cardano

Sustainable Investment Policy Appendix F: Sustainable bonds

Assessment methodology sustainable bonds

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1. Introduction

Cardano's mission is to deliver relevant investment solutions by maximizing long-term financial, environmental and social returns. Investing in Sustainable Bonds is one of the tools to achieve this. The Sustainable bond market has been in existence since 2007. The Sustainable bond market currently knows two types of bonds. First, the "Use of Proceeds" (UoP) bonds use proceeds exclusively to finance or re-finance specific green and/or social projects. Green, Social and Sustainability Bonds fall in this category, but also labels such as Blue, Climate (Action) and SDG Bonds are used by market participants. Secondly, Sustainability-Linked Bonds (SLBs) do not allocate proceeds to specific projects but contain a set of pre-defined issuer-wide sustainability targets. Not meeting those targets will have financial consequences for the issuer. We classify all of the above-mentioned bonds as 'Sustainable Bonds'.

We have a specific process to assess the quality of a sustainable bond issuance: just because the market labels it as a Sustainable bond does not mean we will consider it as such. We only give bonds that successfully pass our assessment process a 'sustainable bond stamp'. We treat bonds that are regarded as sustainable by the market but that do not receive a 'sustainable bond stamp' by us as a grey bond.

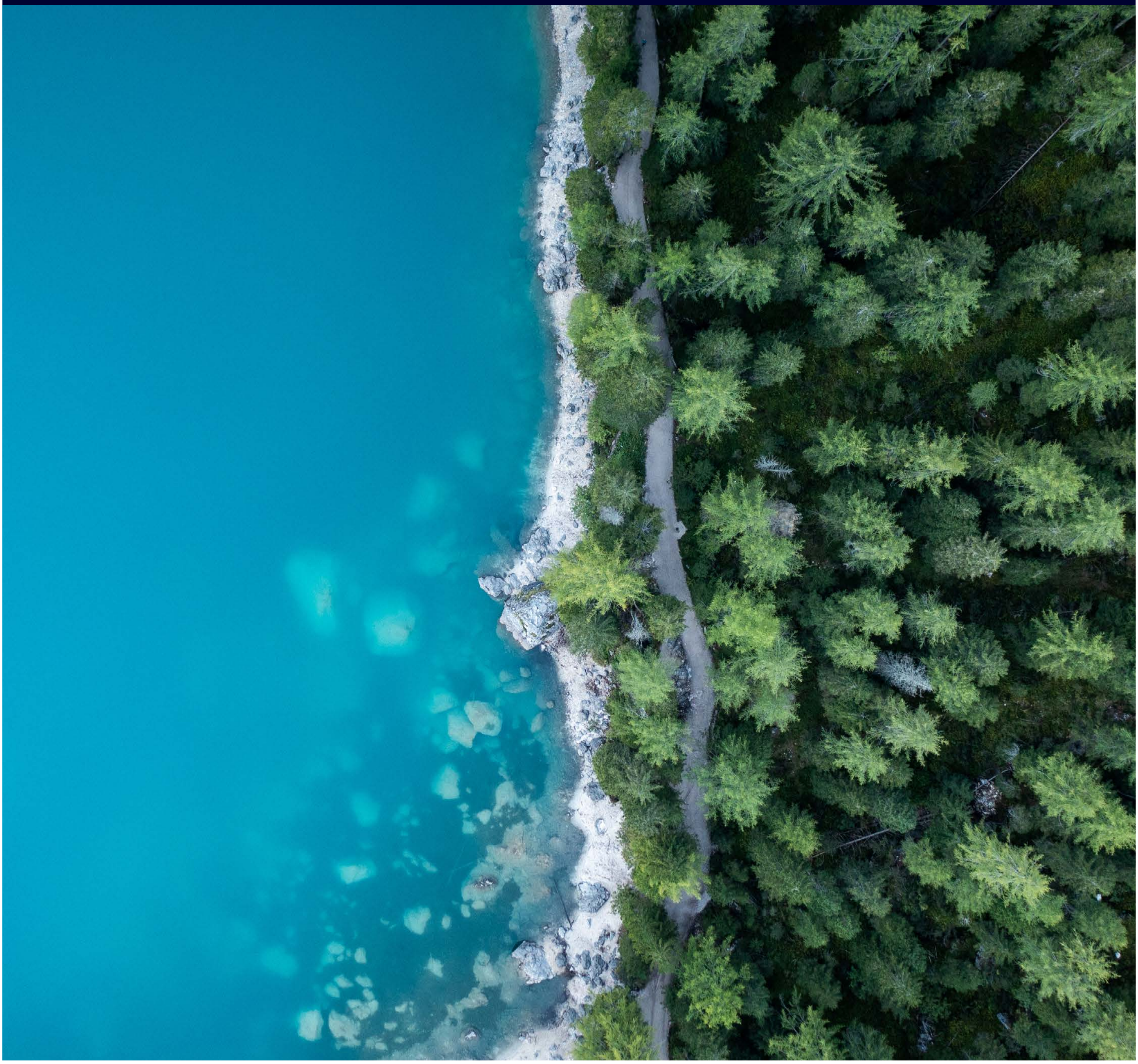
We not only invest in Sustainable Bonds for their sustainable character, but also because we believe that focusing on the societal impact of investments results in higher long-term financial return. This is confirmed by the market expectation and results seen so far which indicate that in a more pressured market, Sustainable Bonds are generally less volatile and outperform plain vanilla bonds. For these reasons, all else being equal, we favour Sustainable Bonds to grey bonds.

In this annex, we explain our Sustainable Bond assessment process.

> **"... just because the market labels it as a Sustainable bond does not mean we will consider it as such.**

2.

Sustainable Bond Assessment Process



2.1 Screening

Bond leads are usually initiated by the Cardano credit team who initially assess its financial characteristics. The Cardano Sustainability Group subsequently analyses the bonds on their sustainability credentials and determines if the bond deserves a ‘sustainable bond stamp’. The final decision to invest in the bond is subject to credit criteria and the view of the Portfolio Manager.

To ensure the timeliness of the assessment, every bond is assessed when it is bought even if we have assessed the framework before. Bonds are expected to always be in line with the most up to date market standards and the criteria in this bond assessment methodology will continuously be updated to reflect this.

Use of Proceed Bonds that successfully pass the first phase of the assessment methodology will generally be classified as ‘Positive Impact’, following our Sustainable Investment Framework. Sustainability Linked Bonds (SLBs) are general-purpose bonds with financial implications for the issuer if it does not reach certain sustainability key performance indicators. Because an SLB’s use of proceeds is not directly linked to impact outcomes and can be used for the financing of all types of activities, we generally classify these in-line with the status of their underlying issuer. These labels can be up- or downgraded by the Cardano Sustainability Group, with approval of the Sustainability Categorisation Committee, if there are good reasons to do so.[1]

Our Sustainable Bond Assessment Framework is presented in the figure below.

“The ESG score is based on the level of ambition and innovativeness of a bond...

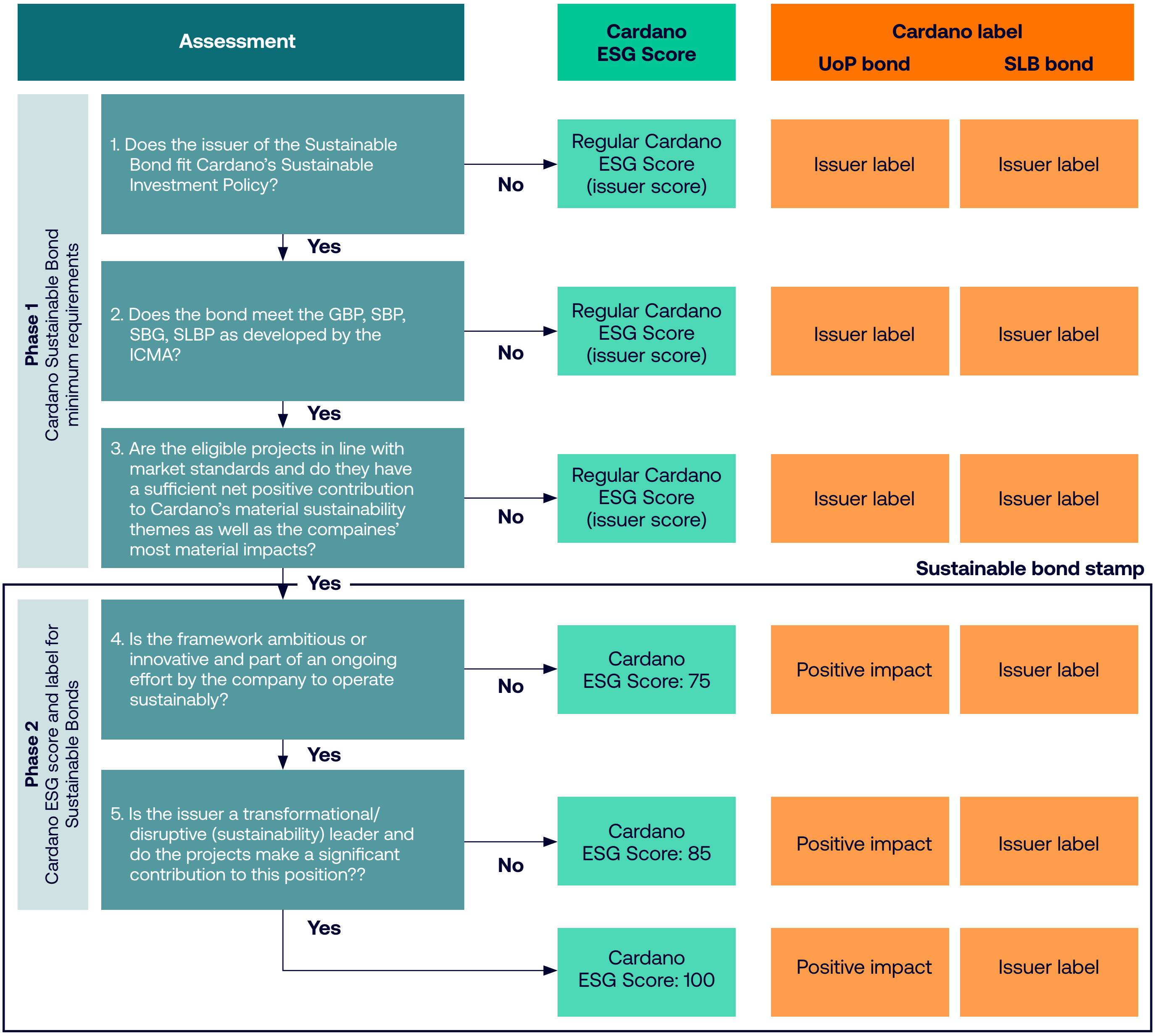
2.2 Proprietary Assessment Methodology

Our assessment methodology exists of two phases. In the first phase we determine whether a bond complies with our minimum sustainable bond requirements and we determine whether a bond receives a ‘sustainable bond stamp’. In the second phase of the assessment we award an ESG score and ESG label to the bond. The ESG score and label are two factors that contribute to the decision on company selection and weighting in specific Cardano funds. Funds classified as Article 9 according to the SFDR can only invest in bonds that are rated as ‘sustainable’ or ‘positive impact’ according to our Sustainable Investment Framework. Also, for our funds, we have set targets on the average ESG score and by upgrading the score, the Sustainable Bond is more attractive to invest in.

The ESG score is based on the level of ambition and innovativeness of a bond and can be either 75, 85 or 100. If a bond does not meet the requirements to be classified as Sustainable Bond, it will receive the regular Cardano ESG score (0-100) of its issuer.

1 Specific bonds are exempted from a label upgrade. Examples are bonds that mostly focus on (reducing the negative impacts of) transition activities. Similarly, SLBs can receive an upgrade in label if they prove to be sufficiently ambitious. Such decisions will always have to be reviewed and approved by an the Sustainability Categorisation Committee, an independent internal committee in which the different teams, among which the Cardano Sustainability Group as well as the investment teams, are represented.

Figure 1: Cardano Sustainable Bond Assessment Framework



2.3 Monitoring

When a bond is issued under an existing framework that we labelled as a Sustainable Bond before, a new issuance under the same framework does not automatically receive the same label and ESG score. We assess whether an issuer complies with its promised targets, reporting commitments and/or transparency and whether the framework is still aligned with the most up-to-date market standards. Also, if not updated regularly, bond frameworks can be overtaken by developments in technology, innovation, market standards and regulation, wherefore they may become insufficiently ambitious to receive our Sustainable Bond label again. For example, the allowed emissions intensity of renewable energy over its entire life-cycle will gradually decrease in order to arrive at zero emissions in 2050 and achieve the targets of the Paris agreement. Also requirements on what constitutes a green building or what is a "significant" reduction in energy or water use will develop over time, based on market developments and advancements in technology. Issuers that rely on the same framework for years and fail to comply with developments in the market will be denied a stamp.

2.4. Measuring and monitoring of outcomes

For the Sustainable Bond in portfolio, we aim to track their social and environmental outcomes and impacts. This includes information about the outcomes achieved by the invested projects, such as avoided carbon emissions or number of people affected by improved health care facilities.[2] We monitor and regularly report the investment allocations and outcomes. For this, we use the issuers' self-reported data in their annual allocation and impact reports and aggregate it to portfolio level. We base our reporting on the Harmonized Framework for Impact Reporting as developed by the International Capital Markets Association (ICMA). We note that impact reporting is still a relatively new topic for many issuers. We therefore support and participate in sector initiatives, such as those of the ICMA, to bring this topic to the attention of issuers and increase further standardization of the field.

2.5. The International Capital Market Association (ICMA)

To prevent potential green or social washing, stimulate comparability of investment strategies and eliminate barriers for (new) issuers of Sustainable Bonds, we aim to contribute to clear and indisputable definitions of Sustainable Bonds. Therefore, we support the Green Bonds Principles (GBP), Social Bond Principles (SBP), Sustainability Bond Guidelines (SBG) and the Sustainability-Linked Bond Principles (SLBP), all together referred to as "The Principles", developed by the ICMA. The Principles provide guidelines on transparency and disclosure while promoting integrity by clarifying the approach for issuance of a Sustainable Bond. We are an active member of The Principles and participate actively in relevant Working Groups and Task Forces. In this way, we support the development of uniform principles on impact and performance indicators and on the definition of sustainability targets.

2 As there is no standardized and verified way to calculate impacts of projects and allocate these to investors yet, the work here is still ongoing. Also, the measurement of projects with a social impact, such as beneficiaries from unemployment programs, is still being developed. As ICMA member, we play an active role in this field and strongly encourage issuers to be transparent on their reporting methodologies and impact calculation methods.

3. Cardano Sustainable Bond Assessment Methodology

To ensure that we invest in bonds that truly contribute to the goals of a sustainable society, we assess bonds in two phases.

3.1. Phase I: Sustainable Bond Label Assessment

In the first phase, we assess (1) the sustainable credentials of the issuing entity, (2) the compliance of the bond with ICMA criteria and (3) the alignment of the projects with our minimum expectations, which are based on market standards and the bond's contribution to material sustainability themes. If a bond fulfils all three criteria, it is labelled as a Cardano Sustainable Bond.

Question 1: Does the issuer of the Sustainable Bond fit Cardano's Sustainable Investment Policy?

We verify whether the issuer of the Sustainable Bond is compliant with our Sustainable Investment Policy. Issuers that are considered too harmful or not in compliance with international standards do not qualify for a Sustainable Bond stamp. Neither are issuers classified as non-adapting. Bonds issued by entities classified as "at-risk" may qualify as a Sustainable Bond under very strict criteria. We want to support positive impact through investing in sustainable bonds issued by at-risk entities but simultaneously ensure that the bond issuance is not opportunistic and the issuer shows a real commitment and willingness to transition. Therefore, bonds issued by "at-risk" issuers must significantly improve the performance of the entity on the sustainability themes on which it is lagging and support the entity's transition towards an "adapting", "sustainable" or "positive impact" status.

We also assess the issuer's involvement in controversies, especially when these are connected with the project categories defined in its Sustainable Framework or related to its predefined targets in a Sustainability-linked bond. For example, if an issuer whose Social Bond framework focusses on employment generation is involved in controversies related to labour rights, the bond will not be labelled as a Sustainable Bond if the controversies affect the chances of the bond's goals being achieved and undermine their credibility.

Question 2: Does the bond meet the Green Bond Principles (GBP), Social Bond Principles (SBP), Sustainability Bond Guidelines (SBG) OR Sustainability-Linked Bond Principles (SLBP)?

In this step, we verify whether a Sustainable bond meets the four core components of the GBP, SBP, SBG or the five components of the SLBP. These voluntary initiatives define guidelines on transparency requirements for the issuance of a bond.

The four core components are:

- Use of proceeds,
- Process for project evaluation and selection,
- Management of proceeds, and
- Reporting.

For a Sustainability-Linked Bond, these components are defined as:

- Selection of Key Performance Indicators,
- Calibration of Sustainability Performance Targets,
- Bond characteristics,
- Reporting, and
- Verification.

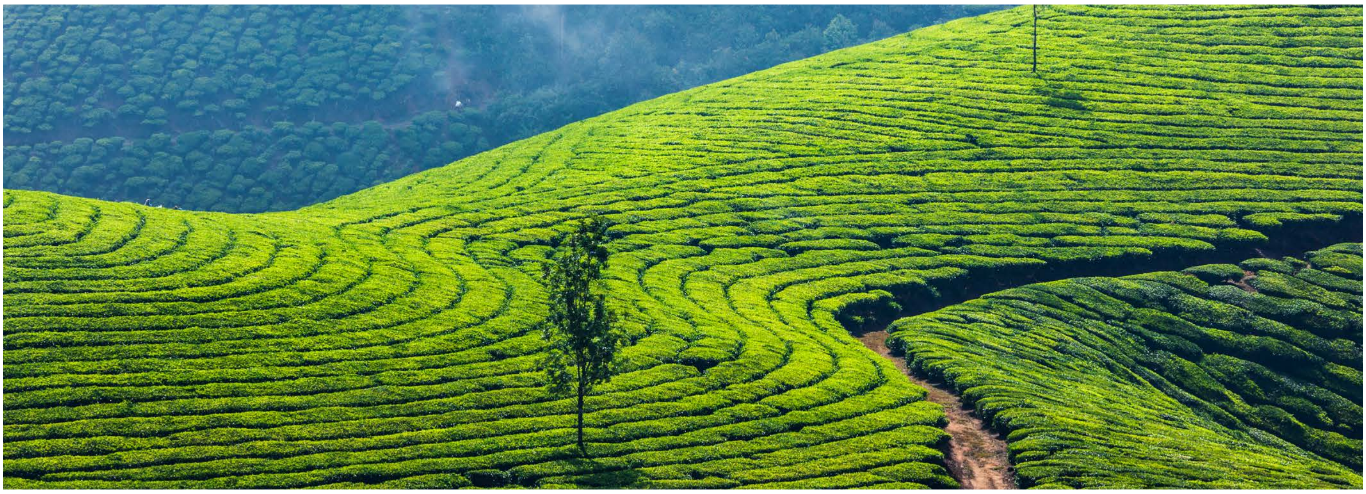
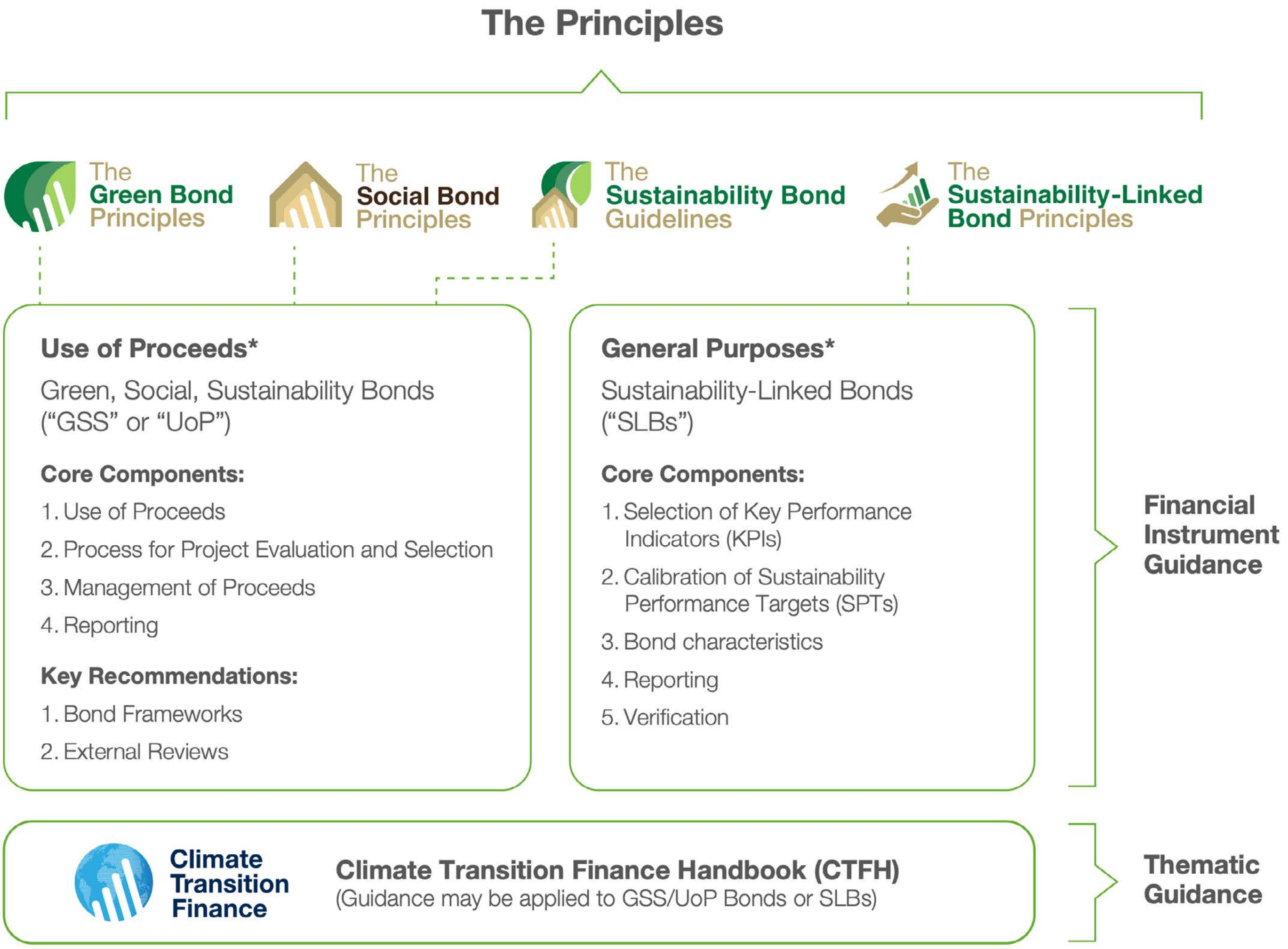


Figure 2: the Core Components of 'The Principles'



Source: ICMA, 2021. Green Bond Principles: Voluntary Process Guidelines for Issuing Green Bonds

In line with the recommendations, we expect a Sustainable Bond to also obtain an external verification in the form of a Second Party Opinion (SPO) from a reputable provider such as Morningstar Sustainalytics, Vigeo Eiris, Moody's, ISS-Corporate or Cicero. If the above is not fulfilled, the bond will not be classified as Sustainable as process transparency cannot be assured.

Question 3: Are the eligible projects in line with market standards and do they make a substantial positive contribution to Cardano's material sustainability themes as well as the issuer's most material impacts?

A. Do the eligible projects align with market standards, such as the Climate Bond Initiative (CBI) and EU taxonomy criteria?
We use available market standards to assess eligible projects within a bond framework. Two of such standards are:

- the Climate Bond Initiative's (CBI) taxonomy to classify activities and technologies that are compliant with the Paris Agreement and/or under which conditions they would be, and
- the EU Taxonomy and related Technical Screening Criteria that provide guidelines on when a project can be classified as environmentally sustainable.

We support further development of standards, also related to social topics, to increase standardization and enhance the thresholds within the sustainable bond market.

B. Are the eligible projects or targets substantially contributing to the relevant sustainability themes as set in our Sustainable Investment Policy without impairing progress on the other themes?
We assess to what extent the eligible projects or predefined targets of a Sustainable Bond reduce exposure to sustainability risks and/or improve management capabilities of the issuers on different material sustainability themes.

These themes range from climate change, biodiversity loss and water to more social themes such as the transition to a fairer society. We also consider whether there is no significant adverse impact on any of the other sustainability themes and/or whether the potential for such impact is sufficiently mitigated.

C. Do the eligible projects cover a substantial share of the issuer's most material potential impacts?
In the last step, to prove that the entity truly aims to make a sustainable transition, we assess if the defined projects and KPIs are financially material and of significant importance for the overall profile of the issuer. As not every theme is equally material to all companies, we have identified the most material themes per sector in our Sustainable Investment Policy. When assessing a sustainable bond framework, we put emphasis on the themes most material to its issuer.[3] In this way, we distinguish between issuers that initiate a Sustainable Bond to follow regulatory defined targets and issuers with ambitious goals. For example, a waste processor aligning its activities with mandatory regulation but leaving out projects and targets on waste reduction will likely not be classified as a Sustainable Bond.

Within an issuer's material themes we expect issuers to cover their most material impacts. For example, if an entity issues a bond with which it aims to reduce carbon emissions on scope 1 and 2 while most of its emissions are in scope 3, the entity does not cover its most material impacts and the effect that can be achieved by investing in such a bond would be relatively limited.

3.2. Phase II: Cardano ESG Score for Sustainable Bonds

In the second phase, we determine the ESG score and the ESG label of the Sustainable Bond. The ESG score and label are two aspects that help determine the eligibility and weighting of a specific bond in the different Cardano portfolios.

Sustainable Bonds that pass the first phase of the assessment receive a minimum Cardano ESG score of 75. If the Sustainable Bond Framework goes beyond current market practice by its criteria, Use of Proceeds (UoP) categories, or targets, or is in another way considered to have a larger positive contribution to sustainability, the score can be upgraded to 85 or 100.

Use of Proceed Bonds that successfully pass the first phase of the assessment methodology are generally labelled as "Positive Impact", even though the underlying issuer may not be labelled as such. For these bonds we have high certainty that they do make direct contributions to environmental and/or social outcomes. SLBs are generally classified in line with the status of their underlying issuer because their use of proceeds is not directly linked to impact outcomes. We reserve ourselves the right to deny specific bonds a label up- or downgrade, for example if bonds are mostly focused on transition activities. Such decision will be reviewed and approved by the Cardano Sustainability Categorisation Committee.

Question 4: Is the framework ambitious or innovative and part of an ongoing effort by the Issuer to operate sustainably?

A. Are the projects or indicators defined in the framework considered ambitious or innovative?

When assessing the ambition level of a framework, we mainly focus on the types of projects financed and the general sustainability vision.

Bond frameworks can be used to finance a broad set of different projects. Ideally, and if relevant to the issuer's profile, an issuer takes into account a combination environmental and social projects in its framework, while defining ambitious project targets and impact indicators. Projects that would qualify for an ESG score of 85, could include the following:

- Issuers that aim to build social housing and do so in a way that does not harm the environment, considering for instance the use of renewable or climate-neutral construction materials.
- Issuers that aim to finance renewable energy projects, but also consider material efficiency, recyclability, biodiversity and/or community relations.
- Issuers that aim to finance projects focusing on 'newer' sustainability themes such as biodiversity or the circular economy.
- Issuers financing social projects that define clear target groups and provide evidence on why this target group is relevant to the bond.

Information on intended allocation as well as post-issuance allocation reports from previous issuances are used to determine if issuer's evenly allocate across all categories listed in their framework.

In general, we value frameworks that contain an integral vision to address the sustainability transition. This does not mean that only frameworks that focus on multiple UoP categories will be labelled as ambitious. Some frameworks

3 Ideally, a bond framework covers all of the issuer's most material drivers. However, it is understood that some topics are more suitable to be addressed by issuing a sustainable financing framework than others (for example increased renewable energy generation versus improving a company's ethics framework). Therefore, also frameworks that focus on only one topic can receive a stamp if their targets and eligibility criteria are sufficiently ambitious.

may contain highly ambitious goals to solve one specific issue. For example, a framework considering clean transportation with the goal to achieve net-zero emissions from transport in 2030, could be considered ambitious.

> **Issuers are expected to report on both outcome and impact indicators to validate the results of their bond issuance.**

Finally, we also consider the ambitiousness and innovativeness of impact indicators. Issuers are expected to report on both outcome and impact indicators to validate the results of their bond issuance. A strong impact indicator does not only focus on the number of schools build but also on how many students are reached and what percentage of students are from underprivileged groups (in terms of gender, income level, or other criteria). By this, the issuer illustrates the expected environmental and/or social impact (in qualitative and/or quantitative terms) of the projects. We support the development of new, innovative indicators and value frameworks that are transparent about their calculation methods and methodologies used to define outcome or impact indicators.

B. Is the issued Sustainable Bond a one-off or does it fit into an overall and ambitious sustainable strategy of the issuer?

We encourage our investees to operate within the planetary boundaries and respect the social foundations. Companies should be transparent about this and explain and/or define the contribution of their operations, activities, and sustainability policies. Issuers that are not yet operating sustainably, are expected to be transparent on how they plan to transition towards a sustainable way of operating. By this, they can show that their Sustainable Bonds are not only a one-off instrument but fit into an overall vision on sustainability where they are adequately managing their sustainability-related risks, their impact on society and their opportunities to become (more) sustainable. We expect the sustainability ambitions of issuers to be best-in-class and fit with our sustainability believes. That is, targets set by an issuer are expected to be in line with our targets and ideally be science-based.

If the issuer meets both elements listed in question 4, the Sustainable Bond will receive of a score of 85.

Question 5: Is the issuer a transformational sustainability leader and do the projects make a significant contribution to this position?

Issuers in this category actively embrace the opportunity to make a positive contribution both to the UN Sustainable Development Goals and to our sustainability objectives. Some sustainability transitions do not just ask for a solution but require a broader shift in deeply rooted consumption and production patterns. We therefore assess whether the Sustainable Bond issuer defines new and/or innovative business models, products or services which are underpinned by transformational leadership, disrupts existing industries and is aligned with the Sustainable Development Goals. For example, issuers focusing on climate-smart agriculture not only reduce carbon emissions but also help to transform agri-food systems towards green and climate resilient practice in the long term, creating better production, better nutrition, and a better environment. Similarly, issuers supporting the shift towards more plant-based proteins or those putting more emphasis on telemedicine treatment and advice (especially in underserved markets) are other examples of transformational business models.

In our assessment we distinguish between the framework and the issuer. Where for other questions the focus is on the framework, in this question also the issuer profile is relevant. Projects need to be an integral part of the company’s strategy, or at least a clear intention to grow this part of the business should be expressed. When defining output, outcome or impact indicators, the issuer should link these to its sustainability strategy and show its ambition by setting targets on these metrics. For example, if a Sustainable Bond focuses on climate-smart agriculture, the issuer is encouraged to set targets on the number of farmers supported, number of emissions reduced and/or percentage of increased productivity.

If the issuer and its framework are assessed as transformational sustainability leaders, the Sustainable Bond will receive a score of 100.

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