ENGAGING WITH SOVEREIGN GREEN BOND ISSUERS

SIGNATORY TYPE	**Investment manager**
OPERATING REGION	**France**
ASSETS UNDER MANAGEMENT (AUM)	**€579 billion***
FIXED INCOME AUM	**€226 billion***
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WHY ENGAGE WITH ISSUERS?

BNP Paribas Asset Management (BNPP AM) is committed to the development of the green bonds sector because we believe they are a suitable financial vehicle to support low-carbon and climate-resilient development. We see green bonds as the missing link between the need for energy transition financing and supply from debt capital markets.

We engage with green bond issuers to protect our clients' investments from reputational greenwashing risks. Managing these factors is also contributing to our assessment of the issuers' creditworthiness, while our focus on the green quality of the underlying assets through engagement is a way to assess current and future desirability and demand for these bonds.

We find that ultimately, green bond prices and traded volumes in the secondary market are driven by demand from buy and hold investors aiming to decarbonise their portfolios. Therefore, if we buy a green bond for our portfolio, and later the market realises that there are substantial unintended reputational liabilities, investors may decide to sell off their positions. This could increase yield, depress prices, and decrease our portfolio value, since our positions are valued in mark to market. Engaging with green bonds issuers is therefore also a fundamental tool to ensure future low price volatility, which will in turn protect the value of our green bonds portfolio.

*As at June 2017

ENGAGEMENT PROCESS

Through our green bond engagement process, we aim to understand all environmental and social risks and expected benefits, as well as to influence issuers towards improved sustainability practices, disclosure levels and transparency. We prioritise our engagements based on:

- the size and weight of the issuer on the fixed income indexes;
- issuances providing innovative solutions or promising important environmental benefits;
- controversial issuances, flagged by the market and different stakeholders because of their non-alignment with a 2 degree pathway or unintended negative externalities.

Our engagement process covers all green bonds in our investment universe. In Q2 2017, this amounted to a complete coverage of the MSCI/Barclays global green bond index, plus off index issuances totalling 175 issuances and 99 issuers.

We engage directly with issuers on two occasions: pre-issuance of the green bond, and later on in the lifecycle where we focus on the impact reporting published by the issuer. In our engagement interactions, we typically engage directly with senior staff, such as the CEO, the CIO, the head of treasury, and the head of sustainability.

We conclude our engagement process by informing our portfolio managers of the scores allocated to each green bond. The score ranges from 0 – 100 points and are accompanied by an investment conviction based on the overall score:

- Positive: if the score is above 70 points
- Neutral: if the score is below 50 points
- Negative: if the score is below 50 points or unsatisfactory engagement feedback as explained below

This process is very selective – at the end of Q2-2017, our process displays an exclusion ratio of 17% of green bond issuances that don't satisfy our engagement process. However, we work to influence excluded issuers to adopt green bonds and sustainability best practices. And we use different tools to build a constructive dialogue with them: we can elect to make public statements, coordinate collective engagement actions or even leverage on our voting power. For corporate green bonds issuers we could vote "abstain" on their financial accounts and on-board election, if we consider their green bonds programme to be highly controversial.

PRE-ISSUANCE ENGAGEMENT

At issuance we focus on three main areas: the issuer's sustainability credentials, alignment with BNPP AM's taxonomy of eligible sectors/technologies, and the green bond programme's implementation (Figure 1). A project's non-alignment with BNPP AM's taxonomy or a weak issuer ESG rating, coupled with unsatisfactory engagement feedback, may trigger an exclusion of the issuance from our investment universe.

Figure 1: BNPP AM's criteria for engagement pre-issuance. Source: BNPP AM

BNPP AM'S CRITERIA FOR ENGAGEMENT PRE-ISSUANCE

We focus on three main areas:

- Issuer ESG rating: We assess the issuer's ESG credentials, and expect the issuer to explain how the green bond will support their overall sustainability strategy. Issuers with the lowest ESG scores are excluded.
- Taxonomy: We seek to ensure that the projects to be funded are in line with our taxonomy of eligible activities. If the issuer plans to finance excluded activities (for example, new large hydro*, nuclear*, or fossil fuels*), the recommendation is not to invest.
- Green bonds implementation: We expect the issuer to disclose a forecast of their green projects allocations; an explanation of how they'll manage the potential E&S risks embedded in this project; and clear governance structure for the project selection and evaluation.

* According to the Climate Bonds Initiative and the Transition Energetique et Ecologique pour le Climat (TEEC)

ENGAGEMENT AFTER GREEN BOND REPORTING

After reporting, we focus our engagement on three key areas: output and impact indicators and actual project allocation (Figure 2). If the issuer fails to provide a satisfactory explanation for not providing impact indicators, the green bond will be excluded from the investment universe.

Figure 2: BNPP AM's criteria for engagement after green bond reporting. Source: BNPP AM

> **BNPP AM'S CRITERIA FOR ENGAGEMENT AFTER GREEN BOND REPORTING**
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> We focus our engagement on the impact reporting published by the issuer and we monitor three key metrics:
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> - actual project allocation;
> - output indicators (for example clean energy installed capacity);
> - impact indicators (for example GHG avoidances).
>
> If the issuer doesn't report, the recommendation is not to invest. If engagement is satisfactory, the recommendation is to invest for another year. If not, it is not to invest.

ENGAGEMENT IN PRACTICE

PRIORITISING SOVEREIGN GREEN BOND ISSUERS FOR ENGAGEMENT

We believe sovereign green bonds are one of the most suitable financial vehicles for countries to finance their sustainable infrastructure needs and climate strategies as described in Nationally Determined Contributions (NDCs) submitted at the Paris Agreement. Green bonds issued by sovereigns have also offered us a unique opportunity to engage with one of the most important players in global debt markets – sovereign issuances represent more than 40% of the global debt securities[1].

We organised engagement meetings in Poland and France where we had the opportunity to discuss green bond frameworks with government officials. In both cases, we met with representatives of the finance and environment ministries. The banks participating in the operation organised the first meeting, after which we were able to secure direct access with issuers' representatives. As a key bond buyer in the market, issuers are also generally quite willing to meet with our investment teams.

Our meetings covered the criteria described at the issuance engagement process. We expect governments to allocate funds raised to environmental projects which are essential to the achievement of their NDCs. The allocations of funds could take several forms, such as subsidies for research, direct investment in sustainable infrastructure, or actions to adapt existing infrastructure to climate impact. In addition, we expect sovereign debt issuers to ringfence their sustainable projects from changes in government policy.

ENGAGEMENT MEETINGS

In the French meeting, we found out that the green bonds framework included an inter-ministerial group, including ministries of finance, environment, agriculture, and research. Besides the government officials, the group was made up of high-level independent experts in charge of the identification of eligible projects and ensuring the quality of the impact reporting provided to investors. This information was essential to better assess the green bond issuance. We believe that, particularly in the case of sovereign green bonds, government officials need to ensure that the green bonds framework is protected from a potential change in the country's fiscal and environmental policy.

The engagement meeting in Poland helped us better understand the green bond's environmental benefits – for example, a large portion of the proceeds will be used to electrify some of Poland's diesel railway lines. We challenged Polish officials to explain how their railway renovation programme will be climate-aligned, since 85% of the country's electricity is generated by coal-fired power plants. We made it clear that sustainability best practices required to take into account scope 1 and 2 of their projects. Reducing scope 1 emissions (from diesel powered railways) to increase scope 2 emissions (from electricity generated by coal power plants) may not have a positive net effect for the environment.

FOLLOWING UP

We have asked government officials from both Poland and France to organise follow-up engagement meetings with us after the publication of their impact reports:

- We expect Polish government officials to provide a clear explanation of their impact assessment model to show the net benefits of their railway renovation programme.
- We expect French officials to explain how they envisage buildings, natural resources, transport and the renewable energy sectors to be impacted. We also expect a high-level group of independent experts to be fully operational to ensure the quality and impacts of the projects selected.

1 http://ideas4development.org/en/sovereign-green-bonds/