ESG Practical Guide for Investors

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What is ESG?

Though not a new concept, ESG – Environmental, Social and Corporate Governance – rose to prominence in the business world in 2020 after certain important economic actors positioned themselves in favor of corporate sustainability, with the wide-ranging social and economic impacts of the Covid-19 pandemic also playing a significant role.

As the name suggests, ESG investments take environmental, social, and corporate governance issues into consideration, placing these criteria alongside traditional economic and financial factors in investment decision-making processes. It should be noted that ESG investing does not merely regard broadly identifying, measuring and managing risks; rather, it involves actively striving for positive results in all areas pertaining to the business. Examples of each ESG theme include:

- Environmental: preventing and mitigating the impacts of climate change; efficient use of natural resources (such as water and biodiversity); energy efficiency and renewable energy sources; preventing and mitigating pollution or contamination, and restoring areas damaged from economic activity; waste management and the circular economy.
- Social: combating bullying, verbal and sexual harassment in work environments; occupational health and safety, and accident prevention; diversity and inclusion across a diverse spectrum (gender, sexual orientation, race, ethnicity, religion, beliefs, disability, physical condition, nationality, age); preventing, mitigating, and remedying the impacts of economic activity on human rights; ethical, transparent and non-abusive relationships with consumers and customers; relationships with traditional communities potentially impacted by economic activity; privacy and data protection for employees and consumers; preventing and combating slave labor, child labor, and sexual exploitation in supply chains.

- **Corporate Governance:** governance structures for sustainability; transparent socio-environmental, and governance results; diversity and independence within corporate boards; variable compensation policies for senior management that consider socio-environmental and governance targets; structured, formalized governance policies and procedures for promoting ESG issues in corporate contexts; auditing, ethics and transparency in stakeholder relations; addressing reporting and complaints related to socio-environmental and governance issues.

ESG-related topics must be addressed with an interdisciplinary approach, as they often have effects on a variety of actors and issues. As examples, industrial environmental contamination can impact local and traditional communities who inhabit the area, while addressing diversity also includes a need to consider questions regarding policy development, addressing complaints and people management.

ESG in Brazil

In line with wider global trends, interest in ESG within Latin America is rapidly evolving.

According to the World Economic Forum's 2021 Global Risk Report, in the next ten years, global economic activity is likely to face risks related to extreme weather, failure to act on climate change, and human impacts on the environment, as well as cybersecurity failures, digital inequality, increasing economic fragility and social divisions.

For Latin America, the Allianz Risk Barometer 2021 indicates that there is a high risk of interruptions to business and supply chains in the coming years, resulting from various political, social, and economic factors. Moreover, credit rating agency Standard & Poor's (S&P) has highlighted the complex nature of regulations in Brazil, which typically sees companies weighed down by heavy compliance costs. This can lead to informal business practices, tax evasion, and corruption, despite the country's strong corporate governance regulations.

Especially in regard to moving funds and attracting investment, the infrastructure, energy, oil and gas, mining, and agribusiness sectors stand out in Brazil for the particular risks involved. These industries demand a high level of investor awareness of concepts such as carbon footprint, deforestation, and supply chains.

Although consolidated regulation on ESG is yet to be implemented in Brazil, discussions have gained a lot of ground in recent years, including within the country's main regulatory bodies. As an example, the Brazilian Securities and Exchange Commission (CVM) recently enacted a resolution requiring public companies to adopt a framework recommended by the International Integrated Reporting Council (IIRC) when reporting information to the market. The resolution also requires securities issuers in public offerings to disclose risk factors and information related to ESG issues.

The CVM also recently opened two public hearings for reviewing rules applicable to the securities issuer registration process and investment funds. The first hearing has put forward a proposal that would require listed companies to include more detailed ESG data when reporting, such as social, environmental and climate risks, as well as diversity-related issues.

The second hearing has proposed creating a credit/securitization fund subcategory (receivables investment fund – FIDC) known as a 'Socioenvironmental FIDC.' The proposal establishes that FIDCs may only be categorized as such if they have more than 50% of their equity in credit transactions or receivables that 'generate socioenvironmental benefits' (as assessed by an independent third party or through certification in line with international standards).

In turn, the National Pension Fund Council (CNPC) has recommended that industry pension fund administrators (EFPCs) pay attention to socially responsible investment criteria. A 2018 resolution from the National Monetary Council (CMN) established that in managing their portfolios, EFPCs must identify, assess, and monitor credit, market, liquidity, operational, legal and systemic risks, taking ESG-related aspects into account whenever possible.

Public pension funds (EAPCs), listed insurers and reinsurers must also disclose risks related to environmental and social issues that could potentially influence investment decisions, as well as data on their environmental policies.

Furthermore, the Brazilian Financial and Capital Markets Association (ANBIMA) requires Brazilian real estate investment funds to disclose environmental risks linked to their portfolios.

Financial institutions in Brazil are required to implement a Social, Environmental, and Climate Responsibility Policy (PRSAC, according to the new nomenclature assigned by CMN Resolution No. 4.945 of 09/15/2021) which should guide actions proportionate to the business model, the nature of operations and the complexity of the institution's products, services, activities and processes and appropriate to the dimension and relevance of the exposure to social risk, environmental risk and climate risk.

The modification of the previous rules established by Resolution CMN n. 4,327/2014 has recent occured within the discussions proposed by the Central Bank on its BC Agenda, wich aimed to establish a series of measures and legal standards for promoting sustainable practices for financial institutions. In line with this agenda, a series of new resolutions and normative rulings were enacted to improve social, environmental and climate risk management rules and new requirements for PRSACs.

What opportunities are out there for investors?

ESG criteria can assist investors in their decision-making by guiding them towards more ethical, responsible, and sustainable investments that create a positive impact.

It is already possible to safely invest this way via funds based on ESG criteria or funds with an exclusive focus on sustainable investing via diverse means (FIDCs, FIPs, ETFs and others). Another option is to invest in companies listed on sustainability indexes such as:

- ISE B3 (Corporate Sustainability Index): For over 15 years, the ISE B3 has listed companies that use socio-environmental and governance criteria in their corporate strategies. Developed by the Brazilian Stock Exchange (B3), it has undergone comprehensive reforms to ensure its analysis reflects market trends and international best practices.
- S&P/B3 Brazil Index: Recently established, the S&P/B3 Index seeks to measure the performance of securities that meet sustainability criteria. The Index is weighted according to ESG scores in the S&P DJI (Dow Jones Index).

Furthermore, there is the possibility of investing in thematic (sustainable) bonds via capital markets. Conceived to finance a diverse range of socio-environmental initiatives, the emergence of thematic bonds in Brazil has provided an opportunity for the ESG area to evolve. The market for these bonds is booming, both in Brazil and worldwide.

Companies, governments, and multilateral entities can issue these bonds to allocate funding for projects or assets that provide environmental benefits (green bonds), social benefits (social bonds), or both (sustainable bonds). Bonds linked to sustainability targets (sustainability-linked bonds) also exist, and they can all be aligned with a wide variety of activities, as outlined below:

- **Green Bonds:** renewable energy and transmission; energy efficiency (including public lighting); pollution prevention or control; sustainable land use; land and aquatic biodiversity conservation; low-carbon transport (including infrastructure to reduce emissions); sanitation; solid waste treatment for generating energy; buildings with low GHG emissions, among others;
- **Social Bonds:** accessible basic infrastructure (potable water, sanitation, transport, energy); access to essential services (health, education and financial services); job creation and unemployment prevention programs arising from socioeconomic crises; sustainable food production systems; socioeconomic development and empowerment (equal participation in the market and society, including the reduction of income inequality), among others;
- **Sustainability-linked bonds:** targets linked to increasing diversity within the workforce or in leadership positions; obtaining sustainability-related certifications or qualifications; other targets that reflect ESG commitments that do not fall within the scope of the environmental and social categories.

An independent third party is required to confirm the eligibility of projects for funding via thematic bonds, which can be carried out through providing a second opinion, certification or a rating assignment. Any debt security or credit instrument that allows for identifying the funding it generates can be reclassified as a thematic bond, including debentures, Real Estate Receivables Certificates (CRIs) and Agribusiness Receivables Certificates (CRAs).

Although there are international standards for the criteria used to determine a project or asset's eligibility for thematic bond financing, the market has yet to reach a consensus on a specific taxonomy for the criteria themselves (they can vary depending on the sector or location of the project involved). Regardless, the most internationally credible taxonomy standards today are linked to the criteria issued by the International Capital Markets Association (ICMA) and the Climate Bonds Initiative (CBI).

How can investments be evaluated from an ESG perspective?

Certain practices can be adopted to assist decision-making when investing based on ESG criteria to identify the quality of investments. These can also help investors avoid 'ESGwashing' – a practice where investments that appear to be guided by ESG criteria are not actually implemented adequately:

- Ensure international principles and standards guide decisions, such the Principles for Responsible Investment (PRI), the International Finance Corporation (IFC) and the United Nations Environment Program Finance Initiative (UNEP FI);
- Consider whether the securities issuer is listed on the most highly regarded indexes in the Brazilian market, such as the ISE B3 and the S&P B3;
- Confirm with independent rating agencies - such as MSCI, Sustainalytics, and S&P - how the company scores on its ESG criteria;
- Verify whether the securities issuer has international and/or local certification related to principal ESG themes, such as environment and labor safety, data protection, anti-corruption, among others;
- Verify if the securities issuer participates in forums with entities qualified to discuss socio-environmental and governance issues and/or adheres to multilateral or sector-specific commitments on these topics, such as the UN Global Compact, Sustainable Development Goals and the PRI;
- Invest in thematic funds that demonstrate an appreciation of ESG criteria for selecting assets in their investment policies;
- Assess whether the securities issuer releases sustainability reports and uses internationally accredited reporting models, such as the Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB) or the Task Force on Climate-related Financial Disclosures (TCFD);

- Check that thematic bonds have been adequately audited and accredited by independent, credible players in the market. Moreover, assess how reasonable the ESG-related targets are in terms of generating positive impact, environmental productivity growth and appropriate deadlines, among others.

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