pi ESG CLUB

The social pillar of ESG has undergone many changes. First it was about encouraging investors to protect indigenous communities, then it was diversity and inequality, so what's next? Our ESG feature this month reveals all.

SEPTEMBER 2022

Members

GREEN BOND PREMIUM SHRINKS, BUT DEMAND RISES

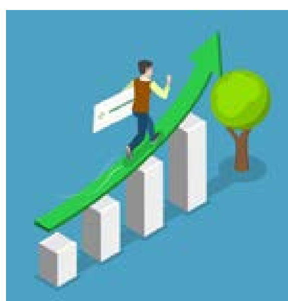
Momentum in the green bond market remains strong despite concerns over returns, finds *Andrew Holt*.

Problems are afoot in Europe's green bond market. The standout difficulty is the 'greenium,' – the premium paid by green bonds over conventional debt – has shrunk from more than 9 basis points in 2020 to around 2 basis points in July, according to the Association for Financial Markets in Europe.

This, it has been suggested, could be problematic, potentially impacting demand for such debt.

But Jennifer O'Neill, a partner at Aon, offers a more moderate response, suggesting that other factors could be at work. "A reducing greenium suggests that investors are scrutinising the particulars of each issue carefully. If the criteria are strong and credible, we believe the greenium will persist."

This, she believes, is due to the net-zero targets which companies are setting. "It is becoming far more challenging for mainstream corporates to continue to operate and issue debt – whether green-accredited or not – without developing transition plans. We believe that investors' baseline expectations for ESG issuance by corporates are increasing."



Market bonding

The shrinking greenium does raise another concern: will issuers continue to come to market? The answer is simple: green bonds are still coming to the market – in vast numbers.

Global issuance of green, social, sustainability and sustainability-linked (GSSS) bonds totalled $225bn (£186bn) in the second quarter – 19% lower than in the second quarter of last year, but a modest 2% higher than the $221bn (£181bn) issued during the first quarter of this year, according to Moody's.

The green bond market is proving resilient in the face of challenging market conditions, suggesting that the trend of issuers linking their capital market financing activities with their sustainability objectives will persist.

Matthew Kuchtyak, vice president of sustainable finance at Moody's, is optimistic. "We continue to expect an increase in GSSS bond volumes in the second half of the year and are maintaining our revised forecast of approximately $1trn (£821bn) issuance in 2022, which would imply second-half issuance to be approximately 24% higher than the first half of the year," he said.

Although the forecasted $1trn for 2022 would be roughly flat compared with issuance in 2021. On one level, this could be seen as a slowdown – given how rapidly the market has grown – but on another, probably a more accurate reading, is that Moody's forecast of global issuance of GSSS bonds this year shows that green bonds do appeal, and their imminent demise is much exaggerated.

Putting the green bond picture into perspective, Kuchtyak added: "Despite global headwinds continuing to affect the bond markets, sustainable bond issuance was down less than the broader market in the first half of the year and represented 15% of global total issuance in the second quarter, the highest quarterly share on record."

Europe goes green

Green bond issuance in Europe is even more positive. European issuers returned to the market in force in the second quarter, raising $87bn (£71bn), accounting for 64% of the global total.

This total represented a substantial 82% growth in issuance from the opening three months of the year, when European green bonds totalled just $48bn (£39bn), the lowest total since the final quarter of 2020.

In fact, European issuers remain the driving force behind sustainability-linked bond volumes, accounting for a 63% share of issuance in the second quarter with those in North America and Asia Pacific following with 16% and 15%, respectively.

O'Neill added: "As issuance increases, there is a larger opportunity set for investors seeking to invest in green bonds. We see the demand for sustainable debt as structural rather than opportunistic – investors are keen to evidence their beliefs and priorities through portfolio choices."

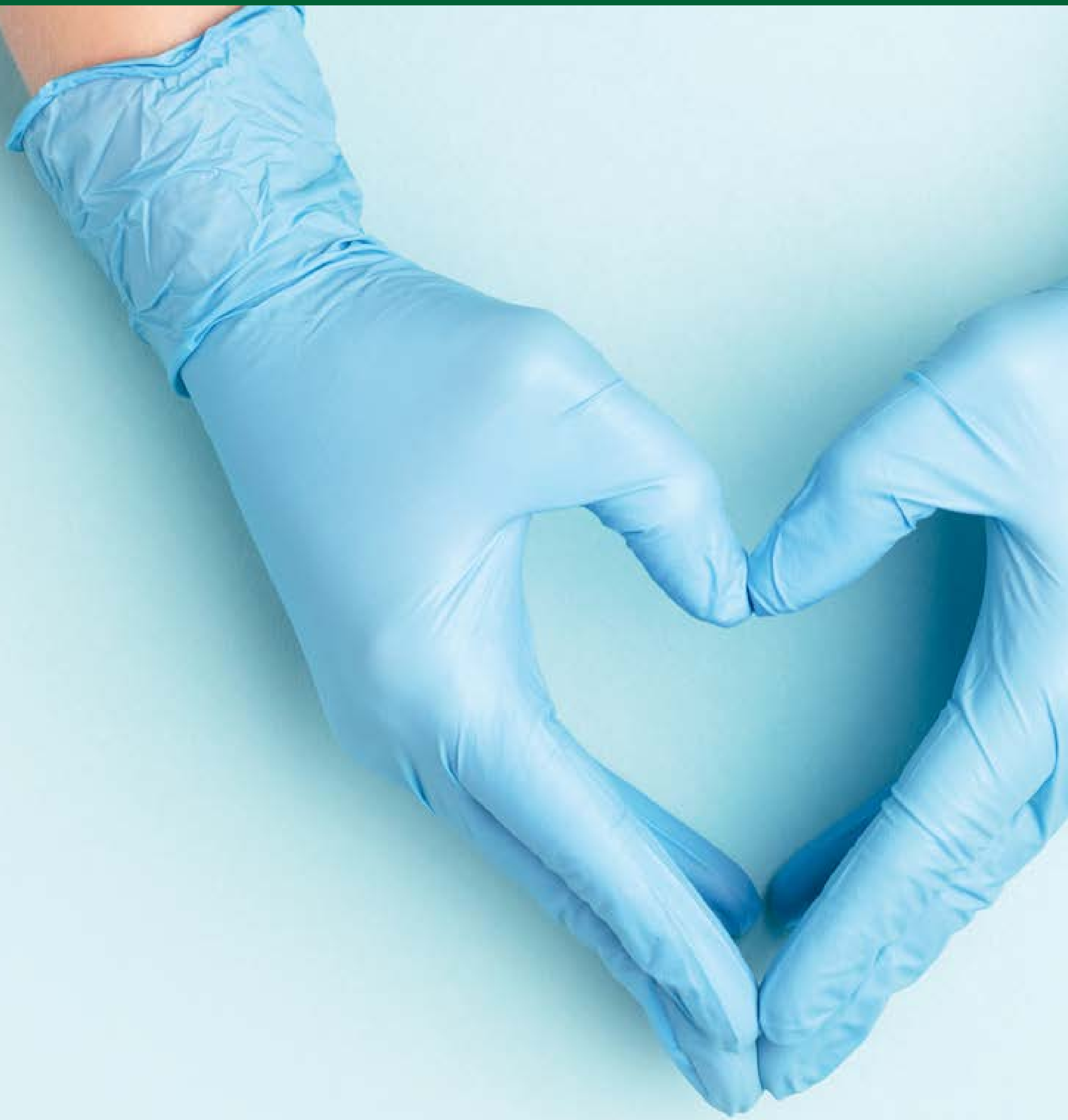
The trajectory of green bond issuance has been one way for some time – upwards and at a pretty rapid rate.

For example, issuance of GSSS bonds as a percentage of global bond issuance rose from around 2% at the start of 2018 to a peak of more than 12% at the end of 2021, according to Moody's.

A bit of greenwash

There are factors on the near horizon, however, that could have a negative impact on the green bond story. These include a focus on greenwashing and closer regulatory scrutiny.

"There are many policy, regulatory and market-driven developments with implications for volumes," Kuchtyak said. "Notable developments in recent months include the classification of some nuclear and gas projects as eligible under the EU taxonomy, updates to the Common Ground Taxonomy, a US Supreme Court ruling on greenhouse gas emissions regulation and the European Central Bank tilting its corporate bond portfolio toward greener companies."



ESG: THE SOCIAL TRANSITION

Difficult times are pushing the social pillar of ESG into the spotlight. *Mark Dunne* reports on how investors can ease the cost of living crisis.

The dawn of this millennium was a dark time for Argentina. The country, once one of the most prosperous in Latin America, was in the midst of a three-year recession which saw the economy shrink by 28%.

The situation was so dire that an early attempt to print money was thwarted by the government not having enough cash to buy the paper to print it on. That problem was solved, but it did not feed through to those who were lucky enough to have kept their jobs. One news report showed a shoe factory worker buying groceries with a pair of trainers he had received in lieu of his salary.

That period in Argentina's history has been labelled "The Great Depression". Yet a look at the country today shows that the recession of 1999 to 2002 should be re-classified. With inflation at 64% and bond yields reaching an eyewatering 70%, the country is on the verge of another default and another recession.

There are signs that this downturn is even harsher on its citizens than the last one. A third of the population suffers from a shortage of affordable food, the United Nations (UN) says, and some people are scavenging in landfill to feed their families. Argentina is not an isolated case when it comes to problems accessing food as economies re-open following the pandemic.

There have been protests over the rising cost of food and energy as well as access to medicine in Cuba, Iran, Indonesia, Peru, Pakistan and Tunisia. But in Sri Lanka, anger over rising poverty, and claims that corruption exacerbated the situation, led to the president fleeing the country after protestors invaded his house. Such actions are unsurprising, with the UN claiming that 150 million people globally have regularly missed meals since the outbreak of Covid. With little sign that the price of food and energy will fall in the short term, the number of hungry mouths across the world looks set to rise.

And this is the next phase in the evolution of the social pillar of ESG. Initially, the S was about respecting indigenous people and their communities. But in recent years the focus has switched to diversity, inclusion and human rights. Now, it has been expanded to include income inequality, accessing education and healthcare, adequate housing and creating the infrastructure that connects urban and rural areas.

"The industry is evolving to another way of framing the S. It has taken many forms and is not only about diversity," says Delphine Riou, an ESG analyst and Inclusive Growth lead at BNP Paribas Asset Management.

A broad theme

The huge rises in food and energy prices are a sign that the world's infrastructure and supply chains need to be more efficient. Investors can play a role here by pushing companies to change their business models and invest in technologies that

could produce better social outcomes. "We have a duty to deliver long-term sustainable returns to our clients," Riou says, "so we encourage companies to shift towards better social practices."

Yet improving their social profile has traditionally been a lower priority for corporates and sovereigns compared to environmental issues. Changes to our climate are rightly seen as one of the biggest threats to humankind, so the social element of ESG has never been at the top of the agenda. But there could be another reason for this.

"The S is a broad theme," Riou says. "One of the major challenges is the huge range of indicators it covers."

Climate change is a global issue, so a tonne of carbon in the UK is a tonne of carbon in Australia. But measuring social issues can vary from country to country. "The S is difficult to capture," Riou says. "The minimum wage is different in England than in France, so you have to put a contextual lens on everything."

Issues which fall within the social pillar of ESG are getting more press coverage, which is stimulating debate, but the environmental element continuing to dominate sustainable strategies is frustrating for Maria Ortino, a global ESG manager at Legal & General Investment Management (LGIM). "That is not to say climate change is not important, but the S pillar is just as important," she says.

Yet attitudes towards the social element of sustainable investing are changing, which is down to Covid. Riou says that BNP Paribas research discovered that investors were more aware of social issues following the first lockdown. "This was due to several things, such as people losing their jobs overnight."

"It also made people realise that there are imbalances in society, highlighting inequalities," she adds.

Yet this could cause conflict with investors needing to generate a certain return to pay members pensions and drive better social outcomes. Should they accept dividends from oil majors when some households are having to choose between eating and heating?

Don't forget the G

BNP Paribas AM has been active in the social thematic area for more than 10 years with Riou putting such aspects on par with energy transition and environment issues. "We have a conviction that companies nurturing social indicators will perform better over the medium to long term," she says.

"If you nurture the diversity in your company it will break group thinking and better reflect consumer needs. That is the link between the S and financial performance," Riou adds.

And there can be no link between the S and financial performance without the G. LGIM has focused on diversity for more than a decade. Employee relationships and taking care of supply chains were woven into conversations with company directors. "We might have included that under the G back then, but it is now taking more prominence under the S," Ortino says.

Anti-microbial resistance is climate change and the Covid pandemic combined.

Maria Ortino, Legal & General Investment Management

"But the G is important," she adds. "You cannot have a good E or S without a good foundation of governance. That takes it back to composition of the board and its oversight of the company. If the foundation is not good, the work with the E and the S will fail.

"The inter-connectedness of the E, S and G, with the G being the grounding, is essential," she adds.

Healthy concerns

With so many social issues making the headlines, investors need to ensure that they are not following what could be a short-term fashion. "The focus has been on diversity for a long time, but we are now moving to specific health issues, as well as income inequality," Ortino says. "We need to be focused on several pillars at once and avoid the flavour of the month issue.

"These are long-term trends for long-term investment horizons," Ortino says. "We are still engaging on diversity after more than 10 years.

"This is a multi-year issue, so I hope we are not putting an issue on the table that pushes other ones out," she adds.

Another multi-year issue is health, the importance of which was highlighted by the pandemic. Growing anti-microbial resistance is a serious issue. People could die from grazing their knee, unless new anti-biotics are discovered.

Ortino warns against underestimating the severity of this problem. "Anti-microbial resistance is climate change and the Covid pandemic combined," she says. "It is a long-term issue, a systemic risk and will impact multiple sectors."

Managing this risk is not just about funding pharmaceuticals

or looking at the practices in farming and the wider food industry.

"Investors must use a two-pronged approach," Ortino says. "We must not just engage with our companies but also with regional, national and supranational policymakers. And it also needs to be done collaboratively with other investors. We cannot do this just on our own."

It is said that prevention is better than cure, so looking at how food and beverage companies are reformulating their products, how they market them and who they are lobbying is important.

"It goes back to that two-pronged approach of engaging with policymakers, and our investee holdings," Ortino says.

In the E, the material risk is not questioned, especially when it comes to climate change. Companies are responding to that through the information they are disclosing. "Anti-microbial resistance is where climate change was five to 10 years ago, where it is still challenged on if it is a material risk for investors," Ortino says. "The risk is real. If we don't do something, we are going to be in a critical situation."

Dirty work

Yet there is one barrier investors are working to overcome when trying to produce better social outcomes: data, or the lack of it. "Gender data has significantly improved over the years following investor engagement. Similarly for ethnicity, even if we are not there yet. But for everything else under the S pillar it is difficult to get quantifiable, comparable and verifiable data," Ortino says. "It is easier for the E because we have, for example, scope 1, 2 and 3 emissions data."

This is also a concern for Riou. "We look at gender diversity, but we would like to enlarge the theme to ethnicity and disability. However, iIn several parts of Europe, it is not legal for companies to report on the ethnicity of its workforce," she says.

"There is no one-stop-shop for data from a social angle," Riou adds. "Different data providers, provide different information. It requires tremendous work from our quant research team to make indicators comparable," she adds.

This is a symptom of social investing being in its infancy. "Compared to 'G', the 'S' is in much more of an initial phase," Ortino says. "As investors, it is important that we do not hide behind a lack of verifiable data. We must get our hands dirty trying to identify the data we need and who can we push to provide it."

We are evolving to another way of framing the S. It has taken many forms and is not only about diversity.

Delphine Riou, BNP Paribas Asset Management

What's next?

So the social pillar of ESG is evolving to encompass new trends and is becoming more prominent. It has evolved since socially-responsible investing became a popular term in the 1990s, and it will continue to consider new issues. But what will investors be discussing in corporate boardrooms in the next 10 years?

Under the S pillar, Ortino and the LGIM team will be focusing on anti-microbial resistance, nutrition, human rights, income inequality and diversity.

"I would certainly hope that we will have made progress on what we are looking at today.

"I hope that anti-microbial resistance is part of company analysis for investors," she adds.

Yet Ortino remains open minded that new challenges will arrive for socially-minded investors to consider. "We must also be open to challenges that we have not seen yet, while avoiding the flavour of the month," she says.

Riou will also concentrate on anything related to the minimum wage. "Inequality of income is widening across Europe."

The rising cost of energy which, Riou says, will increase the cost of living. The digital transition will also be on her radar. "There will be a shift as jobs disappear because of artificial intelligence. This will be another critical issue.

"These will drive major changes in company business models, and the first to be affected will be the employee," she adds. "When we speak to companies, we want to know if, due to energy and digital transitions, they have an acute understanding of the skills needed in 10 years' time."

While the E in ESG is about the planet, the S concerns the people living on it. These are difficult times and they will, it seems, get worse before they get better. Investors have a role to play here by engaging with the companies in their portfolio to eradicate hunger, generate cheaper clean energy and provide access to healthcare.

Fighting climate change is important, but we should not underestimate the positive impact that a sound social investment policy can have. Just look at Argentina.

Jennifer O'Neill is an associate partner in Aon's responsible investment team

A JUST TRANSITION – WHAT ROLE CAN INVESTORS PLAY?

The transition to a more sustainable, low-carbon economy will create winners and losers – but is it possible to deliver a transition that leaves no one behind?

The concept of a just transition seeks to address this and is based on the principle that those affected by climate decisions are considered by government, business and investment leaders making the decisions. The aim is to deliver an equitable transition to a climate-resilient future, creating decent work, opportunities and economic growth – leaving no one behind.

Governments at COP26 supported the Just Transition Declaration, which is based on dialogue – not a fixed set of rules – between workers, industries and governments in all national, social and cultural contexts.

Why does this matter?

In my conversation with Mark Carney last year, he highlighted that *"one of the greatest injustices of climate change is that those who were doing the least to cause it will bear the biggest brunt, and that puts a special responsibility on those of us who have the most resources to address it, to use those resources now"*.

So, it's positive that discussion about how to address the climate challenge now includes the theme of social justice – essentially, environmental, social and governance factors should no longer be viewed as distinct from each other.

With pension scheme investors playing a key role in driving the race to net zero, this interplay between environmental and social issues is increasingly considered. But many are struggling to translate these considerations into tangible investment decisions and portfolio allocations.

Let's take the case of a South African energy and chemicals company, one of the highest carbon emitters in Africa. If an investor focused their investment decisions on the firm's carbon emissions, its harmful operations and negative environmental footprint, they may advocate to mothball the company's operations, or decide to divest altogether.

However, as a large national employer, located in a disadvantaged area, thousands of staff and their families rely on the company for their livelihoods. To mothball or shut down the operations without regard for them would have significant implications for the local society – and its economy.

In this scenario, how can investors support positive climate outcomes, and protect the people who work for the firm and the communities it serves?

One option is to take a more holistic view and, through engagement, support its transition to lower-carbon operations, safeguarding employment in the process and creating re-training opportunities for the future. This has the potential to benefit the local and national economy and the many thousands of individuals and families dependent on the company for income.

In fact, the company mentioned here did exactly this following investor engagement, and last year shared 2030 and 2050 decarbonisation roadmaps, planning a transition to net zero and positively managing the societal impact as part of the process.

How to consider a just transition?

Institutional investors tell us they do not want to focus on climate objectives in isolation but to consider broader societal and environmental together. As a result, they are looking at financial value and considering the impact on the environment and society before investing – so, what elements inform those decisions?

Measurement is critical – Through their investments, investors want to quantify the risks and opportunities of combatting climate change and managing social impact. Transparent disclosures and high-quality data will support investors to better understand those risks and opportunities – and, as a result, make better investment decisions. The concept of the *Task Force on Inequality-related Financial Disclosures*, and government's response to its consultation on social matters in pension fund decision making support this.

Stewardship – This is a tool for setting expectations of companies to take account of just transition principles, and particularly where there are significant investment risks. Investors may seek to align their investment principles with international standards, like the PRI or Climate Action 100+.

Engagement – Investors can use their power to engage with policymakers and communicate with a broader audience to deliver better outcomes for all stakeholders – and work with their advisers to do this. At Aon, we continue to respond to regulatory consultations, drawing on our client's experiences and insights to ensure their needs are factored into policy decisions.

Every day, we work with our clients to bring clarity and confidence to managing a just transition. To learn more, contact me – or, Aon's responsible investment team.

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CRACKING THE CHINA CONUNDRUM

China remains a conundrum for many investors: a source of dynamism and growth potential, and yet, like many other emerging markets, often somewhat opaque in terms of governance.

China remains a compelling investment destination, but getting comfortable with it requires an appreciation of the backdrop one is operating in, and a demanding level of due diligence on the companies that one might want to own.

It has always been important to have a good understanding of (and alignment with) China's policy initiatives, and with prevailing macro trends. That starting position has not wavered, but what is changing are the policy initiatives and macro trends. We see several fundamental shifts:

China is no longer in a period of exceptional growth

China is now the largest economy in the world on a purchasing power parity-adjusted basis. GDP per capita is now 11 times higher than it was 20 years ago. Debt levels are now bloated, with private-sector debt-to-GDP at more than 200%. China's working population is also expected to decline by about 160 million people during the next 30 years.

China's economy is experiencing a huge amount of change

Certain areas of growth are no longer secular – gross capital formation is bloated at more than $6trn (£4.9trn) per annum, and real estate is too large at around 30% of GDP. Even in e-commerce, China is seeing the highest levels of penetration globally. These industries have broadly served their purpose, so it should be no surprise to see greater regulation and less government support. We believe sustainably higher levels of growth will be easier to find in areas upgrading China's economic infrastructure, such as semi-conductors, software, industrial automation and healthcare R&D.

China has globally leading companies in strategically important sectors

China consumes almost twice as much electricity as the US, and thus it is little surprise that Chinese companies lead the way in the solar-energy supply chain. It has also built around 1.5 million base stations for 5G mobile networks, versus around 100,000 in the US. We see a similar story in other strategically important areas, such as electric-vehicle batteries, where China dominates.

In terms of due diligence, we understand there are significant issues in China as well as bad corporate actors. For these reasons, and given China's emergence as a superpower, we are set for an era of tensions between China and the US, or indeed the West more broadly.

Some take an extreme view, and argue either that these things do not matter, or that you cannot invest in China at all. Instead, we believe it makes sense to understand the opportunities and pitfalls that result. As seasoned emerging market investors, we think the answer is to make sure you ask the right questions before investing, and to have sufficient expertise and resources at your disposal to do so.

Many emerging markets, like China, are undergoing massive changes. There are also large variations in terms of institutional strength, the rule of law and property rights. In that sense, the governance backdrop in emerging markets is more complicated. But what we are looking for in terms of high-quality governance is quite simple: it is important to understand who we are aligning ourselves with, their core competency and the company culture they are promoting.

Specifically, we seek answers to the following criteria: evidence of alignment with minority shareholders; evidence that the business has been built on merit in a healthy, competitive environment, rather than via protectionism or patronage; and an understanding of the culture of a business, and how this leads it to attract and retain talent, intellectual property, customer relationships or other intangibles.

The final, crucial, step is to understand how good governance then drives franchise and financial results. Too often in emerging markets we see people viewing governance as a restrictive, tick-box exercise where set rules can be applied. Instead, it can be an immensely important factor in determining franchise quality.

Lastly, one of the most common questions we receive on the quality of governance in emerging markets is "how can you know?" Our ambition is to ask ourselves the right questions about the more qualitative risks we are taking on behalf of our clients. By doing so, we believe we have a better chance of compounding durable long-term investment returns in emerging markets.

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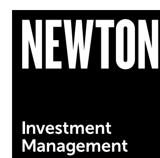

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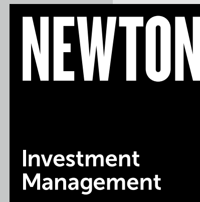

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Nigel Peaple is director of policy and advocacy at the PLSA

THOUGHT PROVOKING AGENDA WILL WELCOME DELEGATES BACK TO THE PLSA'S FIRST IN-PERSON ANNUAL CONFERENCE

So far, 2022 has been a big year for the pensions industry.

With substantial work being undertaken for the imminent arrival of pensions dashboards, the application of Task Force on Climate-Related Financial Disclosures reporting for a greater number of schemes, the on-going challenges for defined contribution (DC) schemes of GMP reconciliation, and managing pension investments as global asset markets respond to the growing risk of recession – it's been a busy time for everyone involved in the sector.

The PLSA has been busy on the industries behalf as well.

Producing a report on industry adoption of new DC decumulation strategies similar to those set out in the PLSA's Guided Retirement Income Choices proposals, writing a report with the Association of British Insurers (ABI) on how to address the challenges of small DC pots, and drafting a PLSA report on the challenges and opportunities facing the local government pension scheme has kept us occupied. As have responding to numerous government consultations, making sure the Retirement Living Standards momentum continues, and helping spearhead, with the ABI, the launch of the UK's first pensions engagement season – known as Pay your Pensions Some Attention.

And on top of all that, we have held our first two in-person PLSA conferences since before the pandemic (our Investment Conference in Edinburgh and our Local Authority Conference in the Cotswolds), with the next instalment – Annual Conference 2022 – imminently upon us.

And with so much already having happened this year and plenty more in the pipeline, there is – as usual – a lot to speak about in this year's edition of the UK's largest pensions conference.

The PLSA's Annual Conference – held this year in Liverpool on Wednesday 12 and Thursday 13 October – is the perfect place for delegates to join the policy drivers, disruptors, engagers and thought leaders to discuss all things pensions.

This year's conference takes a look at how can people save enough for retirement while the cost of living spirals and how can tools like the Retirement Living Standards and pensions dashboards help savers with the decisions that matter.

It also will delve into what are schemes' latest investment priorities in an era of active stewardship and ESG and how can we ensure the regulatory environment works for all schemes, and enough flexibility for defined benefits?

The programme will look at a wide range of subjects with a variety of speakers talking delegates through the sessions kicking off with a talk on Wednesday about PLSA policy proposals for improving the UK pensions system so that more people will have a better income in retirement.

Moving on from that, focus shifts to the pensions dashboard and with less than five months from the beginning of an 18-month period for all schemes to connect to the pensions dashboards ecosystem, our panel will give a detailed update on pensions dashboards and what pension funds must do to be ready for them.

The first day's afternoon will see discussions on a variety issues including what we can expect from the second part of The Pensions Regulator's DB Funding Code proposals that are due out this autumn as well as looking at the climate crisis that has driven a financial services regulatory revolution in the last few years.

The second of the two days will continue the influx of though-provoking material with a session kicking off the day that asks the question, how can we make savings attractive? Here the panel will explore how the industry can make people interested in their pensions and why would people prioritise pensions when they are not interesting, not immediate and no help with today's cost of living?

There will also be a keynote speech from pensions minister Guy Opperman reflecting on his time in office and sets out where are we now, his priorities for tackling current challenges and his vision for the next two years before finishing off with esteemed journalist and broadcaster Clive Myrie, who will give his thoughts on the increasing de-globalisation, ongoing international conflict and growing risks for a global recession.

It's a full-on two-day schedule and one that is sure to leave something with everyone who attends to think about when they return to their workplaces.

More than anything, with this being the PLSA's first in-person Annual Conference since 2019, we are looking forward to seeing everyone back together again. This conference gives us the opportunity to strengthen existing relationships while also forging new ones.

Through our continued work as an industry, and sharing of new ideas and ways of working, we can try and help to ensure that the millions of people saving into workplace pensions can achieve a better income in retirement.

For more information about the conference – and how you can get tickets – visit *www.plsa.co.uk*.

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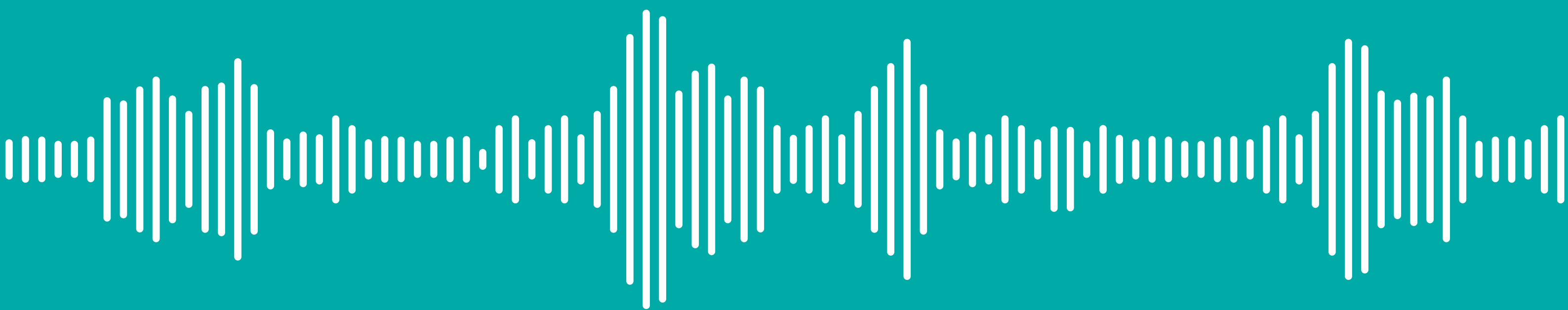

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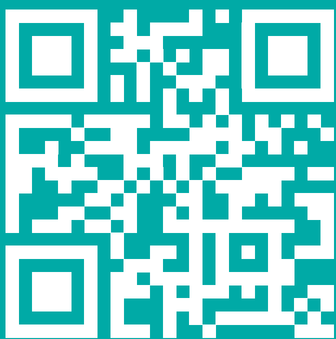

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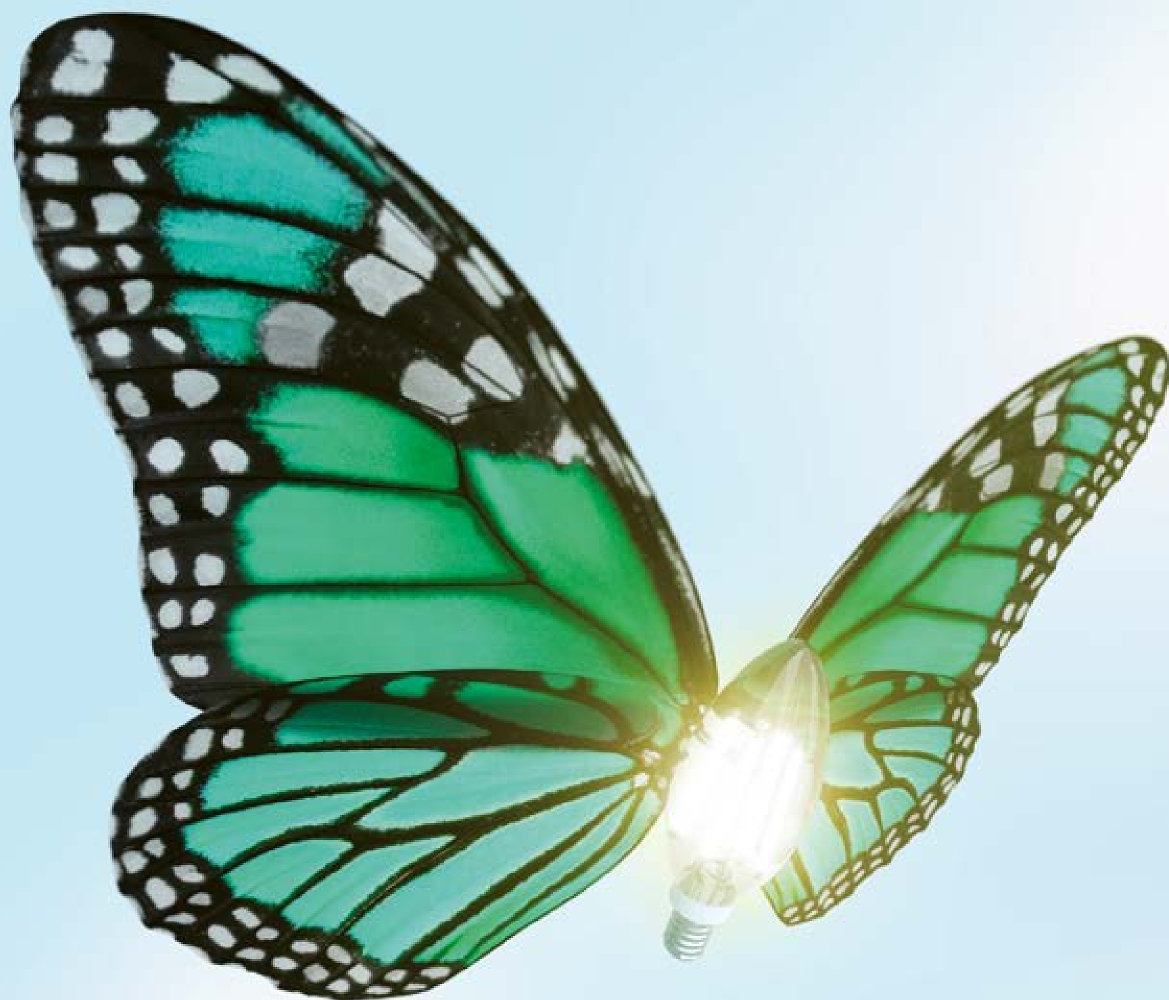

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