Corporate Bond Stewardship

ESG, M&A and Corporate Governance Research

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Introduction

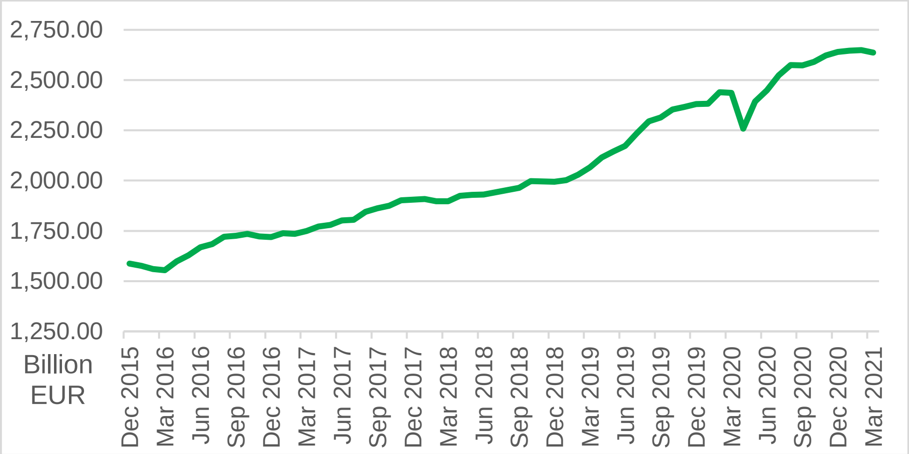
Engagement activities, also known as stewardship or active ownership are purpose-driven meetings between listed companies and their major shareholders. Engagement between issuers and investors are an established and important exercise to share views and highlight general concerns ahead of the preparation of the Annual General Meeting (AGM). Such extra-financial engagements have usually been focused on corporate governance topics in the past, but the addition of environmental and social topics to the list of discussion points has already become an established practice. Compared with equity investments, engagements by and with bondholders are a relatively new trend, and only recently this practice has gained a certain degree of acceptance and growth. This is because stewardship originates from the idea that equity investors are shareholders and therefore beneficial residual owners of companies, as such, their interests should extend beyond bondholders who are primarily concerned about debt repayment and coupons. However, the stewardship landscape is rapidly shifting, starting from the 2020 UK Stewardship Code that highlights the need for stewardship to cover all asset-classes and be outcomes-driven.

Bond Basics

Debt investors are a critical stakeholder for corporate issuers as this source of financing is an important pillar for companies. When a bond is issued, the interest rates a company offers to pay for the bond is directly related to their specific credit risk rating. The higher the calculated risk for a company, the higher the interest rate it needs to offer. In the same way credit risk downgrades over time have the potential to negatively impact the value of the traded bond and cost of borrowing for companies.

But, whereas holders of common shares are entitled to vote at shareholder meetings, a bondholder instead is without such rights.

Compared with equities, the upside potential of returns or values of bonds are limited which means on the other hand that bond investors have more a focus on the downside risks, they may be cash outflows related to fines due to bribery and corruption, health and safety incidents or tax evasion.[1] The evaluation of ESG performance and inclusion of ESG metrics are widely accepted as the methodology of assessing material ESG issues stem from identifying material risks and the quality of risk management. Today, many credit risk and other types of rating agencies and index providers have implemented ESG metrics into their valuation models, including some others specialized on ESG ratings itself.



Over the past five years alone, the Market Value of the **iBoxx[2] EUR Corporate Bond Index** has grown more than 66% and at the end of March 2021 has shown a value of over 2,637 trillion Euro.

The Status Quo

The UN PRI principles have never been limited to equity portfolios only. Principle Two encourages investors to apply active stewardship in all investments and incorporate ESG factors into practices across different asset classes.[3] According to the UN PRI, debt engagements are an important pillar within an active stakeholder approach. Going forward, the UN PRI will continue to develop this topic though various publications such as the Timing of Bond Engagement[4], prioritizing

[1] https://www.investopedia.com/articles/bonds/08/bond-risks.asp
[2] https://ihsmarkit.com/products/iboxx.html
[3] https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment
[4] https://www.unpri.org/fixed-income/timing-fixed-income-engagement-/2933.article

“Fixed Income Engagement Activities”[5] or Overcoming Common Hurdles[6].

“There is a growing body of practical and academic evidence of the benefits to investors of engagement. They include: Better understanding of companies by investors, and of investors’ expectations by company management; improved ESG disclosure; management and mitigation of financial risks; and the maximizing of positive sustainability outcomes, including those related to the UN Sustainable Development Goals.”7

UN PRI, Fixed Income, Executive Summary

At its core, Corporate Governance is about how to systematically anticipate and address possible risks and make improvements in managing those risks. Under this light, it is not a surprise that important organizations such as the ICGN (International Corporate Governance Network), an investor led organization representing US$53 trillion assets under management, published a dedicated viewpoint about the role of the creditor in corporate governance and investor stewardship[8]:

“As awareness of ESG risks build, ESG factors are increasingly featured in fixed income analytics and credit analysis, linking levels of ESG risk to assessments of profitability, cash flow, balance sheet strength and ability to service debt capital. This in turn links to credit quality and the cost of debt capital.”

ICGN offers a Governance, Stewardship & Sustainability (GSS) course. The GARP (Global Association of Risk Professionals) also acknowledged the materiality around sustainability and climate risks for companies. It also offers training courses and certifications in this field.[9] And even some of the most important credit rating agencies acknowledge the effect of ESG performance on credit ratings.

[5] https://www.unpri.org/fixed-income/prioritising-fixed-income-engagement-activities-/2925.article
[6] https://www.unpri.org/fixed-income/overcoming-common-hurdles-in-fixed-income-engagement/2936.article
[7] https://www.unpri.org/fixed-income/esg-engagement-for-fixed-income-investors/2922.article
[8] https://www.icgn.org/what-role-creditor-corporate-governance-and-investor-stewardship
[9] https://www.garp.org/?#!/scr

“What will happen to the 30-year mortgage – a key building block of finance – if lenders can’t estimate the impact of climate risk over such a long timeline (…)”10

Larry Fink, BlackRock CEO and Chairman in A Fundamental Reshaping of Finance

What the UN PRI, the ICGN and most available investor statements have in common is the implementation of ESG as a key for analyzing and interpreting a company, not exclusively, but with a big focus on risks and the approach of its management.

Leading Investors Increase Bondholder Engagement

Pimco[11] or Legal & General Investment Management’s fixed income teams[12], both leading debt investors, as well as PGIM[13], Federated Hermes[14], Russell Investment[15], or Schroders[16] already consider bond related engagements as important activities and partially disclose their views and commitments. Investors such as BMO Global Asset Management[17] leads in transparency, disclosing case studies on bondholder engagements and their outcome.

Intelligence from interviews with stewardship professionals shows that fixed income engagements have been gaining momentum. Two stewardship professionals from leading global asset managers have stated that due to rising demand from asset owners and other stakeholders, they have recently started bondholder engagement programs.

“Engagement by fixed income investors has grown rapidly. Some 27% of signatories engaged with issuers on more than 50% of their fixed income AUM in 2019, compared to only 14% in 2017, while

[10] https://www.blackrock.com/ae/intermediaries/larry-fink-ceo-letter
[11] https://www.pimco.com/en-us/insights/viewpoints/in-depth/sustainability-in-bond-markets-amid-covid-19-esg-in-focus/
[12] https://update.lgim.com/Active_Ownership_long_report
[13] https://www.pgim.com/fixed-income/environmental-social-governance
[14] https://www.hermes-investment.com/insight/fixed-income/sdg-engagement-high-yield-credit-h1-2020-report/
[15] https://russellinvestments.com/us/blog/engagement-in-fixed-income
[16] https://www.schroders.com/en/insights/economics/green-and-esg-bonds-whats-behind-their-rise/
[17] https://www.bmogam.com/wp-content/uploads/2020/01/esg-in-fixed-income.pdf

the number of signatories that did not engage shrank significantly – from 43% in 2017 to 7% in 2019."

Carmen Nuzzo, Head of Fixed Income at PRI18

Another stewardship professional from a leading German asset manager explained that they are observing this trend, but for now, they have decided not to include bonds in their activities. They expect client demand to increase rather than to decrease with impact on the engagement strategy and focus of institutional investors.

A topic that is often cited by institutional investors about why at this stage there is no full integration of ESG and stewardship across all asset classes is the problems around lack of data-availability, comparability, and relevance of such intelligence. Expected developments regarding more standardized legal frameworks and reporting standards may provide an additional push into bond engagements.

"We saw a 363% increase in companies reporting SASB metrics from 2019 to 2020."19

Janine Guillot, CEO of SASB

One of these developments are the steps by the IFRS to include sustainability and climate reporting in their set of accounting standards[20], which would be no less than a milestone and has already gained the support from important investors like BlackRock[21].

Another important step is the EU Taxonomy[22] rules, which introduce a common classification system for sustainable economic activities. Such a framework will urge companies to make relevant data available in a standardized form. Additionally, the EU is planning to launch a

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[18] https://www.unpri.org/pri-blogs/responsible-fixed-income-investment-investors-are-starting-to-catch-up/6932.article
[19] https://www.sasb.org/blog/investors-fuel-market-movement-for-comparable-esg-data/
[20] https://www.ifrs.org/news-and-events/2020/09/ifrs-foundation-trustees-consult-on-global-approach-to-sustainability-reporting/
[21] https://www.blackrock.com/corporate/literature/publication/blk-response-to-ifrsf-on-sustainability-reporting-standards.pdf
[22] https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en

platform similar to the one of the SEC[23], where all such reports are easily available.[24]

"Assessing sustainability risks requires that investors have access to consistent, high-quality, and material public information."

Larry Fink, BlackRock CEO and Chairman in Larry Fink's 2021 letter to CEOs

Even countries that are not members of the European Union are taking steps in that direction. In November 2020, the UK Government's Finance Minister, Rishi Sunak, announced that climate risk reporting will become mandatory[25] for large companies and financial institutions in the UK beginning in 2021. This means that companies, banks, pension schemes will be urged to align with the TCFD[26] framework.

Only a few month later Switzerland announced a similar move. The Swiss Federal Council announced to support disclosures under TCFD rules in order to "strengthen Switzerland's role as a global leader in sustainable financial services"[27], starting by recommending its implementation on a voluntary basis, with the intention to make it legally binding soon.

Furthermore, recognized sustainability and integrated reporting bodies as the Sustainability Accounting Standards Board (SASB)[28], CDP[29], the Climate Disclosure Standards Board (CDSB)[30], the Global Reporting Initiative (GRI)[31] and the International Integrated Reporting Council (IIRC)[32] issued a joint statement[33] stating to work together with the goal to align their single frameworks and achieve a common and globally accepted comprehensive corporate reporting system and to be

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[23] https://www.sec.gov/edgar.shtml
[24] https://ec.europa.eu/commission/commissioners/2019-2024/mcguinness/announcements/keynote-address-launch-climate-disclosure-standards-board-report-state-eu-environmental-disclosures_en
[25] https://www.gov.uk/government/publications/uk-joint-regulator-and-government-tcfd-taskforce-interim-report-and-roadmap
[26] https://www.fsb-tcfd.org/
[27] https://www.admin.ch/gov/en/start/delocumentation/media-releases.msg-id-81924.html
[28] https://www.sasb.org/
[29] https://www.cdp.net
[30] https://www.cdsb.net/
[31] https://www.globalreporting.org/
[32] https://integratedreporting.org/
[33] https://29kjwb3armds2g3gi4lq2sx1-wpengine.netdna-ssl.com/wp-content/uploads/Statement-of-Intent-to-Work-Together-Towards-Comprehensive-Corporate-Reporting.pdf

complementary to possible new IFRS reporting rules as well as with the TCFD framework.[34]

Conclusion

Rising client demand and readily available, comparable, and materially relevant ESG data will drive engagement especially fixed income engagement. In addition, the accelerating growth of Sustainability-linked and Green Bonds provide additional exciting opportunities because sustainability metrics used and the specificity in the use of proceeds make ESG performance measurement much more focused. According to the Climate Bonds Initiative (CBI), green bond issuance reached a record high of $269.5 billion by the end of 2020[35].

In the not too distant future, companies will be urged to disclose a set of non-financial data, which will make them much more transparent. Companies will need to prepare for a rapidly evolving sustainability landscape from reporting to compliance.

IHS Markit offers a suite of ESG solutions from reporting repository using AI powered Natural Language Processing (NLP) techniques to advisory solutions that map the specific ESG engagement priorities of capital providers to the company's competences and strengths.

[34] https://www.sasb.org/wp-content/uploads/2020/12/Press-release-prototype-climate-related-financial-disclosure-standard-Dec20-FINAL.pdf
[35] https://www.climatebonds.net/2021/01/record-2695bn-green-issuance-2020-late-surge-sees-pandemic-year-pip-2019-total-3bn

Key contacts

Andreas Posavac, MBA

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Andreas runs a global team that supports companies and their C-suite and Investor Relations teams as well as their banking and legal advisers with market intelligence, risk analytics and advisory services focused on institutional investors in the lead up to M&A transactions, general meetings or special situations. His team also works with companies to develop a coherent ESG and engagement strategy to follow legal and industry best practice standards and take advantage of the opportunities in sustainable investments and increased ESG integration. Andreas has deep knowledge of the ESG and corporate governance sensitivities of institutional investors, their relationships to external advisors as proxy advisory and ESG rating firms and can help stakeholders better understand how to address governance and ESG in order to have the greatest impact in minimizing risks and maximizing opportunities in the current capital markets landscape.

Christine Chow, Ph.D.

Executive Director - Global Head of Strategic Governance Advisory & ESG Integration

Before joining IHS Markit, Christine was Head of Federated Hermes EOS in Asia and global emerging markets. Her PhD thesis on responsible investment was short-listed for a United Nations award in Sweden for industry relevance and academic excellence. She is a Member of Court and Investment Committee of the London School of Economics (LSE), a Board Member of the International Corporate Governance Network (ICGN) and a member in the Data Governance Task Force of the UK All Party Parliamentary Group (APPG) on Artificial Intelligence. She was named as one of the top 30 Inspirational Women in the City of London. In 2020, she won the Finance Monthly Women in Finance Award as the Investment Management Leader of the Year (Asia). Christine is a graduate of the London School of Economics and the University of Melbourne. She completed an executive education course on financial engineering at Stanford University. She was an Adjunct Professor in Finance at the Hong Kong University of Science and Technology (2014-2016).

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Before joining IHS Markit, Sandro spent over five years at Morrow Sodali, where he worked on M&A, Corporate Governance, Proxy Season and Special Situation related projects for many European and other international markets. He holds a German degree in Business Law (Diplom-Wirtschaftsjurist) and is an ESG Analyst (CESGA) certified by The European Federation of Financial Analysts Societies. In addition, he is certified in Investor Relations (ICIR) by the IR Society in London, where he is also a member (MIRSoc).

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