



Maturity Model for ESG Portfolio Management

A practical guideline

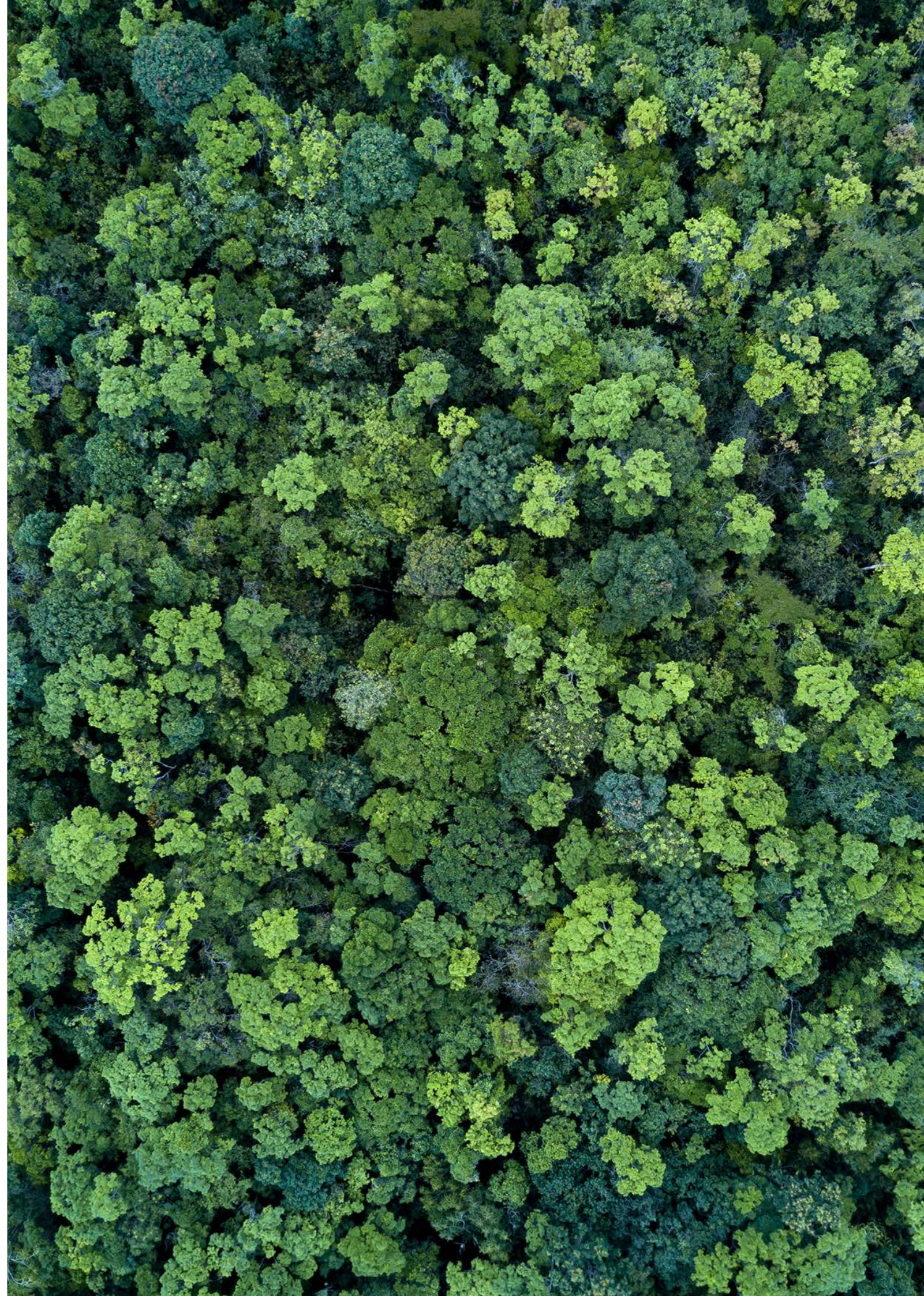
April 2022

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Why ESG?

Implementing sustainable strategies based on data relating to environmental, social and corporate governance (ESG data) is a hot topic in today's financial industry, particularly in the asset management sector. As demand for sustainable products grows steadily among clients, public entities and portfolio managers, regulators are already dealing with this issue and plan to ramp up their efforts considerably in the future. This paper introduces a Maturity Model for ESG Portfolio Management designed specifically for portfolio managers and addresses specific use cases/examples for use of the model.



What is a maturity model and why do we need it?

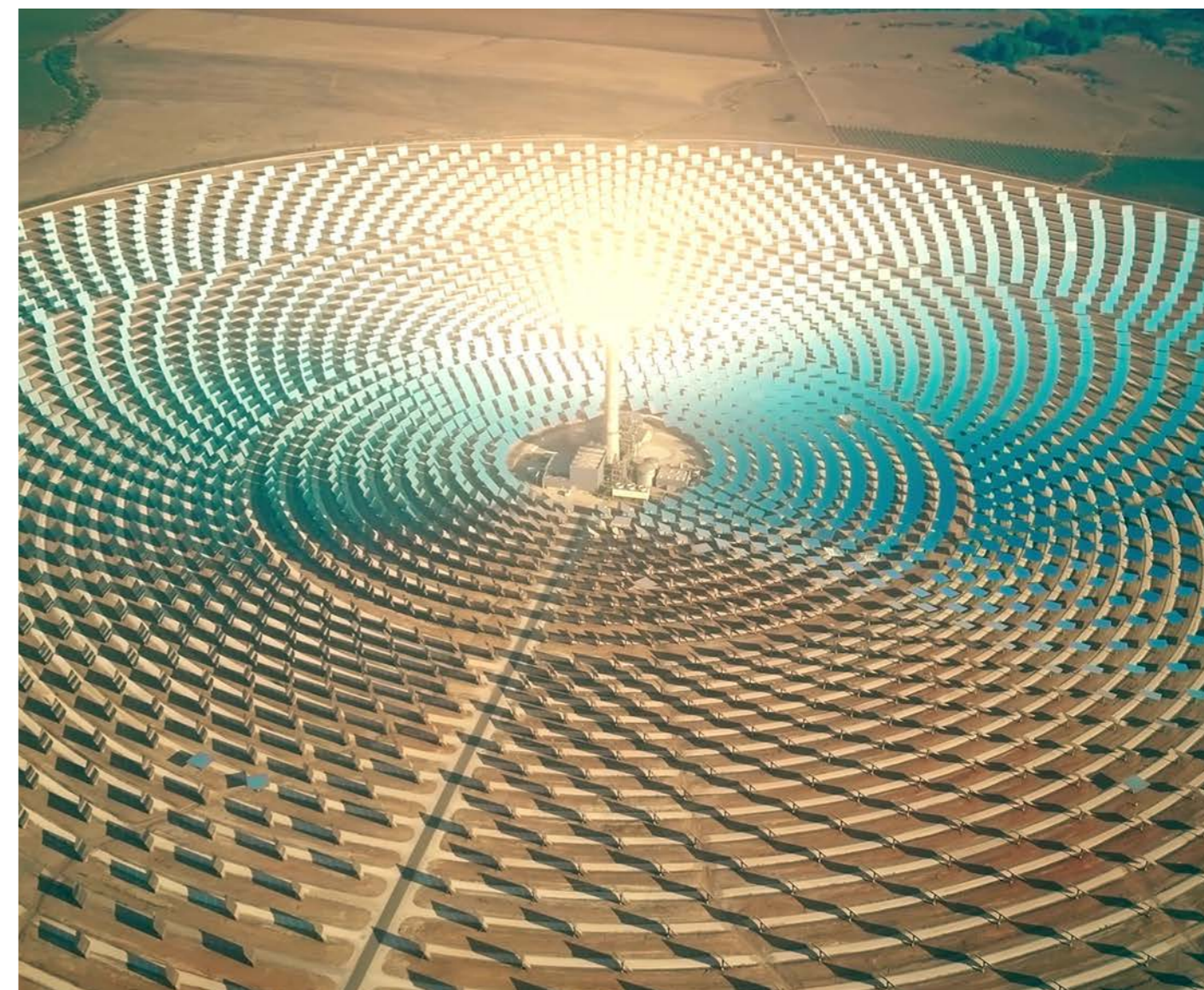
A maturity model can be used as a structural approach to a topic that is relatively unfamiliar today and as an overall guiding principle or vision statement (in the last phase of a maturity model). These models are particularly useful for the asset management industry as a whole due to three major factors in the current market:

01. New ESG and data regulations: For asset management companies, the Sustainable Finance Disclosures Regulation (SFDR) is one of the most significant pieces of the EU's new ESG directive. Some regulations have already been adopted (e.g., Regulation (EU) 2019/2088 of the European Parliament and of the Council), while others are under consultation, but not yet ratified (e.g., "Taxonomy-related sustainability disclosures"), and the Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin) plans to introduce even broader and more in-depth regulations relating to data, including ESG data. The plan features a series of interlinking regulations designed to encourage sustainable investing, which is proving difficult to implement for the majority of portfolio managers. Moreover, most asset management companies have not yet implemented an ESG strategy or put the necessary organizational structures and processes in place.

02. Asset management companies are lacking an ESG market leader. To clarify, a leader here does not mean a company with a significant market share of ESG

products or a portfolio of sustainable products. A market leader in this context is a company with sustainable DNA, i.e., that has implemented an ESG culture, an ESG strategy as well as all of the related business and IT processes. To be fair, there doesn't appear to be an ESG leader anywhere in Europe, the US or in the APAC region, which means we have no established best practice approaches (for major players).

03. New portfolio management approach: Especially for portfolio managers (front office), factoring ESG data into their daily trading activities is a completely new endeavor. The problem is twofold: (a) Asset management company leaders have to develop an overall concept and monitor data on ESG performance delivered by their portfolio managers (e.g., how are the ESG metrics for a specific product developing over time and how will this impact the PAI statement for specific legal entities?). (b) Portfolio managers themselves need to change how they research the market and measure portfolio performance (e.g., how can we increase returns without increasing specific PAI metrics).



What are the challenges?

In general, today's market poses three major challenges:

- (I) Due to rather broad regulations and high-level regulatory directives, portfolio managers (i.e., the legal department) have to interpret the articles and establish a clear understanding of each paragraph.
- (II) Without an established market leader, it is up to asset managers to decide on and develop their own individual ESG approach.

The challenge of such a project is to figure out where to start. If portfolio managers with a long time-to-market focus more on planning than execution, they are likely to miss the right moment.

That said, asset managers need to take each attempt very seriously, as misunderstandings can lead to faulty ESG data (or a greenwashing scandal).

(III) It is not only important to consider the impact that ESG reporting has on business overall, but also on IT. At first

glance, it might seem to be purely a business endeavor; however, when it comes to implementation, the major cost driver will definitely be on the IT-side.

Firms therefore need to understand that rolling out an ESG strategy requires very specialized IT implementation and IT management skills, and that IT risk requires constant monitoring. It is essential for business leaders to be strongly aligned with IT leaders.



The maturity model for ESG Portfolio Management

To overcome today's challenges and establish a robust ESG strategy in portfolio management, this paper recommends adopting a maturity model. The maturity model can help solve current problems and challenges or serve as a guiding principle for the implementation strategy. We have structured the maturity model for ESG Portfolio Management in five different phases.

Overview of different phases

Before diving into the model, it is important to clarify some of our design principles: **(a)** Each step may include the previous phase, but does not have to, **(b)** the steps do not need to be implemented chronologically and **(c)** there is no need to start with step 1. The maturity model for ESG Portfolio Management is designed for use in an asset management company's front-office system (e.g., systems used to research and trade assets for a specific fund). There are five phases to this model:

1. Passive ESG selection

In the first phase of the ESG Portfolio Management maturity model, portfolio managers can only trade assets on their system (e.g., to rebalance the fund) that have been pre-selected. The portfolio managers will be working with a filtered list of assets without any further information about the underlying ESG metrics of the asset.

2. Forming signals

In this phase, portfolio managers receive a list of all relevant assets (which can still be pre-selected, but based on detailed ESG criteria; in other words, a client may want sustainable investments for a specific fund, but explicitly excludes pornography). When portfolio managers select an asset, they receive a prompt to buy the asset and/or information based on the ESG data (e.g., PAI data). The ESG data itself is still not accessible to the portfolio managers in this case, they are trading based purely on screen prompts.

3. Active ESG selection

In the third phase, portfolio managers will see the ESG metrics on the front office system (e.g., all ESG data or just a partial view) and will be able to compare these assets based on ESG data or actively search for alternative trades that align with the client's sustainability strategy.

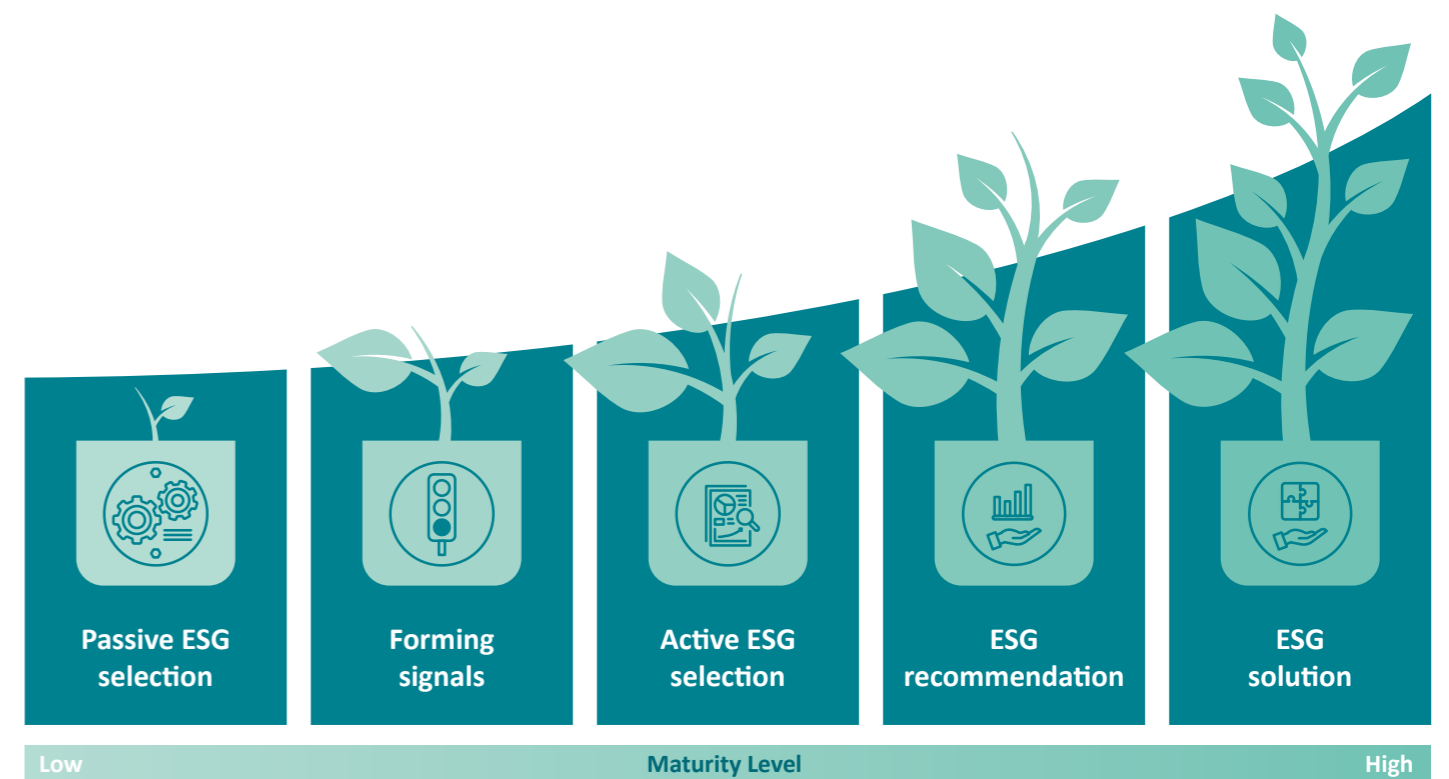
4. ESG recommendation

This phase entails making direct ESG recommendations for alternative trades. Portfolio managers can enter additional data about their personal ESG strategies (e.g., their favorites, stricter ESG thresholds, etc.) into the system and obtain a sub-list of comparable assets based on their input parameters. The assets are recommended by the system and tailored to each portfolio manager.

5. ESG solution

The final phase goes beyond the front-office system, integrating all previous phases and introducing additional features such as established business processes, audit tracking and compliance checks. Portfolio managers can focus on their clients' needs and the performance of the fund without having to audit specific trades, because the system verifies all assets based on the relevant sustainability-related regulations.

The maturity model for ESG Portfolio Management



How is the model used in practice?

In the following, we offer a guide for implementation of the maturity model in the form of use cases/ examples. These only represent a snapshot and are not mutually exclusive. In addition, portfolio managers must ensure they have: (I) a unique ESG data source that provides the front-office system with the right information at the right time (e.g., every morning at 6 a.m. before the trading desks open) and (II) all of the necessary business processes in place to perform these operations on a daily basis. These use cases demonstrate how enterprises can bring the five phases of the maturity model to life:

1. Passive ESG selection

The pre-selected list is only an input parameter for the front-office system (not visible to portfolio managers). The sustainability team is responsible for developing the list based on the underlying ESG data. We don't recommend uploading these pre-selected lists on a daily basis with the current technological setup. One possible solution to minimize the workload for staff would be to perform frequent and recurring updates (e.g., every three months).

2. Forming signals

The signals can take the form of a RAG traffic light with R = red, A = amber or G = green status. Red means a hard stop for portfolio managers, i.e., they are blocked from buying the asset. Amber status requires portfolio managers to provide additional information (e.g., why the portfolio managers want to buy the asset) and green is simply a go.

Companies can structure the signals in a variety of ways (grades from 1 = very good to 5 = rejected) and set different boundaries based on ESG data (e.g., portfolio managers cannot trade assets with a gender pay gap higher than 100%). Of course, it would be possible to use more complex logical structures for the thresholds in this context, but we recommend starting with a small, reasonable approach.

3. Active ESG selection

Asset management companies need to determine what ESG metrics they will use to monitor and track their portfolio managers' performance. These metrics should be embedded in the front-office system and form the basis for regular monitoring (e.g., management reviews the ESG metrics of all traded assets and their impact on the quantitative PAI statement for the legal entity on a quarterly basis and uses this analysis to set additional trading thresholds).



This is also the first phase in which portfolio managers get to see the ESG data and factor it into their future decision-making. Even though portfolio managers have a high level of flexibility in terms of trading opportunities, we must also consider psychological factors as well. It is vital for portfolio managers to become more familiar with ESG trading and incorporate ESG into every aspect of their day-to-day operations. This will make portfolio managers more aware of the firm's sustainability efforts, more willing to act on them and more committed to the sustainability culture overall.

4. ESG recommendation

This phase is more of an outlook into the future, which means any concrete use cases are more theoretical ideas rather than practical activities that have been or will be implemented by different portfolio managers. Establishing an ESG and interlinked

performance score (e.g., return correlation) based on monitored and tracked ESG data is key. However, as each portfolio manager tracks their portfolio using different data, it doesn't make sense to rely on an overall ESG score provided by a vendor.

An individual ESG and interlinked performance score enables an asset management company to compare assets and make the right recommendation to portfolio managers.

5. ESG solution

As indicated above, this final step relies on three additional factors:

- (I) Business processes: For example, when ESG data is missing, we can introduce additional internal processes that significantly increase the amount of ESG metrics covered by the system (e.g., PAI data on unadjusted gender pay gap);

- (II) Audit tracks: We can upgrade the system (incl. all relevant back office systems for the ESG data) to track ESG data processes and changes across a full front-to-back system trial;

- (III) Compliance checks: This entails developing an intelligent system that can check traded assets based on Art. 2 (17) and link them to the sustainability asset allocation in the regulatory reports (ANNEX IV RTS linked to Article 8(1) of Regulation (EU) 2019/2088).

Summary

In summary, the Maturity Model for ESG Portfolio Management offers a structured and targeted approach that is designed for portfolio managers to use in their front-office systems. It includes five phases: 1.) Passive ESG selection, 2.) Forming signals, 3.) Active ESG selection, 4.) ESG recommendation and 5.) ESG solution.

These five phases have been examined through numerous applications with several clients. It is a composition of gained project experience and professional expertise. Our tool can support you in your ESG Portfolio Management.



Contacts

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Holger Dümler

Partner
Business Transformation
Tel: +49 151 5807 7051
hduemler@deloitte.de



Dorothea Schmidt

Partner
Financial Services
Tel: +49 173 6101 592
dschmidt@deloitte.de



Dr. Torben Küpper

Senior Manager
Business Transformation
Tel: +49 151 5807 0019
tkuepper@deloitte.de



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