NOVEMBER 2020

SUSTAINABLE INVESTMENT UNDER THE BIDEN ADMINISTRATION

WE IDENTIFY FIVE WAYS IN WHICH A BIDEN ADMINISTRATION MIGHT IMPACT THE OUTLOOK FOR ESG ISSUES, AND THE IMPLICATIONS FOR INVESTORS GLOBALLY.

Our analysis of President-elect Joe Biden's policy platform highlights five principal ways in which a Biden administration might impact responsible investors, outlined below. We expect that these would broadly affect corporate issuers of bond and equity securities, governments and potentially even asset-backed securities.

A central question remains over the extent of political and judicial support for President-elect Biden. At the time of writing, a majority Republican Senate remains the most likely outcome. This will affect the extent to which a Biden administration might be able to progress the initiatives we have highlighted.

FIVE POLICY COMMITMENTS FROM THE BIDEN CAMPAIGN ON ESG ISSUES

1. **Recommit the US to a more proactive stance on tackling climate change**

- Climate leadership is a genuine possibility under the new administration

2. **Adjust rules on sustainable investing**

- We anticipate that the Biden administration will encourage sustainable investment to support his climate-change investment plan

3. **Accelerate a range of energy transition rules**

- Emerging compliance costs could have significant effects across the oil and gas sector. We would expect pipeline and shale-oil companies to be directly impacted

4. **Strengthen sustainability-related priorities for corporate America**

- We expect social development, particularly labor management, to become a greater priority for US issuers
- A new era of transparency on sustainability issues is likely

5. **Set significant long-term and aspirational environment goals**

- Large utilities may face significant pressure to reorient their power generation away from fossil fuels, creating potential credit risks
- We expect the broadest federal climate-change proposals in US history

The points above are not intended as a comprehensive overview of the Biden policy platform but are selected highlights that we believe are of relevance to investors focused on ESG issues. All references to the Biden policy platform in this paper are derived from www.joebiden.com. Most notably, references to climate change policy are taken from https://joebiden.com/climate-plan/.

1. RECOMMIT THE US TO A MORE PROACTIVE STANCE ON TACKLING CLIMATE CHANGE

- **Climate leadership is a genuine possibility under the new administration, based on a wide range of initiatives focused on tackling climate change in President-elect Biden's policy platform.**

The Obama-Biden administration signed the 2015 Paris Agreement that aims to keep any global temperature rise to "well below" two degrees Celsius and pursue a more aspirational 1.5-degree Celsius limit alongside greater climate disclosure[1].

In 2017, President Trump withdrew from the Agreement driven by concerns that "The Paris Accord would undermine our economy, hamstring our workers, weaken our sovereignty, impose unacceptable legal risks, and put us at a permanent disadvantage to the other countries of the world"[2].

President-elect Biden orchestrated the original involvement of the US, and so we anticipate an early recommitment by the US government to the Paris Agreement. Because this agreement is not legally a treaty, no Congressional approval is needed.

As a result, next year's United Nations Climate Change Conference, to take place in the UK, is likely to take on new importance. The conference could be an opportunity for the US to again take the lead on climate change, a role which over the last four years has been assumed by the European Union.

One area likely to gain increasing attention is a carbon border adjustment mechanism, colloquially seen as a carbon tax. The tax effectively charges a financial penalty to imported goods that have in-built carbon emissions within their production. Exporting nations with high carbon (led by China) will be most negatively impacted. More than 3,000 US economists and all living former chairs of the Federal Reserve have endorsed a carbon tax, making it possible a Biden administration will seek to advance this policy to align with an expected EU carbon border tax. Company carbon-intensity metrics will become more important for investors to interrogate, and sectors with higher intensity metrics, such as utilities and materials, are most likely to be impacted.

However, changes to the US tax code require Congressional approval, making it difficult for President-elect Biden to achieve if the Republican Party holds the Senate.

- **We believe a carbon border tax would impact, either directly or indirectly, all sectors that rely on imported goods. Manufacturers face greater risk, where production is often outsourced in search of lower cost production, and where carbon externalities are not priced.**

Arguments against the proposals will likely lead with concerns on the economic impact to the US economy, and we have less confidence this proposal is politically acceptable.

Awareness of climate risks in the US grows. The Biden policy platform outlines a commitment to spend "$1.7 trillion over the next ten years, leveraging additional private sector and state and local investments to total to more than $5 trillion". These spending measures require Congressional approval, so we would expect any infrastructure program to be significantly pared back if the Republican Party holds the Senate.

Several areas, including real estate, water, transportation, and energy infrastructure are targeted to prevent, reduce, and withstand a changing climate.

- **However, while other countries have issued green bonds to allocate investor proceeds to these themes and US municipalities will remain large issuers of green instruments, we do not expect a federal green bond issuance program.**

We expect climate change to form a key part of foreign policy, including trade. Many development banks are strongly focused on environment and social impacts and President-elect Biden has committed to ensuring the new US International Development Finance Corporation significantly reduces the carbon footprint of the investment portfolio.

Most tellingly, the US will look to introduce "green debt relief" for developing countries that make climate commitments, a timely initiative with growing COVID-19 related debt issuance and need for poorer countries to undertake climate mitigating action. While details are lacking, this will require close monitoring by emerging market debt investors.

2. ADJUST RULES ON SUSTAINABLE INVESTING

Five days before the election, in one of its last policy initiatives, the Department of Labor (DOL) approved new rules for ERISA plan fiduciaries. When originally proposed, these rules were interpreted as limiting environmental, social and governance (ESG) investment strategies for US ERISA investors[3].

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[1] https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement

[2] https://www.whitehouse.gov/briefings-statements/statement-president-trump-paris-climate-accord/

[3] For example, see https://www.responsible-investor.com/articles/us-industry-groups-respond-to-government-proposals-to-limit-esg

The finalized rules specifically require that ERISA plan fiduciaries "select investments and investment courses of action based on pecuniary factors – i.e., any factor that the responsible fiduciary prudently determines is expected to have a material effect on risk and/or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and funding policy."[4]

This effectively limits corporate retirement plans from applying strategies with even 'light' non-financial parameters, such as restricting investments in tobacco, but incorporating ESG factors is not prohibited so long as it is based solely on material economic considerations.

The DOL highlighted that there are no universally accepted definitions for ESG factors. However, this may not necessarily be a complete obstacle to ERISA investors effectively integrating these factors to a degree within portfolio design and investment analysis. That there are different perspectives reflects that investors are interpreting ESG signals in line with their processes to seek better ways to identify credit risks and incorporate this information into product design. We welcome the fact that the DOL did not recommend banning the inclusion of ESG factors as relevant factors within investment decisions. Rather, the policy focus is on explicit and implicit pecuniary objectives within pension-scheme allocations.

- **President-elect Biden has not directly commented on the DOL ruling or ESG factors specifically, but we anticipate that a new administration will encourage sustainable investment to support his climate-change investment plan.**

We believe that, while it is possible that newly appointed officials at the DOL could seek to propose or alter rules to facilitate such investments, at this time it is difficult to predict whether any such changes are within the intermediate or even long-term priorities of the new administration.

Separately, we note that momentum appears to be building for the SEC to require ESG disclosures to be standardized. In May 2020, the SEC Investor Advisory Committee called for the SEC to "begin in earnest an effort to update the reporting requirements of Issuers to include material, decision-useful, ESG factors"[5].

In August, SEC Commissioner Allison Herren Lee said it was time for the SEC to "begin to work through how to get investors the standardized, consistent, reliable, and comparable ESG disclosures they need to protect their investments and allocate capital toward a sustainable economy"[6], and made similar comments earlier this month, with a particular focus on climate change[7].

- **Given these developments, we expect momentum to continue towards standardized ESG disclosures being required by the SEC.**

3. ACCELERATE A RANGE OF ENERGY-TRANSITION POLICIES

President-elect Biden argued in the final presidential debate that he expects the US to "transition" away from fossil fuels[8]. While we expect economic factors will determine the speed and trajectory of that transition, we anticipate President-elect Biden to focus policy initiatives on stricter emissions rules. These rules come at a time of record-low energy prices and profitability, and so the cost to industry could be material.

The low-hanging fruit will involve setting pollution limits, especially around methane pollution on existing oil and gas operations. This would be a reversal from the previous administration, which loosened energy rules. For example, the Environmental Protection Agency (EPA) revised pollution controls exempting low-production wells from monitoring leaks, reducing leak monitoring requirements, allowing for longer deferrals of leak repairs, and removing methane emissions requirements.

- **Emerging compliance costs could have significant effects across the oil and gas sector. We would expect pipeline and shale-oil companies to be directly impacted.**

We would expect President-elect Biden to significantly curtail new fracking on federal lands (accounting for over one-third of US fracking production). In the short term, if this leads to lower production, it could result in higher prices. However, the regulation of hydraulic fracturing and producing on federal lands is held by Congress.

- **A total halt to drilling on federal lands cannot be done without an act of Congress, and therefore we expect a**

[4] https://www.dol.gov/newsroom/releases/ebsa/ebsa20201030

[5] https://www.sec.gov/spotlight/investor-advisory-committee-2012/esg-disclosure.pdf

[6] https://www.sec.gov/news/public-statement/lee-regulation-s-k-2020-08-26

[7] https://www.sec.gov/news/speech/lee-playing-long-game-110520

[8] https://eu.usatoday.com/story/news/politics/elections/2020/10/23/debate-transcript-trump-biden-final-presidential-debate-nashville/3740152001/

- **minimal impact on overall fossil-fuel production over the next four years**.

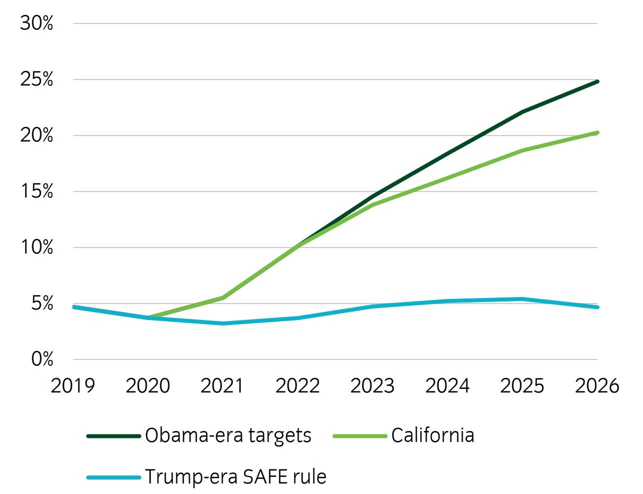
The president-elect has also promised to strengthen the Clean Air Act to accelerate emissions reductions across industries. Transportation is a primary target. Weaker rules under the previous administration, perhaps most notably the Safer Affordable Fuel Efficient (SAFE) Vehicles rule[9], have contributed to lower electric vehicle (EV) sales compared to other nations.

Under a new administration EVs could grow to 25% of total sales by 2026, compared to just 5% under President Trump, according to BloombergNEF[10]. Ultimately, the Biden climate plan commits to "developing rigorous new fuel economy standards aimed at ensuring 100% of new sales for light- and medium-duty vehicles will be electrified". Together with California's declared 2035 deadline for fossil fuel-free vehicles, this would significantly alter the trajectory of US EV demand, and likely raise the US share of global demand for electric vehicles (see Figure 1).

The anticipated growth in EVs does have a limitation: the number of vehicle-charging points. While President-elect Biden intends to target installing over 500,000 units by the end of 2030, there has been no cost projection, and millions of units will need to be installed. Also, a spending measure like this will require Congressional approval. Some policy details may therefore be lacking, but the impact for the vehicle industry appears certain – more research and development is critical to meet challenging new technological and demand shifts.

- **Investors will need to closely monitor manufacturers' progress in developing and deploying EV technology.**

Figure 1: Estimated EV share of annual vehicle sales, US[11]



4. STRENGTHEN SUSTAINABILITY-RELATED PRIORITIES FOR CORPORATE AMERICA

- **We believe a new era of transparency on sustainability issues is likely.**

First, President-elect Biden hopes to pass tax reform. This includes a 15% percent alternative minimum tax on book income for US companies. Further, all income earned overseas would be taxed at 21%, twice the current rate, with the previous administration's corporate tax cut set for reversal. The caveat is the familiar challenging political climate: many attempts at tax reform often fail. If the Republican Party controls the Senate, any significant changes to the tax code are extremely unlikely.

Putting workers first is an oft-used mantra in US elections, and this election was no exception. President elect Biden has stated he will seek to strengthen the ability of employees to challenge discriminatory pay practices and hold employers accountable. The Obama administration required large employers to collect and disclose compensation information by race, gender and ethnicity, to ensure better insight into pay disparities and potential enforcement. While rolled back by the previous administration, President-elect Biden has explicitly highlighted this policy as an "essential step to ending the gender pay gap".

Vice President-elect Harris will likely focus on the role of corporate America in advancing gender equality. In May 2019, Vice President-elect Harris proposed a new law compelling companies of 100 employees or more to prove they pay men and women equally or face fines equal to 1% of profit for every 1% of pay gap, though such a measure has very little chance of becoming law. This focus comes as many large companies are promoting their diversity and inclusion policies, announcing targets and making investments in diversity hiring and training.

- **We therefore expect social development, particularly labor management, to become a greater priority for US issuers.**

Corporate America appears to support efforts to address issues like income inequality, societal divisions and the climate crisis: 73% of US directors agreed with the World Economic Forum's statement that "We are in the midst of a fundamental change in capitalism from a primary focus on shareholder return towards a

[9] https://www.nhtsa.gov/sites/nhtsa.dot.gov/files/documents/final_safe_preamble_web_version_200330.pdf

[10] https://about.bnef.com/electric-vehicle-outlook/

[11] Source: BloombergNEF.

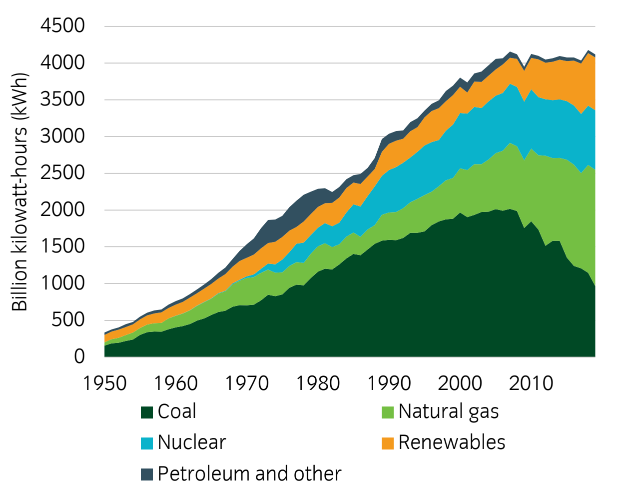
system in which corporations must have a societal purpose and serve all stakeholders (sometimes referred to as 'stakeholder capitalism,' 'conscious capitalism,' or 'accountable capitalism')"[12], though we note this is less than the 92% of non-US directors who agreed. It appears that President-elect Biden will add pressure on corporate America to move further in this direction. Public companies, for example, will be expected to disclose climate risks and the greenhouse gas emissions in their operations and supply chains. It will no longer be voluntary.

5. SET SIGNIFICANT LONG-TERM AND ASPIRATIONAL ENVIRONMENTAL GOALS

The Biden-Harris platform included environment targets with far-ranging impacts.

Taking Europe's lead, the new administration hopes to set a 0% CO_2 target for the US power sector. President-elect Biden aims for the US achieving net-zero emissions by 2050 through clean energy policy incentives, energy-efficiency projects and public-works programs. The plan does not address the role of natural gas, which generated approximately 40% of US power in 2019 (see Figure 2) and promotes nuclear power, which has proven technologically and politically difficult in other markets.

Figure 2: US electricity generation by major energy source[13]



Within the first year of a Biden administration we expect proposals that work towards a net zero-target. First is an enforcement mechanism that will introduce milestone targets by 2025, though passage of such a measure through a divided Congress will be difficult.

- **The targets are uncertain, but we anticipate large utilities will face significant pressure to reorient their power generation away from fossil fuels, creating potential credit risks.**

Utility firms often have challenges decarbonizing, but many US utilities have been on a green transition for many years. Issuers have made significant investments in solar and wind to replace coal. Many large utilities already have a 70%-80% CO_2 reduction target, from a 2000 or 2005 baseline, by 2030, and broader and more aggressive commitments may be accelerated, especially with the right incentives[14]. Even without potential regulations, many utilities are on course to eliminate all coal in the next decade. Economics is creating a fundamental shift in the direction of companies and political changes may have only a small effect on that trajectory.

One principle we identify throughout the Biden policy platform is shared responsibility and accountability. An enforcement mechanism will engender polluters to bear the full cost of their carbon externalities. The enforcement mechanism aims to "achieve clear, legally-binding emissions reductions with environmental integrity", and will likely face significant opposition. While there are clear risks for investors in polluting entities, there are also opportunities. President-elect Biden has also outlined a target to reduce the carbon footprint of the US building stock 50% by 2035. We believe this would create incentives for real estate developers to issue green bonds.

The environmental commitment is economy-wide. President-elect Biden will require state and local governments to monitor their water systems for lead and other contaminants and incentives for the rapid deployment of clean energy innovations.

- **Politically, the proposals are likely to face challenges, but if moderately successful we expect the broadest federal climate-change proposals in US history, based on an assessment of existing environmental policies covering renewable energy, EVs and roads.**

[12] https://www.diligentinstitute.com/wp-content/uploads/2020/08/20200713-Diligent-Institute-Report-Stakeholders-and-Boards-R5.pdf

[13] Source: US Energy Information Administration.

[14] https://www.spglobal.com/en/research-insights/articles/us-utilities-race-to-slash-emissions-as-esg-reporting-takes-off

SUMMARY

A Biden-Harris administration is widely expected to introduce more regulation impacting corporate America, though political dynamics are likely to limit the more ambitious goals laid out in their platform.

To manage the potential risks and opportunities highlighted in this paper, we believe investors' research processes should consider:

- **Issuers with high Scope 1 and Scope 2 carbon emissions[15]**
- **Utility operators with material exposure to coal and gas generation**
- **Issuers with weak disclosure and transparency**
- **Issuers prioritizing renewable energy and clean technology**
- **Issuers with weak environmental and social commitments**

Credit research that integrates ESG factors can help identify potential leaders and laggards, and so Insight's analysts aim to process material ESG signals to support risk management. Issuers exposed to such risks may require closer monitoring and engagement to learn how disruptive sustainability factors can be to their finances, including profitability and cashflow.

We do not expect rules as ambitious as those seen in other jurisdictions. The European Union, for example, has prioritized sustainable finance and corporate action focused principally on climate change. Japan has advanced corporate governance initiatives. The Biden administration may aspire to replicate these, but a divided legislature would constrain efforts to introduce aspirational sustainable finance and corporate accountability goals.

Nevertheless, we expect corporate issuers to find a receptive investor base looking to support such goals. More attention on green and social issues is an opportunity to issue green bonds, and the US market has seen a significant growth in corporate issuance of such debt. With more investors looking to create resilient and sustainability-focused portfolios, we believe companies may seek to make greater commitments towards sustainability themes, irrespective of any regulatory requirements.

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IMPORTANT INFORMATION

IMPORTANT DISCLOSURES

[15] The GHG Protocol Corporate Standard classifies a company's GHG emissions into three 'scopes'. Scope 1 emissions are direct emissions from owned or controlled sources. Scope 2 emissions are indirect emissions from the generation of purchased energy. Scope 3 emissions are all indirect emissions (not included in scope 2) that occur in the value chain of the reporting company, including both upstream and downstream emissions. For more information: https://ghgprotocol.org/sites/default/files/standards_supporting/FAQ.pdf

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