ETHIAS SFDR ARTICLE 2 (17)

SUSTAINABLE INVESTMENT METHODOLOGY

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Inhoud

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1. Sustainable Finance Disclosure Regulation (SFDR)

To meet its 2050 carbon-neutrality goal, the EU is further ramping up its sustainable finance efforts. At the core of the Action Plan is the EU Sustainable Finance Disclosure Regulation (SFDR)[1] .

SFDR supplements the current rulebooks governing manufacturers of, and advisers on, financial products. Broadly, managers must disclose how sustainability risks are considered in their investment process, what metrics they use to assess ESG factors, and how they consider investment decisions that might result in negative effects on sustainability factors (or Principal Adverse Impacts [PAIs] in the regulators' language). The SFDR has, above anything else, raised the bar for investment products -particularly those seeking to promote E&S characteristics (Article 8 products) and those with ESG objectives (Article 9 products)- by setting strict minimum-disclosure standards to prevent greenwashing.

SFDR aims to increase transparency around sustainability claims made by financial market participants. It imposes comprehensive sustainability disclosure requirements covering a broad range of environmental, social & governance (ESG) metrics at both entity- and product-level.

2. Sustainable Investment

One important sustainability disclosure required by SFDR is the % of ***sustainable investments*** («SI») that a product classified as «Article 8» contains (Article 9 is supposed to have 100% of sustainable investments -excluding cash & hedging instruments-).

Under the SFDR, the Article 2 (17) gives the following definition => « **«sustainable investment»** means an investment in an economic activity that ***contributes to an environmental objective***, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that ***contributes to a social objective***, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment ***in human capital or economically or socially disadvantaged communities***, provided that such investments ***do not significantly harm[2] any of those objectives and that the investee companies follow good governance practices***, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance».

1 https://eur-lex.europa.eu/legal-content/fr/ALL/?uri=CELEX%3A32019R2088

2 Do not significantly harm = DNSH

3. Impact on IDD/MiFID II ESG preferences

Since2 August 2022, financial advisors are required to consider clients' sustainability preferences when conducting suitability assessments to implement the amended Insurance Distribution Directive -IDD- (or the amended Markets in Financial Instruments Directive II -MiFID II-).

To avoid misrepresentations, investment advisers should assess their objectives, time horizon and individual circumstances (as already required by local regulations and following best practices) before asking for the client's potential sustainability preferences.

Financial instruments need to have specific features to be able to meet the client's potential sustainability preferences. Clients *either need to have a minimum proportion of their investments in SIs*, as defined under the European Union (EU) *Taxonomy* or Sustainable Finance Disclosure Regulation **(SFDR)** or *consider principal adverse impacts* on sustainability factors on a quantitative or qualitative basis as defined under the SFDR, i.e., have a list of environmental, social and governance key performance indicators (ESG KPIs). **The adviser needs to determine the proportion of the client's investments in SIs**, or the consideration given to adverse impacts, with the products identified accordingly.

4. Ethias' definition

As a market participant Ethias must provide its definition of a Sustainable Investment under SFDR for all its Article 8 (and Article 9) products. Each asset class of the investment has its own sustainable investment definition.

To meet this challenge, the following 3-step approach is put in place.

In line with the answer (on question 1) provided by EC on the interpretation of Regulation 2019/2088[3] the notion of sustainable investment can be measured at the level of a company and not only at the level of a specific activity. This is the adopted approach with a pass or fail status associated at company level.

4.1. Sustainable investment contribution

The first step is to identify the sustainable investment contribution, 5 different angles will be analyzed.

1. Implied Temperature Rise ("ITR") or SBTi approved status.
2. EU Taxonomy.
3. Sustainable Development Goals (SDGs).
4. Sustainable Bonds.
5. Real estate investments.

3 See document \\ethias.adms\srvfin\01\finances\Investissement Responsable\02-Regulations\SFDR\2023.04.dd - ESAs - 2023-51_Answers_to_questions_on_the_interpretation_of_Regulation_(EU)_2019-2088.pdf

4.1.1. Implied Temperature Rise (ITR) or SBTi approved status

MSCI has developed an extensive methodology[4] to provide an indication on how companies align to global climate targets as being set within the Paris Agreement. It refers to a 2°C-aligned (i.e. limiting to below 2°C the global mean temperature increase in the year 2100, compared with pre-industrial levels) and another important target is the 1.5°C limit, the maximal objective of the Paris Agreement.

The (operational) metric calculated is called ITR (Implied Temperature Rise) and should be equal to or lower than 1.5°C.

Another interesting parameter to consider with regards to the alignment with Paris agreement on climate is the commitment of a company vis-a-vis SBTi (Science-Based Target Initiative). Companies with a carbon commitment in line with SBTi are considered as well.

4.1.2. EU Taxonomy

This activity-based criterion is obtained via MSCI (or any other equivalent source of information) and is calculated using the % of total revenues from activities aligned with EU Taxonomy. Paragraph 36 of the RTS states that revenue should be the default key performance indicator to ensure comparability, but if the % of capital expenditure or the % of operational expenditure indicators are more representative then they can be used.

4.1.3. Sustainable Development Goals (SDGS)

MSCI has developed a methodology to adjust the SDGs (written in 2015 by UN for countries) for corporate issuers.

This activity-based criterion is obtained via MSCI (or any other equivalent source of information) and is considered as follows :

- the highest % of revenue contributing to any of the SDG (obtained via the SDG Product Alignment Score) is considered. This prevents double counting revenue between SDGs;
- given that the SDG Product Alignment Score represents ranges of revenue % (see Exhibit 4 from the MSCI SDG Alignment Methodology[5]), Ethias considers for each score the lowest % of the range (e.g., a Score of +5 translates into 10% of revenue).

4 «\\ethias.adms\srvfin\01\finances\Investissement Responsable\04-Investment policies & governance\ESG incorporation\ESG Integration\PASIs\Climate\2022.09.27 - MSCI - Implied Temperature Rise Methodology.pdf»

5 MSCI SDG Alignment Methodology

Exhibit 4: SDG Product Alignment Score aggregation

Product Alignment Score	Score Contribution
Positive Product Alignment Score	
>50% of revenue aligned with SDG	+10
25 - 50% of revenue aligned with SDG	+7
10 - 25% of revenue aligned with SDG	+5
5 - 10% of revenue aligned with SDG	+3
0 - 5% of revenue aligned with SDG	+1
Negative Product Alignment Score	
0 - 5% of revenue negatively aligned with SDG	-1
5 - 10% of revenue negatively aligned with SDG	-3
10 - 25% of revenue negatively aligned with SDG	-5
25 - 50% of revenue negatively aligned with SDG	-7
>50% of revenue negatively aligned with SDG	-10
Product Alignment Score	**Range: -10 to 10**

Only the 15 first SDGs will be considered.

The last 2 additions (to make the «5 Ps»), SDG 16 (Peace, Justice and Strong Institutions) & SDG 17 (Partnerships for the Goals), are not considered.

4.1.4. Sustainable Bonds

Green, Social or Sustainability bonds issued by a Corporate or Sovereign (and related)[6] are considered to be sustainable investments. Ethias does not consider Sustainability-linked bonds in its sustainable investment definition as there are no guarantee that the use of proceeds will be used to finance a sustainable project.

Ethias applies a «pass-fail» approach to determine whether such a bond is sustainable, considering a position fully sustainable if it can be classified as a use-of-proceeds instrument financing sustainable projects, ranging from green bonds to social bonds towards more focused instruments (blue bonds, gender bonds etc.) and including sustainability bonds.

Ethias relies on the alignment of the use-of-proceeds instruments with the recognized international standards for green, social or sustainability bonds, with a special consideration for the ICMA framework and other internationally recognized standards. The certification verification can be complemented by an internal analysis to determine the eligibility of the instrument, in case external assurance or third-party assessment is lacking. The complementary analysis focuses on the alignment of the instrument with the ICMA framework and other international standards, evaluating the instrument’s use of proceeds, project evaluation and selection, management of proceeds and reporting as well as the contribution of the project to the relevant UN SDG(s).

6 Please note that, at the date of writing the document, this is the only possible way to consider Sovereigns as a sustainable investment.

Additionally, Ethias has developed a methodology to identify the sovereign entities that, according to MSCI, present not only a low ESG risk but also the highest scores in terms of environmental risk and social risk management. With this methodology, Ethias intends to foster investment in bonds of countries or regions that have strong environmental or social policies, and therefore undertake investment projects that contribute to environmental or social challenges. Ethias considers the government bonds of these countries and regions to be sustainable.

4.1.5. Real estate investments

Real estate investments are considered separately from all other asset classes.

The sustainable investment component is identified depending on the type of investment. *For direct real estate investments*, Ethias defined criteria for new Buildings and existing buildings:

» **New buildings**

The contribution of New Buildings (buildings built after 31/12/2020) to a Sustainable Investment objective is defined in accordance with the eligibility criteria defined in our Green Finance Framework dated April 2023.

Assets, either residential, logistics, healthcare, offices, or alternative and any other type of real estate, that meet either criteria 1 or 2 below:

1. construction of new buildings with an energy performance classification that is at least 10% lower than the primary energy demand resulting from the current national building regulation in accordance with NZEB requirements[7];
2. construction of new buildings that have one of the following recognized environmental performance certificates and as minimum, demonstrating or expected to demonstrate compliance with:
   a. Energy Performance Certificate (EPC) class A; or
   b. BREEAM (minimum certification level «Excellent»); or
   c. DGNB[8] (minimum certification level «Gold»); or
   d. WELL[9] (minimum certification level «Gold»); or

» **Existing buildings**

In order for an existing building to be considered as a Sustainable Investment, the building will need to respect the criteria outlined in one of the two sections below.

7 NZEB means «nearly zero-emission building», a building that has a very high energy performance regulated in the Energy Performance of Buildings Directive (EPBD), thus Member States have the responsibility to define their national building code in line with NZEB. In Belgium, NZEB requirements for energy performance is in accordance with energy class «A».

8 https://www.dgnb.de/

9 https://www.wellcertified.com/

a) Property upgrades (current portfolio)

Property upgrades, of either residential, logistics, healthcare, offices or alternative and any other type of real estate, that meet one of the following criteria:

1. the renovation is compliant with applicable national regulations for major renovations. The energy performance of the building or the renovated part that is upgraded meets cost-optimal minimum energy performance requirements in accordance with the respective directive[10] ;
2. the renovation achieves energy savings of at least 30% in comparison to the baseline performance of the building before the renovation.

b) Ownership or acquisitions of either residential, logistics, healthcare, offices or alternative and any other type of *l real estate built before 30/12/2020* that meet criteria 1, 2 or 3 below, and if over 290 kW, also criterion 4 below, subject to data availability:

1. an Energy Performance Certificate (EPC) class A; or
2. an energy performance level which places the building in the top 15% of the national existing stock per building type (i.e. distinguishes between residential and non-residential buildings) in terms of operational Primary Energy Demand; or
3. buildings holding an environmental certificate (in line with 2 above in the 'New buildings' section) and as minimum, certification demonstrating compliance with EPC Class A[11]; or
4. a large non-residential building (with an effective rated output for heating systems, systems for combined space heating and ventilation, air-conditioning systems or systems for combined air-conditioning and ventilation of over 290kW) efficiently operated through energy performance monitoring and assessment[12].

For indirect real estate investments via funds, the % of Sustainable Investments as defined by the fund should be used if Ethias assesses that the methodology of the Fund Manager is aligned with its own methodology for direct investments. In case Ethias assesses that the methodology is not aligned with its own, a look-through to the asset-level will be performed to evaluate the % of Sustainable Investments based on its own methodology for direct investments.

For indirect real estate investments via other structures, a look-through to the asset-level will be performed to evaluate the % of Sustainable Investments based on its own methodology for direct investments.

10 As set out in the applicable national and regional building regulations for 'major renovation' implementing EU Directive 2010/31/EU.

11 Ethias promotes the use of green certifications as a holistic approach to sustainability in real estate, including environmental and social criteria beyond energy use. By incorporating a minimum EPC class of «A», we ensure a baseline of strong energy performance in the property.

12 This can be demonstrated, for example, through an Energy Performance Certificate or a building automation and control system.

4.2. DNSH test

In accordance with SFDR, sustainable investments should not cause significant harm to any environmental or social objective. This «*do not significantly harm*» (DNSH) principle is carried out through all steps of the investment decision process, in which the PAI are taken into account.

In addition to the exclusion policy and the integration policy, Ethias applies a DNSH test that consists of excluding from its sustainable investment, any issuer or asset that meet the below criteria:

For corporates:

» PAI 1-6: As per Ethias exclusion policy, companies in the following sectors:

- coal;
- Unconventional oil and gas;
- Conventional oil and gas;
- Power generation.

Ethias intends to take a strict approach towards the coal industry and considers that companies are not sustainable if they derive revenues from thermal coal mining;

» PAI 7-11: As per Ethias exclusion policy, companies that violate the United Nations Global Compact, the United Nations Guiding Principles on Business and Human Rights, the OECD Guidelines for Multinational Enterprises and the conventions of the International Labour Organization (ILO). Also, companies that are involved in one or more very severe ongoing controversies related to its operations and/or products;

» PAI 14: Companies that have any ties to cluster munitions, landmines, biological / chemical weapons, depleted uranium weapons, blinding laser weapons, incendiary weapons, and/or non-detectable fragments.

For Sovereign:

» PAI 15: As per Ethias' Exclusion policy, countries that are not signatories of the Paris Agreements

» PAI 16: As per Ethias' Exclusion policy, countries that are:

- subject to international sanctions;
- states that have not ratified or transposed into their equivalent national legislation the eight fundamental conventions identified in the International Labor Organization's Declaration of International Labor Organization's Declaration on Fundamental Principles and Rights at Work;
- states that have not ratified or implemented in their national legislation at least half of the legislation at least half of the 18 fundamental international treaties related to Human Rights.

For Real Estate:

» PAI 17: Real estate asset involved in the extraction, storage, transport or manufacture of fossil fuels

» PAI 18: Real estate asset categorized as energy-inefficient:

- for assets built before 31/12/2020, an EPC of C or below
- for assets built after 31/12/2020, an PED below NZEB in Directive 2010/31/EU.

For PAI 12-13, Ethias apply its ESG integration policy to qualitatively assess companies' gender pay gap and Board gender diversity and to limit the adverse impacts.

In addition, companies that manufacture tobacco products or that derive more than 5% of revenues from any tobacco-related business activity are also not considered as sustainable investments.

Ethias also intends to reinforce the DNSH pillar of this definition of sustainable investment over time, as PAI data become more standardized and reliable.

4.3. Good governance practices

The third step in our approach is to test the governance practices.

The MSCI methodology described the following approach to evaluate the good governance practices of corporates.

«The EU defines good governance as a core requirement for a sustainable investment under SFDR Article 2(17). The four included elements of «good governance» – sound management structures, employee relations, remuneration of staff and tax compliance – give a general sense of the indicator but leave room for interpretation on specific metrics to be applied and minimum criteria to be met.

The MSCI ESG dataset includes many metrics reflecting the four elements of «good governance» mentioned in SFDR Article 2(17), such as the Corporate Governance Theme score, the Tax Transparency Key Issue score, the Human Capital Theme score as well as a wide range of input indicators factored in each of these scores. However, building a screen using multiple metrics may be more difficult to implement due to disclosure limitations and a lack of relevant, universally applicable thresholds. Using MSCI ESG Ratings as a baseline measure for «good governance» encompasses all four aspects of good governance practices highlighted by SFDR Article 2(17).

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A corporate issuer needs to obtain a MSCI ESG Rating of at least BB to pass the good governance practices' test.

Good governance for sovereign issuers is not defined in the Sustainable Investment definition under SFDR Article 2(17). The exclusion policy includes a set of criteria that aims to exclude countries that would report poor governance practices. In particular, Ethias would not invest in a county with a weak score on the Worldwide Governance indicators (WGI) published by the World Bank.

5. Data availability

A lack of data coverage on non-financial information is observed today on the market, which sometimes prevents Ethias from making a fair assessment of investments' alignment with its definition of Sustainable Investment. The following approaches are therefore taken to overcome data unavailability for each building block of the Sustainable Investment definition:

» **sustainable investment contribution**: Ethias only considers that an investment contributes to an environmental or social objective if the necessary data to meet any of the 5 angles is available via MSCI or any other equivalent source of information;

» **DNSH test**: due to the lack of data coverage for some of the PAI indicators, Ethias will consider equivalent data points to the extent possible and commits to testing the DNSH principle on a best-effort basis. Ethias will strive to increase data coverage on PAI indicators by engaging with issuers and data providers;

» **Good governance**: on a best effort basis, Ethias commits to testing the good governance practices. In case the issuer's ESG Rating is not available via MSCI and to the extent possible, Ethias may consider other information at disposal.

6. Sustainable Investment aggregation methodology

At a product level, Sustainable Investments (%) are calculated as the addition of each investment's market value multiplied by the proportion of the company (Revenue / CapEx / OpEx if more relevant) assessed as sustainable and divided by the portfolio's market value. Sustainable investments are defined based on SFDR Article 2(17), and Ethias' interpretation of the three building blocks: good governance practices, do no significant harm, and the sustainable investment component. An investment can be considered fully or partially sustainable (conditional on demonstrating good governance practices and not causing significant harm):

» fully sustainable investment: 100% of an issuer's revenues are considered sustainable if the issuer meets the conditions set out in 5.1.1, 5.1.4 or 5.1.5;

» partially sustainable investment: only a percentage of the investment is sustainable and correspond to the share of revenue / CapEx / OpEx that meet the conditions set out in 5.1.2 or 5.1.3 (whichever is greater), and in case the issuer fails to meet conditions stated in 5.1.1, 5.1.4 and 5.1.5.