



**ASIAN INFRASTRUCTURE
INVESTMENT BANK**

**Asian Infrastructure Investment Bank (AIIB)
Asia Climate Bond Portfolio ESG Framework
Version 1, March 2020**

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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 to achieving long-term sustainable development goals. This project aims to develop the climate bond markets through the establishment of managed fixed income portfolio compliant with the AIIB Climate Change Investment Framework.

The project consists of four main objectives:

- (1) Increase climate finance flows for sustainable infrastructure in emerging market Asia through the debt capital markets by identifying and investing in climate champions.
- (2) Create a Climate Change Investment Framework to assess the exposure of an investment to climate change investment risks and opportunities as defined in the Paris Agreement's objectives.
- (3) Catalyze and mobilize investment from one or more climate change-focused institutional investors, which will further validate the Climate Change Investment Framework.
- (4) Provide market education and engage with B-list issuers to support their transformation to become A-list climate champions.

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 the demonstration of an AIIB ESG Framework that is consistent with the spirit and vision of the 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 and reputable third-party ESG risk scores and reputational risks.
- (4) AIIB Environmental and Social Exclusion List, which is captured as product-based exclusions or norms-based exclusions.

Product-based Exclusions

The investment advisor will not knowingly invest in, with respect to an issuer or principal guarantor, or any of their subsidiaries whose results are fully consolidated in such issuer's or principal guarantor's financial statements, any of the following:

Production of, or Trade in, Weapons and Munitions, including Paramilitary Materials. The investment advisor 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.

Production of, or Trade in, Alcoholic Beverages. The investment advisor will not invest in issuers which derive over 10 percent of their annual turnover from the production and/or sale of alcoholic beverages.

Production of, or Trade in, Tobacco. The investment advisor will not invest in issuers which make over 10 percent of their gross annual turnover from the production and/or sale of tobacco products.

Gambling, Casinos and Equivalent Enterprises. The investment advisor 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.

Production of, or Trade in of Unbonded Asbestos Fibers. The investment advisor 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 ESG aspects, which are determined by AIIB. When it comes to norms-based exclusions, it is both difficult to obtain information and 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 described in the Guidelines for AIIB's ESG Focus List and Escalation Process (see also Step 4: Monitoring and Reporting; and 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:

- (1) **Controversies Screening.** Controversies screening using third-party data services.

- (2) **Internal ESG Risk Score.** An internal ESG risk score that reflects the potential for ESG risks to lead to financial impacts.
- (3) **Use of Proceeds Analysis for Labelled Green Bonds.** Compliance with leading industry standards such as the Green Bond Principles and/or the Climate Bonds Standard will be assessed.
- (4) **A-List or B-List Issuer Categorization.** An issuer will only be eligible for investment with an appropriate classification as an A-List or B-List Climate Bond issuer using the AIIB Climate Change Investment Framework. The Framework takes into account three variables based on the three key objectives of the Paris Agreement: portion of green business activities, climate mitigation and resilience to climate change, to categorize issuers as A or B-List based on their ability to cope with climate change. A-List issuers are companies that are leaders in aligning business practices with the three variables. B-List issuers are companies that are on the transition path in aligning themselves with the three variables (i.e. companies who are on a trajectory to enter the A-List and currently transitioning to a low-carbon and climate-resilient business model).

Post-Investment

Step 3: Engagement with Issuers

Throughout the mandate, AIIB will work with the investment advisor 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 an annual report to AIIB, the investment advisor 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

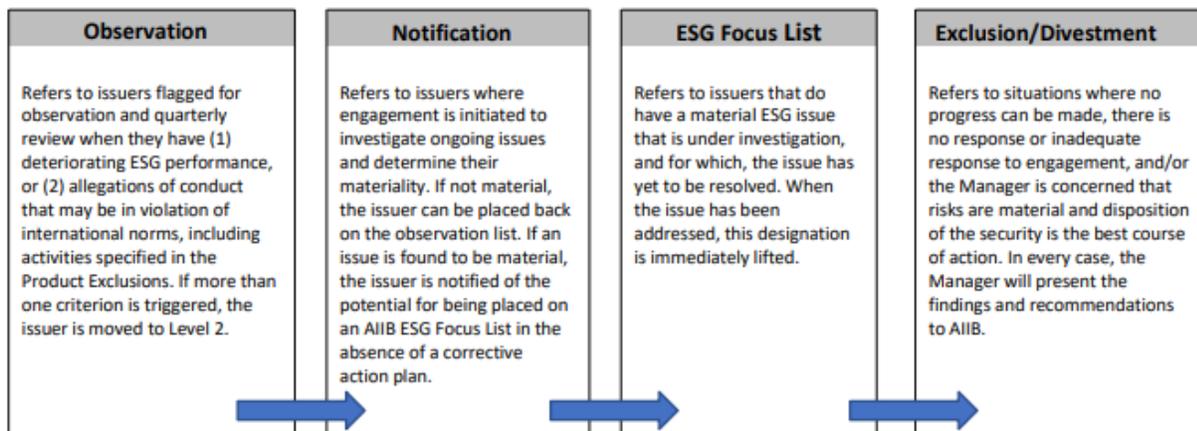
All holdings are subject to a thorough research and monitoring process. This includes ongoing monitoring for financial and nonfinancial news and developments.

ESG Focus List and Escalation Process

The investment advisor 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 is described in Annex 1.

Reporting

The investment advisor will provide AIIB with annual reports summarizing the portfolio's ESG performance, including:

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

- Changes in proportion and number of A-List and B-List issuers and corresponding aggregated distribution of Climate Mitigation, Climate Adaptation and Contribution to the Transition scores.
- Changes in proportion and number of issuances that have been certified by climate-related industry standards.
- Summary of the use of proceeds from labeled green bonds, and gross total carbon dioxide equivalent avoided emissions.
- Best-in-class climate mitigation, adaptation and/or transition case studies at the issuer level.

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 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 Capital Markets Portfolio

The objectives of setting up the Asia Climate Bond Portfolio and Asia ESG Enhanced Credit Managed Portfolio are to (a) encourage private sector financing for infrastructure and other productive sectors from institutional investors, through the development of Asian debt capital markets and infrastructure as an asset class; (b) provide financing to infrastructure-related issuers via subscriptions to primary issuances when possible and (c) 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 investment advisor will work to develop relevant benchmarks/indices based on learnings from the two portfolios. The creation of indices encourages innovation of different investment products such as exchange-traded funds or, at the very minimum, informs 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 investment advisor 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 investment advisor 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

Investment advisors 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 investment advisor 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 investment advisor will work with partners and stakeholders to build capacity in selected local markets through workshops and other industry events. Additionally, AIIB and the investment advisor 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 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 AIIB is engaging.
- **Divestment.** Consideration for divestment.

Monitoring of ESG Controversies

Using third-party data providers and real-time controversy screening services, AIIB will work closely with the investment advisor to 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 (Figure A.1).

Figure A.1. Monitoring of ESG Controversies

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

ESF = Environmental and Social Framework.

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 investment advisor 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 investment advisor 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 the full range of measures at its disposal prior to divestment.