Labelled Bonds Evaluation Criteria

Credit Rating Agency

HR Sustainable Impact
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Green, social and sustainability bonds are financial instruments that can be issued by corporations, financial institutions, development banks, governments and trusts. These bonds may not only be limited to unsecured obligations, but may also be issued to finance a new project with no flow history (project finance), non-recourse issuer bonds, and asset-backed bonds, among others.

The assets, projects or activities financed through the proceeds obtained from the placement of these instruments must generate environmental benefit in the case of green bonds, a social benefit in the case of social bonds and a combined benefit in the case of sustainability bonds.

The objective of these criteria is to provide an opinion on the compliance of green, social or sustainability bonds with three pillars:

1. The first, and most important pillar, analyzes compliance with the four components presented by the ICMA[1] in its Green Bond Principles (GBPs), Social Bond Principles (SBPs), and Sustainability Bond Guidelines (SBGs).[2] If there are standards developed by the local market, they may be taken into consideration to the extent that they expand the requirements submitted.
2. The second pillar focuses on the expected impact of the projects to be implemented considering their relevance in local contexts and possible externalities.
3. Finally, the extent to which the projects described in the reference framework, or instrument, support progress on the entity's comprehensive sustainability strategy is evaluated.

HR Ratings may assign labels such as "Favorable" or "Unfavorable" to the reference framework, as well as to bonds related to that reference framework.[3] For this purpose, the extent to which the bonds comply with the relevant reference framework, the environmental and/or social effect of the projects selected to receive the instrument's funding, and the variation of the expected

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[1] International Capital Market Association (ICMA)

[2] The version of the principles in force at the time of the analysis will be used.

[3] Available documentation that defines the rules for the use of proceeds and project impacts may be used as a basis in cases where a reference framework is not available

impact in relation to the projects mentioned in the reference framework will be evaluated. Furthermore, the evaluation may vary based on compliance with the applicable principles.

The evaluations described in this document do not offer any opinion regarding the credit quality of the financial instrument or the entity. HR Ratings may use public or private sources of information to conduct its evaluation.

This document is the exclusive property of HR Ratings, and it substitutes the documents “Green Bonds Evaluation Criteria”, “Social Bonds Evaluation Criteria”, “Evaluation Criteria for Sustainable Bonds and Sustainability Linked Bonds” published in December 2021. This document becomes applicable after October 31, 2024.

Compliance with the components of the Green Bond Principles, Social Bond Principles and Sustainability Bond Guidelines

The reference framework, and/or bonds, shall be aligned with the Green Bond Principles, the Social Bond Principles and the Sustainability Bond Guidelines established by the ICMA. They share the following four components: 1) Use of Proceeds, 2) Project Evaluation and Selection Process, 3) Management of Proceeds, and 4) Reporting.

1) Use of Proceeds

The entity must clearly report the project(s) where the proceeds obtained from its placement will be invested in the bond’s legal documentation. This must include a statement on environmental and/or social targets and, where possible, the method or procedure through which the environmental and social benefits of the project are estimated or calculated.

The use of proceeds may include the refinancing of debt incurred during project financing. If part or all of the funds are or may be used for refinancing, the entity must disclose such amounts, the portfolio of projects eligible for refinancing and a detailed description of the projects. HR Ratings will evaluate the use of proceeds based on the following:

- The total amount of the eligible project portfolio must be greater than the expected amount of proceeds to be received through the labeled instrument.
- The entity’s transparency when presenting the investment plan, including the statement on the instrument’s environmental and/or social targets.
- If the instrument is used for refinancing, the impact of the associated project must be analyzed retroactively analyzed considering the retroactive period of the products to be refinanced at the time of placement.
- Cases in which the proceeds obtained are allocated to CAPEX or OPEX expenditure must show the impact and trajectory of project investments, as well as how these impacts align with a sustainable economy.
- Investment effectiveness in terms of time horizon.

2) Process for Project Evaluation and Selection

The entity will clearly establish and document the procedure, protocol and/or process to determine the eligibility criteria and decision making when determining which project(s) proceeds will be allocated.

This must include an explanation of the project's environmental and/or social targets, and how they are compatible with eligible projects under relevant national or international guidelines. It should also include selection criteria, as well as exclusion criteria, standards, certifications or any other process used to identify collateral risks associated with the projects. Project evaluation and selection will be reviewed based on the following:

- The entity's level of transparency and efficiency when documenting, maintaining and recording the decision-making process for determining project eligibility.
- Methodologies, taxonomies or standards used to define potential projects to be financed or refinanced as well as how they are aligned with the entity's ESG or sustainability strategy.
- Experience and historical performance of the entity, or decision makers, in the environmental and/or social bond sectors, or concerning the experience of participants, the presence of external consultants with experience in the field.
- Possible externalities or environmental and/or social risks that may exist in project implementation.

3) Management of Proceeds

The management of proceeds criteria evaluates capacity, transparency and efficiency in the process of allocating bond placement proceeds. Accordingly, the management of proceeds process must be documented at all times. The following items will be taken into consideration:

- The management of proceeds is clearly established in legal documentation for the process.
- Transparency in accounts, sub-accounts, trusts or any other management vehicle in which the proceeds obtained are placed.
- Period when the proceeds will be used.
- Whether temporary investments are placed in:
  a. Temporary investment instruments that are cash or cash equivalent instruments within a treasury function;
  b. Temporary investment instruments that do not include GHG projects that could negatively impact society and/or climate change;
  c. Temporary transactions that reduce revolving indebtedness before being used for investments in selected projects and assets.

4) Reporting

Entities will have to provide public and technical information on the project, along with information on the environmental and/or social implications observed and/or expected from the project, as well as the amount of proceeds allocated and their use. They should also be able to have and keep such information up-to-date until the proceeds have been fully allocated. This component will be evaluated based on the following:

- The quality of information provided in terms of qualitative and quantitative indicators (e.g., energy generation capacity, electricity generation, reduced/avoided GHG emissions, the number of people with access to clean energy, reduction in the number of vehicles required, number of people benefited in terms of poverty measures or access to services, estimates of the benefit due to resource savings or increased consumption, etc.). The above together with methodologies or processes for calculating indicators.
- The frequency with which the entity provides this information.
- Availability of information for review by interested parties.
- Verification of reports by an independent third party.

Environmental and/or Social Impact Analysis of Eligible Projects

The following sections describe the applicable impact analysis depending on the type of bond. The social impact analysis will determine the results of this pillar for green bonds. The social impact analysis will be implemented for social bonds. Finally, a combination of what is described in both sections will be applied for sustainability bonds.

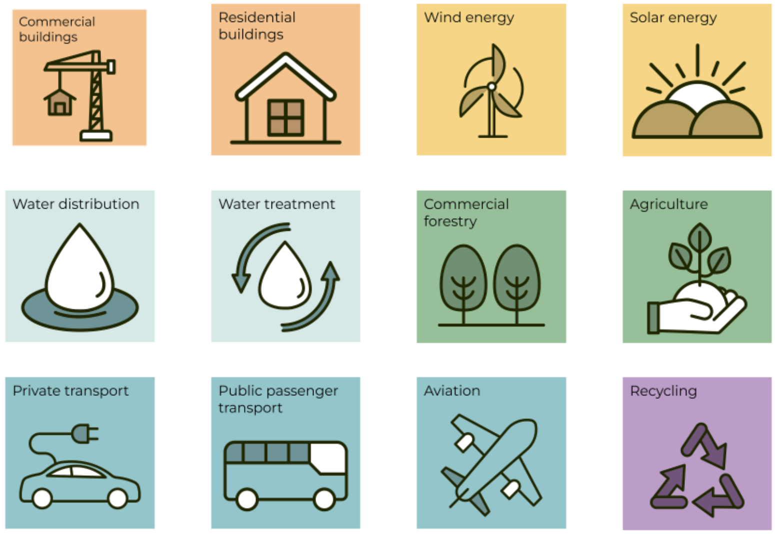
Environmental Impact Analysis

Part of the evaluation offered in these criteria consists of analyzing the type of project in terms of the environmental solution it offers. For example, GHG emission reductions, energy efficiency, waste management, or any type of project that contributes to environmental goals relevant to the industry in which it participates under the applicable sustainable taxonomy.

A basic step in the process of issuing a sustainable financial instrument is creating the reference framework for the project or asset in which the proceeds will be invested or refinanced. The projects mentioned in this document as example projects contribute to the development of a zero-emission economy or to limit the impact of global warming based on national and international taxonomies.

Figure 1 shows the type of project, which are commonly referred to as Environmental, that may form part of the reference framework or portfolio of projects specific to a structure.

__Figure 1. Allocation of Proceeds (Environmental Projects)__



Source: HR Ratings

The purpose of the evaluation in this section is to determine the environmental benefits of the projects. HR Ratings prepares an evaluation that includes not only the technical and qualitative characteristics of a project, but also the surrounding context for a more accurate and complete evaluation of the project's environmental impact.

Different environmental impact measures can be used depending on the nature of the sector or project. The criteria establish an analysis in which projects will be comparable regardless of their size.

A project's life cycle is another important aspect considered in the evaluation. This is important because projects that offer a long-term environmental solution will be chosen over those with short-term solutions. However, the operation of a long-term project must show that the asset will be able to maintain its environmental benefits throughout its life cycle, instead of just in the initial stages. Therefore, this will be linked to the technology used in the investment. Projects that implement the latest technological advances in their field may be more likely to offer a long term solution.

While the inherent impact of the project is the main focus of this evaluation, the reliability of these criteria would be reduced if the context in which the project is developed is not considered. This is why the evaluation is complemented by external factors that could reduce or increase the impact.

A project's geographic location is an additional factor that will be taken into account. The location is important because a project's marginal benefit is greater in countries or regions that are in an early stage of sustainable transition than in countries or regions that have progressed further towards that goal.

These factors will be taken into consideration and evaluated based on specific quantitative or qualitative measurements. This analysis will allow the project in question to be compared with other projects in terms of its relative contribution to environmental improvement targets, without ignoring the project's context and its spillover effects.

Social Impact Analysis

This evaluation consists of an analysis of a project's capacity to improve the development or well-being of the population, in terms of the ability to mitigate a given social issue. HR Ratings must continually determine that each project meets one or more goals established in applicable national or international guidelines.

The analysis is mainly qualitative in nature. A social project could focus on multiple targets, or it could specialize in only one, with an expected net positive social effect. As mentioned, where possible, a quantitative analysis of the expected social profitability of the project will be conducted.

It is important that the project does not counteract the impact of other targets to meet a specific goal, for example, implementing a project that efficiently combats poverty in the short term could have a negative effect on inequality in a certain region or within a certain income percentile. This could hinder the development of local institutions and, in turn, adversely affect poverty in the long term. In this particular case it may not be possible to develop a measurement that quantifies the expected loss for the region or decile involved, but the qualitative analysis would reveal red flags that would be included in the report issued by HR Ratings. HR Ratings will analyze the social benefits of the project under the following assumptions:

- The project's potential to offer permanent solutions. There is a risk that the region or the population may benefit temporarily, but then regress after the project ends.
- The creation of incentives favorable to society, without adversely modifying the behavior of the target population. The project could generate perverse incentives that could be exploited by various agents and reduce the social benefit in the long term.
- The project could generate externalities or collateral effects, both positive and negative, within and outside the region or target population.

The targets and/or goals shown are particularly sensitive to the project's surrounding context. In other words, not all countries or regions share the same definitions of poverty, health, well-being and development. Different regions may have different cultural traits that could lead to different results for similar projects.

Figure 2 shows the list of SDG targets that can be used as a basis for defining the goal in terms of bond impact.

Figure 2. Allocation of Proceeds (ODS)

Source: HR Ratings

Sustainability Bond Analysis

This analysis consists of an evaluation of the project's capacity in terms of the environmental and social solutions it offers. Since it is classified as a sustainability bond, it must be ensured that the portfolio of eligible projects has solutions that address both types of issues. If the KPIs selected for the reference framework targets focus primarily on combating social issues or progress towards a green economy, the bond will be treated as a social or green bond rather than a sustainability bond.

Sustainability strategy consistency analysis

The evaluated bonds should be aligned with the entity's sustainability strategy. The company's sustainability strategy must establish a comprehensive and long-term vision of how the entity intends to achieve its environmental and social targets according to its industry and local context. The strategy must also establish a monitoring and mitigation plan for possible negative project externalities. In this regard, labeled bonds should be understood as a tool used to help the company progress towards its sustainability goals.

Evaluation Process

The bonds will be evaluated based on the principles established for each of the three pillars. In other words, each evaluation must conclude that the bond duly complies with the applicable principles, the impact analysis, and the entity's sustainability strategy consistency analysis. The assignment of a "Favorable" opinion implies compliance with applicable principles and project impact analysis, while the sustainability strategy consistency analysis is offered as a complement to provide further information to the market. In other words, failure to comply with any of the items evaluated in the first two pillars will result in an "Unfavorable" rating.

Figure 3. Evaluation Structure

"Favorable Opinion"

Compliance with Applicable Principles

Principle	Compliance
1) Use of Proceeds	✓
2) Process for Project Evaluation and Selection	✓
3) Management of Proceeds	✓
4) Reporting	✓

Impact Analysis

Environmental/Social Impact	Analysis
Project type align with local /international taxonomies	✓
Project contribution	✓
Project life cycle	✓
Impact depending on project context	✓

Sustainability Strategy Consistency Analysis

Concept	Analysis
Strategy Clarity	✓
Long-term vision	✓
Project impact towards strategic objectives	✓
Monitoring systems and mitigation plans for externalities	✓

Source: HR Ratings

The figure shows the structure of an evaluation that was assigned a "Favorable" opinion. The analysis of the first pillar consists of a binary evaluation in which the framework or instrument is reviewed to ensure that it complies with the four components presented in the first section. Failure to comply with any of the four components leads to the immediate assignment of an "unfavorable" opinion regardless of the analysis of the rest of the pillars. In this regard, it can be concluded that the first pillar's analysis is the most important in determining the evaluation's results.

The analysis applied to the second pillar may vary depending on the type of bond (green, social, sustainability) and the context surrounding the projects. The figure shows the characteristics that projects should generally have to determine that the expected impact is sufficient to support a favorable opinion. The projects are expected to be aligned with the suggestions proposed by local and/or global taxonomies for companies involved in different industries or economic activities. Projects are expected to contribute to a zero-emission economy and/or offer solutions to mitigate the impact of climate change in the case of green bonds. For social bonds, projects are expected to contribute to solving a social issue in line with the SDGs or other targets established within local taxonomies. Sustainability bond projects should offer a solution to both issues. Finally, projects must offer solutions that consider the regional context where the project is implemented, focusing on long term effects. The considerations applicable to the analysis of this pillar will depend on the characteristics presented in each case, which is why the items analyzed may vary to the extent necessary to ensure the quality of the evaluation. The conclusion of this analysis will determine whether the expectation of impact is sufficient to support a "Favorable" opinion.

Finally, the analysis of the third pillar evaluates whether the projects contribute to the company's sustainable strategy. The company placing the labeled instruments must have a formalized strategy in its internal policies, which presents a clear long-term vision in order to be able to evaluate how the projects contribute to these targets. Unlike the other pillars, the evaluation of consistency with the sustainability strategy will not necessarily affect the final opinion on the instruments. Its aim is to provide further information for the market on the company's progress in developing a sustainable strategy and/or the ambition and completeness of existing and regularly updated strategies. Thus the project is considered as a contributing to a sustainable economy if the labeled financial instrument has a positive environmental and/or social impact, thereby complying with the two previous pillars.

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