ASSET OWNERS NETWORK

EMBEDDING ESG FACTORS INTO FIXED INCOME INVESTMENTS

A summary guide for pension trustees

Fixed income is a diverse asset class that can serve a range of purposes in pension scheme portfolios. Investment-grade sovereign and corporate bonds offer a source of relatively stable, contractual cash flows, and do not typically exhibit the volatility inherent in global equity markets. Long-dated bonds also play a key role in matching long-term liabilities for a range of institutional investors. There are also higher risk and return options, including high-yield debt securities issued by organizations or countries with low credit. These securities can offer attractive ongoing returns to compensate for the higher risk of default, and investors would benefit from improved credit ratings in the future.

Relevance of ESG considerations in achieving these objectives

It is now widely acknowledged that environmental, social and governance risk factors can affect both sovereign and corporate issuers' creditworthiness, and thus ultimately their ability to meet their debt obligations (ie not to default). Governance factors have historically been incorporated into credit analysis. Increasingly, however, social and environmental factors are also being considered in the context of evaluating the quality of the debt instruments, and the ability of a borrower to meet its debt obligations.

In the context of government debt, the importance of assessing governance risk factors such as political stability, institutional strength and the rule of law, is well recognized. In parallel, however, environmental risk factors, such as climate disasters, energy and food security are increasingly seen as influencing economic factors such as tax revenues and a government's ability to attract foreign investment. ESG factors, in impacting a country's economy, can also influence underlying inflation and interest rates – core metrics to consider when assessing the potential interest rate risk of any bond investment.

For corporate bonds, a business needs to identify ESG issues that are relevant and financially material in the short, medium and/or long term so it can grow and avoid defaulting on its debts. ESG factors are increasingly being identified and incorporated into credit ratings. This helps to make ESG data within credit analysis more transparent and gives a more holistic understanding of whether a company is likely to default.

Pension schemes and their asset managers, then, must consider a range of ESG risk factors and incorporate these when selecting, managing and monitoring fixed income investments. Just like traditional financial risk factors, how companies deal with ESG issues will affect their ability to meet their long-term debt obligations.

When it comes to stewardship, regular engagement with issuers is important, but in the absence of any ownership rights, investors have most influence during the marketing period for a new issue, when they can engage with the issuer with a view to influencing price and ESG-related undertakings.

Within fixed income, there are also opportunities to support specific ESG solutions. For example, green bonds and other sustainability-focused bonds are designed to fund projects that have positive ESG benefits. Investing in these instruments can be a useful way to achieve responsible investment goals for the fixed income asset class.

ESG maturity map

The A4S ESG maturity map, part of its ESG Toolkit for Pension Chairs and Trustees, sets out example behaviours for integrating ESG into fixed income investment decision making. At the beginning of a pension scheme's journey, trustees might seek to demonstrate they can confidently discuss how it engages with companies whose debt it owns; whereas at the leading edge of this journey, trustees may be actively promoting ESG in debt investing with peers.

	Level 1 Understanding	Level 2 Adopting
Example behaviours	The Board: • can confidently discuss the role that ESG can play in determining credit ratings, defaults and bond pricing (from the perspective of both corporate and sovereign debt), and how this can have a significant influence over future pension values and ability to pay long-term retirement income to beneficiaries • can confidently discuss the types of engagement it can have with companies whose debt it owns (especially where it has large debt holdings), despite not having ownership rights • can confidently discuss the different approaches asset managers can take to integrate ESG factors into debt investing, and that investing in sustainability-linked bonds – eg green bonds, sustainability bonds, etc – is only one avenue of incorporating ESG considerations into debt investments • has considered and documented how it will integrate ESG into debt investment decisions and risk management practices, particularly on credit ratings, defaults and bond pricing	The Board: • is developing a framework for integrating ESG factors into fixed income investments (including corporate and sovereign bonds) • has identified the material issues their investments are exposed to (and how these differ between corporate bonds and sovereign debt) and has defined expectations of what companies and/or its fund managers should be doing to manage and mitigate these • has identified sources of ESG information and data for both corporate and sovereign debt investments • has developed and implemented a coherent stewardship strategy for fixed income
	Level 3 Deepening	**Level 4 Leading**
	The Board: • has implemented a framework for integrating ESG factors into debt investments, covering both direct and / or fund-level investing by external managers • has tested an approach to engagement around ESG issues for investments made by external managers • has a process for continual assessment of external managers' ESG investment capabilities in corporate and sovereign debt through regular reporting against a clearly defined set of metrics • has considered and implemented or documented reasons for not implementing the procurement of green, social or sustainability bonds as part of its asset mix • uses the influence and rights as a debtholder to engage with company management on ESG issues	The Board: • actively promotes an increased focus on ESG in debt investing to peers • speaks openly about the benefits and challenges of incorporating sustainability-linked bonds into an investment strategy, including to scheme beneficiaries • is active in promoting better standards around ESG investing in sovereign debt • collaborates with bond fund managers to enhance the ESG performance of their funds • leads collaborative debt-holder engagement activities and collective action on ESG integration in underlying companies and countries

Practical actions that trustees can take

Area	Action
Education	• Arrange for all trustees to be educated about the ESG risks and opportunities associated with investing in fixed income, including: – How ESG factors affect credit ratings, interest rate risk and defaults, and therefore bond yields and pricing; – The different factors within ESG that impact corporate and sovereign fixed income; – The opportunities associated with investing in sustainability-linked bonds, and how these can be integrated into the schemes asset mix.
External manager expectations	• Ensure there is a consistent approach to assessing new and existing external managers on capabilities around fixed income ESG investing, by examining: – Quality of ESG-related research across both corporate and sovereign fixed income investing; – Quality of annual disclosures to UN Principles of Responsible Investing on fixed income investing; – ESG strategies currently used across fixed income offer; – Use of ESG analysis and data by fixed income portfolio managers; – Whether the manager uses engagement as a tool to achieve desired outcomes in its fixed income investing.
Direct fixed income investing	• Oversee the development of a framework for embedding ESG factors into the direct fixed income investment process, covering sovereign, investment-grade and high-yield corporate debt. • Work with credit rating agencies and ESG data providers to identify data and analysis that can be incorporated fixed income yield and price analysis. • Establish whether the scheme could and should invest in bonds which aim to achieve positive environmental and social outcomes, such as green bonds.
Engagement	• Include fixed income in the scheme's overall approach to stewardship. • Use the influence and rights as a debtholder to engage with company management on ESG issues (especially at both issuance and reissuance points when engaged investors can impact pricing and the inclusion of specific ESG-related covenants). • Work with external managers to ensure any externally managed fixed income portfolios are aligned with the scheme's overall strategy.
Collective action	• Collaborate with other large debtholders, as well as aligning engagement goals with equity investors, to increase influence and persuade companies to take action on relevant and material ESG issues. • Collaborate with other pension schemes to articulate market demand for green or sustainable government bond issuance.
Measurement and reporting	• Actively explore ways for the scheme to generate ESG metrics from the real estate portfolio, such as: – Social metrics – people employed through construction, social tenants housed and social businesses provided with commercial / office space; – Environmental metrics – including carbon emissions, trees plated and water recycled.

This summary guide for pension trustees is part of an ESG Toolkit for Pension Chairs and Trustees by The Prince's Accounting for Sustainability Project.