Sustainable Fitch

GAINING SPECIALIST CLARITY ON ESG IN FIXED INCOME

HOW ESCALATING DEMANDS IN THE LABELLED BOND SPACE ARE CHANGING PRACTICES FOR INVESTORS AND WHAT YOU NEED TO DO TO KEEP PACE

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INTRODUCTION

Investor thirst for sustainable investments, across all asset classes, has seen fixed income issuance creation & supply skyrocket YoY to meet the demand. The labelled bond space has exploded, with labelled issuance growing 69% between 2020 and 2021. In real terms, this was 3,184 transactions totalling USD1.02 trillion. Corporates represented the largest category of issuers, claiming 36% of the market share, compared with 26% in 2020.

Green bond issuance grew to $552m but, having previously dominated GSS issuance, only accounted for 53% by value of all GSS issuances in 2021, giving way to growth in other categories, the most significant being KPI linked bonds at 9% in 2021. Research by Bloomberg forecasts that global ESG assets will exceed $53 trillion by 2025, more than one-third of the estimated $140.5 trillion in assets under management by that date. (Environmental Finance, Sustainable Bond Insight 2022).

This market boom and increasing focus on labeled bonds represent a significant challenge for investors, where issues around information and behaviors have led to controversy, adverse headlines and even sanctions, along with widespread concerns around greenwashing. There is growing scrutiny of corporate activity and behavior by stakeholders, particularly from investors who also have increased discrimination & surveillance of their investments. When taken with increasing regulatory and compliance requirements, these factors demonstrate the need for next-generation high-quality data and analysis of both companies and the investments into them. Our response is the creation of that high-quality data and analysis. We're providing asset managers and owners with detail to help inform strategy, make better investment decisions, and better manage, control, and transition portfolios. Our solution helps meet stakeholder and regulatory needs, helping firms shift their investment strategies and supporting the global mission towards sustainability.

Sustainable Fitch ESG Ratings can be used in investment strategy, security selection or exclusion, issuer engagement, and stewardship. They also support disclosure and understanding of ESG themes within an investor's portfolio. ESG Ratings support portfolio construction where the overall ESG rating, or sub-components, are used for positive/negative screening and ESG optimization at the entity or instrument level. Another use case is benchmarking and performance, where ESG Ratings can be used for weighting or inclusion/exclusion. ESG Ratings are also a useful tool for issuers and stakeholders to communicate alignment, ESG quality and thematic breakdowns.

This paper seeks to help investors understand the challenges and drivers emerging in ESG investing and possible solutions. We examine questions that matter most to investors.

WHAT DOES THE BOOM IN THE LABELLED BOND SPACE OVER THE LAST YEAR SIGNIFY?

ESG investing is no longer a niche pursuit but rather rapidly becoming a go-to strategy for investment managers looking to meet the increasing demands and ESG awareness of their end capital owners. The boom in the labelled bond space signifies a continuing market shift of entities using ESG principles and metrics to shape how they attract capital and assist their transition towards sustainability and away from harmful activities. This is coupled with a desire from asset owners and asset managers to adjust investment strategy and investments to support those companies pursuing that mission. Regulation is also a driving force in this, creating distinctions between fund types, such as EU Article 6, 8 and 9 funds for asset managers to grapple with.

As interest in ESG increases, the requirement for a more sophisticated, detailed and granular understanding of the issues has also significantly increased. With this desire for extra knowledge comes a requirement to augment current ESG review practices with more robust processes and additional sources of information. This requirement is as yet unmet, with asset managers having to rely on non-standardized company disclosures, which are complicated & time-consuming to ingest or format into something useful and comparable from which insights can be drawn.

The ESG data market has grown significantly in recent years, with multiple providers capturing and generating data to address issues and fill gaps, often using models and assumptions. So far, the ESG data market has tried to standardize public disclosure information and cover data gaps with assumptions, which has created deficiencies. The increasing sophistication of investors and the advancement of data needs to manage portfolios, as well as meet regulatory requirements, means that the next generation of more substantive and robust ESG analysis and data is required to support and serve investors.

With ESG taking centre stage as opposed to being a marginalized investment strategy, greater scrutiny is rightly being applied, and lower quality solutions are being more robustly challenged as they can result in headline risks or even sanctions for investors. A gap exists for the next-generation product to meet the market's approaching levels of maturity. A solution that helps investors to connect the dots through a granular methodology and framework, consolidating the complex world of ESG evaluation, is needed to complement the market's evolution. It is this which we believe we have created and something which, for the first time, can take a granular view on specific debt instruments (bonds or loans), underlying labelled frameworks and also the companies themselves.

CHALLENGES FACED BY INVESTORS AS THEY TRANSITION TO MORE SUSTAINABLE INVESTMENTS

As investors transition their investments to be more sustainable, they need to be able to invest effectively, manage portfolios, support ESG strategies and meet commitments made to their beneficiaries. They also need to be able to perform timely and robust reporting to stakeholders and attract new end capital owners who can trust them to steward their ownership and support that transition. There are increasingly likely to be more regulatory requirements and reporting needs. The moves towards more commonly accepted standards, and means of measuring progress in ESG, are welcome for the transparency they create and the meaningful progress that the added transparency facilitates.

However, in practice it can be difficult for any firm to manage and report data against different principles, taxonomies, reporting requirements, commitments, and policies. The landscape is diverse and varies depending on where you are in the world. Whilst this is not unusual in the world of financial regulation, the variation in detailed and disparate sets of standards that apply to ESG is relatively new, and a comprehensive or universally applicable standard is yet to emerge. This poses a significant challenge for investors looking to find a way of easily reporting against multiple standards across different portfolios, especially in emerging markets, which are arguably the most important constituents in any transition to a low carbon world.

Another challenge is also to solve the communication gap between issuers and investors, addressing the variable disclosure investors receive from issuers in a way that allows investors to work more easily, at speed, across all asset classes. For fixed income, there is a lack of instrument-level data to enable and facilitate portfolio managers to meet the challenges outlined above. Any solution must offer comparability and precise information that investors can use to improve their investment process and provide greater confidence around regulatory reporting requirements. Our approach to evaluation is science-based. Our analysts' analysis framework focuses on impact, outcome and performance. At an entity level, it balances the impact of each existing business activity with the goals and aspirations of the company. Our analysts then critically evaluate policies, procedures and governance practices that apply across all business activities, emphasizing best practices, track record, and the real impact and outcomes of the policies in place. At an instrument level where there is a framework (labelled or KPI) we look at the effectiveness of the framework in delivering the goals of the debt instrument, and for a conventional debt, we do a detailed analysis of the documentation for alignment with the entity's strategies and goals around ESG. We assess all the factors that comprise our ESG ratings on an absolute and cross-comparable scale, meaning that whether an investor is interested in an aggregate view of ESG or in a single component factor, our data is cross-comparable between different types of debt, entities, sectors and asset classes.

THE ESG STANDARDS LANDSCAPE

Types Of Standards	Examples
Principles and Taxonomies	• ICMA • EU Taxonomy / CBI Taxonomy/ ASEAN Taxonomy/Chinese Green Bond Catalogue • ICMA Climate Transition Handbook • International Labor Organization Decent Work Standards • Principles for responsible Investment (PRI) • Science-Based Targets Initiative (SBTi) • UN Global Compact • UN Guiding Principles on Business and Human Rights • UN SDGs
Voluntary reporting	• On ESG metrics and materiality: GRI, SASB/ISSB, CDP
Mandatory reporting	• SFDR (asset managers & FIs, from 2022) • CSRD (corporates >250 FTE, expected from 2024) • TCFD (mandatory in the UK & Japan, for listed companies in NZ, Singapore, Hong Kong, US pending (under consultation), voluntary elsewhere) • Many country-level mandatory disclosures – most common after emissions/climate change is diversity
Commitments and Policies	• RE100 (100% renewable commitments by large corporations) • Net-zero 2050, carbon-neutrality • Sector-specific objectives • ISO series

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WHAT ARE THE INTERRELATED ASPECTS OF E, S AND G FACTORS?

Up until now, many ESG analyses have focused primarily on environmental risks and impacts, particularly as issuance has predominately been skewed towards Green bonds. However, with the rise of sustainability-linked bonds, a wider and more comprehensive view is becoming increasingly important. A recent analysis by Sustainable Fitch has highlighted the importance of the social impact of issuers' business activities and how that should contribute to higher ESG Entity Ratings. This means that for two peers with similar environmental and governance profiles, any activities serving social needs should lead to overall differentiation. Greater granularity and a full analysis of the E, S and G helps investors to look beyond an overall score and enables the comparison of specific factors related to the use of proceeds for similar instruments. This also enables comparison of instruments that may be issued by entities from varying sectors, but that achieve similar impacts under their respective ESG Framework Ratings.

The ability to analyze an instrument in the context of the issuing entity (Susatainbale Fitch's ESG IR) gives further context to the impact and performance of the debt instrument relative to other instruments and also other sectors. The detail provided by Sustainable Fitch ESG Ratings gives investors the ability to look further at the correlation and relationships between E and S in the context of the challenges faced across different sectors and asset classes.

PERFORMING EFFECTIVE ESG REVIEW WHEN PUBLICLY AVAILABLE DATA IS LIMITED

Unlike financial reporting standards across the globe which have been in place for decades, ESG reporting standards are still in a development phase, and consequently, disparate and limited market and issuer information is available. Whilst some businesses have started to make voluntary disclosures, they are in the minority, and there remain multiple standards being reported on to varying degrees. Investors need to perform their own review, which means that even the most diligent analyst faces an uphill struggle and a significant time commitment to gather and filter information.

As a reliable, trusted third party renowned for its objectivity, we can gather this information by leveraging existing relationships and sharing all our reports (solicited or otherwise) with an issuing entity for quality control and often elective engagement. Sustainable Fitch has invested in human-driven analysis with qualitative commentary to be able to serve the needs of multiple investors and facilitate better interactive dialogues with issuers. Our status as an established information provider means we have capabilities and proficiency in sourcing, capturing and evaluating data. We're also in a unique position to access and engage with the companies themselves to check the data upon which determinations are made, making us an ideal candidate to perform this function at a level of quality and scale that is useful to the market.

RESPONDING TO THE CHALLENGE OF INCONSISTENCY IN ESG DATA PRESENTATION FROM ISSUERS

According to a recent market report, few entities share all the ESG information required to perform best practice review for impact investing and achieve reliable absolute comparability across all sectors and asset classes. As mentioned standards vary and issuers present data in different formats and to varying degrees. Whilst some investors have the capability to decipher the information, the lack of standardization creates a lot of intensive, expert-level effort for ESG analysts and becomes very resource intensive if done at scale. Building bespoke analysis frameworks in a rapidly developing market is inefficient on an asset manager by asset manager basis.

We are focused on supporting the market need for standardized data and robust analysis, with experience in capturing information, and a reputation for producing high-quality evaluations and insightful analysis. By using our data, the analyst can move straight to the actual work of analysis rather than expending precious hours of hand sorting information before it can be properly assessed. The ability to read and query our analysts' qualitative commentary provides a significant head start in the analysis process, and is substantially different to algorithmically produced scores. Sustainable Fitch ESG Ratings provide transparency and granularity on a consistent cross-comparable basis and high-quality qualitative commentaries at a sub-factor level.

ENABLING COMPARABILITY OF DEBT INSTRUMENTS FROM AN ESG PERSPECTIVE

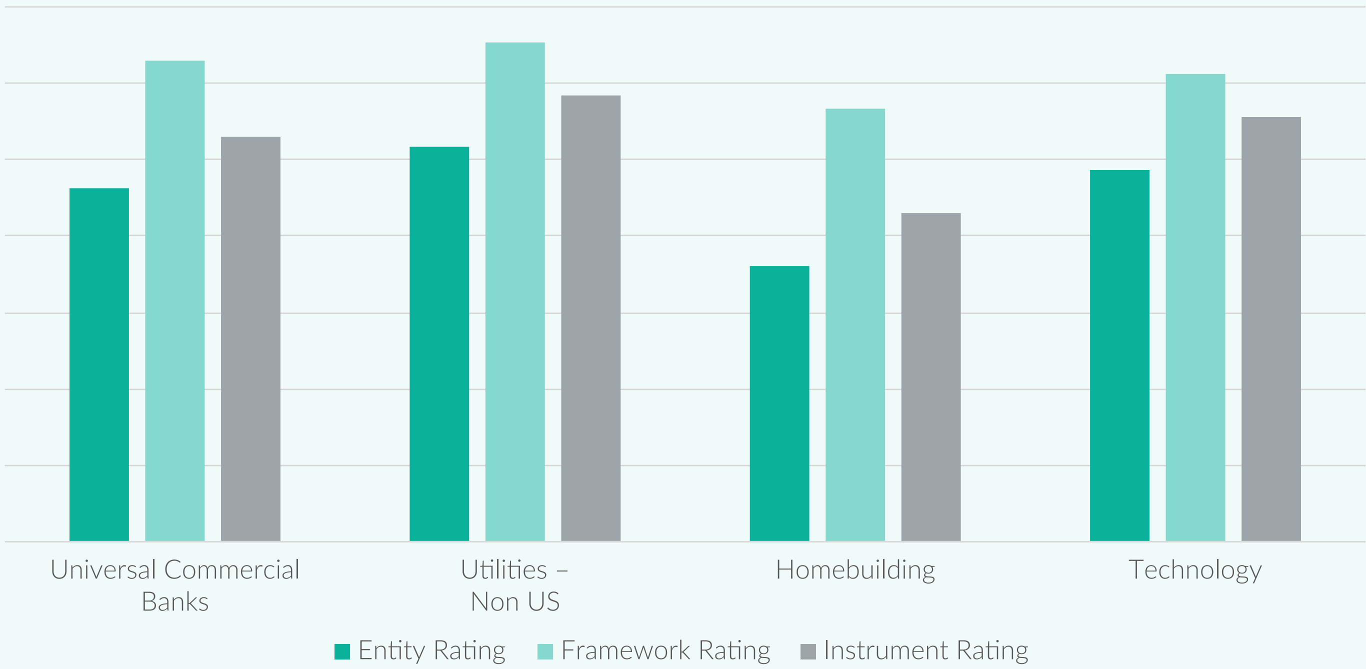
One of the key questions asked of ESG leaders and analysts is "how does this particular asset in my portfolio stack up against similar instruments in this sector, industry or geography?" This comparison is essential to be able to execute investment strategies – exclusion, integration, tilt, best in class or impact. Cross comparability at an instrument level also helps asset managers swiftly and accurately use the information to assist with fiduciary duties, comply with strategies, and communicate with clients, stakeholders and regulators. Instrument level analysis again requires significant analyst resources to enable each investment decision. The level of standardization and depth of data and high-quality commentary produced by our experienced, professional analysts is both more efficient and also necessary to be able to allocate investments in the fixed income space appropriately.

We have developed a reliable central repository of information, standardized and analyzed by ESG professionals with specific sector and geographic knowledge. This provides the potential for accurate and meaningful benchmarking across different industries, geographies and even bond purposes or aims. By way of illustration, our recent analysis of a sample of Sustainable Fitch ESG Ratings data revealed that the sector with the highest average framework score is power utilities and electricity providers (despite some of the entity ratings being very low), whereas food, beverage and tobacco have the lowest average framework scores (despite some of the entities having stronger profiles).

Sustainable Fitch ESG Ratings have been designed to allow for almost unlimited comparability, not just at an overall ESG Rating level, or even just at the E, S or G level, but at a granular sub-factor level, with specific sub-factor groupings and over 750 data points available to offer comparisons on things as granular as a set of social scores for supply chain risk for entities in a particular sector or geography.

SUSTAINABLE FITCH ESG RATINGS BY INDUSTRY (AVERAGE)

Entity Rating-Framework Rating-Instrument Rating By Industry



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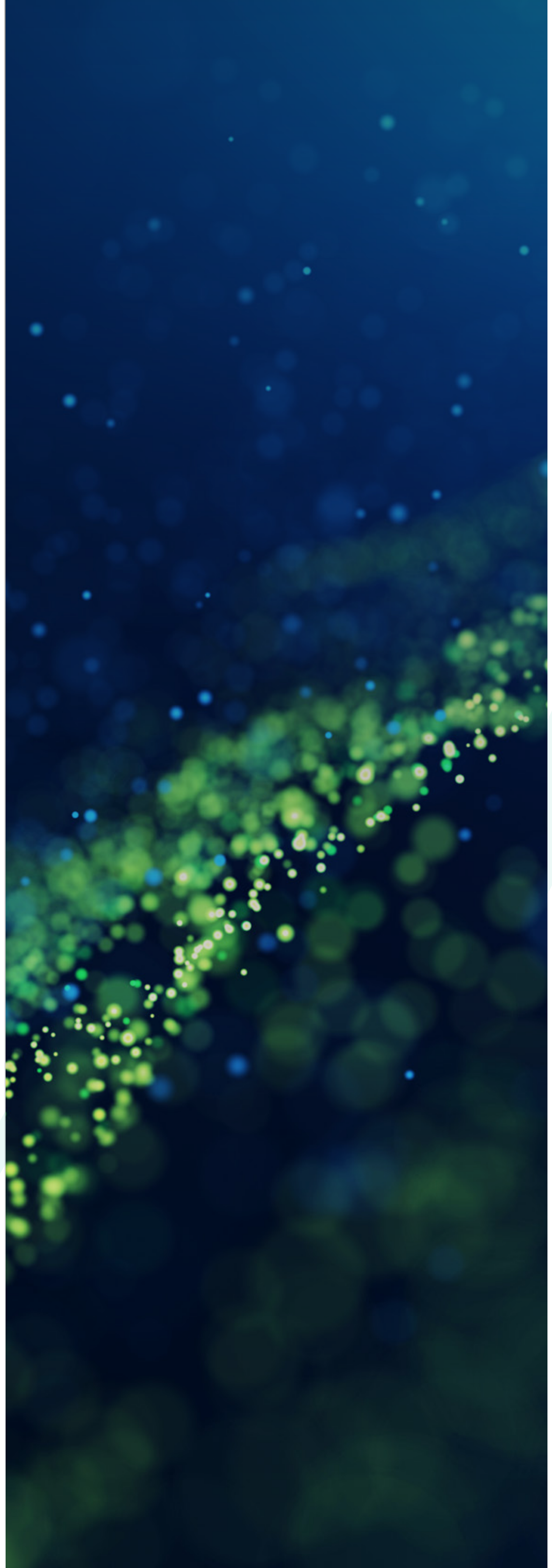
HOW CAN INVESTORS EFFECTIVELY REPORT AGAINST THE VARIOUS ESG STANDARDS, REGULATIONS, FRAMEWORKS, AND TAXONOMIES THAT EXIST ACROSS DIFFERENT JURISDICTIONS?

Until recently, this has been a difficult and largely manual internal process for investment managers. Sustainable Fitch ESG Ratings include data and reports that correlate to or directly reference many of the major frameworks. They reveal the level of alignment of an instrument to standards such as ICMA, EU GBS, EU Taxonomy, and the UN SDGs.

While many ESG assessments for issuers or their debt instruments cite framework alignments or source from third-party Second Party Opinions (SPOs), Sustainable Fitch ESG Ratings provide a more detailed individual Use of Proceeds' alignment with EU Green Bond Standards, scoring aspects at a technical screening criteria level, as well as instrument alignment with ICMA Green and Social Bond Principals. The analysis concentrates on fundamentals regardless of issuer labelling. Additionally, SDG alignment at the target level is determined for both the entity and instrument. As global taxonomies develop and start to take the form of regulations in some jurisdictions, Sustainable Fitch's focus on fundamentals and structuring its analysis around the best-in-class taxonomies of reference available means that the framework and methodology should remain consistent and relevant.

IDENTIFYING AND AVOIDING GREENWASHING

A more detailed and granular understanding of sustainability and what that means for the various entities and instruments are required and one that balances both existing activities with aspirations, policies and outcomes. To do that, there needs to be a solution that goes beyond ESG risk scoring of financial materiality or somewhat simplistic Second Party Opinions. The current data offerings often are unclear about the interaction or weightings of existing business activities, use of proceeds, transition strategies or KPI definitions and tracking. When combined with patchy and inconsistent monitored coverage, this makes it incredibly challenging for investors to consider actual ESG impact and performance at the entity and instrument level, leaving them open to accusations of supporting greenwashing. Our ESG Rating data contains granular, instrument level, use of proceeds data output alongside entities business activity information as well as DNSH & raw data. Not surprisingly, in our recent analysis of a sample of Sustainable Fitch ESG Ratings data, there were significant differences between average framework scores for instruments and overall entity scores, which incorporate a detailed analysis of individual business activities, impacts and outcomes. Providing clarity at an instrument level and an entity level enables investors to quickly and easily identify where instruments are well aligned with entity statements, outcomes and aspirations and where they appear to be poorly aligned or a token instrument.



INTRODUCING SUSTAINABLE FITCH ESG RATINGS

WHAT DO ESG RATINGS FROM SUSTAINABLE FITCH ALLOW YOU TO DO?

Evaluate the ESG impact and performance of any fixed income instrument and the issuing entity with a robust, comprehensive, transparent, cross-comparable, and independent qualitative and quantitative assessment from Fitch, a name recognized and trusted for over 100 years in the fixed income space.

ESG Ratings provide investors with comprehensive qualitative analytical reports, entity and ISIN level ratings, and detailed underlying quantitative datasets for all Green, Social, Sustainable and KPI-linked bonds. This is supported by a detailed and comprehensive data set that delivers entity, instrument and framework ratings, the underpinning scores and sub-factors, plus raw data currently extending to 750 fields with the potential to be expanded further dependent on investor demand. We have multi-channel delivery via feed, API, web & excel tools to support individual asset interrogation and to help aggregate data to enable investment processes, ongoing asset management and reporting meaningfully. We also provide additional screening functionality to aid control and governance.

HOW ARE SUSTAINABLE FITCH ESG RATINGS DIFFERENT?

We created Sustainable Fitch ESG Ratings primarily as a fixed-income next-generation product that solves the instrument level data gap and that can tackle the issues of standardization, coverage and data quality. Our product is a human-powered analysis which ensures the information you're getting is transparent, granular and created by experienced ESG analysts with sector knowledge. Specialists that you can connect with directly, to discuss and better understand their analysis.

ESG Ratings are purpose-built and designed specifically for use in fixed income investment decisioning, management & reporting. ESG Ratings are fit for purpose and give you clarity on the measurement of the ESG impact of individual financial instruments and issuers across industries and geographies. Our rating methodology leverages and is informed by major science-based taxonomies, principles, policies and reporting standards, making reporting against any of them simple. ESG Ratings provide detailed information on financial instruments at a Use of Proceeds and/or KPI level, including analyst opinions and ratings on underlying bond features. Additionally, issuer ratings include detailed analysis and ratings of the E and S impact of business activities, outcomes, and strategy.

Our ESG Ratings are monitored and maintained to provide useful, relevant information designed to help you minimize greenwashing risk, create actionable insights, and maximize the ESG impact and performance of fixed income investing.

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SUSTAINABLE FITCH ESG RATINGS, DATA & ANALYSIS

Evaluate the ESG impact and performance of labelled fixed income instruments and the issuing entity, with a comprehensive, transparent and cross-comparable qualitative and quantitative assessment from Fitch, a name recognized and trusted for over 100 years in the fixed income space.

Our ESG Ratings is the only product in the market with coverage of global issuances >$250M in value spanning global coverage across all sectors (i.e. corporates, financial institutions, structured finance etc.).

LEARN MORE

Visit **sustainablefitch.com/products/esg-ratings-data-analysis** or email us at **info@sustainablefitch.com** to request additional information or speak to a dedicated advisor.