FitchRatings

Webinar: ESG in the Time of Coronavirus

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How Are We Defining ESG Relevance to Credit?

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.

Latest ESG-Related Reports

ESG Credit Trends 2020 (December 2019)

Regulatory Risk Amid Global Emissions Gap: Carbon Pricing (December 2019)

ESG Has Growing Influence on Bank Lending to Corporates (January 2020)

Industry Faces Climate Transition Challenge (February 2020)

Fitch Ratings' ESG Framework and Coronavirus

Climate Risk and the Coronavirus Pandemic (April 2020)

ESG Credit Quarterly: 1Q20 (April 2020)

ESG In Credit (April 2020)

Lure of Higher Inflows to Fuel ESG Fund Launches Post-Coronavirus (April 2020)

Crisis Conditions to Expose Governance and Credit Risks (April 2020)

Further information on Fitch's ESG Relevance Scores and research can be found on https://www.fitchratings.com/site/esg

ESG Credit Trends 2020

Trend 1: ESG Considerations Tilt Financing Landscape: ESG-driven risk allocation decisions by banks and investors are starting to affect the ability of corporates to refinance. Survey evidence indicates a significant number of banks have included ESG considerations in their risk management frameworks, and an increasing number of funds are explicitly adopting ESG mandates. This is starting to introduce additional liquidity for borrowers in certain sectors or with certain assets.

Trend 2: Taxonomy Lays Groundwork for Policy Push: Fitch does not expect the establishment of the EU's Taxonomy for Sustainable Activities to have credit implications in the short-term, but believes it could lay the foundation for a sustainable finance ecosystem. Such activities may also become the target of direct financial incentives should policymakers take a more aggressive approach to directing capital, such as the incorporation of sustainability into prudential requirements.

Trend 3: Climate Policy Gap Poses Regulatory Risk: The gap between government pledges to cut carbon emissions and policies now in place highlights the future risk of a sharp shift in the policy landscape. Climate regulations have only been relevant to credit ratings for a handful of sectors so far, such as European utilities and autos, with existing policies often lacking financial impact or immediacy. Fitch views carbon pricing schemes as the most convenient lever for policymakers to expand the reach and impact of climate policies.

ESG Credit Trends 2020

Trend 4: Cost of Data Breaches Will Become Clearer: The consequences of widespread changes to data protection regulation globally will become clearer as more fines and penalties for data breaches emerge. Fitch believes that regulatory changes recently implemented are likely to result in bigger fines than in the past. Until recently, few cases of data breaches have been relevant to credit ratings, as the overall impact on companies has generally been low and often mitigated by insurance.

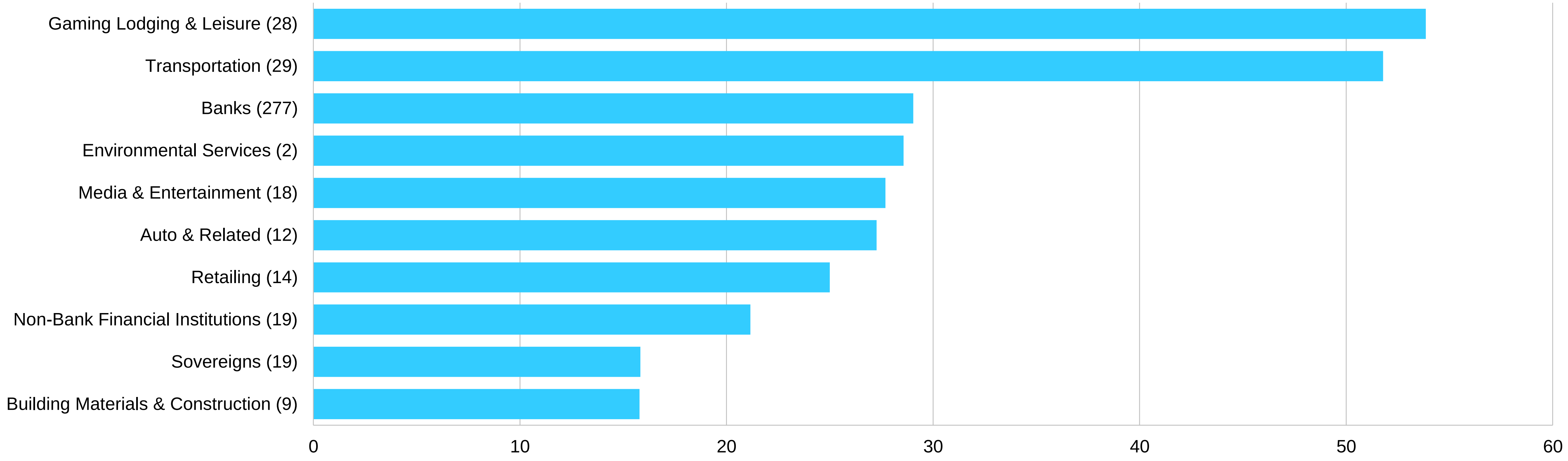
Trend 5: Governance Most Dynamic ESG Factor: Governance is and will likely remain the most dynamic ESG factor, driving most changes to ESG Relevance Scores. This is consistent with earlier findings that governance issues are most relevant to credit ratings in all analytical groups. The types of issues driving governance score changes vary widely, from conduct issues in banks to changes in board directors and management in non-financial corporates.

Trend 6: Economic Fairness Shapes Political Agenda : Fitch expects perceptions regarding income inequality and broader economic unfairness to continue shaping the policy agenda in 2020. This can have broad credit implications across analytical groups, from higher risks of social unrest to political and societal pressure to contain prices of necessities such as drugs and fuel. This is already evident in some countries, such as the recent spate of political unrest in Latin America.

Widespread Negative Rating Actions, But Not Due to ESG Factors

Sectors Most Hit by Coronavirus Impact

Percentage of Sector Subjected to Negative Rating Action



As of April 17, 2020
Source: Fitch Ratings

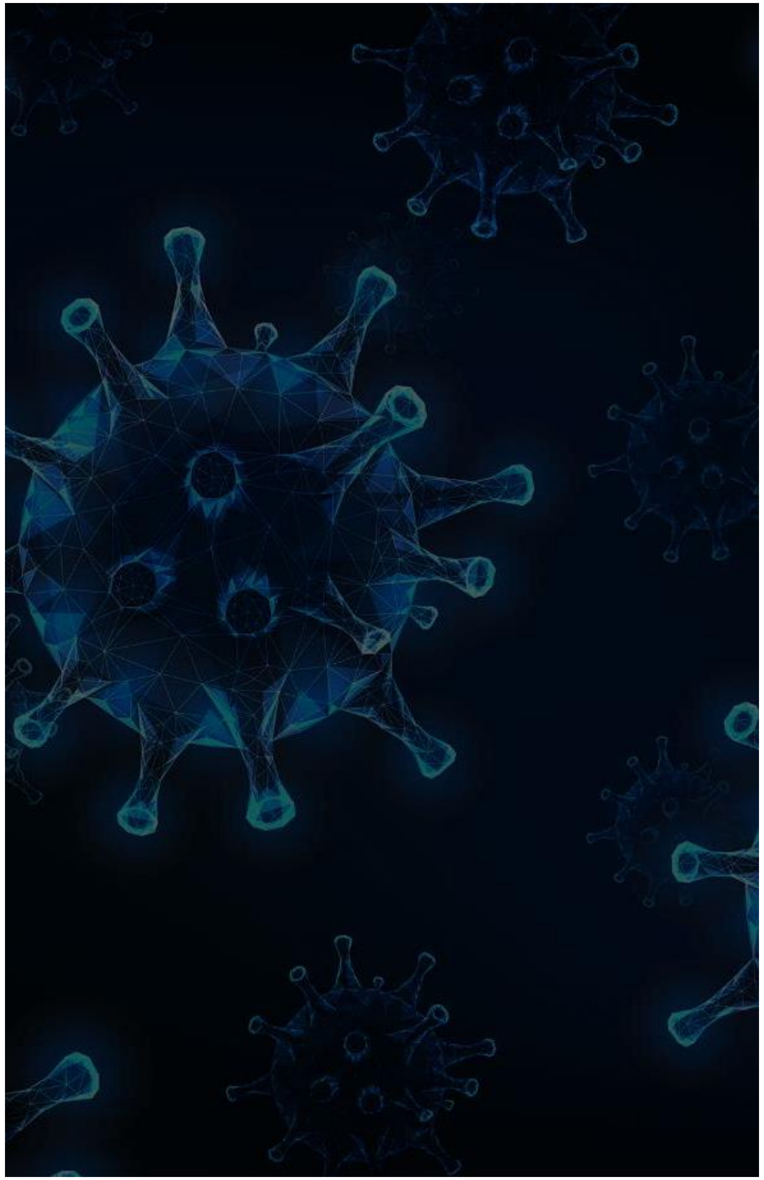
ESG Credit Trends – Impact of Coronavirus

- **Long-term ESG Effects Unclear:** The coronavirus outbreak undoubtedly has had a short-term impact on ESG factors such as labour management and short-term carbon emissions. Long-term ESG implications remain unclear, and will depend on the severity and duration of the outbreak.

- **Weaker Finances Affects Ability to Manage ESG Risks:** Companies with a weaker financial position due to the pandemic may find it challenging to make the necessary investment to manage long-term ESG risks, particularly if capital intensive like carbon transition (Trend 3,4).

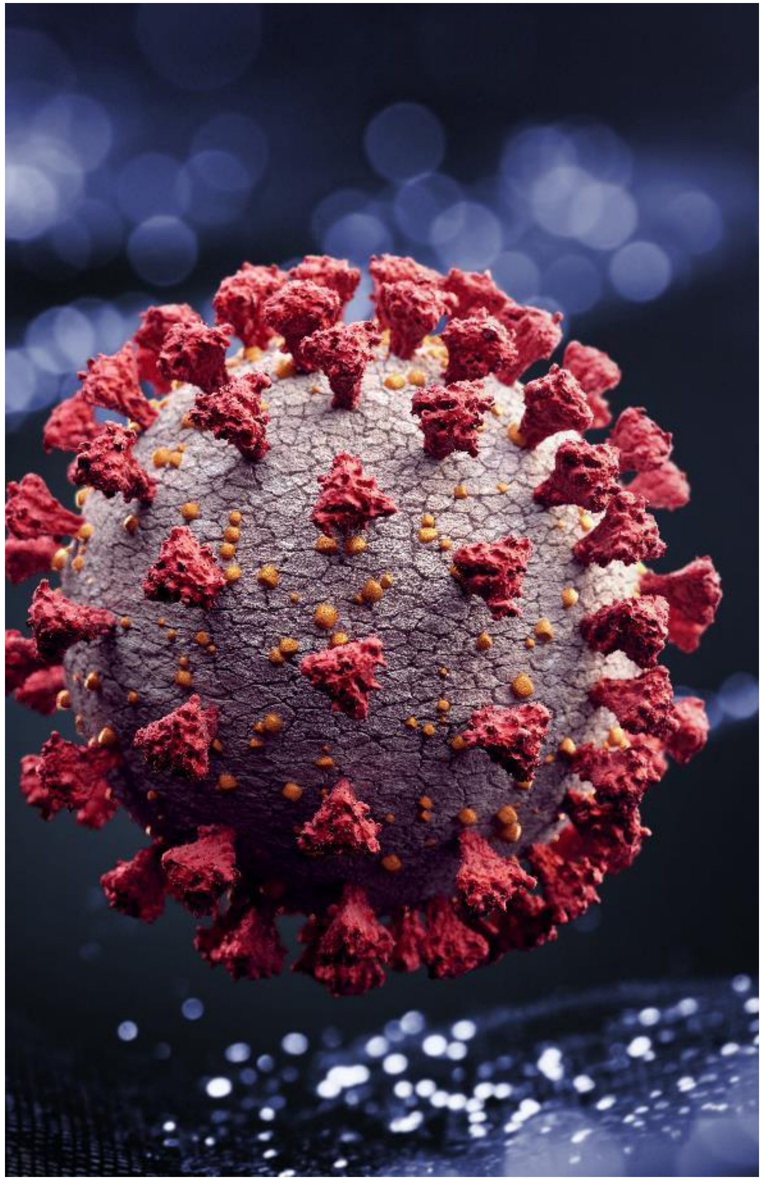
- **Fiscal Deterioration Tests ESG Policy Priorities:** Limited fiscal resources may force governments to choose between ESG and other policy objectives. This is highly unlikely to affect sovereign creditworthiness, but may shift the policy environment for companies (Trend 2,3,6).

- **Coronavirus Crisis Response May Accelerate Energy Transition in Some Regions, Slow Others:** Recent policies and market trends could accelerate low-carbon transition in developed markets, but a 'brown recovery' is a high risk in emerging markets, locking in emissions for many years (Trend 2,3).



ESG Credit Trends – Impact of Coronavirus

- **Lure of Higher Inflows to Fuel ESG Fund Launches Post-Coronavirus:** Recently announced fund launches and/or fundraising plans by large IMs may be delayed by the coronavirus pandemic; however, the longer-term focus on ESG should continue to be supported by increased pressure on governments to correlate stimulus aid to emission controls, evolving consumer behavior and the attitudes of younger generations as they increasingly benefit from the transfer of wealth from baby boomers. (Trend 1).
- **Crisis Conditions to Expose Governance and Credit Risk:** The collapse of Singapore-based oil trader Hin Leong Trading amid revelations of USD800 million in undisclosed losses again illustrates how tougher economic times can reveal governance failures, and leave creditors of the affected companies exposed to potential losses (Trend 5).
- **"Social Licenses to Operate" under further scrutiny:** The exacerbation of inequality and other social issues will increase scrutiny on the impact of issuers to society, particularly those that benefit from government support packages (Trend 6).



ESG Relevance Scores and Carbon Regulation Risk

ESG General Issues	Sectors with Low Relevance (ESG.RS '3')	Sectors with Some Relevance (ESG.RS '4' or 5)
GHG Emissions & Air Quality	• Utilities • Natural Resources (e.g. Steel, Mining) • Industrial & Transport • Auto Manufacturers, Auto Suppliers • Auto Lease, Oil Vessels (Structured Finance) • Aircraft Leasing (NBFIs) • USPF: Tax, LRGs, GREs • Public Power, (USPF: Revenue) • Energy, Thermal Power (Infrastructure)	• Auto Manufacturers, Auto Suppliers • EMEA, LATAM, US Utilities • US Coal Mining • Pipeline and Energy Midstream
Energy Management	• Utilities • Natural Resources (e.g. Steel, Mining) • Business Services DAP, Global Tech, Telecommunications • Airlines, Shipping • Food + Non-Food Retail • Aircraft Leasing (NBFIs) • Aircraft Finance, Oil Vessels (Structured Finance) • Public Power, Higher Education (USPF: Revenue), Energy, Thermal Power, Water and Wastewater (Infrastructure) • Sovereigns, USPF: Tax, LRGs, GREs	• EMEA Utilities • LATAM Pulp Producers

EMEA

- 2013: UK Carbon Price Support
- 2013-20: EU ETS Phase 3 & MSM
- 2019: EIB Fossil Fuel divestment
- 2019: Germany EV subsidy package

- *2030: EU PT emissions targets (-37.5%)*
- *2030: EU Industrial Emissions Targets*
- *2030: EU Energy Performance and RE Directive*

APAC

- 2013: China ETS pilots
- 2017: India GST coal tax, NEP
- 2012: Japan Global Warming Tax
- 2015: South Korea ETS scheme

- *Japan Energy Plan incentives*
- *India ICE phase out*

AMS

- 2015: Chile, Mexico carbon tax, ET Law
- 2017: Argentina carbon tax
- 2015: US Clean Power Plan
- 2019: Canada GG Pollution Pricing Act

- *US Post-2025 GHG targets*
- *Canada, Chile ICE phase out*
- *California ETS reduction in offsets*

2010s | 2020s | 2030s | 2040s

EMEA

- 2021 - 28,30: EU ETS Phase 4, LULUCF Regulation
- 2021-26: CORSIA Phase I aviation
- 2025: EU vehicle emissions standards

- *Petrol and Diesel ICE bans*
- *Meat consumption taxes*
- *Norway: all electric flights*

APAC

- 2020: India, China, SG vehicle emissions standards
- 2020: China national ETS and provincial coal caps
- 202: China 5YP renewable and coal targets

- *Japan ICE phase out*

AMS

- 2020-22: Mexico ETS pilot
- 2020: California ETS price support mechanism
- 2020: Canada coal and gas GHG standards

Other initiatives

Coal Phase Out

- 2030s to 2040s

Forestry and Land Use

- Supply chain regulations, FLEGT
- Financial transfers/ forest carbon credits

Border Carbon Taxes

- Proposed EU BCA tax, 2020s>

Shipping

- Regulations to strengthen 2050 IMO target, 2030s>

CCS

- CapEx in manufacturing processes, 2020s>
- Supporting policies and financial incentives

Agriculture

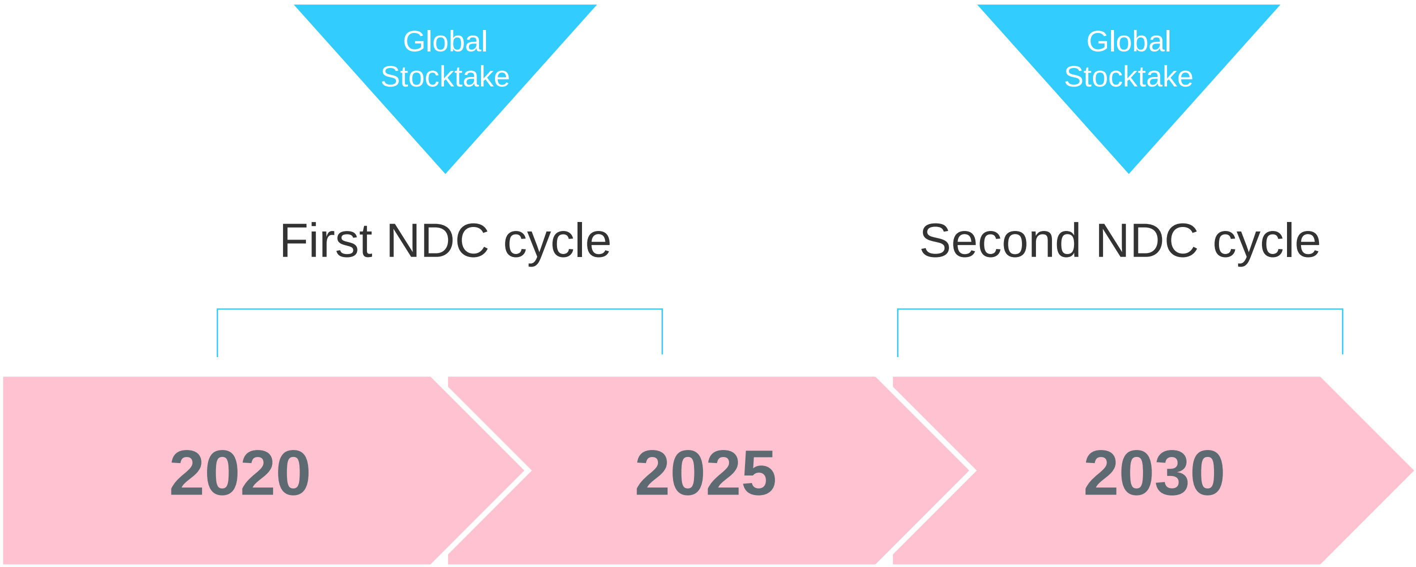
- R&D and technology transfer in yield improvement, 2020s>

Energy Efficiency

- New mandatory standards focusing on buildings and industry

Climate Risk and Credit Risk

Paris Agreement Review Cycles



- ‘High Ambition’ Group have pledged to revisit targets in 2020 ahead of COP 26
- National climate packages (eg. Germany) and Net Zero pledges
- Chile’s recently published NDC entails a sharp tightening of targets
- Japan’s has faced criticism

EU ETS Price Has Staged a Tentative Recovery, Supported by MSR

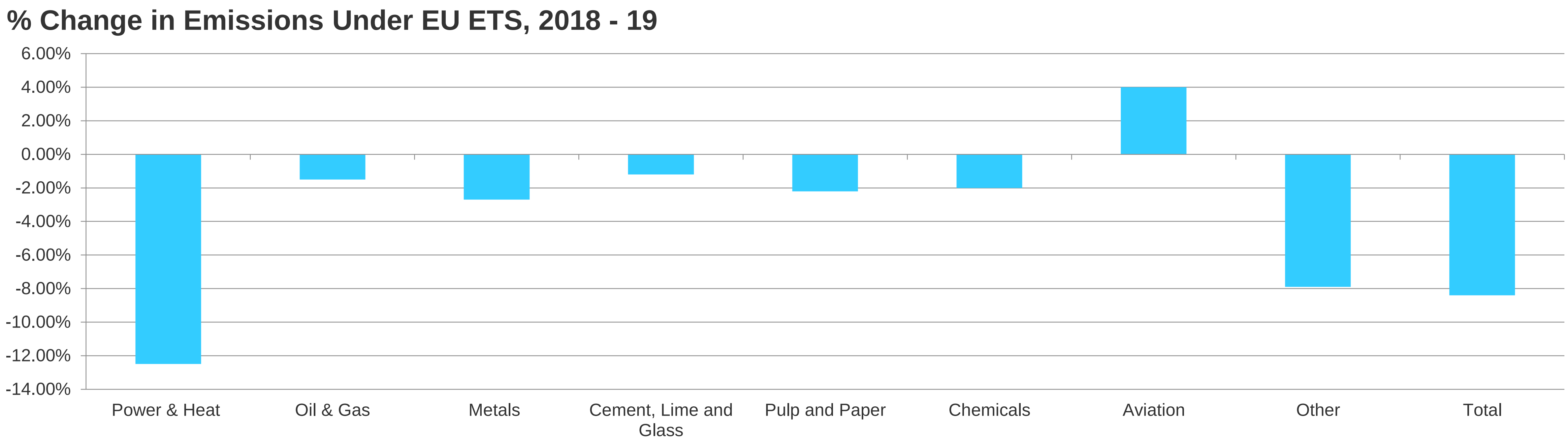
ETS Price (EUR/tonne)
Price per t/CO2e

Data up to April 24, 2020
Source: Fitch Ratings, Bloomberg

- EUR 19/tonne price average compares to previous EUR 27 in 2019
- Forecasts had pointed to EUR 35 by 2021
- Shell recently estimated EUR 200 price required by 2050 to achieve net zero, similar to previous estimates by the IEA, WB
- At EUR 20, thermal coal still faces price disadvantage to other energy sources
- Recovery in price expected to be supported by the Markets Stability Reserve
- Uncertainties over pace of free allocation withdrawal

Source: Fitch Ratings, Bloomberg

Aviation Was Fastest Growing Share of Emissions Pre Crisis

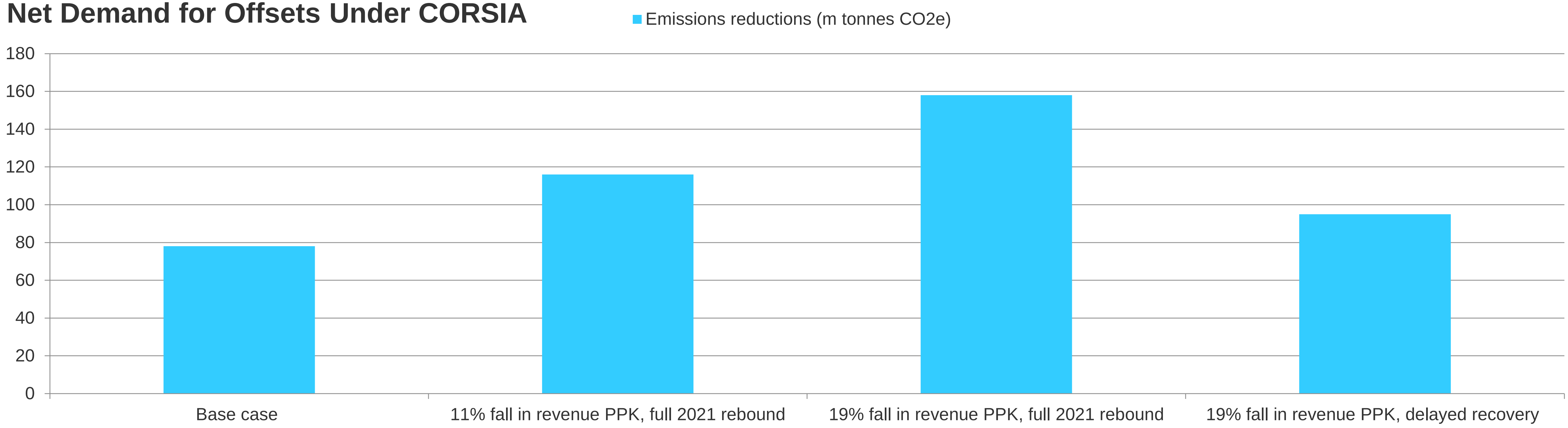


Source: Fitch Ratings, Bloomberg

- Persistently high carbon price in 2019 drove rapid fuel switching, cleantech investments
- Aviation emissions allowed to increase sharply this cycle, offset by deeper cuts elsewhere

Aviation Decline Complicates Carbon Markets

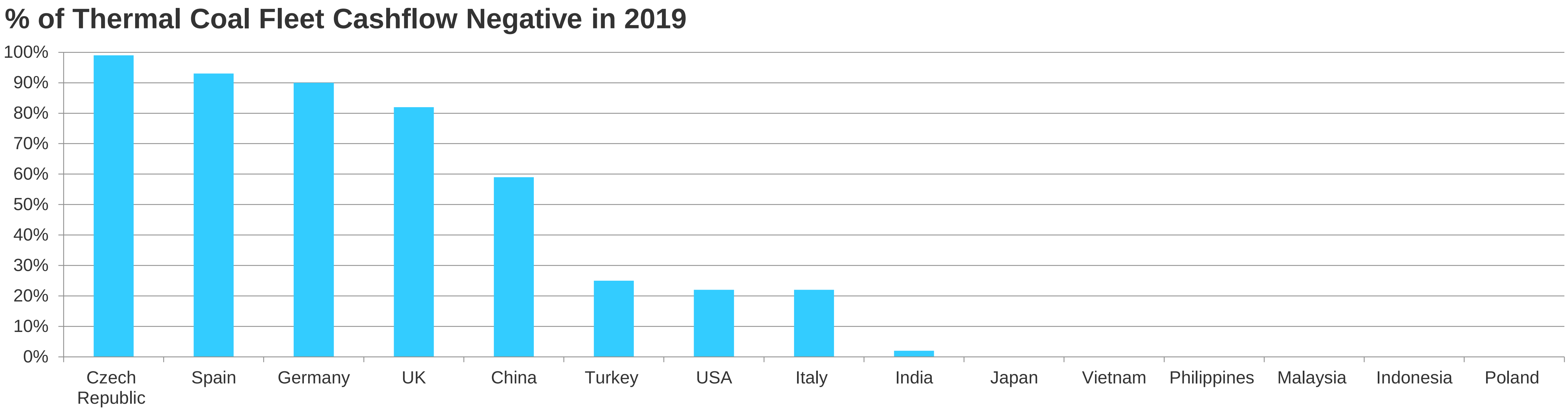
Net Demand for Offsets Under CORSIA



Source: Fitch Ratings, IETA, EDF

- Our ratings projections point to delayed recovery in demand to 2023
- A range of offsets will be valid under the scheme, leading to concerns regarding low prices/oversupply

Coal's Problems Exacerbated

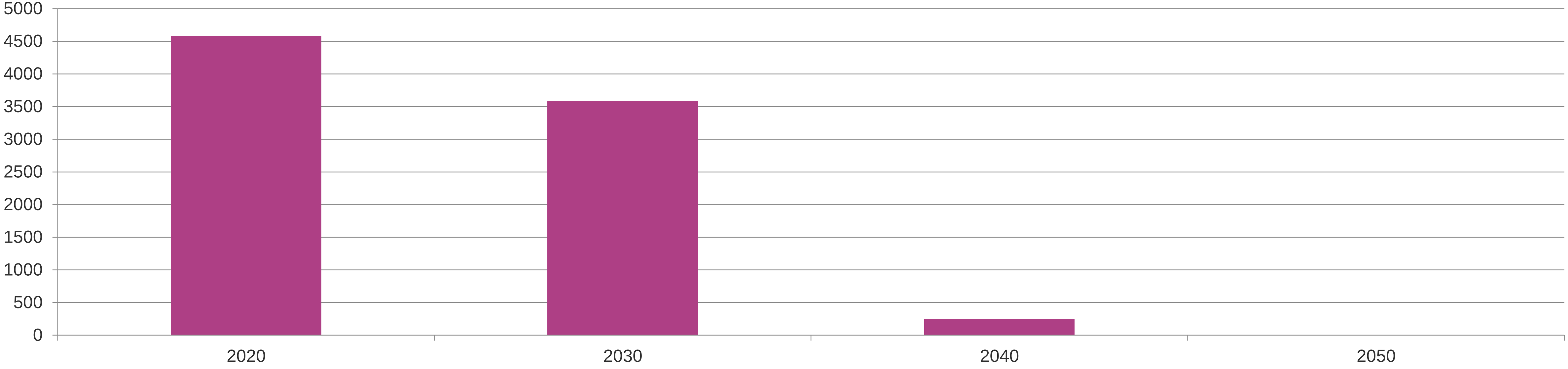


Source: Fitch Ratings, Carbon Tracker

- China is seeking to address overcapacity through gradual shutdowns & mergers of SOEs
- Nonetheless, short term pressure to support thermal coal for growth is strong
- Korea's Green New Deal will be disruptive – 3rd highest financier of overseas coal projects

China’s Role in Global Coal Phase Out

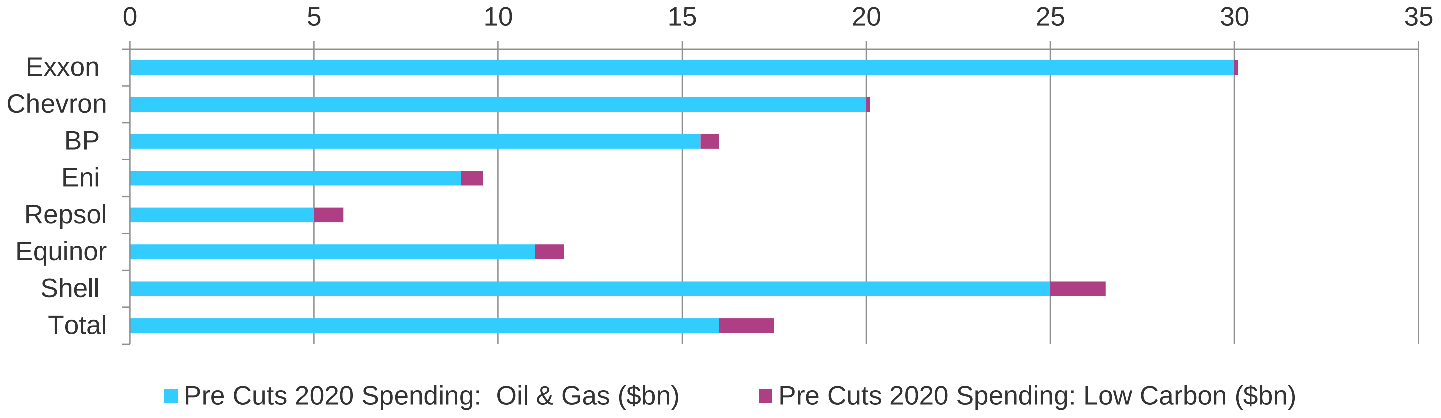
China Coal Power Generation – UN PRI ‘Inevitable Policy Response’
Scenario (TWh)

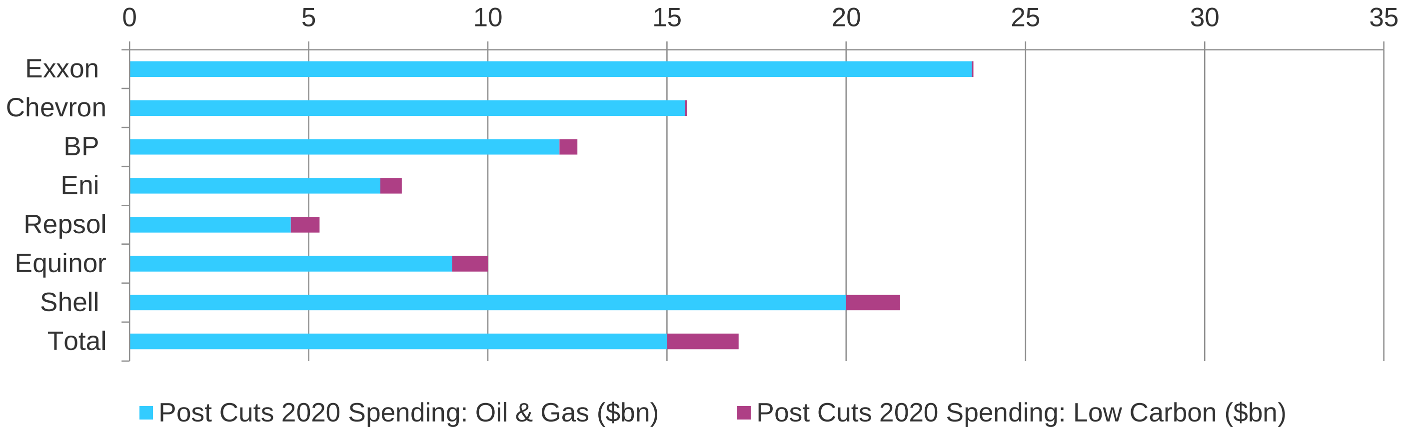


Source: Fitch Ratings, UN PRI

- [Assumptions in our rating cases differ from these scenarios]

European Oil Majors Maintain Renewable Investment





- European Oil Majors have largely maintained spending on renewables and low carbon technologies, despite 20% overall investment cuts across the sector

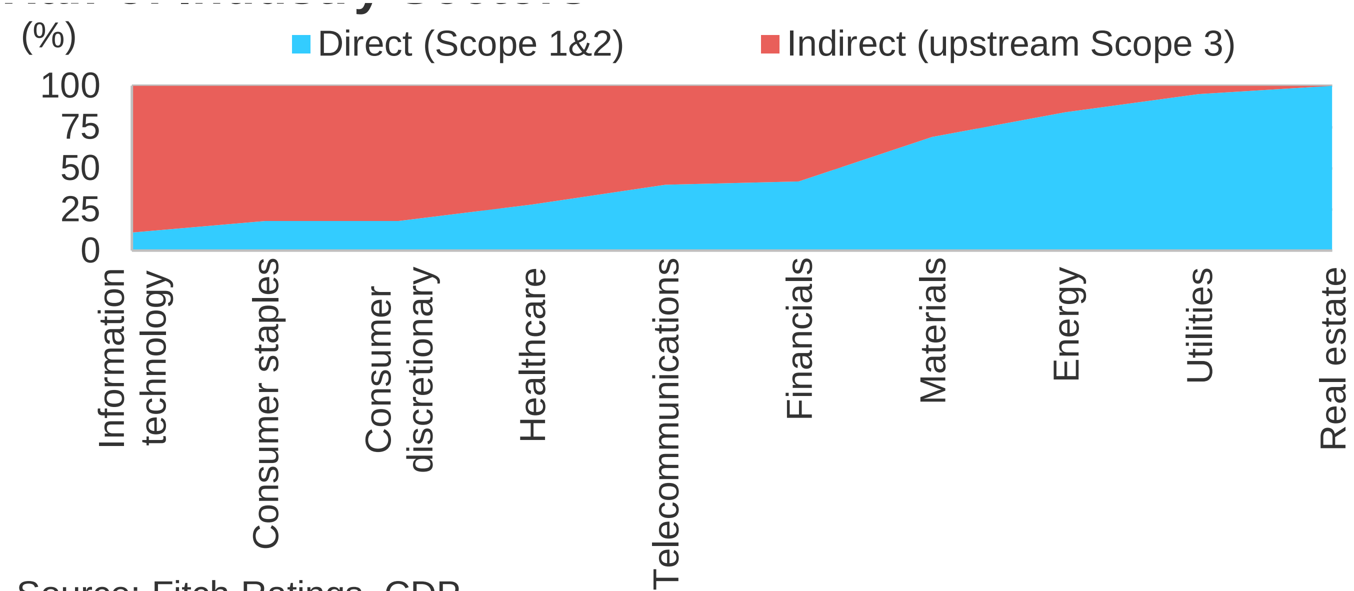
Climate Considerations in Policy Response

- Responses to date primarily crisis management - not recovery
- Climate criteria starting to appear in aviation bailouts (eg. France)
- UoOxford survey – only 3 % of policy announcements ‘green’ or ‘brown’, respectively, the remaining 94% ‘neutral’
- Expansion of Network for Greening of the Financial System, BoE and BoF, ECB pronouncements signal central bank support
- Growing support for assessment of ‘green’ and ‘brown’ assets in prudential frameworks and idea of brown-penalizing factor to address stranded asset risk to macroeconomic stability

Heightened Scrutiny of Supply Chains

- GHG risk in supply chains pertain to rising energy and carbon costs
- Physical risks are likely to gain increasing importance, with water scarcity and natural disaster leading to considerations beyond price efficiency in sourcing and procurement

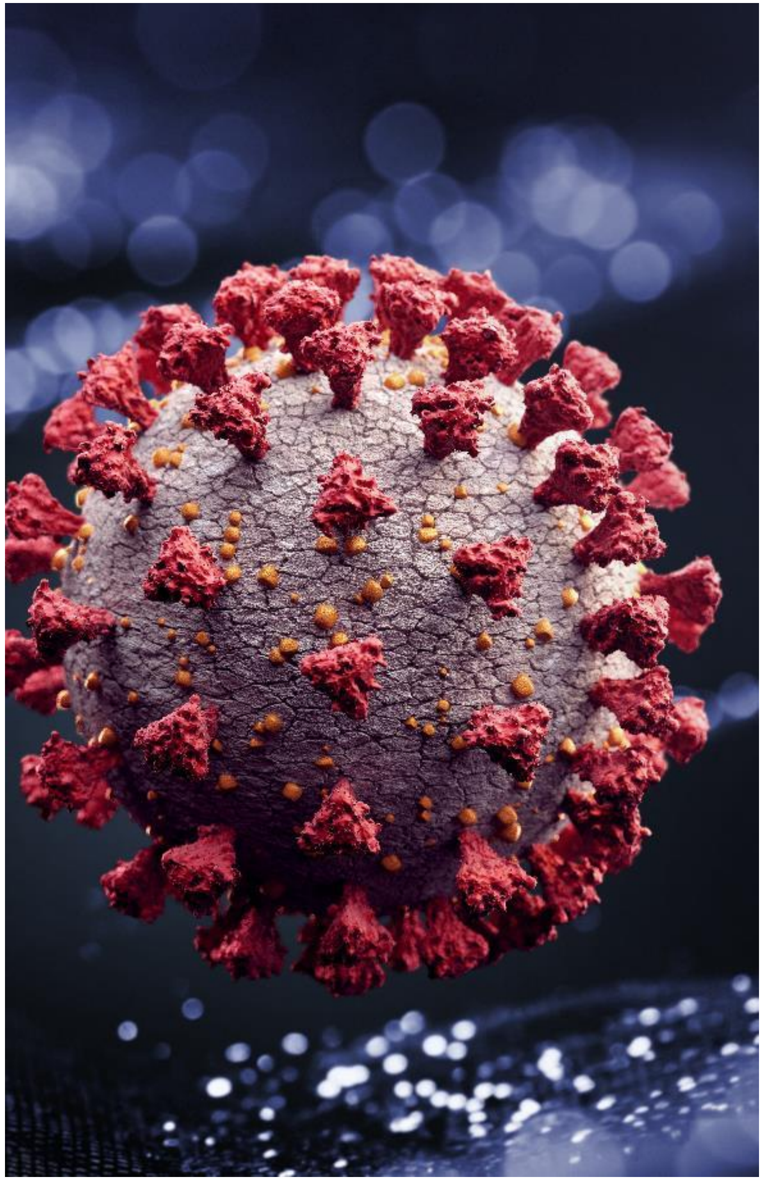
Supply Chain Emissions (Scope 3) Dominate Half of Industry Sectors



Source: Fitch Ratings, CDP

Key Messages

- The coronavirus outbreak undoubtedly has had a short-term impact on ESG factors such as labour management and short-term carbon emissions. Long-term ESG implications remain unclear, and will depend on the severity and duration of the outbreak.
- Financial impact on issuers will have implications for ESG policy, as well as financial and strategic flexibility to manage long-term ESG risks.
- Similarly, the recovery policy response is likely to be positive for low carbon investment in developed markets, although a 'brown recovery' is a risk in EM
- Renewables have proven resilient, although cancellation of capacity auctions and shifting investment by energy majors will impact in the coming months



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