INTERVIEW

TRANSITION BOND MARKET: REGARDLESS OF FINANCING FORMATS, THE MAIN QUESTION IS WHETHER THE ISSUER IS ON THE PATH TO A CREDIBLE CLIMATE TRANSITION

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Prior to AXA IM, he spent seven years working as Director, Governance and Sustainable Investment at BMO Global Asset Management where he led the ESG engagement overlay service. He also has previous experiences as a business journalist for the BBC, CNBC, Bloomberg News and Asahi Shimbun.
Yo holds a MBA (distinction) from Cass Business School and a MA / BA (hons) undergraduate degree in Geography from the University of Cambridge. He speaks English and Japanese.

AXA Investment Managers is a global asset management company with €801 bn (as of the end of Sept 2019) in assets under management. For more details: https://www.axa-im.com/about-us

Q1. Climate finance is at a crossroads. How can we find a balance between "green puritanism", which may condemn us to a niche and excludes the firms where the lion's share of CO2 emissions lies, and "transition leniency", which accommodates minor progress and locks CO2 in the economy?

For practioners - such as you and me - how we find this balance is the big question! In the long-term, we all have to be green puritans. The goal is net zero carbon emissions by 2050 and keeping a lid on global warming to 1.5 degrees Celsius. But, the route to getting there is unclear and uncertain.

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Over the past two years, we have conducted extensive research into climate scenario analysis techniques for our investment portfolios. Two of the key variables affecting the future "warming potential" of our investments are time and carbon budget, and our findings are consistent with those of the Intergovernmental Panel on Climate Change (IPCC).

Put simply, a lot of carbon emissions need to be reduced very quickly. At the current pace, the IPCC believes that temperature increases will breach the +1.5°C threshold between 2030-2050 unless annual global carbon dioxide (CO_2) emissions decline by 45% by 2030 and reach 'net zero' by 2050.

Another of the sobering findings from our research has been that it is not sufficient just to focus on the extremities of investment portfolios.

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We have taken steps to divest from the darkest brown, most carbon-intensive investments. In our climate risks policy, we exclude companies involved in coal and tar sands*. At the other end of the spectrum we have allocated increasing levels of investment capital to the deepest green, lowest-carbon investments. We do this across asset classes such as listed equity, corporate bonds, private equity and real estate. For example, we are very active buyers of Green Bonds and currently hold investments worth around 5.5 billion Euros in this rapidly growing sector.

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Despite these important steps, the "warming potential" of our investments is still higher than those required to align with the goals of the Paris Agreement. In fact, we have found no major equity or bond benchmark that has a current alignment close to the +1.5°C limit sought by COP21. The warming potential of the main corporate market indices is +3.3°C.

This analysis shows that if we are serious in our commitment to help achieve global climate change goals, we need to switch our focus to the middle part of the portfolio – the section which is neither the most nor the least carbon intensive. This is the part which represents the real economy, the one we developed after the Second World War and which has brought us prosperity, but also left us with a deep environmental footprint that has now become all too apparent.

*AXA IM Climate Risks Policy, 2019 - https://www.axa-im.com/documents/20195/15774517/AXA+IM+Climate+Risks+Policy+EN+en.pdf/265cc5b4-caa7-b244-fbcc-1f9cf80e78c9

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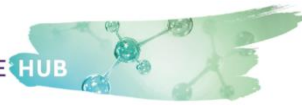
Fortunately, there are many ways we can make genuine progress in decarbonizing the world economy. They include challenging carbon-intensive companies in one-to-one engagements and participating in collaborative initiatives such as Climate Action 100+ or the Powering Past Coal Alliance, which seeks to end the use of coal-fired power generation without measures to substantially reduce CO_2 emissions. We use our position in industry groups and trade associations to press for better outcomes in the public policy arena.

Much of the dialogue with companies focuses on how they are considering their climate transition, and pushing them towards a better understanding of global-warming-related risks and opportunities. We want these companies to establish a clear strategic commitment to strengthen environmental practices and to enhance oversight and transparency. A lot of this is now neatly framed under the expectations set in the Taskforce for Climate-related Financial Disclosures.



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But there is always more to be done. We wanted to ensure that our engagement work and our broader advocacy on climate change mitigation was reflected in our financing activities. So last June, we published a call-to-action which sought the establishment of a new fixed income asset class called Transition Bonds. We believe it is important that companies which are committed to meaningful decarbonisation at the corporate-level and which can adequately evidence progress should be able to secure stable and long-term funding through the Transition Bond market. Our objective was to kick-start a discussion between issuers, investment banks, policy makers and wider stakeholders.

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It's fair to say that we succeeded in that. The response has been really amazing. We have gathered all sorts of views from across the wider industry and this is exactly what we were hoping for. A vibrant debate has taken place which brought us into direct contact with capital market participants and many others. However, as I said earlier, the moment for talk is over. Now, the hard work of taking this to the next stage has to begin.

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As part of the ICMA GBP a dedicated Working Group on the topic of Climate Transition Financing has been established. We are one of the co-chairs.

> *As part of the ICMA Green and Social Bond Principles a dedicated Working Group on the topic of Climate Transition Financing has been established. […] Around 50 institutions have already asked to participate. […] signaling a growing critical mass of interest in the topic from around the world.*

Around 50 institutions have already asked to participate and therefore, signaling a growing critical mass of interest in the topic from around the world.

In 2020, our Working Group will consider how all bond issuers – including those from heavy industries, manufacturing and extractives sectors which haven't come to the green bond market – can be encouraged to take the important step to link financing activities with climate-related public commitments. This is an inclusive effort and all perspectives will be considered. Together, we have a far better chance of developing a well-considered and lasting solution to the defining challenge of our time.

We have ever more sophisticated (and hopefully accurate) science-based approaches to model how different sectors should get there but let's be absolutely clear, no amount of forward-looking theory thing is going to be a substitute for urgent actions taken today to decarbonize our economic activities. Every year lost to doing nothing or waiting for the perfect solution can never be clawed back. Time is of the essence.

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Q2. Transition is on everyone's lips but rarely defined. Can you present us your definition of "transition" at corporate level? Does it require business model change? What is the end-goal, i.e. towards what are brown industries meant to transition?

We do not have a set definition for climate transition at corporate level. That is because the world economy is incredibly varied and complex – so, we are never going to have a one-size fits all definition. Transition should be defined by the end-goal. As highlighted earlier, the goal is business activity which is consistent with net zero carbon emissions by 2050 and keeping a lid on global warming to +1.5°C. What's not clear is different entities' pathway to that goal.

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Some sectors will not require much transition at all. For others the change will be fundamental and without drastic action to alter the business model, products and services – the company may not able to continue to exist in its current form. Climate change will be disruptive.

We all talk about companies having an over-arching multi-decade climate policy but the truth is that senior executives and board directors of many of the companies we engage with are only starting to understand and acknowledge the scale of the changes required to mitigate global warming.

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Transparency frameworks have emerged in recent years such as the Taskforce for Climate-related Financial Disclosures (TCFD). This has provided common approaches for companies to consider and present this information to investors. TCFD is only a few years old and adoption needs to ramp up rapidly. We have a principle expectation that all companies should be reporting on the TCFD.

The companies need to be able to evidence that not only do they understand the issue but that they can implement robust corporate practices aided by sufficient expertise and resources to ensure a "true" transition. The short/mid/long-term KPIs and targets are clearly an important for investors to be able to monitor over time whether the transition is successful or not.

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Q3. Are all high emitting companies or sectors equal and facing the same "transition tightrope"? Are some sectors urged to transition faster and more radically? Apart from the existence of lower-carbon technology substitutes, do you also look at other criteria related to basic needs fulfillment or access and fairness?

Of course, not all high emitting sectors are equal. There is a major differentiation to be made between the providers (supply-side) and users (demand-side) of energy. We are doing a lot of research and analysis currently into energy using sectors. What is becoming clear is that there is an enormous amount of innovation is taking place which can enable a significant reduction in carbon emissions compared to existing processes. However, the challenge remains cost competitiveness and scalability of the operational/manufacturing process or of the product/service itself. This is where institutional investors can play a real role as partners. Across our investment platforms in different asset classes, we are seeking long-term investments which will generate returns. We do obviously need to consider other sustainability issues or negative externalities as part of our due diligence and ongoing monitoring but the emphasis on climate change is strong.

> *"However, the challenge remains cost competitiveness and scalability of the operational/manufacturing process or of the product/service itself"*

Q4. How would you define a meaningful transition from an oil and gas companies? Does it require a minimum level of diversification towards low-carbon energy sources?

This is such a difficult question. Oil and gas companies can meaningfully transition by significant reduction of Scope 3 emissions but even that may not satisfy the expectation of all societal stakeholders. We do see some announcements from oil & gas companies which are pointing in the right direction, but – let's be clear – the transition of this sector will be seen as being the most challenging.

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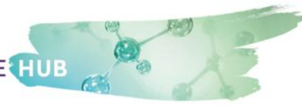
Q5. It may be challenging to assess the transition spillover of Use-of-Proceeds Bonds because the underlying assets hardly affect the overall climate performance of a company. It is why at Natixis GSH we believe that KPI-linked instruments are best suited for the transition because of their "skin in the game", material, holistic and forward-looking features. What is your opinion on this assertion? What synergies do you see between UoP and KPI-linked formats?

The most important aspect of both these financing approaches is that they are first and foremost looking at what is happening at the issuer-level. The big question being posed as a condition of financing in both is whether the issuer is on the path to a credible climate transition or not. So, I am encouraged that both these approaches are focusing on that part.



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So, the distinction between Use of Proceeds or KPI-linked format is essentially one of how the issuer can evidence its transition to the investor. One is about corporate expenditure as evidence – and that transparency is important to investors. The other is about tracking key performance indicators over the maturity of the bond. I see a lot of synergies because ultimately, they want to achieve the same goal.

"[UoP] is about corporate expenditure as evidence – and that transparency is important to investors". The other [KPI-linked] is about tracking key performance indicators over the maturity of the bond. I see a lot of synergies because ultimately, they want to achieve the same goal."

With regards to KPI linked formats – the challenge will be to convince investors that the KPI selected by corporates is the most appropriate measure and that the targets in place are ambitious/stretching or not. We also will need to know the likelihood of the targets being achieved. This will determine whether the outcome of a KPI target being achieved – such as the coupon stepping up or down has any value to it. If the corporate issuer has selected an easy to achieve target – what I call a "slamdunk" - we should assume that the coupon step up/down feature is of no value to investors as it will never bear fruit. The corporate will always have significantly more information than investors – and there will be a financial motive to control this information in its favour. So, interesting consideration needed to balance out this asymmetry.

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For anyone who has worked in corporate governance, they will know this situation intimately from analyzing executive compensation plans for voting at annual general meetings in the UK and the US. It's not something that is easy to analyse quickly. A lot of engagement dialogue is needed by investor and issuer in the build up. Something to bear in mind for the rapid nature of the bond market.

That said, I expect to see considerable innovation in climate finance in the coming years. Let's be clear – there will be no single silver bullet that makes this global warming thing go away. We need to encourage innovation and I, personally, expect to see a lot of novel climate financing ideas in the next few years. We should welcome them. I do. The status quo will not resolve climate change as quickly as we need it too.

Q6. Do you believe that this topic of "transition" will at some point be brought to sovereign debt market? Can we imagine transition bonds from governments related to the achievement of their NDCs?

Yes, of course. Why not? I am from Japan where climate transition is becoming a big topic. I would encourage not just Japanese companies but the Japanese government to consider this market for external financing too.