, investors or customers)?

Do you consider potential changes in environmental legislation when assessing your exposure to transition risks?

Have you reviewed existing climate models in order to measure your exposure to physical and transition risks? Do you intend to contribute to bridging the current methodological gaps?
Integration of ESG and climate factors into investments

Do you incorporate ESG criteria into the analysis of your main asset classes?
To what extent do the non-financial criteria that you take into account, facilitate your portfolio managers’ investment decisions?

To what extent are climate topics addressed as part of your engagement activities?

Do you communicate to issuers on examples of successful and failed engagement initiatives? Do you measure the concrete impacts of your engagement activities?

As an asset owner with externally-managed assets, have you established regular dialogue with your portfolio managers to monitor their ESG and climate performance and communicate your views? What are the ESG and climate impact indicators that you monitor?

Quality of ESG and climate performance metrics

Are you considering assessing your portfolio carbon footprint and 2°C alignment in a foreseeable future and disclosing and tracking the results on a regular basis?

Do you plan to increase the transparency level of the methodologies you use to assess your portfolio carbon footprint and 2°C alignment? Do you plan to increase the asset class coverage of your indicators?

Are you aligned or close to being aligned with a 2°C temperature increase scenario?

Do you intend to contribute to bridging the current methodological gaps?
Methodological approach

This study covers a panel of 23 entities subject to the ESG and Climate reporting requirements under Article 173-VI of the French “Energy Transition for Green Growth” law. The panel represents total assets of approximately EUR 4,500 billion.

It includes 15 insurance groups (Aviva France, AG2R la Mondiale, MACIF, AXA, Groupama, Natixis Assurances, Scor, Generali France, Allianz France, MAIF, Sogecap, BNP Cardif, SMA BTP, Covea and CNP Assurances), six asset management companies (Sycomore Asset Management, Edmond de Rothschild Asset Management, Amundi Asset Management, Lyxor Asset Management, Mirova Asset Management, and BNP Asset Management), and two pension funds (IRCANTEC and ERAFP).

The data collected as part of this study is publicly available ESG and climate information disclosed by the investors mentioned above.
Glossary

AFG: Association Française de la Gestion financière (French Asset Management Association)
CDP: Carbon Disclosure Project
EETC: Energy and Ecological Transition for the Climate
ESG: Environmental, Social and Governance
FIR: Forum pour l’Investissement Responsable (French Sustainable Investment Forum)
GHG: Greenhouse Gas
IIGCC: Institutional Investors Group for Climate Change
RFP: Request For Proposal
SRI: Socially Responsible Investment
TCFD: Task Force on Climate-related Financial Disclosures
UN: United Nations

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