Background

Environmental, social and governance (ESG) factors are becoming increasingly important in investment decision processes for mainstream fixed income. This is driven by growing evidence that ESG factors influence credit risk, and that ESG considerations are part of risk mitigation. Separately, even if most fixed income investors do not deliberately consider ‘impact’ in their investment decisions, reporting on portfolio impact is becoming more common.

Despite these developments, there are still significant challenges to fully incorporating ESG in fixed income. There is insufficient data, disparate standards, and scarce statistical data linking the financial performance of an investment with sustainability considerations. There are also different views on the definition of ‘social’ considerations.

Japan’s Government Pension Investment Fund (GPIF) and the World Bank Group have partnered to identify and address these challenges, with the broader goal of directing more capital towards sustainable investments. The first step is a joint research project that explores practical solutions for integrating ESG into fixed income portfolios and seeks feedback from investors and market participants. The final report on this research will be published in time for the 2018 Spring Meetings of the World Bank Group and IMF (April 20-22, 2018), and will include a study of existing research, the results of interviews with investors and ESG data providers, and feedback from a workshop convened by GPIF and the World Bank Group on April 3, 2018. At the workshop, 20 investors discussed the draft report and explored challenges and opportunities for growing sustainable fixed income markets.

Five Key Take-Aways from the Investor Workshop

This note provides a summary of highlights from the investor workshop. The final research report will reflect these inputs and those of investors that were interviewed as part of the research, but not present at the workshop.

I. Technology and data will revolutionize ESG fixed income investing.

An abundance of ESG data exists for corporates, multilaterals and sovereign issuers, but it often lacks standards or references, some of it is outdated, and its relevance is often not well understood. This is particularly problematic for emerging market credits. A better understanding of sustainability, and guidance on the relevance of indicators on performance and impact, are needed. Data should also be more easily accessible, reliable and timely. Some investors at the workshop stated preference for data that focuses on key ESG indicators rather than bundled ESG ratings, and on trends rather than absolute levels.

II. ESG is important to both short and long-term fixed income investments.

No matter the investment timeframe, ESG considerations are widely believed to impact investment risk. Even for investments with short-term horizons, ESG considerations can be material. For example, changed perceptions of the potential impact of climate-related disasters could affect credit assessments and bond prices long before actual events occur. And beyond pure risk mitigation, if investors recognize a positive ESG trend, issuers could be rewarded with better funding costs.

III. Customization is a growing trend for fixed income.

Asset managers are seeing more requests for customized investment approaches that consider clients’ expectations and values. This may include focusing on specific Sustainable Development Goals (SDGs) or sustainable themes. Exclusions/negative screening requests also remain common. For instance, clients may request to exclude products that support fossil fuels (especially coal), certain types of weapons, and tobacco, in some cases, despite potential effects on performance. Sophisticated ESG technology, integration, expertise and impact reporting frameworks may offer asset managers the ability to differentiate themselves and deliver on these growing demands by asset owners.
IV. Fixed income investors can influence issuers.

Even if bondholders don’t have voting rights, they have influence. For corporates, fixed income investors can leverage equity investor conversations with management. Some investors also approach issuers as a group on these issues. While initial conversations may not appear to yield results, investors note that they have seen change in subsequent communications by issuers on reporting and disclosure, which can lead to changes in policies and action.

V. Fixed income investors can consider impact in a range of ways.

Investors consider impact in a range of ways. At one end of the spectrum are the majority, who incorporate ESG considerations in the investment process exclusively to mitigate risk. These investors are focused on portfolio risk and return, without factoring in external costs – that is, they do not explicitly incorporate into their decisions the potential impact their investments may have on the environment or society. At the other end are investors who intentionally integrate impact in their investment decisions, with some even prioritizing positive impact over financial return for their portfolios. In the middle are investors who do not yet include impact value in their investment decisions, but collect, assess and report on outcomes and/or impact that their investments help support. These investors appreciate the value of contributing to social impact and the benefits of communicating it with clients or stakeholders and prioritize products that focus on positive social and/or environmental benefits. Investors expect that the distribution of investors within this spectrum will evolve over time. More transparent reporting and more reliable and comparable impact data will make it easier for investors to choose investments that have a positive effect on their portfolio and on society.

The workshop also sparked discussion on comparisons between ‘labeled’ and ‘non-labeled’ bonds. Labeled bonds (those that have earmarked use of proceeds, e.g. green bonds) have catalyzed the interest in ESG integration for fixed income and investing “for purpose”. However, this market remains small (less than 0.1% of the total bond market) and fragmented, making it difficult for technical analysis.

Labeled bonds are generally priced in line with non-labeled bonds. Investors, typically, do not support a price difference since there is no difference between an underlying credit for labeled and non-labeled bonds from the same issuer. On the other hand, issuers assume greater transaction costs for labeled bonds, given the additional internal systems and analysis required for earmarking proceeds and reporting on project impact. While there are ongoing efforts to scale up the labeled bond market, which continues to play a crucial role in building sustainable capital markets, the workshop acknowledged that it would also be valuable—at the same time—to increase transparency and disclosure on ESG factors and impact for the entire balance sheet funded through conventional, non-earmarked bonds.

Expanding the Market for ESG Fixed Income Investing: The Potential Role of the World Bank Group and GPIF

Investors agreed that the World Bank Group and GPIF can spearhead positive change and promote a broader uptake of ESG integration into fixed income investment strategies. The initial focus could be on five areas:

- **Convening market stakeholders for conversations to achieve concrete change.** This includes convening regular dialogue on strategic issues such as data and reporting, and leading efforts to promote solutions.
- **Deepening market understanding of sustainability data and how it can inform investment decisions.** A priority is determining the data that defines “sustainability” and demonstrating how such data can support investment decision-making. The World Bank is also scaling up its efforts to map the impact of its lending on the SDGs, which can serve as a model for other issuers.
- **Leveraging World Bank Group data for investors.** World Bank Group data can inform definitions of the “E” and “S”. This includes the World Bank’s Human Capital Project—research on the link between investing in people and economic growth—and research on comprehensive wealth indicators to guide understanding of the sustainable use of capital.
- **Moving the needle on transparency and disclosure.** The World Bank Group is an excellent source for development data, definitions and standards. Deeper empirical analysis on how sustainability considerations can affect bond prices, particularly for sovereign bonds, would be useful. The World Bank Group also has deep expertise in impact measurement and reporting, especially with issuers in emerging markets. Supporting industry efforts that promote transparency—including IFC’s framework for assessing emerging market corporates—can support more sustainable capital markets.