



ESG at Fitch: Impact / Financial Materiality

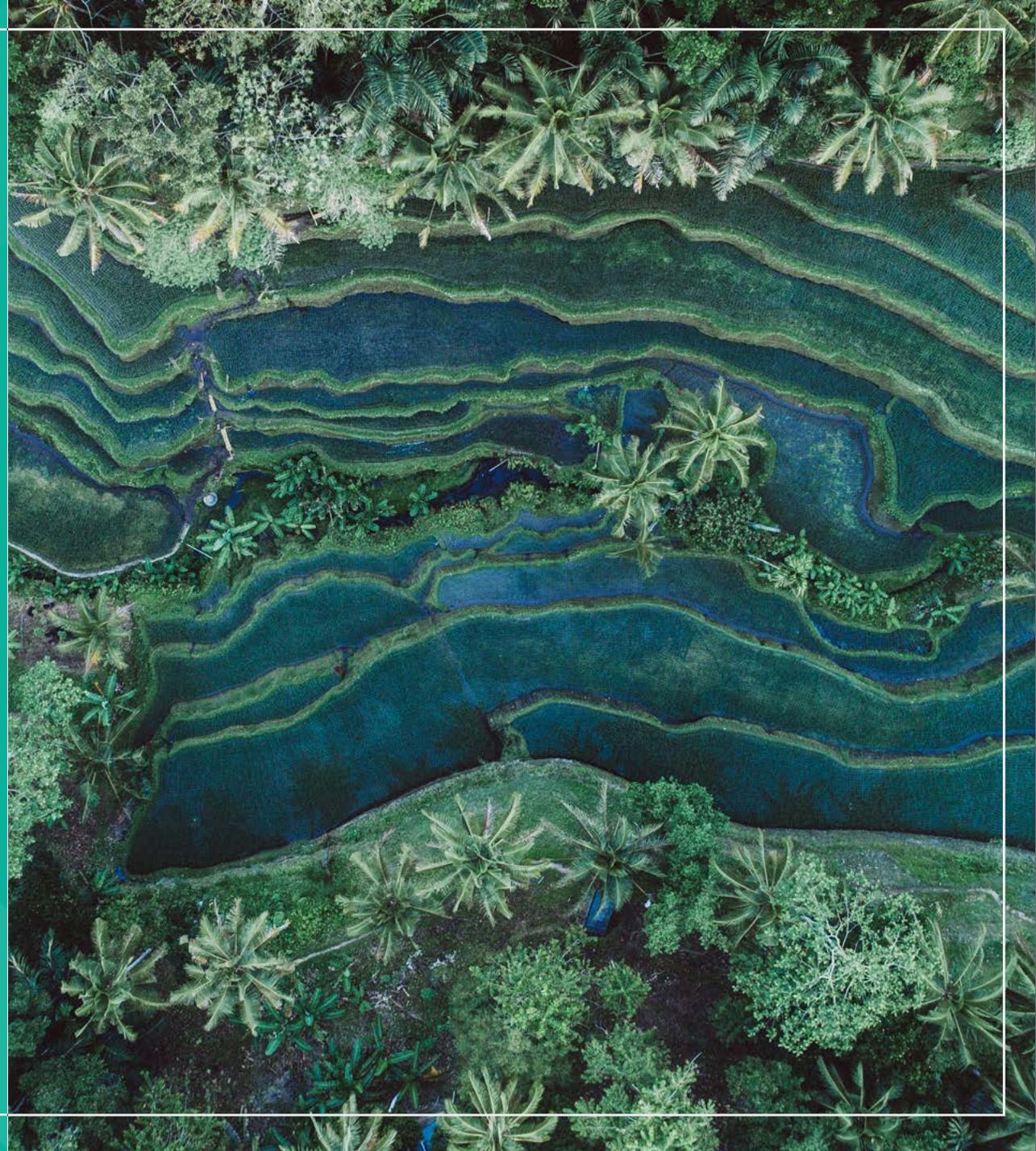
Carmen Muñoz
Head of Risk

14th VIRTUAL EEMI BAUHAUS EVENT



Discussion Topics

- Financial Materiality Versus Impact
- Fitch Group Sustainability Product Offering
- ESG Relevance Scores Versus ESG Ratings
- Rating Scales
- ESG Rating and Modular Approach
- ESG Rating Difference between Secured and Unsecured
- The importance of Assets in Secured Debt
- Case Studies
- Appendix with Additional Material



ESG Ratings: Unregulated and Diversified Market

More than 100 different ESG rating providers according to estimates.

The European Securities and Markets Authority (ESMA) called for regulation within the ESG rating market in January 2022. Smaller and unprepared agencies more likely to be absorbed or disappear.

ESG ratings can be :

- Solicited (concern for some investors)
- Unsolicited (potential gaps in analysis)
- Hybrid (Sustainable Fitch). Ratings will indicate whether solicited or unsolicited and if issuer participated or not

How does Fitch assess ESG? 2 separate approaches



FitchRatings

Assess financial risk and exposure to ESG factors

Influence the strategy to report on and minimize ESG risk factors

Benefits: Investors can limit future cash-flow risk triggered by ESG. Issuers can demonstrate their oversight on ESG risks

Fitch Ratings product:
ESG relevance score



Sustainable Fitch

Assess companies' contribution to ESG factors

Measure ESG performance and assess the sustainability profile to assist impact investors and issuers in their transition

Benefits: Investors can invest in line with an impact investing mandate. Issuers can demonstrate how they align with and contribute to sustainability

Sustainable Fitch product:
ESG ratings

Fitch Group ESG Solutions

FitchRatings



ESG-integrated Credit Research & Analysis

Short-term

Long-term

ESG Relevance Scores

- ESG Relevance Scores articulate the level of influence an environmental, social or governance issue has had on a credit rating decision.
- ESG Relevance Scores are forward looking and based on the base case forecasts for the credit ratings of entities and transactions
- Fitch Ratings' credit analysts systematically evaluate ESG credit considerations incorporated in its ratings methodologies
- The scores cover Environmental, Social and Governance (E, S and G, respectively) risks under a transparent sector based, cross-asset, global framework
- Sector based templates provide clear articulation of credit relevant ESG risks

Sector / Entity / Transaction

ESG Vulnerability Scores

- Credit risk analysis based on a credible downside credit risk scenario whereby climate change is limited to 2 degrees of warming by 2050
- Vulnerability scores provide a time series comparative risk score of credit risk vulnerability for sectors, entities within a sector, and debt instruments
- Time-profiled scores at regular intervals from 2025 to 2050. Unique granular view for investors looking to manage longer term ESG credit risks
- Based on the UN-backed Principles for Responsible Investment's Inevitable Policy Response scenario, refined and adjusted for the in-depth sector knowledge of Fitch's rating analysts

Sector / Entity / Transaction

Medium-term

ESG Research

- Dedicated global ESG Research team based across 3 continents who cover thematic and cross-sector ESG credit risk, as well as supporting credit analysts with themed issuer and transaction specific research
- Thematic reports analysing ESG themes at a macro-level, a sector level, and an entity / transaction level with an emphasis on how they are likely to affect sectors and entities from a credit perspective
- The ESG Research team prioritize emerging ESG themes that are most material and likely to disrupt industries and business models

Sector / Thematic

Pure ESG Analysis & Reports

Short-term

Medium-term

ESG Ratings

- Holistic ESG analytical tools that help market players to discriminate the ESG quality of financial instruments and companies/issuers
- 3 main pillars:**
- ESG Entity Rating, with ESG peer comparison tool
 - ESG Instrument Rating (bond and loan) for both framework and conventional bonds and loans. Financial instrument assessment which takes account of the ESG credentials of the issuer as well as the debt instrument to produce an absolute comparative grade for every piece of debt issued.
 - ESG Framework Rating for Green / Social / Sustainability / Sustainability-linked bonds and loan

Entity / Transaction

Items Evaluated: ESG Relevance Scores

ENVIRONMENTAL	SOCIAL	GOVERNANCE
GHG Emissions & Air Quality	Human Rights, Diversity & Inclusion	Management Strategy
Energy Management	Customer Welfare: Fair Messaging, Privacy & Data Security	Governance Structure
Water & Wastewater Management	Labor Relations & Practices (+ IPF: GREs, USPF: Revenue)	Group Structure
Waste & Hazardous Materials Management; Ecological Impacts	Employee Wellbeing	Financial Transparency
Exposure to Environmental Impacts	Exposure to Social Impacts	Political Stability and Rights
Water Resources & Management	Human Rights & Political Freedoms	Rule of Law, Institutional & Regulatory Quality, Control of Corruption
Biodiversity & Natural Resources Management	Human Development, Health & Education	International Relations & Trade
Natural Disasters & Climate Change	Employment & Income Inequality (<i>Sovereigns/region Only</i>)	Creditor Rights
	Public Safety & Security	Data Quality & Transparency
	Population Demographics (<i>Sovereigns/region Only</i>)	Rule of Law, Institutional & Regulatory Quality
	Demographic Trends (<i>IPF: GREs, USPF: Tax Only</i>)	Transaction & Collateral Structure
		Transaction Parties & Operational Risk
		Data Quality & Privacy

- Applies to All Analytical Groups
- Applies to Corporates, Financial Institutions, IPF: GREs, USPF: Revenue, Infrastructure, Structured Finance
- Applies to Corporates, Financial Institutions, IPF: GREs, USPF: Revenue, Infrastructure
- Applies to Sovereigns, IPF: Local and Regional Governments, USPF: Tax
- Applies to Structured Finance and Covered Bonds

Rating Scales: ESG Relevance Scores Versus ESG Ratings

FitchRatings

ESG Relevance Scores

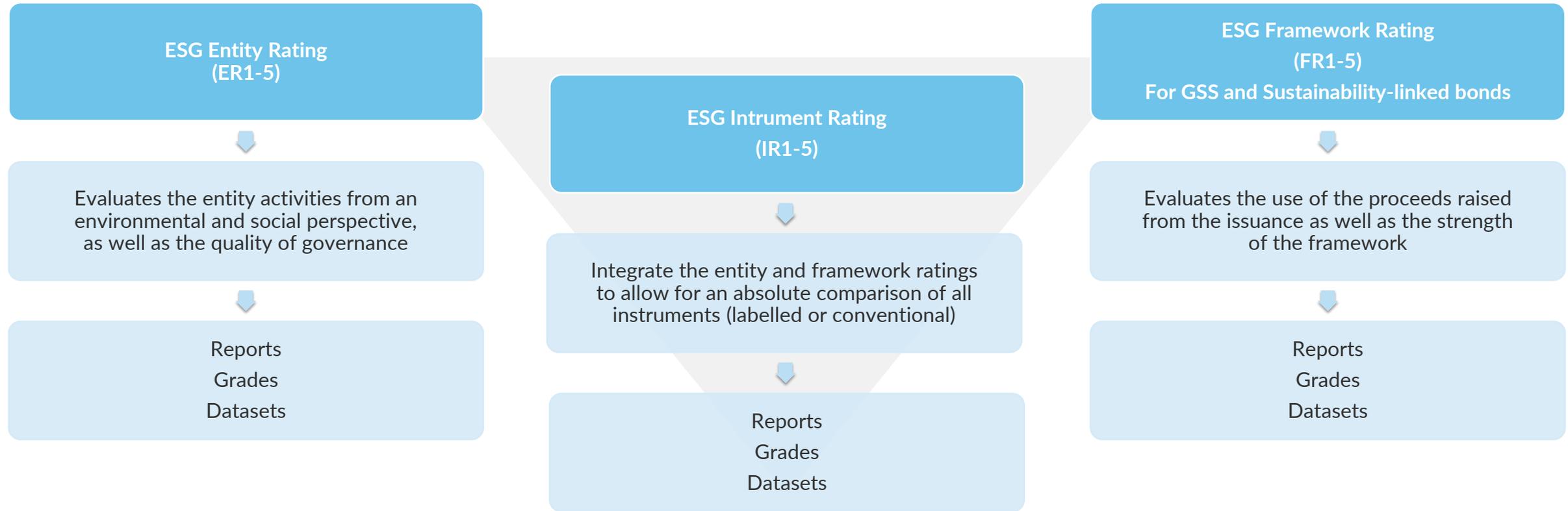
1	Irrelevant to ratings and sector
2	Irrelevant to ratings; Relevant to the sector
3	Minimally relevant to ratings, either very low impact or actively mitigated in a way that results in no impact on ratings.
4	Relevant to the rating; not a key rating driver on itself but has an impact on ratings in combination with other factors .
5	Highly relevant , a key rating driver that has a significant impact on an individual basis.

 Sustainable
Fitch

ESG Instrument Rating

		Excellent
		Entity:
		<ul style="list-style-type: none"> Business, Strategy & Management and integration of ESG considerations into these. Business activities: alignment with science-based taxonomies and ESG
		Framework / Instrument
		<ul style="list-style-type: none"> Use of Proceeds: framework structure and proceeds destination.
1	100-87.5	
2	87.5-62.5	Good
3	62.5-37.5	Average
4	37.5-12.5	Sub-Sverage
5	12.5-0.0	Poor

ESG Ratings: “Covering Labelled and Conventional Bonds”



These ESG Ratings enable an absolute comparison of GSS^a, sustainability-linked

and conventional bonds, loans and entities on a single scale

^a GSS: Green, Social, Sustainability

ESG Rating Products: Overview for Unsecured Instruments

DEBT INSTRUMENT STRUCTURE

GSS^a

OR

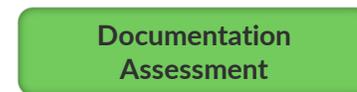
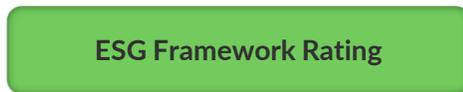
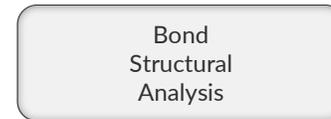
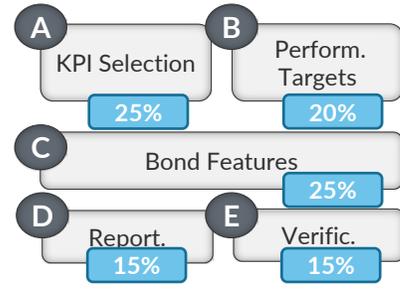
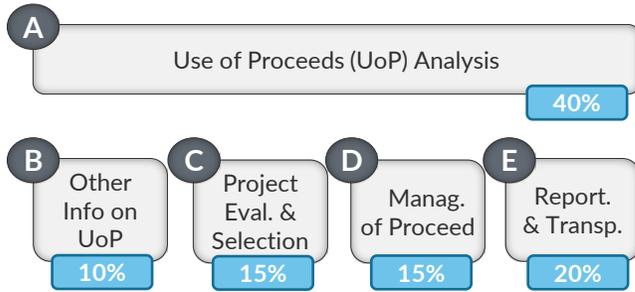
KPI-linked

OR

Conventional

20+ multiple factors across 5 areas

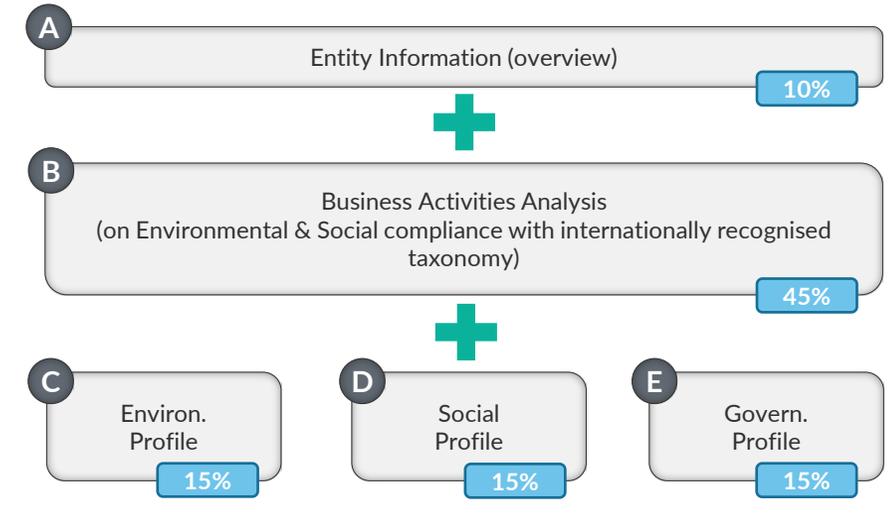
10+ multiple factors across 5 areas



(5) Filters

ENTITY

40+ multiple factors across 5 areas



^a GSS: Green, Social, Sustainability

ESG Rating Products: Overview for Secured Instruments

DEBT INSTRUMENT STRUCTURE

GSS^a

OR

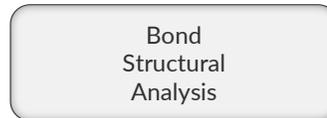
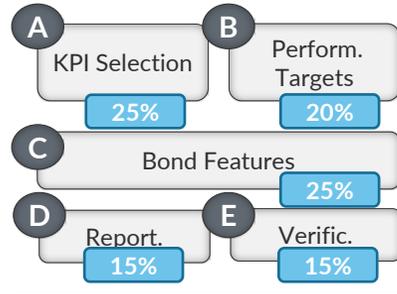
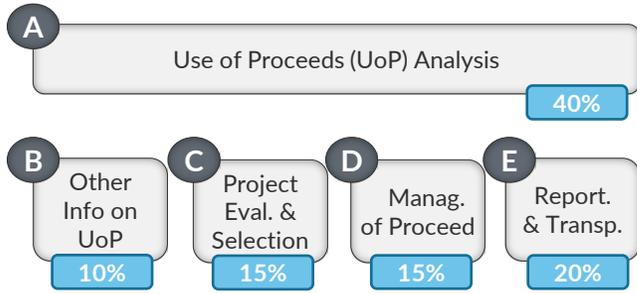
KPI-linked

OR

Conventional

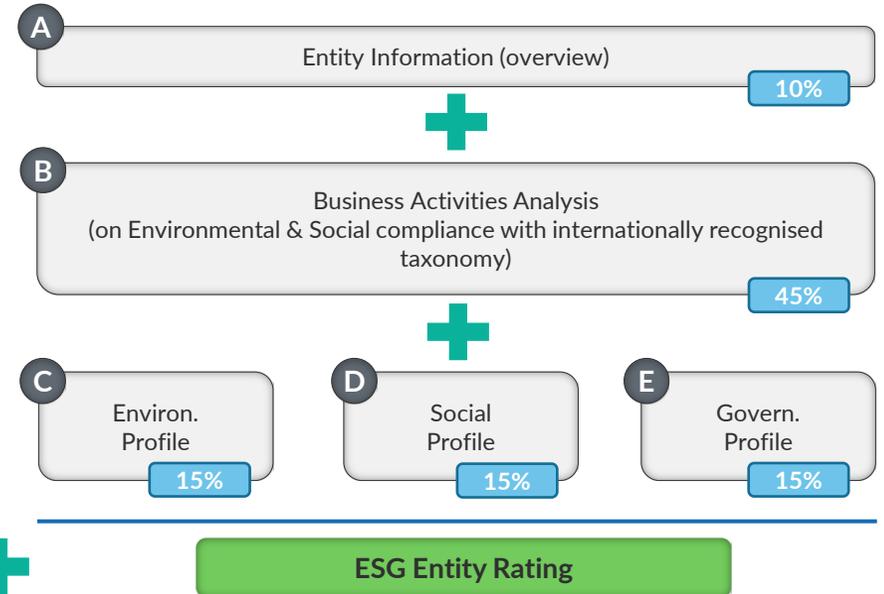
20+ multiple factors across 5 areas

10+ multiple factors across 5 areas



ENTITY

40+ multiple factors across 5 areas

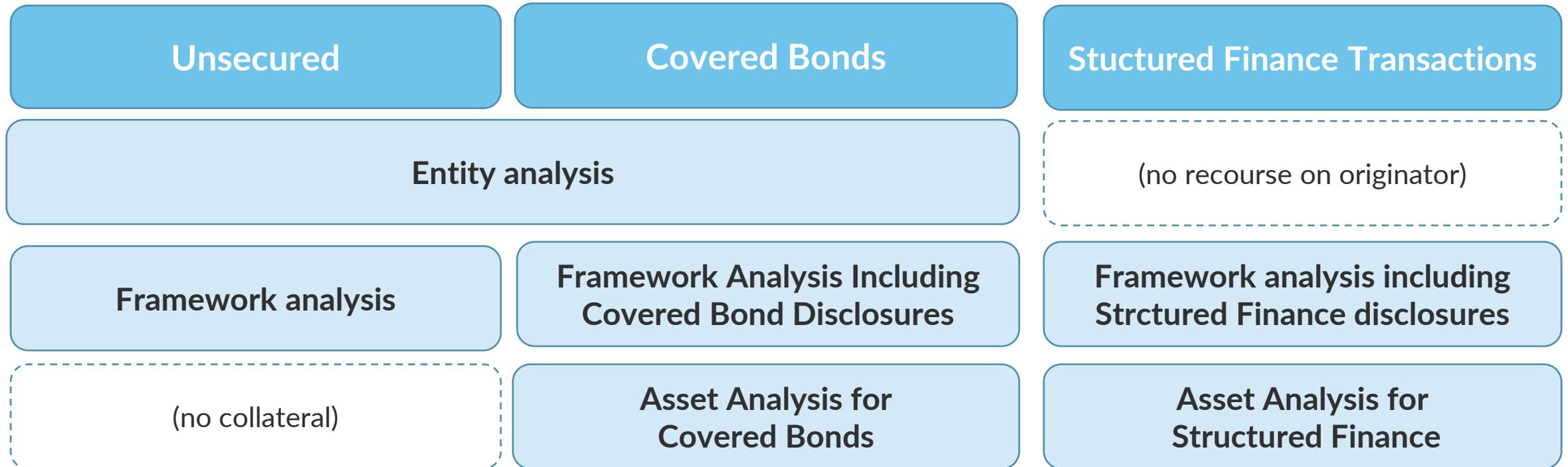


(5) Filters

ESG Instrument Rating

^a GSS: Green, Social, Sustainability

Comparison Between Unsecured, Covered Bonds and SF transactions



- Entity analysis done for Unsecured and Covered Bonds (dual recourse)
- For Asset-Backed Securities, entity analysis is not performed given asset isolation

ESG Asset Review: Structured Finance & Covered Bonds

Factor Reviewed	Benchmark
Environmental or Social Nature of the Assets	Contribution of assets to general environmental and social good.
Green Social Sustainability Asset Tracking Method	Recourse of the sustainable investor to the assets with environmental or social characteristics in priority to other creditors, and how these assets are segregated from the rest of the collateral.
Quantity of the GSS Assets:	Amount of GSS assets available in the structure in relation to the analysed instrument volume and the overall collateral amount available.
GSS Asset Substitution	Extent of the willingness and ability to substitute assets. An example would be external obligations to maintain a certain level of GSS assets such as the required European Banking Authority green asset ratio
Cash Balances	Degree of investment of cash balances in assets with similar characteristics to the UoP of the bond.



Case Studies

Case Study: ESG Relevance Scores Versus ESG Ratings

Global Bank - Netherlands

- First Covered Bond: EUR500m
- Cover Pool: EUR600m
- Mortgage Book: EUR 50bn
- 60% of mortgage cover pool has EPC of A
- 40% of mortgage cover pool has NHG guarantee
- 35% of bank's total mortgage book = EPC A

ESG Relevance Score

- ESG Relevance Score of 4+ for **Human Rights, Community Relations, Access & Affordability**
- 40% of cover assets have NHG guarantee
- Credit profile = Positive impact as lower levels of OC is needed following stresses
- No difference in OC between EPC A and EPC E as data does not show better performance of borrower

ESG Instrument Rating

- **Recourse against E & S assets : Score of 1**
 - Investors have privileged access to the E&S assets
 - Commitment to substitution
 - E & S collateral buffer
- **Asset impact assessment : Score of 1.4**
 - EPC A: Score of 1 for Environmental as it is aligned with the EU taxonomy
 - NHG: Score of 2 is for Social as it offers reduced Interest rate for homes up to EUR355,000

Case Study: Environmental Impact Assessment

Business activities covered by taxonomies

- Science-based approach to determining how a specific sector can be on a path to sustainability
- Two objectives currently covered: climate change **mitigation** and **adaptation**
- Companies need to meet the **Technical Screening Criteria (TSC)** while observing **Do No Significant Harm (DNSH)** and preserving **Minimum Safeguards (MS)**
- Can be measured at UoP level for issuance (EU Green bond standards) or portfolio level (turnover) for overall company alignment to taxonomy

Case Study : Real Estate Company					
Turnover		Meet TSC?		DNSH	MS
	Green building certifications and old buildings	35%	No		
	Acquisition Top 15% or real estate or EPC A (until 31/12/2020)	10%	Yes	Screening and compliance to climate risk	If statement not available, assessment of the policy in place and controversy screening.
	Construction : 10% improvement in PED vs NZEB (from 2021)	55%	Yes	Water usage, circular economy (70% waste prepared for reuse) and pollution	

- 65% of the score will be determined by the taxonomy anchor score
- 35% will be based on internal sector assessment and adjusted based on measures undertaken (certifications, sustainable material, renewable sources, LED lightings etc)

Social Impact Assessment : UNSDGs

SDGs

SUSTAINABLE
DEVELOPMENT
GOALS



Case Study: Private Sector Healthcare Provider

Social Considerations

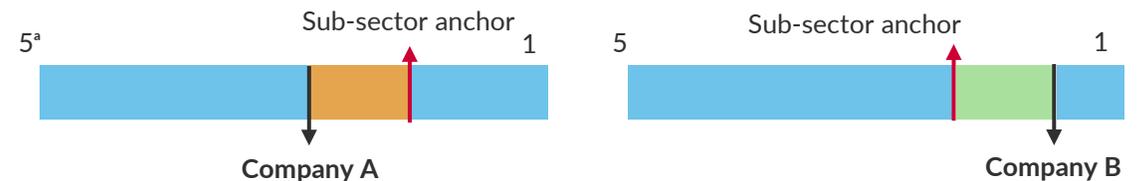
- Is it targeted at vulnerable populations ?
- Provides essential services that are identified as UNSDGs
- Study possible social issues upstream or downstream (suppliers or customers / patients)

Company A

- (-) Private sector operator, no pricing mechanism to ensure accessibility to populations
- (-) Evidence of wrong doings towards patients or employees

Company B

- (+) Private sector operator with strong affordability (state compensation or pricing policy).
- (+) important rural coverage
- (+) catering for vulnerable populations or providing access to specific treatments



^a Where 1 is the best and 5 is the worst



Coverage

Sustainable Fitch: Presence and Coverage

Presence



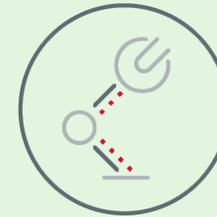
- New Fitch entity created in September 2021
- Presence in Europe, North America, Latin America and Asia
- Worked on coverage **since Q1 2021**. Unsolicited ratings across leverage finance and labelled bond universe (including structured finance)
- **Yearly monitored** ESG ratings at entity and ISIN level

Current Coverage



\$470 billion / 675 labelled bonds

- Green (76%)^a, Social (10%)^a, Sustainable (11%)^a
- KPI-linked (3%)^a



174

Corporates

- 129 finalized, 45 under committee review
- EMEA (83), Americas (54), APAC (37)



85

Financial Institutions

- 48 finalized, 37 under committee review
- EMEA (54), Americas (14), APAC (17)

^a Reviewed analyses only



Appendix

Numerous Reporting and Disclosure: The Role of ESG Ratings

ESG Related Information

Principles and Taxonomies



- ICMA
- UNSDGs
- EU Taxonomy / CBI Taxonomy/ ASEAN Taxonomy / Chinese Taxonomy

Voluntary reporting



- On ESG metrics and materiality : GRI, SASB, CDP

Mandatory reporting



- SFDR (asset managers & FIs, from 2022)
- CSRD (corporates >250 FTE, expected from 2024)
- TCFD (mandatory in the UK for large corporates and FIs, voluntary elsewhere)

Commitments and policies



- RE100 (100% renewable commitments by large corporations)
- Net-zero 2050, carbon-neutrality
- Sector specific objectives (end deforestation, recycling rate etc)
- ISO series (14 and 50 series for E, 26 and 45 for S)

Sustainable Fitch's Role

Holistic and comprehensive ESG assessments by:

- Reviewing and analysing all the **relevant non-financial documentation**
- **Monitoring** of ESG ratings by sector experts
- **Exchanging** with the investors to **explain the assessment** and with the issuers to **bridge information gaps**.
- **Contextualising** targets ambitiousness and companies' trajectory to their specific sector

Best Market Practice for Entities

Environment

Net-zero 2050

- Aim for minimum reliance on offsets or new technologies
- Scopes included : credible ambitions need to include scope 3

Disclosure – GHG protocol

- Harmonisation of GHG emission reporting and transparency on categories reported, notably scope 3
- Sustainable Fitch assesses the number and relevance of scope 3 categories reported

SBTi

- Submission of targets to independent body in charge of supervising and monitoring performance
- Scope 1 and 2 are bare minimum, scope 3 becomes expected by investors

Sustainability report auditing

- Third-party verifying numbers, increasing scrutiny and enhancing accountability to investors

Social

Diversity and pay gap reporting

- Increasing need for transparent and granular diversity reporting (gender, age, nationalities) across different seniorities
- Best practice would see diversity above 40% and paygap below 10%.
- Sustainable Fitch also assesses Gender Equality Index reporting

Supply chain policy and reporting

- Adherence to sector-wide initiatives (ex: Conflict minerals)
- Clear auditing and reporting on human rights compliance, transparently reported

Medium-term targets

- Incident reduction, diversity, tangible community involvement

Human and labour rights

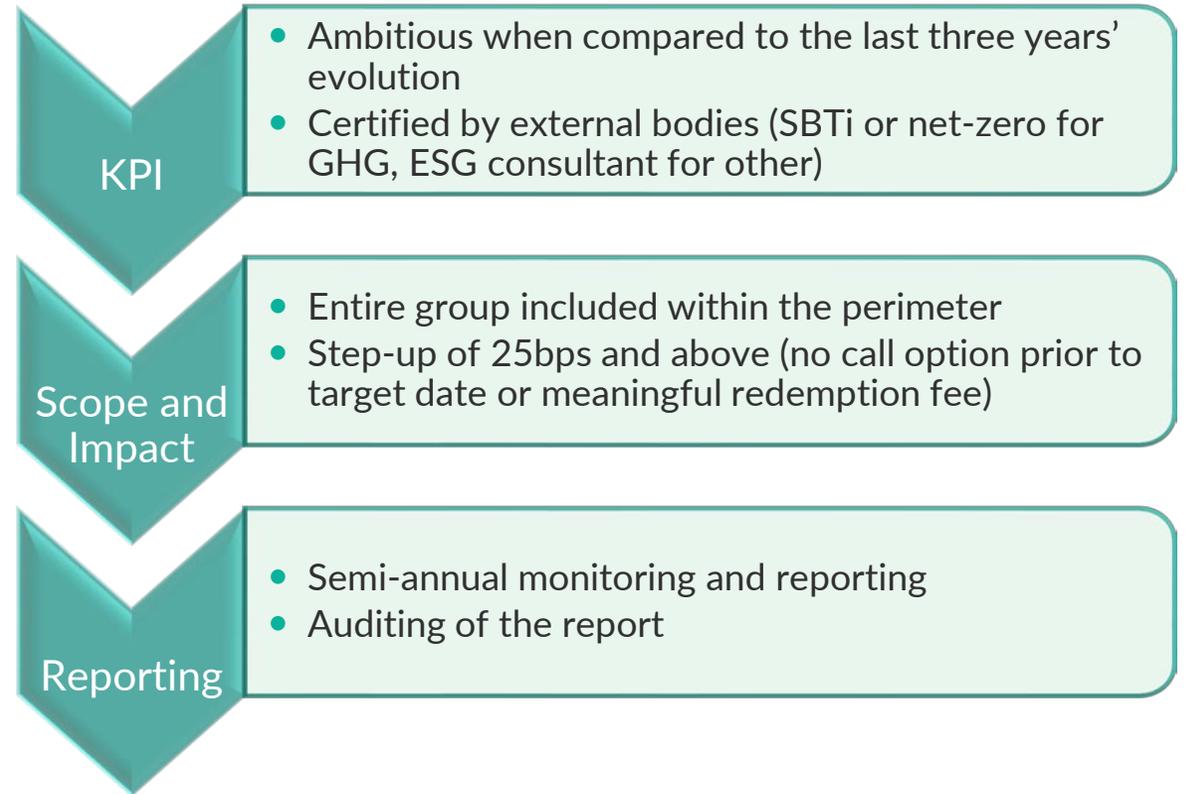
- Compliance and signatory to multilateral bodies and principles such as UN global compact or ILO

Best Market Practice for Bonds

Use of Proceeds Based



KPI-linked



Dataset: A Modular Approach



ESG Ratings and sub-components (L1-L2-L3)
EU Green Bond Standard / EU Taxonomy
ICMA Principles and Guidelines
UN SDG

3 Overall ESG Ratings and Reports plus Individual Datasets (modules and fields) will be available

ESG Framework Rating (FR)

- Full Instrument Level Descriptive Analysis

For GSS instruments

- Use of Proceeds Analysis (Grades, NACE, Allocation share – all for each UoP)
- Use of Proceeds/Other Info (Targets, Refinancing share, Lookback period)
- Project Evaluation & Selection Analysis (Grade)
- Management of Proceeds (Grade, Tracking method)
- Reporting & Transparency (Grade, Verifier, Frequency, Capex/Opex mix, Impact metrics)
- Transition Label (if applicable)
- ICMA alignment
- SDGs contribution details
- EU Green Bonds Standards alignment scorecard
- Instrument relevance & Instrument/Business Activities integration

For Sustainability-linked instruments

- Full details on KPI, Performance Targets, Bond Features, Reporting Frequency, Verification)
- Transition Label (if applicable)
- ICMA alignment
- Instrument relevance

ESG Entity Rating (ER)

- Full Company Specific Descriptive Analysis
- Company Business Activities (E/S Grades, NACE, Impact on Revenues or other relevant/available financial metric)
- ESG Company Strategy (Grade)
- Environmental (Grade, Targets list/details, Disclosure Grade, Evolution Grade, Risk & Incident treatment Grade, Target and Supply Chain Grade)
- Social (Grade, Community and Customers Grade, Diversity Grade, Human Rights Grade, Labor Rights Grade, Risk & Incident treatment Grade, Target and Supply Chain Grade)
- Governance (Grade, Financial & Reporting Grade, Remuneration Grade, Risk Management Grade, Tax Management Grade, Top Management and Control Grade)
- SDGs contribution details
- Company Impact metrics
- Sector Trajectory / Company Direction (Commentary)
- Pure Player label

ESG Instrument Rating

- Full Integrated Instrument Level Analysis
Company Descriptive Information
- Instrument Descriptive Information
- (All the previous)

All these datasets will be available as
Grades with Commentary (from Reports)

ESG Rating Report

The ESG Instrument Rating is an assessment done for an issue but also taking into account the issuing entity's ESG credentials
The report will include 3 steps (ER, FR and IR) plus some additional information

ESG Entity Rating

- We opine on the entity overall E,S,G profiles and its Business Activities.
- We will refer to an internationally recognized taxonomy

ESG Framework Rating

- We opine on the bond structuring features and Use of Proceeds
- We will check the UoP with the ICMA principles
- We distinguish between main GSS bonds categories

ESG Instrument Rating

- We can analyze ESG credentials for both GSS bonds and conventional bonds via the ESG Instrument Rating

Entity Analysis

Business Activities

Company Material Core Contributions	Environmental	Social	ESG Rating
<ul style="list-style-type: none"> Develop and build large scale solar arrays Operate and maintain solar arrays Undergo partnership wind and hydroelectric values 	<ul style="list-style-type: none"> Clear support to a transition to a net zero emissions economy Facilitate Entity receive business credit case best practice (electricity, generation, and access only performing technologies in the longer term) Solar PV technology is eligible for EU temporary alignment and exempt from GHG Mitigation assessment 	<ul style="list-style-type: none"> We find generation of electricity to be neutral from a social perspective, regardless of the number of solar arrays in operation. However, additional solar arrays built proceeds to have a negative impact on the company's ability to produce electricity by one of the operations projects. We will further reflect this in our social alignment assessment 	2

Business Activities

Company Material Core Contributions	Environmental	Social	ESG Rating
<ul style="list-style-type: none"> Processing and using fossil fuel generated electricity Generation of greenhouse gas emissions. As a consequence, it contributes to global warming and climate change Oil and gas activity has been discontinued or is being replaced by long term strategic business 	<ul style="list-style-type: none"> Processing and using fossil fuel generated electricity Generation of greenhouse gas emissions. As a consequence, it contributes to global warming and climate change Oil and gas activity has been discontinued or is being replaced by long term strategic business 	<ul style="list-style-type: none"> Not applicable 	4

Weighted Power

Company Material Core Contributions	Environmental	Social	ESG Rating
<ul style="list-style-type: none"> Modeling towards a net zero emissions economy Modeling towards a net zero emissions economy Modeling towards a net zero emissions economy 	<ul style="list-style-type: none"> Modeling towards a net zero emissions economy Modeling towards a net zero emissions economy Modeling towards a net zero emissions economy 	<ul style="list-style-type: none"> We find generation of electricity to be neutral from a social perspective, regardless of the number of solar arrays in operation. However, additional solar arrays built proceeds to have a negative impact on the company's ability to produce electricity by one of the operations projects. We will further reflect this in our social alignment assessment 	2

Fictional Entity GmbH
ESG Rating Entity Research | 3 September 2023

Framework Analysis

Use of Proceeds - Eligible Projects

Company Material Core Contributions	Environmental	Social	ESG Rating
<ul style="list-style-type: none"> Investment activities related to development, construction and installation of solar arrays Investment to be related to solar panels, batteries, inverters, cables, transmission assets and any other related relating to the completion of a solar array. To ensure limited negative impacts on communities, environmental impact assessments are conducted by available before new arrays are constructed 	<ul style="list-style-type: none"> 80% of the proceeds of the bond will be used for renewable energy projects that are part of the 2023 Solar Report either in operation or in construction Specifically, 60% of the proceeds have been allocated to solar projects and 24% to hydroelectric projects Clear energy critical for reducing greenhouse gas emissions Other renewable energy production types 	<ul style="list-style-type: none"> We recognize the positive environmental contribution of renewable in our assessment of this cash flow. However, solar photovoltaic solar PV power generation is currently aligned with the EU Taxonomy (Transition) framework, currently emerging 	4

Use of Proceeds - Other Information

Company Material Core Contributions	Environmental	Social	ESG Rating
<ul style="list-style-type: none"> To finance the acquisition, development and construction of renewable energy projects To maximize and optimize existing eligible projects Eligible projects may include projects (beyond or below the operation) to be 12 months prior to approval for grid hook-up for a full list of Eligible projects Eligible projects must be a net zero emissions project, funded in whole or in part by Fictional Entity through the transition to low carbon and decarbonization growth and a net zero emissions economy as intended by Fictional Entity Fictional Entity will not finance fossil energy projects 	<ul style="list-style-type: none"> 80% of the proceeds of the bond will be used for renewable energy projects that are part of the 2023 Solar Report either in operation or in construction Specifically, 60% of the proceeds have been allocated to solar projects and 24% to hydroelectric projects Clear energy critical for reducing greenhouse gas emissions Other renewable energy production types 	<ul style="list-style-type: none"> We recognize the positive environmental contribution of renewable in our assessment of this cash flow. However, solar photovoltaic solar PV power generation is currently aligned with the EU Taxonomy (Transition) framework, currently emerging 	4

Evaluation and Selection

Company Material Core Contributions	Environmental	Social	ESG Rating
<ul style="list-style-type: none"> Generation of central power stations by nuclear and coal are not eligible business Business must be sustainable as the transition to a net zero emissions economy is pursued 	<ul style="list-style-type: none"> Long term must be to reduce carbon intensity energy sources to reduce climate change and achieve UN targets According to the Fictional Entity, the business operations will not be affected by the transition to a net zero emissions economy Environmental, Health and Safety Considerations, and will continue to focus on the main challenges such as: 1) maintain operating sustainable year-round and 2) competition with fossil 	<ul style="list-style-type: none"> Not applicable 	4

Fictional Entity GmbH
ESG Rating Entity Research | 3 September 2023

Fictional Entity GmbH

ESG Ratings

Entity	ESG Rating	Score	Analysis Type
Entity	2	72	Full Entity
Instrument	2	85	Instrument only
Transaction	2	82	Transaction

Credentials

Transition: ● ICMA: ● EU Green Bond: ●

Key Debt Details

Instrument	Issue Date	Currency	Amount	Coupon	Maturity Date	Type*
Bond	22 Jul 23	EUR	€40 million	1.50%	21 August 2028	Green

Instrument Overview

Instrument	Issue Date	Currency	Amount	Coupon	Maturity Date	Type*
EU Green Bond	22 Jul 23	EUR	€40 million	1.50%	21 August 2028	Green

Business Activity Overlay with Use of Proceeds

85%

Contact - Analytical

ABC DEF
+44 1234 567890
info@fitch.com

Fictional Entity GmbH
ESG Rating Entity Research | 3 September 2023

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