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ESG Investing: How to Do Well by Doing Good

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ESG-related financial products

- **Loan market**:
  - Green loans
  - Sustainability-linked loans

Loan Market Association
the authoritative voice of the EMEA market

Green Loan Principles
Supporting environmentally sustainable economic activity

Sustainability Linked Loan Principles
Supporting environmentally and socially sustainable economic activity

- **Debt capital markets**:
  - Green bonds (climate bonds)
  - Social bonds
  - Sustainability bonds
  - Sustainability-linked bonds

The Green Bond Principles

The Social Bond Principles

The Sustainability Bond Guidelines

The Sustainability-Linked Bond Principles

- **Equity capital markets**:
  - Green preferred
  - Green convertible bonds

ESG-related financial products *(cont.)*

Other products:

- Green Project Finance
- Green Venture Capital & PE
- Green Indices
- ESG Derivatives
- Green Investment Funds
- Green Insurance, etc.
- "Blue" Bonds, Transition Bonds (especially for energy companies), etc.
- Other specific products – *e.g.*, Property Assessed Clean Energy, Fannie Mae's HomeStyle Energy Mortgage

ESG financial products – Use of Proceeds Products

- Core Components of Green and Social Bonds/Loans:
  - Use of Proceeds (allocation to the financing/refinancing of ESG projects/ investments ("**UoPs**")
  - Process for Project Evaluation and Selection
  - Management of Proceeds
  - Reporting (impact and allocation)
  - *EU Green Bond Framework also requires:*
    - Completion of prescriptive templates (comparative data between issuers)
    - Contribute to at least one of the 6 environmental objectives of EU Taxonomy
    - Comply with the DNSH Principle

ESG financial products – Linked Products

- Core Components of Sustainability-linked Bonds/Loans:
  - Financial and/or structural characteristics of the Bonds varies depending on whether the issuer achieves predefined Sustainability/ESG objectives (*e.g.* Coupon Step-Ups)
  - Incentivise the issuer's achievement of material, quantitative, pre-determined, ambitious, regularly monitored and externally verified sustainability (ESG) objectives through Key Performance Indicators (**KPIs**) and Sustainability Performance Targets (**SPTs**)
  - Proceeds of SLBs are intended to be used for general purposes.
  - Not UoPs (*i.e.*, unlike Green, Social or Sustainability Bonds/Loans)

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ESG Investor Trends in Europe/US

Do ESG Bonds achieve better commercial terms?

Often difficult to prove/promise, especially for highly rated/IG issuers in current interest rate environment

- Defensive/pro-active attempt to try to address reservations among investors as a result of actual or perceived weaknesses with regard to ESG credentials? Avoid "Brownium" Penalty?
- Use of corporate disclosures to evaluate company ESG performance on the rise, driven by ever more prescriptive (comparative) disclosures
- As demand outstrips supply, some evidence that ESG bonds come in at a slightly tighter spread (5/10 bps)
- Academic research fails to show any "Greenium" – However, this may be due to the lack of comparable issues (although a study of US municipals also failed to show evidence of any Greenium)
- Some market reports of 3-5bp benefit to issuers

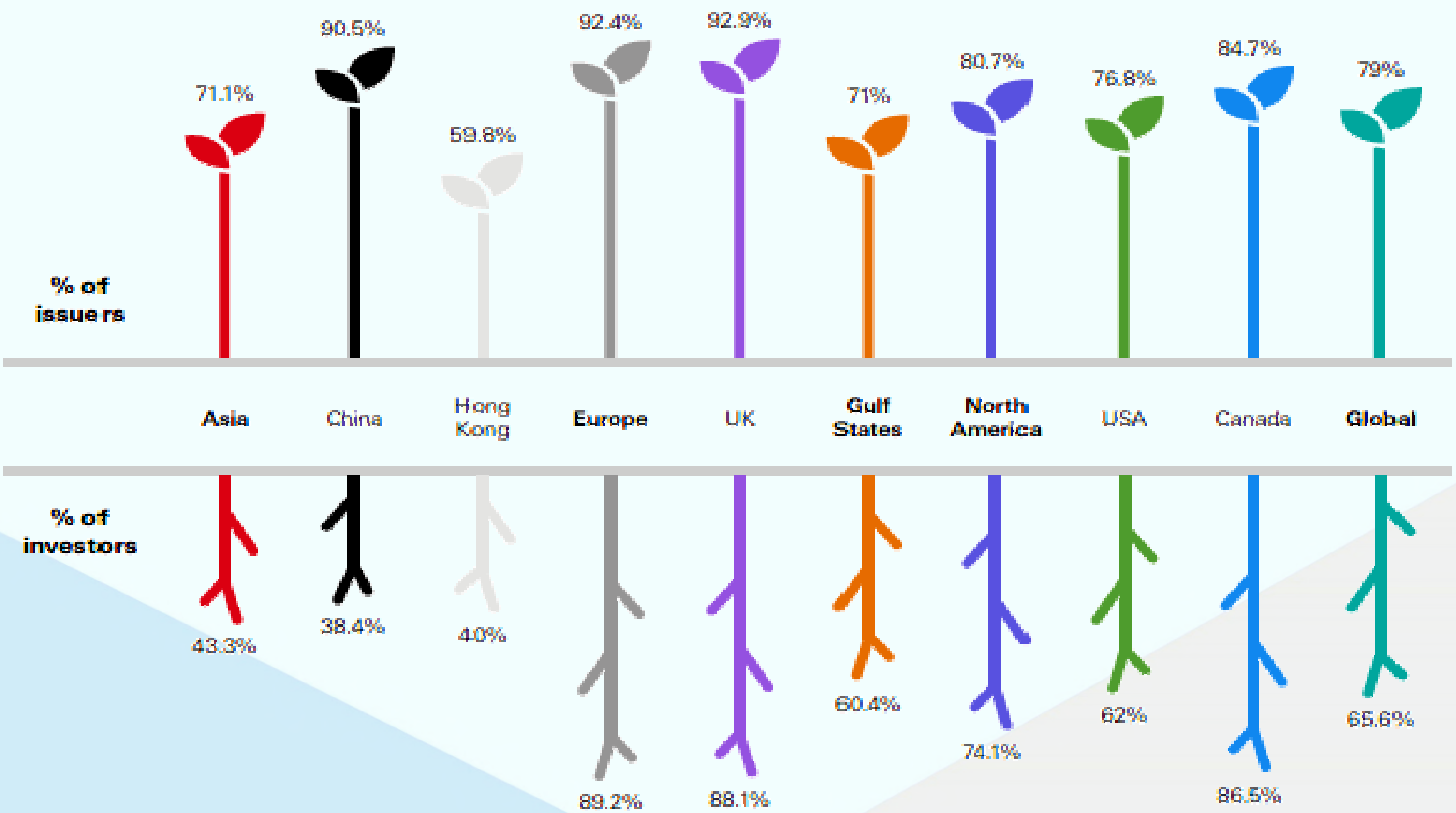
Some Additional Things to Consider

- If ESG cannot be measured, it cannot be managed, reported/disclosed or compared

- Defining ESG (*such that it can be measured*) presents several significant challenges:
  - There is no global consensus about the meaning of ESG (and, in fact, there are areas of significant and impassioned controversy – *e.g.*, nuclear; biomass; land use change impacts; etc.)
  - It needs to be dynamic to account for future developments (even the authors of the EU taxonomy were aware that, almost immediately after the publication/adoption thereof, it would be outdated) which limits comparability over time unless it can be reconciled (expanding the required reporting/disclosure – perhaps substantially
  - The current 'universe" of reporting regimes (TCFD/SASB/CDP etc.) needs to either be harmonized or replaced by a single regime – instead new reporting regimes continue to be developed – e.g., carbon for financials
  - Must of the value in ESG is in the future (various scenarios coming about over the next several decades and is "material" – how to balance the need for robust disclosure about the future on which investors and others may rely, yet protect parties who make such disclosure from their own naïveté or innocent mistakes *(i.e.*, good faith projections)

ESG Issuer/Investor Penetration

Penetration of ESG Financing and Investing



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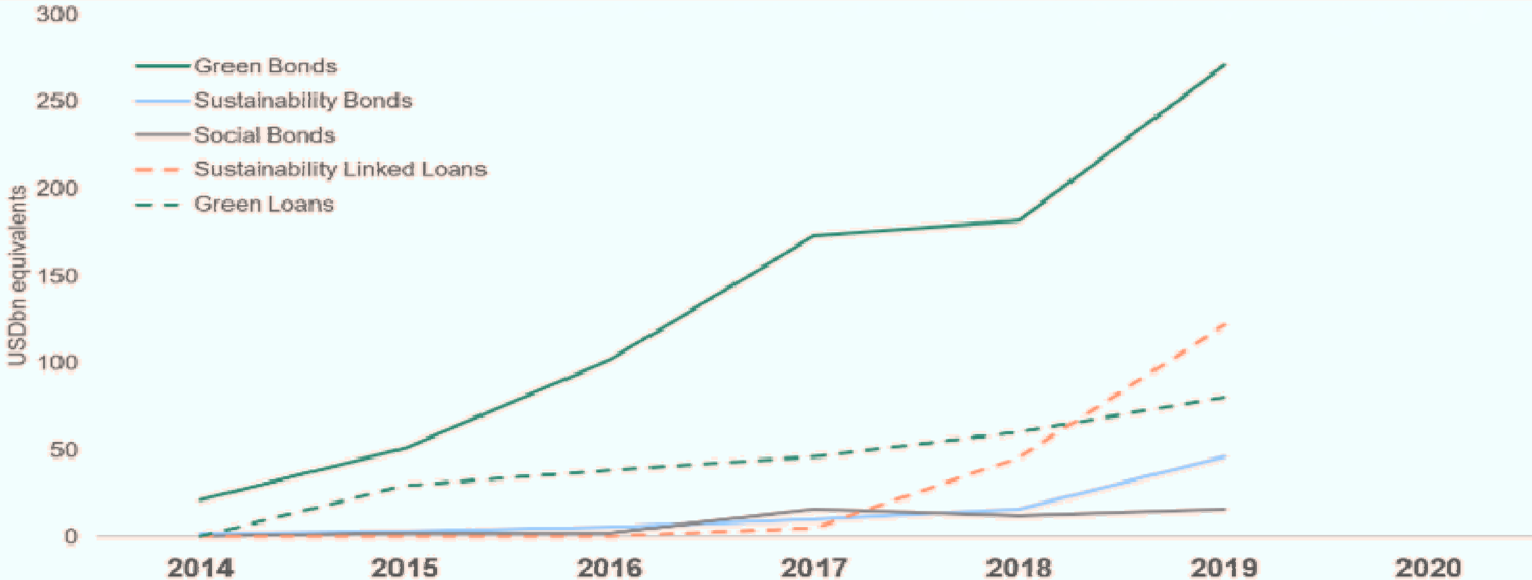
Timeline/Market for GSS Finance



	2014	2015	2016	2017	2018	2019	2020
Bond principles	The Green Bond Principles [1st version]	The Green Bond Principles [2nd version]	The Green Bond Principles [3rd version and Guidance on Social Bonds]	The Green Bond Principles [4th version] The Social Bond Principles [1st version] The Sustainability Bond Guidelines [1st version]	The Green Bond Principles [5th version] The Social Bond Principles [2nd version] The Sustainability Bond Guidelines [2nd version]		
Loan principles					Green Loan Principles [1st version]	Sustainability Linked Loan Principles [1st version]	Green Loan Principles [2nd version and Guidelines] Sustainability Linked Loan Principles [2nd version and Guidelines]

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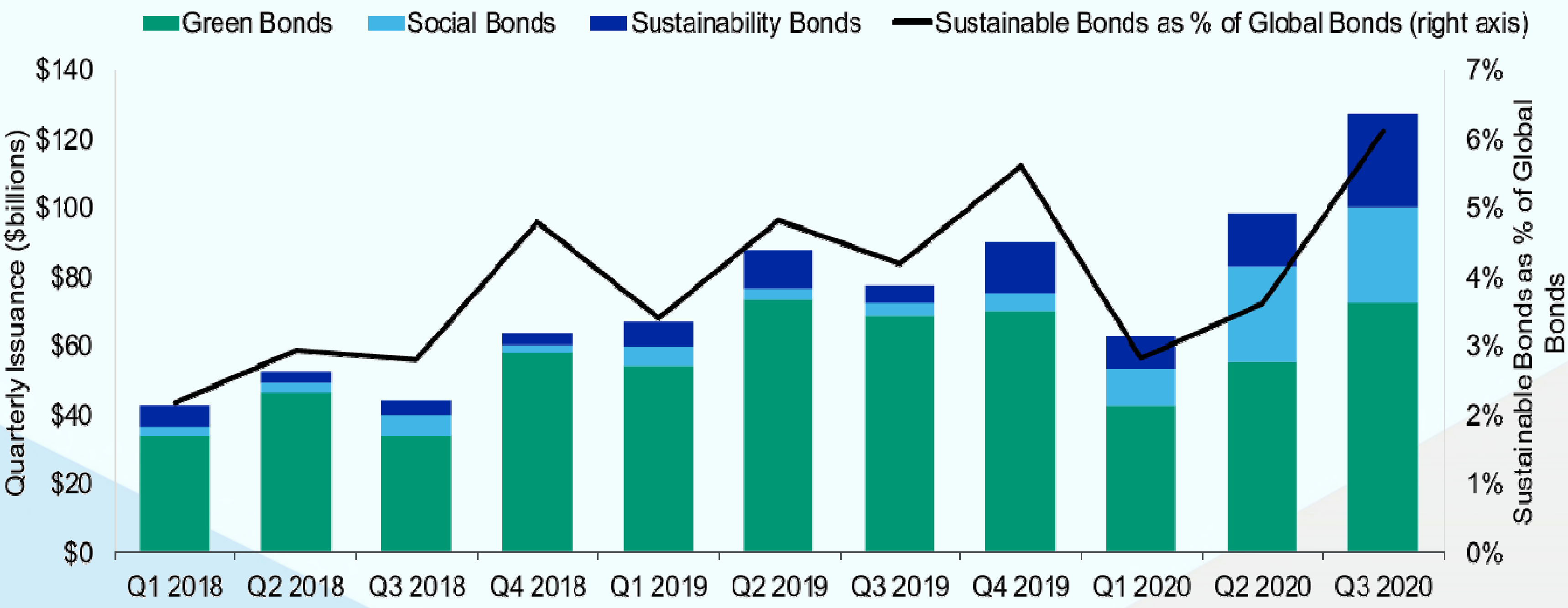
Moody's 03/2020 Sustainable Finance Market Update



Sources: Climate Bonds Initiative, Dealogic and Moody's Investors Service

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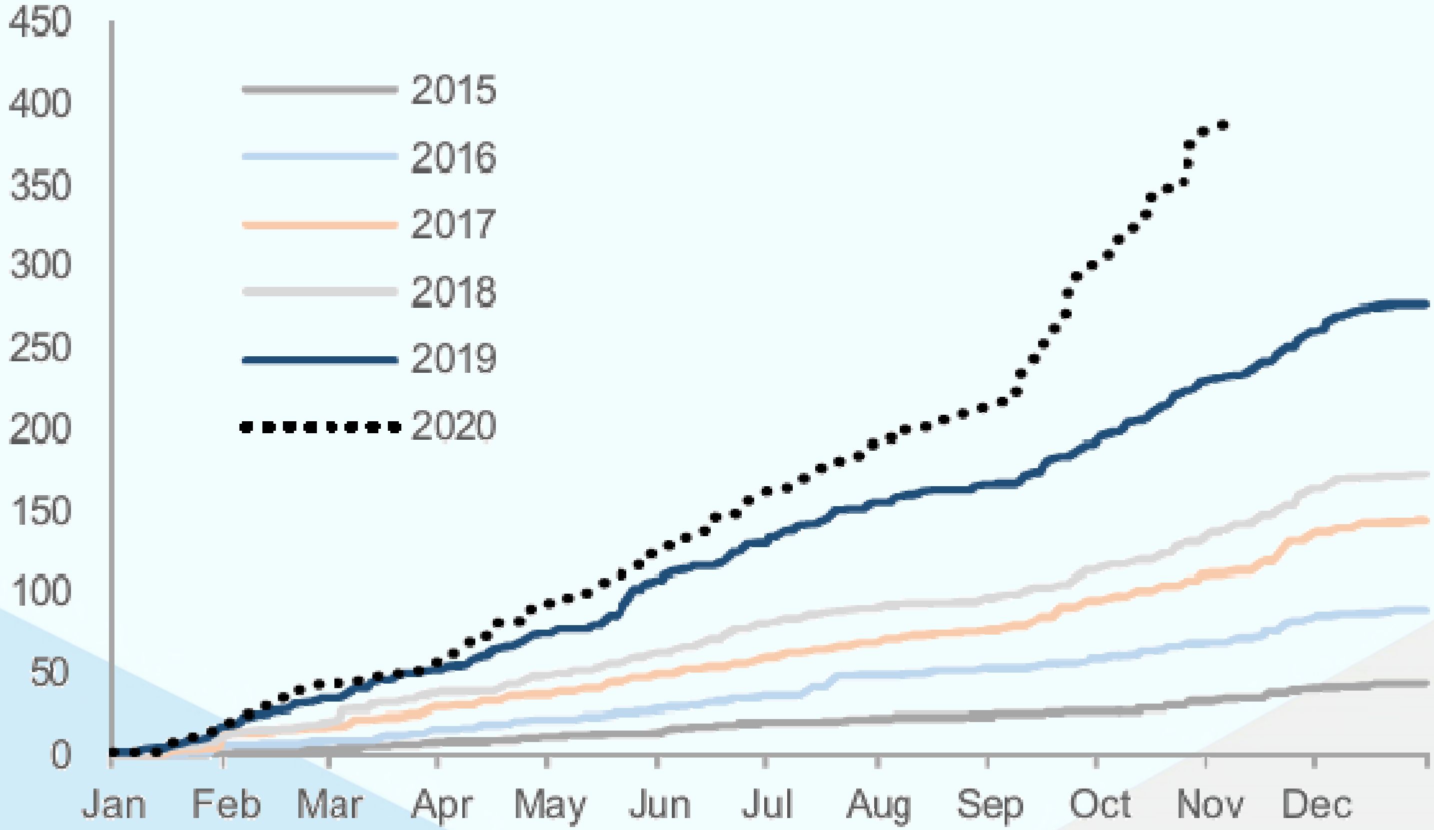
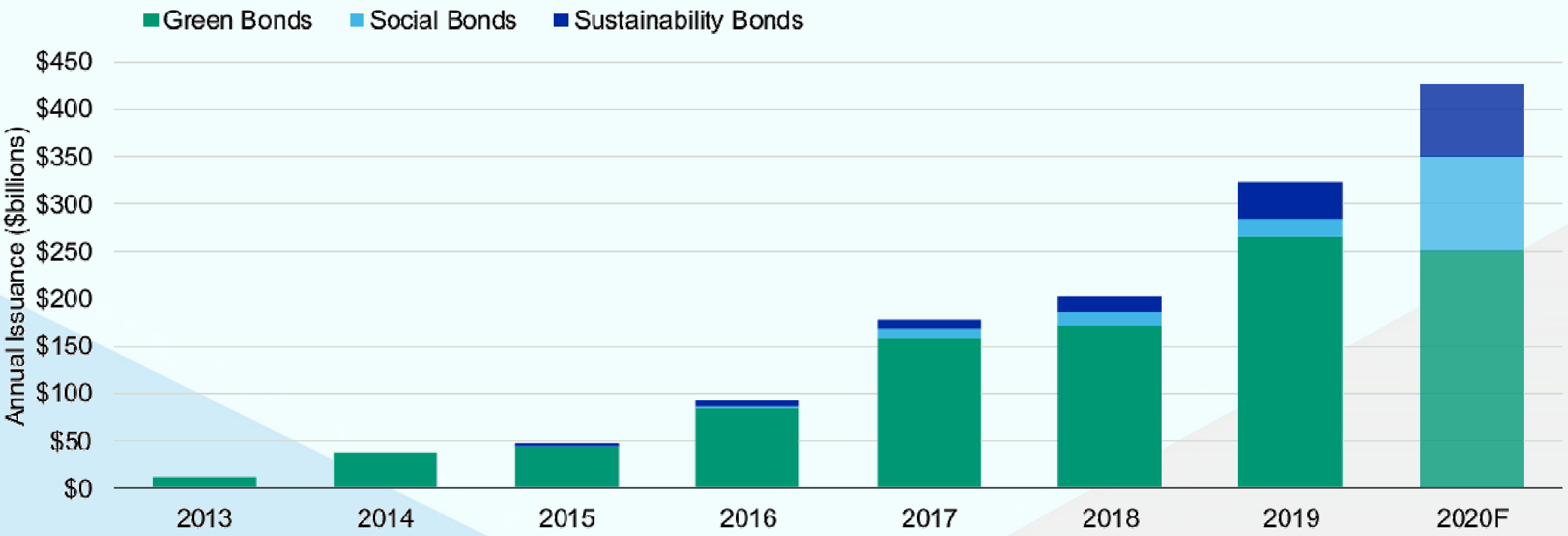
JPMorgan 11/2020 GSS Market Update



Source: J.P. Morgan, Bloomberg Finance L.P., Dealogic. Including GSS bonds up to 4 Nov 2020

Moody's 03/2020 Sustainable Finance Market Update

Sustainable bonds to set new issuance record in 2020 despite coronavirus-related disruptions



2020F represents Moody's Investors Service 2020 full-year forecast.
Sources: Climate Bonds Initiative, Dealogic and Moody's Investors Service

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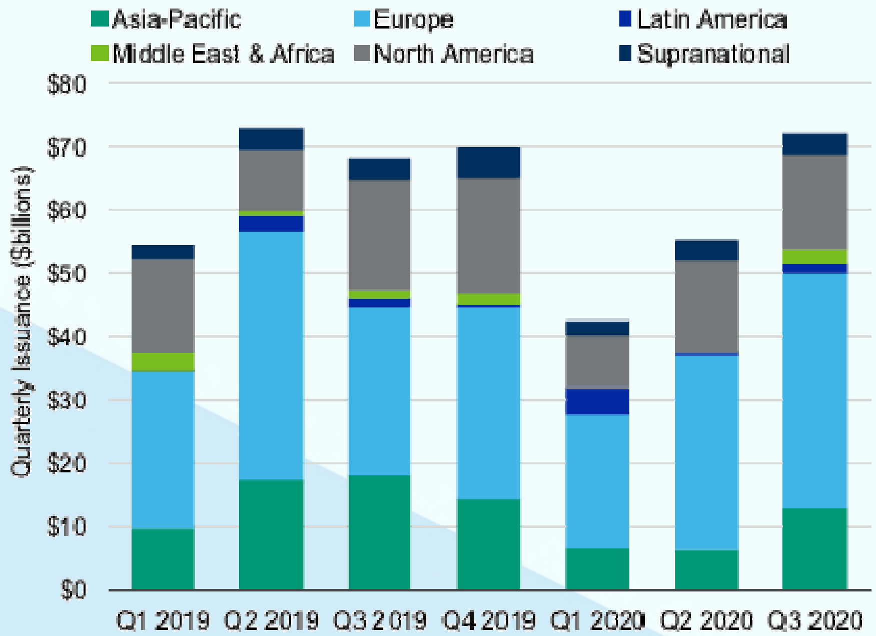
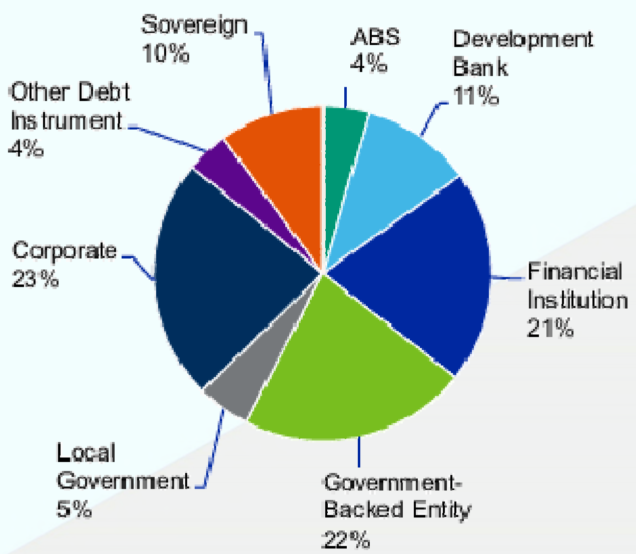
Moody's 03/2020 Sustainable Finance Market Update

Green bond issuance returned to 2019 levels in the third quarter



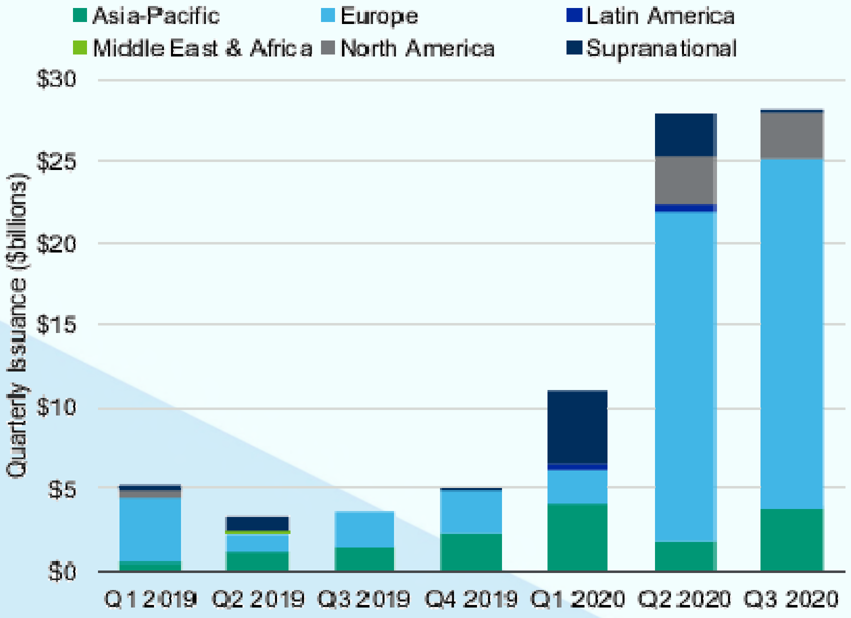
Sources: Climate Bonds Initiative and Moody's Investors Service

Percent of Q1-Q3 2020 global green bond issuance



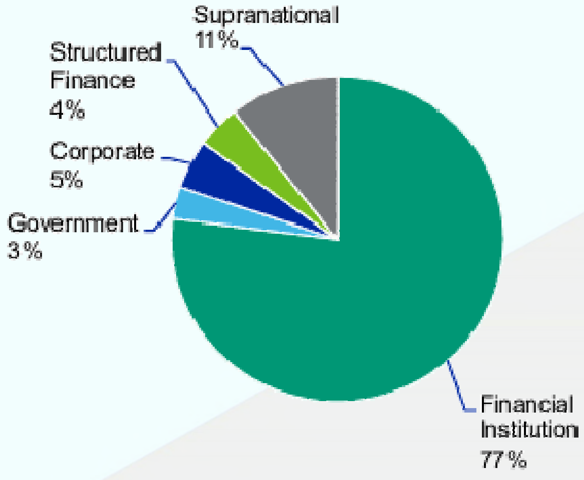
Moody's 03/2020 Sustainable Finance Market Update

Pandemic propels social bond issuance to new heights



Sources: Dealogic and Moody's Investors Service

Percent of Q1-Q3 2020 global social bond issuance



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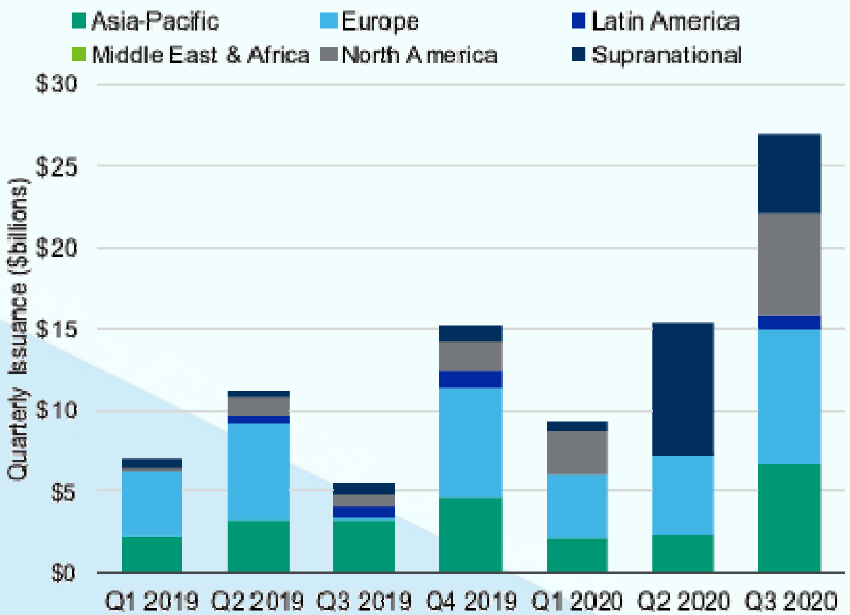
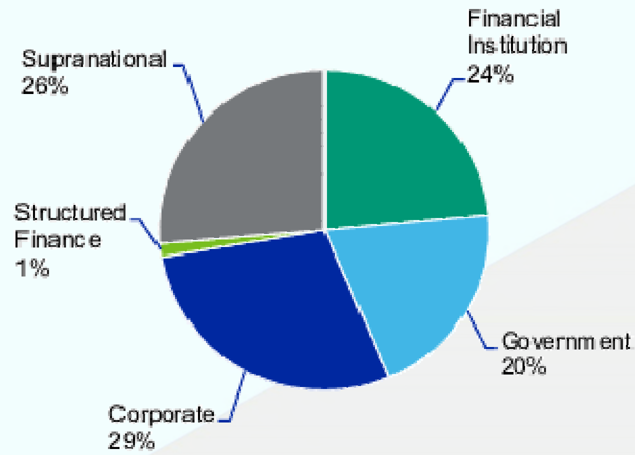
Moody's 03/2020 Sustainable Finance Market Update

Sustainability bond volumes hit new record in the third quarter



Sources: Dealogic and Moody's Investors Service

Percent of Q1-Q3 2020 global sustainability bond issuance



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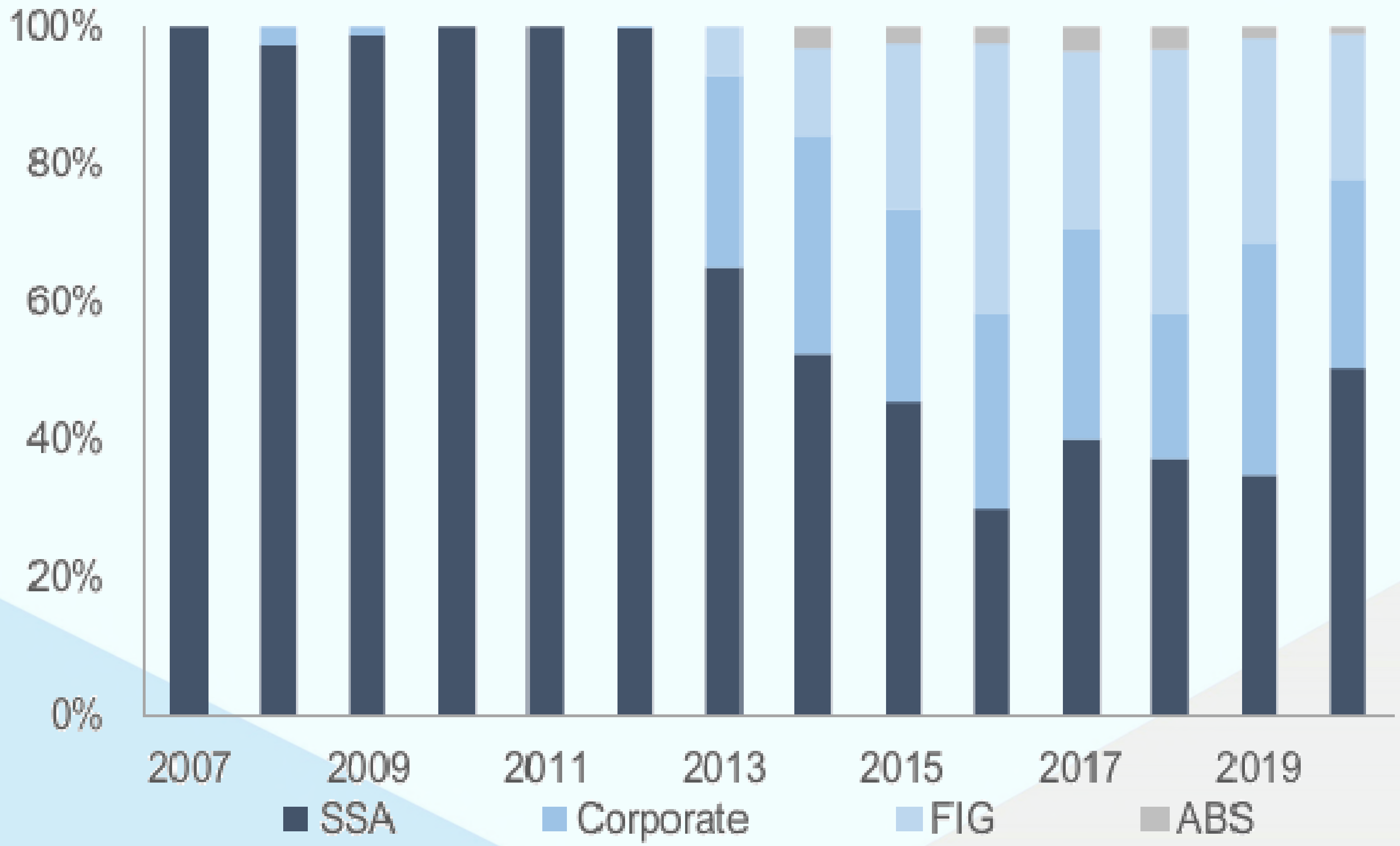
Type of GSS Issuer and Volume Has Changed Over Time



Source: J.P. Morgan, Bloomberg Finance L.P., Dealogic

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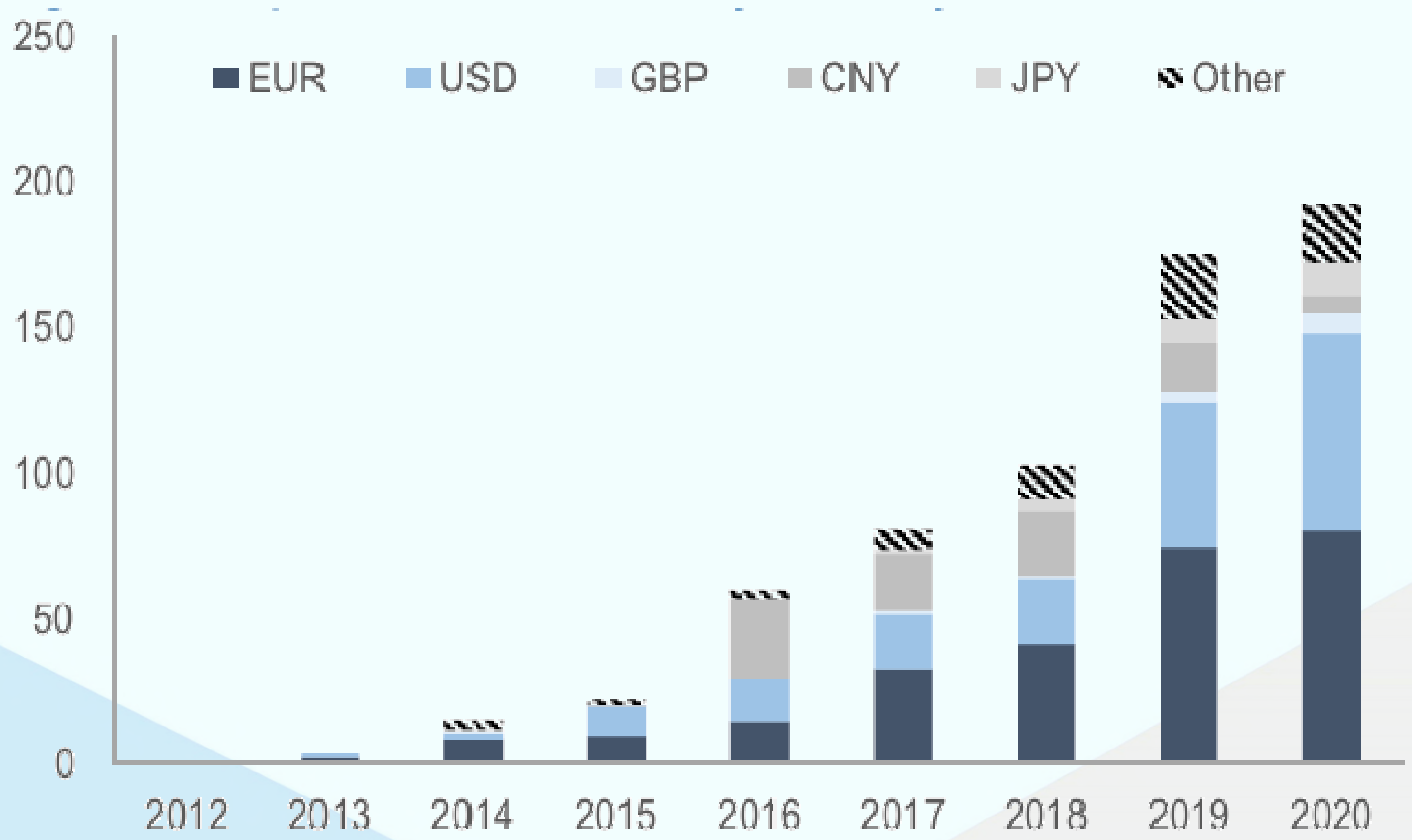
Currency of GSS Issuance Has Also Changed Over Time



Source: J.P. Morgan, Bloomberg Finance L.P., Dealogic. Including GSS bonds up to 4 Nov 2020

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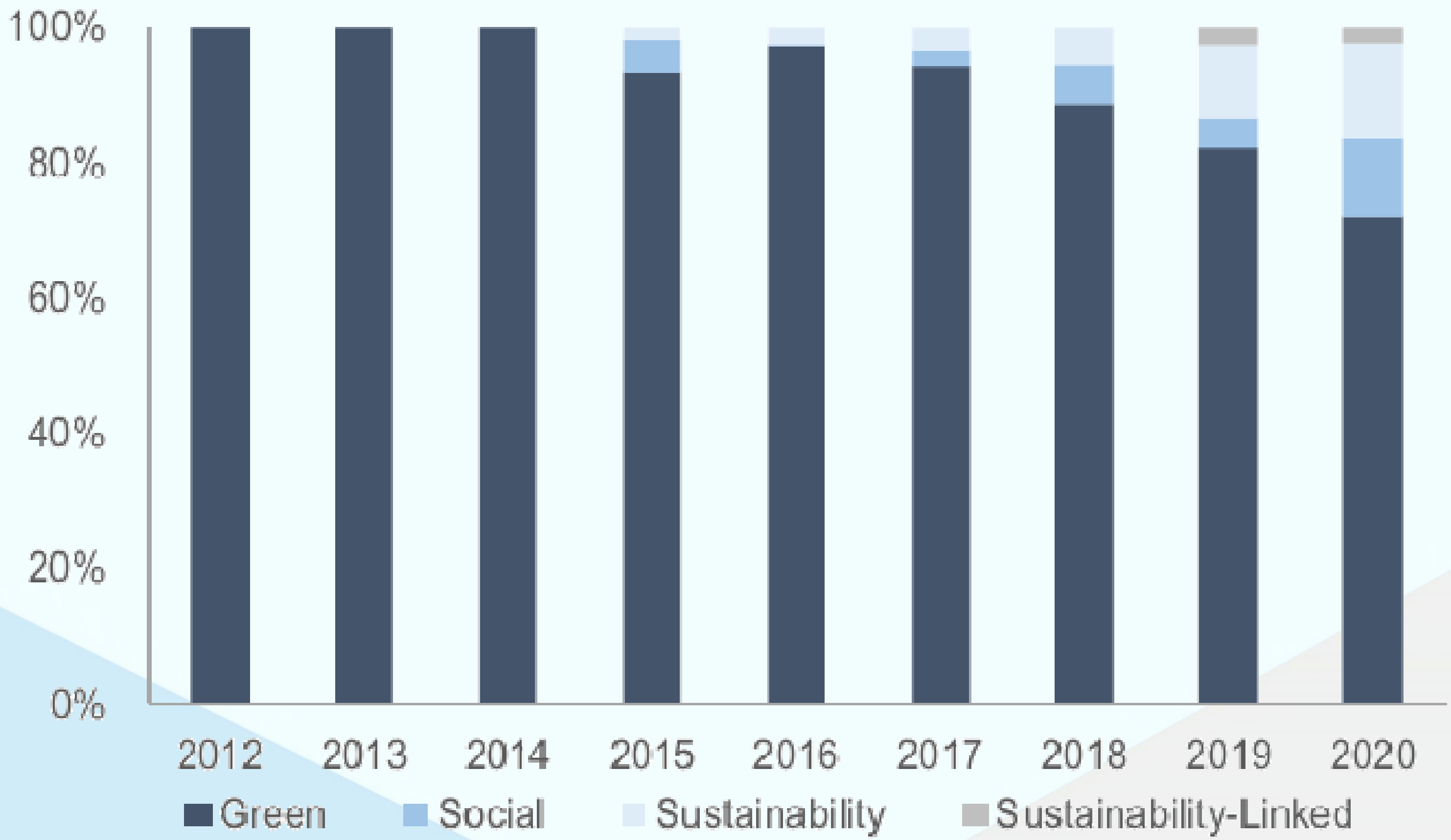
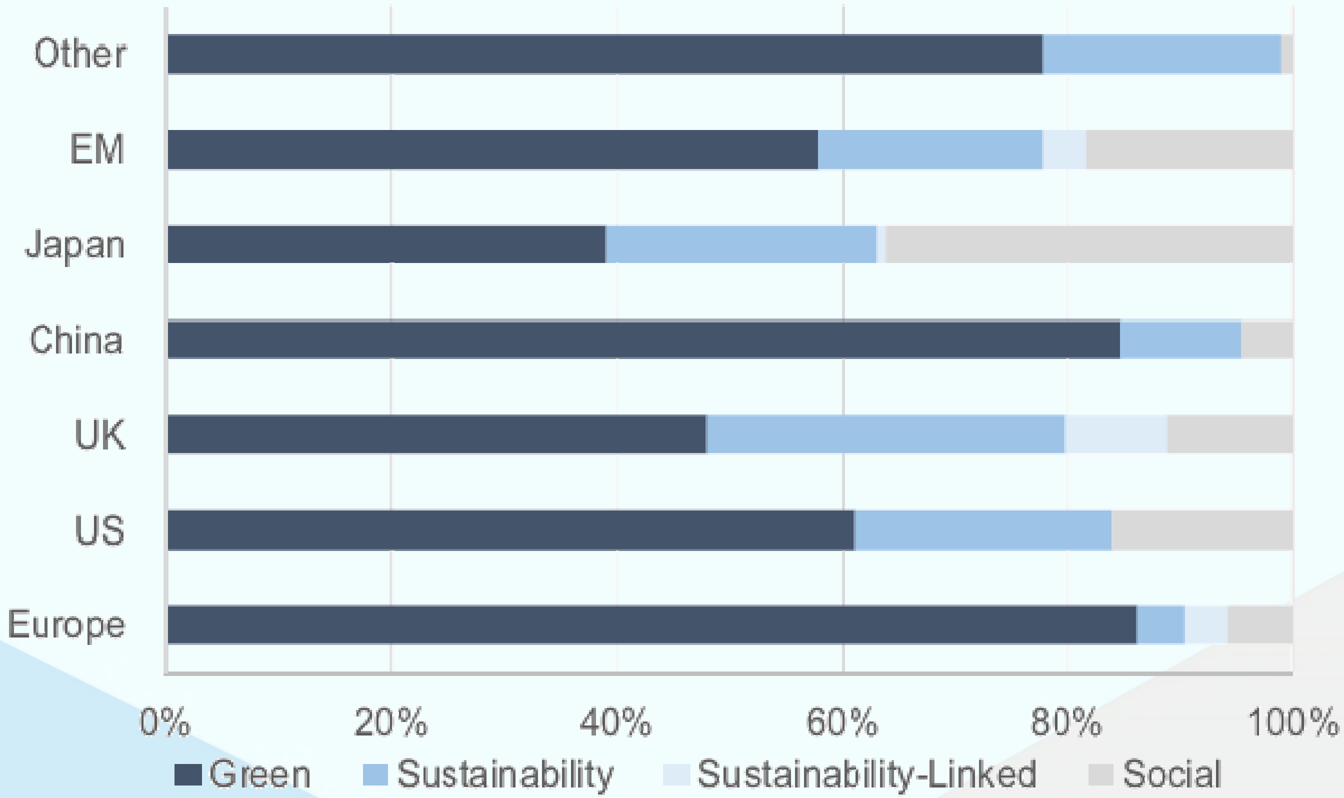
Type of GSS Issuance Has Changed Over Time



Source: J.P. Morgan, Bloomberg Finance L.P., Dealogic.

GSS Investors Show Different Interest Regionally



Source: J.P. Morgan, Bloomberg Finance L.P., Dealogic. Region classification based on Country of Risk.

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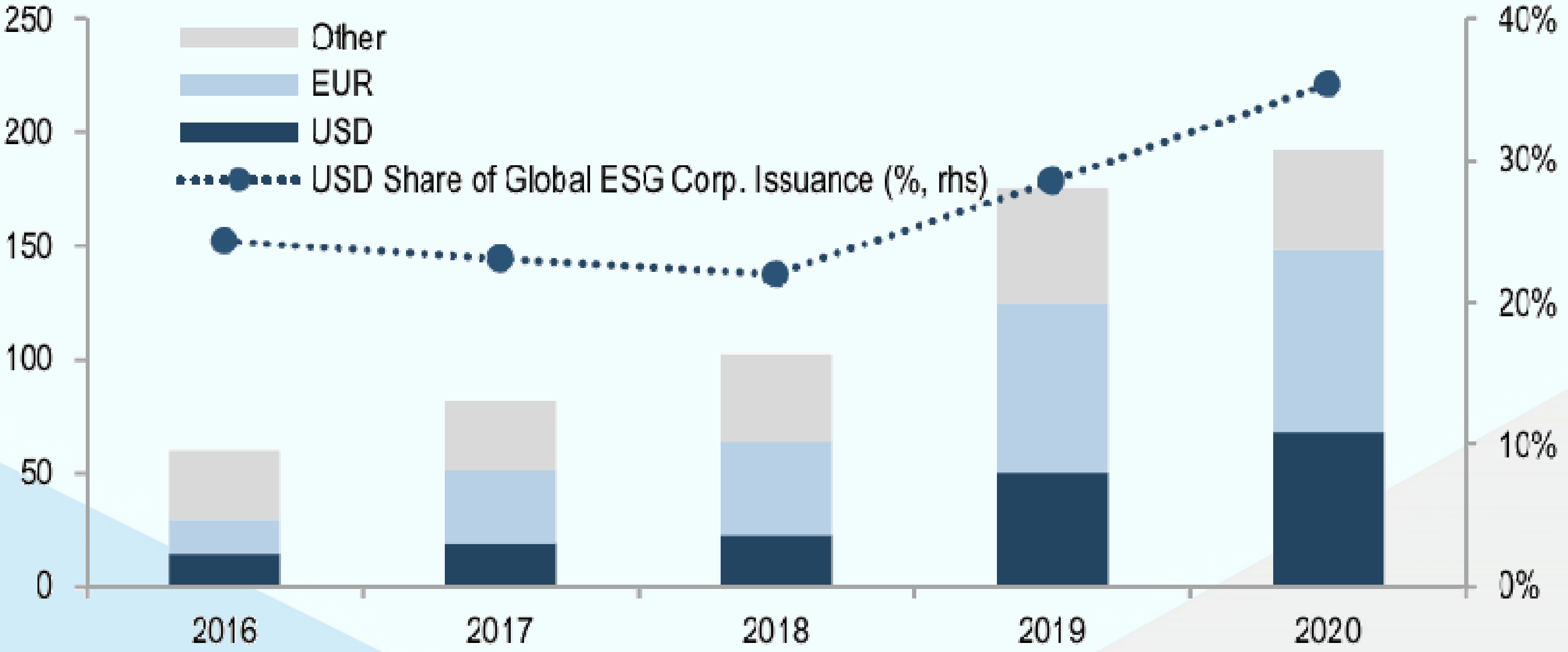
US GSS Interest is Rising



Source: J.P. Morgan, Dealogic, Bloomberg Finance L.P.

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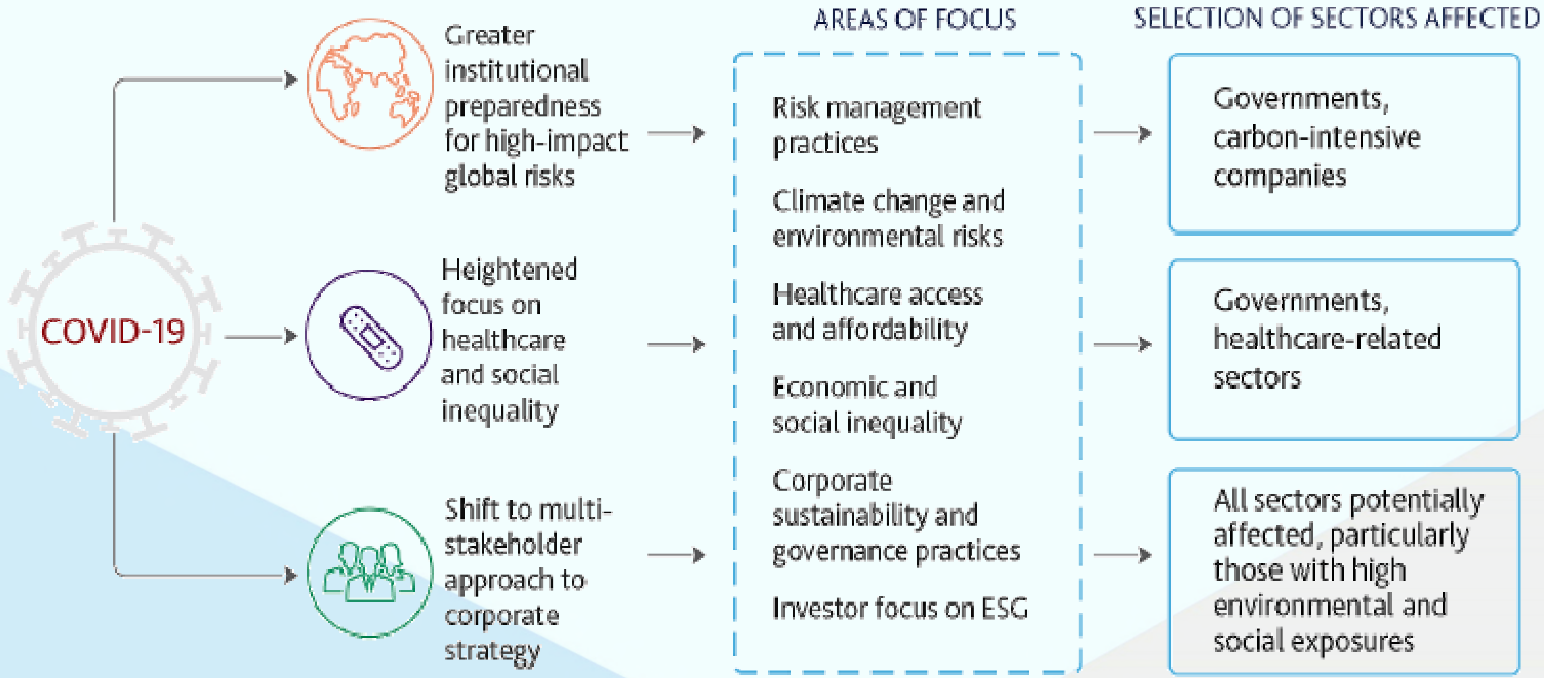
Moody's 03/2020 Sustainable Finance Market Update

ESG risks will come into greater focus, supporting sustainable bond issuance



Source: Moody's Investors Service

Moody's 03/2020 Sustainable Finance Market Update

Sustainability-linked bonds set for growth

ESG & CLIMATE RISK

- Debut sustainability-linked bonds (SLBs) from Italian utility **Enel** in 2019 launched market interest
- Instruments offer the **flexibility of general corporate purposes borrowing**, while still allowing issuers the ability to highlight their enterprise-wide sustainability objectives
- Three transactions in the third quarter point toward further growth:
  - Brazilian pulp and paper company **Suzano S.A.**, $750 million SLB, tied to reducing its greenhouse gas emissions intensity
  - Swiss pharmaceutical company **Novartis AG**, €1.85 billion SLB, tied to the achievement of social targets
  - French fashion house **Chanel**, €600 million SLB, tied to decreasing its carbon emissions and shifting to 100% renewable electricity in its operations
- Publication of ICMA **Sustainability-Linked Bond Principles (SLBP)** in June 2020 supports market standardization
- Announcement from ECB that **sustainability-linked bonds will become eligible as central bank collateral** beginning in January 2021 further bolsters market

Moody's 03/2020 Sustainable Finance Market Update

Twenty countries have now issued sustainable bonds for a combined $83.8 billion to date

Country	Moody's Credit Rating	Sustainable Bond Type	First Sustainable Bond Issuance	Number of Transactions	Total Issuance to Date (US$ millions)
Belgium	Aa3 stable	Green bond	Mar-18	1	$5,531
Chile	A1 negative	Green bond	Jun-19	4	$6,236
Ecuador	Caa3 negative	Social bond	Jan-20	1	$327
Egypt	B2 stable	Green bond	Oct-20	1	$750
Fiji	Ba3 negative	Green bond	Dec-17	1	$54
France	Aa2 stable	Green bond	Jan-17	11	$28,249
Germany	Aaa stable	Green bond	Sep-20	2	$13,616
Hong Kong	Aa3 stable	Green bond	May-19	1	$1,000
Hungary	Baa3 positive	Green bond	Jun-20	2	$2,234
Indonesia	Baa2 stable	Green bond	Feb-18	4	$3,500
Ireland	A2 stable	Green bond	Oct-18	2	$5,638
Lithuania	A3 positive	Green bond	Apr-18	3	$155
Luxembourg	Aaa stable	Sustainability bond	Sep-20	1	$1,777
Mexico	Baa1 negative	Sustainability bond	Sep-20	1	$888
Netherlands	Aaa stable	Green bond	May-19	1	$6,680
Nigeria	B2 negative	Green bond	Dec-17	2	$71
Poland	A2 stable	Green bond	Dec-16	4	$4,311
Seychelles	Unrated	Sustainability bond	Oct-18	1	$15
South Korea	Aa2 stable	Sustainability bond	Jun-19	1	$500
Sweden	Aaa stable	Green bond	Sep-20	1	$2,316

Sources: Moody's Investors Service and Environmental Finance Bond Database

Green Bonds

- 2016 In Brief re Green Bond Principles (GBP)
- Latest June 2018 GBPs and June 2019 Green Project Mapping
- Core requirements (and embedded potential complexity):
  - Use of proceeds
  - Process for project evaluation and selection
  - Management of proceeds
  - Reporting
- June 2020 Sustainability Standards and Labels to guide assessments of project eligibility
- EU Green Bond Standard, as a component of the EU Green Deal, and related March 2020 usability guide

Green Bonds

- GBP explicitly recognizes broad categories of eligibility with the overarching objective to address "key areas of environmental concern" such as climate change, natural resources depletion, loss of biodiversity and pollution
- High-Level Mapping to 17 EU Sustainable Development Goals:

Green, Social and Sustainability Bonds: A High-Level Mapping to the Sustainable Development Goals

Green Bonds

- *Green Bonds* are any type of bond instrument or loan financing where the proceeds will be exclusively applied to finance or re-finance, in part or in full, new and/or existing eligible Green Projects

- The GBP explicitly recognize several broad categories of eligibility for *Green Projects*, which contribute to environmental objectives such as: climate change mitigation, climate change adaptation, natural resource conservation, biodiversity conservation, and pollution prevention and control

- The GBP were introduced to formalize perceived market 'best practices' and to encourage transparency and reporting; however, they are voluntary and there are concerns regarding "greenwashing"

Green Bonds

- *Illustrative* types of eligible Green Projects include:
  - Renewable energy (including production and transmission)
  - Energy efficiency (including energy storage, district heating and smart grids)
  - Pollution prevention and control
  - Environmentally sustainable management of living natural resources (including sustainable agriculture and forestry)
  - Clean transportation
  - Sustainable water and wastewater management
  - Climate change adaptation
  - Green buildings

- ICMA maintains current databases for Green Bonds and related Green Bond Indicies, which reflect the substantial breadth and variety of eligible Green Projects, related Green Bond standards and external reviewers

Green Bonds – Rating Agency "Assessment"

- Fitch, Standard & Poor's and Moody's "assess" Green Bonds
- S&P's "evaluation"
- Moody's 2016 "assessment" methodology describes how Moody's evaluates five key factors and scores Green Bonds for the relative likelihood that bond proceeds will be invested to support environmentally beneficial projects as designated by the issuer. Green Bonds are assessed as GB1 (Excellent) through GB5 (Poor)
- Fitch's ESG "Relevance Scores" and Green Bonds

Summary of certain core EU Sustainable Finance Regulatory Rules

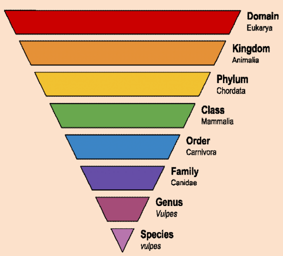
(There are others as well…)

Regulation/ Directive	Summary Description	Status
The Non-Financial Reporting Directive (NFRD) 	Rules across Europe on disclosure of non-financial and diversity information by large companies (more than **500 employees**), banks, insurance firms and other designated public-interest entities (around 6,000 companies across Europe) (e.g. annual reports) – covers: • environmental protection • social responsibility and treatment of employees • respect for human rights • anti-corruption and bribery • diversity on company boards (in terms of age, gender, educational and professional background) Disclosure should cover business models, policies and outcomes, risk and risk management and KPIs. Adopts **"comply or explain" system**, meaning if no policy is in place in one of the above matters, company must explain the reasons behind this Issues relate to non-comparability of data between companies with different standards and reporting frameworks being used (e.g. Global Reporting Initiative, Sustainability Accounting Standards)	Effective in all EU Member States since 2018 Under update to better facilitate disclosures by asset managers and pension providers under Disclosure Regulation (see below)

EU Sustainable Finance Regulatory Reforms

Regulation/ Directive	Summary Description	Status
Disclosure Regulation 	Imposes **transparency** and **disclosure** requirements on investment managers, insurers, pension providers and advisers: • what firms must disclose and maintain on their websites; • information that must be provided to investors (e.g. pre-contractual disclosures); • periodic reporting to investors. Aim is for firms to integrate into investment decisions, advice, remuneration, impact reporting information related to sustainability factors (environmental, social, employee, human rights, anti-corruption and anti-bribery) Sustainable investment is an investment which (i) contributes to an environmental or social objective, (ii) does not significantly harm (DNSH principle) any environmental or social objective and (iii) where investee company follows good governance policies	The Disclosure Regulation entered into force on **29 December 2019**. The main provisions apply from **10 March 2021**.

EU Sustainable Finance Regulatory Reforms

Regulation/ Directive	Summary Description	Status
Taxonomy Regulation 	Amends the Disclosure Regulation. Establishes EU-wide classification system to provide businesses and investors with **a common language to identify environmentally sustainable economic activities** for the purposes of establishing the degree of environmental sustainability of an investment. Intended to provide businesses and investors with a common language to identify what degree economic activities can be considered environmentally sustainable (or "green"). Obliges financial market participants and large public-interest entities to make statements about **how their financial products and activities align with the taxonomy it specifies**.	Published in the OJ on **22 June 2020**. Requirements relating to the climate mitigation and adaptation objectives due to apply from **1 January 2022**. Requirements relating to the other environmental objectives due to apply from **1 January 2023** (including sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control and protection and restoration of biodiversity and ecosystem)**.** Integrated with **EU Green Bond** Framework to alleviate concerns around greenwashing, consistency in reporting standards etc. Bonds will need to contribute to at least one of the 6 environmental objectives of EU Taxonomy Regulation, not significantly harm any of these objectives, comply with minimum safeguards and technical screening criteria

EU Sustainable Finance Regulatory Reforms *(cont.)*

Regulation/ Directive	Summary Description	Status
Low Carbon Benchmarks Regulation 	Amends Benchmarks Regulation by introducing a regulatory framework that lays down **minimum requirements for an EU climate transition benchmark and an EU Paris-aligned benchmark.**	Published on **9 December 2019.** New ESG disclosure requirements in the BMR were meant to apply from **30 April 2020**. But Level 2 measures, are not yet ready → on **29 April 2020**, ESMA published a no-action letter addressed to NCAs.
Draft Delegated Regulations amending MiFID II (as well as AIFMD, UCITS Directive, IDD)	• Mandatory **assessments of clients' ESG preferences**. • Prepare **reports to clients** explaining how recommendations **meets ESG preferences**. • **Provide information** re ESG factors of financial products **before providing investment advice**.	• Draft texts of delegated legislation published by the Commission on **8 June 2020** • Feedback on the draft Delegated Regulations and Directives must be sent to the Commission by **6 July 2020** • The Delegated Regulations and Directives will apply 12 months after they enter into force.

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EU Sustainable Finance Regulatory Reforms *(cont.)*

Regulation/ Directive	Summary Description	Status
Forthcoming regulation and directive on prudential supervision of investment firms (IFR/ IFD) 	IFD requires the **EBA to submit a report to the Commission** (within two years after entry into force) on the **introduction of criteria on ESG risks**, **how investment firms can take account of these risks** in their risk management and **how supervisors can assess the impact** of those risks in their supervisory review and evaluation process (SREP). Based on this report, the EBA may choose to adopt guidelines to introduce criteria for ESG-related risks into the SREP for certain categories of firms holding assets of a certain threshold.	The EBA should submit these reports by **26 December 2021.**

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ESG-Related Corporate Structures: Benefit Corporations

- **What is a Benefit Corporation?**
  - Relatively new, growing model of corporate form whereby laws hardwire into the DNA of the company the ability to look at social and other non-purely-financial factors, and reduce risk and pressure to directors that they worried about before
  - Starting to cover not just corporations, but also other business organizations like LLCs as well
  - Legislation passed in 39 states plus the District of Columbia and has been proposed in several other states; expanding internationally with legislation passed in several countries
  - Growing in popularity in public and private markets
    - Benefit corporations have done many of the things that traditional for-profit corporations have done, including going public (e.g., Laureate Education, Lemonade and Vital Farms)
    - Public companies seeking to convert to benefit corporation form (e.g., Veeva Systems)
    - Mainstream VCs investing in benefit corporations (e.g., Andreesen Horowitz)

ESG-Related Corporate Structures: Benefit Corporations *(cont.)*

- **How are Benefit Corporations different from Traditional For-Profit Corporations?** In the U.S., a benefit corporation is generally treated as a traditional for-profit corporation with some key differences that are focused mainly on (a) protecting directors and officers who consider socially-minded matters and (b) enabling shareholders to assess how much and how well the goals of the public "purpose" are being met
  - Directors and officers can consider stakeholders of the company beyond just shareholders and are required to take into account factors outside of shareholder value maximization (e.g., employees, vendors, the environment and other stakeholders impacted by the company)
  - Corporation required to state a public benefit "purpose" in its formation documentation
  - Increased transparency through annual or biennial shareholder and/or public reporting with respect to public benefit "purpose"
  - Many states require benefit corporations to report against a third party standard (e.g., B Lab, which is one of the better known "certifiers" in the ESG space)

Key Issues and Considerations: Benefit Corporation Structure

- **Addressing increased director and officer liability concerns**
  - Generally, directors and officers of benefit corporations do <u>not</u> face increased liability as a result of being part of a benefit corporation (although it should be noted that this is a new evolving area of law)
  - Only certain parties can bring benefit enforcement proceedings to enforce "purpose" of benefit corporation and this is usually the shareholders (or certain types or groups of shareholders) unless there is express permission (either in statute or the company's organizational documents) for non-shareholders to do so
  - Benefit corporations should be able to obtain D&O insurance on similar terms to for-profit corporations
- **Potential increased investor and talent attractiveness**
  - Benefit corporations may be more attractive to both investors and talent because the "mission" of the company is built into the organization documents and the directors and officers legally required to work towards that "mission"
  - By not solely focusing on shareholder maximization, may attract shareholders with a longer-term investment in the company

ESG-Related Corporate Structures: Certified B Corp

- **What is a Certified B Corp and Why is Certification Important?**
  - An entity that has obtained a third party certification from B Lab (a private nonprofit)
  - Being a Certified B Corp can help a company "stand out from the crowd" by demonstrating commitment to ESG factors, and can provide credibility in both the consumer and talent marketplaces
  - B Lab evaluates an entity's social and environmental performance through the B Impact Assessment
  - Any for-profit entity, regardless of corporate structure (i.e., not just corporations, but LLCs and LLPs too) or jurisdiction of formation, can obtain B Lab certification
  - Must be recertified every three years against the then-current B Lab standards
  - Certification by B Lab does not go to matters affecting the company's legal structure (although a company seeking B Lab certification may be required to convert to a benefit corporation legal structure), so such entity remains subject to the laws and regulations relating to its underlying legal structure (e.g., traditional for-profit corporation)

Questions?