

ESG IN CREDIT SERIES: ESG IN FIXED INCOME

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4 August 2020



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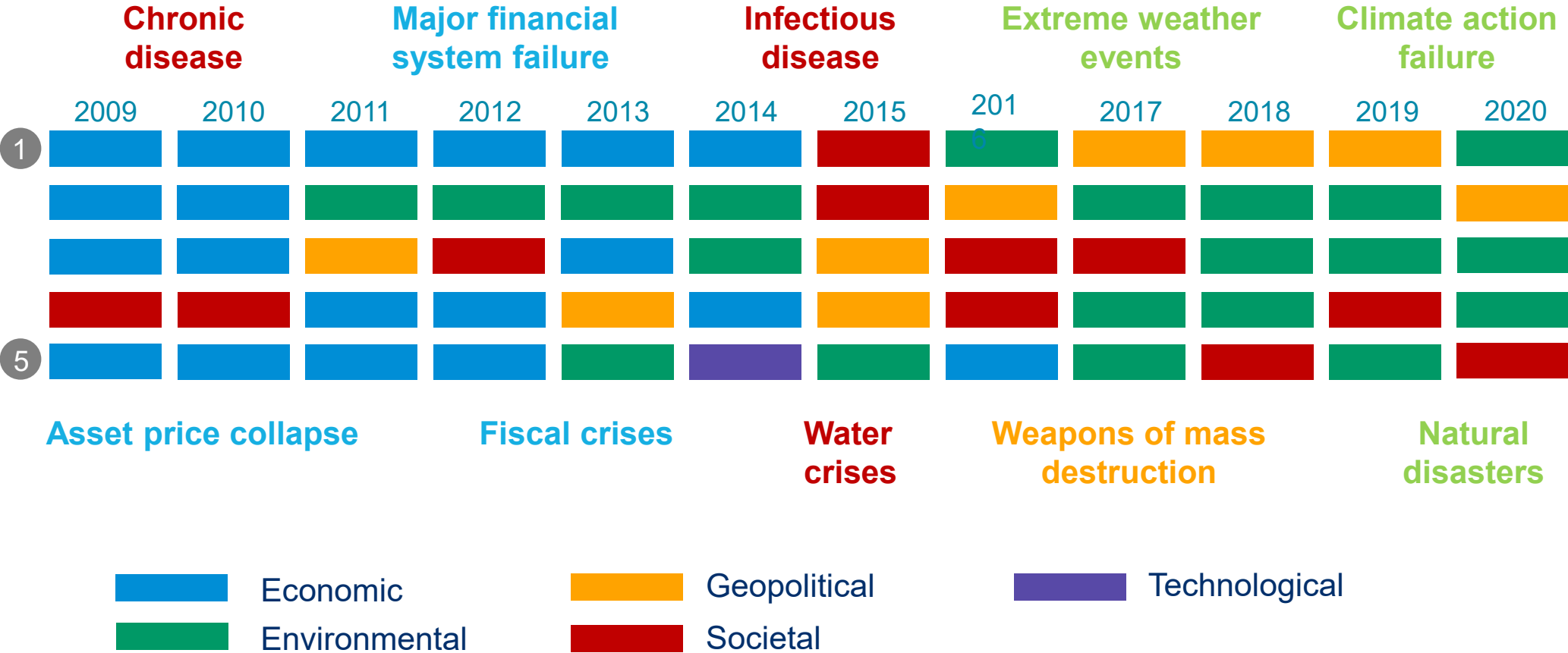


FAST AND SLOW



THE EVOLVING RISK LANDSCAPE: 2009-2020

Top five risks in terms of potential impact



Source: World Economic Forum, Global Risks Report 2020

ESG IN THE TIME OF COVID-19

Bloomberg

ESG a Win for Stocks, Less So for Bonds Amid Covid-19

THE WALL STREET JOURNAL.

Coronavirus Pandemic Could Elevate ESG Factors

FINANCIAL TIMES

ESG passes the Covid challenge



South China Morning Post

Coronavirus strengthens case for sustainable investing as ESG stocks outperform market in crisis

ET Markets

Covid-19 is proving to be the litmus test for ESG investing

Forbes

Covid-19 Is Accelerating ESG Investing And Corporate Sustainability Practices



ETF TRENDS

ESG Investing Could Get a Lift From Retirement Plan Focus

THE Asset 財資

Covid-19 crisis could turn into the ESG era

GlobalCapital

Covid cuts flow of green bonds and loans, but not their appeal

funds europe

Covid-19 could shape ESG investing “for years to come”

ASIAN PRIVATE BANKER The logo for Asian Private Banker, featuring a blue sun-like icon.

PB CEOs optimistic about growth of ESG investment in Asia after COVID-19



Mervyn Tang, CFA

Senior Director and Global Head of ESG Research,
Fitch Ratings



ESG in Credit Webinar Series: ESG in Fixed Income

Mervyn Tang, Senior Director, Global Head of ESG
Research

4 August 2020

UN PRI Signatories Incorporating ESG Issues



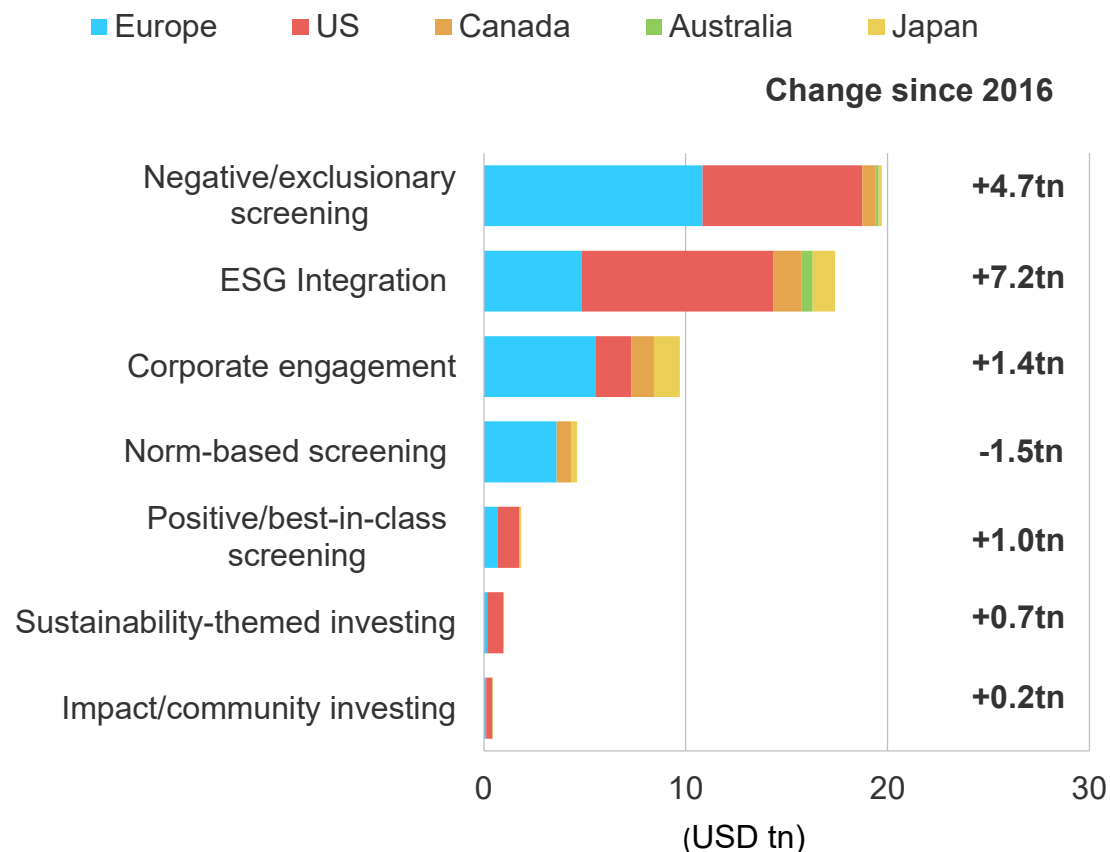
Source: Fitch Ratings, UN PRI

ESG in Fixed Income – Key Differences Compared to Equities

- **Fixed Maturities and Time Horizon:** ESG risk profiles may vary by instruments, particularly with some ESG risks outside the life of a bond
- **Credit Risk vs Earnings Risk:** ESG risks that have an earnings impact may not necessarily be sufficient to have a credit impact
- **Use of Proceeds:** Use of proceeds can be defined for debt instruments, allowing proceeds to be earmarked for specific projects
- **No Ownership or Voting Rights:** This changes how FI investors may engage with issuers.
- **Variety of Asset Classes:** Asset types such as Securitizations, Sovereigns, Convertible Instruments may have different ESG profiles.

NAV of Funds by ESG Strategy

Assets under management (2018)



Source: Fitch Ratings, Global Sustainable Investing Alliance

ESG Strategies and Fixed Income

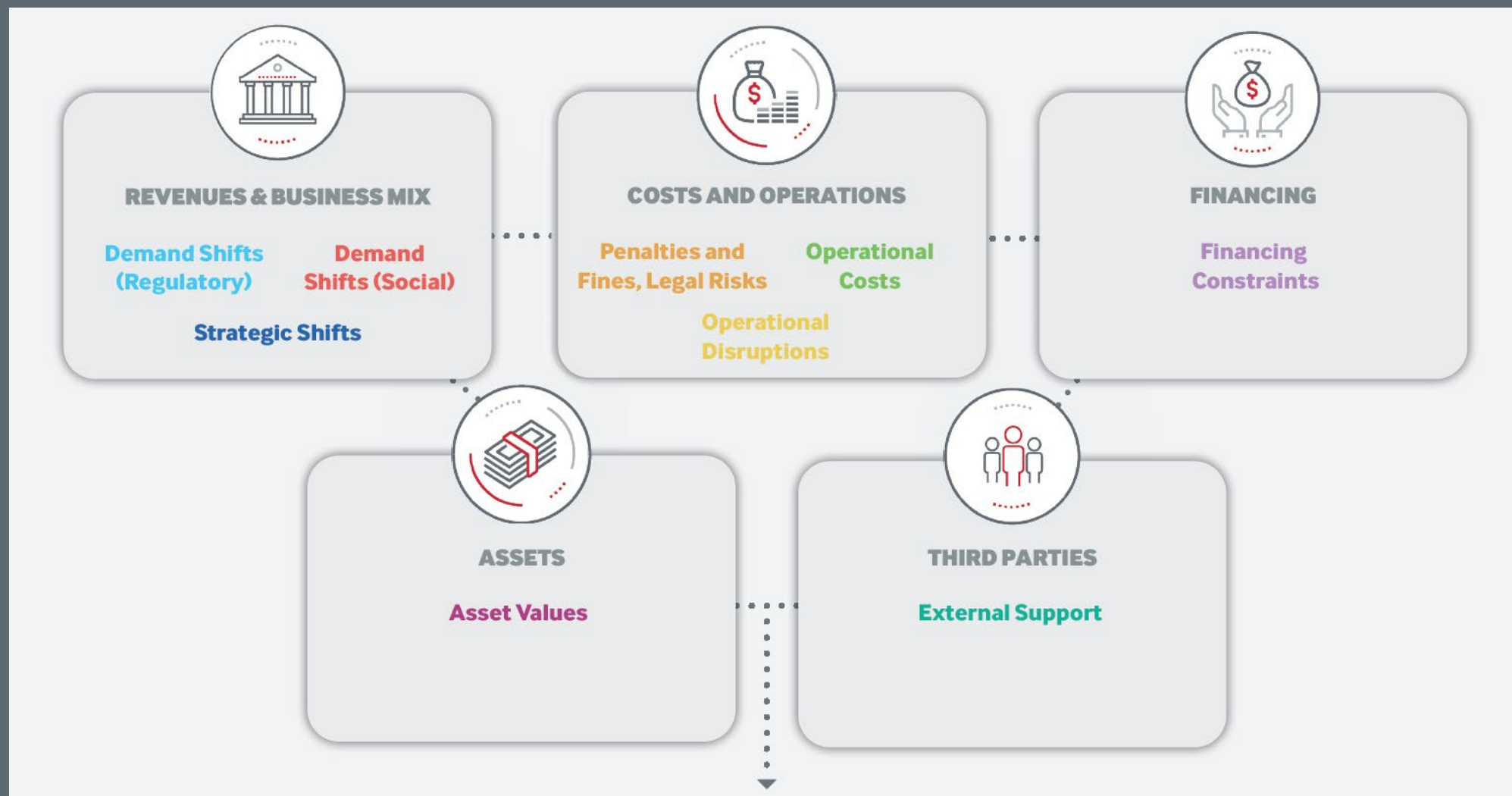
- Many of the underlying ESG approaches applied to equities can be applied to fixed income, but there can be specific considerations such as parent-subsidary relationships.
- ESG approaches may focus on impact, risk-adjusted return, or mix of both. Green and other ESG bonds do not have a different credit profile to an equivalent conventional bond, so part of the impact component of strategies. Liquidity profile can also differ.
- Fixed income investors assessing ESG from a risk-adjusted return perspective try to understand how ESG issues impact credit risk and ratings.

Fitch ESG Relevance Score	Definition
5	Highly relevant, a key entity, transaction or program rating driver that has a significant impact on an individual basis.
4	Relevant to entity, transaction or program rating; not a key rating driver but has an impact on the ratings in combination with other factors.
3	Minimally relevant to ratings, either very low impact or actively mitigated in a way that results in no impact on the entity, transaction or program rating.
2	Irrelevant to the entity, transaction or program ratings; relevant to the sector.
1	Irrelevant to the entity, transaction or program ratings; irrelevant to the sector.

ESG and Credit Ratings

- Since 2015 investors have been calling on CRA's to systemically incorporate ESG characteristics into their credit ratings
- Fitch's ESG Relevance Scores (ESG.RS) framework is designed to provide an integral, comprehensive and credit focused approach to displaying sector and issuer level ESG credit risks across all its ratings
- ESG.RS do not assess "ESG performance", they are observations of whether ESG risks are relevant and material to credit rating decisions
- Only a portion of ESG risks translate to credit risks, through a variety of transmission mechanisms.

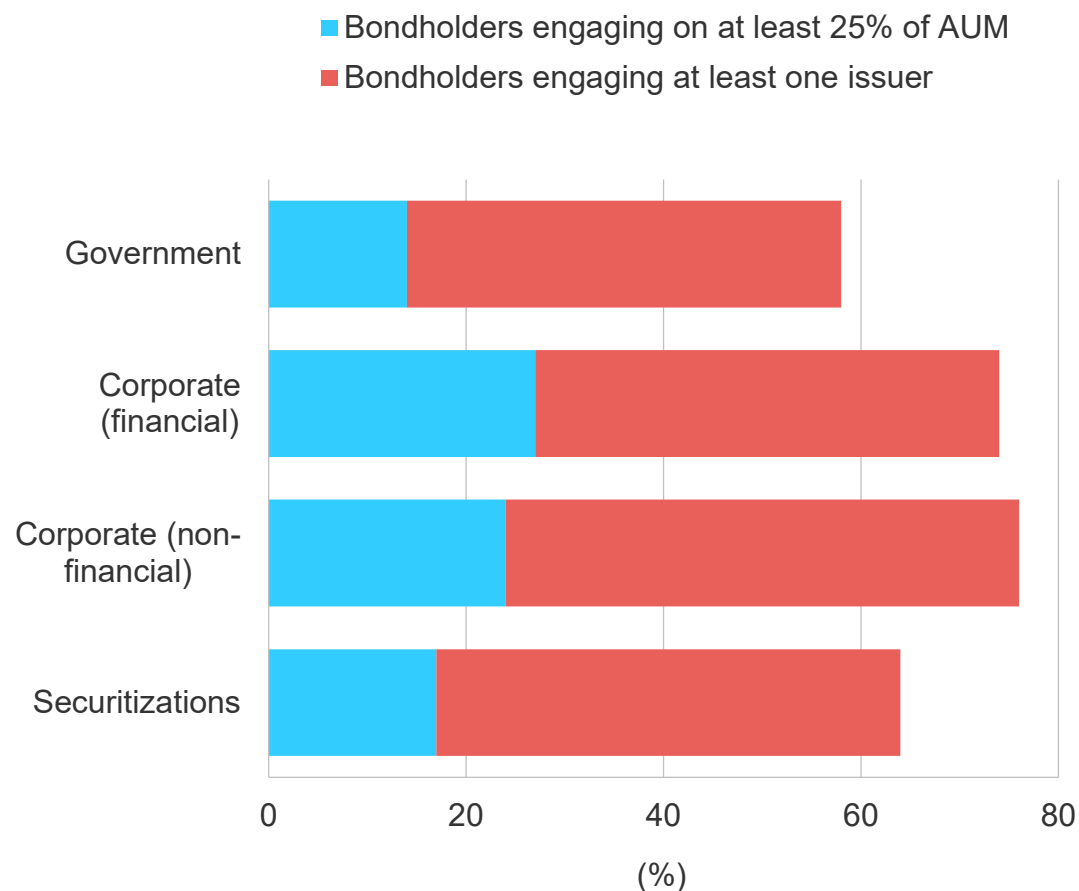
Environmental and Social Risks in Credit: Transmission Mechanisms



Environmental and Social Risks in Credit: Examples

Financial Impacts	Examples of Entities/Sectors Affected	Causation/ESG Risk
Demand Shifts (Regulatory)	Chilean Utilities With Coal Exposure	Government regulations leading to reduced use of coal.
Demand Shifts (Social)	Tobacco	Continued decline in consumption and regulatory risk connected with the widespread well-publicized health effects of tobacco products.
Penalties and Fines, Legal Risks	Australian Banks	Remediation programs underway following Royal Commission investigation into misconduct.
Operational Costs	San Francisco Bay Area Rapid Transit District (CA)	Recent strikes with resulting contracts more favorable to unions than to the issuer, limiting expenditure flexibility.
Operational Disruptions	Cenovus Energy Inc (Canadian corporate)	High exposure to pipeline and logistics takeaway capacity, which has been delayed multiple times due to social resistance to pipelines in Canada. This has widened the Canadian oil price differential to record levels and negatively impacts producers like Cenovus.
Financing Constraint	Corecivic Inc (US Prison REIT)	Withdrawal of funding of financing from U.S. and international banks following social welfare issues that has resulted in access to capital concerns
Strategic Shifts	Global Auto Manufacturers	Tightening global emissions legislation remains a pivotal issue for the industry. Adoption rate of electric vehicles (EV) is still uncertain and depends on factors outside of car makers' control, such as the development of charging infrastructure. In addition, EVs are less profitable, so an increasing share of EVs will initially burden manufacturers' earnings.
Asset Values	FLNG Liquefaction (2&3) LLC (infrastructure project)	Hurricane Harvey caused delays and cost overruns, which remain an issue.
External Support	Structured Agency Notes	GSE program focused on customer welfare and fair messaging while driving strong performance contributing to reduced expected losses, which has a positive impact on the credit profile, and is relevant to the ratings in conjunction with other factors.

Bondholders Engagement with Issuers by Type



Source: Fitch Ratings, UN PRI

Engagement is Increasing Amongst Fixed Income Investors

- Engagement by fixed income investors was limited compared to equity investors given lack of ownership and voting rights, but is increasing.
- Covenants set out contractual terms and bondholder rights, but for now rarely used for E&S considerations.
- Engagement particularly effective for investors in primary markets, particularly for repeat issuers.
- Engagement is reaching a wider set of issuers that are outside the scope of equity investors, such as Sovereigns and private companies.

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PANEL DISCUSSION



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THANK YOU

