PIMCO

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PIMCO's Best Practice Guidance for Sustainable Bond Issuance

PIMCO's ESG (environmental, social, and governance) portfolio management team outlines the following best practices for issuers of green, social, sustainability or sustainability-linked bonds.

Outline:

I) Best practice guidance for green, social and sustainability bonds
II) Sustainability-linked bonds
III) Social bonds related to COVID-19
IV) Background on PIMCO green bond and climate engagement frameworks

I) Best practice guidance for green, social and sustainability bonds

1. **International Capital Market Association (ICMA) Principles and Guidelines:** Bond framework should be clearly aligned with ICMA Green and Social Bond Principles and Sustainability Bond Guidelines (e.g., setting out eligibility thresholds and planned impact reporting) with specific details where feasible (e.g., examples of investments linked to positive sustainability outcomes).
2. **Sustainable Development Goals (SDGs)**: Use of proceeds should be clearly aligned with the Sustainable Development Goals, with impact reporting referencing specific targets or indicators. ICMA has provided a high level mapping to the SDGs.
3. **Connection with the issuer long-term strategy**: Bond framework should be aligned with sustainability objectives that are connected to the firm-wide business strategy, e.g.:
    a. Governance recognized by standards such as Task Force on Climate-related Financial Disclosures (TCFD).
    b. Ambitious carbon emission reduction target recognized by standards or scenarios such as the science-based target initiative.
    c. Business and investment mix shift as per recognized standards or scenarios such as the International Energy Agency (IEA) and Intergovernmental Panel on Climate Change (IPCC)/Paris agreement-aligned pathways, including sector specific indicators, e.g., coal or internal combustion engine scale down and phase out for utilities and auto, respectively.
4. **Lookback period:** If using a lookback period, issuer should indicate how much of the use of proceeds (UOP) will be allocated to projects already funded (approximate estimate can be acceptable).
    a. Preference is for UOP to fund new investments.
    b. If UOP will be used to refinance or re-label prior spending, this should be disclosed.
5. **Intended UOP split by activity:** The issuer should communicate the expected UOP by type of activity (e.g., renewable energy by type, building by green certification level) and type of spending (e.g., capital expenditures versus operating expenditures) ahead of the new issue.
    a. UOP should finance/refinance eligible capital or operating expenses, not philanthropic efforts.
    b. Potential project pipeline: UOP on projects should disclose the total expected cost of the possible project pipeline.
6. **Duration of activities:** Operating expenses should be supported by a compelling case (e.g., maintenance costs related to green assets, or research and development spending) or kept to a minimum, in line with the guidelines developed in the context of the European Union (EU) Green Bond Standards.

7. **Eligible projects should have duration at least equal to the full life of the bond:** Or the issuer should commit that repayments and maturing investments will be reinvested in additional eligible projects until the maturity of the bond.
    a. For example, proceeds used to purchase goods for sale or make loans should be renewed over the expected life of the issue or longer.
    b. The reinvestment commitment aligns the "flow" UOP for the purchase of sustainable cost of goods sold (COGS) with a "stock" UOP that funds long term capital investments (e.g., solar and wind generation).
8. **EU Taxonomy / EU Green Bond Standard**: Proactively communicate the likely alignment of the Use of Proceeds with the EU taxonomy for sustainable activities.
    a. Wherever possible and appropriate, issuers should ensure that the Use of Proceeds is aligned with the latest technical screening criteria (e.g., <100g CO_2 /kWh for electricity generation, etc.) and that the bond is more broadly aligned with the other proposed core components of EU Green Bond Standard.
    b. This guidance is relevant for issuers based outside of the EU as well (US, UK, Asia, South America) to expand the set of investors that may be able to invest in the bond.
9. **Demonstrate Ambition.**
    a. **Issuer's firm-wide performance:** ICMA's Climate Transition Finance Handbook provides guidance for issuers in 'hard to abate' sectors to demonstrate their credentials.
    b. **Eligibility thresholds:** The Paris Agreement-aligned pathways imply meaningful improvements versus business as usual and the ambition to improve should be increased over time (e.g., at least a 30% improvement for buildings retrofits and if possible higher).
    c. **Types of expenses:** Emphasize investments that are the most pressing and critical to advance the Paris Agreement on climate change (e.g. Capital Expenditures and Research & Development expenditures into areas identified as priorities and leading to meaningful carbon savings for issuers' core business and assets, including renewable energy generation and infrastructure, energy storage, electrification of energy end-use, green hydrogen, energy storage, sustainable bioenergy, alternative proteins, instead of Corporate Renewable PPAs and operational expenditures linked to modest energy efficiency improvements).
10. **Transparency:** Provide supporting documentation to investors in a timely fashion so they can make an informed underwriting decision, at least a full working day prior to issuance (for syndicates).
    a. Bond framework should be a standalone document (i.e., not only as a Use of Proceeds statement in the prospectus or pricing supplement) available publicly on the issuer's website. In jurisdictions where there are legal challenges to publishing a separate framework in advance of a new issuance, issuers should make the framework available on their website as soon as feasible after the deal is announced.
    b. External review (second party opinion, verification, or certification).
    c. Sustainability report or update for the issuer and/or parent company.
    d. Previous green, social or sustainability bond reports (allocation, impact).
11. **Impact Reporting:** Should be In line with ICMA principles, for impact reporting, and the SDGs:
    a. Issuers should commit to providing an updated impact report including outcome metrics at least annually as long as each bond remains outstanding, allowing investors to track changes and progress. The first report should be published no later than one year after the initial bond issuance.
    b. Impact reporting should link to firm-wide targets (e.g., if the company is targeting a 30% reduction in carbon intensity by 2025, they should present this in the framework document alongside metrics that the company reports related to the bond).
    c. Standardized format should enable aggregation from an investor's perspective, with outcome metrics attributable to the specific investments funded by the UOP. Investors need to be able to calculate their impact per unit of investment in the bond and need to be able to aggregate impacts at a portfolio level across multiple bonds. Example of good practice: Nordic Investment Bank (NIB)'s impact tables.
    d. Regarding carbon emissions, issuers should include avoided emissions and aggregate absolute emissions, lifecycle carbon intensity per sales and relevant output-based metrics (e.g., megawatt hour (MWh) for energy or square meter for real estate), to allow comparison with firm-wide carbon performance and peers in a portfolio context, and in line with the Greenhouse Gas (GHG) Protocol that indicates 'Companies should not make claims about positive impacts without

being transparent about whether their Scope 1, 2, and 3 emissions are increasing or decreasing'. Example of good practice: Castellum. The Greenhouse Gas Protocol defines Scope 3 emissions as all indirect emissions in the value chain of a company not captured in Scope 2, indirect emissions from the generation of purchased energy, or Scope 1, direct emissions from owned or controlled sources.

e. Provide specific guidelines about output-based metrics (buildings per exact certification level, e.g., Leadership in Energy and Environmental Design (LEED) Silver or above, and energy performance improvements for retrofits, e.g., two notch increase in Energy Performance Certificate (EPC) label). Example of good practice: ARE.
f. Include the geographic location of each project. Example of good practice: Avangrid Green Bond Report.
g. Provide 'ownership' impact metric, total and project specific data. Example of good practice: MUFG Green Bond Report. Investors need to attribute outcome metrics relative to the amount invested in the bond. Issuers should report the [Outcome Metric] volume that can be attributed specifically to the investment funded by the bond and all firm-wide numbers need to be on a bond-by-bond basis. In cases where the bond only partially funds a larger project, the portion funded by the bond needs to be disclosed on a project-by-project level.
h. Include details on the methodology and calculation for the metrics reported including emission factors, including independent verification. Example of good practice: BBVA Green Bond Report.

Recap of noteworthy practices structured per sector, including additional examples:

Sector	Example	Best Practice for disclosing…	Source
Banks	**KBC Groep NV**	Methodology to calculate avoided emissions, including independent verification	Link
Banks	**ING**	Methodology to calculate avoided emissions, including consultant input and publication of both pre and post issuance impact reports	Link
REIT	**Castellum**	Detailed environmental data for each project (e.g., specific environmental certification level, carbon, water footprint), coupled with context regarding the portfolio's carbon and energy intensity and performance over time	Link
REIT	**Alexandria Real Estate**	Providing the LEED Certification level for each project	Link
Utilities	**Orsted**	Granular and comprehensive green bond impact reporting, including connections with firm-wide strategy and targets	Link
Utilities	**Iberdrola**	Granular and comprehensive green bond impact reporting	Link
Utilities	**Xcel**	Holistic approach that includes social indicators mapped to the SDGs	Link
Telecom	**Telefonica**	Audited impact measurement including detailed allocation, impact methodology and several KPIs	Link
Government-related	**NIB**	In a user friendly and standardized format that enables aggregation from an investor's perspective and to produce annual data (impact tables in Excel)	Link
Government-related	**SNCF**	Detailed methodology for avoided emissions on a lifecycle basis	Link

12. **Temporary use of proceeds**: Issuers should avoid "temporary" Use of Proceeds. In cases where this is unavoidable, the issuer should transparently justify any temporary uses related to debt refinancing or investment (e.g. project timetable, detailed disclosure and appropriate timeline for full allocation), demonstrating that the delay in allocation to Eligible Projects is minimized.
    a. The debt repayment and investments concerned should not be related directly or indirectly to any activities misaligned with the green bond objectives or ESG exclusion criteria (e.g. General Corporate Purpose assets that may be linked to fossil fuel projects or dividends to shareholders of companies involved in such activities).
13. **Green Bank Additional Tier 1 / Preferred Capital**: Use of proceeds perpetual capital instruments are not favored. The AT1 structure is capital for regulatory purposes, which means that its Use of Proceeds cannot be used directly to fund Green lending (loss absorbing equity capital; perpetual maturity; bail-in eligible; regulatory call dates; etc.). Our view is that Green, Social and Sustainability bonds that are intended to support lending for Eligible Projects should be limited to Senior and Subordinated instruments; however, we do see a strong rationale for banks to issue capital instruments under the SLBP that are aligned with long term corporate targets .

II) Sustainability-linked bonds

The Sustainability-Linked Bond Principles (SLBP) provide a framework for issuers to connect financing needs with the achievement of firm-wide sustainability performance and targets that advance the United Nations (UN) Sustainable Development Goals (SDGs).

PIMCO sees bonds linked to the SDGs as an emerging best practice for issuers seeking to demonstrate positive sustainability outcomes. We encourage issuers to come to the market with frameworks that align with these voluntary process guidelines, particularly for issuers in carbon intensive industries looking to make long term progress.

The EU Technical Expert Group final report on the taxonomy provides another useful resource that issuers may leverage when issuing a Sustainability-linked bond. For example, issuers may contemplate targets that would include an increase in the share of revenues, loans or investment that is associated with activities compatible with the eligibility criteria.

In addition to the guidelines outlined by the SLBP, **PIMCO encourages issuers to incorporate progressive milestones into their SPTs** (sustainability performance targets) to ensure that issuers demonstrate progress throughout the life of the bond. For example, a ten-year bond with a KPI (key performance indicators) measuring the issuer's share of renewable electricity generation could include several progressively more-challenging SPTs over the life of the bond (e.g., 40% by year 3, 50% by year 5, and 60% by year 7, etc.).

a. To be compelling, **Sustainability-linked bond should include an interim sustainability performance targets** to reflect the issuer's commitment to make consistent progress and the importance of clear intermediary targets (i.e. coupon step-up instead of variable redemption amount at maturity). We do not regard SLBs with long maturities (>5yrs) that do not have an interim step.
b. PIMCO prefers coupon steps structured like typical bond covenants to facilitate the mainstreaming of the instrument and its connection with credible and ambitious targets, i.e. cash payments to investors rather than charitable donations.
c. Coupon steps should be step-ups and not step-downs.

The table below identifies potential themes, indicators, SDGs and metrics that could inform the two first components of the SLBP, namely: 1) The selection of key performance indicators (KPIs); and 2) Calibration of sustainability performance targets (SPTs).

Potential KPIs for Sustainability-Linked Bonds

Sector	SDG	Bond reporting	Firm-wide target	Initiative or benchmarks
Water	6 CLEAN WATER AND SANITATION	Number of people with access to clean drinking water, absolute (gross) water saving	Water intensity reduction, water withdrawals monitoring and reduction (context-based), supplier engagement, Water, Sanitation & Hygiene (WASH))	CDP, CEO Water Mandate
Renewable energy	7 AFFORDABLE AND CLEAN ENERGY	Installed renewable capacity and generation	Share of renewable electricity consumption / production	RE100
Electric vehicle	11 SUSTAINABLE CITIES AND COMMUNITIES	Share of battery electric vehicle and lifecycle GHG emissions of the project portfolio (intensity and absolute)	Share of battery electric vehicle in the fleet and lifecycle GHG emissions of the fleet (intensity and absolute)	EV100
Carbon emissions	13 CLIMATE ACTION	Avoided carbon emissions, carbon intensity of the portfolio (e.g., CO2/MWh or square meter)	Paris-alignment or net zero carbon emissions	Science Based Target initiative
Circular economy	12 RESPONSIBLE CONSUMPTION AND PRODUCTION 14 LIFE BELOW WATER	Amount of recovered materials thanks to product re-design, new business models and/or reverse logistics or Increase of bio based/recycled materials utilization	Phasing out single-use plastics, % of recyclable, reusable or compostable plastic packaging, % of bio-based materials	New Plastic Economy Global Commitment
Health & Nutrition	2 ZERO HUNGER 3 GOOD HEALTH AND WELL-BEING 12 RESPONSIBLE CONSUMPTION AND PRODUCTION	Increased/decreased positive/negative nutrients (sodium, sugar, bad fats vs protein, fiber), affordability	Increased/decreased exposure to products associated with positive/negative nutrients and health outcomes	Access to Nutrition Index, nutrient profile systems, WHO guidelines

III) <u>Social bonds related to COVID-19</u>

ICMA's Social Bond Principles provide guidelines for use of proceeds bonds that raise funds for new and existing projects with positive social outcomes, including programs to prevent and alleviate unemployment from socioeconomic crises. We anticipate significant growth social bond issuance to aid in recovery from the impacts of COVID-19.We support ICMA's guidance for issuers.

1. **Use of proceeds (UOP) should be used to benefit COVID-19 challenges, and/or other challenges laid out in the Social/Green Bond Principles, for the <u>full life of the bond</u>.**
    a. We recognize there is uncertainty around the level of needed investment for COVID-19. Bonds should be issued with a use of proceeds framework that ensures UOP will be directed towards COVID-19 needs, then broader social and/or environmental challenges specific to the issuers, for the life of the bond.
2. **Impact metrics should be <u>specific to COVID-19 needs</u>. For example:**
    a. <u>Banks</u> providing SME (Small and Mid-size Enterprise) loans could report jobs maintained/created and the number of business loan recipients extending additional healthcare benefits to workers.
    b. <u>Pharmaceutical companies</u> could report amount invested in research and development (R&D) for COVID-19 drugs or testing and the number of people treated/tested.
    c. <u>Manufacturing companies</u> could report the number of protective equipment produced.
    d. <u>Education companies</u> could report the number of students enrolled in alternative forms of education (including online).
    e. All deeply impacted sectors could report the number employees with increased access to healthcare and benefits (including access to telehealth, mental health counselling, childcare alternatives, etc.)
3. **Issuers should have a <u>substantive sustainability strategy</u> in place, addressing immediate challenges around COVID-19 alongside other material risks such as climate risks, natural resource use, supply chain sustainability, and human capital management.**
    a. An effective governance structure should be in place to oversee ESG challenges.
    b. A special committee to oversee COVID-19 risk may be warranted. This body could oversee the company's internal operational risk management around COVID-19 and/or ensure UOP are designated towards credible projects.
    c. The company should have a demonstrated track record on effectively management material ESG risk/opportunity.

IV) <u>Background on PIMCO green bond and climate engagement frameworks</u>

PIMCO green bond framework

Our framework (outlined in our ESG Annual Report) assesses these instruments both prior to and after issuance, mapping them across a spectrum based on three criteria:

1. <u>Strategic fit</u>: Alignment of the issuers' climate / environmental / social strategies with the bond's objectives and use of proceeds.
2. <u>Impact assessment</u>: Evidence of significant positive outcomes compared to "business as usual" by the issuer.
3. <u>Red flags and reporting</u>: Screening for "red flags" and controversies and analysis of reporting and process (misalignments to market standards (e.g. Green Bond Principles)).

This results in a score and ESG recommendation regarding the suitability of these bonds for PIMCO's portfolios.

PIMCO expectations towards issuers on climate change

We evaluate the evidence of issuer's best effort and performance in relation to the following points, acknowledging issuers are at various stages, and the importance of the direction of travel and momentum.

Issuer's response to these questions inform: 1) Our green bond framework criteria (strategic fit) for our green bond score at the issuance level and; 2) PIMCO's environmental assessment and score at the issuer level.

Both scores are integrated into PIMCO's credit research notes.

For more information, please see the following publications:

- Managing Climate Risk in Investment Portfolios: PIMCO's Approach
- PIMCO Climate Bond Strategy: Investing in Sustainable Solutions

Climate Awareness	***Recognition***	i	Does the issuer recognize climate change as a significant issue and has it developed a policy?
Climate Readiness	***Reporting***	i	Does the issuer reports both its absolute and relative carbon emissions across the entire value chain (including scope 3), including carbon intensity based on relevant production metrics (e.g. MWh for Utilities, km for Auto)?
	Target	ii	Has the issuer set a GHG emissions reductions target?
Climate Alignment	***Scenarios***	i	Does the issuer carry out and disclose a comprehensive and quantitative scenario analysis, including conclusions regarding the financial impact and with reference to transition risk, e.g. policy shift towards 1.5-2°C temperature rise scenario, and physical risks, e.g. rise in frequency of extreme weather events?
		ii	Does the issuer use an internal price of carbon for its most relevant value chain impact (e.g. scope 3 for oil and gas, and auto) and factor it in to business planning and investment decisions?
	Strategy	i	Has the issuer set a Paris Agreement-aligned (1.5°C science-based) GHG emissions reductions target (across all relevant scopes)?
		ii	Has the issuer set a net zero commitment (including quantitative interim targets)?
		iii	Does the issuer report evidence that its business plan is aligned with the Paris Agreement (e.g. capex, R&D, technology, revenues, profit exposure outlook, lobbying) and potential climate adaptation needs (resilience to physical risks)?
		iv	If the company has set a net zero target, 1) which share of lifecycle emissions does it cover; 2) does it plan to absorb and offset emissions; and 3) does the company disclose the absorption and offset mechanism details (including alignment with science and certified methods of GHG removal and offsetting)?

Contact: ESG_Analyst_Inquiries@pimco.com

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