FAB ESG WEEKLY UPDATE

30 September 2022

This week, we identified the following events of significance within sustainability and their respective business implications.

REGULATORY

1. The **European Central Bank (ECB)** identified **gaps in climate-related information provided by credit ratings agencies**, and outlined its own common minimum standards for incorporating climate risks into in-house credit assessment systems used by the Eurosystem central banks. The ECB issued an analytical framework to perform a status-quo assessment of the disclosure of climate change risks in rating methodologies and ratings reports by selected credit rating agencies.

- The ECB found that the information provided by ratings agencies does not allow users to draw a definite conclusion on what would have been the credit rating in absence of climate change risk. The paper compares the climate-related definitions, methodologies, assessment models, data usage and disclosure practices of four credit rating agencies accepted by the Eurosystem as part of its Eurosystem Credit Assessment Framework. It reveals large differences in methodologies and disclosure practices rating agencies and asset classes.
- Issues identified include a lack of granularity in agency disclosures, with conflation of physical climate risks with transitional risks such as carbon pricing, regulation and reputation. The magnitude of the potential impact of climate risks is also rarely disclosed, while potential spill-overs to society and governance are largely ignored. The paper offers recommendations to improve the granularity of material climate risks in disclosures, along with their aggregate magnitude. In addition, it calls for greater transparency around the models and methodology used by agencies to estimate climate-related exposure.

2. The **Bank for International Settlements (BIS)** highlighted that **[sovereign green bonds could help governments meet emissions targets](#)**. Sovereign sustainability-linked bonds with meaningful climate targets and penalties for non-compliance could help issuers make progress towards carbon emission reduction targets. The BIS is owned by 63 central banks, representing countries from around the world that together account for about 95% of world GDP.

- An analysis published in the latest BIS quarterly review shows that while the fungibility requirements of public debt can conflict with the prescribed requirements of green bonds, these tensions can be partially overcome through refined reporting standards and external review.
- Attaching bonds to sustainability performance targets, with accompanying penalties for failing to meet them, would allow proceeds to be used freely by sovereign issuers, thus resolving the issue of fungibility. The volume of sovereign issuances has increased in recent years, but still makes up only 7.5% of the US$2.9tn sustainable bond market.

3. The **canton of Zurich, Switzerland** decided to **enshrine the circular economy in constitution**, being the first of the 26 Swiss cantons to do so. The majority of voters in Switzerland's biggest canton have overwhelmingly approved a new article to promote a cleaner and more efficient use of resources. All political parties were in favour of the idea.

- Just under 90% of Zurich citizens said yes to the idea proposed by the cantonal government. The canton's constitution will therefore be adapted to include an article calling on authorities to create frameworks for a considerate treatment of resources, materials, and goods, as well as the closing of materials loops.
- Authorities hope the move will mean more attention is paid to the question of how raw materials are used and re-used. It's also assumed that gains in efficiency will help to reduce not only waste, but also energy use. Each resident of Zurich produces an average of three tonnes of waste each year, out of which two tonnes are then recycled. Most waste comes from the construction sector.

RESEARCH

1. The **University of Cambridge Institute for Sustainability Leadership (CISL)** published a **report** on detailing the **importance of an integrated approach to addressing environmental challenges, encompassing climate and other nature-related issues**. The study aims to inform the design of a corporate engagement guide for use by financial institutions which enables them, their clients and their investees to achieve net zero whilst protecting and restoring nature. But also, to incorporate nature-related financial risks into existing climate agendas.

- Climate change and nature loss need to be addressed sequentially. Despite their deep interconnections, the risks and financial implications of climate change and the degradation of nature are largely tackled as independent issues. Financial institutions have first focused on addressing the challenges of managing climate-related risks and the transition to a net-zero economy and are engaging and supporting clients with their emissions reduction plans. But this engagement must also address nature loss. If it does not, a number of risks and opportunities will be missed.
- Within the rationale for financial institutions to integrate climate and nature considerations there are 5 risks and opportunities: 1- Materiality of nature-related risks, over and above climate-related financial risks. 2- Unintended consequences for nature when actions focus exclusively on climate mitigation and adaptation. 3- Compounding effects from interactions between climate change and nature loss. 4- Compounding effects from interactions between climate change and nature loss. 5- Macroprudential risks to the stability of the financial sector.

2. S&P Global Ratings shared a **report** that **slashes the sustainable bond forecast on worsening market conditions**. Global issuance volumes for green, social, sustainability, and sustainability-linked bonds (GSSSB) are expected to fall 16% this year to $865 billion, as credit conditions continue to pressure overall global bond issuances. By issuer type, financial services was the only sector to see issuance growth in H1 2022, up 11%. Nonfinancial corporates saw issuance decline 16%, although this represented outperformance compared to a 33% drop in the sector's total bond issuance.

- The new estimate would mark the first annual decline after several years of sharp growth, with yearly GSSSB issuance up 4x since 2018. Despite the decline, S&P noted several bright spots, with sustainability-linked bonds continuing to see strong growth, and the long-term trends remaining supportive of future growth.
- Sustainability-linked bonds (SLBs) are the only GSSSB bond type to see growth this year, up 18% year-to-date. S&P anticipates that SLBs will continue to be the fastest growing class, citing several supportive factors, including the instruments' relative flexibility and accessibility by a wide range of issuers.

3. As You Sow issued a **study** which found that **climate pay links for CEOs do little to cut emissions**. More big U.S. companies have tied their CEO pay to climate goals but few give executives much incentive to make significant emissions cuts. The study examined pay disclosures from 47 large U.S. emitters. Only four companies tied their executive pay to climate metrics, though they were not as strict about reducing emissions.

- As You Sow's study examined all the 47 U.S. companies targeted by the Climate Action 100+ global investor initiative to reduce industrial greenhouse gas emissions. Among the 47, more than half did not directly tie their pay to climate actions. Out of the 47 companies, only one, electric utility Xcel Energy, gave its CEO a goal tied to measurable cuts in greenhouse gas emissions. Xcel CEO received $8.35 million in 2021, including $1.9 million worth of stock awards whose future value depends on what carbon dioxide emissions cuts the company makes by the end of 2023.
- The percentage of companies integrating ESG goals in compensation is rising rapidly as investors push for climate progress. In 2021, 52% of S&P 500 companies reported including ESG metrics in compensation while 69% of companies report they will be included in their 2022 compensation packages. While this indicates some progress, such generalized linkages are generally insufficient to drive climate progress.

COMMERCIAL

1. Masdar and **RWE** signed an **agreement to target key global offshore wind markets**. The memorandum of understanding (MoU) is designed to strengthen both parties collaboration on developing offshore wind projects in a range of key international markets. Besides leveraging the two companies' extensive expertise in the sector, the agreement can help other nations to meet their offshore wind targets, transition to clean energy sources, and meet their net-zero objectives. The announcement is in line with the signing of the Energy Security, Climate Action and Industry Accelerator Growth Pact (ESIA) between the United Arab Emirates and Germany.

- Masdar and RWE were already shareholders in the London Array project, which has been operational since 2012. A wind farm with an operating capacity of 630 megawatts, powering more than half a million homes, while displacing almost 1 million tonnes of carbon dioxide emissions every year.
- Masdar, one of the fastest-growing renewable energy companies in the world, is increasingly targeting offshore wind projects as it aims to reach 100 gigawatts total capacity by 2030. RWE is one of the world's leading renewable energy companies. With an extensive investment and growth programme of €50 billion gross, the company will expand its green portfolio to 50 gigawatts by 2030, including offshore and onshore wind, solar and battery storage.

2. Emirates Steel Arkan announced plans for the construction of a **ferrous raw material production facility in Abu Dhabi that would become an integral part of a global low carbon emission iron supply chain**. The initiative is a partnership between Emirates Steel, ITOCHU Corporation and JFE Steel Corporation. The UAE's largest steel and building materials manufacturer and the two Japanese companies will work together to conduct feasibility studies on creating a project site to meet the growing demand for green steel.

- As part of the initial plan, high-grade iron ore will be imported into Abu Dhabi to produce the ferrous raw material, which is currently expected to begin in the second half of 2025 and will be supplied to customers primarily operating in Asia, including JFE Steel. Ferrous raw material would initially be produced through an enhanced decarbonised process using natural gas to reduce the iron ore. The project also makes provisions for the adoption of renewable energy power sources, as well as green hydrogen for the reduction process.
- Globally some 80% of the carbon dioxide emitted from steelmaking is the result of using coke in the blast furnace during the iron ore reduction process. The Emirates Steel's carbon footprint is already significantly lower than that of its global peers due to its use of natural gas and advanced direct iron reduction technologies. The use of hydrogen might make our high quality and durable steel products even more environmentally friendly and support the sustainability of its customers.

3. HSBC Asset Management unveiled a new policy to **phase out its investments in coal-fired power and thermal coal mining**. A move aimed at ramping engagement with companies on transitioning away from thermal coal and divesting from companies over time with inadequate transition plans. Under the new policy, HSBC AM aims to exclude thermal coal in European Union (EU) companies and OECD countries from its active funds by 2030, and globally by 2040. In its passive funds, HSBC will ensure that all new exchange traded funds and index funds have no more than 2.5% exposure to thermal coal issuers, unless the fund strategy has Paris-aligned 1.5°C objectives or clear divestment pathways.

- The company stated that the new policy marks an important step towards HSBC Group's net zero ambitions and contributes to the company's plans to phase out coal-fired power and thermal coal mining. HSBC Group set a target in 2020 to align its financed emissions to net zero by 2050, and last year introduced a policy to phase out its financing of coal-fired power and thermal coal mining, targeting exits by 2030 in EU and OECD markets and by 2040 worldwide. The new policy also aligns with HSBC AM's commitments as part of the Net Zero Asset Managers initiative.
- As part of the new policy, HSBC AM aims to engage with all listed issuers with more than 10% revenue exposure to thermal coal in its active portfolios by the end of 2023, and in all ETF and index portfolios by the end of 2025, with the option of divesting over time from companies whose transition plans are considered incompatible with the firm's climate goals. The asset manager will vote against chairs whose company's transition plans remain inadequate following engagement, or for chairs of issuers with more than 10% revenue exposure to thermal coal which do not provide TCFD disclosures or equivalent reporting.