

Sleeping Giants: Are Bond Investors Ready to Act on Climate Change?

Based on interviews with corporate bond market experts, this report examines whether corporate bond investors are motivated to speed up alignment with the Paris Agreement and participate in forceful engagement.

Authors

Wolfgang Kuhn

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Design: Emily Dawson

About the author

This report and the research on which it is based was produced by Wolfgang Kuhn, with input, guidance and editing advice from Toby Belsom and the ShareAction research team.

Wolfgang is a Fellow at ShareAction with over 20 years' experience in fixed income markets. With a strong interest in risk management, he has been exploring approaches to sustainability in corporate bond management since 2006. His most recent role was Head of Pan-European Fixed Income at Aberdeen Asset Management. Previously, he worked for UBS, Deutsche Asset Management and DG Bank.

Wolfgang is a CFA Charterholder, a Certified EFFAS Financial Analyst, and a Financial Risk Manager (FRM).

About ShareAction

ShareAction is a UK registered charity working globally to lay the tracks for responsible investment across the investment system. Its vision is a world where ordinary savers and institutional investors work together to ensure our communities and environment are safe and sustainable for all.

In particular, ShareAction encourages institutional investors to be active owners and responsible providers of financial capital to investee companies, while engaging meaningfully with the individual savers whose money they manage. Since 2005, ShareAction has ranked the largest UK asset owners and asset managers on their responsible investment performance.

ShareAction works with players across the investment chain to create a movement for responsible investment. This movement includes savers who all too often feel excluded from the investment system, to the institutional investors that operate within it and the policy-makers that regulate it.

Contact us about this report

Toby Belsom
Head of Research
ShareAction
toby.belsom@shareaction.org
+44 (0)20 7403 7800

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Institutional investor engagement with companies about climate-related risk has recently become widespread, with more than 300 investor signatories of Climate Action 100+ signing up to a statement “that engaging and working with the companies in which we invest... is consistent with our fiduciary duty to our beneficiaries.”¹

When investors engage with conviction² and when they operate collaboratively, there is little doubt that engagement can be effective. Unilever’s decision in late 2018 to rethink proposed changes to its UK listing structure is only the most recent high-profile example of the power investors wield when they assert a strong, collective view. On climate issues, a 2017 survey conducted by HSBC showed that “investor pressure is a key driver for disclosing more on climate risk.”^{2,5} The joint announcement by Royal Dutch Shell and the CA100+ investor

coalition announcing emissions targets in December 2018 is further good evidence that collaborative investor engagement can influence corporate strategy.

In today’s capital markets, engagement with firms on ESG issues is largely seen as an activity for equity investors. Our view is that engaging on climate issues should be the responsibility of debt as well as equity holders, and indeed of all finance providers. Fiduciary duties are a universal responsibility; if engagement with companies is an effective tool, it makes no sense to limit engagement to a single asset class.

But can bondholder engagement with companies be effective? The 2013 Parliamentary Commission on Banking Standards thought so when it demanded that “market discipline from creditors should encourage banks and their managements better to balance

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It is our conviction that corporate bond investors, especially signatories to the CA100+, should co-ordinate and utilise the power they wield during debt re-financing and issuance to communicate to issuers that, unless a robust strategy to manage climate-related risks and impacts is adopted, they will cease to invest in a company's bonds.

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downside and upside risks.”³ More recently examples of activism surrounding Mexico City Airport Trust bonds and the Canary Wharf securitization show that mainstream institutional bond investors can be comfortable with high profile, collaborative and organised engagement where material value is at risk.⁴

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Through the summer and autumn of 2018, we undertook a series of interviews with asset owners, bond managers, issuers and other experts in the field to explore their thinking on the opportunities and

responsibilities that arise for bond investors in relation to climate change and climate-related risks. This is intended to build on the work undertaken by the PRI.⁵ We tested the hypothesis that bond investors should use their leverage to press for corporate management teams to minimise climate related risks and align their business strategies with the Paris Agreement.

This report summarises the insights and findings from 22 in-depth interviews with bond market experts. We make a number of recommendations for asset owners, asset managers, financial market supervisors and policy makers.

Interview Findings

- 1 ESG risk is seen as relevant to bond investment**
Almost universally, bond investors see ESG as a manifestation of downside risk. For most interviewees, there is no question that the analysis of any type of risk needs to be integrated into the investment process
- 2 Many ESG engagement teams already straddle bond and equity portfolios**
Engagement activities for bond and equity portfolios seem to have been combined at many asset management firms
- 3 Complexity and poor data are barriers to climate action**
Participants say that they do not have the data needed to make ESG and climate change integral parts of their investment decision making process
- 4 Views on green bonds are mixed**
Most participants said they would buy green bonds if there was no valuation differential with conventional bonds. Some investors liked the concept, particularly the added transparency, but some did not understand the purpose of green bonds
- 5 Sector exclusions are approached with great caution**
Virtually all respondents expressed concern over the exclusion of whole industries or sectors from portfolios

6

Refusal to refinance/roll over bonds and issuer specific divestment are seen as effective escalation tools

Despite being sceptical around sector exclusions, investors acknowledge that the threat of divesting a specific issuer's bonds or refusal to refinance/roll over corporate debt could influence issuers

7

The idea of bondholder collaboration is viewed with unease

Collaborating around engagement with issuers or publicly communicating conditions for continued investment are widely considered to be legally problematic. However, we found a small minority would consider such actions

8

Little clarity on what clients or beneficiaries expect with respect to climate change

Communication with clients, whether asset owners or individual savers, is difficult

9

When it comes to climate change, most bond investors hope that governments will bail everyone out

Most participants thought that, ultimately, climate change was for governments to tackle, and that the investment industry's steps would not amount to much in terms of mitigation

10

Bondholders are focused on mitigating portfolio level climate risk, but not climate change itself

Bondholders interviewed are thinking about the implications of climate-related risks for portfolio management and asset selection. They are not yet focused on the impact of investments. The question of how to limit global warming to 2 degrees (let alone 1.5 degrees) is not a question that bond investors think they need to ask or answer

Recommendations

Our research and the findings outlined within this report bring us to a number of recommendations for asset managers, asset owners and regulators.

Institutional Investors - Targeting high impact issuers

The CA100+ has provided bond and equity investors with clear guidance on engagement with issuers with some of the most material exposures to technological, regulatory and physical climate related risks. It has also provided a clear target for heightened engagement. PRI members and CA100+ signatories have also committed to place engagement at the heart of some of their activities and reaffirm that it is aligned with fiduciary duty.

This report highlights that bond investors' engagement practice falls short of what is required to contribute to climate change mitigation. Many investors take a comfortable 'tea-and-cookies' approach.

1

ShareAction's view is that CA100+ signatories and PRI members should commit to engage and escalate across all asset classes.

For bond fund managers, this might include challenging high carbon issuers (commodity, integrated oil and utility sectors) to ensure business models and capital expenditure plans are compatible with the Paris goals - a challenge that has been requested by equity investors in shareholder resolutions at selected high carbon business. Independently to equity investors, bond investors should set clear paths to escalate engagement where issuers have not published information assessing progress towards targets such as:

- Scope 1 and 2 and projections for Scope 3 GHG emission reductions compatible with the Paris Goals,
- Anticipated levels of investment in and development of (a) fossil fuel resources and reserves and (b) technologies in line with the Paris goals
- These requests should be aligned across equity and bond fund managers, but for bond investors the ultimate escalation step would be to withdraw participation in future debt issuance from a specific issuer.

Asset owners - taking responsibility

2

Asset owners should not blindly rely on asset managers to undertake their fiduciary responsibility in this area but take a pro-active approach and discuss with their fund managers a robust engagement and escalation strategy for high carbon issuers across all asset classes, including corporate bonds.

3

Asset managers & asset owners - building a consortium of leaders

We believe that debt investors' engagement will only be effective in collaboration (see recommendation to regulators below). Leaders need to build a corporate bond investor consortium that is comfortable working to apply a forceful engagement process to high carbon emitting industries and issuers. Steps include:

- Forming of a leadership group from the CA 100+ signatories to explore opportunities for co-operation among bondholders;
- Identifying an adequate platform to facilitate collaboration; and
- Taking steps to introduce a process of public and forceful and, where necessary, public engagement.

4

Regulators and supervisors – enforcing fiduciary responsibility

We believe various governmental entities, financial regulators and supervisory bodies could take a number of simple steps to encourage action in this crucial segment of the capital markets.

European supervisors, such as the Financial Conduct Authority – Our report uncovered evidence that bond investors were concerned about concert party issues surrounding collaboration and joint engagement. We do not believe stifling engagement among institutional investors on systematic challenges such as climate change is in the interest of financial stability. EIOPA and ESME and other European financial supervisors including the FCA should provide clear guidance on how bond investors can engage collectively.

Department of Work and Pensions - In October 2018 the UK Department of Work and Pensions introduced rules to ensure trustees of both defined benefit (DB) and defined contribution (DC) plans have to state their policy on taking account of “financially material” considerations such as climate change. The appropriate financial regulator or supervisor, such as The Pensions Regulator, ought to ensure this explicitly requires reference to action in both equity and bond portfolios.

Financial Reporting Council – The FRC oversees the Stewardship Code and is shortly about to undertake a review and consultation of this code. There is limited reference to stewardship ‘requirements’ through bond portfolios or holdings within the current code. The FRC should introduce explicit guidance to bond investors on stewardship in its review.

The EU Commission – The EU Parliament has introduced the definition of “sustainability risk” into draft regulation. In this definition, sustainability risk is seen to split into two parts: risk to the investment and risk to the environment. According to the draft, asset managers will have to report on both. EU Council and Commission should adopt this definition.

The difference between equity and debt

Traditionally, engagement has been seen as the domain of equity investors. As shareholders have voting rights on a range of company matters. Debt investors have no such rights. So, can practices from the equity side be applied to bonds?

Bonds are debt securities that formalise a lending agreement between borrower (the security's issuer) and lender (the investor buying the security). The largest group of bond market instruments apart from government (or sovereign) bonds are publicly issued corporate bonds with a coupon, denominated in US-Dollar, Euro, Sterling or another G7 currency. They are rated from AAA down to BBB by one or more rating agencies and (together with government-related bonds) referred to as investment grade credit. Such bonds, if sizeable, form part of general bond indices published by institutions like Bloomberg, Markit, and ICE that are often used as benchmarks by asset managers. General market practice is to distinguish Investment grade credit from High Yield (rated BB down to C), Emerging market debt, Private debt, and some other categories. Classification is often fluid and bond mandates may allow investment across several categories. Most bonds have a fixed maturity at which the amount borrowed needs to be repaid. As bonds approach maturity, they need to be refinanced if the financial profile of the company is not to be changed.

Bond fund turnover tends to be higher than turnover of equity funds for two reasons. Bonds mature and need to be replaced in portfolios and multiple debt instruments may exist for a single issuer which allows for the exploitation of value differences. Unlike in the equity market, where new and secondary issues are relatively uncommon, bond fund managers will often deal with

several new issues a day. Despite shorter holding periods, bond investors may only be switching between bonds rather than issuers, and hence retain a long-term interest in the financial stability of corporate issuers.

Bond investors face two principal risks. The first is interest rate risk, which refers to potential loss of market value due to rising interest rates. When this happens an existing bond look less attractive than a bond issued with a higher coupon at the new prevailing rate. The second risk is credit risk: the risk that the investor will not get back a bond's nominal investment amount if the issuer becomes unable to repay and defaults on their debt. Default risk is remote for investment grade rated issuers (the one-year default probability for A-rated issuers is 0.08%, according to Moody's Investor Services⁶), and is only one component of the risk premium (the yield premium over government bond yields) or spread. Spreads are also compensating for the risk of an issuer's credit quality deterioration, and price volatility. Spreads increase when things go wrong for an issuer, as they did in the case of the BP Macondo oil spil.⁷

As a rule, for high quality corporate borrowers with a wide range of bonds outstanding in stable refinancing market conditions, bond investor communication is infrequent and bond investors' leverage is limited. As issuers have access to fewer funding sources, credit quality is lower, or market conditions become more difficult, the influence of bond investors increases, and communication often intensifies.⁸ In the extreme case of default (for example as a consequence of bankruptcy), the influence of equity-holders may be wiped out completely, and bond investors may step in as the new owners.

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Bond investor stewardship

While Socially Responsible Investment (SRI) exclusions have been practice in bond portfolios for decades, bond investor engagement on ESG risks has emerged as a practice only recently. The topic is explored in a recent paper by the Principles for Responsible Investment (PRI)”⁹

Equity investors have the right to speak out and vote at Annual General Meetings, and even small ones can seek to influence corporate strategy. Bond investors have no such privilege. The main right they have is the right to receive interest and principal back after a predetermined period, within the rules set by the bond covenants.

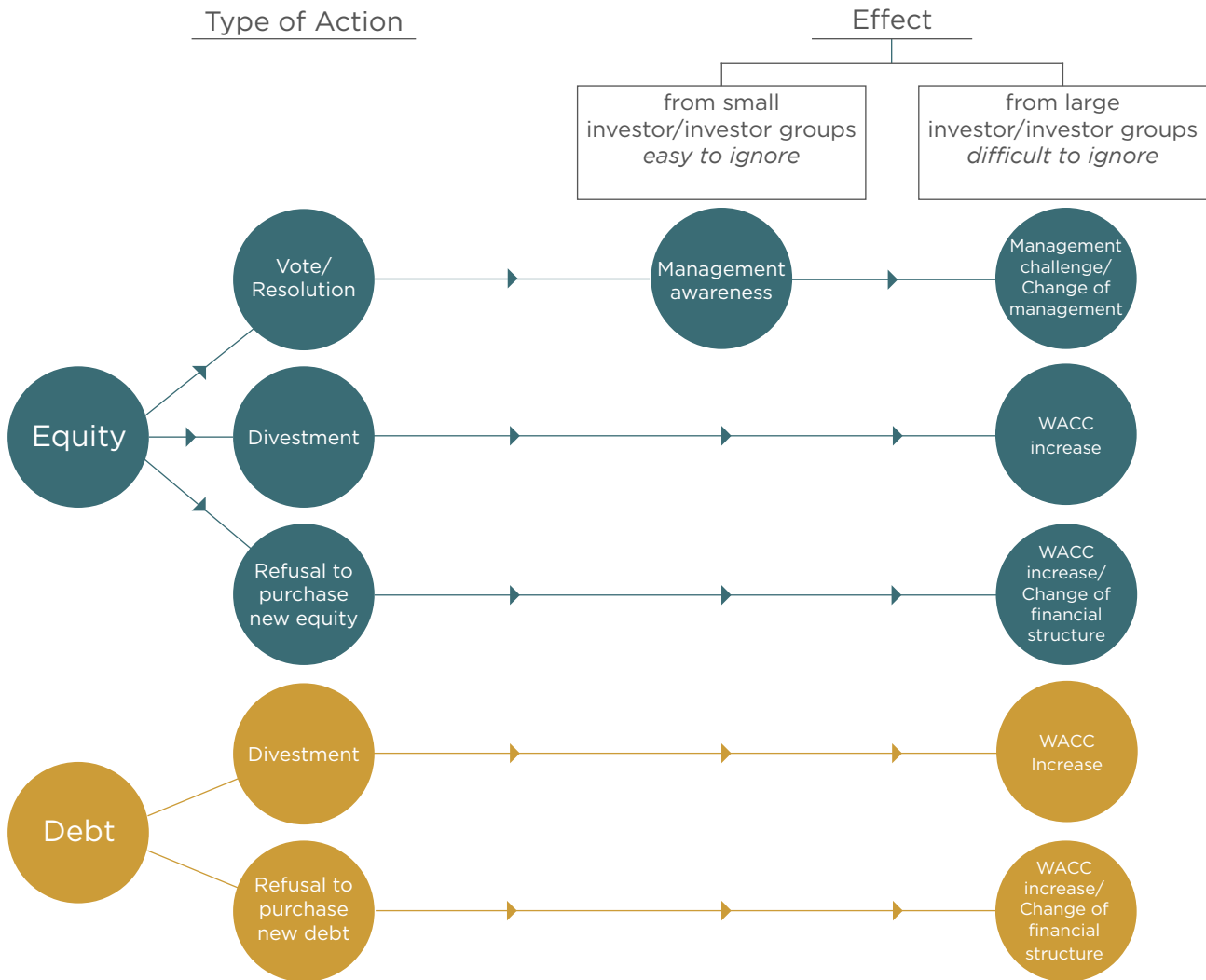
But according to a recent report by the World Bank, there are three leverage points for debtholders: “They can consider engagement during investor roadshows, at debt reissuance and in collaboration with other bond investors.”¹⁰ The report goes on to argue “that bond investors, in some aspects, may actually

be more powerful than equity holders,”¹¹

as bonds need to be refinanced, and refinancing can be withheld. This possibility creates potential leverage for bond investors. Equity, on the other hand, is permanent capital.

As outlined in the chart on the following page, various actions may impact the Weighted Average Cost of Capital (WACC) and as one interview participant in our research suggested: “The realisation that bonds can be a much more relevant to the WACC than equity is slowly sinking in.”

Figure 1: The Structure of Influence



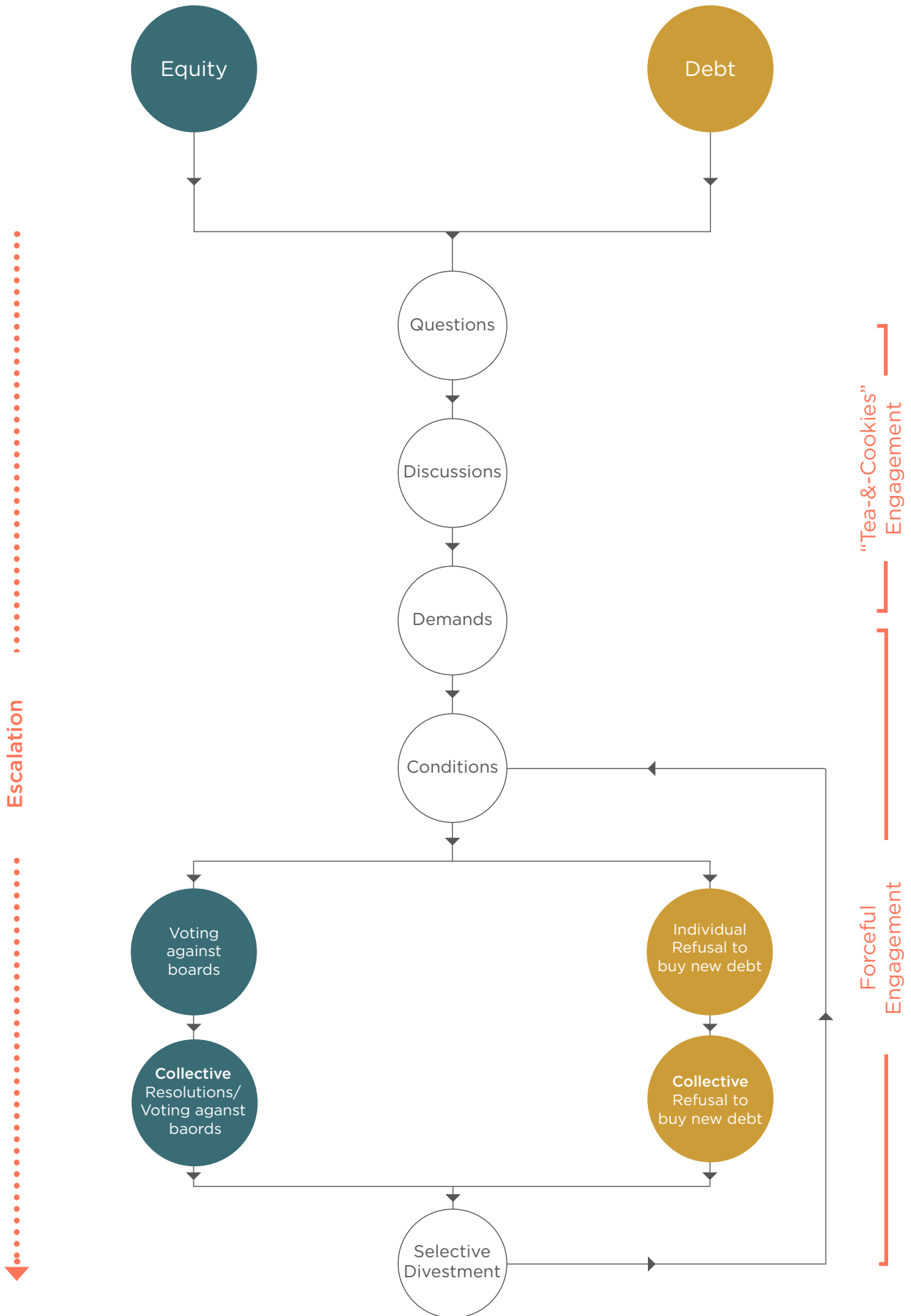
Source: ShareAction WACC: Weighted Cost of Capital, see glossary

In special circumstances, refinancing becomes an issue for shareholders as well: in a corporate crisis or an M&A situation, an issuer might have to shore up equity capital. In such a case, shareholders can, in addition to using their voting rights, exert influence by choosing not to subscribe to new stock.

In any case, refinancing only becomes a leverage point if one's share of the total debt outstanding is material. This is similar to dissent at proxy resolutions for equity holders particularly where votes are considered 'controversial' e.g. inclusion in the Investment Associations's Public Register where dissent is above 20 per cent.

We wanted to find out whether, on a continuum of stewardship steps, bond investors might choose a more forceful, escalated form of engagement. Such engagement is depicted in Figure 2. One respondent described it as "playing hardball."

Figure 2: Equity and Bond Investor Stewardship – Steps and Differences



Source: ShareAction

Methodology

This project had three objectives

- Open a discussion with asset owners and asset managers on the methods and benefits of engaging with corporate bond issuers on climate related financial risks;
- Establish appetite for preferred engagement strategies; and
- Explore perceptions of how ESG and climate issues affect credit risk

The research process entailed

- 17 semi-structured interviews with asset owners, asset managers and issuers, based on 10 interview questions (see Appendix);
- 5 interviews with experts drawn from investment consultancies, rating agencies and industry bodies (“Advisory”);
- Reviewing a sample of publicly available investment process documents from leading asset managers/owners;
- Interviews were conducted between May and October 2018, and participants were assured of anonymity.

Table 1: Participants

Organisation Type	Avg. Assets in billion GBP	Count
Advisory	0	5
Asset Manager	311	5
Charity/Church Investor	8	4
Government-related Investor	398	2
Issuer/Debt Capital markets	0	2
Pension/Insurance Investor	16	4
Grand Total		22

Organisation Domicile	Count	Job Functions	Count
Germany	4	CIO/Head of Strategy/Trustee	5
Norway	1	Consultant/Advisor	5
Switzerland	1	Issuer/Syndicate	2
UK	15	Portfolio Manager Bonds Credit	5
US	1	Responsible Investment Director	5
Grand Total	22	Grand Total	22

Source: ShareAction

Findings & Recommendations

This section provides details on what emerged from the interviews.



Finding
1

ESG risk is seen as relevant to bond investment

Almost universally, bond investors see ESG as manifestation of downside risk. For most interviewees, there is no question that the analysis of any type of risk needs to be integrated into the investment process

Many participants subsumed climate change under ESG. The integration of ESG factors into bond investment processes appears to be far advanced. Several interviews echoed one respondent who stated: “The bottom-up perspective is done.”

This conclusion makes intuitive sense as incorporating all aspects of ESG (e.g. asbestos and tobacco liabilities) into credit analysis and valuation is almost universally accepted as reducing risk. In fact, it is often argued that bond investors have always considered ESG risks, because this is a natural way to approach downside-risk mitigation. Rating agencies were seen to have significantly expanded the space that ESG commands within their company ratings over the last 5 years. While the case for ESG integration is well established at asset managers, clients were often reported to still be sceptical, and require conclusive, statistically robust evidence that ESG analysis contributes to out-performance. Some participants commented that the burden of proof for ESG issues is much higher than for other financial factors.

How longer-term ESG and systematic issues such as climate change are incorporated into credit analysis and valuation in practice is less clear for both investment managers and credit agencies. Several asset managers use scoring and/or industry-specific materiality frameworks to inform investment decisions. Some participants thought that climate change was more relevant to equities because of shorter investment horizons or higher sensitivity, and that the relevance of ESG risk varied greatly according to the maturity of bonds.

Participants thought that climate risks, just as most other risks facing credit investors, might take a long time to materialize (In this context, the TCFD differentiates acute from chronic physical climate risks¹²). On the flipside, investments with significant ESG risks could have long periods of positive performance. ESG-related risks are often explicitly accepted by investors if compensation in the form of yield pick-up is high enough. One asset owner described a lack of practical evidence on investment decisions directly determined by ESG considerations.

ShareAction challenge

Asset managers are adamant that ESG risks have been fully integrated into their credit analysis work. But with climate change seen as just one ESG dimension amongst others, urgency may be lost. Furthermore, reducing ESG considerations to an element of risk analysis falls short of what is needed to fulfil the goals of the Paris Agreement. Achieving these goals is highly relevant to people, especially millennials who now make up 35% of the workforce, whose retirement savings are invested in the capital markets.



Finding 2

Many ESG engagement teams already straddle bond and equity portfolios

Engagement activities for bond and equity portfolios seem to have been combined at many asset management firms

Asset managers interviewed explained that members from both equity and bond teams took part in corporate issuer meetings and were well served by an integrated team. Asset owners agreed with this approach, with an expectation of consistency amongst the divisions of an asset manager. From another angle it makes sense to combine as climate risk was pointed out as relevant to sectors, not asset classes.

Some participants shared the experience that during engagement, the amount of equity or debt they held was almost never of interest to the issuer. Others thought that equity ownership would be the more powerful or efficient basis for engagement.

Only one participant pointed out that debt investors may have very different objectives from equity investors which in turn would affect what each asset class was willing to do when engaging. They also thought equity and debt holders had different timeframes which are relevant when considering climate related risk and engagement. The question was asked whether bond investor and shareholder engagement, if indeed separate, would have to be considered as continuous (according to the position in the capital stack) or completed in parallel.

Some participants shared their experience that management teams of issuers are often not aware of bond investors' needs. According to them, Chief Financial Officers were sometimes very surprised to find that bond investors have a view and are looking to engage.

Views on whether engagement was a part of fiduciary duty were split: Some participants thought it was, but more disagreed.

One participant saw a principal-agent problem: While asset owners recognized the relevance of climate change for their beneficiaries in the long term, commercially driven asset managers were not incentivized to adopt such a time horizon. Another participant suggested that asset managers may have enough subject-matter knowledge, but do not provide adequate investment solutions.

ShareAction challenge

Because of their different position in the capital structure, bond and equity holders can have different interests. By centralising engagement functions, the interests of bond investors (and ultimate beneficiaries) may be subordinated to the interest of other asset classes or a 'firm wide' strategy. Any potential leverage bond investors might have could be lost. Nevertheless, engagement with issuers by both bond and equity investors can advance the interests of clients and ultimate beneficiaries. Fiduciary duties are a universal responsibility. If engagement, including more forceful forms of engagement, is a valuable tool with which to fulfil those duties by professional equity investors, the same case can be made for bond investors.



Finding
3

Complexity and poor data are barriers to climate action

Participants say that they do not have the data needed to make ESG and climate change integral parts of their investment decision making process

The lack of common language was seen as a significant obstacle to progress, likened by some to an earlier phase in asset management when the term risk was not well understood.¹³

Some participants believed that the complexity of climate change and its implications meant kite-marks were needed to differentiate between products or approaches. The EU Commission's work creating a taxonomy was seen as a necessary step, although the focus was seen to be too narrowly on environmental, rather than social or governance, issues.

Framing the problem of climate change in a less negative or pessimistic way was also thought to be useful by one participant. There was a need to break down the required action over the multi-decade horizon into smaller parts making actions in the near future easier to undertake.

One participant thought that the presentation of climate change was often too abstract, causing financial decision makers to feel powerless. Several interviews highlighted the importance of case studies of institutions successfully taking first steps to overcome scepticism and "too much following in the industry". Several respondents saw the putative lack of ESG focus of the US asset management industry as a big obstacle to climate progress.

One participant thought that climate change was easier to tackle than other ESG areas, as quantitative objectives were easier to develop.

Many asset managers look to external data providers whereas some use proprietary resources. Multiple participants (asset owners and managers) pointed to the need to collaborate with academics to ensure a rigorous and disciplined approach. One participant found that most existing investor data services or were overly complex or not accessible. The lack of good Scope 3 data for the banking sector to calculate a meaningful carbon footprint was highlighted as an example. One asset owner outlined the difficulty of analysing multiple portfolios and asset classes across different asset managers due to a lack of commercial solutions with consistency across asset classes. Some participants questioned the intense focus on scenario analysis. It was also thought that while data for blue-chip companies was ample, small-cap and emerging market company data was scarce.

ShareAction Challenge

Investment activity never has the luxury of complete knowledge, and the financial system itself is highly complex. The complexity of climate risk and the lack of data cannot be taken as reasons not to fulfill fiduciary duty.



Finding 4

Views on green bonds are mixed

Most participants said they would buy green bonds if there was no valuation differential with conventional bonds. Some investors liked the concept, particularly the added transparency, but some did not understand the purpose of green bonds

Diametrically opposed views exist among investment professionals over the merits of green bonds. One participant called green bonds “a good idea, poorly implemented.” Positive and negative views included:

- Extra transparency on both the issuer and the portfolio (many participants)
- Ease of use because there is no risk differential versus conventional bond of the same issuer (one participant)
- Opportunity for issuers wanting to diversify away from high-carbon core business models (several participants)
- Opportunity for greenwashing (several participants)
- Green bond Key Performance Indicators (KPIs) varying significantly across countries, even within industries (one participant)
- Cynicism around issuers who have no motivation to diversify away from fossil fuels (several participants)
- Limited incentive to select green bonds unless valuation is at least as attractive as for conventional (“brown”) bond (many participants)
- Small market size relative to overall bond market. An issue that was expected to persist. (several participants)

Mandate use

One participant reported a client mandate that excludes investments in fossil fuel issuers. Bonds from such issuers can nevertheless be bought if they are green and used to fund diversification away from a high-carbon business model.

Next Step

Some participants thought that the regulatory obstacles for green securitisations (e.g. asset backed securities backed by green auto loans or solar photovoltaic generation systems) were too great to make them a viable alternative for investors, and that even issuers were sceptical. Moody’s thinks that growth of green securitisation may be hindered by a lack of green collateral.¹⁴

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It was also suggested that dedicating the use of proceeds to green purposes was a somewhat artificial concept, and that evolution towards more issuer-focused green credentials was preferable.

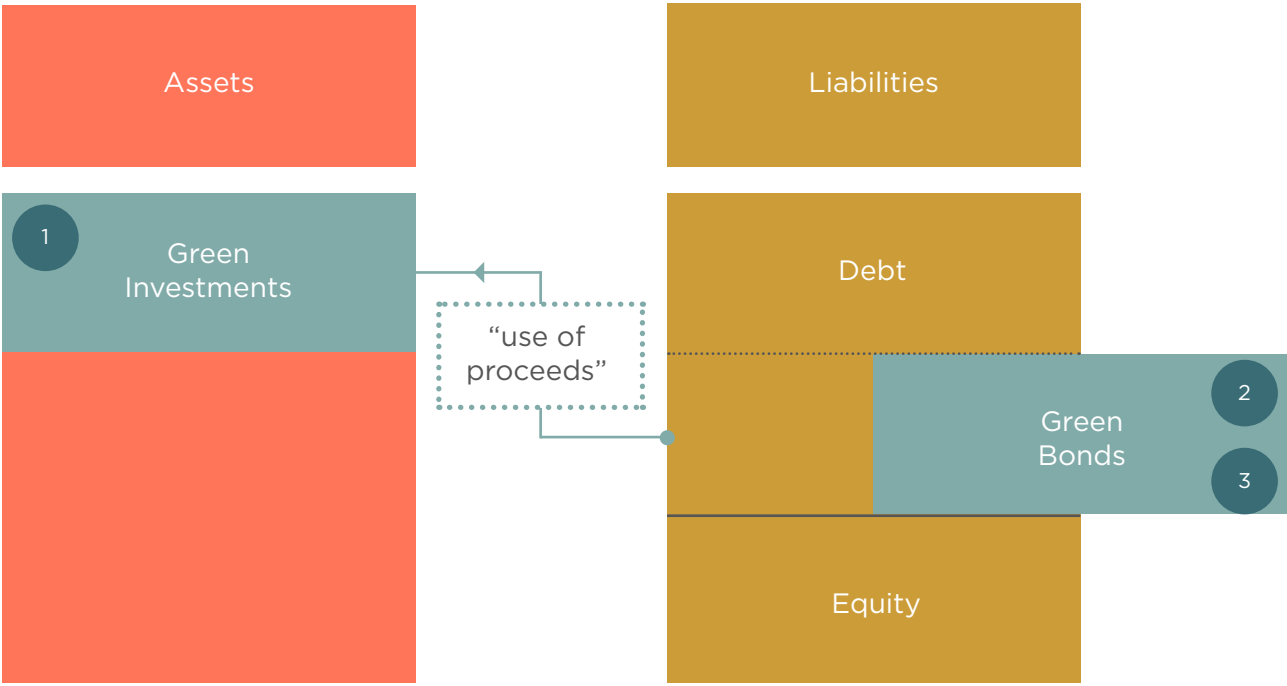
ShareAction challenge

To genuinely assign green impact to a green bond, it needs to facilitate green investment in a way that a ‘brown’ bond would not. This can be either on the asset or liability side of the balance sheet.¹⁵

For example, the green investment itself could be additional (see Facilitation option (1) in Figure 3); or the financing conditions could enable pre-existing green investment by enabling (2) access to new funding markets (for example for the Republic of Seychelles, who has defaulted on its debt in the last decade and might not find buyers for conventional bonds¹⁶); or by allowing (3) cheaper funding than through ‘conventional’ options.

If none of these facilitation options are present, the green bond is green in form and name only and cannot be seen as mitigating climate change. Investing in such green bonds will not hurt, but it will not contribute additional environmental benefit either.

Figure 3: What makes green bonds spark



1 New investment

2 New funding market

3 Cheaper funding

Source: ShareAction



Finding 5

Sector exclusions are approached with great caution

Virtually all respondents expressed concern over the exclusion of whole industries or sectors from portfolios

In contrast to equities, excluding single issuers was not seen as particularly problematic by bond managers due to the return asymmetry of bonds (the potential for total loss of capital but only limited gain). However, it was reported that clients were fearful of missed opportunities and often demanded evidence in support of ESG-based exclusions. But it was pointed out by participants that exclusions at stock-selection level were far less relevant to asset owners' returns than high-level strategic asset allocation, and thus asset owners should not be concerned.

Participants in general were not keen on sector exclusions (where applied to either bonds or equities), believing they would affect relative returns. However, participants had no clear sense of what kind or magnitude of effect climate-based exclusions would have on (either equity or debt) portfolio returns and reported a lack of comprehensive quantitative studies. A participant pointed out that the extent of climate change risk varied across different sectors but did not vary across different asset classes within a certain sector.

Sector exclusions were frequently seen as a portfolio-construction problem. Several participants thought that sector exclusions were not helpful in dealing with climate change, as all sectors were thought to be required for a 2-degree pathway. Investing in companies that were strategically focused on the transition would be more effective than de-carbonizing portfolios. One participant pointed out that sovereign bond exclusions were as relevant as those regarding corporate bonds.

Exclusions dictated by asset owners are accepted practice, but were seen as values-based, requiring an explicit request or instruction. Some participants were explicit in saying that they excluded for profit, not for impact. Many participants mentioned ex-ante exclusions determined by the asset manager (rather than the asset owners), particularly for controversial weapons and tobacco.¹⁷

Some participants were keen for appropriate climate indices to be developed, though others expressed concern around the influence of index providers' ESG views or judgements. According to two asset owners, a reliance on indices or benchmarks made it more difficult for portfolio managers to underweight or exclude carbon intensive sectors, hence a preference for total-return targets. They argued that the advantage in terms of sustainability was that a manager did not need to grapple with exclusions or underweights that could potentially lead to relative underperformance if issuers, de-selected on the basis of ESG considerations, outperformed.

One participant described an investment process where issuers were scored according to ESG criteria and excluded the lowest 20 per cent. This best-in-class approach was seen as effective in changing company behaviour when communicated transparently but privately to the respective issuer. Another participant subscribed to informing issuers about being lowest quartile under CDP methodology, but did not outline an escalation process.

ShareAction challenge

Fiduciary investors, both asset owners and asset managers, should acknowledge the relevance to their clients and ultimate beneficiaries of climate change itself and not only of climate-related portfolio level risk.

Having done so, such investors may adopt more ambitious impact-driven climate strategies that seek to mitigate carbon emissions and support a swift low carbon transition across the global economy. Forceful engagement with high carbon issuers by equity and bond investors is a key tool to deliver positive environmental outcomes that meet the interests of clients and ultimate beneficiaries.



Finding
6

Refusal to refinance/roll over bonds and issuer specific divestment are seen as effective escalation tools

Despite being sceptical around sector-wide exclusions investors acknowledge that the threat of divesting a specific issuer's bonds or refusal to refinance could influence issuers

Many participants thought escalating engagement by threatening to withhold investment at refinancing occasions (i.e. not buying new issues) or divestment was an effective escalation step.

Several participants were concerned that divestment would curtail influence and expressed their preference for engagement over divestment. One participant reported in some cases divestment had resulted in greater dialogue on ESG issues. In the same vein, another interviewee reported that when ESG factors influenced order size for a new bond issue, the issuing company had taken notice and sought to understand the reasons for reduced demand. Other fund managers have also used the possibility of re-investment as a powerful engagement tool.

Participants also stated the level of influence differed depending on market volatility and liquidity. Multiple participants highlighted that when markets became more bearish and financing conditions tightened, investors would be able to address ESG issues and exert more influence on covenants and pricing.

Some participants thought that engagement often was too friendly and in danger of becoming a marketing activity; "Tea-and-Cookies" engagement, as one participant called it. One participant thought that, with a few notable exceptions, escalation strategies of asset managers were not sufficiently transparent.

A number of participants said that they did not want to be too “prescriptive” when talking to companies’ management teams and were concerned this might undermine management’s accountability.

Those participants who were most outspoken on the view that divestment was a necessary escalation step were also those who had most enthusiasm for collaborative bond investor pressure.

ShareAction challenge

The ability of bondholders to participate in or sit out issuance by high carbon corporates gives those investors leverage that could incentivise companies to improve their climate-related risk management and to align their business models and capex with the goals of the Paris Climate Agreement.



Finding 7

The idea of bondholder collaboration is viewed with unease

Collaboration around engagement with issuers or publicly communicating conditions for continued investment are widely considered to be legally problematic. However, we found a small minority would consider such actions

There appeared to be reluctance from a majority of participants to consider publicly co-ordinated communication or collaboration on the conditions for continued investment in an issuer's bonds. This seemed to be due to concerns over legality, effectiveness and publicity. However, collaborative escalation was judged to be "really powerful" by several participants and a few expressed enthusiasm for an investor-led initiative along these lines.

Legal concerns

Concern about legal consequences of collaborative activities was widespread and shared across jurisdictions.¹⁸ Concerns include:

- Acting in concert, requiring the aggregation of voting rights;
- Anti-competitive behaviour under anti-trust laws; and
- Market manipulation according to the EU Market Abuse Regulation (MAR).

Collaboration through initiatives such as Climate Action 100+ was seen as less problematic, as engagement was conducted on a one-on-one basis.

Effectiveness

Most participants believed that one-on-one interaction between investor and issuer in private ("behind closed doors") was more effective, because finding agreement across investors was considered difficult.

Some participants thought that some sustainability investor coalitions might have grown too big. Others, however, held the view that large investor coalitions, such as the PRI, were the most effective way to deal with global issuers, and allowed the most active investors to move the debate towards influencing ESG impacts.

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Publicity

Participants had a variety of reasons why they did not like to be part of a public communication strategy. Concerns included:

- Being seen to be acting politically;
- Drawing attention to the asset base;
- Reputational risk of being associated with the wrong kind of partners; and
- Lack of specific client guidance.

Nevertheless, a small number of respondents thought a public escalation strategy was viable and there would be some appetite for forceful bond investor engagement.

ShareAction challenge

Legal concerns among institutional bondholders pose an obstacle to collaborative engagement with issuers on climate-related risks. In the last decade, such concerns have largely been overcome in the equity markets. Regulators and financial supervisors should act to reassure bond investors that collaborative engagement activity driven by an objective of managing risks for clients and ultimate beneficiaries is legally permissible, indeed desirable.



Finding 8

Little clarity on what clients or beneficiaries expect with respect to climate change

Communication with clients and understanding their needs whether institutional asset owners or individual savers, is difficult

Respondents outlined several issues around their interaction with their respective clients.

On retail clients:

- Where retail clients were asked, the maximisation of returns still seemed paramount.
- Where impact-aware offerings exist, demand was variable.
- Offering too many choices could be daunting for clients (and too expensive for asset managers).
- A lack of clarity existed on whether clients should be asked about or advised on ESG offerings or preferences, and to what extent the respective regulator needed to be involved.
- Sustainable retail products were seen as problematic due to the value-based nature and changing client demands, both of which posed a distribution challenge.

On institutional clients (asset owners):

- Several participants thought that the push for more climate-focussed investment would come from asset owners.
- On the other hand, asset owners were seen to be happy to delegate ESG considerations to asset managers.
- Also, asset owners in general were deemed by asset manager participants to be lacking a clear view over what specific impact they expected. Asset owners needed to become more specific on their expectations.
- On the other hand, asset owner participants thought that the asset management industry did not offer enough thought leadership in this regard.
- The mismatch between the beneficiaries' horizon and that of trustees (who were thought to only look out to 3 years in terms of investment risk) was repeatedly mentioned.

Participants made a number of comments in relation to the role of investment consultants including:

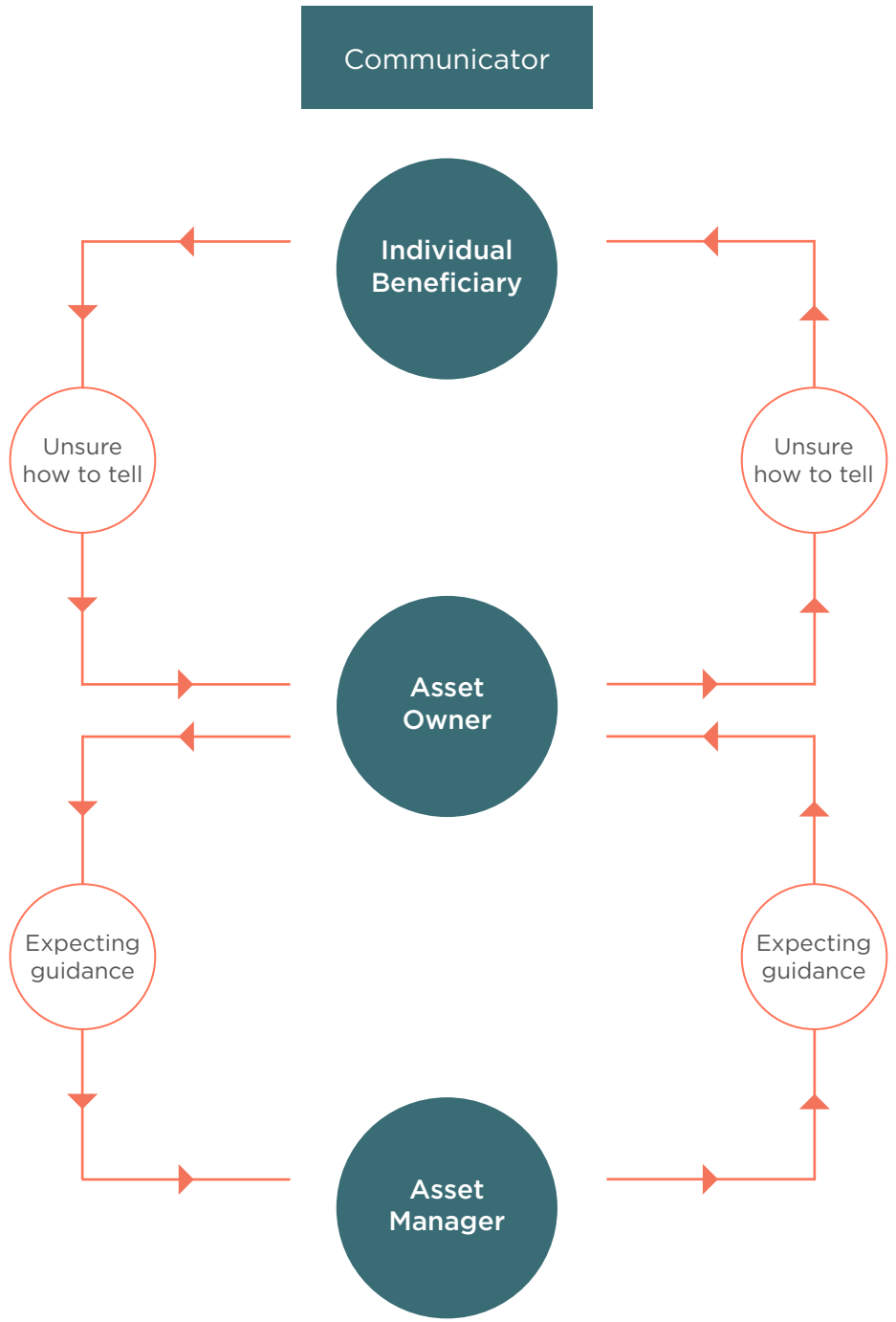
- Consultants' insistence on long performance track records to show ESG made financial sense;
- Consultants' focus on defined benefit portfolios and underfunding concerns, which held them back from a genuine focus on climate risk;
- The fact that climate change was specific to sectors/industries rather than asset classes, which made it difficult to incorporate into consultants' strategic asset allocation advice; and
- Climate change being pitched by consultants as one among many strategic issues relevant to clients.

ShareAction challenge

Many institutional (asset owner) clients like to delegate decisions relating to ESG matters to their asset managers. Asset managers, on the other hand, are frequently unwilling to make bold decisions on ESG matters without clear guidance and explicit encouragement from their institutional clients.

This sort of circularity (see Figure 4) creates a barrier to appropriate action by fiduciary investors to address climate risks in the best interests of pension savers. Both asset owners and asset managers should step up to meet the challenge presented by climate change.

Figure 4: Communication in circles



Source: ShareAction



Finding
9

When it comes to climate change, most bond investors hope that governments will bail everyone out

Most participants thought that ultimately, climate change was for governments to tackle, and that the investment industry's steps would not amount to much in terms of mitigation

Survey participants believe that decisive action on climate change is ultimately expected to originate from governments and/or regulators, thus removing the need for investors to take responsibility. Survey participants also highlighted the role of emerging markets and state-owned business in the fossil fuel sector, limiting the influence of both equity or debt investors'. However, several state-owned oil companies like Petróleos Mexicanos (PEMEX) and Petróleo Brasileiro S.A.-Petrobras are important corporate bond issuers.

In the mind of many participants, it was for governments to describe the next steps towards a solution to the climate change problem. One participant thought that lobbying governments through investor coalitions was the most effective action individual investors could take to mitigate climate change.

Several asset managers considered French asset owners to be thought leaders on climate related risk, due to the recently enacted Climate Change Law. One issuer reported that French asset managers were much more advanced in the way they thought and talked about sustainability than investors in other jurisdictions.

Regulators were pointed out by participants to be the driving force that was pushing asset owners to identify solutions.

ShareAction challenge

The need for government involvement arises because existing frameworks do not adequately capture the risk of climate change. But reacting to changing legislation can be costly.



Finding 10

Bondholders are focused on mitigating portfolio level climate risk, but not climate change itself

Bondholders interviewed are thinking about the implications of climate-related risks for portfolio management and asset selection. They are not yet focused on the impacts of their investments. The question of how to limit global warming to 2 or 1.5 degrees is not a question that bond investors think they need to ask or answer.

Our survey indicates that, with the clear exception of value-based investors like church pension funds and charities, investors seem to have difficulties incorporating the direct and explicit objective of limiting global warming into their investment process. This is despite a growing focus on climate related risks.

Several participants were adamant that values were not necessary to make investment decisions in line with the Paris Agreement, and that a risk-based approach, e.g. through the application of Climate Value at risk,¹⁹ was sufficient to tackle climate change. According to one participant, a focus on non-financial objectives would effectively be regressing to “ethical” investment, which would raise resistance unnecessarily. In contrast, other participants thought that climate change might best be incorporated into the investment process by considering the impacts of investment decisions. Some participants also pointed to the concept of Universal Ownership,²⁰ which they thought was enough to justify climate action in portfolios.

Interestingly in this context, one participant pointed to their experience that investors were more interested in Sustainable Development Goals (focus on impacts) than TCFD recommendations (focus on risk management).

One participant thought that climate change considerations tended to come too late in asset managers’ investment process. Another interviewee suggested that the severity of climate change would significantly alter the way portfolio managers needed to react, with the economic and societal impact of future temperature increase making climate change mitigation a more direct objective for investors. Yet another participant suggested that asset owners’ only priority was to make sure they were able to make all contractual payments to beneficiaries but had no consideration for how climate change might influence the lives of those same beneficiaries and savers.

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But, to use an analogy, building your house on the hill may give adequate protection from flooding; it will not stop the sea-level rising.

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ShareAction challenge

Many bond investors recognise that addressing climate related risk is a matter of good portfolio risk management. But, to use an analogy, building your house on the hill may give adequate protection from flooding; it will not stop the sea-level rising.

In order to deal with the emerging impacts of climate change itself, investment objectives need to include a third dimension to the traditional dimensions of risk and return. Real-world impact (see Figure 5: a PRI-promoted concept) “extends the traditional two dimensional view of risk versus return (which should already include all material ESG factors based on current interpretations of fiduciary duty), with a third dimension that charts the real-world impact that investments can have, on the natural environment and/or society.”²¹

The issue with Time-value of Money

One reason for the missing motivation to go for more forceful engagement may be the concept of time-value of money, which is core to fixed income investors' thinking. Lack of urgency when engaging with bond issuers may stem from an inability to incorporate extra-long-term risk due to discounting. This can be illustrated as follows: For a constant annual cash flow of £1 for the remainder of the century, assuming a 7.5% discount rate, the present value (PV) of the last 25 years to 2100 will be a mere 1% of the total PV, and close to insignificant (see Table 2).

Table 2: PV of £1 paid yearly till 2100

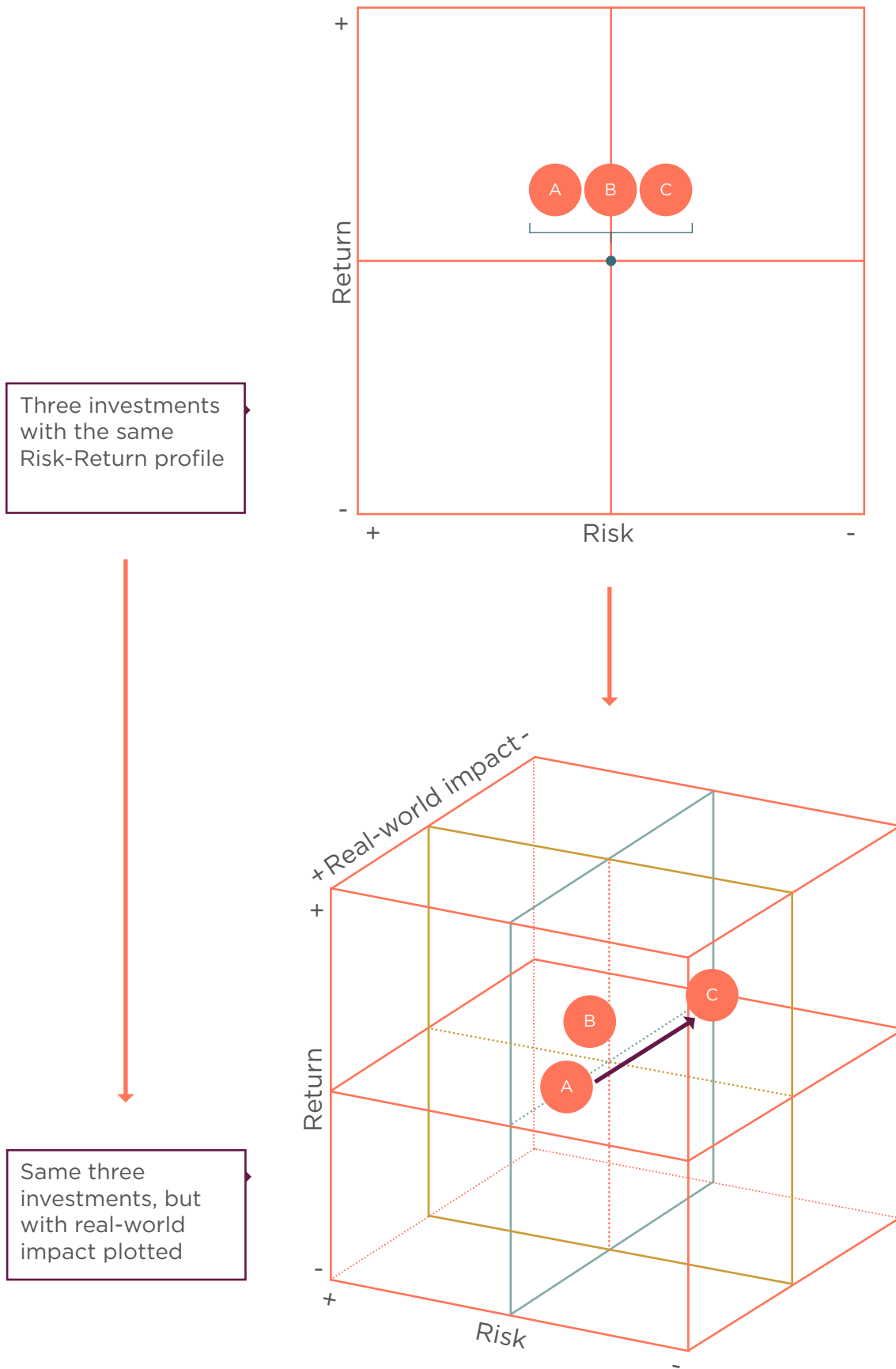
	Years	Current value in £	% of total
2019 till 2025	7	5.30	40%
2026 till 2050	25	6.72	51%
2050 till 2075	25	1.10	8%
2075 till 2100	25	0.18	1%
Total	82	13.30	100%
<i>Discount rate</i>	<i>7.5%</i>		

The fact that risks to cash flows beyond a certain point are not relevant to bond investors can also be witnessed in practice: When Mexico issued a 100-year bond in 2010, the risk was not considered to be significantly different from a 30-year bond. "The bond will actually behave very much like the 2040 Mexican bond [...] there's little difference in risk."²²

It is also visible in a well know Mercer study that considers fundamental investment impact for the most negative climate scenario to be neutral, because many aspects of climate change will only become apparent after 2050, which is beyond the study's horizon.²³

Source: ShareAction. For illustration purposes only

Figure 5: Including a third dimension



Source: Principles for Responsible Investment

This scoping project attempts to gauge to what extent corporate bond investors are motivated to include climate-related risk and issuer engagement into their investment process. More specifically, we were attempting to find out whether bond investors would be willing to communicate with issuers in a co-ordinated manner.

The interviews showed that, in principle, bond investors are comfortable integrating ESG factors into investment decisions. This comes as no surprise: with corporate bonds having an asymmetric risk-return profile, it is almost natural to consider climate change and ESG issues as forms of risk (Finding 1).

But this observation is at odds with the lack of appetite for coordinated engagement that was a theme throughout many interviews.

Lack of ownership was mentioned as cause for such engagement restraint, but only by a few participants. Multiple other reasons came up, such as complexity and poor data (Finding 3), and a lack of clarity on clients' objectives with regard to climate change (Finding 8). Legal concerns about concert parties appeared

as an important reason for holding back (Finding 7).

Most participants viewed engagement on climate action as something to be driven by ESG teams (Finding 2), or for investors in the green bond market (Finding 4). However, there was a broad recognition that the prospect of refusing to refinance or of divestment would be an effective engagement step (Finding 6), although investors are not keen to use sector wide exclusions (Finding 6). Most participants believed that ultimately, government action was required to promote climate objectives (Finding 9), rather than actions by bond investors (Finding 10).

Our observation on the interviews was that bond investors, for various reasons, are timid in their approach to engagement on issues including climate change. We believe that robust engagement is feasible at intervention points during refinancing. Reviewing asset managers' approaches in this area will be an important step forward, requiring adapted thinking and challenging of established practices.

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Only the Impact-aware view (View 3) that considers the preservation of an inhabitable world as an objective in its own right is able to grasp the effects of climate change in its entirety.

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In this respect, the concept of Real-world impact may help bond investors justify engagement to promote climate action beyond values-based investment strategies, political positions or ethical considerations. Participants insisted this required a specific mandate from investors (also Finding 6). However, examples of values-based actions without specific mandates are widespread in the form of exclusion of tobacco and controversial weapons investments.

In Figure 6, we attempt to show why awareness of Real-world impact is important in understanding climate risks clearly. As we move from left to right, the ability to consider long term horizons increases. The Risk-aware view (see View 2 in Figure 6), currently becoming more widespread in the financial industry, is able to consider the risks posed by climate change to a portfolio, which a Naïve view (View 1) cannot understand. But even a Risk-aware view is not able to consider effects beyond 2050, due to the concept of time-value of money, amongst other reasons.

Today's young pension saver, however, has a strong interest in both capital and climate protection beyond that date.

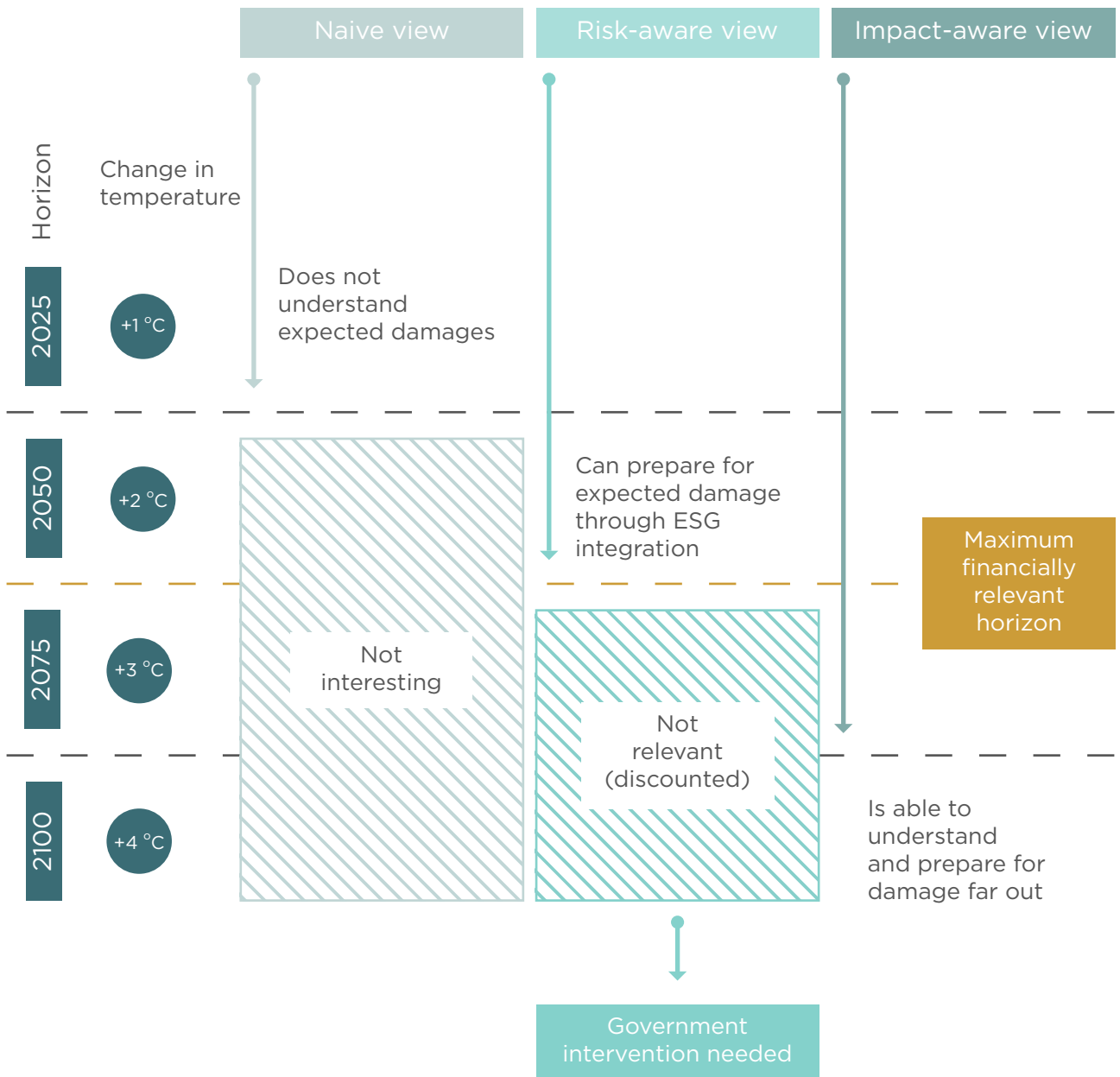
But without the ability to consider effects materialising in the second half of the century, the motivation of the private sector to mitigate climate change will remain less enthusiastic than required, and the public sector will be looked to for all the solutions.

Only the Impact-aware view (View 3) that considers the preservation of an inhabitable world as an objective in its own right is able to grasp the effects of climate change in its entirety.

We believe this is particularly relevant for Climate Action 100+ signatories who are contemplating or involved in the refinancing of issuance from carbon-intensive businesses such as utilities, integrated oils, automotive and high-energy users. Looking at the engagement process in Figure 2, it is clear that the value of 'tea-and-cookies' engagement is limited.

We keep the optimism of one participant who observed: “The debate has only just started to shift from disclosure to performance, and proper engagement is only just beginning.”

Figure 6: The Limitation of Horizons



Source: ShareAction; Change in temperature values for illustration only

Appendix

Interview Questions

Objectives

- Q1: How do you see climate related issues impacting your bond investments?
- Q2: Has your organisation looked at return implications of considering climate related risks in asset selection?
- Q3: Would you consider either climate change-related advocacy/engagement or asset selection part of your fiduciary duty?
- Q4: Have you encountered any barriers to incorporating climate change considerations? Q5. Have your clients/beneficiaries been receptive/proactive?

Communication

- Q6. Would you consider demanding climate commitments from bond issuers?
- Q7. Would you consider joining a public declaration on demanding climate commitments?

Portfolio action

- Q8. How far can conditional exclusion go without impairing your objectives: to issue, issuer, or sector level?
- Q9. Do you see a role for Green bonds?
- Q10. How do you see bond and equity engagement overlapping and where do you see the best intervention points for bond investors?

2-degree pathway

The way the world will develop if measures are taken to limit global warming to 2 degrees Celsius by the end of the century compared to pre-industrial temperature levels

Amortizing bond

A bond that pays back principal over its life, either according to a schedule or without

Asset Backed Security (ABS)

An example of a securitisation. A debt security whose cash flows are derived from a pool of assets, e.g. car loans. If the assets are mortgages, the security is called Mortgage Backed Security (MBS)

Asset Manager

A commercial institution that offers investment services to asset owners along with a wide range of traditional and alternative product offerings that might not be available to the average investor

Asset Owner

An entity that has legal ownership of assets, like an insurance company, a pension fund, a sovereign wealth fund or a charity/foundation. Asset owners often have fiduciary duties to ultimate beneficiaries

Capital stack

The order of seniority of liabilities which are claims to the assets of a company, with senior debt the highest and common equity the lowest

CDP (Carbon Disclosure Project)

Formerly Carbon Disclosure Project, an organisation dedicated to the disclosure of carbon footprints

Credit

Summary term for financial debt assets that carry a risk of default, like corporate bonds. Government bonds are often assumed to be default-free

Climate Action 100+

An investor initiative that targets companies that contribute most to the world's greenhouse gas emissions

Decarbonise

Reduce the carbon footprint of an asset or portfolio of assets

Engagement

Any form of communication between an investor and the company they have made an investment in, through purchasing shares or bonds in that company

Environmental, Social & Governance (ESG)

Financially material non-financial factors of company behaviour which are taken into account when making investment decisions

Externality

Consequence of an economic activity impacting on unrelated parties or society as a whole

Fiduciary Duty

A legal obligation to apply a high standard of care to act in the best interests of the person whose financial assets are managed

Fixed Income

Also called fixed interest. Summary term for debt investments under which the issuer is obliged to make payments of a pre-determined amount on a fixed schedule, like bonds and loans

Green bond

Bonds whose proceeds have been agreed to be used for green investment projects

Investment Association

The UK's main lobby group for asset managers

Issuer

A legal entity that sells securities for financing purposes

Paris Agreement

Agreement signed by 195 members of the United Nations Framework Convention on Climate Change (UNFCCC) to keep global warming well below 2 degrees Celsius above pre-industrial levels until 2100, with a stated ambition to keep temperature rise below 1.5 degrees Celsius

Principal-Agent-Problem

When the agent has authority to make (investment) decisions on behalf of a principal, but incentives are not in alignment

Principles for Responsible Investment (PRI)

Global investor organisation with UN-affiliation focused on sustainability

Rating agencies

For-profit organisations publishing estimates of default risk for bond issuers. The most influential ones are Moody's, Standard & Poor's, and Fitch. Ratings are usually assigned on a letter scale from AAA (highest quality or lowest risk of default) to C (lowest quality or highest risk of default)

Real-world impact

Third dimension next to the traditional dimensions Risk and Return used in financial decision-making. Concept promoted by PRI

Refinancing or 'rolling over'

Replacing the existing funding of a business with new funding, because the existing funding is running out or better terms can be achieved

Responsible Investment (RI)

Responsible investment is an investment strategy which seeks to generate both financial and sustainable value, often by excluding certain industrial sectors or domiciles. SRI is often considered to have been a precursor to ESG integration

Scope 3

Indirect greenhouse gas emissions from the value chain of an organisation

Securitisation

The practice of turning an asset or pool of assets into a security which derives its cash flows from that asset or pool of assets

Stewardship

The process of an investor using their influence over a corporate entity to leverage improvement in their ESG performance through the exercise of their shareholder rights to vote, engage with the company, pose resolutions and ultimately divest their share

Stewardship Code

UK company law defining expected behaviour of institutional investors

TCFD

Task Force on Climate-related Financial Disclosures; A project group under the G20 Financial Stability board tasked with development of disclosure standards which have become best practice

WACC

The Weighted Average Cost of Capital is the required rate of return of a company. Projects of similar risk profile should be discounted with that rate

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