ESG AND CAPITAL
PART 1: EQUITY

Bank for Transition Series

October 2021

NAB IS THE BANK FOR TRANSITION

We are working towards net zero emissions by 2050, and are supporting our customers to do the same. We are here to serve customers well and help our communities prosper.

#1 MOST SUSTAINABLE AU FINANCIAL SERVICES COMPANY

44th ranked company globally, Top 100 Most Sustainable Companies[1]

1 OF 30 FOUNDING BANKS FOR PRINCIPLES FOR RESPONSIBLE BANKING

Launched in 2019, the Principles for Responsible Banking includes almost 250 banks representing 40% of banking assets globally

NET ZERO EMISSIONS

portfolio commitment by 2050

73%

of power generation EAD invested in renewables

Supported the research and launch of the climate measurement standards

$42.8M

Community investment

ONLY AUS BANK

to sign Collective Commitment to Climate Action

51%

greenhouse gas emissions reduction from 2015 baseline levels by 2025

$42.6BN

in environmental financing since 2015[2]

$70BN

environmental financing commitment by 2025

$2BN

affordable housing commitment

100%

NAB wide electricity consumption from renewable sources by 2025 commitment

50%

reduction in thermal coal mining exposures by 2028

10YRS

certified carbon neutral

Sources: 1. Corporate Knights, 2021; 2. Group environmental financing commitment represents total cumulative new flows of environmental financing from 1 October 2015. Refer to our 2020 Sustainability Data Pack for a further breakdown of this number and reference to how our environmental financing commitment is calculated.

CONTENTS

ABOUT THIS REPORT

Welcome to NAB's Bank for Transition series

This report is the first of a series that will cover a range of topics related to sustainability and transition to net zero emissions.

The series will provide a detailed look at global trends in sustainability, and offers insights for business leaders, company boards and sustainability professionals.

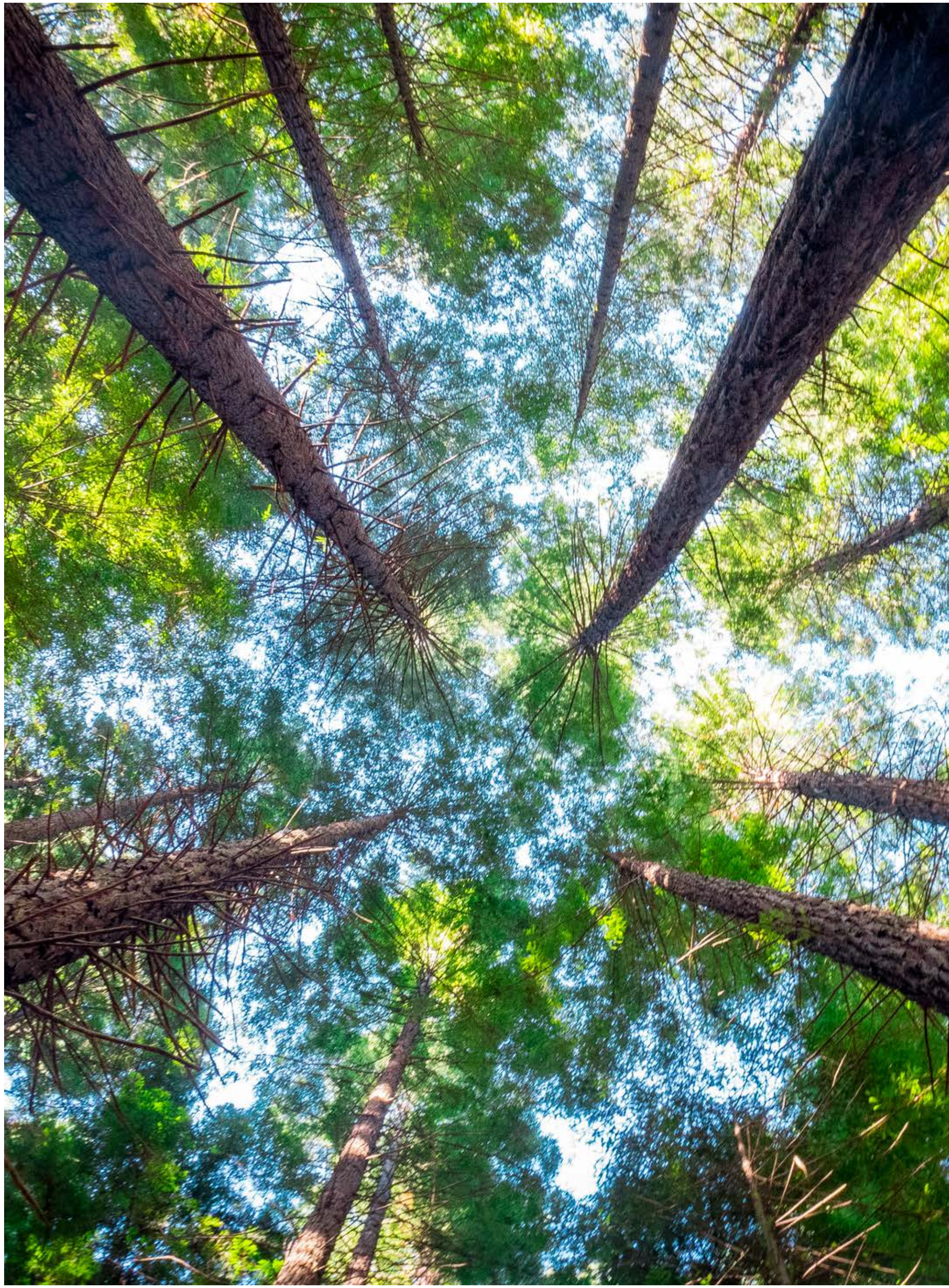
The first topic in the Bank for Transition series is 'ESG Trends and Capital'.

The topic covers:

- The role of capital providers in adoption of ESG and factors influencing their behaviours
- Trends in ESG, availability of capital and cost of capital
- Pathways to improve availability of capital, cost of capital and valuation
- Emerging ESG developments, opportunities and challenges being experienced by capital providers

Due to the substantive nature of this topic, ESG Trends and Capital will be split into a two part series:

- Part 1: Equity (this report)
- Part 2: Debt (to be released early 2022)



ACKNOWLEDGMENTS

The Bank for Transition series along with this report have been brought to life by Corporate & Institutional Banking (C&IB) personnel who are dedicated to helping our clients achieve their ESG and transition goals. This group is very grateful to a number of market leading ESG experts who have provided insights through a series of interviews.

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Adam is responsible for coordinating integration of ESG and responsible investment practices for A$200 billion assets under management (AUM). Adam has over 25 years international multi-sector experience in risk, governance, environmental and sustainability issues. He serves as co-founding Advisory Board member of GRESB Infrastructure standard and is a member of the UN PRI Australasia Steering Committee.

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With thanks to:
Belinda Kischkel, Senior Marketing Consultant, Corporate & Institutional Banking, NAB.

EXECUTIVE SUMMARY

ESG HAS GONE MAINSTREAM IN RECENT YEARS

The widespread adoption of ESG by asset managers reflects asset owner demands, financial performance benefits and regulatory requirements.

EUR AND NZ
are among leaders in ESG[1]

>100 COUNTRIES
had net zero emissions targets proposed, in policy or in legislation in 2020[2]

65% of N100 companies disclosed carbon reduction targets.
In their 2020 corporate reporting[3]

80% of N100 companies reported on sustainability in their 2020 corporate reports[3]

90%	77%	59%	84%
AMERICA	EUROPE	MEA	ASIA PACIFIC

STRONG ESG
improves fund performance
There is a positive or neutral relationship between general corporate ESG and investment returns in 59% of studies; and emissions related corporate ESG and investment returns in 65% of studies[4]

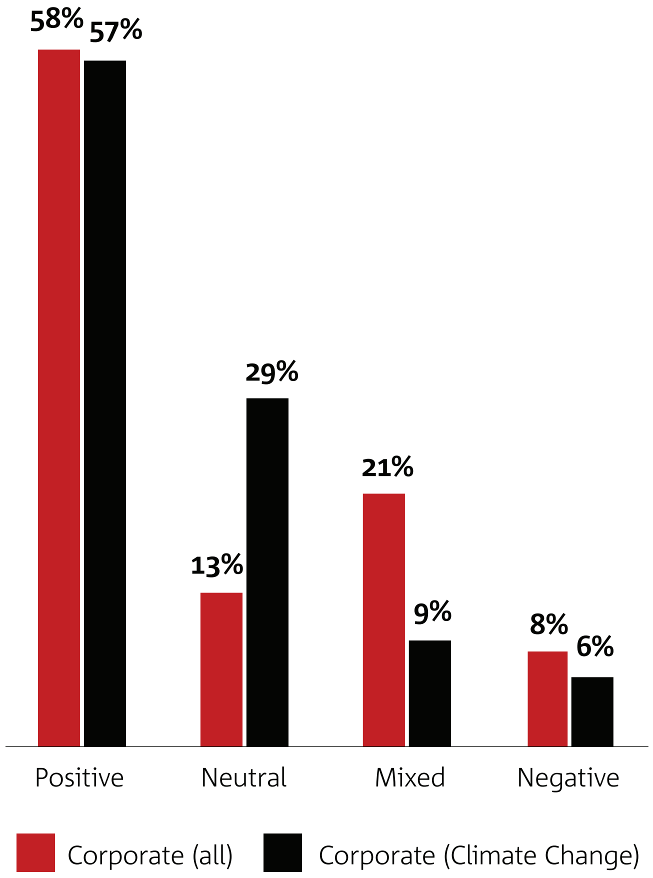
HIGH CARBON EMITTERS
are the N100 companies most likely to disclose carbon reduction targets[3]

80%	72%	71%
AUTOMOTIVE	MINING	ENERGY & UTILITIES

ASSET OWNER DEMAND
#1 driver of asset manager ESG adoption

45%
of asset managers have been practising responsible investing for less than three years[5]

There is a positive relationship between ESG and corporate financial performance.
Based on >1,000 research papers from 2015-2020[4]



Sources: 1. The Global Sustainable Competitiveness Index (GSCI), 2020; 2. Bloomberg New Energy Finance, 2021; Energy and Climate Intelligence Unit, 2021; 3. KPMG, Survey of Sustainability Reporting, 2020; 4. NY Stern Centre for Sustainable Business, 2020; 5. Morgan Stanley Institute for Sustainable Investing, 2019.

Note: The GSCI measures competitiveness of countries based on 127 measurable, quantitative indicators derived from reliable sources, such as the World Bank, the IMF, and various UN agencies. Indicators are grouped into 5 sub-indexes: Natural Capital, Resource Efficiency & Intensity, Intellectual Capital, Governance Efficiency, and Social Cohesion.

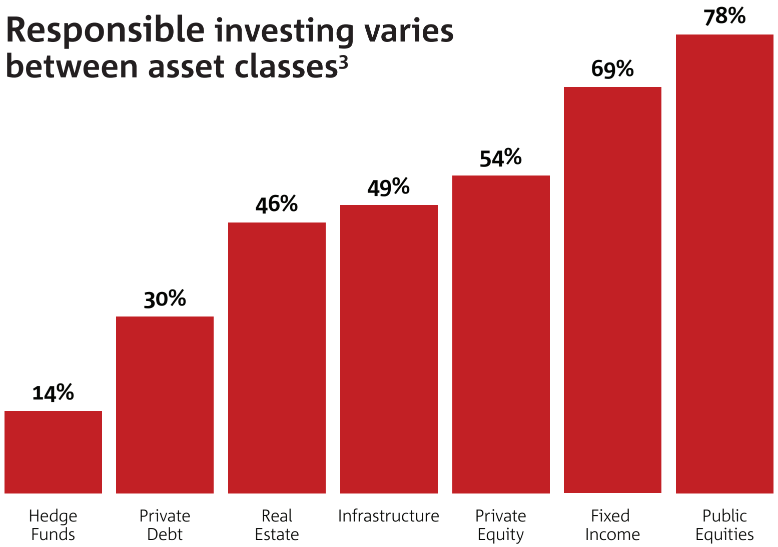
EQUITY IS SHIFTING AND INFLUENCING COST OF EQUITY

>3/4 OF GLOBAL AUM linked to managers with ESG commitments, e.g. UN PRI, Climate Action 100+ & Net Zero Asset Managers[1].

~50% OF GLOBAL AUM responsibly invested today[2]

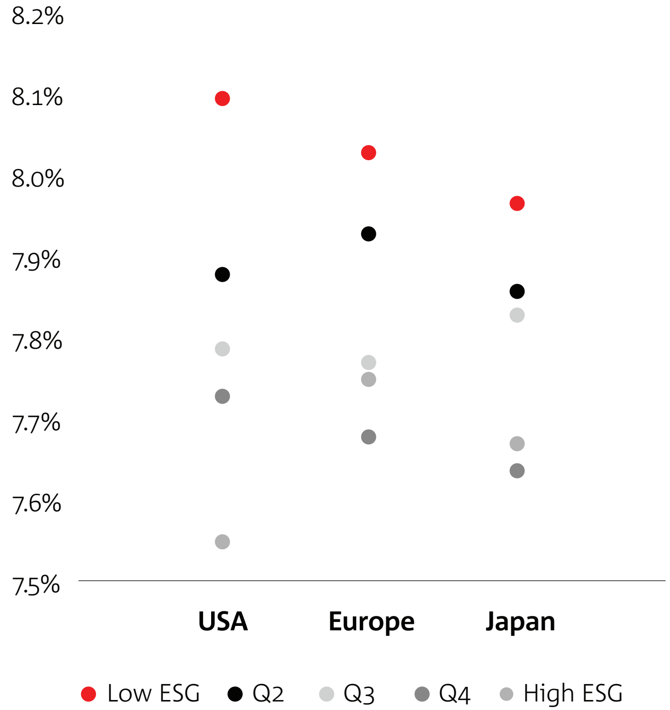
~95% OF GLOBAL AUM PREDICTED TO BE RESPONSIBLY INVESTED BY 2030[2]

Responsible investing varies between asset classes[3]



Companies believe the **link between ESG scores and the cost of capital is growing**, particularly for high carbon emitting companies[6]

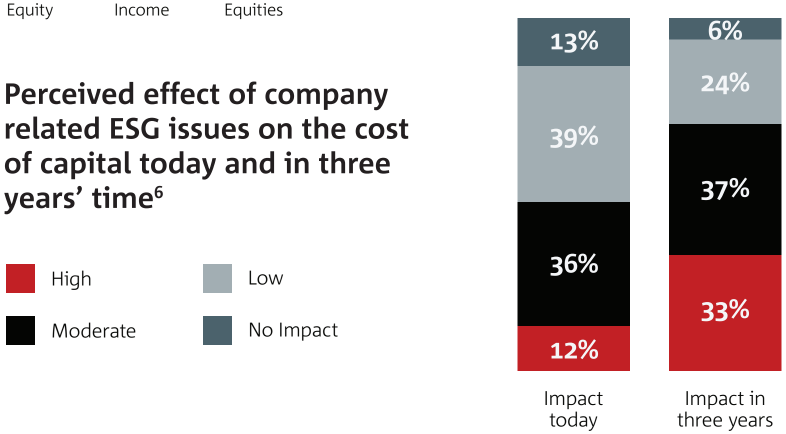
ESG ratings vs. cost of equity



Levels of responsible investing vary by region

>60% Canadian AUM
>40% European AUM
>35% AU/NZ AUM
>30% US AUM[4]

Perceived effect of company related ESG issues on the cost of capital today and in three years' time[6]



Strong relationship between ESG ratings and cost of equity. Based on a study of over 1,500 companies from 2015 to 2019[5]

Sources: 1. Principles for Responsible Investing (PRI), 2020; Climate Action 100+, 2021; Net Zero Asset Managers, 2021; 2. Deutsche Bank; Global Sustainable Investment Alliance; 3. Deloitte European CFO Survey, 2020; 4. Global Sustainable Investment Alliance, 2020; 5. MSCI, 2020; 6. Deloitte European CFO Survey 2020.

ESG TREND TAKEOUTS FOR CORPORATES

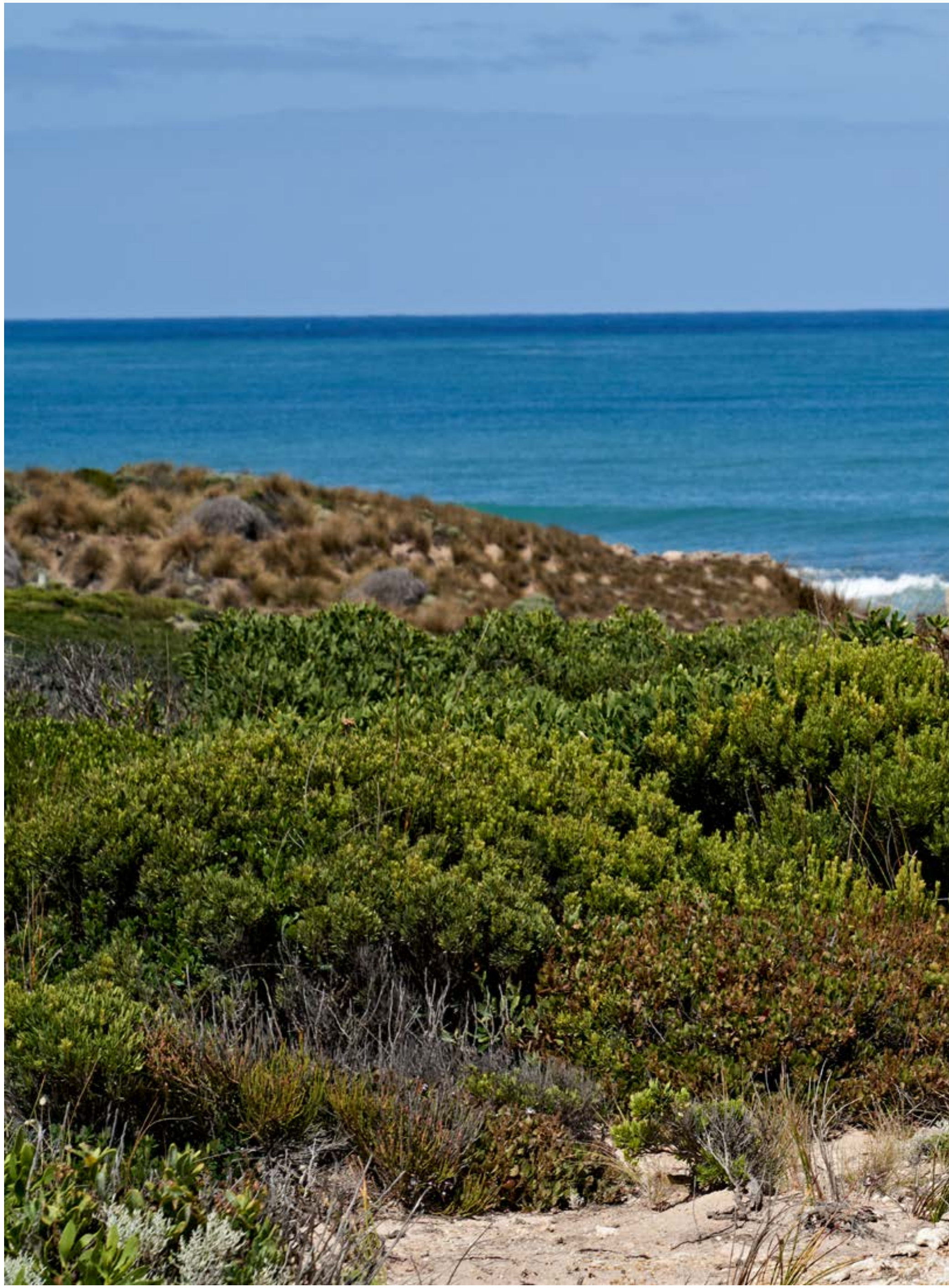
Asset managers are increasingly seeking investments with positive ESG characteristics. As a result, public or private companies with strong ESG characteristics are experiencing increased availability of equity and a reduced cost of equity.

Conversely, companies facing some of the highest levels of ESG scrutiny include Australian listed, high carbon emitters.

These companies are under pressure as a result of:

1. High and increasing levels of responsible investing in Australia;
2. High levels of visibility; and
3. A strong and growing relationship between low ESG ratings and high costs of equity, particularly for heavy carbon emitters.

In the future, it is likely that the requirements being placed on all market participants will evolve and increase as asset managers seek to improve their responsible investing practices.[1]



Source: 1. MSCI, 2020.

ASSET MANAGERS UNDERTAKE A RANGE OF ESG ACTIVITIES

Asset managers use three key types of investing activities, in conjunction with voting and engagement to deliver on their ESG objectives.

Investing Activities

ESG Integration
- >90% asset mgrs[1]
- c.25% AuM[2]
- US$25tn[2]

Negative Screens
- >90% asset mgrs[1]
- c.15% AuM[2]
- US$15n[2]

Norms Based Screens
- >60% asset mgrs[1]
- c.4% AuM[2]
- US$4tn[2]

Positive Screens
- >50% asset mgrs[1]
- c.1% AuM[2]
- US$1tn[2]

Sust. Themed
- c.2% AuM[2]
- US$2tn[2]

Impact Invest
- <1% AuM[2]
- <US$1tn[2]

Integration | **Screening** | **Thematics**

Stewardship Activities

Voting
- >98% asset mgrs[1]
- 100% AuM[2]
- US$100tn[2]

Engagement
- >80% asset mgrs[1]
- 11% AuM[2]
- US$11tn[2]

Stewardship

- **Integration:**
  - Systematic inclusion of ESG factors into decision-making
- **Screening:**
  - Involves including or excluding investments based on ESG criteria
  - Screens can be negative, norms-based or positive
- **Thematics:**
  - Generate positive social and environmental improvements or impacts alongside a financial return

- **Voting:**
  - Influences strategy, priorities and activities by exercising legal rights as an equity holder
- **Engagement:**
  - Involves working with companies to manage and improve ESG related risks, activities and performance

Source: 1 Principles for Responsible Investing, 2020; Schroders, 2018; Morgan Stanley, 2020; expert interviews and internal NAB analysis. 2 Global Sustainable Investment Alliance, 2020; with US$ value of AUM calculations based on global institutional AUM of c.US100tn.

ESG IMPACTS INVESTING AND STEWARDSHIP ACTIVITIES

ESG in incorporated into public and private market activities in sightly different ways

		Public Markets	Private Markets
Investing Activities	**Integration**	• **ESG integration is a continuous process** that influences investment decisions. • Key steps in ESG integration involve: **1) research** (including selection of ESG drivers, ESG metrics and data)**; 2) valuation and assessment;** and **3) portfolio construction** and **management.**	• ESG committed funds **do not rebalance their portfolio regularly**. As a result ESG integration is undertaken in different ways during different parts of the asset lifecycle. • **Research and due diligence (DD) are important pre-acquisition, while processes to improve ESG performance are important post-acquisition.**
Investing Activities	**Screening**	• Screening is very popular among listed equity managers, and commonly combined with ESG integration. • To apply a screen asset managers **choose between: 1) absolute screens; 2) threshold screens;** and **3) relative screens**.	• **Often effectively implement screens through internal processes, instead of formal screens**. Investment committees decisions reflect: **1) asset owner requirements**; and **2) need for explanation in event of underperformance**. • **Take a long term view of investment risks**, reflective of hold periods. Factors like climate change and future ESG trends often feature prominently. • More likely to **focus on a path to achieve ESG goals, instead of requiring high initial ESG ratings**.
Investing Activities	**Thematics**	• Differences between a regular fund and a thematic fund often relate to fund strategy and priorities. • **Similar ESG approaches** (e.g. integration and screening) **are used, but to a completely different degree.**	• Private markets asset managers are **more likely to embed ESG within all activities rather than setting up thematic funds**.
Stewardship	**Engagement** **Voting**	• **Engagement and voting** activities are **interrelated.** • **Engagement can be proactive** and based on a company's performance against pre-selected ESG risk areas, **or reactive** as a response to emerging issues. • The **influence exerted by shareholder activist investor groups is increasing.** In response companies are becoming more proactive with their engagement. Approximately 20 companies globally including Oil Search, Rio Tinto, Santos, Woodside Origin Energy and Glencore have committed to **'Say on climate'**. • Asset managers will **engage individually, or in groups.** • Asset managers and owners **vote individually, but are increasingly coordinating their voting** activities (particularly for groups such as Climate Action 100+).	• **Engagement and voting is often the single most important activity that private markets asset managers undertake.** • Due to large shareholdings, and often Board seats, private markets shareholders can effectively control or influence ESG undertaken within a portfolio company including: - ESG strategy and priorities - ESG driver and metrics - Internal assessment tools (e.g. GRESB); and - Reporting • Where Board seats are not held, several asset managers will often work collectively to gain the required influence to achieve their ESG objectives.

PATHWAYS TO IMPROVE COST AND AVAILABILITY OF EQUITY

Investing activities

1. **Seek to understand the ESG position, goals and needs of key asset managers[1]**
   - **Consider their:** 1) ESG priorities; 2) preferred ESG drivers and metrics; 4) preferred data sources; and 5) reporting requirements
   - **Screening:** Identify screens currently being applied, or being considered
2. **Review best practice for your industry[1]**
   - **ESG integration:** Consider ESG application and reporting recommendations provided by key bodies such as SASB, GRESB, GRI and TCFD
   - **Screening:** Consider market wide screening trends
3. **Develop or refine a Board approved ESG strategy, priorities, sustainability drivers and metrics**
   - Strongly guided by company specific characteristics
4. **Take action if your company may be impacted by a negative screen, or if there is potential to be included in a positive or norms based screen**
   - Elevate discussions to senior management and Board level
   - Recognise relevant ESG risks (and opportunities) and provide a strategic plan to mitigate (or capture) these
5. **Provide relevant and consistent disclosures**
   - Provide data and reporting that meets asset manager requirements, while also being specific to the company
   - Be consistent in approach to reporting, communications and data
6. **Engage, educate and influence**
   - Educate key stakeholders on the unique characteristics of your company
   - Seek to influence the ESG drivers and key metrics used by asset managers to assess your company
   - Proactively respond to ESG investment related requests
   - Ensure ratings and data available from external data providers represent your business well

Stewardship activities

1. **Actively engage with asset managers and stakeholders broadly**
   - Determine views on your company's ESG strengths and weaknesses, and identify recent changes in views
2. **Develop annual ESG priorities for discussion with asset managers**
   - These should support your company's ESG 1) priorities; 2) strengths; and 3) areas of future development
   - Prepare for questions that asset managers will ask regarding their own priorities
3. **Develop an engagement program with key asset managers (outside of reporting and AGM season)**
   - Undertake activities that will build relationships, across multiple levels
   - Educate asset managers on the unique characteristics of your company
   - Ensure consistency of message
4. **Proactively engage on sensitive topics**
   - Where an announcement may not be well received by asset managers, engage with them in advance
   - Make adjustments for asset manager feedback where possible
   - Proactively respond to investor questions and requests
5. **Respond to shareholder resolutions**
   - Review ESG related (and particularly climate related) shareholder resolutions being put forward at AGMs
   - Present an alternative case and data where required
   - Where reasonable, respond with positive and constructive action, even if the resolution does not pass

Note: 1. Thematic investing activity recommendations are incorporated in ESG integration and screening recommendations.

EMERGING ESG TRENDS IMPACTING ASSET MANAGERS

INTEGRATION

- For many asset managers, ESG risk assessments do not practically impact investment decisions.
- Asset owners are putting pressure on asset managers to better manage use of third party vs. in-house analysis, and improve processes to incorporate ESG data into investment decisions.

SCREENS

- Pressure to apply new screens is high, but they can be difficult to implement. Asset managers are focused on resolving or minimising:
  - Measurement and data limitations
  - Impact of screens on fund strategy
  - Balancing screens and sustainable development goals (SDGs)

THEMATICS

- There is high and increasing demand for thematic based funds of all types.
- However, in the future asset managers will need to improve disclosures that demonstrate a fund is what it claims to be.

ENGAGEMENT

- Asset managers need to improve the quality and quantity of their engagement activities and reporting to meet asset owner expectations.
- Best practice involves engagement reporting and disclosing evidence of the impact of engagement processes and activities on ESG outcomes.

VOTING

- Asset managers are adopting a structured and proactive approach to voting.
- Asset managers are aligning with activist investor groups, particularly for transition.
- Activist investor groups are holding asset managers to account for their voting.

Getting to net zero

- Asset owners and managers need to consider ethical and moral issues, as well as practical and commercial issues when deciding what approach to take in supporting the transition to net zero.
- Two key approaches are:
  1. **Risk transfer** – involves divestment or avoidance of high carbon emitting investments. Often preferred by small or specialist funds; and
  2. **Impact reduction** – involves activities to deliver change. Often adopted by large or flagship funds to minimise social issues and negative impacts on UN Sustainable Development Goals (SDGs).
- In time asset managers will seek demonstrated results from impact reduction activities and may increasingly switch benchmarks to climate indices (e.g. MSCI ACWI low carbon index).

Transparency, Standardisation & Data

- Different industry participants have differing views on the value of standardised vs. bespoke data. It is likely that in time, for all industries, some ESG measures will become accepted as best practice. However, bespoke ESG risk analysis will remain essential to deliver alpha.
- Public markets-style third party rating systems are not available for private markets managers. Various standards bodies and data providers are seeking to fill the gap.
- Asset owners and managers use data to assess a company's:
  1. **Progress against ESG strategy;**
  2. **ESG risks (transition and physical); and**
  3. **ESG impacts**
- Standards bodies and asset owners are seeking improvements in data quality and useability.

Reporting

- **ESG Impact Reporting**
  - Best practice by asset managers will increasingly include impact reporting.
- **Climate impact and Task Force on Climate-related Financial Disclosures (TCFD)**
  - Climate related impact and management reporting was recently legislated by New Zealand to commence 2023. Reporting will be based on TCFD recommendations that ensure companies provide climate risk related data that is useful.
  - Other countries and many asset managers will likely also require TCFD in the future.
- **EU Sustainable Finance Disclosure Regulation (SFDR)**
  - Requires asset managers to provide clients ESG-related information and demonstrate the level of ESG capabilities they are claiming.

THE RISE OF ESG

ESG FACTORS ARE IMPORTANT TO THE EVALUATION OF AN INVESTMENT

ESG in the broadest sense covers environmental, social and governance activities.

ESG is often referred to as 'sustainable' or 'responsible' investing with an aim to help better determine the future outlook and financial performance of a business, as well as its impact on the community.

E

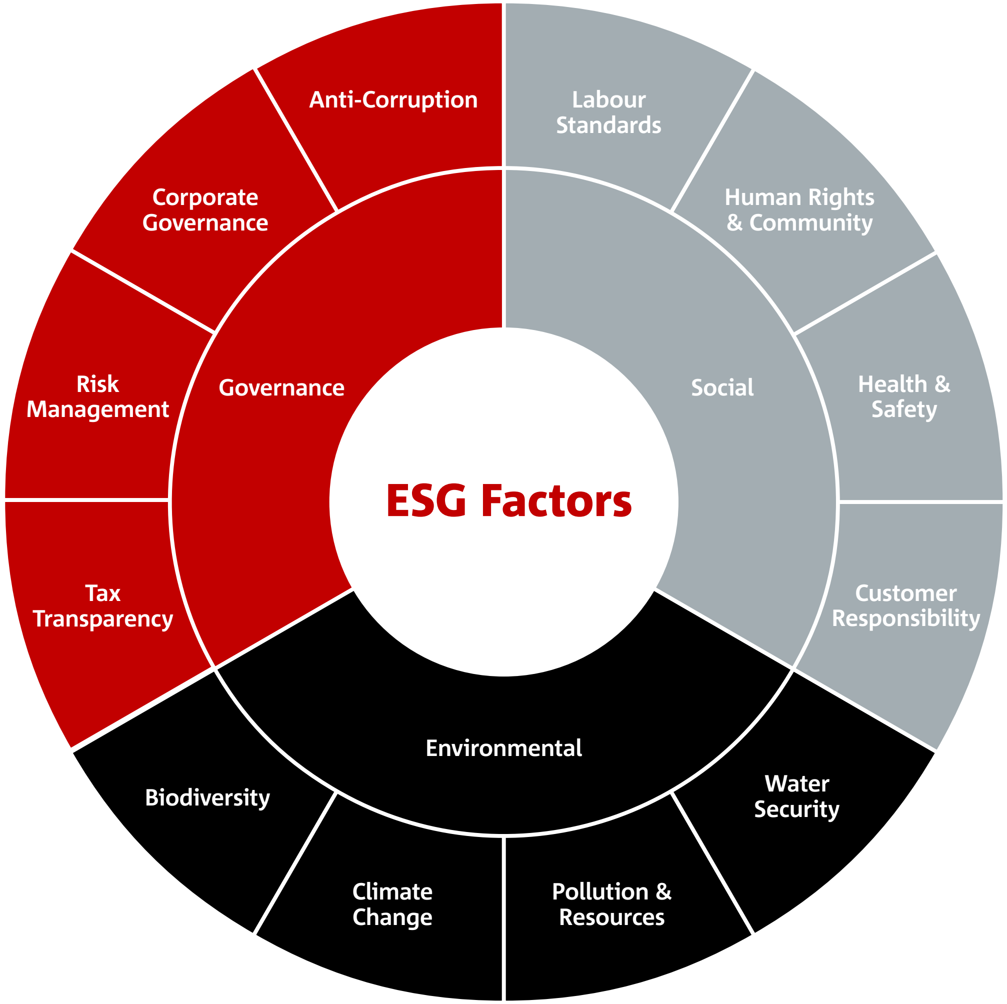
Environmental factors such as climate change, pollution and biodiversity reduction present critical challenges. They create physical and transition risks, which will require substantial changes to the way businesses operate. However, environmental factors can also provide opportunities, with development underway of new technologies and markets to drive a climate-resilient economy.

S

Social factors including human rights, employee wellbeing and relations, and supply chain issues have become increasingly relevant for investor relations and brand management. Addressing these factors will lead to reduced litigation risk while also being a significant brand and business enabler.

G

Governance has long been a focus for institutional investors through factors relating to management strategy, group structure, compliance and financial transparency. These factors play an essential part in reducing, managing and monitoring both environmental and social risks.



Source: 1. Linklaters Infrastructure, Risks and opportunities in the Infrastructure Investment Cycle, 2020.

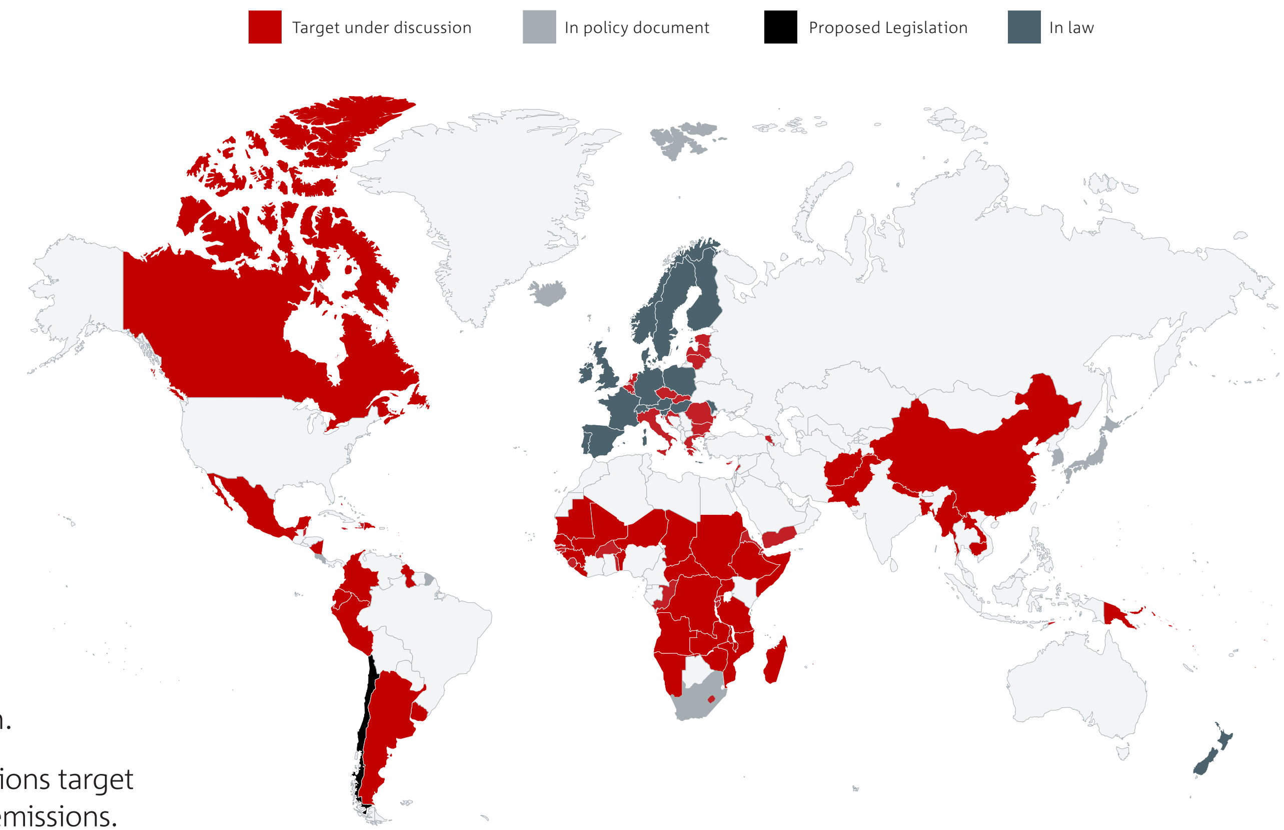
ESG AND CLIMATE CHANGE HAS GONE MAINSTREAM

Businesses are preparing for climate change to become a major area of focus

In 2019 and 2020, ESG and climate change became two of the most important areas of boardroom conversation.

- The next decade will see transition to net zero emissions become a major challenge, and opportunity, due to changed:
  - Societal expectations;
  - Asset owner preferences; and
  - Risk management expectations of regulators.
- At the World Economic Forum (WEF) in 2020, for the first time, climate and environmental risks were listed as the top five global risk areas[1].
  - Edged out other significant issues such as regulation, reputational and cyber risk.
- As of mid-2021, 132 countries had goals to decarbonise their economies. At this date:
  - Suriname and Bhutan had already achieved their net zero emissions targets;
  - Sweden, UK, France, Denmark, NZ and Hungary had embedded their targets in law;
  - The EU, Canada, South Korea, Spain, Chile and Fiji had all proposed legislations;
  - Twenty other countries including the US, Germany, China and Japan had targets in key policy documents; and
  - Ninety-eight other countries had targets under discussion.
- Although Australia is not identified as having a net zero emissions target in the chart to the right, Australia has committed to net zero emissions. However, the Federal Government is yet to set a target date.

Net zero emissions targets – 132 countries have goals to decarbonise[2]



Source: 1. World Economic Forum, Global Risk Report 2020; 2. Energy & Climate Change Intelligence Unit Net Zero Tracker, May 2021.

COMPANIES ARE RESPONDING WITH ESG TARGETS

Relating to both ESG in general and climate related emissions reduction targets

ESG related targets and reporting

- 80% of N100 companies worldwide now report on sustainability, with a growing number also including performance against the United Nations' Sustainable Development Goals (SGDs) in their corporate reporting.[1,2]

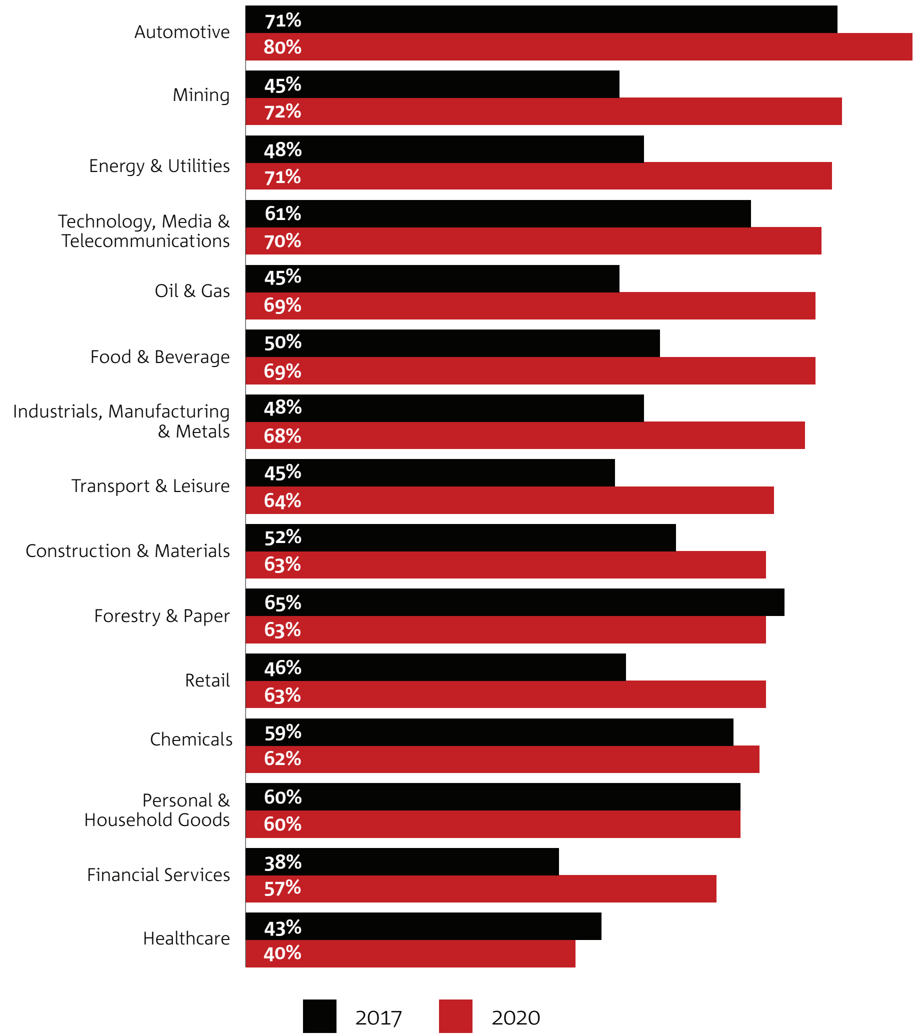
Climate related emissions reductions targets

- In 2020, a majority of N100 companies reported carbon emissions reduction targets.
- Companies within sectors associated with high levels of carbon emissions are most likely to disclose carbon reduction targets. This reflects pressure on companies within these sectors to reduce their carbon emissions.
- Over half of N100 companies link their emission reduction targets to external goals, the most popular being the Paris Agreement.[2]
- While company commitments to reducing emissions aren't binding, pressure is mounting from investors, regulators and consumers for corporations to set interim emissions goals and to reach their milestones.[2]

2020 Sustainability Reporting Rates: N100 by region[2]

90%	77%	59%	84%
AMERICA	EUROPE	MEA	ASIA PACIFIC

Companies disclosing carbon reduction targets: N100 by sector[2]



Source: 2. KPMG, Survey of Sustainability Reporting, 2020. Note: 1. N100 companies include 5,200 companies comprising the top 100 companies by revenue in 52 countries.

THERE IS A RELATIONSHIP BETWEEN ESG AND CORPORATE PERFORMANCE

Driven by improved long-term earnings growth and reduced earnings volatility

There is a link between general corporate ESG as well as climate related corporate ESG and improved earnings.

A recent review of >1,000 academic studies, published between 2015 and 2020, considered the relationship between ESG and corporate financial performance (via operational metrics such as ROE, ROA, or stock price).

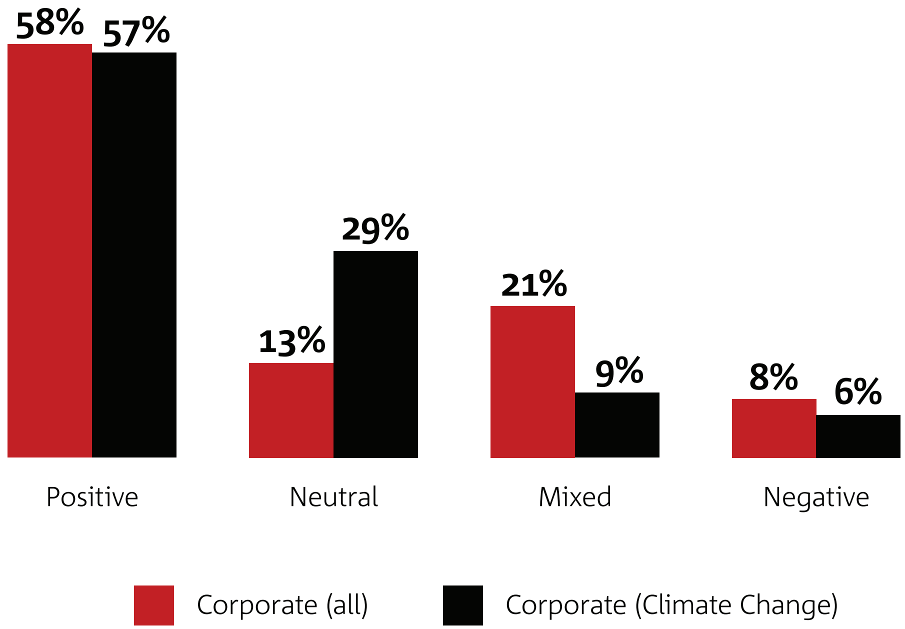
- The review found a positive or neutral relationship between ESG and corporate financial performance in 71% of the studies.
- A similar result was found when reviewing climate change or low-carbon specific studies related to corporate financial performance.

Key study findings:

1. Improved financial performance due to ESG becomes more marked over a longer time horizon.
2. Good management of ESG risks appear to provide asymmetric benefits. ESG appears to provide downside protection to companies, especially during a social or economic crisis.
3. Sustainability initiatives in corporations appear to drive financial performance due to various factors such as improved risk management and greater innovation.
4. Managing for a low-carbon future improves financial performance.
5. ESG disclosure on its own does not drive financial performance.

The relationship between ESG and financial performance

based on studies between 2015-2020[1]



Source: 1. NY Stern Centre for Sustainable Business, ESG and Financial Performance, 2021.

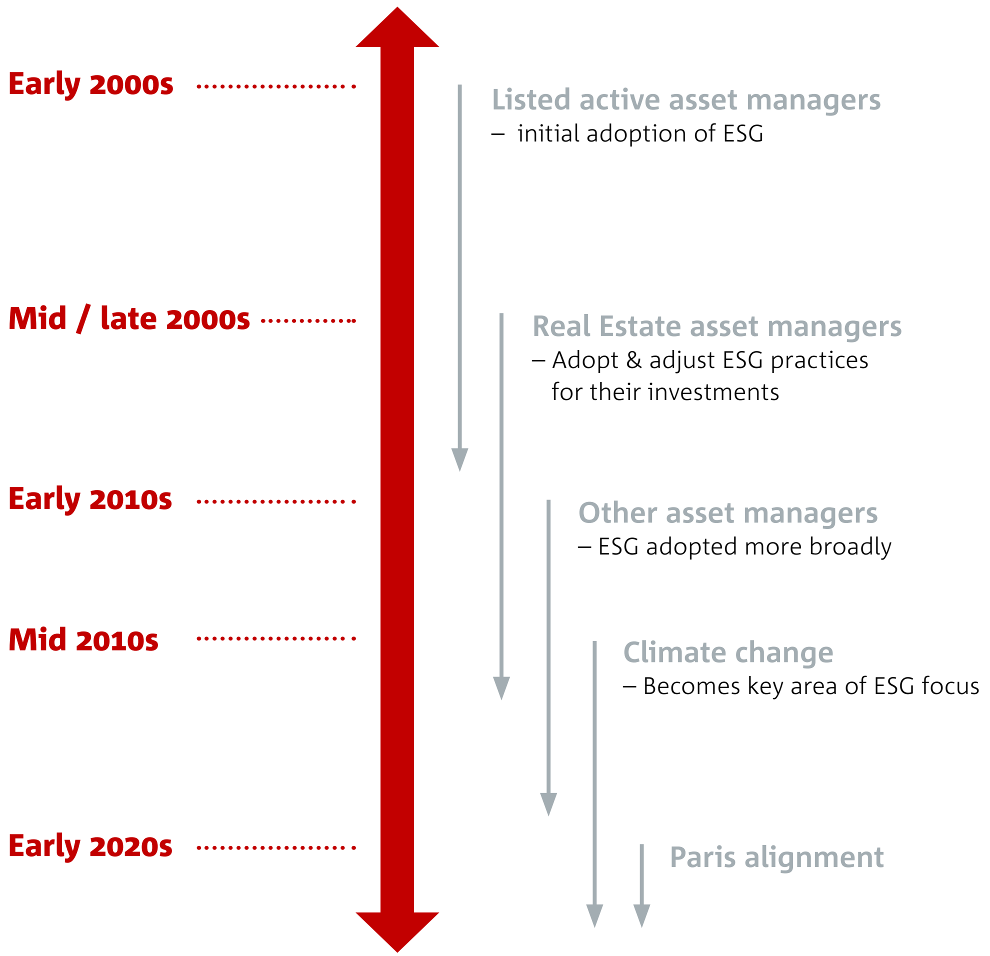
INVESTORS AND THE ESG MARKET LANDSCAPE

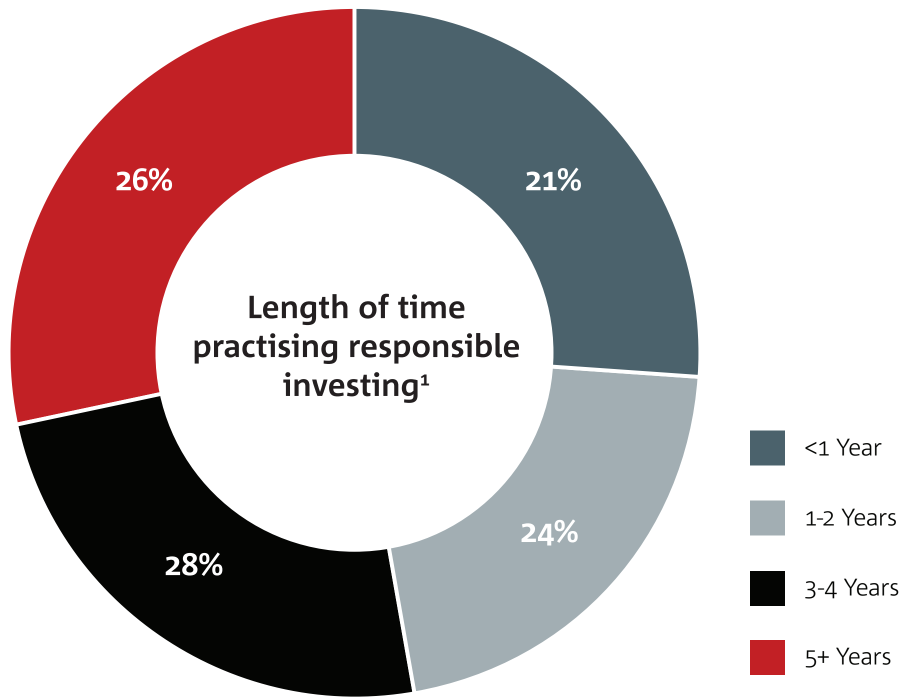
History, trends and drivers of change

ASSET MANAGERS HAVE A LONG HISTORY OF ESG

Asset managers have been increasingly adopting ESG practices for nearly two decades

The concept of investing with a broader goal in mind has been around for centuries, but modern ESG began in the asset management industry in the early 2000s. ESG practices were initially championed by listed equity asset managers and have since spread to all types of asset management. As of today, the majority of asset managers incorporate ESG practices and activities into their investment processes and seek to positively influence the ESG activities of companies in which they invest.





Despite a long history of responsible investing, the mainstream adoption of ESG across the industry is a recent phenomenon.[1]

Source: 1. Morgan Stanley Institute for Sustainable Investing , Sustainable Signals, 2020.

THREE FACTORS ARE DRIVING ESG ADOPTION BY ASSET MANAGERS

The most influential of these is asset owner demand

The most commonly cited reasons for adoption of ESG practices are client demand (81%), financial return potential (78%) and evolving policy and regulation requirements (76%).[1] In response to asset owner demands, the world's largest asset managers are increasingly committing to net zero emissions by 2050.

Asset Owner Demand
Impacts asset manager AUM

- Asset managers raise AUM from a range of asset owners including: institutional, high-net worth, wholesale and retail investors.
- Average asset management fees are in decline.[3] Across the industry profitability increases are being achieved by asset managers who are able to grow AUM.
- Against this backdrop, asset managers who do not meet their asset owners' ESG requirements are increasingly unable to raise or retain AUM. For example, for asset managers without a formal ESG investing approach:[1]
  - 22% of investors already limit allocations
  - 35% of investors have stated they will limit allocations in the future
  - 19% are not sure, but may move in that direction
- In addition to strong ESG capabilities, asset owners are starting to require Paris alignment. As a result asset managers are also committing to net zero emissions by 2050, or sooner, and Paris alignment.

Financial Performance of Investments
Impacts performance fees on AUM[2]

- As a result of fund level performance fees there is a direct link between the financial performance of companies in a portfolio and asset manager revenues.
- A recent review of hundreds of academic studies, published between 2016 and 2020, identified a positive or neutral relationship between:
  - general corporate ESG and investment returns in 59% of studies; and
  - emissions related ESG and investment returns in >65% of studies.[4]
- There is evidence that variability of investment return is reduced by strong ESG.
  - Application of concepts, such as inclusive and flexible employment practices build more resilient businesses.
  - During the COVID-19 pandemic, firms with high ESG scores recorded lower financial losses than those with lower scores.[5]
- Increased global awareness of these linkages is transforming ESG from a 'nice to have' into a 'need to do'.

Policy and Regulation
Impacts ability to operate

- The ESG requirements of the investment community can be viewed against a background of various, interlinking initiatives at the global, regional and individual country level.
- Global initiatives continue to be the main driver for ESG adoption. However, many countries have their own individual regulations and/or government-supported schemes to assist in promoting ESG adoption.
- Key global initiatives include:
  - The UN 2030 Sustainable Development Goals (SDGs)
  - The UN Principles for Responsible Investment (PRI)
  - Task Force on Climate-related Financial Disclosures (TCFD)
  - Sustainable Stock Exchanges Initiative (SSE)
- Many countries have implemented regional initiatives to achieve net zero by 2050, or some other date.[6]

Sources: 1. Morgan Stanley Institute for Sustainable Investing , Sustainable Signals, 2020; 4. NY Stern Centre for Sustainable Business, ESG and Financial Performance, 2021; 5. Refinitiv and Probability & Partners, How do ESG Scores Relate to Financial Returns, August 2020.

Notes: 2. Performance fees are common for actively managed portfolios, 3. Due to a low interest rate environment and the rise of passives. 6. E.g. The European Green Deal aims to achieve net zero emissions by 2050.

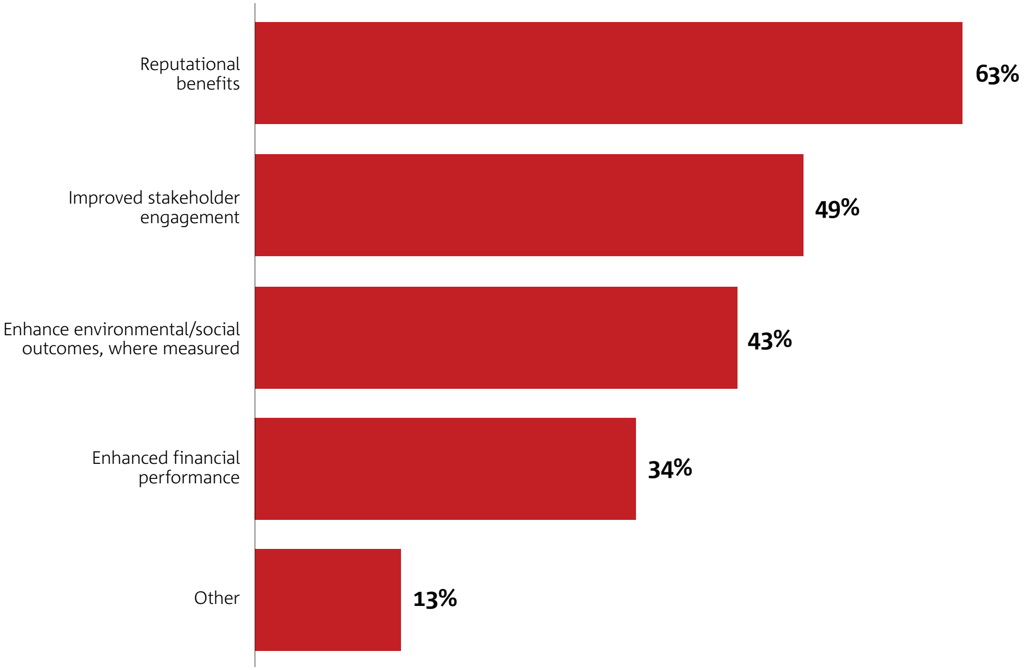
ASSET OWNER DEMAND FOR ESG IS DRIVEN BY A BELIEF IN THE BENEFITS

Particularly financial benefits and benefits to broader society

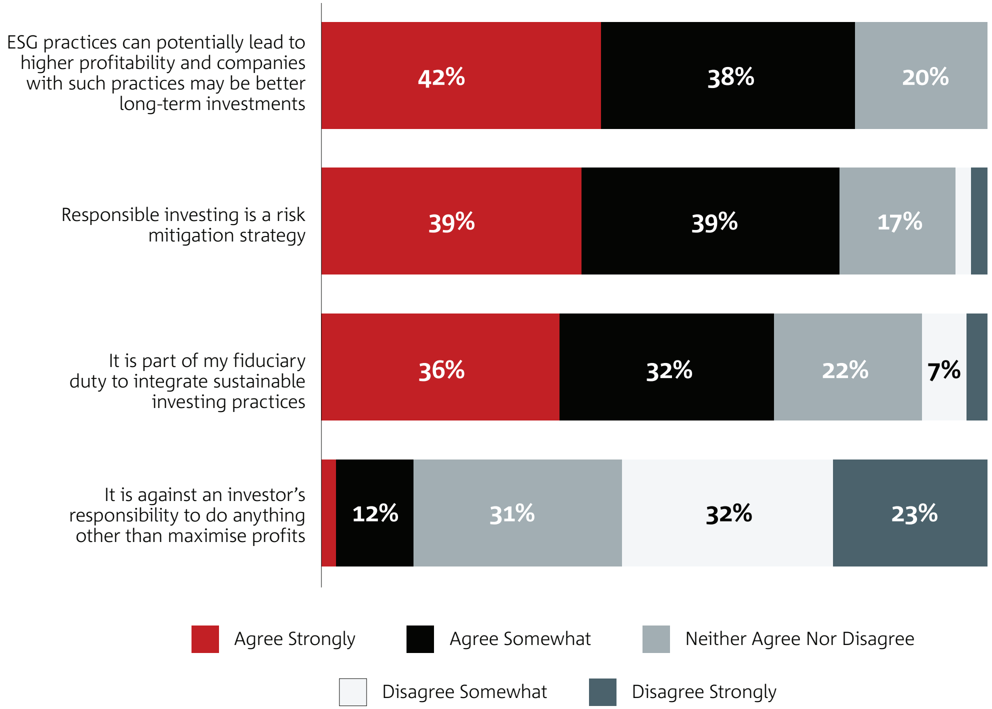
Asset owners who practise responsible investing identify:

- financial benefits from investing in companies with strong ESG;
- reputational and stakeholder engagement benefits; and
- a view that they have a responsibility to integrate responsible investing practices and deliver more to their stakeholders than profit alone.[1]

Beliefs of asset owner – Benefits from adoption of ESG and responsible investing practices[1]



Beliefs of asset owner – Views towards ESG and responsible investing practices[1]



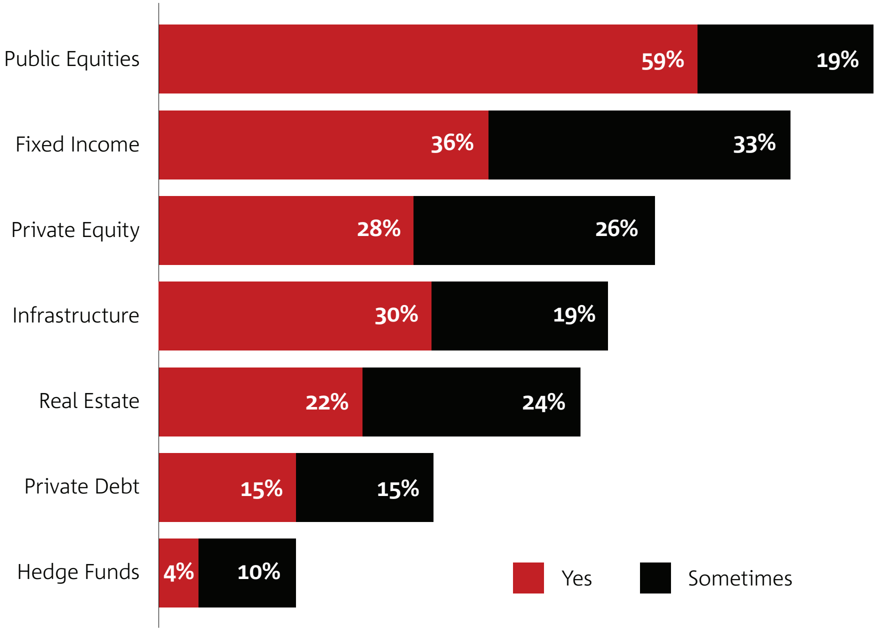
Source: 1. Morgan Stanley Institute for Sustainable Investing, Sustainable Signals, 2020.

ESG ADOPTION VARIES BY ASSET CLASS

Asset managers are most likely to adopt ESG practices when investing in public markets

Public equities (78%) and fixed income (69%) are the asset classes that attract the highest level of responsible investing activity. This is largely due to the quality and quantity of ESG relevant data that is available for these asset classes vs unlisted or specialist asset classes.

Asset managers currently practising or considering ESG and responsible investing (by asset classes)[1]



ESG activities are more common across public market asset classes because data quality and availability is higher.

ESG adoption and data considerations

There is both evidence, and a belief among asset managers, that strong ESG improves a company's financial performance. However, to date, asset managers' understanding of which ESG drivers are the most important for different companies, within different industries, has been limited. There are so many nuances around ESG that what is important for one company is not necessarily the same for another.

As a result, there has been a lack of equivalence around approaches and methodologies, making it challenging for fund managers to engage consistently with, and effectively apply ESG policies in practice.

In addition, few asset managers have the tools to assess the alignment of their investments in individual companies against their own responsible investing goals.

Availability and quality of data is a commonly cited as a challenge for fund managers. Most asset managers:

1. Receive a large volume of varied data requests from their own investors;
2. Are not able to easily access ESG related company data they may want; and
3. Are unable to quantitatively support the validity of the data and metrics they use to assess company ESG performance.

Source: 1. Morgan Stanley Institute for Sustainable Investing, Sustainable Signals, 2020.

ESG, AVAILABILITY OF EQUITY AND COST OF EQUITY

Giving consideration to current and future trends

>3/4 GLOBAL AUM IS LINKED TO MANAGERS WITH ESG COMMITMENTS

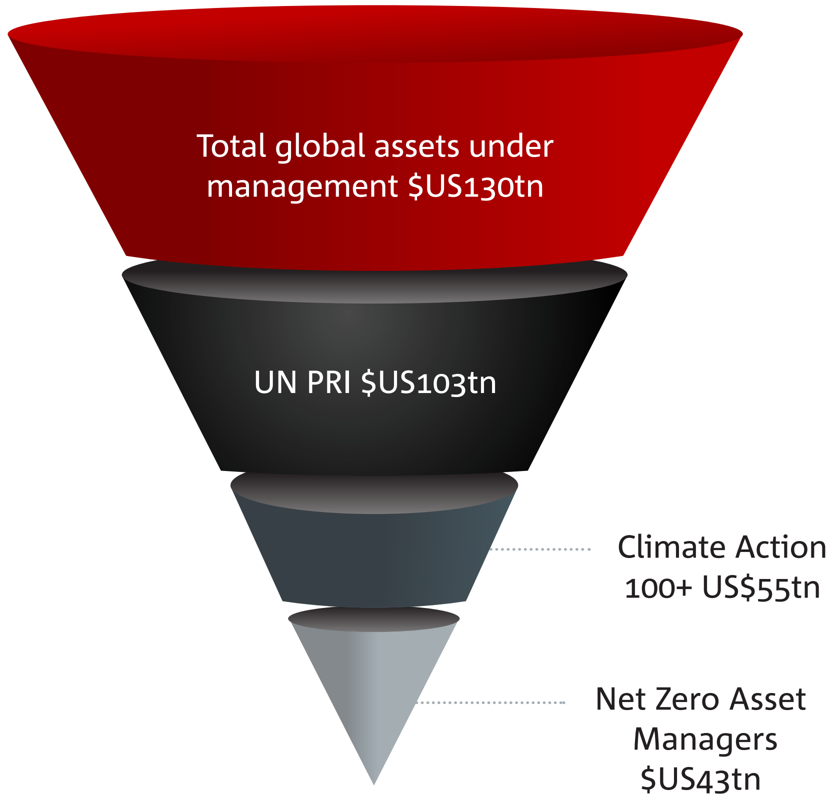
These managers have signed up to initiatives such as UN PRI, Climate Action 100+ & Net Zero Asset Mgrs

Equity is shifting to investments with positive ESG characteristic.

Key initiatives that asset managers are signing up to include:

- **Principles for Responsible Investment (PRI):** United Nations supported international network of investors working together to implement six aspirational principles.
- **Climate Action 100+:** The largest ever investor engagement initiative on climate change. 545 asset managers and owners are working with 167 companies who are responsible for over 80% global emission to achieve net zero emissions
- **Net Zero Asset Managers:** Includes asset managers committed to support the goal of net zero emissions by 2050 or sooner, in line with global efforts to limit global warming to 1.5 degrees Celsius.

AUM held by asset managers who have signed-up to key ESG bodies[1]



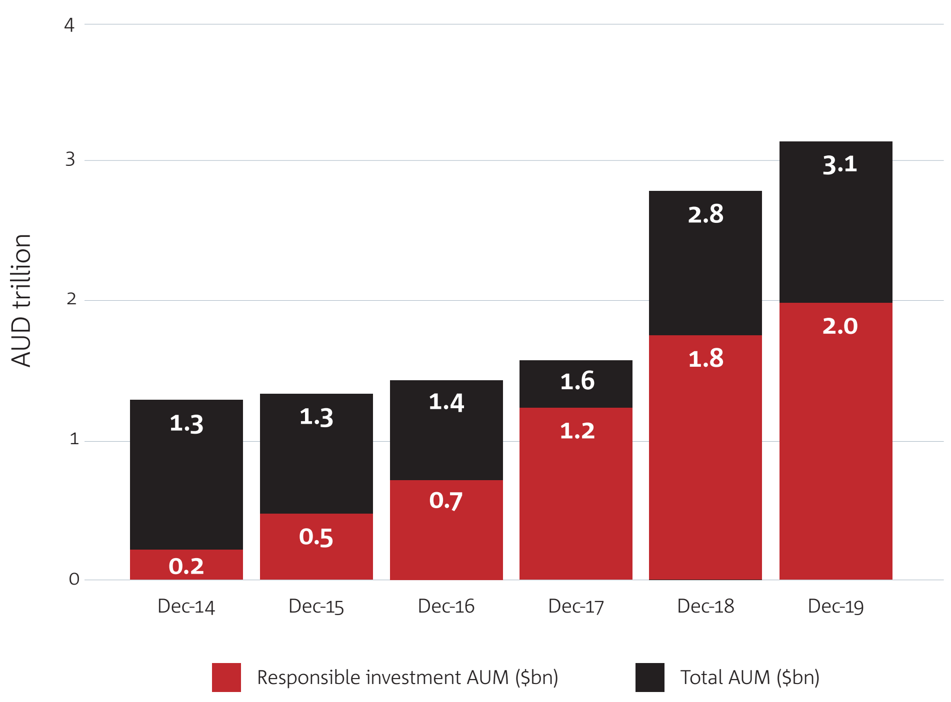
Source: 1. Principles for Responsible Investing (PRI), 2020; Climate Action 100+, 2021; Net Zero Asset Managers, 2021; NAB Analysis, 2021.

AUM INVESTED IN ESG FUNDS OR MANDATES IS GROWING FAST

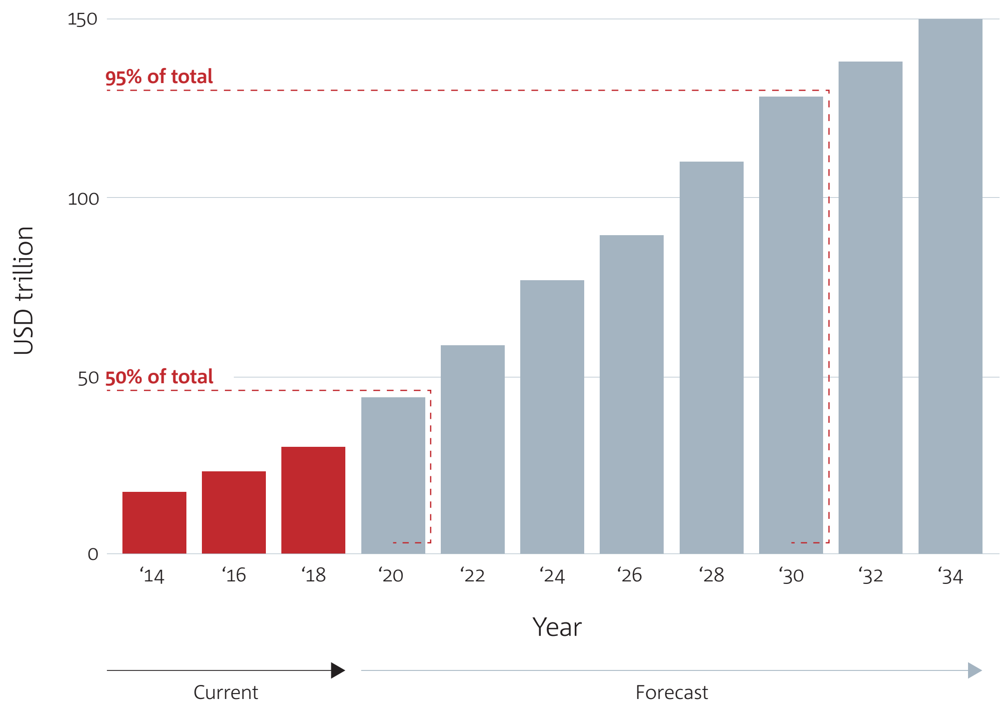
Impacting availability of equity for businesses with positive or negative ESG characteristics

Globally, ESG funds and mandates have reached nearly US$50tn in AUM and currently represent about 50% of total global institutional AUM (c.US$100tn). By 2030 ESG funds and mandates may represent up to 95% of total institutional AUM.[2]

ESG invested AUM and total AUM in Australia (AUDtn)[1]



Global institutional AUM invested in ESG funds & mandates (USD tn)[2]



MOST REGIONS ARE EXPERIENCING STRONG GROWTH IN ESG AUM

European and Australasian growth in responsible investing impacted by definitions

Strong growth in responsible investing has been experienced across most regions. Europe and Australasia have enacted significant changes in the way sustainable investment is defined in these regions, so direct comparisons across years are not easily made.[1]

Europe

- Several UN led initiatives have pushed Europe to the forefront of ESG.
- In 2019, the European Union:
  - introduced a new "taxonomy" to standardise how sustainability measures are integrated into financial systems; and
  - announced new ESG disclosure rules for investment managers.
- In 2020, the European Securities Market Authority (ESMA) rolled out a Sustainable Finance Strategy building on these frameworks to improve transparency around ESG.

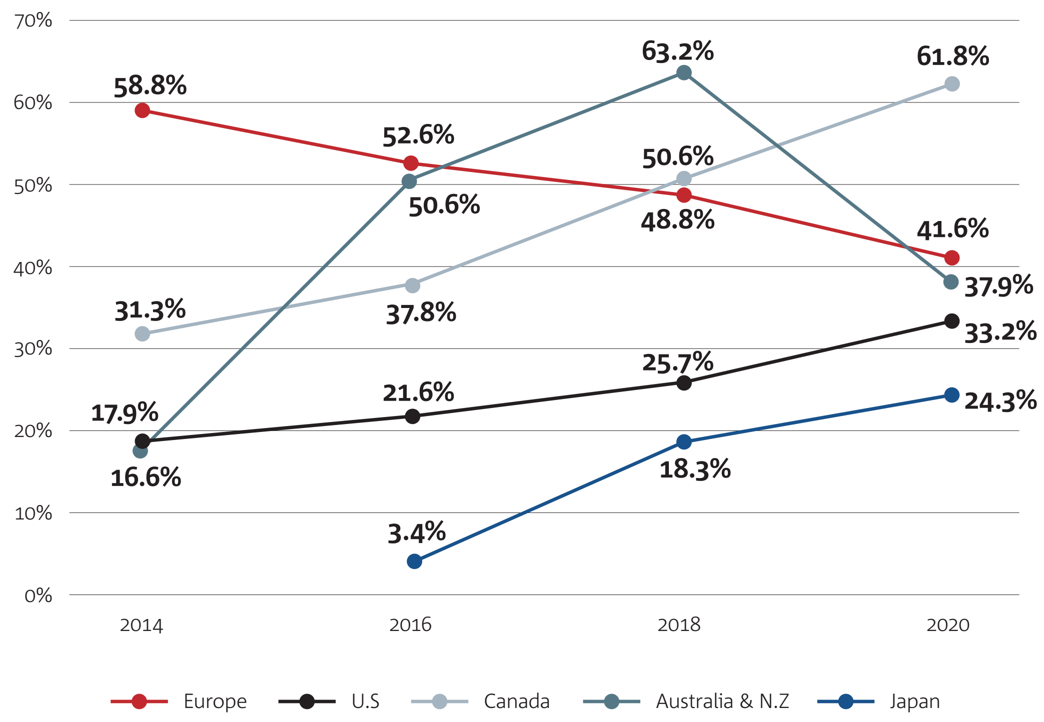
North America

- The relatively slow adoption of ESG in the US is due to:
  - deep roots of shareholder primacy in U.S. business practice;
  - strong skepticism towards regulation; and
  - legal obstacles to new disclosure requirements.
- Political headwinds may be shifting under the leadership of Joe Biden.

Asia

- While ESG investing in Asia continues to progress slowly, Japan is emerging as a region of ESG activity growth, driven by:
  - Structural reforms initiated under "Abenomics" to redirect Japanese firms to the expectations of modern, global investors;
  - Japan's Government Pension Investment Fund (GPIF), which is the largest retirement fund in the world; and
  - The Japanese Stewardship Code initiated in 2014.

Portion of Sustainable Investing Assets Relative to Total Managed Assets[1]



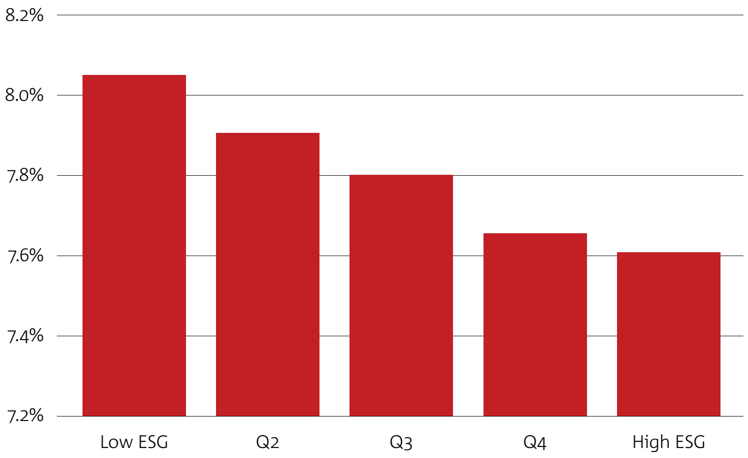
Source: 1. Global Sustainability Investment Alliance, GSIR Review, 2020 (in 2014, data for Japan was combined with the rest of Asia).

DUE TO HIGH DEMAND FOR INVESTMENTS WITH STRONG ESG CHARACTERISTICS

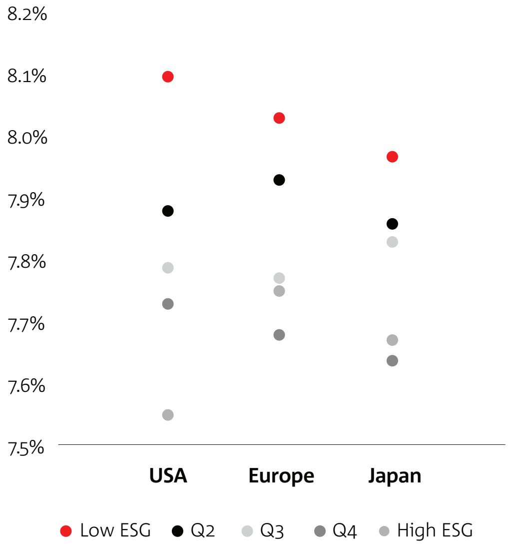
Cost of equity is now impacted by a company's ESG characteristics

There is evidence that a high ESG rating reduces a company's cost of equity in all regions of the world. In addition, there is a strong belief among companies that the positive link between a company's ESG performance and cost of equity will grow in the future, particularly for traditionally high emitting sectors such as energy, mining and utilities.

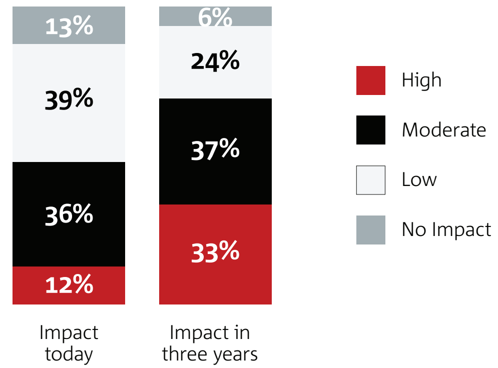
Global - cost of equity[1]



Regional - cost of equity[1]



Perceived effect of company related ESG issues on the cost of capital today and in three years' time[2]



- A study of over 1,500 companies from 2015 to 2019 found that on average, companies with a high ESG score experienced a lower cost of equity compared to companies with poor ESG score in both developed and emerging markets[1].
- A survey of 1,000 CFOs in 18 countries found that:
  – 48% of CFOs believe their ESG performance has a moderate or high impact on cost of capital now; and
  – 70% of CFOs expect their ESG performance to have a moderate or high impact on the cost of capital in three years' time.
- In addition, the survey identified a strong belief among CFOs that the link between a company's ESG performance and future cost of equity is greatest for companies in high emitting sectors.
  – Energy, mining and utilities were identified as the sectors with the strongest perceived relationship between ESG performance and their cost of capital. The transition towards cleaner energy sources has been an area of focus for these sectors for some time and will remain a priority in the longer term.

Source: 1. MSCI, ESG and the Cost of Capital, 2020; 2. Deloitte, Financing a Sustainable Transition, 2020.

POSITIONING FOR SUCCESS

Pathways to improve availability of equity and cost of equity

ASSET MANAGERS UNDERTAKE A RANGE OF ACTIVITIES

To deliver on their ESG objectives

They use three key types of investing activities in conjunction with voting and engagement to maximise ESG benefits.

Investing Activities

Integration

ESG Integration
- >90% asset mgrs[1]
- c.25% AuM[2]
- US$25tn[2]

Screening

Negative Screens
- >90% asset mgrs[1]
- c.15% AuM[2]
- US$15tn[2]

Norms Based Screens
- >60% asset mgrs[1]
- c.4% AuM[2]
- US$4tn[2]

Positive Screens
- >50% asset mgrs[1]
- c.1% AuM[2]
- US$1tn[2]

Thematics

Sust. Themed
- c.2% AuM[2]
- US$2tn[2]

Impact Invest
- <1% AuM[2]
- <US$1tn[2]

Stewardship Activities

Stewardship

Voting
- >98% asset mgrs[1]
- 100% AuM[2]
- US$100tn[2]

Engagement
- >80% asset mgrs[1]
- 11% AuM[2]
- US$11tn[2]

- **ESG Integration** – The systematic and explicit inclusion by asset managers of ESG factors into investment decision making.
- **Negative Screening** – The exclusion from an investment portfolio of certain sectors or companies based on specific ESG criteria, such as: 1) what goods and services a company produces; and 2) adequacy of a company's or country's response to emergent risks (e.g. climate change).
- **Norms Based Screening** – The exclusion from an investment portfolio of certain companies based on minimum standards of business or government practice.
- **Positive Screening** – Intentionally tilting a proportion of an investment portfolio towards positive solutions, or targeting companies or industries assessed to have better ESG performance relative to benchmarks or peers.
- **Sustainability Themed** – Investment in activities, assets and programs intended to generate positive social and environmental improvements (e.g. safe & accessible water, sustainable agriculture, green buildings, lower carbon emissions, community programs). Approach prioritises both financial returns and sustainability.
- **Impact Investing** – investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return. At times financial hurdles are lowered in order to achieve targeted sustainability outcomes.

- **Voting** – Involves influencing a company's strategy, priorities and activities through the use of position and legal rights as an equity holder.
- **Engagement** – Involves working with a company, or companies, to improve how they manage or disclose ESG related risks, activities and performance.

Source: 1 Principles for Responsible Investing, 2020; Schroders, 2018; Morgan Stanley, 2020; expert interviews and internal NAB analysis. 2 Global Sustainable Investment Alliance, 2020; with US$ value of AUM calculations based on global institutional AUM of c.US100tn.

A: ESG INTEGRATION – CHARACTERISTICS AND APPROACHES

ESG integration is the core ESG activity undertaken by most asset managers

ESG integration is common for both public and private market asset managers and forms a base for other ESG activities. However, approaches to ESG integration vary between public and private market asset managers.

Public Markets
(e.g. Public Equities Investors)

ESG integration is an ongoing process that is able to be incorporated in all investment styles.

Key steps in ESG integration involve: 1) research (including selection of ESG drivers, ESG metrics and data); 2) valuation and assessment; and 3) portfolio construction and management.

Fundamental investing:

- ESG factors are able to be integrated into both qualitative analysis and quantitative valuation models alongside other material factors. Asset managers adjust forecasted financials or company valuation models for the expected impact of ESG factors.[1]

Quantitative, systematic and smart beta:

- ESG factors can be integrated into quantitative models alongside factors such as value, quality, size, momentum, growth and volatility.
- ESG factors and scores can be used as a weight in smart beta portfolio construction to contribute to excess risk adjusted returns, reduce downside risk and/or enhance a portfolio's ESG risk profile.

Index investing:

- Material ESG issues can be identified and translated into rules that feed into portfolio construction, alongside traditional factors.
- The overall ESG risk profile, or exposure to a particular ESG factor, can be reduced by adjusting index constituent weights or by tracking an index that already does so.

Private Markets
(e.g. Infrastructure Investors, Private Equity)

ESG committed funds do not rebalance their portfolios regularly. As a result ESG integration is undertaken in different ways during different stages of the asset lifecycle.

Acquisition:

- ESG is an important part of the acquisition research and due diligence process. Asset managers often have well developed industry specific ESG issue lists that they utilise when considering an investment. They also engage with specialist firms for certain ESG topics.
- Converting risks to value at risk (VaR) is challenging. Right now, most asset managers undertake qualitative assessments of financial risk.
- A poor ESG score is not necessarily viewed as a concern. In many cases it will be considered an opportunity if ESG improvement and value capture is possible.

Ongoing investment management:

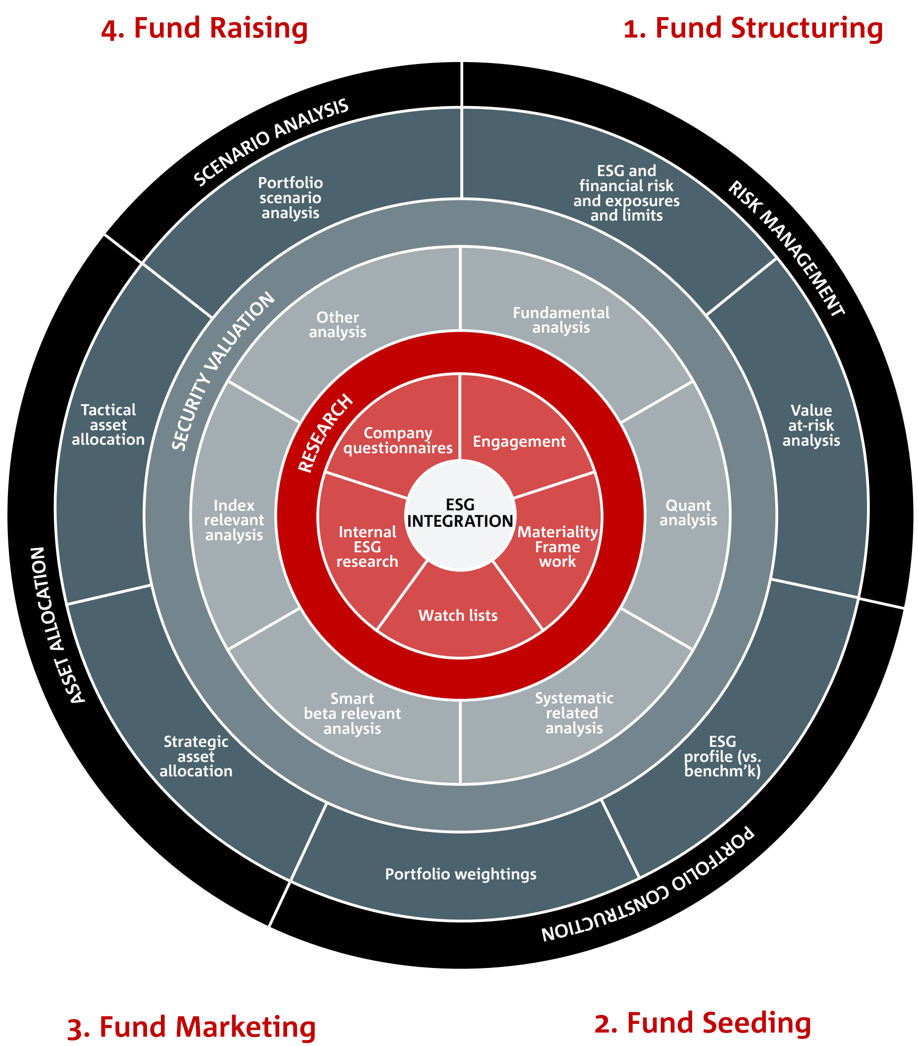
- Private markets asset managers will seek to directly influence the ESG performance of a company they own. Partial or full owner status allow asset managers to engage far more effectively than listed equity owners.
- Unlisted equity managers often encourage portfolio companies to utilise standards and assessment processes set by organisations such as SASB or GRESB to determine ESG performance, influence strategy, set targets and track progress.

Note 1. Company valuation models may include, dividend discount model, the discounted cash flow model and adjusted present value model.

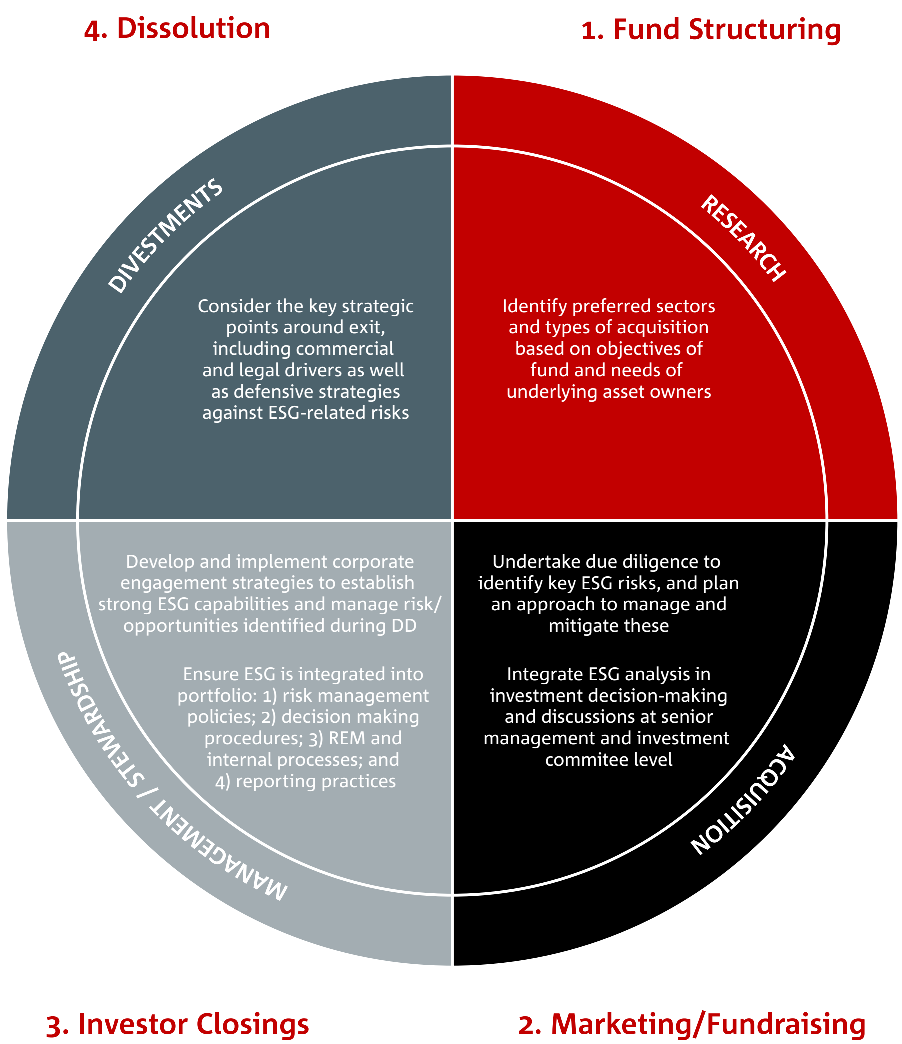
A: ESG INTEGRATION – KEY STEPS BY INVESTOR TYPE

ESG integration is undertaken in different ways by different types of asset managers

Public Markets – ESG Integration Steps



Private Markets – ESG Committed Fund Steps



Source: 1. PRI, An Introduction to Responsible Investment, 2020; Preqin, Integrating ESG Can Help Fund Managers Raise Capital in More Regions, 2020; NAB analysis.

A: ESG INTEGRATION – KEY STEPS IN MORE DETAIL

Key steps in ESG integration are relevant for both public and private market funds

As the ESG expectations and requirements placed on asset managers increase, these same expectations and requirements will be placed on companies in which asset managers invest. Understanding steps in ESG integration is core in efficiently and effectively undertaking activities that will reduce a company's cost of equity and increase availability of equity (and/or share price).

Key Steps in ESG Integration

1. Research	• **Industry** – Identify which sub-industry (or industries) a company sits within • **Sustainability drivers** – Identify sub-industry specific sustainability drivers that are material and how these drivers impact value creation • **Accounting metrics** – For each sustainability driver identify a set of quantitative and/or qualitative accounting metrics intended to measure performance[1] • **Materiality weightings** – Identify sector materiality weightings for accounting metrics and sustainability drivers • **Data** – Obtain relevant quantitative and qualitative information and data[2,3] – There is a need for better company reporting and data. However, there is a long way to go before there are commonly agreed metrics and data requirements – To date, ESG assessment at the company level has largely been Excel, or paper-report driven
2. Valuation & assessment; or due diligence	• **Quantitative** – Integrate quantitative metrics into financial analysis and valuation. For example by making adjustments to required rates of return, valuation multiples, forecast earnings, cash flows and balance sheet strength • **Qualitative** – Undertake qualitative analysis
3. Portfolio construction & management; or Asset acquisition and disposal	Examples of approaches to utilise ESG integration include: • Consideration of ESG analysis in decisions around sector weightings or companies to be included in a portfolio • Consideration of external fund manager ESG ranking when outsourcing asset management activities • Consideration of ESG analysis in decisions to acquire or dispose of a stake in a privately held company

Source: 1. PRI, An Introduction to Responsible Investment, 2020

Notes: 1. Each accounting metric is accompanied by a technical protocol that provides guidance on definitions, scope, implementation, compilation, and presentation; 2. Asset managers source data and information from 1) engagement; 2) via company questionnaires; 3) from their own analysis and 4) from external data providers.

A: ESG INTEGRATION – RECOMMENDATIONS

Companies can undertake activities to improve cost and availability of equity

1. Seek to understand the ESG position, goals and needs of key asset managers[1]
– Consider their: 1) ESG priorities; 2) preferred ESG drivers and metrics; 3) preferred data sources; and 4) reporting requirements
– Consider how they will assess your company's: 1) progress against ESG strategy; 2) ESG risks (transitional and physical); and 3) ESG impact (e.g. carbon emission reductions etc)

2. Review best practice for your industry
– Consider ESG application and reporting recommendations provided by key bodies such as: 1) SASB and GRESB, for industry specific guidance; 2) GRI, for expectations regarding material ESG issues; and 3) TCFD, for climate-related risks

3. Develop or refine a Board approved ESG strategy, priorities, sustainability drivers and metrics
– This should be strongly guided by company specific characteristics

4. Provide relevant and consistent disclosures
– Provide data that meets asset manager requirements, while also being specific to the company
– Be consistent in approach to reporting, communications and data

5. Engage, educate and influence
– Educate key stakeholders on the unique characteristics of your company
– Seek to influence the ESG drivers and key metrics used by asset managers to assess your company
– Proactively respond to ESG investment related requests
– Ensure ratings and data available from external data providers represent your business well[2]

Note: 1. In event of M&A activity seek to understand the ESG characteristics and needs of potential buyers and include ESG performance in any vendor due diligence (VDD) process.;
2. Common data providers include: 1) MSCI ESG; 2) Sustainalytics; 3) Institutional Shareholder Services (ISS); and 4) GRESB. Due to differences in ratings approaches, correlations between different listed equity ratings providers can be low. See stewardship recommendations to compliment the recommendations above.

B: SCREENING – CHARACTERISTICS AND APPROACHES

Screening is a core ESG activity for the vast majority of asset managers

The use of screening for ESG purposes when constructing a portfolio has a long history with responsible investment. This can be traced to faith-based approaches to avoiding, or divesting from, companies which were involved in activities seen as incompatible with beliefs or values.

Negative Screening:

- Negative screens typically focus on companies involved in controversial activities. Negative screening does have a cost. The cumulative long term returns of MSCI world index fall slightly when common negative screens are applied.[1]

Norms based screening:

- Typically focus on performance relative to international norms such as those issued by the UN, OECD and NGOs (e.g. Transparency International) and may include exclusions of investments that are not in compliance, or over / underweight.

Positive screening:

- Focus on investing in sectors, companies or projects selected for positive ESG performance relative to industry peers. Positive screening is one of the fastest growing approaches to ESG investing.

Approaches to ESG Screening

Public Markets
(e.g. Public Equities Investors)

- Screens are a very popular ESG tool for public markets investors.
- Much of the pressure to apply screens is morally based and is coming from the ultimate beneficiaries of the relevant asset manager's investments.
- A global study of 800 institutional investors found that most adopters of ESG deploy screening into their investment decision making.[1]
- Screening is commonly combined with ESG integration.[1]

Private Markets
(e.g. Infrastructure Investors, Private Equity)

- Private market asset managers are less likely to have formal screens. However, many effectively implement screens through ESG risk and investment processes. For example:
  - A large portion of private markets managers do not invest in traditional 'sin' industries (e.g. tobacco, gambling, alcohol, pornography).
  - Increasingly investment committees are avoiding controversial carbon intensive industries, due to the requirements and expectations of their asset owners.
- Private markets asset managers are more likely to focus on a path to achieve alignment with ESG investment goals, instead of requiring high initial ESG ratings. An investment with poor ESG characteristics can provide an opportunity to capture value.

Source: 1. Responsible Investment Association Australasia, UNPRI, An Introduction to Responsible Investment Screening, 2020; Schroders, Global Investors Study, 2020.

B: SCREENING – KEY STEPS

Similar screens constructed with slightly different processes can have very different outcomes

Differences between absolute, threshold and relative approaches can provide opportunities.

Key Steps in ESG Screening

1. Determine screen priorities:	Asset managers seek to maximise both retail and institutional AUM raisings by listening to their asset owners and offering products (with screens) that meet their needs.
2. Define & publicise clear screening criteria	**Retail funds:** Include screening criteria in marketing documentation and literature. **Institutional products:** Agree on screening criteria during negotiations with client/trustee board. Include criteria in Investment Management Agreement (IMA) and vocalise during ongoing discussions with asset owners.
3. Adapt investment processes	Adjustments to investment processes will be determined by screens being implemented and rules being adopted: **Absolute exclusion / inclusions** · **Threshold exclusion / inclusions** · **Relative exclusion / inclusions** Assess and adjust for screen implications on factors such as tracking error and style bias. Discuss these with impacted clients.[1]
4. Introduce oversight	Through an external advisory committee or by empowering internal compliance to conduct reviews, monitor implementation and results, and criteria changes. Screens are often based on data, obtained from third-party providers, which feeds into internal order management systems to ensure compliance during portfolio construction.
5. Undertake monitoring, reporting & audit	Implement controls to ensure the agreed-upon screening criteria are being implemented. Checks and reviews may be conducted by internal compliance personnel, or by an external advisory committee. It is increasingly popular to use an independent body or committee for this purpose.

**The steps outlined are largely applied by Public Market asset managers. However, increasingly private markets managers' policies and positions are impacting investments.*

Note: 1. Engagement will only occur with companies already in a portfolio who may be screened out. Engagement will not occur with companies in whom investment never occurs.

B: SCREENING – RECOMMENDATIONS

Screening arguably has the biggest impact of all ESG investing activities and should be a priority

1. Identify screens applied, or being considered, by key asset managers

– Engage with key shareholders to understand the types of screens they apply and how they are applied

2. Consider market wide screening trends

– As an example, while fossil fuel exclusions are currently small, high interest means the value of negatively screened assets is growing quickly from a low base, particularly for thermal coal

3. Take action if your company may be impacted by a negative screen

– Elevate discussions to senior management and Board level to consider strategic options

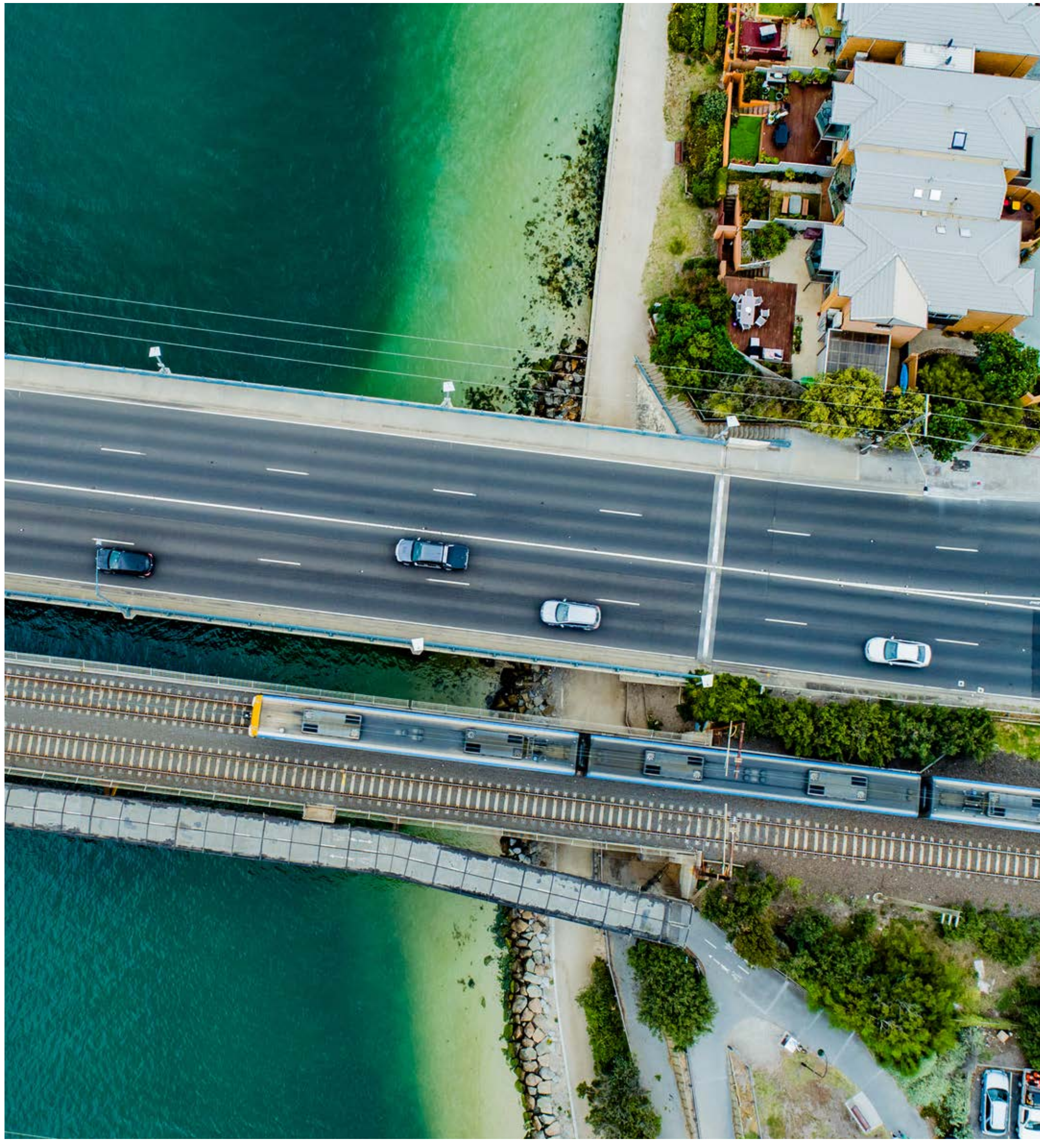
– Recognise relevant ESG risk(s) and provide a path to mitigate these through a well considered strategy and initiatives

– Highlight the positive and differentiating ESG aspects of your company. Many asset managers will be seeking help to provide a case to their asset owners that allows them to retain their portfolio performers

4. Consider opportunities to refine ESG strategy and priorities to benefit from positive screens or norms based screens

– Best in class ESG activities can result in inclusion in positive or norms based screens, regardless of industry

– Recognise relevant ESG opportunities and establish a clear plan to outperform in relevant areas

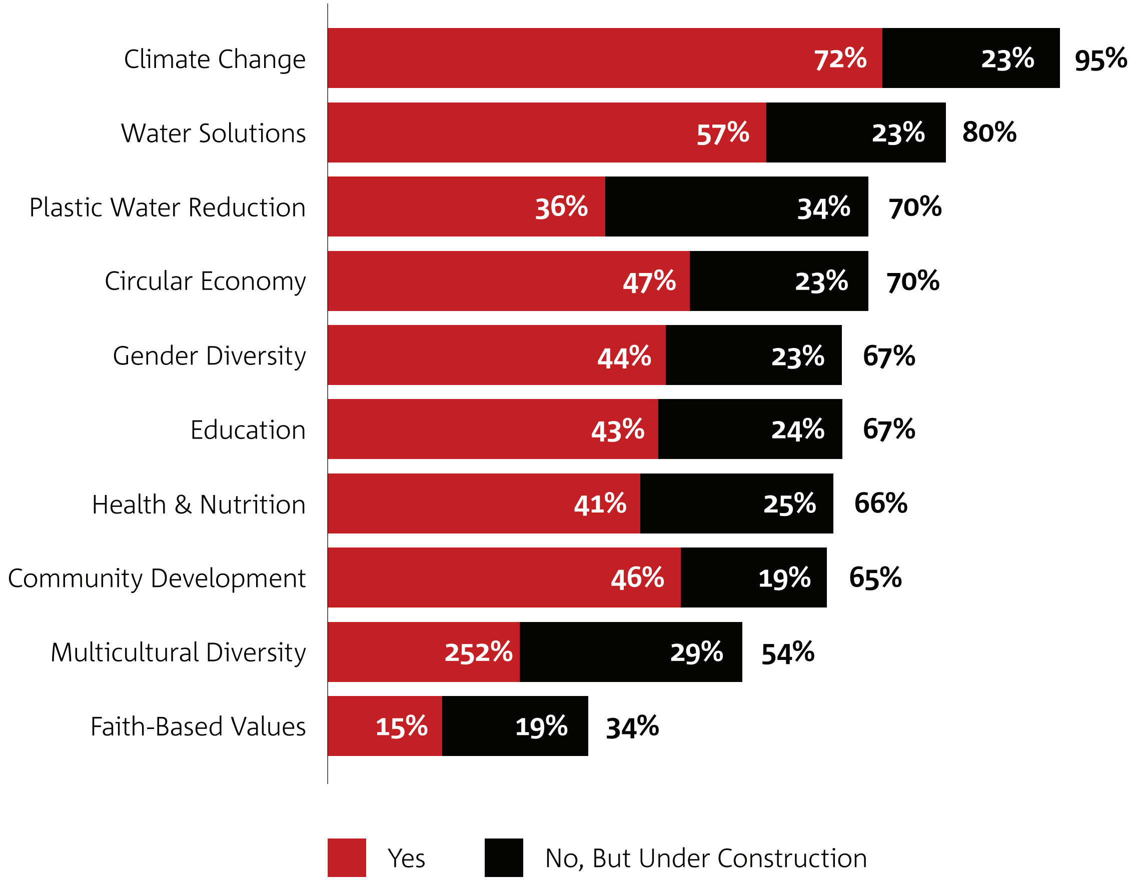


C: THEMATIC INVESTING – CHARACTERISTICS

Thematic investing is growing fast off a relatively small base

Thematic based investing is only undertaken by c.3% of assets under management but is growing at over 30% p.a.

Asset manager observations - ESG issues currently addressed within thematic funds



Source: 1. Morgan Stanley Institute for Sustainable Investing, Sustainable Signals, 2020.

C: THEMATIC INVESTING – CHARACTERISTICS

Thematic funds often apply a range of ESG investing and stewardship activities to a high standard

Public markets managers are increasingly offering thematic funds within their broader portfolio. Private markets managers are increasingly incorporating sustainability themed activities into their portfolio, but don't necessarily classify their activities as thematic.

Approaches to Thematic Investing

Public Markets (e.g. Public Equities Investors)	**Private Markets** (e.g. Infrastructure Investors, Private Equity)
• The difference between a regular fund and a thematic fund often relates to the fund's strategy and objectives. • Similar ESG approaches are utilised, such as ESG integration and screens. However, these activities are often applied to a very high standard.	• Unlisted equity managers and infrastructure investors are more likely to embed sustainability across everything they do, as opposed to set up sustainability specific funds. • Consistent with their ability to drive genuine positive change in their portfolios.

Key Steps in Thematic Investing

1. **Determine thematic strategy and priorities**
2. **Define and publicise** Thematic objectives and approach
3. **Adapt investment processes** Utilise ESG integration & screens to deliver desired thematic strategy and priorities
4. **Introduce oversight** Through an external advisory committee or by empowering internal compliance
5. **Undertake portfolio construction, management and oversight**
6. **Implement monitoring, reporting and audit**

Take-outs for Companies

1. Identify any thematic fund investors on your company's register and identify trends relevant to your industry
2. Apply previously outlined recommendations relating to ESG integration and screens. In combination, these activities are likely to maximise your positioning in relation to thematic investors

D: STEWARDSHIP – CHARACTERISTICS AND APPROACHES

Stewardship activities are experiencing significant growth and change

Stewardship is one of the fastest-growing ESG related activities. Through stewardship public markets investors seek to: 1) better manage material ESG issues in their portfolio; 2) increase the quality of information they disclose to asset owners on ESG issues; and 3) improve corporate practices, partially in areas such as reporting.

Public Markets
(Public Equities Investors)

Engagement:

- Engagement is an essential part of integrated ESG risk management.
- Engagement is ideally proactive and based on a company's performance against key ESG risk areas, often relative to peers, that are material to an asset manager's portfolio.
  – However, often substantial engagement is a reactive response to an emerging issue.
- Transition risk is an increasing area of focus for asset managers.
  – A meaningful number of asset owners are demanding asset managers align with the Paris Agreement and TCFD. This is impacting engagement practices with companies.
- Asset managers will engage individually, or in groups, with the companies in which they invest.
  – Traditionally engagement was largely a bilateral process. If relevant bilateral engagement was unsuccessful, investors would consider escalation strategies including contacting the board, reducing exposure or, as a last resort, divesting.
  – Asset managers are increasingly working together to maximise their influence in the most efficient way possible, e.g. Climate Action 100+.

Voting:

- Voting is core to how asset managers influence a company's ESG strategies and activities.
  – It is good practice to communicate with investee companies before and after the AGM and explain the reasons for any votes against management or voting abstentions.
  – Public reporting of voting decisions is becoming increasingly common. E.g. through UN PRI.
- Asset managers are adopting a targeted, structured and proactive approach to voting.
- They vote individually but are increasingly coordinating their voting activities, particularly for proposals that are put forward by a major initiative based organisations such as Climate Action 100+.
- Environmental and social issues are dominating pre-AGM conversations.
  – Asset managers are requesting ESG transparency and accountability during these conversations.
- The number of ESG related (and particularly climate related) shareholder resolutions being put forward at AGMs is increasing.
- At times a company's management team will partner with one or more asset managers on their register to ensure support for a resolution. This approach is a response to increased levels of advocacy group involvement.
- Asset managers are starting to become more willing to vote against the re-election of Directors, where ESG concerns are identified.

D: STEWARDSHIP – APPROACHES

Stewardship is a core ESG activity for unlisted equity investors

Stewardship is an incredibly important tool for unlisted equity investors. They use engagement to achieve positive ESG outcomes and deliver value to their clients.

Private Markets
(e.g. Infrastructure Investors, Private Equity)

Engagement and Voting:

- Engagement and voting activities are interrelated activities for many private market asset managers.
- Private market asset managers often hold one or more Board seats for any given company in which they hold an investment.
  – This places them in an excellent position to achieve positive ESG change.
- Where an asset manager does not hold a controlling, or large equity stake, they may still be able to exert significant influence on ESG activities by working with other shareholder to achieve their ESG objectives.
- Key areas of Board level ESG focus usually include:
  – ESG strategy and initiatives.
  – Assessment and performance measurement (e.g. utilising SASB, GRESB or Infrastructure Sustainability Council (ISC) standards).
  – Commitment to reporting.
- Larger asset managers may also:
  – Share learnings by bringing together portfolio CEOs, who are experiencing similar challenges and opportunities.
  – Provide access to experts in key fields relevant to portfolio companies.

D: STEWARDSHIP – CHARACTERISTICS AND KEY STEPS

Engagement, voting and investment decisions are strongly linked

Stewardship is generally regarded as one of the most effective mechanisms to reduce risks, maximise returns and have a positive impact on ESG outcomes.

Key steps and interaction – voting, engagement and investment decisions[1]

Engagement

Research on the issue
Determine which ESG issues are material to the portfolio

Select companies
Prioritise which companies to engage, e.g. problem sectors or markets, worst performers

Set objectives
Choose objectives and milestones including how to track them

Engage
Meetings, emails/letters, site visits (individually or collaboratively)

Escalate if necessary
Strengthen position through collaboration, file a shareholder resolution, vote against directors

Voting

Review voting agendas
Decide how to vote based on research

Clarification
If required, collect further information from the company to make a voting decision

Submit voting instructions
Let the company know of the voting decision in advance and potentially report voting decision

Shareholder proposal
Submit an item for the agenda

Investment decision

ESG integration
Information learned from engagement feeds into investment analysis

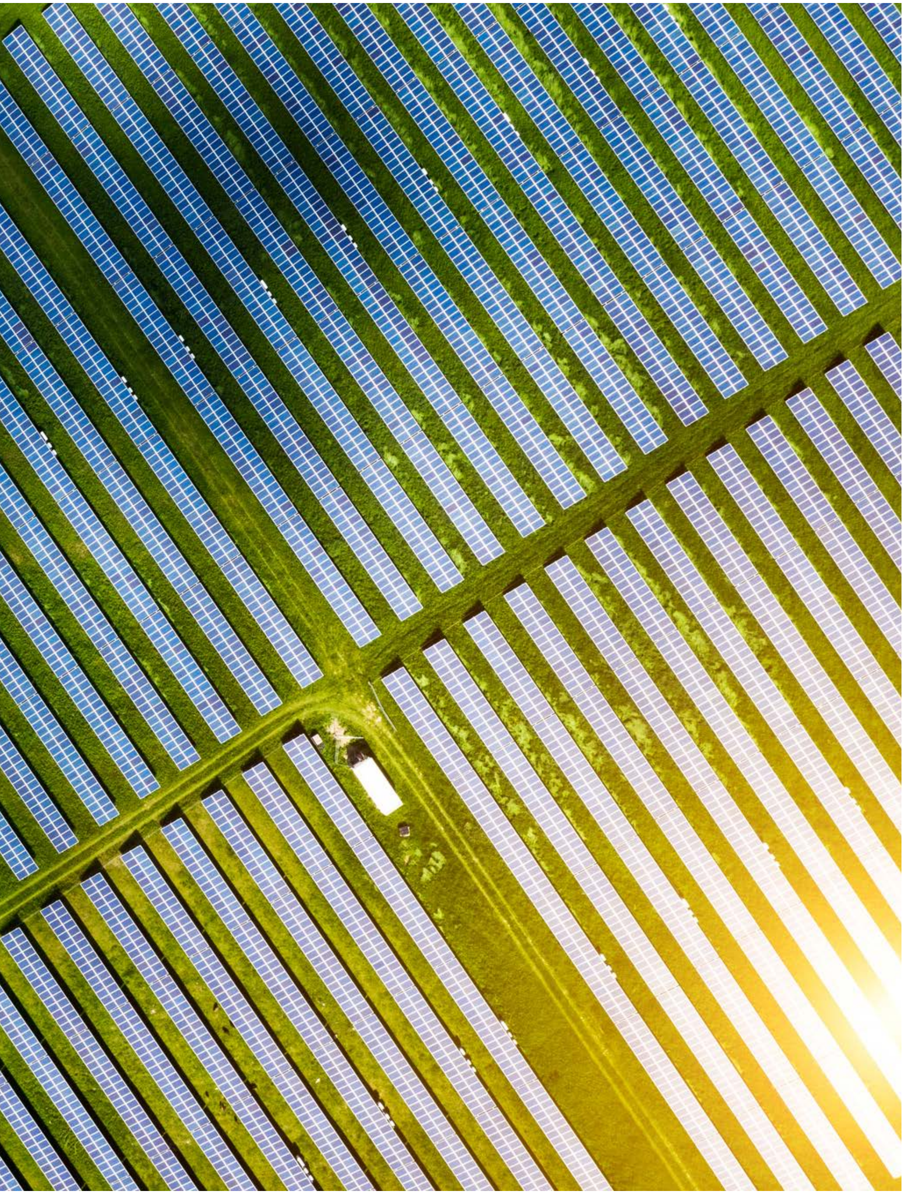
Divest
Investors can divest as a last resort

As asset managers increase their stewardship activities, companies are experiencing the following:

- Increased meeting requests
- Increased data requests
- Increased number of shareholder resolutions
- Additional resourcing requirements

Source: 1. PRI, The Evolution of Responsible Investment an Analysis of Advanced Signatory Practices, 2021.

D: STEWARDSHIP – RECOMMENDATIONS



1. **Actively engage with asset managers and stakeholders broadly**
   – Determine views on your company's ESG strengths and weaknesses, and identify recent changes in views
2. **Develop annual ESG priorities for discussion with asset managers**
   – These should support your company's ESG 1) priorities; 2) strengths; and 3) areas of future development
   – Prepare for questions that asset managers will ask regarding their own priorities
3. **Develop an engagement program with key asset managers (outside of reporting and AGM season)**
   – Undertake activities that will help build relationships and educate asset managers about the unique characteristics of your company
   – Bring together your company's senior management and ESG professionals with relevant asset managers ESG professionals and investment professionals[1]
   – Ensure consistency of message
4. **Proactively engage on sensitive topics**
   – Where an announcement may not be well received by asset managers, engage with them in advance
   – Make adjustments for asset manager feedback where possible
   – Proactively respond to investor questions and requests
5. **Respond to shareholder resolutions**
   – Review ESG related (and particularly climate related) shareholder resolutions being put forward at AGMs
   – Present an alternative case and data where required
   – Where reasonable, respond with positive and constructive action, even if they do not pass

Note: 1. Engaging with asset managers, ESG professionals and investment professionals helps to ensure consistent views are formed across the relevant asset manager.

D: STEWARDSHIP – "SAY ON CLIMATE" CASE STUDY

High emitting companies are starting to put their climate strategy plans forward for shareholder vote

'Say on Climate'

- A small group of companies globally have committed to put their climate strategy plans to shareholder vote at future AGMs
  - These companies include Oil Search, Rio Tinto, Santos, Woodside Energy, Glencore, Origin Energy and a handful of other global companies
  - They have voluntarily agreed to provide shareholders with a non-binding vote on their climate change reports
  - The votes are non-binding, but will create a direct line of responsibility for climate risk management to the Board
  - While non-binding resolutions are being used in other areas such as executive remuneration, this is the first time that any Australian company will put its climate strategy to non-binding votes
- 'Say on Climate' is a response to an increasing number of shareholder resolutions being organised by activists and civil society organisations calling for greater climate-related disclosure and set targets
- Asset managers as well as activist groups are supportive of the initiative[2]
  - The vote will provide a formal mechanism to respond to climate plans, increase positive engagement and reduce the time and effort spent on preparing or responding to climate related shareholder resolutions[1]
  - The initiative is expected to improve consistency on what is being voted on
- The approach is growing and is expected to gain popularity across a range of sectors over the coming years

Note: 1. Under current regulations a shareholder resolution is able to be put forward by 100 shareholders or shareholders owning 5% of a company. Advocacy groups are well organised and have little trouble meeting the 100 shareholder requirements. 2. Key activist groups include the Australasian Centre for Corporate Responsibility (ACCR) and Market Forces.

EMERGING OPPORTUNITIES AND CHALLENGES FOR INVESTORS

Recent developments

INVESTING ACTIVITY DEVELOPMENTS

Approaches to ESG integration and screening are continuously evolving

ESG Integration

- A key challenge for asset managers is to utilise high quality ESG data in portfolio construction that positively influences investment decisions.
- Many investment managers have yet to reach a point where ESG risk assessment (outside of screening) regularly impacts investment decisions, particularly for funds that are not thematic based or ethical in nature.
- Asset managers are increasingly focused on:
  1. What data is essential for their analysis
  2. What third party information they rely on vs. what analysis is undertaken in-house
  3. The process to incorporate ESG data into investment decisions (or acquisition process)

Screening

- Exclusions can be difficult to implement and several practical considerations cause challenges for managers.
  1. **Measurement and data limitations:** Screening for activities such as animal cruelty, human rights and deforestation are difficult to implement due to measurement and data availability challenges.
  2. **Negative impacts on fund strategy:** Screening is difficult to implement, in regions where the relevant activity is common. If the screen renders a large portion of the relevant regional index un-investible this will result in many fund strategies becoming unachievable.
  3. **Negative impacts on SDGs:** Screening for activities that are critical to economic development, such as for fossil fuel activities, can have negative consequences for several of the UN's SDGs.
- Advocacy for various screens is popular among NGOs and special interest groups, particularly in Australia. However, few asset managers will adopt a screen where it causes one of the challenges identified above. Most asset managers prefer to utilise ESG integration and engagement instead with a focus on credible transition strategies.

Thematics

- Key emerging areas of focus vary between asset managers but include: 1) transition to net zero emissions; 2) food security; 3) human rights including modern slavery, the supply chain and living wage; and 4) healthcare as a result of Covid-19.
- Asset owners and regulators are becoming increasingly focused on requiring asset managers to demonstrate the level of ESG capabilities they are claiming (see page 51 for an overview of related EU Sustainable Finance Disclosure Regulation). As a result a key challenge for asset managers will be to demonstrate their thematic funds' ESG credentials.

STEWARDSHIP DEVELOPMENTS

Strong engagement and voting is essential for asset managers who wish to differentiate

General considerations

- Engagement and voting is becoming increasingly important for:
  - asset managers to: 1) deliver on ESG strategy; 2) assess ESG risks (transition and physical); and 3) influence ESG impact improvements
  - asset owners are assessing stewardship as a differentiating factor when selecting asset managers.

Engagement

- In order to differentiate, asset managers need to improve:
  - the quality and quantity of their engagement activities; and
  - the reporting for asset owners on their engagement activity.
- Best practice involves engagement reporting and disclosing evidence of the impact of engagement processes and activities on ESG outcomes. Engagement reporting involves disclosure of the engagement process, engagement themes and objectives, key engagement statistics as well as measures of success and progress.

Passive asset managers

Passive managers are under pressure to improve their ESG performance. Engagement and voting are the best tools they have to achieve this.

As an example Blackrock had the fastest growing ESG offering globally, based on fund flows between 2017 and 2020, but it has traditionally scored poorly for ESG practices.[1]

Managers such as Blackrock are taking action to increase and improve their engagement and voting practices to meet the requirements of their asset owners.

Voting

- At times, asset managers will align with, and co-file a resolution with, advocacy groups to encourage companies to provide the disclosures (or undertake actions) they require to achieve ESG goals.
  - Groups such as Australian Centre for Corporate Responsibility (ACCR) will approach asset manager in advance of an AGM to gain support for a resolution. This is particularly common for climate action related resolutions for heavy emitters.
  - Even if the resolution does not pass, a 20-30% vote will make a clear point and the relevant company will often adopt the recommendation.
- As a result of a push towards vote disclosures, advocacy groups are also increasingly holding asset managers to account for their voting activities.
  - If an asset manager represents themselves as having high ESG standards and does not vote accordingly, advocacy groups will highlight this to their asset owners.

Source: 1. Citywire, 2021; 2. ESGClarity, 2021.

NET ZERO EMISSIONS DEVELOPMENTS

Impact reduction is commonly used to support achievement of net zero emissions.

- Many large asset owners and managers are currently gearing up to publicly take a position on transitioning to net-zero carbon emissions, if they have not done so already.
- Asset owners and managers are having to consider ethical and moral issues as well as practical and commercial issues when deciding what approach to take in supporting their transition to net zero carbon.
- Two key approaches being adopted by asset managers are 1) risk transfer and 2) impact reduction.
- The majority of large or flagship funds (either passive or active) currently adopt an impact reduction approach:
  – Major funds would not be able to deliver on their investment goals if they adopted a pure risk transfer approach. Their investment universe would shrink by c.90%.
    - Impact reduction is consistent with continued support for global communities and UN SDGs

  – Relevant asset managers are seeking credible paths to net zero and are utilising ESG integration and stewardship to drive positive change.
- Small asset managers or specialist thematic based funds are more likely to incorporate risk transfer into their activities (e.g. exclude fossil fuels from their portfolio).
  – These funds often invest in sectors and companies that will provide future solutions for transition to net zero emissions.

  – These funds are often specialist and able to deliver on their investment goals without requiring exposure to a broad cross-section of the economy.

Approaches to support delivery of net zero emissions

Risk transfer

– Involves exiting and excluding high emitting companies and industries from a portfolio.

Upside: Immediately removes risk from portfolio and sends a clear message to heavy emitters.

Downside: 1) Transferring a risk does not mean it is reduced, so this approach may not support change; 2) Potential for social issues; 3) Not consistent with some UN SDG's.

Impact reduction

– Involves working with all types of companies to reduce their emissions.

Climate Action 100+

Upside: Positive change achieved by working with companies, while also supporting UN SDGs such as no poverty, no hunger.[1]

Downside: Potential for greenwashing and potential to remain invested in companies that do not intend to transition once available.

Index innovation – Low carbon indices

Indices serve as a benchmarking tool for asset owners and managers. The broad adoption of common indices as benchmarks standardises performance measurement, increases transparency and supports base level capital allocations.

However, existing indices are not designed to support transition to net zero.

Index providers (e.g. MSCI) are increasingly offering a variety of climate indices that support the objectives of climate strategy. These indices utilise exclusions, tilting and optimisation.

Adoption of these indices by asset managers will allow them to shift to an increasingly carbon neutral portfolio without tracking error and style bias.

Note: 1. These are best supported by economic growth in developing nations.

TRANSPARENCY, STANDARDISATION & DATA DEVELOPMENTS

Standardisation is challenging as many companies and assets have ESG features that are not comparable

Standardised vs. bespoke data

- Most asset owners and asset managers, are unsure about how to hold their investments accountable.
  - Standardisation is challenging as many companies are unique and have ESG characteristics that are not comparable.
- Different industry participants have differing views on the value of standardised vs. bespoke data. As an example:
  - Systematic or index based funds, who rely on common types of data, often prefer a shift to greater standardisation of metrics and data.
  - Fundamental investors, who are seeking alpha from high quality ESG analysis, are more likely to have a preference for a case by case analysis of ESG drivers and metrics.
- It is likely that in time, for all industries, some ESG measures will become accepted as best practice and these will come to be expected. However, bespoke ESG risk analysis that relies on bespoke data will remain essential to deliver alpha.

Private markets vs public markets

- Most large public markets asset owners and managers utilise multiple external ESG data providers and also undertake in-house ESG analysis.
- Public markets style third party rating systems are not available for private markets investors. Private markets managers can access data directly from their portfolio companies, however, in many cases asset owners need to rely on their asset manager's representations of the ESG characteristics of their portfolio.
  - Within private markets, ESG transparency increases with fund size.[1] However, this is off a very low base.
- Several private markets data providers (e.g. GRESB) offer metrics aimed at providing accountability and transparency at both the fund manager and asset level and more data providers are seeking to fill the gap.
  - Portfolio companies provide extensive asset level information that allows them to be rated against their peers.
  - Asset scores are rolled-up to achieve a fund level score
- Assessments are often used to identify areas of future ESG focus.

Company level data

- Asset owners and managers are becoming more vocal about how portfolio level ESG data is used and therefore what data is, and is not, valuable. In general asset owners and managers use data to assess:
  - progress against ESG strategy;
  - ESG risks (transition and physical); and
  - ESG impact (e.g. improvements in emissions, water and waste associated with the investment).
- Different types of data are required to assess each of these. If companies are to provide asset managers with the detailed data they require the industry will need to improve general ESG data publication standards as well as transparency and accountability from all participants.

Source: 1. Preqin, Why ESG Transparency is Easier for Larger Managers, 2021.

REPORTING DEVELOPMENTS

Reporting trends that start in Europe will increasingly impact all asset managers

Impact reporting

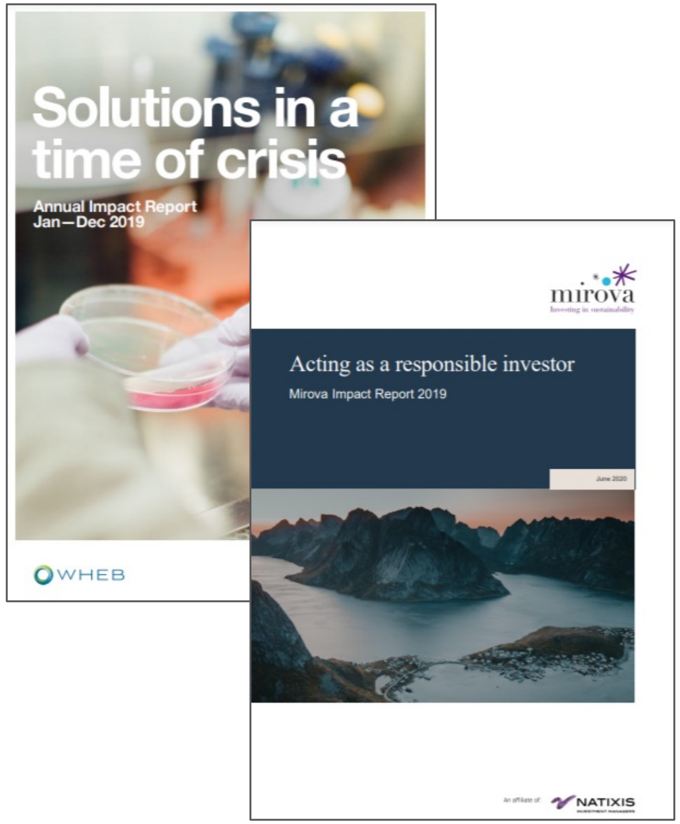
- Best practice by asset managers increasingly involves an annual impact report. An impact report outlines how an asset manager's ESG strategy and investment activities have and will deliver real world outcomes.
- Impact reports provide extensive details, using relevant metrics, on topics such as ESG investment strategy, portfolio impact and ESG performance, transition to net zero, engagement and voting.

Climate impact and management

- New Zealand has become the first country to introduce a law that will require banks, insurers and investment managers to report the impact of their investments on the climate and explain how they will manage climate-related risks and opportunities. The first reports will be required in 2023 and will be based on TCFD recommendations. In addition to New Zealand, the UK has announced they will make TCFD mandatory from 2022.
- TCFD recommendations on climate-related financial disclosures are designed to be widely adoptable and applicable to organisations across sectors and jurisdictions. The recommendations ensure companies provide data that is useful for assessing climate related risks and impact.
- In regions where TCFD reporting is not mandatory asset managers will increasingly be pushed by asset owners and voluntary bodies (e.g. the PRI and Australian Sustainable Finance Initiative) to comply with TCFD standards. There will be flow through implications for portfolio companies.

EU Sustainable Finance Disclosure Regulation (SFDR)

- SFDR is part of a European regulatory wave aiming to reorient capital flows towards a more sustainable economy. SFDR compliments the EU taxonomy which is a classification system that provides detailed characteristics of various levels of responsible investing.
- The SFDR requires asset managers to provide clients ESG-related information and demonstrate the level of ESG capabilities they are claiming.
- As per TCFD disclosures, in regions where SFDR reporting is not mandatory, asset managers will increasingly be pushed by asset owners and voluntary bodies to comply with SFDR standards.



Note: It is estimated that <50 Australian listed companies are currently meeting TCFD reporting standards.

DEFINITIONS

Key definitions

- **Asset managers:** entities responsible for the management of investments on behalf of asset owners[1]
- **Asset owners:** the owners of the underlying assets who entrust the management of these assets to an asset manager
- **Investors:** a term for both asset owners and asset managers
- **Private markets:** markets for privately held financial instruments, such as equities or debt, of privately owned companies.
- **Public markets:** markets for tradeable financial assets, such as equities or fixed income, available on an exchange or an over-the-counter market
- **Responsible investing:** a broad-based approach to investing which factors in people, society and the environment, along with financial performance, when making and managing investments

Note: 1. The term asset manager and fund manager usually hold the same meaning when used by industry participants. Equally assets under management (AUM) and funds under management (FUM) are terms that can be interchanged.

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WHAT'S NEXT

Upcoming: ESG and Capital Part 2: Debt

Next on NAB's Bank for Transition series is the second part of the ESG and Capital topic, which covers the trends in sustainability that impact debt providers and debt markets. This is expected to be released early 2022.

Similarly to this report, Part 2 will cover the following, with a specific focus on debt:

- The role of debt providers in adoption of ESG and factors driving their behaviours
- Trends in ESG, availability of debt and cost of debt
- Pathways to improve availability of debt and cost of debt
- Emerging ESG developments, opportunities and challenges being experienced by banks