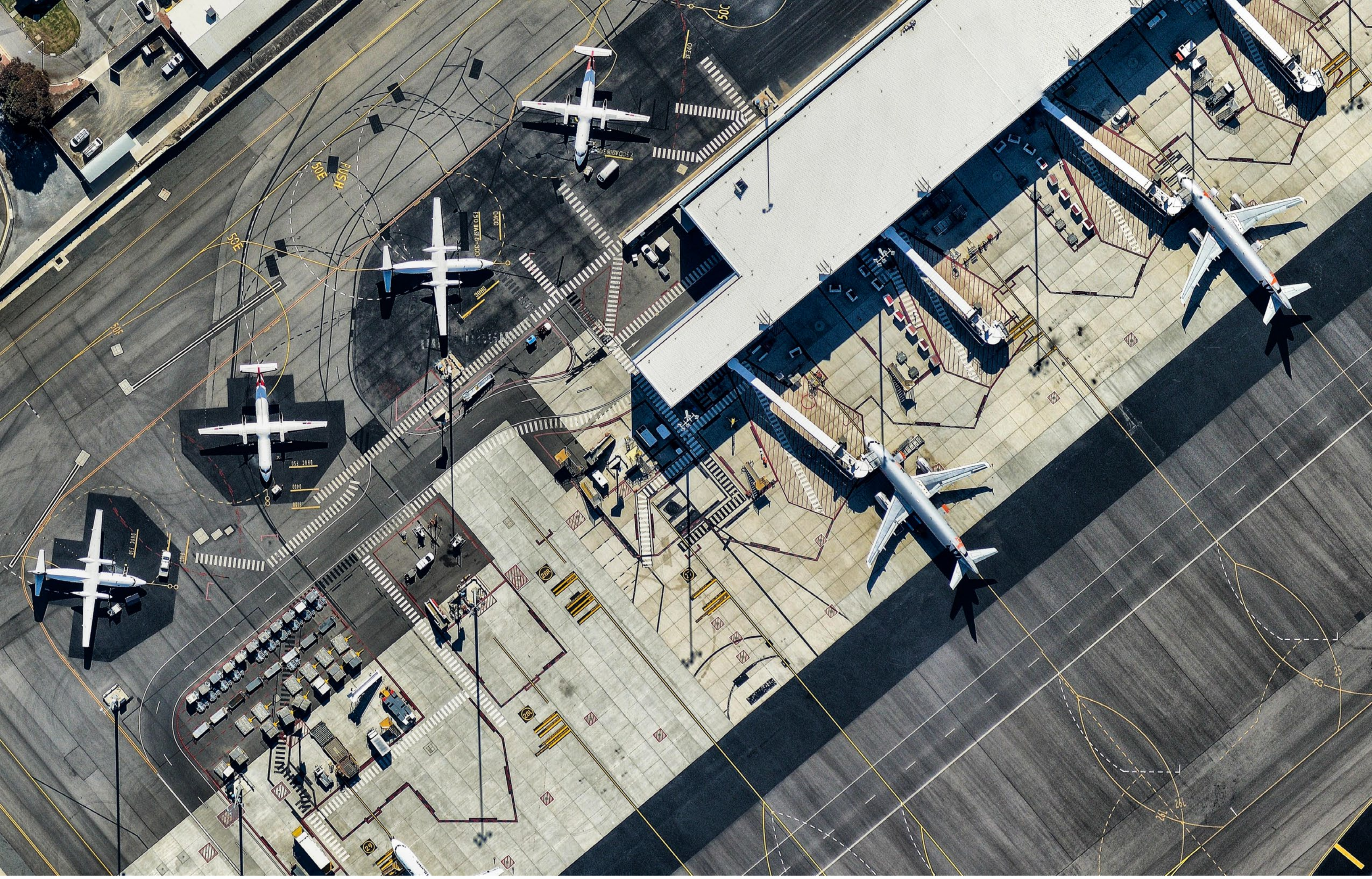

ESG: Aviation Finance

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Introduction

Despite a growing body of commentary on Environmental, Social and Governance (ESG), it remains an area many aviation finance stakeholders are grappling with. This report aims to help resolve that challenge, highlighting the specific risks and opportunities facing the industry.

There are many drivers of the ESG agenda for aviation finance stakeholders, depending on where they sit in the value chain and whether they are public or private organisations. Regardless, those that lead on ESG are most likely to find competitive advantage and create greater value for those stakeholders.

ESG in the context of Aviation Finance

Pre-Covid-19, aviation accounted for 2.5% of man-made CO2 emissions. However, sustained growth in demand will outpace further efficiency improvements, whilst other industries are expected to decarbonise at a faster rate. Inevitably, aviation's share of harmful emissions will rise and the weight of public opinion will increasingly encourage governments to take action.

IATA has stated, "Climate change is not just an issue for protesters or scientists…This is on the top of the agenda for mainstream investors now". The lack of viable near-term solutions to solving the net-zero challenge the industry faces will drive demand for younger, new technology aircraft as the industry seeks to reduce its carbon footprint.

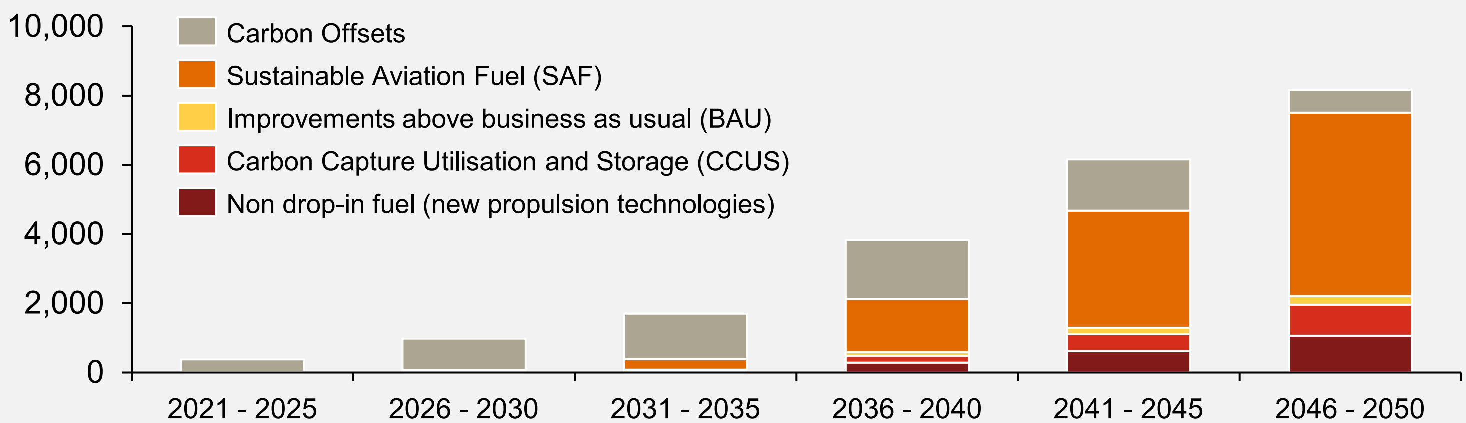
Incorporating ESG principles is increasingly an industry imperative as it can impact performance indicators such as:

- Access to financing / capital markets
- Credit rating
- Access to Tier 1 credits
- Future proofing of business model and business resilience
- Meeting regulatory requirements

While the 'E' has attracted the most attention, aviation financiers must also address the 'S' and the 'G'. It is easy to overlook the positive societal benefits of the aviation industry. Tourism tends to play a larger role in developing economies, creating employment and a means of upward social mobility. Aviation is aiding the recovery from Covid-19, transporting vaccines and medical equipment to emerging markets, while also, reconnecting friends and families. The ESG transformation will require governance and oversight to be successful. The risk function is also expected to play a bigger role going forward as ESG and climate risks emerge as key elements of customer analysis.

Estimated pathway towards net-zero

CO2 abatement, megatonnes



Source: IATA

How should aviation financiers think about ESG?

Risks and opportunities

ESG addresses a broad spectrum of topics and can affect all components of a company's strategy, operating model and execution. To make it easier to tackle, management should first weigh up both the risks of not acting and potential opportunities available to ESG adopters. Below is an illustrative list of ESG risks and opportunities to help management to better understand the implications ESG could have on their business.

ESG Risks

- **Market Risks -** availability and pricing of capital.
- **Strategic Risks -** exposure to out of favour asset types.
- **Reputational Risk** - ability to attract and retain talent
- **Transition Risks -** failure to comply with government policy and regulation.
- **Climate & Physical Risks -** impact of extreme weather events on assets.
- **Credit Risks - c**ustomers' exposure to rising costs of carbon credits and local climate risks.

ESG Opportunities

- **Demand for sustainable and transition financing** is expected to increase rapidly in the coming years (e.g. Sustainability KPI-linked Bonds, Transition Bonds, etc.)
- **Investor appetite** for ESG and sustainable investments is growing.
- Identify **new markets** and channelling investment towards them.
- Increased **customer demand for younger, fuel-efficient aircraft.**
- Enhancing reputation and **brand value**.
- Creating a positive and inclusive work environment that will help **attract and retain talent**.
- Develop business with **new customers** who share the same ESG values.
- Build **trusted relationships** with other businesses along the supply chain.

Management should think through the three elements of ESG separately, and do so with the additional granularity of sub-elements of E, S, and G. For instance, 'E' might include the impact from aviation financier's products and services, risk management and supply chain. After setting out an ESG framework identifying the likely impacts on the business, management's next steps should include agreeing on an ESG ambition, assessing potential strategic opportunities and mapping stakeholder communication.

Agree an ESG ambition

Aviation financiers should first make decisions based on organisational purpose and values, and set an ESG persona that reflects their ESG beliefs and commitment. Management with a low level of commitment ('Sceptics') may focus on minimum regulatory requirements, while those with a high level of belief in ESG principles ('Strategists') may incorporate ESG actions fully into strategies and more fundamentally change their organisations.

Scale of ESG adoption

Sceptic	Pragmatist	Strategist
Rejects ESG as a strategic priority, integrating minimum regulatory standards, low incentives for suppliers and clients to support internal metrics, if any.	Deploys targeted ESG quick wins which align with overall strategy. Core ESG values remain important, but are not aligned to everyday activities.	Integrates ESG opportunities which align with corporate strategy. Everyday activities are aligned with ESG ambitious self-set sustainability targets.

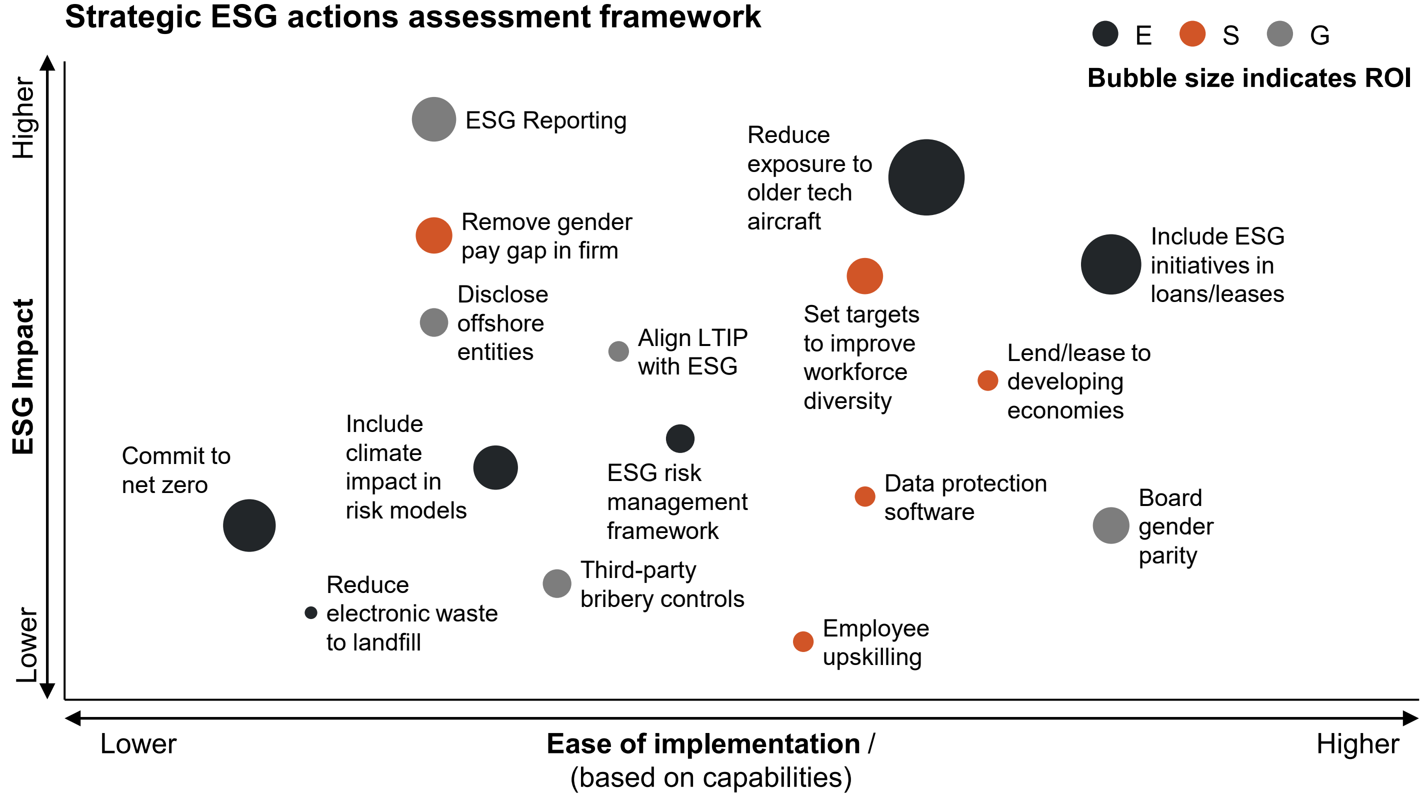
After deciding how ESG fits into the company's strategy, management should consider the available ESG actions and opportunities that can be implemented to help them to realise their goals.

Assess strategic actions

Aviation financiers should identify and prioritise business and operating model dimensions to change or redesign.

The table below provides an example of such a prioritisation exercise. Rather than selecting initiatives at random, ESG actions should be assessed based on how impactful they are, how important they are to the stakeholders that matter most and how easy they are to implement. While management will naturally want to estimate the return on investment, there remains much to do to narrow the gap between historical performance measurement (e.g. return on investment) and the new, longer-term concepts coming with ESG.

Strategic ESG actions assessment framework



Environmental	Social	Governance
Reduce exposure to higher carbon aircraft over time.	Set targets to improve workforce diversity in respect of gender, ethnicity etc.	Voluntarily commit to higher-standard ESG reporting, such as SASB Standards.
Commit to net zero across the business.	Remove gender pay gap across company in X years.	Disclose offshore entities to increase tax transparency.
Include environmental initiatives in loan/lease contracts (e.g. SAF).	Provide digital analytics upskilling training for employees.	Realise gender parity in Board membership.
Include climate impact in corporate risk models and pricing.	Provide lending/leasing to emerging economies or remote locations dependent on air travel.	Implement 3rd party controls, databases and monitoring to reduce potential bribery.
Develop and implement ESG risk management framework.	Compliance with employment safety and health protection.	Align executive LTIPs with corporate ESG outcomes.

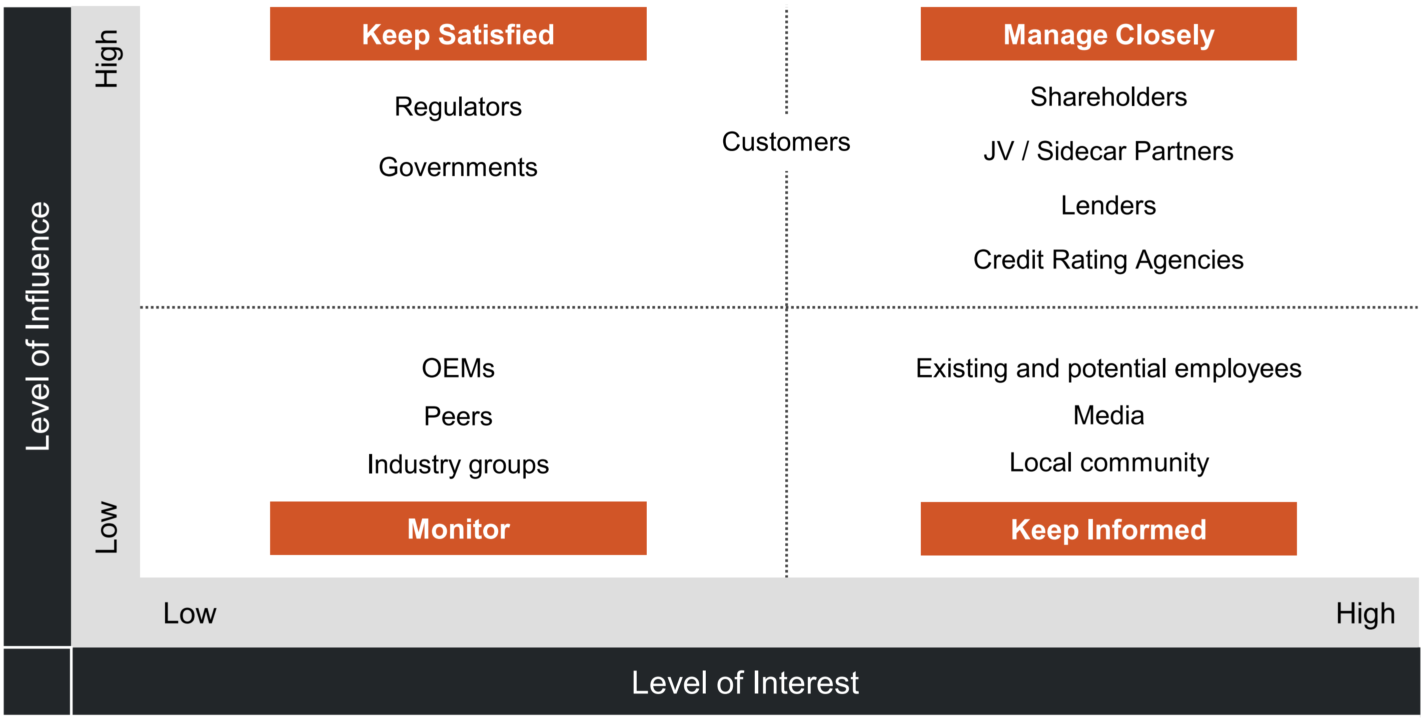
Once the ESG actions have been agreed, management should consider how the company's ESG message is communicated to each of the interested stakeholders.

Agree stakeholder communication

Aviation financiers are no longer answerable just to shareholders but a new set of stakeholders: customers, employees, suppliers, communities, the media and regulators. These broader and more vocal groups are increasingly interested in how ESG drives corporate performance. Management should assess each stakeholder's level of influence on the business and interest in ESG activities to help manage and communicate their ESG message. This will help determine the time and resources necessary to satisfy each of the stakeholders needs (i.e. helping to decide what ESG reporting standards to implement).

Below is an example of an ESG mapping exercise for an aircraft lessor noting that each business will be unique due to differences in shareholder commitment, local regulation, sources of finance, etc.

Stakeholder mapping example



Reporting organisations have developed multiple frameworks to help companies disclose comparable ESG information. However, the wide variety of standards, frameworks, rating agencies and alliances make the ESG landscape difficult to navigate. As more standards and frameworks are moving from voluntary to mandatory around the world, this should be the trigger for management to not only discuss compliance reporting but a more holistic reporting strategy approach as well as business strategy and transformation. Good reporting starts with a clear strategy – and informs decision making throughout the transformation process.

Aligning ambition, actions and communication

Aviation financiers will need to be pragmatic in executing and rolling out initiatives, communicating timely progress and outcomes to stakeholders. While some initiatives will be more short-term focused, often driven by regulatory timelines, others may require a multi-year phased approach. Success will be influenced by management tone and behaviours that can enable a purpose-orientated culture. Base expectations are increasing and these are already permeating across different stakeholder groups in the industry.

The table below provides an example of the different approaches aviation financiers can take when addressing ESG.

		Sceptic	Pragmatist	Strategist
	Example player	**Mid-life lessor** focused on cargo market	**Specialist lessor**, focusing on regional aircraft market	**Large-scale bank** offering financing solutions for lessors and airlines.
ESG Approach	Product and markets	Minimal change beyond regulation	Invests in new technology aircraft only as a quick win	Reduces portfolio of less fuel efficient aircraft in over time in line with the Paris Agreement / Net Zero commitment
ESG Approach	Operating model	Does not change operating model beyond what is required to meet regulations	Enters "green leases" with some customers	Works with customers to develop ESG aligned product offerings
ESG Approach	Execution	No exceptional execution approach for ESG outside of existing change and investment process	Takes an adhoc approach to execution with a selected number of business cases	Sets up an ESG programme including Net Zero commitment and implementation plan, led by a "Head of ESG"
ESG Approach	Risk Management	ESG risks not considered	ESG risks considered case-by-case, on reputational grounds	ESG risks fully integrated into RM framework
ESG Approach	Communication	Reporting to Board as part of existing governance approach (no separate forum or KPIs for ESG)	Reporting to Board as part of BAU updates on business progress (no separate forum for ESG)	Sets up ESG governance forums and KPI's to communicate and report back to key stakeholders

Management should make an active choice on what their ambition is and how they are going to deliver on it. They must execute these changes and transform, rolling out chosen strategic initiatives backed by the support of strong leadership. To ensure success, management should set targets, and track and report these back to stakeholders. Those that perform best will be those that most closely align strategy to ESG ambition, as this enables them to meet stakeholder needs while creating value. As the regulatory landscape and stakeholder demands continue to evolve, management should regularly review and update their strategy and policies.

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