What Investors Want to Know: Key Questions from Fitch's ESG Outlook Conference

Questions Highlight Increasing Sophistication of ESG Analysis Amongst Investors

Fitch Ratings hosted its inaugural ESG outlook conference on 1-3 December 2020, a live virtual event featuring 28 Fitch analysts alongside 24 guest panellists across 19 sessions. The conference hosted more than 1,500 unique attendees, attracting a wide variety of thoughtful questions on numerous ESG topics. This report answers the main questions asked by attendees during the conference, across key ESG themes, instruments and asset classes.

Replays of the conference are available on-demand here.

Related Research

ESG Credit Quarterly: 3Q20 (November 2020)
Sustainability-Linked Debt Ties Borrowers to ESG Goals (November 2020)
Utilities - Long-Term ESG Vulnerability Scores (October 2020)

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ESG Themes: Regulations and Standards

How has the development of regulations to support Sustainable Finance varied across the world?

The sustainable finance market has grown rapidly over the past decade, from issuance of ESG-labelled bonds to assets under management where ESG considerations are applied. The market initially developed through voluntary guidelines and standard setters, but regulators are now paying increasing attention as the market continues to grow at scale.

There are multiples strands of regulation being introduced to support the development of sustainable finance, ranging from company and financial disclosure requirements to rules and guidelines around the labelling of ESG related instruments and products. The EU has taken the most comprehensive set of actions through its Sustainable Finance Action Plan, covering such areas as the development of sustainability benchmarks, incorporation of sustainability in prudential requirements and the clarification of duties for institutional investors and asset managers. The EU plans to present a renewed sustainable finance strategy in 2021 to build on the efforts of the action plan.

Regulatory development outside the EU has been piecemeal in comparison, focused on specific areas. Regulatory efforts in APAC and Latin America have targeted developing green finance as well as enhancing company ESG disclosures. The US has looked to clarify how sustainable investing and ESG fits under the existing regulatory regime, such as rules around fiduciary duty. For example, the Department of Labor reiterated that a US pension fund's primary purpose is to provide for workers' retirement security which must be prioritized above sustainable investing and other non-financial goals. This is in contrast to EU/UK regulators, which have historically promoted a more holistic approach, allowing investment managers to incorporate broader public non-financial considerations when making investment decisions, with EU regulators looking to develop this approach further through its action plan. However, measures from the new Biden administration could shift the regulatory landscape to one more supportive of sustainable finance.

How do you see ESG Reporting Standards evolving, and will we see global harmonisation?

There have been calls for greater harmonisation of ESG reporting standards from many stakeholders, from investors looking for comparable and consistent data to companies looking for guidance on what and how to report. A challenge facing harmonisation is the variety of users of ESG data, each with different perspectives and views on materiality. This has driven the development of a plethora of standard-setters serving different needs, leading to fragmentation in disclosure practices.

A host of developments in 2020 should help pave the way for greater harmonisation. Five leading voluntary standard-setters said they are working together to build a comprehensive global corporate reporting system and two of these have since announced their intention to merge. The IFRS Foundation also published a consultation paper to assess the level of demand for global sustainability standards and to determine whether it should play a role in the development of these. While these steps support harmonisation efforts, one challenge is the rapidly evolving ESG landscape, where data demand from investors and ESG score providers outpace the development of standards. That said, greater coordination amongst standards setters will put them in a better position to adapt to changing industry needs.

Different priorities in terms of sustainability objectives and views on materiality across regions could be a hurdle for global harmonisation, particularly as these differences are proliferated in the development of the broader sustainable finance architecture, such as taxonomies for sustainable activities. Global initiatives, for example, the Task Force on Climate-related Financial Disclosures (TCFD), are an example of how coordination can help to overcome challenges for some issues, but less clearly defined issues, such as social risks, where there are greater divergences in views, are likely to be much more challenging.

Fitch ESG Relevance Scores

Fitch launched ESG Relevance Scores (ESG.RS) for 1,534 corporate issuers in January 2019 and has since released in excess of 150,000 ESG.RS for more than 11,000 issuers, transactions and programmes across Corporates, Financial Institutions, Sovereigns, Public Finances, Infrastructure, Structured Finance and Covered Bonds. The scores, which are produced by Fitch's analytical teams, transparently and consistently display both the relevance and materiality of individually identified ESG risk elements to the rating decision, and whether any impact is positive or negative.

ESG.RS Definitions

Score	Credit relevance	Description
1	No impact	Irrelevant to the entity, transaction or programme rating and irrelevant to the sector.
2	No impact	Irrelevant to the entity, transaction or programme rating but relevant to the sector.
3	Low impact	Minimally relevant to rating; either very low impact or actively managed resulting in no entity, transaction or programme rating impact.
4	Medium impact	Relevant to the entity, transaction or programme rating but not a key driver; has a rating impact in combination with other factors.
5	High impact	Highly relevant, a key rating driver that has a significant impact on the entity, transaction or programme rating on an individual basis.

Source: Fitch Ratings

ESG Themes: Climate Change Risks

How do you factor longer-term climate risks into credit ratings? Is greater weight placed on more near-term risks?

Our credit ratings balance all reasonably foreseeable risks to credit quality, incorporate companies' actions to address these risks and are calibrated to a base scenario. Ratings are continuously monitored by our analysts and tend to be weighted towards the nearer term, when such risks and responses can be more meaningfully assessed. For example, our corporate forecasts rarely look further than three to five years and include base-case and stress-case scenarios. As a result, climate risks material to rating decisions, as captured by Fitch's ESG.RS, are more commonly seen where climate-related regulations are already in place or are about to be implemented, or where physical risks have already had a significant impact.

Investors are increasingly considering how ESG factors may affect credit risk in the longer term, a driver for the development of our ESG Vulnerability Scores (ESG.VS) and our pilot report for utilities published in October 2020. ESG.VS assess the relative vulnerability of entities' creditworthiness to a stress scenario incorporating reasonably foreseeable credit risks arising from ESG developments up to 2050. This framework considers long-term financial risks from climate change while accounting for entity-specific characteristics such as cost recovery mechanisms, exposure to different regulatory environments and competitive position.

Do you see companies' awareness of climate risks differing across the world?

Awareness of climate risks among investors and companies has been influenced by regional policy differences. In Europe, frameworks and processes to assess low-carbon transition risks and disclosure of relevant indicators are often more advanced given early adoption of climate policies such as the EU Emission Trading System. The recent string of net-zero emission pledges from governments outside the EU, including such large APAC economies as China, Japan and Korea, is putting transition risks under greater scrutiny globally. Even companies in regions with less stringent climate regulations are forced to pay more attention to macroeconomic consequences, for example, commodity price changes given the scale of potential global policy action, as well as the extraterritorial policy proposals such as the proposed EU border carbon adjustments.

Global asset owners and institutional investors have helped to spread awareness of climate risks, pressing companies to improve management of such risks and related disclosures in regions in which they invest. Japan is an interesting example. Investor engagement has been a factor in prompting changes to company policies, such as the exclusion of fossil fuel financing by Japanese banks. This pressure is increasingly coming from different directions, from listing requirements mandated by stock exchanges to central banks and supervisors for financial institutions.

How significant is the role of FDI in eliminating barriers to the adoption of low-carbon and climate-friendly technologies to the developing/emerging markets?

Foreign direct investment can be a significant source of financing for low-carbon technologies in emerging markets, particularly where local governments and businesses have limited resources or debt capacity to make investments directly. Pressure on large multinational corporations from investors to reduce operational and supply chain emissions is driving rapid growth in demand for renewable energy power purchase agreements, which is leading to higher levels of installed low-carbon energy capacity and economies of scale in emerging markets. This 'levelling-up' effect is likely to strengthen with growing scrutiny of operational emissions and pressure for more detailed asset-level reporting of effects.

Is there a risk that companies are "too early" in preparing for climate risk and the transition to low carbon?

Balancing competitiveness and profitability considerations with readiness for low-carbon transition is a challenge for companies and policymakers, particularly given that regulations are asymmetric and changing rapidly. That said, investment and adjustment costs in the short term can help to avoid rapid and costly disruption and enhance competitiveness, particularly with the emerging global policy consensus to reduce GHG emissions and tackle climate change.

For banks, our assessment is that they are not too early in recognising that transition to low-carbon economies poses widespread risks to their business models. Many large international banks have identified high-risk sectors and identified new business opportunities in renewable energy, digital transformation and other sectors likely to benefit from economic transition. Several large banks have already committed to net-zero 'financed emission' targets and are implementing processes to help customers identify these risks. Unravelling transition risks throughout banks' supply chains is complex and arduous, hindered by customers' lack of understanding. Education and awareness tools are already being rolled out by some banks but data-gathering will take time.

ESG Themes: Water Scarcity

Will regions with greater abundance of water resources have a competitive advantage?

Climate change is widely expected to exacerbate the unevenness in the distribution of water resources. Changes in relative prices, with an increase in those of water-intensive goods relative to other types of goods, will result in an improvement in the terms of trade of the exporters of water-intensive goods. We expect this to alter production specialisation and structure across the globe with an expansion in the trade of "virtual water". Migrations from areas affected by water scarcity would harm growth in these regions and boost labour forces in immigration zones.

However, such shifts in production patterns would ultimately depend on the existence of other resources that complement water resources. For example, it depends how those water resources are distributed across a country and which sector of society have the most demand for them. Some of the largest agricultural producers, including Australia and China, have medium-to-high water stress, but have other benefits for growing crops and livestock based on geography, climate and size. Other countries, such as Ireland, may face low water stress, but have few comparative advantages in agriculture, for example, due to constraints on land availability or high costs for low-skilled labour.

Mining is another water-intensive sector, but it is tied to the location of the resources deposits. Mining companies operating in Chile cannot easily relocate due to the country's high water stress, given the small number of countries with large copper reserves.

Still, water-rich countries will benefit from comparative advantage from lower energy costs, given the existence of a strong water-energy nexus. Water is intensely used in electricity generation and the aggravation in water scarcity will raise power production costs across the globe. This would harm the profitability of electricityintensive such industries as automobile manufacturing, chemicals and metals in water-stressed regions.

How do you view the UN FAO's approach to integrated water resources management in your analysis?

We view a country's overall vulnerability to water risks as being a product of both its exposure and resilience to these risks. Resilience itself cannot be quantified as it depends on countries' capacity to mitigate and adapt to water stress by boosting the efficiency of water use and implementing adequate water management policies.

We view the UN FAO's integrated water resources management (IWMR) through the lens of its role in building resilience to water risks, under our analytical framework, which aims to capture the impact of vulnerability to water risks on creditworthiness. The IWMR, as defined by the UN, "promotes the co-ordinated development and management of water, land and related resources in order to maximize the resultant and social welfare". In that sense, it could contribute to mitigating the aggravation of water risks through measures extending beyond narrowly defined water management policies. However, Fitch does not consider any particular policy approach to be superior to others in terms of supporting resilience to water risks and aims to make its own judgement on a case-by-case basis, based on empirical evidence.

What is the role of water utilities and public-private partnerships in managing water scarcity, and how will the market for water evolve?

The aggravation of water risks will raise increasing pressures on governments to boost investment in water storage, treatment and supply facilities. Such infrastructure projects could be taken in charge directly by the government budget, leading to higher capital spending and consuming scarce fiscal resources, or could otherwise be also implemented by public or private utilities or public-private partnerships (PPPs). The latter could require government subsidies to bridge the gap between the private cost of such investments and their public benefits. As such, governments may provide guarantees on loans or financial returns to water projects.

From a sovereign rating perspective, resorting to off-budget investment in water infrastructure through government support to utilities or PPPs would minimise the immediate cost for the budget. However, this would raise contingent liabilities for the sovereign which could materialise either in bulk, with financial liabilities migrating on to the sovereign's balance sheet, or very gradually, should the government need to make annual payments to compensate investors for a shortfall in returns for example.

The aggravation of water risks will also encourage governments to reform the broad management of the water market. On the supply side, governments could be expected to attempt to minimise economic and social disruptions from increased water scarcity by enhancing the efficiency of water utilities, for example through transparency-increasing reforms to public bidding procedures and procurement rules, flexible pricing mechanisms and cost auditing.

Demand-side measures are more complex and arduous to implement given the conflicting objectives they usually pursue. For example, promoting water efficiency may require imposing high prices for access or "Pigouvian" taxes while guaranteeing universal access to the most basic of necessity goods requires instituting subsidies.

ESG Themes: Pandemic

Should pandemic risk be counted as an ESG risk or "just" an operational risk?

The coronavirus pandemic rapidly led to a wave of negative rating actions, yet Fitch's ESG.RS rarely changed in unison. This indicates that the rating actions were not due to changes in Fitch's assessment of ESG factors. The pandemic has undoubtedly had an impact on ESG factors, such as labour management and short-term carbon emissions. However, the overall impact of ESG factors on credit profiles is generally limited compared to the myriad factors constraining the liquidity and debt-servicing capacity of entities.

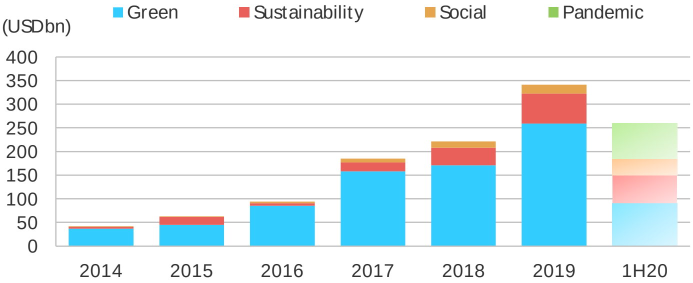
The pandemic does have long-term implications for ESG-related trends, as it has for economies more broadly. Many governments have responded to the pandemic with fiscal stimulus and recovery plans, and some regions, such as the EU and Korea, have used this to boost green objectives. Weaker company and government balance sheets may influence ESG-related investments, such as those aimed at facilitating low-carbon transition or alleviating water scarcity challenges. Fitch identified the low-carbon transition as one of three secular trends influencing corporate credit risks, alongside digital transformation and supply chain shifts.

The pandemic has hit societies hard, exacerbating inequality and poverty, and amplifying specific challenges faced by some societal groups. For financial institutions, we identified 'a move towards a more equitable society' as one of the megatrends relevant globally over the medium term. Despite banks becoming more vocal about their financial inclusion, community-focused and diversity targets, our assessment is that loan recovery tactic, particularly of Covid-19 loans, is likely to be the area to attract most social media and stakeholder attention in the near future. It is becoming increasingly clear that recovery of the loans may be difficult, given high reported levels of alleged fraudulent applications, loans made to unviable companies and the harsh economic impact on businesses arising from pandemic-related loss of sales, enforced business closures and changes in consumer behaviour. Recovery of the loans lies, in the first instance, with banks and signs of heavy-handed recovery tactics could lead to a backlash. Depending on how banks handle this, our credit assessments could be affected by reputational risk concerns.

Has the pandemic changed the way companies view 'S' factors? Are certain issues becoming more prominent (e.g. racial diversity)?

There has been a growing focus on 'S' factors from companies and investors, highlighted by the growing share of sustainable debt issuance labelled as "social" or "pandemic-related". This has also been accompanied by an increase in disclosure of social-related indicators, although the range of social issues captured under the 'S' category is particularly broad and there is often less consistency and comparability in reporting.

Sustainable Debt Issuance by Theme



Source: Fitch Ratings, Climate Bond Initiative

US institutions have been the most vocal on race-related issues, although there are examples of such discussions globally. This is unsurprising given that the Black Lives Matter movement resurfaced strongly in the US in 2020. ESG and sustainability reports filed by leading US banks, for example, JPMorgan, focus prominently on financial inclusion programmes to build wealth and boost lending access to racial minority groups, as well as support for community businesses and individuals.

In the UK, HSBC and Lloyds Banking Group have set new racial targets and leading EU banks updated their diversity and inclusion objectives.

ESG Instruments: Green Bonds

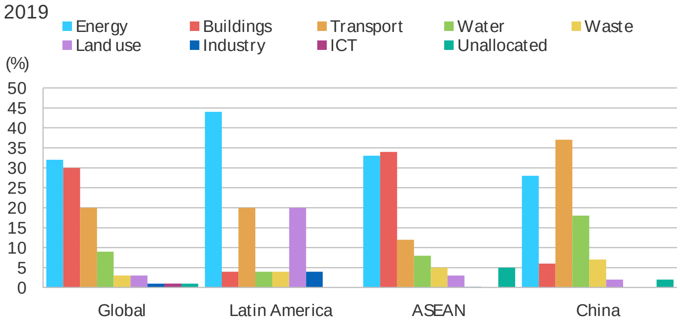
Which other sectors do you see accessing green financing in economies where the expansion of green energy generation is limited?

Globally, energy projects are the top use of proceeds for green bonds. Of the10 categories listed as eligible projects in the Green Bond Principles; however, only two – renewable energy and energy efficiency –relate to energy. A wide range of activities that have environmental benefits are included, such as conservation, pollution prevention, and circular economy. This allows for issuers with non-energy assets or operations to still access the green bonds market.

Outside Europe and North America, there is more diversity in use of proceeds outside of energy. In Latin America, 20% of green bonds focus on land use, likely due to the presence of major rainforests and the importance of commercial agriculture in the region. Clean transportation features highly in Chinese green bond issuances, accounting for more than a third of the total in 2019. Green buildings are the primary use of funds in Southeast Asia. There has only been a small number of green bonds issued in sub-Saharan Africa, but water and green buildings feature among project selections.

Green Bonds Use of Proceeds by Region, 2019

2019



Source: Fitch Ratings, Climate Bonds Initiative

Could you see a market where all bonds become green or sustainable, or will there still be a place for non-green bonds?

Issuers come to the bond market to raise capital for many reasons that have no direct link to ESG factors. As use-of-proceeds bonds (e.g. green, social, sustainability) require issuers to finance eligible assets or activities, they are not feasible for many businesses, such as asset-light companies or highly diversified corporations. It would be even more challenging for such issuers as sovereigns, public finance, and structured finance to fit all of their fundraising needs within this category of bonds.

While the proceeds of sustainability-linked bonds can be used for general purposes, issuers must be willing to identify performance targets and work to achieve them within the bond's maturity. We do not yet have an example of an issuer that failed to meet its targets, so it is difficult to know how the market will respond if and when that occurs. There are additional accounting considerations with a step-up or step-down feature that could limit what share of a company's debt such bonds will make up; there are also similar considerations for investors.

Do you see enforcement challenges related to labelled or sustainability-linked bonds, given guidelines are voluntary?

The labelling of these bonds is currently voluntary and subject to some level of interpretation that may differ between issuers, investors, certifiers, second-party opinion providers and index providers. There are few precedents for how markets perceive labelling of ESG bonds when circumstances change post-issuance. There have been two notable cases where intended use of proceeds changed significantly following the issuance of a green bond.

Grupo Aeroportuario de la Ciudad de Mexico, S.A. de C.V. (Standalone Credit Profile: bbb-) issued USD6 billion in green bonds in 2016 and 2017 to build a new international airport, but a change in government in 2018 led to the cancellation of the project. The new plan includes refurbishing existing airport facilities and building a new smaller airport. The Mexican government bought back USD1.8 billion of the bonds and removed the green label from those outstanding.

In 2017, a subsidiary of RWE AG (BBB/Stable) called Innogy issued a EUR850 million green bond. When RWE and E.ON SE (BBB+/Stable) entered into an asset swap in 2018, RWE retained Innogy's wind farms and acquired E.ON's renewable energy business, meaning that Innogy no longer had green assets to finance. The bond proceeds were used for grid projects, only a portion of which were directly tied to renewable energy.

There is no established consensus among investors on how to treat such bonds. The development of regulatory standards, such as the EU Green Bond Standards, could formalise the labelling process and add legal and policy consequences.

ESG Instruments: Sustainability-Linked Debt

Do you think there are conflicts for ESG investors holding sustainability-linked bonds, given failure to meet key performance indicators may indicate poor ESG performance, but also trigger higher return?

Not all investors have the same rationale for investing in a particular security, nor the same ESG objectives. As with use-of-proceed bonds, some may purchase sustainability-linked bonds specifically to achieve sustainability objectives, while others may primarily want exposure to that issuer or sector and are attracted by the risk-return profile. As a result, how investors consider such bonds will depend on their individual assessments and objectives. Given the short history of the sustainability-linked bond market, there is not enough evidence to show how investors will respond in cases where an issuer fails to meet its sustainability performance targets.

An issuer's failure to meet performance targets is also not necessarily an indicator of overall poor ESG performance, given targets often cover a narrow subset of ESG issues. Suzano S.A. (BBB-/Negative) is a pulp and paper company whose corporate sustainability programme includes waste reduction and producing substitutes for plastic packaging, but its sustainability-linked bond is only tied to greenhouse gas emissions from its operations. While the voluntary sustainability-linked bond principles (SLBPs) expect targets to be meaningful to an issuer's business, they are not meant to fully capture the entirety of its ESG risk exposures.

Additionally, the SLBPs allow for a variety of incentives or penalties for missing targets other than a coupon step-up or step-down. A bond's terms could require the issuer to use an amount of money linked to the bond's value for a sustainable purpose, such as a charitable donation or an allocation to a fully sustainable corporate activity. In these cases, there is no financial benefit to the investor as a result of the issuer's performance.

Do you see more issuers using coupon step-down linked to key performance indicators instead of step-ups?

Singaporean agribusiness Olam International Limited (not rated) issued a JPY7 billion (USD67 million) five-year sustainability-linked note in December 2020 through a private placement, with a step-down coupon adjustment. This is the first sustainability-linked bond with this feature as opposed to a step-up, although the structure has been seen before in sustainability-linked loans. Whether or not more issuers choose this structure will depend on market demand. As Olam's note is a private placement, it is difficult to make such a judgement at this time.

ESG by Asset Class: Financial Institutions

How does implementation of ESG practices by banks affect Fitch's credit assessment?

Governance weaknesses displayed by banks have been the most significant of all ESG risks to affect global financial institutions. We are striving to improve our early identification of governance weaknesses in banks and are increasingly focused on news-flow and data-screening to help with this.

Many of the credit-related environmental risks affecting financial institutions are likely to fall outside the timeframe captured by our credit ratings. Nevertheless, we expect such future credit impacts to arise primarily from changes in regulatory and government policies, and analysts are monitoring these developments closely. Once we see clear signs that regulatory or government environmental policies are likely to affect bank credit ratings, analysts will reflect these in rating actions or forward-looking research commentaries. Environmental strategies, risk management tools and risk mitigation processes are regularly discussed with rated banks at senior management meetings and our rating action commentaries and rating reports are increasingly highlighting emerging environmental credit risks for banks.

However, our credit assessments will only change when analysts see evidence that banks' environmental practices are either likely to affect, or have started affecting, credit profiles. For example, if the cost of introducing new climate change risk identification tools and procedures are likely to have a material negative impact on a bank's earnings profile, analysts could adjust their assessment of its financial metrics outlook. This could have an impact on the credit rating. Similarly, a bank's ability to significantly alter its business mix due to new government environmental policies could affect, either positively or negatively, on our assessment of its franchise strength, which could have credit implications.

How does Fitch consider climate risk in financial institution's credit ratings?

Our ESG.RS identify the relevance and materiality of climate risks on financial institutions' credit ratings. For many, the credit impact from climate risk is highly uncertain given the lack of consensus around climate scenarios and clarity on how banks should measure and adequately reserve for potential credit losses arising from physical and transition risks associated with climate change. Our ESG.RS measure credit impact from ESG risks, and while there is much discussion around future bank regulatory requirements, there is currently no visibility on whether or how this could represent a significant credit cost to banks.

Our assessment is that climate regulatory stress tests conducted on banks and insurance companies will provide greater clarity. While no stress test either underway (France and the UK) or planned (the EU, Australia, Brazil, Canada, China, the EU, Hong Kong, Japan and Singapore) ties findings to increased capital requirements, we believe the findings will throw light, and more importantly transparency in numbers, on some of the risks and likely time horizons. Once test findings are published, we will be in a better position to assess any potential credit impact that longer-term climate risks may have on our ratings.

How do you see mandatory disclosure for banks evolving? Will it cover disclosure for banks themselves as well as their lending and investment activity?

Mandatory environmental disclosure for banks, in line with TCFD guidelines, is rapidly becoming the international norm. In our view, harmonisation of all ESG bank disclosure is set to grow. The European Banking Authority is set to publish consultation on its requirements for mandatory harmonisation in early 2021 and our expectations is that the EU will be the first area to introduce these types of regulations.

Disclosure regarding ESG risks affecting banks' supply chains (customer lending and investments made by banks) is still fraught with complexities and, in our view, mandatory disclosure is still some way off given data limitations. On the market side, investors, in particular asset managers and pension funds, will start to demand more clarity given EU requirements for greater sustainability disclosure coming into force in March 2021.

Do you see the ESG momentum leading to potential capital charges?

Yes. Bank and insurance regulators are increasingly vocal about the risks posed by environmental risks to systemic financial stability. Asset valuation risks impacted by physical and transitional climate change risks are likely to be uncovered by regulatory climate change stress tests and it is increasingly likely that additional capital charges will be introduced, particularly in the more developed markets. Data limitations are likely to make it difficult to allow risk-weighting differentiations across more environmentally friendly or sustainable asset classes given the absence of supporting data histories but additional ESG capital buffers should be easier to introduce. Whether the cost of these requirements has a credit impact can only be assessed once the detail becomes available.

ESG by Asset Class: Public Finance

How are investors considering ESG in credit analysis when investing in public-sector infrastructure bonds?

We have noted a significant increase in investor ESG risk analysis occurring alongside traditional risk analysis of infrastructure projects. Asset owners are the main driver behind this change and have implemented responsible investment practices, such as screening for ESG factors in their fixed-income portfolios.

Similar to traditional investment analysis, investors are evaluating public sector ESG risks for impacts to revenue (from regulatory, economic or social drivers), expenditure (from legal, environmental or societal drivers) and financial performance, including the impact of government or management practices. More specifically, investors are reviewing cybersecurity protocols, environmental resiliency and board diversity, among other concerns.

Increased investor focus is driving demand for greater issuer disclosure of risks related to ESG factors; investors are increasingly requiring information on an issuer's strategies for identifying and mitigating ESG risks and how the issuer plans to report on these considerations. If a project is green or sustainability bond funded, investor requirements include annual updates on project construction status that incorporates 'green' or sustainability performance metrics. For example, an investor in a renewable energy project would require reporting on reduced/avoided carbon dioxide emissions in addition to more traditional reporting on installed capacity and annual energy generation. In our view, mandatory ESG disclosure from all public finance and infrastructure issuers is still quite a way off given regulators' current spotlight on corporate entities and financial institutions.

How are ESG considerations affecting US states or local governments' policy decisions?

We believe state governments remain focused on addressing identified ESG risks, although policy efforts since March 2020 have been primarily directed to Covid-19 response and recovery. Mitigation of environmental risks, particularly those related to natural disasters and drinking water infrastructure continue to contribute to regulatory and legislative decisions although the pace of enacted legislation slowed considerably in 2020. California, Colorado, Florida, Maine and New Hampshire were able to enact legislation addressing clean drinking water and water toxins, while Louisiana, Maine and Minnesota enacted legislation addressing indoor air quality related to tobacco and vaping products.

Impediments to local government efforts to mitigate risks related to coastal and inland flooding, and beach erosion continue to be driven by the sizeable costs associated with these projects, requiring federal government support to move forward. There are several U.S. Army Corps of Engineer projects in the pipeline that we believe may gain traction with the incoming federal administration. Positively, more states bolstered environmental resilience efforts in 2020 through the hiring of chief resilience officers, including in South Carolina and West Virginia.

Fitch believes US state governments are generally well positioned to address social concerns and infrastructure projects as these priorities are typically not as costly as environmental initiatives. California's issuance of almost USD2 billion in No Place Like Home bonds over the past year to construct permanent supportive housing for persons in need of mental health services and experiencing homelessness represented, however, a significant investment by the state in addressing this social issue.

Other social issues confronting US states and local governments in 2020 related to the social unrest that began in May and then spread globally. Many governments were compelled to reimagine the delivery of public safety and social services to their populace, largely through budgetary and staff reallocations that moved funds between these two departments. The long-term sustainability of this revised approach will become clearer in future budgets.

What is the appetite from investor community for sustainable bonds from US municipal issuers?

Investors believe there is strong interest in sustainable bond issuance by US municipal issuers and growth in this sector could bring in new participants to the municipal market, similar to when Build America Bonds (BABs) were introduced in 2009 as part of President Obama's American Recovery and Reinvestment Act. BABs, as taxable municipal bonds that featured federal tax credits or subsidies for bondholders, drew investors that customarily invested in taxable securities into public finance. However, unlike BABs, issuer-provided data and disclosure on sustainability metrics is lacking and could deter some investors. Investors believe the development of more robust reporting requirements would help to grow the US municipal market although demand in Europe is likely to remain more robust for some time.

ESG by Asset Class: Structured Finance

How are ESG risks mitigated in securitisation structures?

The concept of asset isolation is a key consideration for structured finance and covered bond transactions and contributes to Fitch's ESG approach where the key Governance factors are all deemed to be at least minimally relevant – and are assigned a score of '3' as a baseline. The handling of operational risk, data transparency, transaction and collateral structure, and regulatory quality can contribute to elevated Governance scoring to the extent these things meaningfully contribute to or directly affect the credit analysis at the transaction level. For example, results from due-diligence reports, operational risk reviews of transaction parties and transaction governance frameworks can influence analytical assumptions and lead to elevated scoring.

Likewise, transactions that include unaffordable loans could be exposed to elevated default behaviour and potentially regulatory focus and litigation expenses; these could receive elevated Social scores. On the Environmental front, assets such as US RMBS are reviewed by Fitch for such aspects as considering catastrophe risk; if this risk is material to the transaction – in the form of higher stressed losses – the transaction will receive an elevated ESG score.

How will stricter green standards for commercial buildings affect CMBS?

Fitch expects a limited impact to multi-borrower transactions given the diversity of property type, quality and age. In the US, older properties are likely to be 'grandfathered', or excused from more stringent regulations, and would therefore be unlikely to be affected by potentially expensive retrofitting and capital expenditures. In addition, older properties are often in desirable in-fill locations and may hold value for longer. In Europe, where regulations may be more stringent, these capital and repair expenses may have more impact on older properties, which may be required to upgrade and maintain green standards. In addition, more-stringent green regulations may highlight property quality differences; older properties' long-term value may be negatively affected by increasing need for repairs and upgrades over time to abide by regulations.

Appendix: Referenced Reports

U.S. 2020 Election and Climate Policy (November 2020)

The Next Phase: Megatrends and Financial Institutions' Ratings (November 2020)

The Next Phase: Corporate Credit Risks Shift as Pandemic Amplifies Secular Trends (November 2020)

Green Finance Expands to Support China's Transition to Low Carbon Emissions (November 2020)

Sustainability-Linked Debt Ties Borrowers to ESG Goals (November 2020)

Banks Need ESG Standardisation (November 2020)

Governance Risk for Banks - Drawing on Experience and External Expertise to Assess Financial Crime Risk (October 2020)

Constraints to Growth in Water-Stressed Regions - Many More Regions Will Become Water-Stressed, Imposing Substantial Adjustment Costs (October 2020)

Utilities - Long-Term ESG Vulnerability Scores (October 2020)

Tightening Climate Policy to Drive Carbon Offsetting and Emissions Trading (September 2020)

U.S., EU Investment Management ESG Rules Diverge (Investment Considerations, Risks and Potential Returns to Differ by Regulatory Regime) (September 2020)

Water Risks and Sovereign Ratings (September 2020)

Bank Climate-Change Stress Tests (September 2020)

Sustainability of Coronavirus Rescue Financing (August 2020)

ESG Credit Quarterly: 2Q20 (July 2020)

Increasing Water Risks in Metals and Mining (July 2020)

Water Risk in the Agricultural Supply Chain (June 2020)

Fitch Ratings' ESG Framework and Coronavirus (April 2020)

Industry Faces Climate Transition Challenge (February 2020)