Principles for Responsible Investment

BRINGING TOGETHER SOVEREIGN DEBT INVESTORS AND INDEX PROVIDERS

UN environment programme | finance initiative

United Nations Global Compact

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

THE SIX PRINCIPLES

PREAMBLE TO THE PRINCIPLES

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

1 We will incorporate ESG issues into investment analysis and decision-making processes.

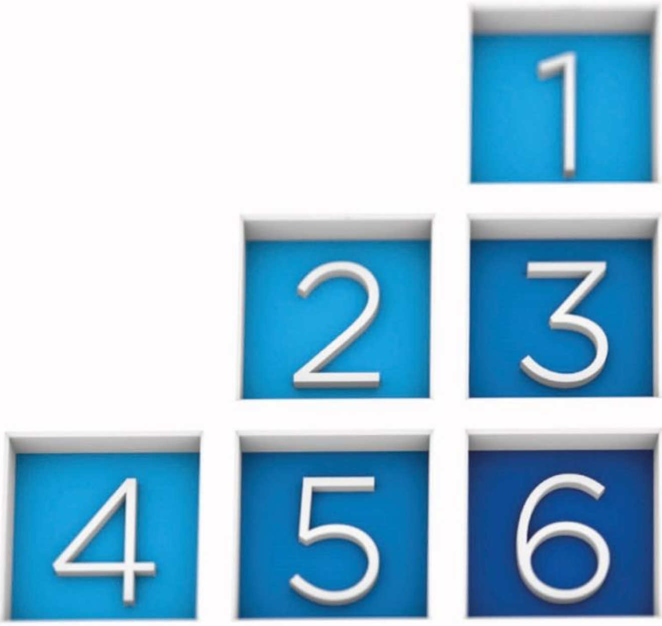
2 We will be active owners and incorporate ESG issues into our ownership policies and practices.

3 We will seek appropriate disclosure on ESG issues by the entities in which we invest.

4 We will promote acceptance and implementation of the Principles within the investment industry.

5 We will work together to enhance our effectiveness in implementing the Principles.

6 We will each report on our activities and progress towards implementing the Principles.



PRI'S MISSION

We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

INTRODUCTION

Indices play an important part in shaping investment decisions, whether investors use active or passive strategies. Investors seeking to incorporate environmental, social and governance (ESG) factors are therefore paying increasing attention to the growing number of ESG indices. In the sovereign debt market, constructing such indices can present unique challenges and opportunities compared with corporate indices. To explore these factors and better understand the building blocks of such indices, the Principles for Responsible Investment (PRI) convened a group of sovereign bond investors and six index providers in November 2021 (see Figure 1).

Figure 1: Workshop participants

Index providers[1]	
Bloomberg	JP Morgan
FTSE Russell	MSCI
Intercontinental Exchange (ICE)	Solactive
Investment organisations[2]	
Amundi	Manulife Investment Management
AP2	Neuberger Berman
BlueBay Asset Management	Ninety One
Colchester Global Investors	Nordea Asset Management
Danske Bank Asset Management	PIMCO
Fim Partners	QIC
Franklin Templeton	Robeco
GAM	Western Asset Management
Global Footprint Network	William Blair
Lazard Asset Management	

The workshop was a unique opportunity to engage collaboratively, as meetings between index providers and investors often take place on a bilateral basis. It gave the investors an opportunity to ask questions of different providers at the same time, while the index providers could better gauge how investor demand is evolving. Participants appreciated the opportunity to discuss nascent issues with a range of peers.

[1]The hyperlinks are to the webpages containing ESG and sustainability indices offered by the providers who attended the workshop.

[2]Some of the participating investors were also members of the PRI's sovereign debt advisory committee.

To facilitate an open exchange and mutual learning, the discussion was held under the Chatham House Rule and in respect of antitrust rules, with participants reminded not to disclose sensitive topics from a commercial perspective.

KEY THEMES FROM THE DISCUSSION

1) **ESG incorporation and sovereign bond indices – P.4**
   ESG indices are increasingly available to fixed income investors and are piquing the interest of sovereign bondholders.

2) **Conventional (non-ESG) indices versus ESG indices – P.6**
   Given the limited universe of issuers, ESG sovereign debt indices are typically constructed using a tilting approach rather than exclusion, which is more common for corporate indices.

3) **Data and methodology – P.7**
   When choosing data, index providers weigh considerations including timeliness, objectivity, reliability, cost and control. When constructing climate indices tied to countries' emissions, providers have several options; indices based on climate policies are difficult at present.

4) **Engagement with issuers – P.9**
   Index providers do not engage regularly with sovereign issuers, but increased communication could benefit providers, investors and governments.

5) **Next steps – P.10**
   Index providers have scope to broaden the range of ESG sovereign debt indices they offer; meanwhile, investors should be clearer about why they are using indices.

ESG INCORPORATION AND SOVEREIGN BOND INDICES

Index providers design and calculate broad market indices then license (sell) the right to use their designs and calculations to investors for funds and products. Providers set the rules that decide which securities to include in an index, how the index is managed, and how securities will be added and removed from the index over time. Indices are used for passive products (where the index is replicated as closely as possible) or as a benchmark for active products to measure relative performance. They can be developed for multiple asset classes, including equities and fixed income.

Indices tracking the fixed income market are generally limited to issuers or securities meeting certain characteristics, based on factors such as:

- Type of issuer (for example corporate, sovereign or government-related)
- Credit quality (high yield or investment grade)
- Maturity (short or long term)

ESG indices, meanwhile, normally derive from parent, non-ESG indices, with modifications made to factor in ESG criteria. However, the data and methodology (for example whether to exclude securities or tilt their weighting) used to construct ESG indices can vary, with important implications for asset allocation.

ESG indices were originally conceived for equity investors, with the first dating back to 1990 and focusing on US companies.[3] But they have expanded to cover other asset classes and regions since then and the suite of fixed income indices applying some form of ESG criteria or methodology is growing.

Index providers have broadened the range of tailored fixed income ESG indices that they offer in response to different investor objectives and preferences. Where possible, for commercial reasons, they seek to encompass common interests among different investors, resulting in semi-customised indices.

[3] See MSCI KLD 400 Social Index.

“Each client has their own idea and wants to differentiate from others. Customisation is part of ESG.” – Index provider

ESG indices are not the only way to incorporate ESG factors in investment decisions. Active investors using traditional indices as benchmarks may outperform by incorporating ESG factors they believe are not adequately priced. However, ESG indices can be used as a starting point for active management or for passive strategies (which are less common in fixed income than in equity). These indices are particularly useful where investors’ ESG choices and constraints create so much divergence that comparison with traditional benchmarks is inappropriate.

CONVENTIONAL (NON-ESG) INDICES VERSUS ESG INDICES

During the workshop, index providers and investors discussed how index products are constructed. When deciding to launch an ESG sovereign index, providers shared that they make decisions on at least three main criteria (see Figure 2).

Figure 2: Criteria for index construction

Criteria	Examples of different options
Factors	■ Focused on a single ESG factor ■ Including multiple ESG factors (with providers deciding on factor weights)
Scope	■ Blended (corporates and sovereigns) ■ Focused on labelled bonds ■ Themed, e.g., climate
Composition	■ Excluding or screening countries ■ Tilting, e.g., assigning bonds a greater or smaller weighting relative to traditional indices

"In the future, a bigger part of the labelled bond market will perhaps be sustainability-linked bonds. Navigating that space and coming up with something credible could be worth exploring." – Investor

The more limited universe of sovereign debt issuers, compared with the corporate market, makes a screening approach harder for sovereign indices without constraining diversification. Therefore, providers often prefer to use a tilting approach, although some clients may desire hard exclusions.

DATA AND METHODOLOGY

The index providers explained that there are also specific data and methodological considerations that need to be weighed when designing ESG indices. The main ones mentioned were:

Coverage and time series: The availability and timeliness of data across issuers affect which ESG factors an index can take into account. For the purposes of back-testing, the more historical data on the ESG factors, the better. Yet data may be lacking for some countries, particularly in emerging or frontier markets.

> "The more historical data the better. Coverage, particularly in emerging markets, is important." – Index provider

Reliability and objectiveness: The data series used to construct the index need to be updated regularly and not go out of production. Providers also need to have confidence in the objectivity of the data.

Costs: Open-source data (such as that provided by the World Bank or the Social Progress Index) is free but may have limitations, such as time lags and data gaps. Some index providers have the advantage of being part of wider organisations that are also ESG information providers (i.e., they collect and sell ESG data through a different division), and for them using in-house data may be cheaper.

Control: Using in-house data can bring more methodological clarity, consistency and control for providers. However, opting for third-party datasets offers more choice and may be aligned with what clients use.

Eligibility criteria to enable replication: Effective indices need the underlying bonds to be liquid, facilitating the trading needed to replicate the index. Furthermore, providers set caps and thresholds on factors such as credit ratings either at an issuer or bond level. For ESG indices, such restrictions may need to be eased to avoid limiting the investable universe too much. In particular:

- The standard minimum issuance size for bond inclusion may be too high for some ESG labelled bonds.
- The liquidity of sovereign bonds is often a function of the amount of a government's outstanding debt, which can give indices a bias towards larger issuers.

CLIMATE-FOCUSED SOVEREIGN DEBT INDICES

Trade-offs on data and methodology are apparent when building climate indices. Index providers can choose between different ways to measure emissions.[4] Production-based (or territorial) emissions data accounts for all emissions generated within a country's borders. In contrast, consumption-based emissions data is adjusted for trade (i.e., emissions better reflect where products are consumed).

Production-based data is often used when countries report and set targets for emissions; as such, indices using this metric are aligned with how issuers assess their emissions. However, consumption-based data captures "carbon leakage" (e.g., where highly regulated countries import carbon-intensive products from countries with less stringent regulations) and so may be a better gauge of a country's contribution to emissions.

For index construction purposes, emissions can also be weighted by GDP or other factors, but this can pose challenges. First, if GDP or another denominator changes rapidly from one year to the next, index constituent weights can fluctuate significantly. Second, weighting by GDP gives richer countries greater room to emit carbon, raising questions of fairness.

Investors asked providers about plans to build indices based on climate policies, which could reflect the trajectory of a country's emissions and its exposure to transition risk. But providers observed that many policies are yet to be implemented, with the targets far off on the horizon, making measurement of progress difficult. In addition, for the purposes of constructing a climate policy index, providers highlighted the following challenges:

- It can be difficult to find the right numerical measure: for example, simply counting the number of policies a country has introduced is not likely to be an effective way to measure commitment.
- Policies can change from one year to the next when a new government takes office, causing volatility in the metric used.
- The response to climate change does not come from central government alone. The provider would also have to decide how to incorporate responses from the private sector and sub-national administrations.

[4] See Our World in Data (October 2019) How do CO2 emissions compare when we adjust for trade?

ENGAGEMENT WITH ISSUERS

When asked by participating investors if they engaged with sovereign entities, index providers replied that they do not routinely communicate with government bodies.

They highlighted some challenges: finding the right person or department to engage with on ESG-related matters, and retaining independence (i.e., avoiding the risk of a government receiving favourable treatment if it is more conducive to engagement).

"We seek consistent sources of data and have to maintain strict independence." – Index provider

Investors themselves face some of these challenges when engaging with sovereigns, as the PRI highlighted in previous work.[5] Yet they observed that engagement between index providers and sovereigns could be beneficial on a number of levels, as it could:

- improve information disclosure, helping with the construction and maintenance of ESG indices.
- spur issuers to improve their performance on ESG criteria in order to be included in indices. This would in turn increase structural demand for their debt and reduce their funding costs.

[5] See PRI (2020) ESG engagement for sovereign debt investors.

NEXT STEPS

Despite the proliferation of ESG indices, they remain lacking for sovereign bonds, which comprise around half of the global bond market.[6] Demand is evolving quickly as investors seek to consider new ESG factors, incorporate existing ones more comprehensively, and adapt to new regulations such as the European Union's Sustainable Finance Disclosure Regulation (SFDR), which requires them to show the extent to which their investments consider ESG factors. Other regulations are directed at index providers themselves, such as those relating to the EU labels for benchmarks and benchmarks' ESG disclosures.

INDEX PROVIDERS

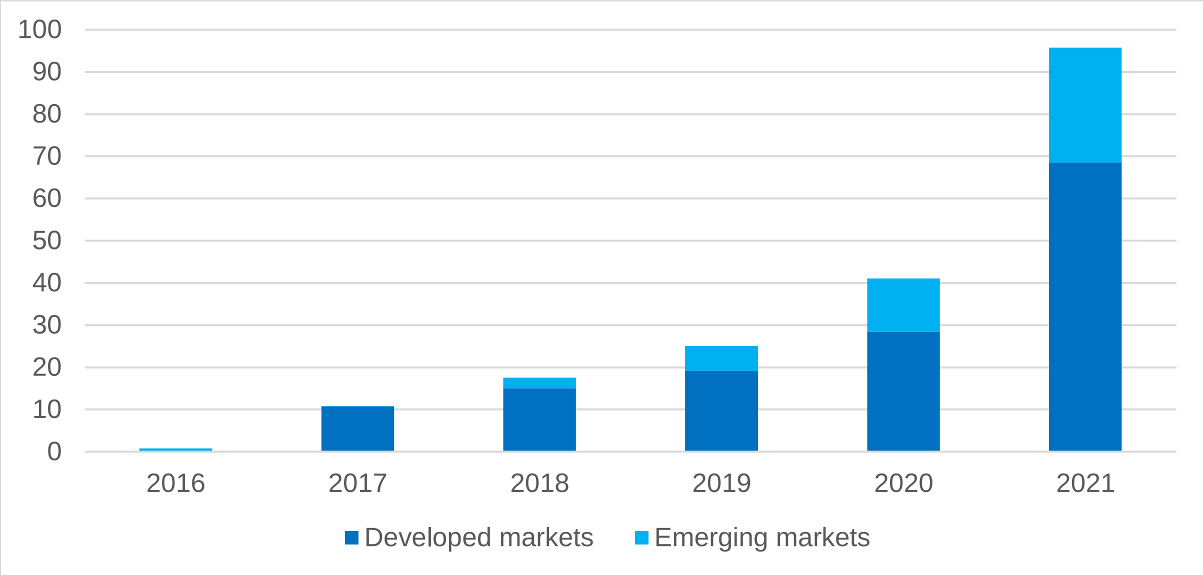
Investors acknowledged the challenges in ESG index construction that providers face but maintained that providers have scope to be more thoughtful and creative in how they incorporate ESG criteria. As sovereign issuers adapt to investors' growing expectations on ESG factors, and as the ESG labelled bond market continues to expand, this scope is likely to increase.

Investors suggested that providers could focus on the following:

- **Adapting to evolving demands for thematic ESG indices**. For example, these could better capture a country's progress in meeting the UN Sustainable Development Goals (SDGs) or meet investors' specific environmental or social goals (such as protecting biodiversity or human rights). In doing so, they should also take into account the starting point of a country because that may affect its ESG performance trajectory.
- **Developing more indices for labelled sustainable sovereign bonds**. Many sovereigns have now issued green bonds, making indices based on these more feasible. In the future, there may be enough issuance of other types, like social bonds or sustainability-linked bonds, to create a wider array of labelled sovereign indices (see Figure 3). Index providers could ease liquidity requirements to allow more securities to be included in these indices.

[6] See International Capital Market Association Bond Market Size (as of August 2020).

Figure 3: Issuance volume of sovereign green, social and sustainability bonds (US$bn). Source: Climate Bonds Initiative*



*In 2016 there was $800m of issuance from emerging markets and none from developed markets.

- **Exploring creating indices aligned with ESG regulations**. Sovereign debt investors are trying to find ways to meet emerging ESG regulations and norms. In Europe, SFDR, sustainability preference requirements under the Markets in Financial Instruments Directive (MiFID) and the taxonomy for sustainable activities are increasing the need to align with standards. Other jurisdictions are looking to develop sustainable finance regulations too. Most regulation so far is focused on investments in corporates, or at least is harder to navigate for sovereign debt investors. New ESG sovereign debt indices could help investors match their holdings in this asset class with regulatory standards. In the context of SFDR, investors may be better able to show credible evidence that they are managing their financial products as Article 8 or 9.
- **Engaging with sovereign issuers on ESG topics**. This may not always be possible, but where it is, engagement can help sovereigns understand how they can be included in ESG indices.
- **Ensuring transparency of data and methodology**. This is particularly pertinent when making methodological changes, either due to regulatory changes or because data and best practice change quickly in ESG finance. When proposing methodological changes, some providers seek feedback from investors through opening a consultation process or arranging individual meetings; more should do so. Moreover, they should better explain whether they use third-party data and then apply their own modelling, as this does not always seem clear to investors. Transparency here is additionally helpful for the purpose of SFDR disclosure.

INVESTORS

Provider feedback indicated that investors need to be clear about why they want to use ESG sovereign debt indices. Questions investors should consider:

- Are they seeking an index that outperforms conventional indices by integrating underappreciated ESG factors, or is the purpose of the index to re-allocate capital to countries in order to pursue positive ESG outcomes and avoid negative ones?
- If the latter is true, do they want to reward countries already scoring highly on ESG factors, countries with the greatest potential to score more highly, or countries most in need of funding to tackle ESG challenges?
- Are asset owners prepared to revisit risk and return expectations in order to use an ESG sovereign bond index that may perform less well?

Investors also noted that using an ESG index should not be an excuse to avoid trying to engage with sovereigns where this is possible.

Within the investment chain, asset owners have a unique role to play in incorporating ESG factors. If they use an ESG index (standard or customised) to track performance, they give asset managers greater scope to consider these factors.[7]

THE PRI

The PRI will continue to use its convening power to bring together sovereign debt investors, asset owners, consultants and index providers in order to foster ongoing dialogue and move the market forward. It is also broadening the outreach to ESG information providers, whose offerings can help investors and index providers alike. The workshop format allows participants to discuss common challenges and opportunities in a more comprehensive way than during standard bilateral client meetings.

Beyond these stakeholders, we will also explore opportunities to bring sovereign issuers themselves into the conversation.

[7] See PRI case study (November 2021) AkademikerPension: Responsible investment in sovereign bonds for an example of active asset management against a customised index that excludes sovereign issuers on human rights grounds.

The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

United Nations Global Compact

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 8,800 companies and 4,000 non-business signatories based in over 160 countries, and more than 80 Local Networks.

More information: www.unglobalcompact.org