



**ASIAN INFRASTRUCTURE  
INVESTMENT BANK**

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**Asian Infrastructure Investment Bank (AIIB)  
Asian ESG Enhanced Credit Managed Portfolio ESG Framework  
Version 1, July 2019**

<b>I. Introduction.....</b>	<b>3</b>
<b>II. ESG Investment Process .....</b>	<b>3</b>
Pre-Investment	
Step 1: Exclusionary Screening .....	3
Step 2: ESG Assessment.....	4
Post-Investment	
Step 3: Engagement with Issuers.....	5
Step 4: Monitoring and Reporting.....	5
ESG Focus List and Escalation Process .....	5
Reporting .....	6
<b>III. Sustainable Capital Markets Initiative (SCMI).....</b>	<b>7</b>
<b>Annex 1. Guidelines for AIIB’s ESG Focus List and Escalation Process.....</b>	<b>9</b>

## I. Introduction

Institutional investors are a key part of the solution to finance Asia's infrastructure investment needs over the coming decades. Additionally, integrating Environmental, Social and Governance (ESG) standards into capital markets in Emerging Asia will be important in achieving long-term sustainable development goals. This Project aims to develop debt capital markets for infrastructure in Emerging Asia with a strong ESG rationale.

The Project consists of two components:

- (i) Development of an Asia ESG Enhanced Credit Managed Portfolio of USD500 million that comprises corporate bonds in Asian infrastructure and other productive sectors.
- (ii) Launch of a Sustainable Capital Markets Initiative in partnership with the appointed Asset Manager to catalyze ESG investing strategies and build capacity with market participants in Emerging Asia.

A key objective of the Project is to catalyze ESG strategies throughout the debt capital market, and the most effective way to do this is through demonstration of an AIIB ESG Framework that is consistent with the spirit and vision of AIIB's Environmental and Social Framework.

## II. ESG Investment Process

In general, the ESG investment process includes the following steps:

### Pre-Investment

#### **Step 1: Exclusionary Screening**

Exclusionary screening can be broken down as follows:

1. Country and Sector Requirements.
2. Issuers listed on AIIB's Debarment List.
3. Exclusion based on internal socially responsible investment (SRI) score and reputational risk.
4. AIIB Environmental and Social Exclusion List, which is captured as product-based exclusions or as Norms-based exclusions.

#### Product-based exclusions

- a. **Production of, or trade in, weapons and munitions, including paramilitary materials.** The Asset Manager will not invest in issuers which derive more than 10 percent of their turnover from the manufacture or sale of conventional weapons, or weapon systems.
- b. **Production of, or trade in, alcoholic beverages.** The Asset Manager will not

invest in issuers which derive over 10 percent of their annual turnover from the production and/or sale of alcoholic beverages.

- c. **Production of, or trade in, tobacco.** The Asset Manager will not invest in issuers which make over 10 percent of their gross annual turnover from the production and/or sale of tobacco products.
- d. **Gambling, casinos and equivalent enterprises.** The Asset Manager will avoid investing in issuers which derive more than 10 percent of their annual turnover from betting or gambling operations and/or from supplying gambling equipment.
- e. **Production of, or trade in of unbonded asbestos fibers.** The Asset Manager will avoid investing in issuers which derive more than 10 percent of their annual turnover from production of, or sale of, unbonded asbestos fibers.

### Norms-based Exclusions

Norms-based Exclusions are defined as violations of widely accepted international standards related to environmental, social and governance aspects which are determined by AIIB.<sup>1</sup> When it comes to Norms-based Exclusions, it is both difficult to obtain information and to assess what qualifies for exclusion. Therefore, AIIB will use a four-step ESG Focus List and escalation process to identify companies that should be further assessed as further described in the Guidelines for AIIB's ESG Focus List and Escalation Process (see also Step 4: Monitoring and Reporting; Annex 1: Guidelines for AIIB's ESG Focus List and Escalation Process).

## **Step 2: ESG Assessment**

All holdings will go through a full and complete research process resulting in the preparation of a briefing note that includes both fundamental credit analysis and ESG assessment. Depending on the level of ESG information available, this may include:

### *Controversies Screening*

Controversies screening using third-party data services.

### *Internal SRI Score*

A proprietary SRI score that provides an assessment of the issuer's exposure and performance and reflects in-house analysis of third party ESG data.

### *Internal ESG Risk Score*

An internal ESG risk score that reflects the potential for ESG risks to lead to financial impacts.

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<sup>1</sup> See "Environmental and Social Exclusion List" in AIIB's Environmental and Social Framework. <https://www.aiib.org/en/policies-strategies/download/environment-framework/20160226043633542.pdf>

## **Post-Investment**

### **Step 3: Engagement with Issuers**

Throughout the mandate, AIIB will work with the Asset Manager to define engagement priorities, including:

- Minimum number of engagements per year and factors used to prioritize engagement.
- Process by which engagement is carried out (e.g., formal proxy, informal investment led, formal investment led, collectively through investor organizations).
- Factors used to prioritize engagement with a particular issuer (e.g., size and duration of holdings, credit quality, degree of transparency, materiality of ESG risks and opportunities, priority themes and issues, among others).
- Timing of the engagement, considering the issuance lifecycle, legal and regulatory rights.
- Defining objectives and measures to gauge the effectiveness of engagement.

As part of its semi-annual reports to AIIB, the Asset Manager will highlight engagement with issuers, including the factors that initiated the engagement, any pattern of ESG factors, and the potential significance of the ESG factors for AIIB and the issuers.

### **Step 4: Monitoring and Reporting**

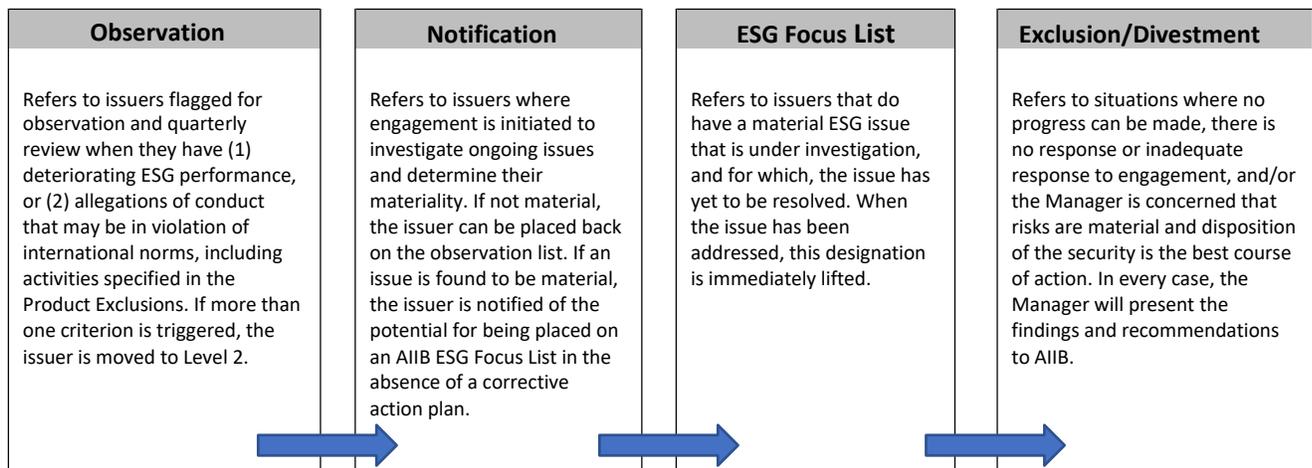
All holdings are subject to a thorough research and monitoring process. This includes ongoing monitoring for financial and nonfinancial news and developments.

#### *ESG Focus List and Escalation Process*

The Asset Manager will monitor the Portfolio from an ESG perspective with the aim of identifying issuers that trigger one or more of the following criteria:

1. Deteriorating ESG performance.
2. Involvement in activities that are specified in the Product Exclusions.
3. Norms-based Exclusions.

All holdings will be subject to the following escalation process:



In addition, there may be occasions when issuers may be flagged for observation and further investigation at the discretion of AIIB. Circumstances may include:

- New information indicates the issuer may be involved in activities specified in the Product Exclusions or which trigger Norms-based Exclusions.
- The issuer is reported by credible third-party sources to be responsible for severe environmental or social damage, human rights violations, corruption or other international norms.
- Country or sector-specific events which may lead to greater ESG risk exposure to an issuer. Further guidance on AIIB’s ESG Focus List and Escalation Process can be found in Annex 1.

### *Reporting*

The Asset Manager will provide AIIB with annual reports summarizing the Portfolio, including:

- Changes in internal SRI score and third-party ESG ratings at the issuer level.
- Summary of key ESG issues across the Portfolio.
- Highlights of engagement with issuers.

Additionally, the annual reports will include a summary of activities undertaken and progress made under the Sustainable Capital Markets Initiative (SCMI), including:

- Coverage of issuers in the eligible investment universe that have an external ESG rating/score.
- Coverage of issuers in the portfolio that have an external ESG rating/score.
- Average portfolio ESG rating/score.
- Penetration of sustainable and responsible investment in the Asia ex-Japan asset management industry.

- Development and dissemination of knowledge products (e.g., reports, papers, conferences, surveys, etc.).

### **III. Sustainable Capital Markets Initiative (SCMI)**

The work of the Sustainable Capital Markets Initiative (SCMI) can be organized into four key pillars. Collectively, these pillars will support the development of debt capital markets for infrastructure in Emerging Markets in Asia.

#### **Pillar 1: AIIB Asia ESG Enhanced Credit Managed Portfolio.**

The objectives of setting up the AIIB Asia ESG Enhanced Credit Managed Portfolio (Credit Portfolio) are to (i) encourage private sector financing for infrastructure and other productive sectors from institutional investors, through the development of Asian Debt Capital Markets (DCM) and infrastructure as an asset class; (ii) provide financing to infrastructure-related issuers via subscriptions to primary issuances when possible and (iii) establish and catalyze an ESG fixed-income investing framework for other market participants in Asia who share AIIB's investment philosophy.

Additionally, AIIB and the Asset Manager will work to develop relevant benchmarks/indices based on learnings from the Credit Portfolio. The creation of indices encourages innovation of different investment products such as exchange-traded funds or, at the very minimum, inform investors of how to allocate capital to sustainable infrastructure and other productive sectors, thereby reducing transaction costs. Altogether, this will help develop and promote infrastructure as an asset class.

#### **Pillar 2: ESG Research.**

To catalyze and encourage the development of ESG fixed income strategies, AIIB and the Asset Manager will work with research partners to share insight and cutting-edge knowledge on the emerging issues and key trends relevant to the Credit Portfolio that drive ESG investing in infrastructure and other productive sectors in Asia.

Additionally, AIIB and the Asset Manager will work with research partners to test and report on ESG integration techniques applied to infrastructure-linked corporate bonds. This is particularly important for fixed income investors, who are most interested in how ESG factors relate to the creditworthiness of an issuer.

#### **Pillar 3: Transparency and Disclosure.**

Asset managers of one-third of all professionally run assets globally—equivalent to over USD20 trillion—now use ESG data to inform their investment decisions, and most of them rely on ESG rating agencies to supply it. However, poor disclosure and data availability have limited the ESG ratings coverage of issuers in Asia.

Expanding ESG ratings coverage to issuers in targeted Asian countries is an important step in the creation of dedicated benchmarks/indices. AIIB and the Asset Manager will promote expanded ESG coverage of additional issuers from targeted Asian countries.

Unfortunately, ESG ratings are only as good as the disclosures made by the issuer. Therefore, a key component of the SCMI will be working with stakeholders to promote better transparency and disclosure in the market.

#### Pillar 4: Market Capacity Building.

Deepening the debt capital markets in Emerging Asia and improving the understanding of ESG will require ongoing capacity building of all market participants (i.e., corporates, industry associations, investors, ratings agencies, exchanges and securities regulators, etc.).

AIIB and the Asset Manager will work with partners and stakeholders to build capacity in selected local markets through workshops and other industry events. Additionally, AIIB and the Asset Manager will jointly coordinate ESG fixed income investing conferences.

## Annex 1. Guidelines for AIIB's ESG Focus List and Escalation Process

These guidelines apply to AIIB funds that utilize an ESG approach. When it comes to norms-based exclusions, it is both difficult to obtain information and to assess what qualifies for exclusion. Therefore, AIIB will use a four-step escalation process to identify companies that should be further assessed. This will allow AIIB to substantiate allegations against a company prior to considering divestment.

Companies that are associated with ESG controversies will be subject to a four-step process:

- Observation: flagging of companies for more frequent monitoring and review.
- Notification: engagement with companies to investigate potential issues.
- ESG Focus List: companies that have significant ESG issues on which the Bank is engaging.
- Divestment: consideration for divestment.

### Monitoring of ESG Controversies

Using third-party data providers and real-time controversy screening services, AIIB will monitor all company holdings in its funds. In addition, AIIB may also receive enquiries from individuals or organizations to examine specific ESG issues or individual companies. These requests will be treated in the same way as information reported through third-party services.

Monitoring of ESG controversies will include, but not be limited to, the following issues in line with AIIB's Environmental and Social Framework.

	ESF Element	ESG Controversies
<b>Environmental</b>	Pollution Prevention Resource Efficiency Climate Change Biodiversity	<ul style="list-style-type: none"> <li>• Local pollution</li> <li>• Overuse and wasting of resources</li> <li>• Global climate impacts</li> <li>• Impacts on critical habitats or protected areas</li> </ul>
<b>Social</b>	Vulnerable Groups and Discrimination Indigenous Peoples Gender Involuntary Resettlement Cultural Resources Labor and Working Conditions	<ul style="list-style-type: none"> <li>• Social discrimination</li> <li>• Impacts to Indigenous Peoples</li> <li>• Controversies related to involuntary resettlement</li> <li>• Impacts to cultural resources</li> <li>• Forced labor or child labor</li> <li>• Poor employment conditions</li> <li>• Occupational health and safety issues</li> </ul>
<b>Governance</b>	Business Ethics Corporate Governance Transparency	<ul style="list-style-type: none"> <li>• Corruption, bribery, extortion, money laundering</li> <li>• Fraud</li> </ul>

## **Observation**

Once a company is identified for observation, a preliminary assessment will be made on the severity of the issue. Severity will be determined from the:

- Gravity and nature of the issue.
- Potential consequences.
- Company's responsibility for, or contribution to, the issue.
- Company's measures to prevent or remedy any damage.
- Potential for the issue to reoccur.

A company that has been flagged for observation will be subject to quarterly reviews of its credit and ESG profiles. If the severity of the issue continues to deteriorate, or additional ESG issues are identified, the company will be moved to the "Notification" stage of the escalation process.

## **Notification**

Companies that have been escalated to the notification stage are prioritized for engagement and further investigation. The Asset Manager will request relevant information from the company, and in some cases, AIIB may commission consultants with local knowledge and expertise of the issues.

If the situation continues to deteriorate, it is at this stage that the company is notified of the potential for being placed on the ESG Focus List. AIIB will clarify to the company why it is being considered for placement on the Focus List. The company will be given a reasonable period of time to present information to AIIB that may be relevant to its case.

Before making a decision to add a company to the Focus List, AIIB will consider any actions the company has taken to address the issue, its willingness to engage with investors and its ability to reduce the risk of similar issues occurring in the future.

## **ESG Focus List**

AIIB will maintain a Focus List of companies that have a material ESG issue under investigation, and for which, the issue has yet to be resolved. The Bank will continue to pursue engagement with companies on the ESG Focus List with the aim of addressing identified issues through an agreed Corrective Action Plan. When the identified issues have been addressed, this designation will be immediately lifted.

## **Exclusion/Divestment**

In situations where no progress can be made, there is no response or inadequate response to engagement, and/or the Asset Manager is concerned that risks are material and disposition of the security is the best course of action, AIIB will consider divestment. Before making such a decision, the Bank will consider whether there are other measures more suited to reduce the ESG risk, and AIIB will consider the full range of measures at its disposal prior to divestment.