PRI Principles for Responsible Investment

UNEP Finance Initiative
Changing finance, financing change

United Nations Global Compact

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

FIXED INCOME INVESTOR GUIDE

PUTTING RESPONSIBLE INVESTMENT INTO PRACTICE IN FIXED INCOME

KFW

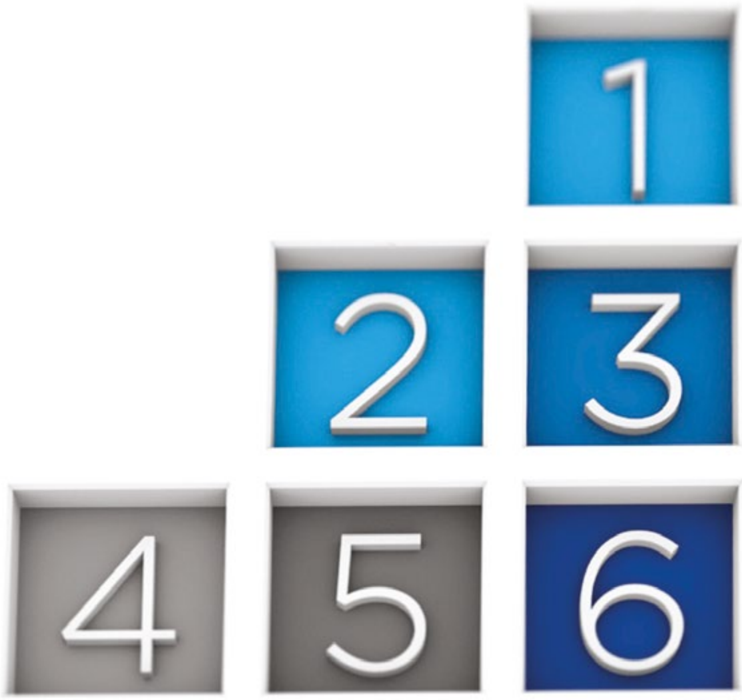
Union Investment

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.**



This publication is intended to promote the application of Principles 1, 2, 3, and 6 of the Principles as they relate to fixed income investing. The PRI Initiative was launched by the United Nations in 2006 after former UN Secretary-General Kofi Annan brought together a group of the world's largest institutional investors, academics and other advisors to draft a set of sustainable investment principles.

DOCUMENT CREDITS

This document was written by Archie Beeching, manager of the PRI's Fixed Income Work Stream. It has been compiled with support from Tomi Nummela, senior manager – listed assets (PRI), an external consultant and a number of PRI signatories listed below. Work stream strategy and planning for this project has been supported by members of the PRI Fixed Income Steering Committee.

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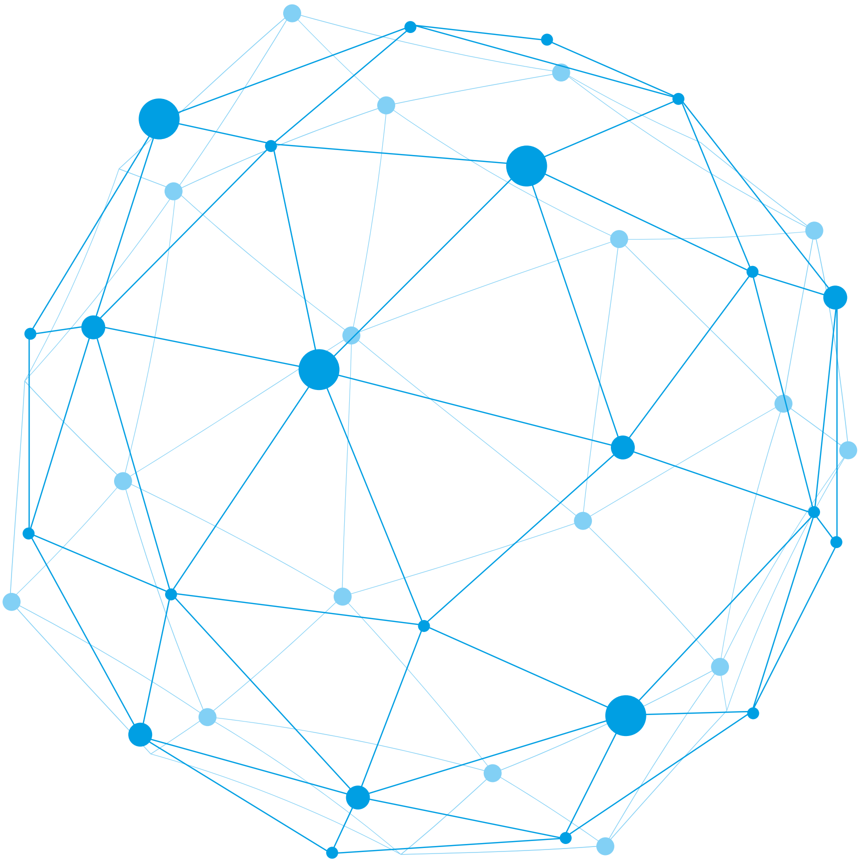

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Fiona Reynolds,
Managing Director, *PRI*

A WORD FROM OUR DIRECTOR

The essence of investment management is the management of risks, not the management of returns. This mantra, popularised by Benjamin Graham, the father of value investing, rings especially true for fixed income investors, who are focused on minimising downside risks and preserving capital within their portfolios. Following the financial crisis, investment returns are more closely linked to a manager's ability to protect value, and there is much greater awareness of how ESG factors can manifest themselves into material risks that undermine creditworthiness.

Awareness is only a first step however. All of the PRI's work is geared towards providing investors with practical guidance on how to implement the Principles in each asset class so they can take action, and this guidance document is no different. Drawing on leading practices from our global network of signatories, we believe it is the first time comprehensive examples of investors implementing responsible investment within fixed income has been gathered in one place. We hope more examples will follow from other signatories over the coming months.

I hope it will equip asset owners in particular with the information they need to make responsible investment the norm in this asset class. Each section includes a series of considerations we believe pension funds should be asking their managers to ensure they have confidence in their approach, and a new module dedicated to fixed income in the PRI's Reporting Framework will also provide a wealth of information that investors can use.

Releasing this guide has been a collaborative effort and I would like to thank all of the signatories and supporters who have contributed to its development.

Fiona Reynolds

Archie Beeching,
Implementation Support Senior Manager – Fixed Income, *PRI*

PRI FIXED INCOME PROGRAMME

The PRI's Fixed Income Work Stream remains one of our most popular. Over 200 representatives from more than 60 organisations have been actively involved since its inception in 2011. Its popularity is testament to the huge appetite for knowledge on responsible investment in an asset class that dominates most pension fund and insurer portfolios. Investors also face increasing pressure from clients and beneficiaries to demonstrate exactly what responsible investment looks like in fixed income.

Three years after its launch, we are starting to see real results from this programme. This guidance document is the latest in a series of activities to help signatories implement the Principles across asset classes, and builds on our 2013 discussion papers exploring how ESG issues are relevant to fixed income performance and the links between ESG and creditworthiness (Corporate Bonds: Spotlight on ESG risks and Sovereign Bonds: Spotlight on ESG Risks).

The next phase of our work will be to help investors engage with debt issuers on ESG issues and explore the role credit rating agencies can play to help investors integrate ESG. I encourage you to get involved.

SPONSOR FOREWORD

KFW BANKENGRUPPE & UNION INVESTMENT

The dynamics of risk and return are changing for fixed income investors. Consequences of the financial crisis still have significant impacts on capital markets, making fixed income investing increasingly complex. What are the implications? Analysing traditional key performance indicators is no longer enough for determining issuers' creditworthiness. In addition, a wide range of previously neglected criteria must now be incorporated. While institutional investors are trying to develop a broader understanding of risk, as yet, no widely accepted standard has been established. At the same time, new opportunities have arisen to finance the transition towards a more sustainable economy, the emerging green bond market is just one of these.

This is where responsible investment comes into play. As long-term supporters of the PRI and chairs of the PRI's original Fixed Income Working Groups, Union Investment and KfW Bankengruppe recognise the fundamental role that responsible investment must play in managing the assets entrusted to us. As prudent investors, we consider a broad range of factors that may impact the risk and return profile of the investments we make, now and in the future. In this context, the importance of environmental, social and governance (ESG) issues is increasing – simply because both clients and market conditions call for it. Analysing ESG factors and how these are likely to affect the credit profile of the issuers we invest in helps us make a more comprehensive assessment of the investment merits of an issuer.

We have already implemented many of the approaches outlined in this guidance document within our own portfolios and ESG analysis is now a part of our risk management framework and investment policies. Our goal now is to foster discussions that will help the PRI establish best practices and set the standard for responsible investment across the industry.

It is still early days for responsible investment in fixed income. But awareness and demand for a more holistic approach to analysing ESG issues in fixed income is increasing, as the calibre of the organisations that have contributed to the PRI's work in this area will attest. We are proud to support the launch of this guide and are grateful to the PRI and our fellow signatories for their leadership and contributions.

It has been a truly collaborative effort by numerous individuals and organisations from around the world and we would like to thank everyone involved for their hard work and insights in making it a success.

Dr Günther Bräunig
Member of the Executive Board of KfW Bankengruppe

Jens Wilhelm
Member of the Executive Board / Union Asset Management Holding AG

Dr Günther Bräunig

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MAKING THE MOST OF THIS GUIDE

The PRI prepared this guidance document with two main audiences in mind: first, fixed income investment managers and, second, asset owners such as pension funds and insurers. The intention of producing a 'live document' is to encourage readers to contribute further insights and promote better understanding of RI in this asset class.

ASSET OWNER CONSIDERATIONS
LOOK OUT FOR THE BLUE BOXES!

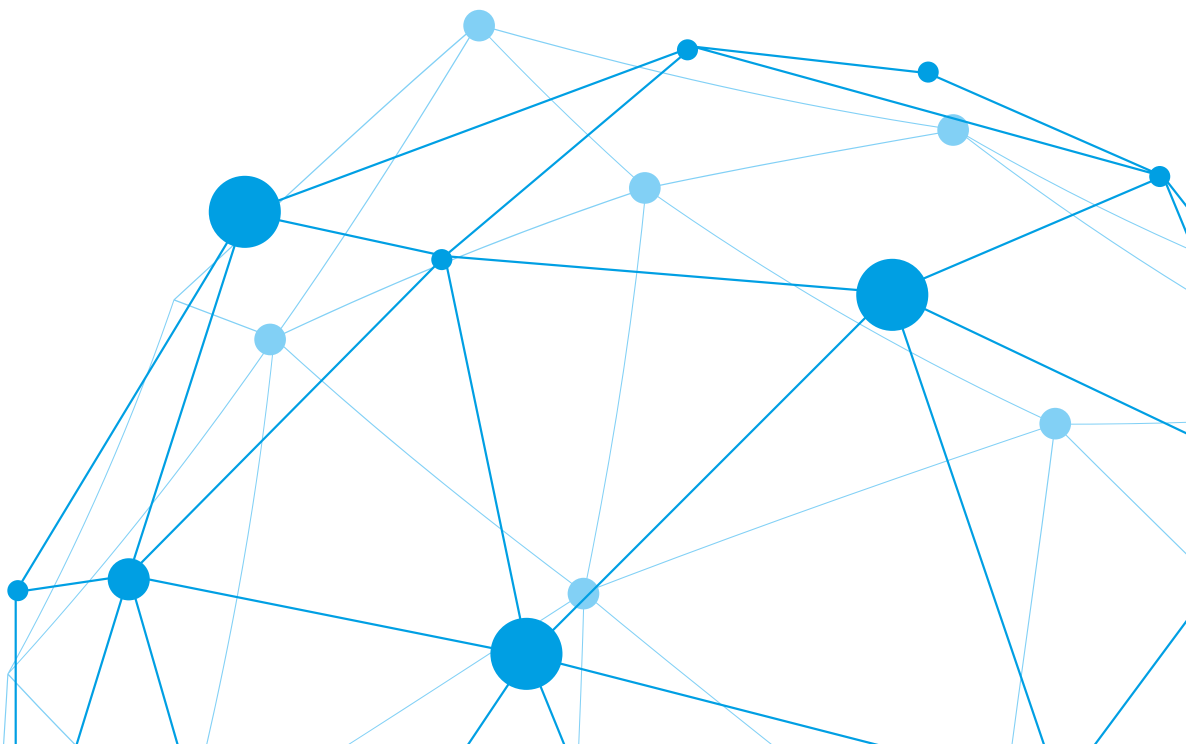
Throughout the document, asset owners will find advice relating to each section. If you work for a pension fund, insurer, sovereign wealth fund or other type of asset owner and want to get more involved, please contact the PRI to ask questions, share your thoughts and share practical examples or case studies.

To get involved, email the PRI here: FI@unpri.org

BE PART OF THE DISCUSSION
LOOK OUT FOR THE ORANGE BOXES!

- Contribute a short case study to share with other investors (review the case studies framework in the Appendix).
- Challenge the material and share innovative ideas.
- Help build a community of fixed income practitioners interested in this subject.

To join the discussion, email the PRI here: FI@unpri.org



EXECUTIVE SUMMARY

This document is intended as a guide for fixed income investors on implementing the Principles for Responsible Investment (the Principles). It draws on desk research, interviews with PRI signatory organisations, the PRI's Fixed Income Implementation Working Group and information disclosed in PRI's Reporting Framework. The document is part of an ongoing stream of work to promote responsible investment (RI) in this asset class. It follows two publications from 2013 that explore links between environmental, social and governance (ESG) factors and creditworthiness.

In producing this document, the PRI has identified a number of fundamental trends that will help investors develop their own style of RI in fixed income. Although this is a relatively new concept for most fixed income professionals, many signatories are putting the Principles into practice, including using ESG analysis in investment decision making and engaging issuers on ESG concerns. As with all asset classes, RI in fixed income is primarily about maximising financial value by managing risks, uncovering opportunities and constructing portfolios that are aligned with the values of clients and beneficiaries.

The document summarises the unique characteristics of fixed income with its various subcategories of issuers and instruments. It helps to explain why fixed income investors should take a bottom-up approach to RI while borrowing from the experiences of other asset classes, such as listed equities.

At the core of this document is an explanation of how investors can integrate ESG analysis into their management of corporate and non-corporate bonds. It explains how to measure various ESG criteria for each of these issuers and how to use this information when making investment decisions, including risk analysis, valuations and screening the investment universe.

While significant investor demand is driving the growth of the green bond market, investors need to develop and demand stricter standards and definitions of 'green' for their investments to have the desired impact. In relation to engagement, bondholders may be relatively unfamiliar with engaging issuers on ESG matters, but many consider it a useful tool for mitigating major ESG risks and aligning issuers with their own values.

It continues to be important for investors to fully embed RI within their organisations' management, research, risk and sales functions, ensuring it is applied systematically and is credible to (potential) clients. It also outlines some of the major challenges that fixed income investors might face when implementing the Principles.

This document was written for asset owners and fixed income managers. It assumes little prior knowledge of the concepts of RI, such as ESG integration and engagement. These are discussed in the context of buy-and-hold investments but apply to investments in secondary markets as well. The document explores a range of issuer types, such as governments, corporations and financial institutions, and it touches on different (listed and private) instruments, including ABS.

INTRODUCTION

Responsible investment is an approach to investment that explicitly acknowledges the relevance of ESG factors and the long-term health and stability of the market as a whole. RI recognises that the generation of long-term sustainable returns is dependent on stable, well-functioning and well-governed social, environmental and economic systems. It encompasses a range of RI approaches, including returns driven, value driven, themed investment and engagement.

"Our objective in the ESG integration process is to uncover non-traditional opportunities and risks that are embedded in companies that we believe exhibit outlier characteristics."

Kim Nguyen-Taylor, Calvert Investments

DEMAND FOR RI IN FIXED INCOME

Motivations for applying RI in fixed income vary from pursuing financial value through the management of risks and opportunities to ethical motivations and reputational concerns. For PRI signatories, it is generally a combination of all three. Figure 1 shows how institutional investors and investment managers can address some of these fundamental drivers for RI.

Figure 1: Drivers and actions for implementing responsible investment.

DRIVER	ASSET OWNER (INDIRECT INVESTOR) ACTIONS	INVESTMENT MANAGER (DIRECT INVESTOR) ACTIONS
	FINANCIAL VALUE **Improving risk management and (long-term) investment outcomes**	
- Capital market impacts of ESG trends (e.g., carbon regulation) - Concentration of ESG risks across all asset classes and instruments - ESG analysis as information advantage - ESG informs due diligence - ESG informs asset allocation/ diversification - ESG as risk-flagging mechanism - ESG as proxy for credit indicators when reliable financial metrics are lacking	- Respond to capital market ESG trends through asset allocation - Consider ESG in asset liability management - Consider ESG competence in selection, appointment and monitoring of FI managers - Seek ESG-related performance attribution from FI managers - Monitor ESG risk concentration within FI portfolios - Engage issuers to mitigate ESG risks	- Ensure competence to analyse ESG risks[1] - Analyse ESG-related investment performance - Integrate ESG into fixed income analysis and pricing models - Understand client needs on ESG - Create funds to specifically address 'E' and 'S' risks and opportunities - Report to clients on management of ESG-related risks - Engage issuers to mitigate ESG risks and gain information
	INSTITUTIONAL DRIVERS	
- Regulation - Soft law – RI codes and standards - Ethical beliefs and social norms - Diverse client needs - Retail and beneficiary demand for ESG-themed investment products - Competition to raise FI allocation and overall FI AUM - Recognition of RI as best practice - Attract and retain staff - Concerns about reputation - Pension holders' and other beneficiaries' concerns about ESG issues - Media scrutiny of institutional investors	- Commit to relevant RI codes - Develop understanding on ESG (from trustees down) - Include ESG screens or watch lists in investment mandates - Consider ESG capacity in FI manager selection, appointment and monitoring - Include ESG screening or themes in investment mandates/fund criteria - Report to beneficiaries on management of ESG factors - Apply screens in mandates for issuers or activities likely to damage reputation - Report to beneficiaries on reputational issues - Engage issuers on ESG factors relating to reputational concerns	- Commit to relevant RI codes - Ensure competence in analysing ESG risks - Develop ESG screens for clients - Develop ESG-themed products - Integrate ESG in risk analysis and controls - Seek issuer disclosure on ESG - Assign responsibility for ESG to senior management and investment staff - Report to clients on ESG process and outcomes - Offer ESG screening to clients - Monitor media feeds for reputational issues - Engage issuers and report to clients on factors likely to affect reputation
	SOCIAL VALUES	
- Ethical motivations of clients and beneficiaries - Ethical motivations of investors - Social norms - Investor mission (e.g., religious organisations, foundations, charities or 'impact' investors)	- Develop exclusion criteria for issuers not aligned with values or breaching social norms - Monitor ESG factors across FI portfolios (e.g., carbon intensity) - Mandate ESG engagement as a tool for managing ethical concerns - Mandate impact investments to address ESG trends - Engage issuers on ESG factors relating to ethical concerns	- Offer ESG screening to clients - Monitor ESG factors across FI portfolios (e.g., carbon intensity) - Develop funds that address common moral concerns - Develop funds that offer positive 'E' and 'S' outcomes - Engage issuers on ESG factors relating to ethical concerns

1 Note – Rather than necessarily avoiding risk, ESG analysis helps investors identify and manage risks and ensure they are appropriately compensated.

APPLYING RI IN FIXED INCOME

Each asset class has unique characteristics that require different approaches to stock-specific analysis and the overall management of portfolios. Investors should tailor their RI approach to meet the requirements of each asset class.

While there is some recognisable crossover between RI as it relates to equities and corporate bonds, there are also technical and cultural differences in the way these asset classes are managed. As a result, fixed income investors are rapidly making RI their own. Figure 2 lists some key characteristics of fixed income and the actions investors should consider in response.

"Nothing has changed fundamentally except for being given more data and a few tools to measure things better – but it is still the same job as before. This is all about understanding and managing risk."

Dominique Kobler, BlueBay Asset Management

Figure 2: Characteristics of fixed income and implications for responsible investment.

CHARACTERISTICS OF FIXED INCOME	RESPONSIBLE INVESTMENT ACTIONS
Potential downside outweighs potential upside – focus is on risk, low volatility and preservation of capital more than on growth opportunities.	Focus on the contribution of ESG factors to financial downside – in particular, significant event risks and systemic risks that can affect issuer creditworthiness. Most prominent of these should be governance.
Lenders have a contractual relationship with borrowers; they are not owners. Debt holders don't vote at AGMs, and access to management can be relatively infrequent.	- To manage risk, use any opportunity to engage issuers on ESG factors of concern (e.g., in run-up to issuance). - Collaborate with other bondholders for more effective engagement. - Vote on governance concerns during debt restructurings.
Multi-layered analysis (e.g., yield spread and yield curve analysis).	Develop robust yet streamlined processes to help analysts identify and manage ESG risks effectively.
Multiple issuer types (e.g., corporate, government, financial sector, and supranational).	ESG analysis varies for different issuers; metrics, criteria weighting and engagement approach vary. There is no one-size-fits-all.
Multiple instruments (e.g., structured products and ABS).	Analyse ESG-related risks to issuer creditworthiness as well as to asset cover pools and originators.
- Debt issued as public or private instruments. - Debt issued as investment grade or high yield.	RI approach varies relative to availability of ESG information, engagement opportunities, investor influence and access to management. Private/ high-yield securities may represent higher risk but offer more opportunity for engagement and outperformance.
Different capital structure levels – senior, subordinated, hybrid etc.	Subordinated debt holders face financial downside before senior debt holders do, making them more sensitive to impacts from ESG risk.
Debt instruments have fixed durations covering different periods.	Consider whether different durations will affect the materiality of ESG to creditworthiness (e.g., will carbon regulation impact three- and ten-year bonds the same?).
Private companies can issue listed/public debt.	Coverage of ESG data for private companies is relatively poor – weaker regulations on reporting for private companies.
Weaker issuing requirements but longer issuing periods for private placements.	Greater concentration of risk for private placements requires closer consideration of ESG risks; a longer issuing period allows for this.
Debt can be issued by subsidiaries and special purpose vehicles (SPV).	Consider exposure and management of ESG risks by parent company, subsidiary and originator.
Multiple outstanding debt securities issued by a single issuer.	Consider concentration of ESG risk related to single issuers across multiple securities.
Fixed income analysis can be heavily reliant on quantitative factors.	Address need for consistent and comparable ESG metrics that are easy 'plug-ins' for existing research models.

"We want people to understand that ESG is part of business evaluation, from a risk perspective as well as from a value perspective."

Inka Winter, Deutsche Asset & Wealth Management

CHARACTERISTICS OF FIXED INCOME	RESPONSIBLE INVESTMENT ACTIONS
Proceeds from issuance can be earmarked for specific projects.	Fixed income is well suited to investment in specific environmental and social 'themed' securities or projects.
In the new issue market, opportunity to analyse securities between marketing and pricing is relatively short.	Fixed income investors need to play the 'long game', investing for long-term outcomes and being consistent in engagements.
Fixed income is one of the largest asset classes in terms of asset owner allocations and market size.	Develop a robust RI approach, and allocate sufficient resources relative to the importance of the asset class.
Fixed income sell-side research is limited relative to equities and does not typically integrate ESG.	Promote and incentivise integration of ESG analysis into fixed income research from brokers to support RI efforts by investment managers.

ASSET OWNER CONSIDERATIONS

- Define your organisation's expectations on which RI approach managers should take in a corporate bond fund versus an emerging market fund or an index linked fund etc.
- Review manager RI policies and responses to PRI Fixed Income Reporting Module.
- Include ESG terms in investment management agreements (IMA).
- Consider ESG in fixed income manager selection, appointment and monitoring.
- Specify ESG needs in fixed income requests for proposal (RFP) and mandates.
- Pay particular attention to managers' understanding of ESG in high-yield and emerging market debt.
- Consider ESG in asset allocation strategy in relation to asset liability management.

To get involved, make comments and ask questions, email the PRI here: FI@unpri.org

Aligning Expectations: Guidance for Asset Owners on Incorporating ESG Factors into Manager Selection, Appointment and Monitoring. We produced this guide to help asset owners who appoint external investment managers. It suggests a framework to include ESG expectations in requests for proposals, questionnaires, monitoring and discussions with managers.

INTEGRATING ESG INTO ISSUER ANALYSIS

In a fixed income context, a key application for ESG information is to inform analysis of issuer creditworthiness. ESG issues, such as corruption or climate change, are potential risks to macro factors that may affect an issuer's ability to repay its debt. Investors stand to benefit by considering these factors as an integral part of their investment philosophy when making decisions on asset allocation, portfolio construction and ongoing investment management.

The fundamental elements of issuer analysis remain the same for all types of issuers.

1. Analyse the issuer's exposure to material risks and their capacity to manage those risks.
2. Understand the financial implications of those risks materialising.
3. Price the risk and determine whether the bond represents good investment value.

ESG analysis can therefore help investors to form an opinion of the value of a bond, identify improving credit stories or differentiate bonds with seemingly similar financial profiles. The remainder of this section covers the integration of ESG into the analysis of different types of issuers.[2]

ESG Integration: The systematic and explicit inclusion by investment managers of environmental, social and governance factors into traditional financial analysis.

GOVERNMENT ISSUERS

While the investment processes for corporate and sovereign bonds may be similar, analysis of company and sovereign creditworthiness is markedly different – most obviously in terms of the criteria assessed. Governance factors such as institutional strength and political risks will have an impact on a sovereign's ability and willingness to repay its debt on time. A country's exposure to systemic environmental risks such as water scarcity, and its resilience to those issues, will also affect economic outputs, borrowing and its ability to attract foreign investment over the longer term. In addition to corruption, investors have identified a number of other ESG indicators that provide greater insight into creditworthiness. For more information on the links between ESG factors and sovereign creditworthiness, see [PRI (2013) Sovereign Bonds: Spotlight on ESG Risks](#).

"It was really the need and desire to strengthen the investment process, capturing the less obvious or quantifiable variables to come to terms with the factors we knew were important but had a very ad hoc approach in rating."

Rob Drijkoningen, Neuberger Berman

Figure 3 shows ESG factors that relate to sovereign credit strength, as identified by the PRI Sovereign Fixed Income Working Group in 2013. In contrast to ESG analysis for listed equities, social factors tend to be given greater weight than environmental factors because of links between political stability, governance and a country's ability to raise taxes or make reforms.

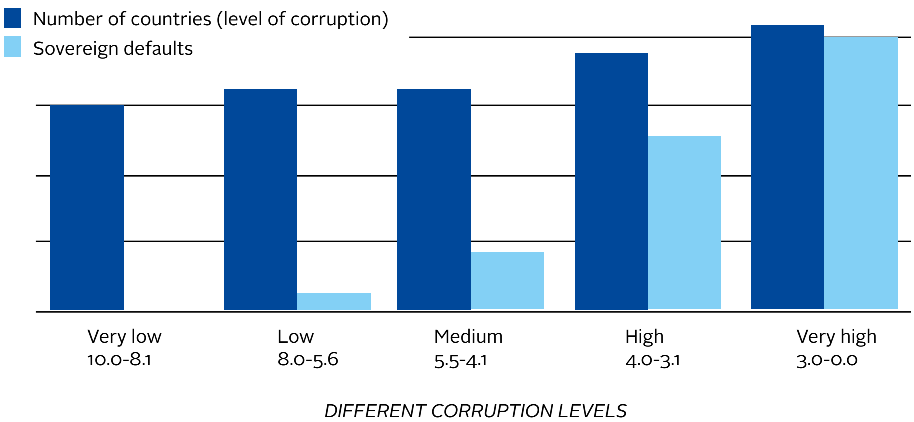
2 The PRI recognises that ESG factors may influence other aspects of fixed income analysis such as interest rate risks. This subject is not covered here, but case studies from readers on other aspects of bond analysis are welcome.

Figure 3: Key ESG criteria for sovereign bond analysis.

ENVIRONMENTAL	SOCIAL	GOVERNANCE
Carbon intensity	Demographics	Institutional strength
Water stress	Education and human capital	Corruption
Energy resources and management	Health levels	Regime stability
Natural disasters	Political and press freedoms	Rule of law
Biocapacity and ecosystem quality	Human rights	Financial reporting
Pollution	Labour standards	Regulatory effectiveness
Biodiversity	Social exclusion	Adherence to conventions
Agriculture	Income inequality	International relations

Union Investment, a German investment manager, assesses corruption as a key indicator of sovereign credit strength because of the relationship between fraud, tax avoidance, financial mismanagement and an issuer's ability to repay its debt obligations.[3] There are strong correlations between corruption and the number of sovereign defaults, as shown in Figure 4.

Figure 4: Corruption levels of 87 countries (Corruption Perception Index) and sovereign defaults since 1970. Source: Union Investment, Transparency International.



"The largest part of our ESG ranking consists of governance variables; it's 60 percent. For example, the political risk variable is very much related to the political regime and how effective that political regime is."

Edith Siermann, Robeco

Figure 5 shows a breakdown of environmental indicators used by French investment manager Oddo Securities' as part of its sovereign credit analysis. Together, these constitute one-third of aggregated ESG scores. Based on performance relative to average ESG score in the group, countries are divided into four categories from 'strong' to 'limited' opportunity. Scores are relative, so they allow investment teams to identify potential investment risks and opportunities. For example, in its 2012 study, Oddo identified Sweden, Denmark and New Zealand as demonstrating the best management of ESG-related risks of all OECD countries. By comparing the relative ESG risks of certain sovereigns, their opportunities to improve those scores and current credit ratings, investors can identify potentially mis-priced securities.[4]

3 Union Investment (2014) Corruption and the Risks of Losses on Government Bonds

4 Oddo Securities (2012) Public debt: Fresh challenges and ESG rating.

Figure 5: Oddo Securities' environmental criteria for governments 2012.

THEME	INDICATOR	SOURCE	WEIGHTING
Agriculture	Food self-sufficiency	FAO	1.0
	Arable land	FAO	2.0
Biodiversity	Endangered species	World Bank	2.5
Climate change/Energy	Per capita energy consumption	World Bank/IEA	4.0
	Per capita CO_2 emissions	World Bank	2.0
	Carbon intensity of growth	World Resources Institute (WRI)	2.0
	Energy mix	International Energy Agency	2.0
Water	Pressure exerted on water resources	Aquastat (FAO)	4.0
	Renewable water resources per capita	Aquastat (FAO)	4.0
Air pollution	Sulphur dioxide emissions	World Resources Institute (WRI)	2.0
Resources	Ecological footprint	Global Footprint Network	2.5
	Forests	Aquastat (FAO)	2.0
	Maritime Exclusive Economic Zone	Flanders Marine Institute (FAO data)	1.5
Transport	Sustainable mobility	Economic Commission for Europe (UN)	2.0
			33.5

DEVELOPING RELIABLE AND COMPARABLE ENVIRONMENTAL INDICATORS FOR GOVERNMENTS

For most sovereign bond investors, developing reliable environmental indicators is a significant challenge. Energy efficiency and natural resource use are commonly applied, but there is no strong consensus on how effective these are as indicators of credit strength.

- The United Nations Environment Programme's Finance Initiative (UNEP FI) is working with NGOs and financial institutions to develop robust environmental indicators based on a ratio of nations' ecological footprint and biocapacity (i.e., availability of natural resources and capacity to assimilate air and other types of pollution). It is assumed that surplus biocapacity is an indicator of long-term creditworthiness and therefore an effective forward-looking indicator for analysts. In 2014, UNEP FI will test this theory with investors to determine whether there is a strong causal relationship between the two.
- French nonprofit RISKERGY aims to develop a sovereign credit rating methodology primarily based on energy resilience. Its mission is to create a more predictive rating methodology that will help investors to address risks related to less energy-resilient countries.

GET INVOLVED

- How does your organisation integrate ESG into government bond investments?
- Can ESG factors provide forward looking insights?
- Which factors give most insight into sovereign credit risk?

To be part of the discussion, email the PRI here: FI@unpri.org

EXAMPLES FROM EMERGING MARKET DEBT INVESTORS

Of those interviewed by the PRI, emerging market debt (EMD) investors gave more weight to ESG factors because of the insights they provide in place of reliable financial indicators. For Rob Drijkoningen, managing director and co-head of emerging market debt at US investment manager Neuberger Berman, becoming a PRI signatory spurred on his team's efforts to develop an internal analytical framework that incorporates material ESG factors alongside economic indicators. Forty percent of its overall sovereign debt score comprises ESG; the remaining 60 percent is based on traditional financial metrics.

It "was fuelled by a desire to have a more structured approach," says Drijkoningen. "We lacked a comprehensive framework on 'soft' factors, which have a huge overlap with ESG criteria." The team started with a list of 40 or 50 indicators and shortened that to 15. It back-tested all of them, looking at a pool of 65 issuers over a 10-year period to find out which were most effective. Figure 6 shows a cutaway of Neuberger Berman's ESG scores for emerging market issuers with energy efficiency used as a proxy for environmental indicators.[5]

Figure 6: Cutaway of ESG scores for emerging market issuers.
Source: Neuberger Berman 2013.

		Environment	Social					Governance								
								Legal			Politics	Economic				
	ESG Score	Energy Intensity	Government Effectiveness	Regulatory Quality	Political Stability and Security	Human Development	Voice and Accountability	Rule of Law	Corruption	Ease of Doing Business	Politics and Election Calendar	Funding Sources	Banking Sector Risk Assessment	Banking Sector Asset Quality	Market Capitalisation	Trade Openness
Hong Kong	85.7	100	84	87.5	66	86.6	60.3	80.7	77	98.9	100	100	80	94.5	99.5	90.9
Singapore	84.9	86.1	93.1	86.5	70.2	85	46.3	83.9	87	99.4	80	100	80	89.5	99.1	90.9
Chile	76.3	96.4	73.5	80.8	59.3	74.2	71.2	77.4	72	81.7	80	85	70	77.8	90.1	59.7
Taiwan	75.3	99.7	73.4	73.3	64.9	86.8	67.5	70.8	61	86.1	90	70	60	96.9	99	84.9
Korea	71.3	42.8	74.6	69.1	53.9	86.9	64.2	70.2	56	95	100	70	70	83.4	94.8	74.4
Qatar	68.5	47.6	66.7	58.8	70.2	76.2	30.8	65.5	68	77.8	70	100	60	82.4	82.5	67.8
Malaysia	67.9	45.9	70	63.2	52.6	67	41.1	60.4	49	92.2	100	90	60	79.4	99.1	89.2
Israel	67.5	87.6	74.1	77	28.4	85.7	63	69.6	60	80	80	60	60	73.6	82.9	50.7

5 Neuberger Berman (2013) ESG Factors in Sovereign Debt Investing.

Turkey is cited as a country with good economic fundamentals but a deteriorating ESG score. “Some of the macro fundamentals have recently improved, but slow growth makes the current account deficit less sustainable, and politics are having an increasingly nasty impact now....that is showing up in how we rate them,” says Mauricio Vargas, economist at Union Investment. Rene Lichtschlag, EMD fund manager with Union Investment, adds, “We saw corruption, rule of law, political stability going south, while movement in the macroeconomic indicators was either neutral or positive. We therefore adjusted our exposure.”

MUNICIPAL ISSUERS

Municipal or local government bonds can be divided into two categories: (1) general obligation bonds backed by tax inflows and (2) revenue bonds backed by revenues from a specific project such as toll roads. The US municipal bond (muni) market is currently at US$3.7 trillion of debt outstanding.[6] The market is considered fairly stable, although default rates have increased considerably since 2008. The bankruptcy of the city of Detroit in 2013 was the largest in US history and served as a wake-up-call for many city employee pension funds.[7]

The analysis of munis shares characteristics with corporate credit analysis; this applies for ESG analysis as well. For both general obligation and revenue bonds, governance and social factors will affect the issuer’s ability to raise revenues from taxes or other types of income. Important environmental criteria include the carbon intensity of a state’s energy production and the quality of public infrastructure such as wastewater treatment plants.

US-based Breckinridge Capital Advisors manages investments in corporate and muni bonds. It says the risk of default in the municipal bond market is higher when public opinion on a project is ambivalent with regard to public infrastructure such as stadiums and housing. Peter Coffin, president at Breckinridge, says, “The more focused a project is on something that’s core to the government’s providing for the education, health care and well-being of its citizens, the safer the bond is”.[8] Breckinridge integrates ESG analysis to help determine the ‘essentiality’ of a municipal project or issuer, the expected support of the community and the quality of the issuer’s governance practices. Local unemployment rate, median household incomes and constituent education levels are used as indicators of long-term creditworthiness in this model.[9]

SHARE A CASE STUDY

Can you provide a case study on integrating ESG into government or municipal bond investments?

Please review the case studies framework in the appendix, and email FI@unpri.org

“Argentina has over recent years persistently understated inflation levels. In fact, this issue dates back to 2007, when just as a sharp increase in inflation due to medical insurance was widely anticipated, data was unexpectedly withheld and the Board of the National Statistics Office replaced overnight – in itself raising clear governance concerns. During visits to the country, it has become abundantly clear to us that inflation is being considerably understated. As a result, we have applied a higher risk premium to Argentinian debt securities.”

Colonial First State Global Asset Management, Responsible Investment and Stewardship Report (2013)

6 Securities and Exchange Commission (2012) State of the Municipal Securities Market.

7 Moody’s (2013) Moody’s Announcement: Moody’s: Municipal bond defaults have increased since financial crisis, but numbers remain low.

8 Fischer, M.S. (2013) An SRI Bond Filter. Financial Advisor Magazine 7 March 2013.

9 See: Breckinridge (2012) A Sustainable Approach to Fixed Income.

SUPRANATIONAL ISSUERS

Supranational organisations, such as the World Bank and the European Bank for Reconstruction and Development, regularly issue bonds to finance sustainable development–related projects and businesses. These organisations are considered relatively low risk and typically issue investment-grade bonds. As a result, ESG analysis on supranationals tends to be more focused on their use of proceeds than on the creditworthiness of the issuer itself. Supranational issuers act very much like banks in the way that they finance their projects, typically with long-term loans, by issuing bonds.

ESG analysis will give investors additional insights into these projects and help to ensure that issuers interests are aligned with those of the investors in these bonds. Many of these investments are made in emerging market economies where regulatory frameworks and transparency may be poor and certain risks less obvious as a result. In these cases, investors should ensure that the issuer has the capacity to identify and manage ESG risks, for example, by following the IFC's Performance Standards or the Equator Principles. The list below contains more details on themed bonds issued by supranationals .

CONSIDERATIONS FOR ANALYSING SOVEREIGN, MUNICIPAL AND SUPRANATIONAL ISSUERS

- ESG factors can inform fundamental sovereign credit analysis, internal credit ratings and, ultimately, bond prices.
- ESG 'scores' or 'ratings' can be used to differentiate issuers and inform diversification.
- Single internal credit ratings that combine ESG and macro analysis will ensure portfolio management does not ignore key ESG risks.
- ESG information on governments is available from UN bodies, the OECD, CIA World Factbook, Transparency International, the World Bank and similar organisations.
- ESG factors play an important role in emerging market debt analysis where financial reporting may be unreliable.
- Share ESG analysis between corporate and government bonds teams in relation to country risk, credit rating ceilings, ESG macro trends and areas of emerging regulation.
- Consider different economic development stages of countries because developing countries tend to have lower ESG ratings but may improve faster than developed countries.
- Local government ESG risk and government risks do not necessarily correlate and should be analysed separately.
- ESG analysis can inform investors on the essentiality of municipal projects and identify risks to specific revenue sources.

CORPORATE (NONFINANCIAL) ISSUERS

CORPORATE ESG ISSUES

Corporate governance factors (e.g., a company's accountability, risk management and director independence) can have strong links to credit strength. Corporate scandals linked to fraud and bribery frequently lead to punitive fines, loss of licence to operate and greater scrutiny from regulators. Conversely, well-managed companies tend to be more aligned with bondholder interests, while corporate transparency keeps bondholders better informed of exposure and management of risk.

Social issues, such as poor health and safety standards or community relations, can also affect creditworthiness if poorly managed. Strike action and productivity have a significant impact on operations. In addition, if governments introduce further regulation to address environmental trends such as climate change, then certain sectors are likely to experience rising operation costs and falling demand for carbon-intensive products or activities, particularly in energy production and coal mining.[10] For more information on the links between ESG factors and corporate credit risks, see PRI (2013) Corporate Bonds: Spotlight on ESG Risks.

Analyses of governance factors such as remuneration and financial auditing are common among bond investors, but few systematically integrate a wide range of ESG factors into credit analysis. Of the 322 investors who completed the PRI's Fixed Income Reporting Module in 2014, 13.5 percent indicated that they apply ESG integration into their actively managed corporate fixed income investments.[11] This is unlikely to be representative of the industry as a whole, given PRI signatories' commitment to ESG integration.

ANALYSING CORPORATE EXPOSURE TO ESG-RELATED RISKS

Figure 7 shows examples of key criteria considered in ESG analysis for corporate issuers. The materiality of different ESG factors depends on the sector the issuer operates in. Investors either determine their own ESG indicators and scores for each issuer or source information from external research providers.

Figure 7: Examples of ESG criteria analysed for corporate issuers.
Source: PRI Corporate Fixed Income Working Group (2013).

ENVIRONMENTAL	SOCIAL	GOVERNANCE
Environmental	Demographics	Business integrity
Climate change	Human rights	Shareholder rights
Biodiversity	Employee relations	Incentive structure
Energy resources and management	Health and safety	Audit practices
Biocapacity and ecosystem quality	Diversity	Board independence & expertise
Air pollution	Customer relations	Fiduciary duty
Water scarcity and pollution	Product responsibility	Transparency/accountability

10 Standard & Poor's (2014) Carbon Constraints Cast a Shadow Over The Future of the Coal Industry.

11 See PRI Reporting and Assessment for more details. The PRI's Fixed Income Module is currently a voluntary requirement but will become mandatory for PRI signatories in October 2015.

INTEGRATED ANALYSIS: LESSONS FROM LISTED EQUITIES

ESG integration may be a new concept to many in fixed income, but it is relatively well established among equity investors. Basic similarities between corporate bonds and listed equities provide opportunities to share some of the lessons already learned, particularly for those investing in hybrid fixed income securities such as convertible bonds.

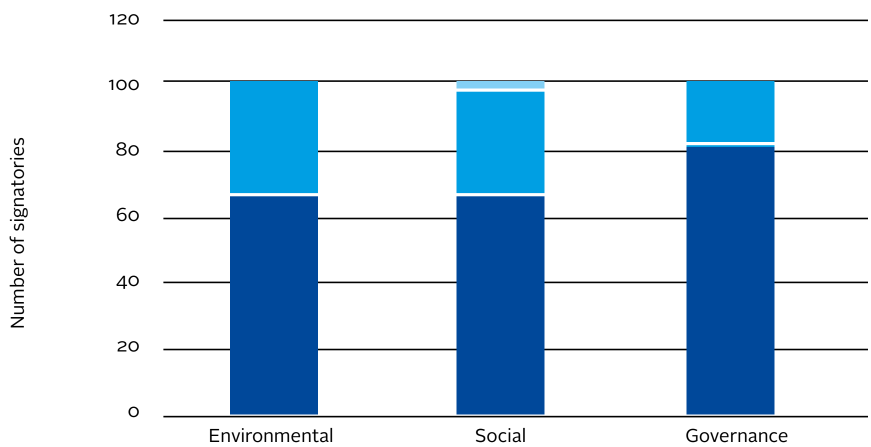
In the PRI's Integrated Analysis document, PRI signatories demonstrate different ways to integrate ESG analysis into economic and industry analysis, company strategy, financial reports and valuation tools for equities. Case studies show how ESG factors are fed into the analysis of growth forecasts, consumer preferences for retail companies, operating costs for utilities, pharmaceutical litigation costs and brand value estimates.

See PRI (2013) Integrated Analysis: How investors are addressing environmental, social and governance factors in fundamental equity valuation.

APPLYING SECTOR WEIGHTING TO E, S AND G FACTORS

Having decided which ESG criteria to integrate into credit analysis, investors need to measure and weight them as part of an aggregated ESG score or rating. Most agree that governance should be weighted most heavily, as these factors relate more closely to management quality and overall creditworthiness. There is little consensus on the importance of environmental and social measures, as these can vary by sector. Figure 8 shows how frequently PRI signatories consider ESG factors in corporate bond analysis.

Figure 8: How PRI signatories analyse E, S and G factors. Source: PRI Reporting Framework.

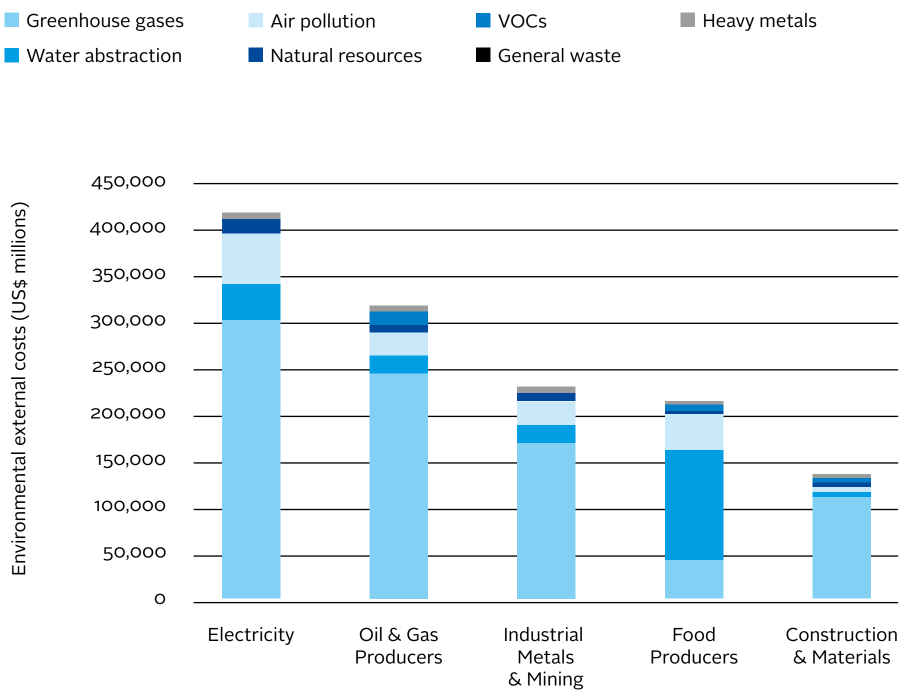


	Environmental	Social	Governance
Never	0	2	0
Occasionally	35	33	21
Systematically	67	67	81

Different ESG lenses should be applied to different business sectors. While governance is universally important, environmental issues such as water stress are only likely to be material for certain sectors, such as extractives, food and beverage, and agricultural companies. For airline companies, fuel efficiency may be a key environmental and financial metric. A carbon-efficient issuer is less likely to be susceptible to fuel price volatility. If fuel costs rise, the issuer will be under less pressure to cut other costs to preserve revenues. In addition, a less carbon-intensive airline fleet will typically fare better under possible future carbon regulations. Cathy Roy, CIO at Calvert Investments, says that its analysis "shows that airline companies with younger, more energy-efficient fleets have higher appraised values and thus perform better on collateral coverage metrics in enhanced equipment trust certificate deals", thereby making for a more attractive long-term investment proposition.

Figure 9 shows external environmental costs for different sectors, assuming a continued trend in regulations to mitigate or 'internalise' certain external costs. Companies that are not in a position to address these risks may experience higher operating costs or other financial penalties and may be considered less creditworthy as a result.

Figure 9: External environmental costs for different sectors.
Source: Trucost and PRI, April 2011.



"Five or six years ago we decided to weight each indicator by sector. For example, we weight the social part higher than the environmental part for banks, whereas for energy companies it would be the other way around."

Christoph Klein, Deutsche Asset & Wealth Management

FOCUS ON ENVIRONMENTAL ISSUES

The Environment Agency Pension Fund (EAPF) provides pensions for employees and former employees of the UK Environment Agency. It works with its corporate bond manager Royal London Asset Management (RLAM) and ESG research provider Trucost to monitor the total environmental footprint of its corporate bond fund. Integrating this information into the EAPF's and RLAM's investment decisions helps account for financially material environmental risks and determine environmentally sustainable investments. EAFP says that "RLAM have found the analysis useful in identifying bonds that are linked to high impact activities and, where practical, replacing them in the portfolio where another bond can meet

"We think about issues like pollution and ask, 'which companies have a solution'? Valeo [a French automotive manufacturer] is a good company because it offers weight reduction and stop-start technology for cars and offers ways to reduce CO2 outputs. So we see it increasing market share as demand increases for these types of products."

Marc Briand, Mirova

"I think integrating ESG is one of the most powerful things investors can do. Putting a price tag on ESG factors using a market mechanism will provide the right incentive structure over time for the corporate sector to deal much more consciously and strategically with ESG issues. If we don't change behaviour, we don't change much."

Manuel Lewin, Zurich Insurance

"The process for unlisted investments is very different as opposed to buying a listed bond – this could take a few months before a transaction is approved. In-depth analysis is conducted, so the analyst has a lot of insight into the company."

Angelique Kalam, Futuregrowth Asset Management

the same portfolio needs but with less impact." In 2012 the fund's environmental footprint was 23 percent lower than its benchmark, the broad-based iBoxx index.[12]

FOCUS ON HIGH-YIELD

High-yield issuers by nature, are more susceptible to impacts from ESG risks. Issuers tend to be smaller; many are private companies and, therefore, do not have to report the same information or operate to the same standards. They are more likely to have unconventional governance structures that may be misaligned with creditor interests. As a result, quality of governance is even more central to the process of determining creditworthiness. In addition, investors should focus on an issuer's capacity to survive low-impact/high-frequency events – for example, how chemicals manufacturers manage exposure to industrial accidents via health and safety standards or how a mining company manages the risks of possible shutdowns due to industrial action.

FOCUS ON PRIVATE PLACEMENTS

Private placements are tradable debt securities issued to a relatively small and select group of investors. Private placements do not have to be registered with the US Securities and Exchange Commission (SEC), but the market is regulated by the North American Insurance Commissioners (NAIC). The US$50 billion private placement market is dominated by insurance companies aiming to match insurance liabilities with shorter-term bond issues. These investors tend to take a buy-and-hold approach because the market is relatively illiquid. Credit ratings for privately placed bonds are issued after the bond is issued, and the average issuance period is 12 weeks. Most issues range from US$100 million to US$1billion.

These key characteristics mean that private placements are particularly well suited to a responsible investment approach that is quite distinct from normal corporate bonds.

- Relatively poor transparency, the lack of divestment options and relatively large ticket sizes require thorough investor due diligence.
- Longer issuance periods allow investors to engage issuers and identify ESG risks before committing to invest.
- Investors can also use ESG concerns to negotiate with issuers on coupons due to the relatively close relationship between both parties.
- Investors can take up the opportunity to impose disclosure and reporting requirements to more precisely address ESG concerns.

GET INVOLVED

- Which sectors do you consider to be at the highest risk from ESG factors? How does ESG analysis inform your investment decisions?
- Do you invest in high-yield bonds or private placements? Can you share a case study to show how you treat ESG factors as part of your due diligence process?

To be part of the discussion, email the PRI here: FI@unpri.org

12 Environment Agency (2012) Active Pension Fund: Fundfare 2012.

Key considerations for corporate bond investors

- Assessing governance risks can limit surprises, such as sudden or aggressive changes to financial policy, management structure and short-term incentive plans.
- Develop a bottom-up approach for addressing ESG risks to corporate creditworthiness and leverage crossover where it exists with equity research teams.
- ESG integration should be considered an important aspect of any fixed income investing.
- Identify material ESG risks relative to sector by narrowing down larger lists and back-testing.
- Apply sector-specific weights to determine overall ESG score or rating.
- When will an ESG factor be material? Consider changes in materiality for different durations.
- Conduct ESG analysis on subsidiary and parent company.
- Consider disclosure in bond prospectuses and covenants as part of governance analysis.
- Consider ESG analysis as a possible tool to identify relative value trades.
- Private placements provide significant opportunities for ESG integration and engagement and for investors to manage ESG risks.
- Corporate bonds are subject to 'event risk', which can show up as a regulatory, litigation or reputational liability to the company.
- Responsible investment in high-yield bonds shares more characteristics with equity investing – greater risks but more engagement opportunities.

FINANCIAL SECTOR ISSUERS AND ABS

In recent years, investors have become increasingly sensitive to the potential financial impacts of risk management failures, malpractice fines and banks' ability to meet new regulatory standards. These issues also present reputational risks, making the investments in bonds issued by some banks less attractive. As both lenders and issuers, banks are exposed to ESG-related risks directly and through their balance sheets. The direct risks to issuer creditworthiness are primarily governance related and, to a lesser extent, linked to customer and community relations. Looking at indirect banking risks is more complex.

To assess direct governance risks relating to banks, investors should consider organisational culture and how they might manage their balance sheet exposure to ESG risks. For example, they may consider whether the bank has a strong whistle-blower policy or risk controls. They may also consider whether it advises on aggressive tax avoidance schemes or how its financial incentives are structured. As with the defence, industrial, pharmaceutical and extractives sectors, corruption is a key indicator when assessing financial sector risk. Employee relations indicators, such as staff turnover rates, are also important to consider. Does the issuer proactively disclose these issues to investors?

To analyse indirect exposure to ESG risks, investors need to review issuer balance sheets. A telling indicator will be whether a bank proactively discloses its exposure to key ESG risks such as corruption or carbon-intensive industries like the coal sector. Another indicator could be the proportion of loans given to certain demographics that might exacerbate over-indebtedness.

"That's part of the challenge in high yield. You're not going to see as much public disclosure due to limited resources and transparency due to the privately held structure of many of these companies. We've done some internal back-testing where we've compared the CDS [credit default swap] spread behaviour of a universe of top and bottom ESG performing companies across various leverage thresholds, over an extended timeframe. We generally observed that ESG efficacy was greater in companies with higher leverage. We also observed that those companies that did not disclose any ESG data tended to underperform companies with low ESG scores. This could imply that a lack of transparency is consistent with an even lower ESG profile."

Kim Nguyen-Taylor, Calvert Investments

"We review all our financial issuers as part of our annual counterparty review. They're reviewed based on five criteria, where ESG risk is one important component. The overall score determines how much trade we allocate to a specific counterparty. The ESG risk assessment typically attracts the most attention when feedback is given to each counterparty."

Yen Wong, Colonial First State Global Asset Management

"We're not investing in additional Tier 1 fixed income bonds at the moment in banks because we feel that the FX litigation could impact some of the returns."

Bryn Jones, Rathbone Investment Management

ASSET-BACKED SECURITIES

Investors are just starting to consider how to analyse ABS from an ESG perspective. ESG analysis of ABS needs to capture risks relating to the originator of the securities, the servicer and the 'cover pool' of assets, respectively. Originators approach ESG analysis in the same way corporates do. Investors should also consider how ESG factors might affect the financial sustainability of 'asset pools' or standalone projects covering the security, such as auto loans and mortgages.

COVERED BONDS

Covered bonds predominantly finance residential mortgages and public sector loans. As with ABS, investors should consider ESG risks relating to the issuer and the sustainability of the assets themselves. For example, as energy prices rise and new regulations on energy efficiency are introduced, older properties are likely to become less valuable. Investors can analyse the energy efficiency of a property portfolio in relation to standards such as the UK's Energy Performance Certificate (EPC) or the Leadership in Energy & Environmental Design (LEED) certification program in the US.

Key considerations for financial sector issuers and asset-backed securities

- ESG analysis for financial sector issuers should focus on governance, risk management, business culture, IT safeguards, whistleblowing provisions and compliance of individual banking units as well as the issuer as a whole.
- If a bank seizes a defaulted issuers' assets, it also takes on its liabilities, which may include fines, ongoing legal costs and environmental clean-ups.
- Financial sector issuers can show their commitment to managing ESG-related risks by reporting exposure to ESG risks on their balance sheet and implementing environmental policies or proprietary ESG frameworks.

SHARE A CASE STUDY

What criteria do you use to analyse balance sheet ESG risk for financial sector issuers?

Please review the case studies framework in the appendix, and email FI@unpri.org

FURTHER CONSIDERATIONS FOR ESG INTEGRATION

PASSIVE INVESTMENTS

Passive fixed income funds play an increasingly important role in institutional portfolios, but very little research has been done on the role of ESG in passive fixed income funds. This is an important subject for future consideration. Below are some initial considerations.

- Investors require new indices to manage passive ESG funds that incorporate ESG analysis. As investor understanding of ESG or sustainability varies and is subjective, some investors may not agree with methodologies applied in indices that integrate ESG factors.
- Aggregated indices that apply negative screens will understandably be considered as niche because accepted ethical values and social norms vary by sector.

- ESG-tilted indices will help fixed income investors develop passive funds that integrate ESG, focusing on environmental and social themes.
- One key opportunity for fixed income investors is to replicate an index in a passive fashion while making weighting changes to reduce overall ESG risk in a portfolio.

INTEGRATED BOND INDICES

In 2013, Barclays and MSCI co-produced a new family of rules-based fixed income benchmark indices that reflect three different ESG incorporation strategies:

1. ESG-weighted indices use ESG ratings and ratings momentum to adjust index weights within an existing Barclays index.
2. Sustainability indices use sector-specific positive ESG screens to adjust weights.
3. Socially responsible indices (SRI) apply ESG screens to exclude certain issuers.

ESG INTEGRATION – FOCUS ON DURATION AND TERM RISK

Duration is infrequently considered in responsible investment, but in a fixed income context timelines are particularly important. Investors interviewed by the PRI had mixed opinions about the links between ESG and creditworthiness. Different ESG factors will present greater risks over different time periods. In the short term, investors face a greater threat from the fallout of low-frequency, high-impact events such as extreme weather or industrial disasters. Beyond 15 years, ESG trends, such as demographic changes and climate change, are likely to have a significant impact on bond yields, but the extent of this is not yet clear. While there may be little difference between ESG analysis for three- and five-year bonds, there is a stronger argument for duration-weighted ESG analysis between two- and ten-year bonds.

ISSUER REPORTING AND BOND DOCUMENTATION

Debt prospectuses open with 'Introductions and Warnings' and also include a 'Risk Factors' section in which the issuer lists possible risks to creditworthiness. These statements vary across sectors and regions, but it is very rare that they mention ESG-related risks in any jurisdiction. Some companies, particularly energy utilities, include risks relating to carbon regulation. Items where ESG factors may be relevant to an issuer include risks arising from the volatility of commodity prices, regulatory and political risks, legal risks, and risks to continuity of business activities.[13]

Bond covenants protect the interests of the borrower and lender in any dispute about terms. When an issuer violates a bond covenant, it is considered to be in technical default, which will most likely affect future credit ratings. It is common for covenants to specify that the issuer provides regular financial statements to the investor and places limits on the proportion of debt it holds relative to income. It is feasible that bond covenants could also include clauses requiring an issuer to conform to certain norms, such as following the Global Compact standards.

"Our goal, in terms of ESG risk assessment for banks, is to understand the balance sheet ESG risk or their indirect exposure in their loan book or lending practices. The ESG research that's out there measures the banks' direct exposure, i.e., their resource consumption or emissions output, but not the risks investors need to know about like the bank's exposure to climate change through its loan book and financing activities."

Yen Wong, Colonial First State Global Asset Management

"Some environmental litigation risk could be ten years down the road. That's an example of where an ESG-related headline could present an attractive buying opportunity in a short-dated bond, say three to five years, but discourage us from going out to ten years in a name."

Cathy Roy, Calvert Investments

13 In 2012 the European Federation of Financial Analysts Societies (EFFAS) suggested issuers apply a broader definition of operational risk to encompass issues such as the impact of "significantly tighter environmental protection requirements" in the automotive industry or the impact of rising oil costs on carbon-intensive sectors. See EFFAS (2012) Minimum Standards for Bond Communications.

"Our relative value framework is predicated upon our belief that ESG factors are most influential on spread performance for companies that exhibit combined outlier fundamental and ESG characteristics, i.e., an overweight stance on companies with both an improving fundamental and ESG profile, and an underweight stance on companies with both a deteriorating fundamental and ESG profile. Therefore, we believe that ESG factors may not affect spread performance when a company's strong (weak) ESG profile is juxtaposed against a weak (strong) fundamental profile."

Calvert Investments, Transparency Report 2014

RISK FLAGGING, WATCH LISTS AND TRAFFIC LIGHT SYSTEMS

Red flags, watch lists or traffic light systems are all effective ways of quickly and effectively highlighting particular ESG-related concerns to investment staff. Issuers with a combined ESG score (or specific ESG indicator) below a pre-set threshold are allocated a red flag, or stop, in the investment process to ensure that credit analysts or portfolio managers are aware of the risks involved. The system works both ways; analysts may identify a bond they consider undervalued given the issuer's exceptional ESG score, although the focus should primarily be on risk.

Ultimately, red flags may prompt a number of different outcomes. At a minimum, they should encourage deeper analysis of the reasons behind a particular concern or failing. Analysts may then be required to justify their preference for that issuer. Poor ESG scores may prompt investors to engage an issuer for more information or to reduce their overall credit rating. This may cause managers to change their opinion on pricing and, ultimately, buy or sell a bond and adjust its weighting in a portfolio. All of these approaches ensure that investors consider ESG systematically rather than in an ad hoc fashion.

INFORMING BUY/SELL/HOLD AND PORTFOLIO WEIGHT DECISIONS

Persistently low ESG scores due to significant risks may ultimately lead an investor to divest from a bond or decline future issues. As an alternative to divestment, a portfolio manager may use ESG analysis to inform their weighting decisions, tilting these in favour of companies that represent better value according to ESG analysis.

ASSET OWNER CONSIDERATIONS

- Assess ESG risk concentration at portfolio and fund levels (via investment managers).
- Review manager integration policy and approach: Are analysts and PMs incentivised to integrate ESG? Is their ESG data verified? Do they have sufficient resource for this?
- Use ESG information to inform asset allocation and diversify bond portfolios. Simple ESG ratings will help asset owners to spread risk across fixed income portfolios to optimise financial, environmental and social value.
- Engage issuers together with investment managers to enhance transparency and gain ESG information.
- Consider exposure to ESG risks via passive bond funds. Can investors actively replicate these with ESG-adjusted portfolio weights to mitigate major risks?

To get involved, make comments and ask questions, email the PRI here: FI@unpri.org

ESG SCREENING

Fixed income investors apply ESG filters or screens to their investment universe to control which issuers or securities are considered for investment. This is an effective way of ensuring their investments are aligned with their (client's) ethical motivations and reduces reputational risks.

Figure 10 below shows some of the typical criteria applied by fixed income investors to screen different types of issuers.

Figure 10: Screening criteria for different types of issuers.

SCREENING APPROACH	CORPORATE CRITERIA	GOVERNMENT CRITERIA	FINANCIAL SECTOR CRITERIA
Ethical/reputation screens	Revenue derived from: - Tobacco - Controversial weapons - Nuclear energy - Pornography - Arms - Gambling - Alcohol - Animal testing	- Adherence to international standards on human rights and environmental issues (see below) - Use of capital punishment	- Financing or ownership of business activities listed under corporate criteria (on left) - Origination of ABS financing business activities listed under corporate criteria (on left) - Predatory lending - Aggressive tax avoidance schemes or consultancy
Norms, standards and international laws	- Illegal activities - Export controls - International Labour Organisation conventions - UN Global Compact Standards [14]	- Trade embargoes - US, EU, UN sanctions - ILO conventions - Human rights conventions - Montreal Treaty - Kyoto Protocol - World Governance Indicators - Ottawa Treaty (anti-personnel mines) - Convention on Cluster Munitions (CCM)	- Export controls - Whistle-blower policy - Regulatory compliance - Community Reinvestment Act (US) - IFC Performance Standards - Equator Principles - International sanctions

There are three common types of ESG screening:

1. Negative/exclusionary screening: The exclusion from a fund or portfolio of certain sectors, companies or practices based on specific ESG criteria
2. Positive/best-in-class screening: Investment in sectors, companies or projects selected for positive ESG performance relative to industry peers
3. Norms-based screening: Screening of investments against minimum standards of business practice based on international norms

PRACTICAL EXAMPLES OF SCREENING

Below we summarise some examples of ESG, norms-based and positive screening for different types of issuers:

CORPORATE

Screening can be applied universally across all assets or to specific mandates or funds. Many investors have developed ethical, 'green', socially responsible or SRI bond funds that apply ESG screening.

GOVERNMENT

Other than the standard screens that investors may apply by region or credit rating, some investors apply positive screening for countries or ESG screens to exclude countries that do not comply with certain criteria, for example signing human rights treaties.

14 See United Nations Global Compact (2014) The Ten Principles.

"We can exclude some issuers from our investment universe that are out of line with our promise to clients. The portfolio managers decide, among what is left, the financial and ESG risk that they are going to take."

Thomas Kjaergaard, Danske Capital

- Investment manager Danske Capital screens its government bonds universe based on the World Bank's Worldwide Governance Indicators (WGI). It excludes lower-scoring countries except for cases where bond financing will clearly help to improve those scores.
- When applying screening, sub-nationals, local governments and government agencies should be considered separately from the countries in which they operate.

FINANCIAL SECTOR

- KfW Bankengruppe excludes banks that own more than 10 percent of companies operating in sectors on the IFC Exclusion List. The same process is applied for ABS originators.
- The US Conference of Catholic Bishops (USCCB) "will not deposit funds in a financial institution that receives less than a 'satisfactory' rating from federal regulatory agencies under the Community Reinvestment Act" (CRA).[15] This CRA is a federal law aimed to encourage lending that meets the needs of the communities in which banks operate.[16]

KEY CONSIDERATIONS FOR SCREENING

- Determine what proportion of a company's revenue derived from a screened activity or sector would qualify an issuer for exclusion.
- Ensure that the ESG data on which screening is based is robust and reviewed regularly.
- Consider possible implications of screening, such as portfolio concentration, for smaller investment universes (e.g., G7 government bonds).
- ESG risks typically flow down from parent company to subsidiary, special purpose vehicle or project, and so screening should relate to parent companies first.
- Screening may be an effective 'last resort' to an ongoing engagement process to influence ESG management by issuers.
- Concepts of positive screening based on environmental performance and environmental themed investing are essentially interchangeable.

15 United States Conference of Catholic Bishops (2003) Socially Responsible Investment Guidelines

16 Community Relations Act (12 U.S.C. 2901).

ENGAGING ISSUERS ON ESG

Engagement is common practice among shareholders as a way of discovering ESG information and influencing a company's governance or sustainability. It is less common among fixed income investors, undoubtedly due to a lack of voting power and the position they hold in capital structures. Nonetheless, debt and equity holders both stand to benefit financially from successful engagements as ESG-related risks are mitigated and opportunities maximised. In this chapter, we explore key aspects of engagement with different types of issuers.

Engagement: Interactions between investors and current or potential investees on ESG issues. Engagements are undertaken to influence (or identify the need to influence) ESG practices and/or improve ESG disclosure.

PRACTICALITIES OF ENGAGING ISSUERS ON ESG

WHY ENGAGE?

- To source ESG data.
- To identify and measure credit risks that are otherwise difficult to evaluate
- To gain a better understanding of how an issuer is managing, or plans to manage, ESG risks
- To influence how issuers manage exposure to major risks
- To influence standard terms and content of bond documentation such as covenants

WHO SHOULD CONDUCT ENGAGEMENTS?

Depending on whether the engagement is conducted to gather ESG information or to influence issuer behaviour:

- Fixed income analysts
- ESG analysts
- Portfolio managers
- Internal engagement specialists
- External service providers

HOW CAN INVESTORS PRIORITISE ENGAGEMENTS AND ENGAGEMENT RESOURCES?

Engagement can be resource intensive, so it is important for investors to prioritise engagements based on:

- Relative ticket sizes in an individual bond or total volume of holdings
- The severity and materiality of the ESG-related risks involved
- ESG concerns where investors expect to have the most impact[17]

WHO TO ENGAGE?

Corporate-focused engagements can be addressed to senior management staff such as chief financial officers, legal, investor relations, health and safety and corporate responsibility staff.

Government-focused[18] engagements vary considerably depending on the scale of the investor, the engagement opportunity and the issuer's willingness to meet with investors. PRI signatories have stated that they engage government officials,

"We look at ESG integration in conjunction with, for example, our engagement approach. We really see upside in companies that improve on ESG criteria. It's very interesting to see where positive changes are being made that are not discounted yet in the value or the spread of a company."

Edith Siermann, Robeco

17 Details on investor engagements currently managed by the PRI can be found on the PRI's website. This includes research on specific topics such as fracking, water risks and employee relations.

18 There is a fine line between engaging and lobbying government officials or influencing public policy. Some investors consider engagement with government issuers as either impossible or inappropriate. Publically available examples of engagement with sovereign issuers are rare. In 2013 NEI Investments, a holder of CA$415 million of Canadian government debt, published an example of an engagement letter to the Canadian Sustainable Development. The letter both supported sovereign policies that address sustainability challenges and expressed concerns about Canada's use of natural resources in light of these challenges.

“Namibia is a relatively well-rated country, but about 82 percent of its electricity comes from high-polluting power stations in Zimbabwe. Our portfolio management team met with their grid operator, Nam Power the local utility – those are the people we need to talk to and say, ‘are you open to green energy?”

Michael Schneider, Deutsche Asset & Wealth Management

“From the government perspective, I think the ability to speak with debt management agencies, debt management officers, public officials on the ground and as well as via conference call – that’s when you get heard.”

Rob Drijkoningen, Neuberger Berman

“We feel, and our empirical research has shown, that we want to engage with countries to the greatest extent possible and incorporate ESG as part of the risk premium that you assign to a country so it’s fully embedded in the overall investment process by which we rate and rank countries.”

Bryn Jones Rathbone Investment Management

including senior management from treasury departments and government agencies (e.g., the US Environmental Protection Agency), debt management offices and export credit agencies.

HOW AND WHEN TO ENGAGE?

Upstream. Although the window for engaging issuers upstream is often small, it is also the time when bondholders can have the greatest influence. Investors can engage pre-issue during fundraising road shows and corporate book builds. PRI signatories typically engage via phone calls, emails, letters, and in person at conferences and during investor round tables.

Downstream. Post-investment, the relationship between bondholder and issuer becomes a contractual one and ESG considerations are unlikely to be a part of that contact. However, investors do retain some influence as potential future investors depending on their size. They should therefore consider engaging at quarterly meetings, in response to financial reporting, in conjunction with shareholder meetings and during country visits (with corporates and governments).[19]

ENGAGEMENT AS CARROT OR STICK?

For longer-term or buy-and-hold style investors, engagement isn’t just about correcting faults; they should also encourage best practices via engagements. In some cases, investors may share knowledge from across their portfolio to support better management of ESG risks to help this process. Solveig Pape-Hamich, vice president at KfW, says, “firstly, we can tell them, ‘we would have liked to invest more into your bonds, but we were not able to for sustainability reasons.’” Marion Marinov, senior manager of asset allocation, adds, “the best ones get a letter as well. We tell them, ‘we really like the fact that you have good sustainability performance, but you might be overtaken next month when the others improve.’”

SHARE A CASE STUDY

- Are you successfully engaging issuers as a bondholder? What makes your engagements successful, and what are the challenges?
- Is it appropriate for sovereign bond investors to engage?

Visit the Fixed Income page on the PRI website to read existing case studies.

WHAT MAKES ENGAGEMENTS SUCCESSFUL?

- Engagement is a ‘long game’; fixed income investors will build credibility with issuers by being consistent in their engagements and monitoring their progress over time. Successful engagements will typically last at least one year.
- The effectiveness of engagements will depend on the strength of the relationship between the issuer and investor. This, in turn, depends on originators, whether the investor purchased the bond directly from the issuer or another investor, and the proportion of a bond that the investor holds. Other variables include current market demand, issuer credit quality and region.

19 New online platforms allow bondholders to contact each other anonymously by signalling their interest in engaging a particular company. Until now, they have been used almost exclusively in cases of corporate liability management or debt restructurings, but this could present an opportunity for more collaborative engagement on ESG.

- Overloading issuers with enquiries about ESG may be counterproductive. Ensure that questionnaires are succinct, and source data from ESG research providers where possible.

FOCUS ON COLLABORATIVE ENGAGEMENT

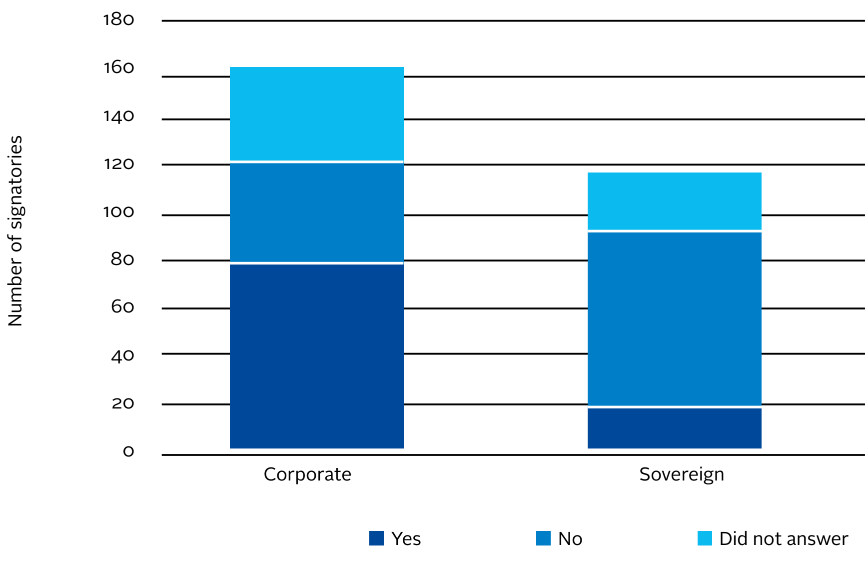
Collaboration helps investors increase their influence and avoid duplication of efforts when trying to manage ESG-related issues. Groups of investors can share important feedback from these engagements in order to improve their understanding of ESG-related risks. Aside from engaging companies and local government issuers, investors may also engage more broadly with regulators, banks, credit rating agencies and other stakeholders. The PRI Investor Engagements team actively supports 15 priority engagements, while the PRI Clearinghouse platform allows signatories to post engagement topics that others can join.

"Meetings with corporate issuers also tend to be a good source of information for the sovereign analysis. The sovereign team gets a lot from their meetings when sovereign ESG issues are discussed. If they don't have an answer on ESG risks, that's also very telling"

Gorky Urquieta, Neuberger Berman

PRI signatories indicated that they engage with corporates more than with sovereigns, although rates for the latter are still surprisingly high. Figure 11 below shows how corporate and sovereign bondholders responded to questions on engagement as part of the PRI reporting framework (2013–2014).

Figure 11: Proportion of PRI signatories engaging with issuers on ESG management.



CONSIDERATIONS FOR INVESTORS ON ENGAGEMENT

- Most bondholder engagements happen in conjunction with in-house equity teams, but bondholder-only engagement directed to different personnel may add to investor influence.
- Bondholders can use the PRI Clearinghouse Platform as a way of collaborating with others to increase their collective influence.
- Engagement should be considered an essential risk management tool by passive investors due to the lack of options to screen for or integrate ESG.

- Build strong relationships with issuers by being consistent on engagement approaches.
- Focus resources on high-risk sectors and larger holdings.
- Engage both leaders and laggards to raise minimum standards across sectors.
- Set clear goals for engagement outcomes, and monitor progress throughout the process.
- Support relevant engagement (or stewardship) codes or directives.
- Consider whether engagement becomes part of normal investment decision making and monitoring or a distinct activity with its own framework and objectives.
- Report on engagement activities and outcomes directly to clients and beneficiaries.
- Green bond road shows and investments provide opportunities for investors to engage on environmental concerns and align issuer activities with investor values.

ASSET OWNER CONSIDERATIONS

- Engage issuers to protect against financial downside of ESG factors including external audit process, transparency, risk management etc.
- Engage issuers to mitigate reputational risks or manage ethical concerns.
- Engage alongside investment managers to increase influence.
- Join asset owner coalitions to collaboratively engage issuers or sectors.
- Encourage collaborative engagement by multiple fixed income managers.
- Include engagement outcomes in manager monitoring.
- Encourage information sharing and collaboration between equity and fixed income managers for greater influence.

To get involved, make comments and ask questions, email the PRI here: FI@unpri.org

THEMED INVESTMENT

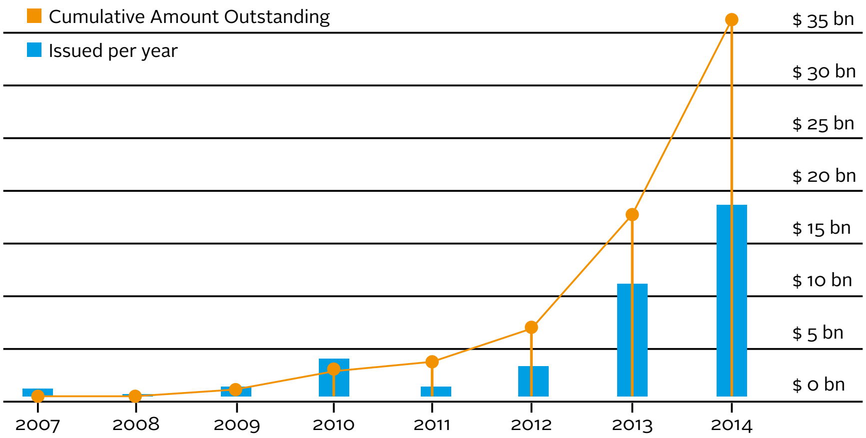
Institutional demand for investment products that deliver both attractive returns and more sustainable outcomes is higher than ever. This guide is predominantly focused on the investment process, while themed investments are considered investment products. Nonetheless, green bonds are seen by many as a way of addressing ESG risks such as climate change and water scarcity. In this section, we explore different types of 'themed' fixed income and explain some of the key considerations around them to ensure investors are aware of the issues involved.

Environmental and social themed investment: Investment in themes or assets specifically related to sustainability (for example clean energy, green technology or sustainable agriculture).

OVERVIEW OF THE THEMED FIXED INCOME MARKET

Themed bonds or ABS are mostly issued by corporates, banks, and supranationals, such as the World Bank, but they are also issued by national agencies and local authorities or municipals. Proceeds are most commonly allocated to renewable energy projects, such as wind farms, or cleaner forms of public transport. ABS may be securitised against solar power installations. Depending on how themed bonds are classified, the outstanding debt in this market totals between US$36 billion (labelled green bonds) and US$502 billion ('climate themed' bonds market).[20] Of the larger estimate, US$358 billion has been designated to finance carbon-efficient transport, while US$75 billion has been allocated to renewable energy development. In 2013 the majority of these bonds by volume were issued by corporate nonfinancial issuers, closely followed by supranationals. Figure 12 shows the growth of green bonds issuance from 2007–2014.

Figure 12: Growth of green bonds issuance 2007–2014. Source: Climate Bonds Initiative.



The market for green bonds can be broken down in a number of different ways. The summary below includes examples of different types of themed bonds and recent issues.

20 Climate Bonds Initiative and HSBC (2014) Bonds & Climate Change 2014.

"People are becoming more aware of ESG issues, but also they're aware of the fact that you can get those ESG or ethical restrictions in place in your fund without giving up an investment return."

Bryn Jones, Rathbone Investment Management

"The simplicity of the product is a key driver right now. The question of energy transition is one that everybody has in mind...it raises awareness about these topics within the financial community."

Tanguy Claquin, Crédit Agricole Corporate and Investment Bank

ENVIRONMENTAL AND SOCIAL THEMED BONDS

PROJECT BONDS AND REVENUE BONDS[21]

Project bond funds are allocated to specific projects, such as the construction of wind power stations or offshore transmission. (For example, in 2013, Brookfield Renewable, a Canadian renewable energy producer, issued a BBB-rated CA$450 million, 17-year bond to finance a 166MW wind farm.) Themed revenue bonds are typically issued by states, municipalities or government agencies to finance income-generating projects such as public transport systems.

GREEN LABELLED USE OF PROCEEDS BONDS

Use-of-proceeds or asset-linked bonds are labelled as green by issuers. Rather than allocating proceeds to a discrete project, funds are ring-fenced for future investments that qualify as green (as defined by the issuer). For example:

- **Corporates**: In 2014, French multinational electric utility GDF Suez issued an A– rated EUR2.5 billion bond linked to both renewable energy and energy efficiency projects.
- **Financials**: In 2014, UK-based Lloyds Bank issued an A rated £250 million four-year ESG bond designed to support a variety of environmental and social projects relating to agriculture, regional growth, health care and regional SME lending.[22]
- **Agencies and local authorities**: In 2013, Norwegian government funding agency Kommunalbanken issued an AAA rated US$500 million three-year bond that will be used to discount interest loans to Norwegian municipal projects relating to climate change mitigation.

SECURITISED GREEN BONDS

Securitised green bond payments are backed income from loans or leases on green asset portfolios or pools such as solar panel installations. (For example, in 2014, Toyota Financial Services, the leasing company of the Japanese carmaker, issued A/A– US$1.75 billion ABS, maturing in three tranches from six to eight years, to finance loans and leases for Toyota's hybrid range of cars.)

CLIMATE-THEMED INVESTMENTS

Climate-themed bonds come under the broader definition of bonds issued to raise capital for climate change solutions, such as low-carbon transport systems and revenue from energy efficient products.

SOCIAL THEMED BONDS

There are a number of themes other than climate change that may be linked specifically to bond proceeds. Social housing finance is one of the most well established, although issuance has still been relatively small to date. The International Finance Facility for Immunisation has been issuing bonds to raise finance for vaccinations since 2006. Other potential allocations of funds include education facilities, health care and other projects that are either public sector or public–private partnerships.

21 All definitions and data sourced from the Climate Bonds Initiative and MSCI.

22 Qualification for finance by the Lloyds ESG bond is determined by a best-in-class scoring system developed by research provider Sustainalytics.

THE NEED FOR GREEN BOND STANDARDS

The themed bond market needs to adopt standards in order to protect the interests of investors and ensure continued growth of the market. Few investors agree on definitions of 'green', and, invariably, investors will need to decide on what shades of green they want to invest in. In addition, few if any issuers will comprehensively audit the additionality or impact of their green investments. In 2013–2014, 39 percent of green bond issues lacked independent reviews to validate their use of proceeds.

Issuing banks, with guidance from issuers, investors and environmental groups, developed the Green Bond Principles (GBP) to provide voluntary guidelines on the issuance of green bonds. The GBP support the certification of green bonds against "fully developed and vetted" standards but do not currently propose a single global standard.

> "A green bond doesn't change the risk of a portfolio because you're still buying the same credits...from a financial standpoint, it's the same risk."
>
> Tanguy Claquin, Crédit Agricole Corporate and Investment Bank

CONSIDERATIONS FOR THEMED BOND INVESTORS

- There is no clear consensus on the definition of 'green'. Investors need to define how green they want to be; for example, do carbon capture and storage (CCS) or fracking count as green?
- Themed bonds can be a useful tool for asset liability management. For example, tighter regulations on carbon outputs may result in a significant decline in demand for coal, and green bonds offer an opportunity to transition away from such sectors.
- Consider measuring the 'ESG impact' of themed investments to ensure they meet desired goals or 'additionality'.
- Green bond indices will help investors to benchmark any green bond funds as well as to create green bond ETFs and structured products. The World Bank and the European Investment Bank developed one green bond index available from Solactive. In July 2014, Barclays and MSCI announced that they would also launch a green bond index.

ASSET OWNER CONSIDERATIONS

- Consider themed investments as part of an asset allocation strategy to address ESG trends such as climate change, water stress and demographic shifts.
- Develop a means of monitoring and reducing the financial (or reputational) downside of specific ESG factors such as carbon output and supply chain issues.
- Review and support standards for themed fixed income products (e.g., green bonds), and ensure issuers align with asset owner beliefs.

To get involved, make comments and ask questions, email the PRI here: FI@unpri.org

EMBEDDING RI WITHIN YOUR ORGANISATION

> "Our portfolio managers now have an objective that says integrate ESG, and that objective flows into their annual assessment."

Manuel Lewin, Zurich Insurance

There was a general consensus among those interviewed for this document that, regardless of initial motivations, when RI is presented as a tool for analysing risks and getting an edge, there is rapid buy-in from staff members despite the necessary changes. There are a number of fundamental building blocks, regardless of asset class, that all investors should consider when setting their organisation up to implement RI.

PEOPLE

RESPON-SABILITY

Incorporating ESG into investment decisions, engagement and reporting requires different teams with different capabilities to collaborate effectively. Cross-functional working groups, steering committees or 'ESG centres of excellence 'should include analytical, marketing, risk management and senior-level staff to aid implementation. In contrast, a 'bolt-on' or ad hoc approach to ESG rarely has the desired results, and clients who are familiar with RI practices are unlikely to consider such approaches credible.

> "For us, systematically factoring in ESG is a relatively new area, and BlueBay has seen a lot of client interest. The question was, 'what are we going to do about ESG and how to integrate it into investment process?' We decided that ESG really is just another risk. By focusing on the risk aspect first of all, ESG could then sit somewhere clearly in a risk department and be driven from there"

Dominique Kobler, BlueBay Asset Management LLP

TRAINING ON ESG

Training options range from broad, sustainability-related courses to dedicated RI courses or units within financial courses. The PRI website lists a number of courses; some investors may have the capacity to develop their own in-house training.

> "The way ESG issues impact, the financial bottom line can be very complex. What does climate change mean for a global retailer, a car manufacturer, or a bank? How much credit spread is a good climate change policy worth? How do you reflect climate risk in a discount rate? There are generations of portfolio managers out there who haven't been trained to understand these issues, and you can't just expect everyone to now deal with them effectively. The starting point has to be training"

Manuel Lewin, Zurich Insurance

INFORMATION

IDENTIFY, SOURCE AND SHARE

Investors face a challenge of identifying consistent and comparable ESG data that provides strong signals of creditworthiness. ESG research providers, universities and nongovernmental organisations (NGOs) offer raw ESG data on issuer/sector/country-related analysis or ratings, customised research, risk mapping and indices. ESG data from sovereigns typically comes from the UN bodies, the World Bank, the International Energy Agency (IEA) and other intergovernmental organisations.

Investors developing proprietary ESG scores or ratings typically start with a broad set of indicators and narrow these down over time based on results from back-testing. Individual ESG factors are typically weighted as part of an overall 'ESG score' subject to an investor's opinion on their materiality relative to sector or region; governance factors are typically given more weight than environmental or social issues. Carbon intensity, water scarcity and waste management are common environmental indicators for corporates. Corruption, political tensions and energy intensity are commonly used indicators for sovereigns.

> "We have a proprietary credit research database which houses all analysts' research and review of credits we own. ESG risk assessment forms a key part of the review process and is captured in this database"

Toni Spencer, Colonial First State Global Asset

CHALLENGES

Implementing RI in fixed income has its challenges, ranging from the technical difficulties of ESG integration to the potential organisational changes.

- The lack of voting rights is a barrier to effective engagement.
- Current lack of consensus on which ESG indicators give the most insights.
- Fixed income performance perceived as less 'sensitive' to ESG factors than other asset classes; many struggle to see the 'business case' for RI.
- Incentives to integrate ESG can be limited by (1) regulation that restricts overseas investment (e.g., Latin America), (2) market scale or conditions (e.g., demand outstrips supply), and (3) asset liability management (ALM).
- The lack of ESG research coverage for high-yield, emerging market and non-listed issuers remains a challenge.
- Reporting on ESG factors for multiple segregated mandates may require additional resources.

"[ESG integration] strengthened the need that we had to have a comprehensive framework to ensure people were analysing countries in a similar or same fashion."

Rob Drijkoningen, Neuberger Berman

PROCESS

DEVELOP

Developing replicable RI processes for integration, engagement and reporting
Few asset owners prescribe how they want to implement RI within their organisation, as no two are the same. Nevertheless, they do want to see a replicable process that has demonstrable results. A policy without sufficient ESG data or analytical resources to back it up will not be successful, neither will an ad hoc approach. Reporting on the process itself is key to engaging with clients, and this should be seen as an iterative rather than fixed process.

"I've found within the employees of Mariner, people applaud us for having a view that we're thinking about these issues."

Bracebridge Young, Mariner Investment Group

CONSIDERATION

- Encourage staff to engage with RI networks (e.g., PRI Regional Networks, Sustainable Investment Forums and UN Global Compact Networks)
- Encourage minimum RI requirements across business units (e.g., ESG scores should be discussed in sector reviews and quarterly meetings).
- Review effectiveness of ESG-related analyst recommendations.
- Ensure internal capacity to gauge the quality of external research and issuer ESG disclosure.
- Appoint external advisory panel to guide on more complex ESG issues.
- Train staff on ESG and include ESG understanding in competency frameworks.
- Encourage ESG analysts to produce regular ESG research for fixed income teams.
- Encourage ESG experts to work with fixed income analysts on a regular basis, and encourage analysts to seek insights of ESG research teams.
- Integrate ESG analysis, red flags and watch list details into internal IT platforms analyst notes, templates and scorecards, and share ESG information with equities and other teams.

KEY MESSAGES & NEXT STEPS

KEY MESSAGES

In producing this document, the PRI has identified a number of fundamental trends that should help investors develop their own style of responsible investment in fixed income. Below we list some key takeaways:

- Although RI in fixed income is relatively new for most investors, many PRI signatories are putting many of the Principles into practice, including using ESG analysis in investment decision making, engaging issuers on ESG and reporting on these activities to clients.
- As with all asset classes, RI in fixed income is primarily about maximising financial value by managing risks, uncovering opportunities and constructing portfolios that are aligned with the values of clients and, ultimately, beneficiaries.
- ESG integration is particularly well suited to 'mainstream' fixed income investment because of the common focus on producing stable incomes to meet liabilities over varied timelines.
- Fixed income has a number of unique characteristics that require a bottom-up RI approach, but investors should also borrow expertise on other asset classes that may already exist within their organisation.
- Significant investor demand is driving the growth of the green bond market. For these themed investments to have the desired impact, investors should demand strict standards on definitions of 'green' and the use of proceeds.
- Bondholders may be relatively unfamiliar with engaging issuers on ESG matters, but PRI signatories consider it a useful tool for mitigating major ESG risks and aligning issuers with their own values.
- It is important for investors to fully embed RI within their organisations' management, research, risk and sales function to ensure that it is applied systematically and is credible to (potential) clients.
- There are some key challenges to implementing RI in fixed income. Investment managers should try to address these with clients to ensure ESG risks are identified and managed efficiently.

NEXT STEPS FOR RESPONSIBLE INVESTMENT IN FIXED INCOME

The growing interest in this agenda is very encouraging, but more work is needed before RI is considered the norm among fixed income investors. This document is just the start of PRI guidance on this subject, and many questions remain open. The PRI welcomes feedback on the list of questions below:

- Is duration important to ESG analysis in order to address changing materiality of ESG factors?
- How can investors address debt seniority in ESG analysis?
- Can ESG analysis be used to inform fixed income relative value trades?
- What changes are required to promote more bondholder engagement on ESG?
- Should more ESG information be included in bond documentation, including covenants?
- What are the greatest incentives for RI in fixed income?
- To what extent are policy and regulation changes required to support RI in fixed income?
- What is the role of credit rating agencies to support investors in identifying ESG risks?
- Is there a middle ground between ESG integration and passive investment?
- How do investors promote a transition towards a more sustainable economy via fixed income investments?
- How can investors help to build robust markets for themed fixed income?

APPENDICES

For explanations of key fixed income terms, please refer to the following websites:

www.investinginbonds.com
www.investinginbonds.eu
www.investopedia.com

Further resources relating to this document are available on the PRI website fixed income page, including:

- Short case studies from practitioners
- PowerPoint presentation summarising key guidance
- Resources library
- Webinar and event panel recordings

FURTHER READING

GOVERNMENT, MUNICIPAL AND SUPRANATIONAL ISSUERS

- Amundi Asset Management (2010) Sovereign bonds and socially responsible investment
- AXA Investment Managers (2012) Sovereign Debt Investing: ESG Framework and Applications
- Breckinridge Capital Advisors (2013) The Investment Merits of Sustainability in Fixed Income Investing
- Danish Council for Corporate Responsibility (2014) Guidelines for Responsible Investment in Government Bonds
- Hoepner, A., Neher, N. (2013) Sovereign Debt and Sustainable Development Culture
- Local Government Super (2012) Global Sustainable Government Bonds
- Oddo Securities (2012) Public Debt: Fresh Challenges and ESG Rating
- PRI (2013) Sovereign Bonds: Spotlight on ESG Risks
- Robeco (2014) Insight: How ESG Adds Value for Bond Investors
- Union Investment (2014) Corruption and the Risks of Losses on Government Bonds
- United Nations Conference on Trade and Development (2012) Principles on Promoting Responsible Sovereign Lending and Borrowing

CORPORATE (NONFINANCIAL) ISSUERS

- Ashbaugh, H., Collins, D. W., and LaFond, R. (2004). "The Effects of Corporate Governance on Firms' Credit Ratings." Journal of Accounting and Economics 42, 203–243
- Bradley, M., Chen, D., Dallas, G. S., and Snyderwine, E. (2010). "The Effects of Corporate Governance Attributes on Credit Ratings and Bond Yields." Working Paper, Duke University
- Bauer, R. and Hann, D. (2011). "Corporate Environmental Management and Credit Risk." Working Paper, Maastricht University
- Calvert Investments (2013) Weak governance beyond challenging fundamentals in Telecom Italia uncovers additional risk to the credit profile and reason to avoid bonds
- Ingram, D. (2012) "Credit and Environmental Risk: Is There a Link?" (PowerPoint presentation at event with no name)
- Kölbel, J. F. and Busch, T. (2013). "The Effect of Bad News on Credit Risk: A Media Based View of the Pricing of Corporate Social Responsibility." Policy Paper No. 40, Duisenberg School of Finance

FINANCIAL SECTOR ISSUERS AND SECURITISED DEBT

- Chava, S. (2011). "Environmental Externalities and Cost of Capital." Working Paper, Georgia Institute of Technology
- Chava, S., Livdan, D., and Purnanandam, A. (2009). "Do Shareholder Rights Affect the Cost of Bank Loans?" Review of Financial Studies 22, 2973–3004
- Goss, A. and Roberts, G. S. (2009). "The Impact of Corporate Social Responsibility on the Cost of Bank Loans." Journal of Banking and Finance 35, 1794–1810
- McKenzie, G. and Wolfe, S., (2004). "The Impact of Environmental Risk on the UK Banking Sector." Applied Financial Economics 14, 1005–1016

ENGAGEMENT

- F&C (2012) F&C's Approach to Bonds, Corporate Governance and Stewardship
- Hermes EOS (2013) BT Pension Scheme Bonds Engagement Report
- KfW Bankengruppe (2014) KfW's Approach to Engagement
- NEI (2013) Re: Planning for a Sustainable Future: A Federal Sustainable Development Strategy for Canada
- List of Collaborative Engagements Coordinated by the PRI
- PRI (2013) The Value Driver Model: A Tool for Communicating the Business Value of Sustainability

THEMED INVESTING

- European Investment Bank (2014) The Europe 2020 Project Bond Initiative – Innovative Infrastructure Financing
- International Capital Markets Association (ICMA) (2014) Green Bond Principles
- Kidney, S. (2015) Île-de-France issues EUR600m ($830m), 12yr, AA+ Green Muni. Climate Bonds Initiative
- Mirova (2014) SRI Bond Funds Are Set to Sail on the Rising Tide of Green and Social Bonds
- Sustainable Investing in World Bank Bonds
- World Bank Green Bonds (2014) About World Bank Green Bonds

SHARING CASE STUDIES

One of the objectives of this document is to encourage readers to share their knowledge of RI in fixed income. The PRI will publish these on its website following approval. Case studies must meet the following criteria to be considered for publication:

- Must relate to one of the subjects listed in the framework below
- Must represent an innovative approach to responsible investment
- Must include practical examples of issuers, decisions made and outcomes
- Must not contain unwarranted marketing
- Must be concise and focused only on the title subject
- Must be no more than 500 words in length (excluding graphs, diagrams or data tables)

TYPES OF ISSUER OR INSTRUMENT	INTEGRATION	ENGAGEMENT	THEMED INVESTING	SCREENING	REGION	SECTOR	REPORTING
Corporate	- Integration in corporate bonds -Integration in private debt	- Public debt - Private debt - Bondholder only engagement	- Green bonds - Other themed bonds	- Screening in corporate bonds - Screening in private debt	- Emerging market - Developed market	-Utilities -Extractives -Transport -Consumer goods	- Reporting to institutional clients - Reporting to beneficiaries and other stakeholders
Financial sector	- Integration in financial bonds - Integration in private debt	- Engagement with financial issuers	- Green bonds	- ESG screening - Positive screening	- Emerging market - Developed market	- All financial sectors	
Government	- Integration in sovereign bonds	- Engagement with sovereign issuers	- Themed sovereign debt	- ESG screening - Positive screening	- Emerging market - Developed market		
Municipal/ local government	- Integration in municipal bonds	- Engagement with municipal issuers	- Themed municipal debt	- ESG screening - Positive screening	- US market - European market - Emerging market		
Asset-backed securities	- Integration in ABS, covered bonds	- Engagement with banks and special purpose vehicles	-Themed ABS -Themed covered bonds	- ESG screening - Positive screening	- Not required/too advanced/not relevant - N/A		
Asset owner case studies	- ESG and asset allocation strategy	- Engagements	-Themed investments	- ESG screening - Positive screening	- Constraints on responsible investment in fixed income		- AO reporting to beneficiaries

REPORTING TO STAKEHOLDERS ON RESPONSIBLE INVESTMENT

What gets reported gets managed. This is as true for investors as it is for the entities they invest in. Fixed income managers are increasingly reporting on their ESG processes and outcomes, just as asset owners should report to their beneficiaries to ensure interests align. Reporting should include an explanation of how the organisation's RI processes work as well as their financial (and ESG) outcomes, challenges and solutions.

CONSIDERATIONS ON REPORTING

- Provide clear, concise ESG 'snapshots' to clients to allow them to identify major ESG risks that might ultimately contribute to credit rating downgrades or defaults.
- Consider simplified reporting and labelling of ESG risks for retail funds.
- Report on ESG process, explaining to clients how this works, who is responsible, why certain approaches are taken, why the approach is considered robust and what the expected outcomes are.
- Encourage clients to use PRI signatory Transparency Reports, and use them to benchmark progress against peers.
- Report on major ESG concerns (i.e., ESG red flags) and breaches of ESG screens.
- Ask clients to define what RI reporting they would like. Work with clients to streamline and align ESG reporting from multiple investment managers and across asset classes.
- Aim to provide ongoing reporting on use of proceeds from green bond and impact funds.

THE PRI REPORTING FRAMEWORK

PRI signatories are required to report annually on their RI activities. In 2013, the PRI launched the new PRI Reporting Framework, which consists of 12 modules. These relate to each organisation's general approach to RI and include an overview of its investments and RI in specific asset classes. The Fixed Income module of the Framework covers aspects of RI such as the proportion of fixed income assets subject to integration, screening, themed investing and engagement; impacts on decision making; and financial and engagement outcomes. The Framework promotes best practice in three ways:

- Publicly available PRI Transparency Reports include a summary of PRI signatories' responses to the Framework. These help investment managers and asset owners to report to their clients and beneficiaries, respectively.
- Private PRI Assessment Reports allow individual signatories to monitor their progress in implementing RI year-on-year and relative to peer groups.
- The PRI's annual 'Report on Progress' is a review of aggregated responses to the Framework and broadly illustrates the progress in responsible investment.

The Principles for Responsible Investment (PRI) Initiative

The PRI Initiative is a UN-supported international network of investors working together to put the six Principles for Responsible Investment into practice. Its goal is to understand the implications of sustainability for investors and support signatories to incorporate these issues into their investment decision making and ownership practices. In implementing the Principles, signatories contribute to the development of a more sustainable global financial system.

The Principles are voluntary and aspirational. They offer a menu of possible actions for incorporating ESG issues into investment practices across asset classes. Responsible investment is a process that must be tailored to fit each organisation's investment strategy, approach and resources. The Principles are designed to be compatible with the investment styles of large, diversified, institutional investors that operate within a traditional fiduciary framework.

The PRI Initiative has quickly become the leading global network for investors to publicly demonstrate their commitment to responsible investment, to collaborate and learn with their peers about the financial and investment implications of ESG issues, and to incorporate these factors into their investment decision making and ownership practices.

More information: www.unpri.org

PRI Principles for Responsible Investment

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

UNEP Finance Initiative
Changing finance, financing change

UN Global Compact

Launched in 2000, the United Nations Global Compact is both a policy platform and practical framework for companies that are committed to sustainability and responsible business practices. As a multi-stakeholder leadership initiative, it seeks to align business operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to catalyse actions in support of broader UN goals. With 7,000 corporate signatories in 135 countries, it is the world's largest voluntary corporate sustainability initiative.

More information: www.unglobalcompact.org

United Nations Global Compact