16 June, 2021

Ms Emma Walmsley
Department for Work & Pensions
Caxton House
Tothill Street
LONDON
SW 1H 9NA

Submitted by E-mail to: pensions.governance@dwp.gov.uk

Dear Ms. Walmsley,

CFA UK response to DWP Call for Evidence: Consideration of social risks and opportunities by occupational pension schemes

The CFA Society of the UK (CFA UK) is pleased to have the opportunity to comment on this call for evidence ("the CfE") from the DWP.

CFA UK's mission is to help build a better investor profession for the ultimate benefit of society[1]. As such this topic is very central to our mission statement since investment without consideration of social issues would be contradictory to our mission. Our ESG Certificate[2], launched in 2019 and now managed globally by CFA Institute, seeks to educate participants in the importance of environmental, social and governance issues across all manner of investments.

Our members are involved across all sectors of investment activity, so, whilst unable to respond to Q1-7 of the CfE which are directed at scheme trustees, we felt drawn to Q8 to provide (i) comment on opportunities available for trustees to invest, directly or indirectly, in companies solving social issues in developing or emerging markets and (ii) an assessment of their relative attractiveness.

Accordingly, we convened a working group of CFA charterholders active in their day-to-day roles in several key asset classes; their detailed thoughts in Appendix II. We hope this proves a rewarding source of ideas for you and UK schemes to consider as well as a guide to some of the potential pitfalls in such investments.

As a final note, we are acutely conscious that pension trustees' primary duty of care, by law, is to their scheme's members and not broader society. In practice, with many investments the interests of scheme members and wider society are often aligned; and indeed in many cases they can be locked in a virtuous feedback loop whereby an investees' strong social credentials serve to lower its cost of capital in comparison to competitors with weaker social credentials. However, that dynamic is unfortunately not present with every investment opportunity and, acknowledging this tension

[1] *A brief overview of both CFA UK and CFA Institute is provided in Appendix 1.*
[2] *CFA UK ESG Certificate (2021): https://www.cfauk.org/study/esg#gsc.tab=0*

where it exists, a trustee's primary fiduciary duty has to be to put their members' interests first. This can be best achieved by adopting investment strategies or approaches which:

- factor in social considerations through an ESG risk-adjusted lens when evaluating each individual investment; and
- screen out (or raising the required returns of) those investments with a weaker social profile and hence material social risks;
- seek improved long-term returns through active engagement with and strong stewardship of investees needing to improve their social risk profile.

Increasing media and regulatory attention is being focused on 'greenwashing' – the practice of an investment firm, or fund, over-stating their ESG credentials in their marketing literature. As the name implies, much of this attention is focusing on the 'E' in ESG, but 'S-washing' or 'greenwashing for social factors' faces every much the same problem. Trustees need to keep this front of mind when reviewing the attractiveness of both new and existing mandates.

Yours sincerely,

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With thanks to:

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And for the oversight of CFA UK's Pensions Expert Panel and Professionalism Steering Committee

Appendix I: About CFA UK & the CFA Institute

CFA UK: serves nearly 12,000 leading members of the UK investment profession. Many of our members work with pension funds, either managing investment portfolios, advising on investments or as an in-house employee responsible for pension investment oversight.

- The mission of CFA UK is to build a better investment profession and to do this through the promotion of the highest standards of ethics, education and professional excellence in order to serve society's best interests.

- Founded in 1955, CFA UK is one of the largest member societies of CFA Institute (see below) and provides continuing education, advocacy, information and career support on behalf of its members.

- Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation, or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

CFA Institute: is the global association for investment professionals that sets the standard for professional excellence and credentials.

- The organization is a champion of ethical behavior in investment markets and a respected source of knowledge in the global financial community. Our aim is to create an environment where investors' interests come first, markets function at their best, and economies grow.

- It awards the Chartered Financial Analyst® (CFA), and Certificate in Investment Performance Measurement® (CIPM) designations worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry.

- CFA Institute now markets the Certificate in ESG Investing, created by CFA UK, across the globe. This program represents a new global qualification for ESG in investment management; it aims to strengthen market integrity by teaching the benchmark knowledge and skills required by investment professionals to integrate environmental, social and governance (ESG) factors into their investment process.

- CFA Institute also sponsors the Mercer CFA Institute Global Pension Index (formerly the Melbourne Mercer Global Pension Index) which provides an annual assessment of the quality of pension provision in different countries around the world.

- CFA Institute has members in 162 markets, of which more than 170,000 hold the Chartered Financial Analyst® (CFA) designation. CFA Institute has nine offices worldwide and there are 158 local member societies.

- For more information, visit www.cfainstitute.org or follow us on Twitter at @CFAInstitute and on Facebook.com/CFAInstitute.

Appendix II: Response to Call for Evidence

Q8: What opportunities are there for trustees to invest, directly or indirectly, in companies solving social issues in developing or emerging markets? How attractive are these investments?

All investments have some form of social impact in the world. The opportunity and challenge for pension fund trustees is to support society's work towards the betterment of social outcomes, while keeping with their legal and fiduciary obligations to the pension fund. Trustees have an over-riding obligation to serve members' interests: specifically, there is no over-riding reason to think that mandates or products which prioritise social outcomes will inherently meet schemes' investment needs or benefit members more generally. They may, but equally they may not.

A strong case can, however, be made that financially material social risks should be taken into account by investment managers, and that pension schemes as large owners of assets, should require their managers engage to ensure that the social risks inherent in their investments are managed appropriately.

Pension funds have a relatively longer time horizon for investment, and therefore match well to the timeframes of certain types of investments. For example, pension funds that are investing in sectors that are transitioning to a low-carbon footprint, or other sectors potentially improving societal outcomes that typically are achieved over a long-term horizon (e.g. healthcare, education and infrastructure) can have a large bearing on other fundamental social issues (e.g. diversity, national wellbeing, reducing child labour and increasing employment). These investments have long-term benefits to the wider community and are seen to generate positive impact for people (and planet).

An important lens to consider with respect to the social factors of EM investing is the current progress on a just transition, given its social implications. Following the International Labour Organisation's Guidelines for a Just Transition (2015) and the codification of the "just transition" concept in the Paris Agreement, the concept of the benefits of a green economy transition being shared widely together while best supporting all who stand to lose economically has taken concrete form in many countries around the world. The European Bank for Reconstruction and Development (1) have highlighted four key global initiatives focused on the importance of a just transition:

- The European Union's Just Transition Mechanism[3] is integral to the EU's Green Deal, targeted at ensuring "a fair transition to a climate-neutral economy, leaving no one behind" and aims to mobilise at least €150 billion over the period 2021-2027;
- The Solidarity and Just Transition Silesia Declaration[4] signed by 50 countries at COP24, which states that: "a just transition of the workforce and the creation of decent work and quality jobs are crucial to ensure an effective and inclusive transition";
- Climate Action for Jobs Initiative[5], co-led by the International Labour Organisation, Spain and Peru, with 46 countries committing to develop "national plans for a just transition and create decent green jobs";

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[3] The Just Transition Mechanism: making sure no-one is left behind (https://ec.europa.eu/commission/presscorner/detail/en/fs_20_39)
[4] The Solidarity & Just Transition Silesia Declaration (https://cop24.gov.pl/fileadmin/user_upload/Solidarity_and_Just_Transition_Silesia_Declaration_2_.pdf)
[5] The Climate Action for Jobs Initiative (https://www.ilo.org/global/topics/green-jobs/areas-of-work/climate-change/WCMS_732060/lang--en/index.htm)

- The UNFCCC Gender Action[6] plan, whereby parties to the UNFCCC have recognized the importance of involving women and men equally in the development and implementation of national climate policies that are gender-responsive.

While we continue to see climate as a clear investing focus within ESG, the just transition will provide ancillary benefits to social factors within EM.

In introducing the curriculum for its ESG certificate, CFA UK highlights a number of social mega-trends which are having both positive and negative impacts on society, some of which are particularly impacting emerging markets (EM). These include:

- **Globalisation** – A rapid increase in the cross-border movement of goods, services, technology and capital. Whilst this leads to increased market efficiency and a wider availability of products, it can result in the offshoring of industries to countries where there is a lower cost of labour and increased supply chain concentration. For example, the migration of the garment industry to low-cost emerging market countries such as Vietnam, Bangladesh and China or the emerging dominance of IT companies in South Korea, Taiwan and China.
- **Automation and Artificial Intelligence (AI)** – The automation of processes with little need for labour inputs displaces workers and renders their skills or experience redundant. AI is expected to have a significant effect on sectors such as healthcare, transportation, financial services and creative industries.
- **Inequality and Wealth Creation –** According to the OECD [7], the average income of the richest 10% of the population is about 9 times that of the poorest 10% across the OCED. Inequality can limit social mobility resulting in a less skilled workforce, a reduction in purchasing power and ultimately a reduction in economic growth.
- **Digital Disruption –** Closely related to automation and AI, there has been increased digital disruption in societies from social media as well as the increased presence of mobile devices and businesses with more digital business models. The use of social media and the emergence of 'big data' has led to questions around privacy issues and the need for increased regulation of the industry. Within both developed and emerging markets, almost everyone owns a mobile phone which provides access to the internet and subsequently other services (for example, banking and financial services) which may not have previously been available.
- **Changes to family structures –** The workforce has become more diverse, with more women entering the workforce and gaining financial dependence., However, women are more likely to face unemployment, accept lower quality jobs and possibly face lower wages versus men, which has resulted in a gender pay gap.
- **Urbanisation –** The population has been shifting from rural to urban areas, with 65% of the world's population expected to be living in an urban environment in 2050 (as compared to 30% in 1950). In addition, there is a shift towards emerging market cities. Nearly half of the world's largest companies are expected to be headquartered in emerging markets by 2025. This will likely increase the mortality of deceases associated with lifestyle, including cancer

[6] The UNFCCC Gender Action Plan (https://unfccc.int/gender)
[7] *Centre for Opportunity and Equality (COPE) 2015 report*

and heart disease, as a result of increased exposure to pollution. Residents living in poor urban areas (i.e. slums) will likely suffer disproportionately.

- **Environmental Impacts –** Climate change and the associated transition impacts have social implications. It is feared that the economic structural change required to tackle climate change will result in the ordinary workforce bearing the cost of the transition. Sectors such as energy, coal, manufacturing and agriculture employ millions of works and so face the possibility of unemployment, poverty and exclusion from the workforce. It is expected that climate change will also lead to increased water scarcity and mass migration from emerging to developed countries.

When investing within emerging markets, there are both internal and external factors which impact various stakeholders. Internal factors typically relate to those employed within a particular organisation and encompass social issues such as working conditions, labour standards, gender balance and pay ratios. External factors typically relate to those outside of an organisation, such as those issues encompassing the supply chain, product liability and consumer protection. A responsible investor needs to assess these risks when deciding to incorporate social factors into their investment decision.

Social factors can be both a risk and an opportunity for investing in emerging markets. For example, financial companies which provide low-cost bank accounts to those who previously did not have one can help to formalise emerging market economies, which in turn helps the government increase tax revenues and invest further in education and other public spending. Similarly, investing in health-care providers can increase the provision and ease of access to health-care services in emerging markets. The UN Sustainable Development Goals (UN SDGs) provide a blueprint to address the key global challenges, including those related to poverty, inequality, climate change, peace and justice. The 17 goals are all interconnected and whilst aimed at governments, have become a powerful framework for businesses and investors too.

Pension funds can invest in emerging markets either directly or indirectly:

- **Direct** – Invest directly into the underlying asset. This allows the pension fund to retain ownership of the investment decision and ensure that all investments are aligned with their social or other ESG objectives. However, in practice almost no schemes in the UK have the scale and resource to follow this approach

- **Indirect** – Investing with a specialised fund manager who then in turn invests in the underlying asset. This is often on a pooled approach, but for larger schemes a segregated approach to emerging market investing is available (to invest its emerging allocation on a segregated basis, a scheme may typically need to be over £1 billion). Segregated approaches offer many of the control advantages of a Direct approach while also giving pension funds access to dedicated, expert resources. Fund managers can be split into two types:

    - **Specialist** – Those fund managers which explicitly incorporate social risks and opportunities into the investment process. The strategy may (i) aim to make a positive impact in society by investing in companies which have a social purpose or (ii) they may aim to identify companies which benefit from social mega-trends, as outlined above and would typically avoid investing in companies with a negative

social impact. When considering strategies that aim to make a positive impact on society, pension funds have to consider whether the strategy is in keeping with their fiduciary responsibility (i.e., does it compromise return to do so?).

- **Generalist** – Those fund managers which do not have an explicit sustainability objective but may aim to incorporate ESG into their investment process. A generalist manager may incorporate material social risks and opportunities into their investment process, having identified these issues through a materiality mapping exercise. The manager may still invest in companies which have a negative social impact (e.g. tobacco companies) exercising stewardship to influence or drive a change in investee strategy, whilst other managers may choose to screen out these companies entirely.

The pension fund can look to understand each manager's investment process, the degree to which social risks and opportunities are incorporated into the investment decision and how this can be evidenced by the manager.

We now explore these approaches to investing in more detail for each of the respective asset classes:

Equity - 'Direct' (Pension fund balance sheet)

Pension funds would have some influence to develop the strategy and objectives to address the social issues at the underlying company levels. This would provide a clear indication to the market of commitment, with a 'double-bottom line' on i) achieving commercial returns (risk adjusted returns commensurate with the risks undertaken) and ii) development agenda to help address ESG/social aspects in the company and wider ecosystem, to the extent that this can be accomplished in keeping with fiduciary obligations. Pension fund investment could help 'mobilise' other local and international capital, thereby playing a catalytical role bringing further social benefits to the emerging economies in question. The social issues along with the standards as outlined above would be proactively addressed and monitored, to the benefit of the company, wider stakeholders and the community. A direct approach could also have a cost advantage – there would be no external management fee or incentive structures to be paid by the pension fund, but significant additional resources would be required by pension funds before they could take this approach (employing fund managers with relevant expertise, plus the direct costs of travel and other related expenses incurred to manage/monitor the investment by the pension fund).

There are however a number of specific risks which are associated with this approach that include macro, geopolitical, currency/FX, transparency risks and the exposure to the lack of legal, judicial and regulatory frameworks to potentially rely upon.

The majority of UK pension funds may not have the required expertise and/or resources to effectively carry out due diligence on the underlying asset in terms of the market, fair value assumptions at entry and evaluating the exit scenarios for achieving liquidity/ultimate returns.

Equity – 'Indirect' (via third party Fund Managers)

Pension funds can decide to invest in equities indirectly with a fund manager either by investing in their pooled fund or by opening a segregated account. A pooled fund allows relatively easy access to a fund manager's strategy by investing alongside other market participants, when compared with a segregated account, which typically requires a higher minimum commitment of assets. In the case of a pooled fund, however, the pension fund does not retain control of the underlying assets or the ability to place additional constraints on the fund manager or indeed control over any voting decisions. The assets and any investment and voting decisions are delegated to the fund manager who will then make decisions in line with their investment policies and processes. The extent to which ESG considerations are incorporated depends on the fund manager selected. This approach may be more suitable to smaller pension funds who do not meet the mandate size requirements for a segregated account or those pension funds which may want to avoid the expense and complexity of setting up segregated accounts.

In contrast, by opening a segregated account with a fund manager, the pension fund retains control of the underlying assets as these are held with their custodian. A benefit of this approach is that pension funds may be able to place additional restrictions on fund managers when defining their mandate guidelines, such as additional ESG requirements or restrictions. The pension fund may also be able to retain control over any voting decisions, *if desired*, allowing them to vote on any ESG-orientated issues in line with their voting policy. Segregated accounts are typically only available to the larger pension funds given that fund managers typically require investments in excess of c. £100m in order to set up a segregated account. In addition, EM strategies may only form a relatively small part of the pension fund's asset allocation. Finally, segregated mandates can be quite expensive and complex to set up and run on an ongoing basis.

Listed Equity

With regards to equity company analysis, recent work done by the ESG Working Group[8] focuses on detailing the following key facets of social or "S" aspects within ESG investing: i) High-risk labour and land issues; ii) Socio-economic inequality, iii) Diversity and Inclusion and iv) Digital rights. They highlight the availability of data across these components from providers including GRI, SASB, Refinitiv and RepRisk, which would allow greater insights into a company's social attributes. It is difficult, however, to comment currently on the availability of data across EM companies. We would also highlight a number of company benchmarks from the World Benchmarking Alliance[9] which are focused on the relevant benchmarking of social factors. While at differing stages of development, these include, i) Corporate Human Rights benchmark, ii) Gender benchmark and iii) Digital Inclusion benchmark. The aim of these benchmarks is to provide greater transparency of practices within companies within both DM and EM and can also provide a means for trustees to explore the social attributes of portfolio companies with asset managers and service providers.

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[8] ESG Working Group is a collaboration including The Thomson Reuters Foundation, Refinitiv, ISFC, White & Case, Eco-Age, The Mekong Club & PRI; "Amplifying the "S" in ESG: Investor Myth Buster

[9] https://www.worldbenchmarkingalliance.org/

With respect to mutual funds, PWC[10] recently estimated the European ESG mutual funds universe to be approx. EUR 1.66 trillion AuM. They explored the thematic breakdown of this universe and found the following exposures: i) Broad-based ESG 74.8%, ii) Environmental 13.2%, iii) Social 5.6% and iv) Governance 6.4%; this suggests that there are mutual funds providing a route-to-market for pension trustees to potentially invest in social thematic funds, should they meet the requirements of a fund selection process; however we do not know the degree to which these funds invest in EM.

Looking at how to evaluate the social opportunities and risks with funds investing in listed equities, ESG data providers are currently sharing company level data on ESG metrics, which are then aggregated to give an overall view for the holdings within the fund. As an example, MSCI ESG Fund Ratings[11] evaluate funds on ESG metrics across different categories. Whilst they produce an overall blended ESG fund rating, this is an aggregation across the following categories, the constituent metrics of which are available for users: i) Overall Sustainable Impact ii) Environmental impact, iii) Social impact, iv) Controversies, v) International norms standards, vi) Business involvement, vii) Environmental risks, viii) Governance risks, ix) scores and ranking covering a relative aggregated positioning among peers. Relevant social factors within fund evaluations, including EM funds, can be explored by trustees by requesting greater transparency from their managers and service providers, who would generally have access to the underlying information.

While the vast majority of ESG benchmarks are focused on DM, there are examples of EM ESG benchmarks available e.g. FTSE4Good Emerging Indexes and MSCI EM ESG Leaders, among others. Granularity at the index level may be available to explore the “S” component of the ESG rating, depending on the provider. However, given the current state of ESG investing and benchmarks, trustees would have to do further work to accurately gauge “S” attributes within EM ESG benchmarks. Depending on the data provider, this may or may not be achievable, but an approach worth exploring with asset managers and service providers.

With respect to exploring the social investing opportunities within EM ETFs, UNCTAD [12] note that the global AuM of ESG ETF is currently estimated at approx. USD25 billion, with a heavy concentration of assets currently within Europe and the US. They also note that 90% of themed ETFs follow 3 of the 17 Sustainable Development Goals (SDGs), namely Climate Action, Gender Equality and Affordable and Clean Energy; this highlights the relatively high occurrence of social factors within the overall ESG ETF universe. Narrowing this further within an EM context would require further work, however it may present trustees a background for further exploration of this opportunity.

Private Equity

Pension funds may gain exposure to a diversified portfolio of companies who have exposure to EM, potentially addressing many social issues across a range of sectors and industries. Fund manager selection can be made based on the necessary ESG skills, approach and experience in the target markets. For example, within the private equity context, investment staff would have closer proximity to investments and can exert influence proactively. In the listed scenario, fund managers are able to reallocate capital faster to/from markets if near-term factors impact return expectations.

[10] PWC 2022 The growth opportunity of the century
[11] MSCI ESG Fund Ratings – MSCI ESG Research LLC
[12] United Nations Conference on Trade and Development (UNCTAD); Leveraging the Potential of ESG ETFs for Sustainable Development

Working with fund managers, direct costs will usually be a fixed management fee, payable to the fund manager and a performance fee calculated on the overall performance can additionally apply. For larger pension funds, these costs are often very similar whether they take a segregated or pooled approach, with the former giving them more scope to set their own clear objectives for the fund manager.

In terms of risks, liquidity is an issue which can be caused by completely unrelated factors to the underlying company. For example, weather can impact the agriculture output in a particular year which could have a knock-on effect in providing liquidity options for the fund managers. For instance, in the listed context, low market trading volumes and pricing/sentiment can keep prices depressed; in the private equity market, the timing of economic cycles would drive prices for exits downwards from prospective buyers entering the market. However, given that the fund managers would be managing diversified portfolios with active exit/liquidity planning, they mitigate liquidity risks for any one year/asset and can ensure that the overall portfolio returns are designed to achieve the targets in line with their fiduciary obligations.

In terms of social objectives, the pension fund can select fund managers based on ESG policies and implementation strategy/track record, as there will be a greater likelihood that the fund will execute objectives incorporate social issues.

With private equity funds, the pension fund will need to conduct detailed due diligence and satisfy itself it has the necessary levers to monitor and influence a general partner in meeting the social objectives alongside the return aspects (e.g. through LP Advisory boards).

Again, similar to the direct investing, investment from a pension fund through fund managers provides capital to EM, allowing their economies to benefit.

<u>Public credit – EM corporates and sovereigns</u>

Within the public credit market, opportunities to address social issues in emerging markets (EM) are present mainly in the form of social bonds issued by EM corporates and sovereigns. Apart from investing in social bonds, pension trustees can also address social issues in EM countries by using positive and negative sector screening to identify industries that improve social outcomes in EM countries. In many cases, direct investing may be out of reach as pension schemes may lack the scale and resources to directly invest in EM bonds. In such cases, pension trustees can invest indirectly through pooled or segregated accounts managed by EM fund managers. Indirect investing could also be done through the growing number of ETFs and publicly listed funds that track EM ESG (Environment, Social and Governance) fixed income benchmarks.

Social bonds are instruments that are issued with the purpose of using proceeds to achieve a positive social outcome or address a specific social issue. For example, social bonds could be issued to finance affordable housing projects, provide food security, or boost employment. The Covid-19 pandemic has accelerated the demand and supply of social bonds with several such bonds issued last year with proceeds to be used to support communities adversely impacted by the pandemic. However, given the current interpretation of the fiduciary obligations upon trustees, it may be difficult to invest in such issues unless an investment rationale can be made. Below are a few examples of social bonds issued by EM sovereigns and corporates:

- Banco Santander Chile $100 mm 0.715% 26/01/2024 - issued in February 2021: proceeds to be used to finance loans to SMEs led by women in Chile.
- Korea Development Bank $500 mm 0.5% 27/10/2023 - issued in October 2020: proceeds to be used to help companies impacted by the Covid-19 pandemic.
- Chile $1.7 bn 3.1% 07/05/2041 - issued in May 2021: proceeds to be used to support the elderly, those with special needs, low-income families, job creation, affordable housing, access to education, food security, health services and SME financing.
- Ecuador $327 mm zero coupon 30/01/2035 - issued in January 2020: proceeds to be used for affordable housing projects.

Pension funds can also consider positive filters to identify bonds from issuers in sectors such as healthcare, education, food/agriculture or negative filters to avoid investments in sectors such a tobacco, weapons, gambling, etc.

For indirect investment opportunities, pension trustees can either: i) hire external fund managers running active strategies that seek to outperform standard indices using social strategies or ii) consider approaches that are benchmarked to EM ESG indices or invest in ETFs that track these indices. For this latter approach the trustee would need an investment rationale for the index selection.

There are several EM fixed income benchmark providers with the most common being JP Morgan, Bloomberg Barclays and Bank of America Merrill Lynch. These index providers have also launched ESG versions of their EM benchmarks; two examples being the JPM ESG EMBI Global Diversified Index and the JPM USD EM IG ESG Diversified Bond Index. While these are broad ESG indices, they can be used as a starting point to build custom EM indices that focus only on the S (social) component of ESG.

Demand for social bonds is growing. In a recent global survey of pension funds conducted by DWS[13], 66% of respondents said that they intend to increase allocation to the ‘S’ pillar passive funds over the next 3 years and 59% said that Covid-19 was a key driver of the heightened interest in the ‘S’ pillar. The pandemic has also boosted the supply of social bonds. According to data tracked by Bloomberg, in 2020, the issuance of social bonds globally totalled $148 bn, a 7x increase year-over-year[14]. This is global bond data but we would expect a similar trend in EM bond data too.

There are certain considerations for pension trustees to be mindful of while determining the attractiveness of social bonds. It is safe to say that there is a strong demand among investors for ESG bonds due to which at the time of pricing new ESG bond issues, we commonly see a ‘greenium’ i.e. ESG bonds are issued at a premium to non-ESG bonds that carry similar characteristics (duration, rating, country risk, etc). While evaluating the attractiveness of social bonds, one of the questions that pension trustees need to ask is whether the ‘greenium’ will sustain over the duration of their investment in the bond? In other words, will social bonds perform as well as regular bonds with similar characteristics over the pension fund’s investment horizon? Another factor to take into consideration while investing in social bonds is whether the companies issuing the bonds bring about an overall improvement in their ESG or social profiles over a period of time. For instance, a company could issue a social bond with proceeds to be used to finance a social project while simultaneously engaging in poor labour practices that exploit workers. Thus, pension trustees should not only identify and invest in opportunities that address social issues in EM, but also engage with companies to improve their

[13] DWS-sponsored report reveals the rise of ESG’s ‘S’ pillar in pension portfolios
[14] Social Bonds Propel ESG Issuance to Record $732 Billion in 2020

business practices with regards to social aspects (or put pressure on their asset manager to do this on their behalf). Finally, while evaluating the attractiveness of social investments, pension trustees need to assess whether these investments will enable them to fulfil their fiduciary duties. It is not a given that investments with a positive social angle will lead to better returns as was recently experienced by Japan's Government Pension Investment Fund, which had to scale back its ESG investments[15] after failing to meet its investment return targets.

Trading costs of EM bonds typically tend to be higher than those of DM bonds due to the thinner liquidity and wider bid-ask spreads in EM bond markets. Pension trustees will have to account for the higher trading costs when evaluating EM social investing opportunities. If using indirect investment opportunities, such as externally managed funds benchmarked to EM ESG indices, there are usually higher fees on these when compared to a non-specialist fund. EM ETF fees tend to reflect the higher trading costs of the underlying EM bonds.

Pension trustees need to be wise to the risk of 'greenwashing'. While ESG bonds generally carry a third-party opinion on use of proceeds, issuers can still reduce the greenwashing risk by providing detailed project information on project timelines and the impact of the use of proceeds. The lack of a standardized methodology to measure the impact of the use of proceeds of social bonds is a particular challenge. While for instance, it is possible to measure and quantify reduction of carbon emissions achieved through use of proceeds of green bonds this can be difficult in the case of social bonds.

Investing in EM bonds carries several other risks typical to EM bond investing such as geopolitical risk, country/macro risk (impacting EM sovereign bonds as well as EM corporate bonds), lack of transparency/poor disclosure, local rather than international reporting standards, weaker institutions, lack of bankruptcy protection laws, and foreign currency risk if investing in EM local currency bonds.

Finally, by investing in these social opportunities in EM, pension trustees (or their fund managers on their behalf) can influence company management and governments to take action to bring about positive social outcomes in EM countries. This could result in better living conditions, higher employment levels, improved education and more equitable societies. All of this would lead to higher per capita income levels in EM countries. Thus, through investments in social opportunities, pension funds could play a major role in helping to bridge the development gap between EM countries and their DM counterparts.

Private Credit

When analysing social risks and opportunities within EM private credit, our scope of private credit refers to the extension of loans directly to firms by institutional investors, including insurance companies, pension funds, hedge funds, foundations and endowments, sovereign wealth funds, and other fund managers; it covers a number of debt strategies, which can include a variety of tenors, capital positioning and return profiles. Investors have found the premium offered by private credit to be appealing when compared to the more liquid areas of credit markets[16]. The EM private credit

[15] The World's Largest Pension Fund Has Cooled on ESG. Should You?

[16] *International Financing Corporation (IFC) Private Credit in Emerging Markets 2021*

market was estimated at USD9.4bn in 2018[17]. Cambridge Associates[18] use the following definitions for three distinct Private Credit strategies:

Capital preservation strategies:

- Senior lending (levered/unlevered) specializing in senior debt—i.e., first-ranking and often secured loans—and is used to finance buy-out transactions and growth funding. Returns are generated almost exclusively by interest payments.
- Subordinated capital (mezzanine debt, capital appreciation) is an intermediate form of financing positioned in terms of risk and return between debt and equity. Also referred to as 'hybrid debt', it is used mainly for buy-outs and growth finance. It is subordinate to bank debt and can retain varying degrees of equity like characteristics such as being non-cash bearing (PIK) or extendible into a perpetual instrument. Returns may be made up of several components, including current and final interest payments, as well as warrants for shares in the company being acquired, known as 'equity kickers'.

Return-enhancing strategies:

- Structured equity/subordinated capital is invested in par debt or equity-like instruments and often functions as a replacement for private equity.
- Distressed credit primarily involves buying deeply discounted debt securities in the secondary market, focusing on acquiring sound assets in situations where companies are in financial difficulties.

Opportunistic and niche strategies:

- Credit opportunities invest across a wide variety of financing structures and situations. Alongside complex refinancing of companies that are cut off from capital markets for various reasons, the funds also specialize in secondary transactions.
- Specialty finance pursues niche strategies such as non-performing loans in one small industry, e.g., aviation finance, pharmaceuticals, music and healthcare royalties, trade finance, rediscount lenders, and catastrophe bonds.

Private credit transactions often comprise a combination of two components: contractual and performance-based returns. The contractual component can consist of a negotiated interest rate, which is often tied to senior, subordinated or unsecured loans. They can also be linked to payable-in-kind (PIK) loans, which are based on accumulating interest and paid out at the end of the loan's term.

Firms can attach an amortization schedule to their loans, while others can also allow borrowers to capitalize the interest and make a bullet payment at the end of the loan's term. The performance-based component is often linked to an equity benefit and can take some of the following forms: i) warrants to be able to purchase equity in the future at a fixed price, ii) conversions, which allow investors to convert their debt into equity and iii) investors may choose to use a profit-sharing structure or covenants that guarantee a dividend if a performance threshold is reached.

[17] *Emerging Markets Private Equity Association. Private Credit Solutions: A Closer Look at the Opportunity in Emerging Markets 2019*

[18] *Cambridge Associates. 2017. "Private Credit Strategies: An Introduction."*

When reviewing the relative attractiveness of social opportunities within EM private debt strategies, pension trustees could explore private debt opportunities aligned with social objectives. The International Financing Corporation describes private debt returns as ranging from 200 to 300 basis points over traditional fixed income instruments (bonds) at the senior lending end of the spectrum, to over 400– 800 bps at the riskier end. They also highlight private credit's lower correlation with traditional asset classes including fixed income and equity, providing greater diversification for portfolios. IFC also mentions the benefits of senior lending strategies, where investments are often collateralized and backed by the real assets of borrowers and make the point that since the industry has matured, private credit now has knowledgeable fund managers, as well as observable and verifiable track records and performance, making it easier for investors to select managers in this asset class.

In gauging the risks, IFC [19] highlight the illiquidity challenge prevalent in private markets and notes that private credit assets have a unique risk profile. In its more standard form, private lending has a cap on the potential upside that can be earned from investments (although it also has more downside mitigation than is the case with equity). Riskier strategies at the hybrid end of the spectrum—such as mezzanine lending, distressed debt, and special opportunities—however, can compete favorably with the return expectations of other 'Alternatives'. Also, they note that private credit strategies can be susceptible to market default rates, but that in comparison to public debt, private debt enjoys a higher recovery rate in the event of default, depending on the type of strategy. Covenants and structuring are usually more robust for the investor.

Comparing DM and EM private credit, some of the following observations have been made by the Emerging Markets Private Equity Association (EMPEA) [20] :

i) potentially higher gross returns; while return targets can vary significantly by geography and strategy, the general consensus is that returns compare favourably when comparing EM and DM private debt strategies e.g. a Cambridge Associates study on private credit strategies suggests that the total unlevered, fund-level target returns typically range between 6% and 10% for senior debt, 14% and 17% for mezzanine, and greater than 15% for distressed debt and special situations;

ii) diversification and risk mitigation characteristics; data has shown that EM private credit potentially operates, on average, with lower leverage and stronger covenants than its counterparts in DM. Covenant-lite loans, which are borrower-friendly structures that offer less security and protective covenants for the lender, have increased in popularity within DM. In contrast, the concept of 'covenant lite' is not one that is common within an emerging market context.

When looking at the Social Opportunities within EM private credit, the Impact Investing Institute[21] has highlighted the following areas:

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[19] *International Financing Corporation (IFC) Private Credit in Emerging Markets 2021*

[20] *Emerging Markets Private Equity Association. Private Credit Solutions: A Closer Look at the Opportunity in Emerging Markets 2019*

[21] Impact Investing Institute Private Debt Funds

- Microfinance is a large category of private debt, providing capital to microfinance institutions to lend to micro-, small and medium-sized enterprises (MSMEs). Since the 1990s, microfinance has developed a strong track record of high repayment rates (95%-99%) and is attracting significant institutional investment;

- Trade finance debt, which provides working capital loans to improve cash flow in value chains, is also a growing sector. The sector is underfinanced by banks and traditional financial institutions, with estimates that the total addressable market for trade finance in Africa and Asia worth around USD 30 billion.

The Impact Investing Institute[22] also note that institutional investors can potentially benefit from:

i) Development Finance Institutions (DFIs) and development banks (for example, the African Development Bank can offer lower risk exposures to EM through their investment vehicles and deals e.g. AAA-rated DFIs / development banks can have strong balance sheets that potentially offer low risk exposures the EM impact investments and can potentially limit currency risk;

ii) DFIs / development banks have deep local research capabilities and experience in the markets in which they operate, reducing uncertainty;

iii) Relationships with local governments reduce political risk as long-standing DFI's / development banks' connections to local governments may reduce political risk in EM investing.

Other Asset Classes

There are also opportunities that sit outside of the traditional asset classes. While equity and fixed income are doubtless the more intuitive avenues for socially conscious investing, markets such as currencies and interest rates derivatives, as well as cash, can offer alternative routes. Indeed, there are impact funds available which aim to generate positive social outcomes via these asset types and live examples of derivative execution mechanisms that consider ESG factors.

Currency derivatives offer an interesting example, providing numerous different routes to impact. For example, impact strategies might invest in frontier or emerging market currencies on a targeted basis, creating positive outcomes through volatility reduction and liquidity provision. The academic community has provided substantial evidence for the need to reduce exchange rate uncertainty in support of economic growth in developing markets. While mature economies are found to be fairly robust with regards to exchange rate volatility, a significant negative impact on growth can be observed in countries with relatively low levels of financial development [23] [24].

[22] Impact Investing Institute Case Study: Masala Green Bond
[23] P. Aghiona, P. Bacchettab, R. Rancierec and K. Rogoff, **Exchange Rare Volatility and Productivity Growth: The Role of Financial Development**, *Journal of Monetary Economics*, 56(4), pp. 494-513, 2009.
[24] B. Eichengreen, **The Real Exchange Rate and Economic Growth**, *Social and Economic Studies*, 56(4), pp. 7-20, 2007.

Therefore, any strategy contributing to a reduction in currency market volatility can serve to benefit the users of that currency "on the ground", which is especially important since the ultimate recipients of development finance tend to hold the currency risk (as development finance is generally delivered in hard currency). Furthermore, increased liquidity in these markets can serve to benefit local participants by reducing spreads, while the asset selection process can also take into account ESG factors at the sovereign level, directing more capital to those countries with positive stories to tell. Taken together, these factors can support recipients in achieving their broader development objectives by more efficiently utilising their financing. This impact is measurable with volatility and liquidity, for example, visible to market participants.

Such strategies seek to provide return by utilizing traditional risk factors – e.g. carry, value and momentum - inherent in currency markets. They can also often be benchmarked against traditional EM Debt indices, particularly if underlain by fixed income assets such as development bonds, because a material proportion of local currency EM debt returns actually comes from the currency component itself (as well as duration, credit etc). As such, currency led impact strategies might seek outperformance versus the traditional EM debt approach by, for example, capitalising on the superior liquidity of the FX market during times of stress. Therefore, this kind of strategy could offer a feasible alternative to (or complement) the traditional EM debt approach, due to its potential to meet the fiduciary requirements of the trustees in terms of return, risk and diversification.

Of course, these strategies are exposed to the typical risks of EM/frontier currency investment; drawdown risk, illiquidity and volatility in the underlying instruments, leverage through derivatives etc. Therefore, a prudent risk management approach should be the primary focus during manager selection, as well as a robust portfolio construction policy.

Pension trustees could potentially also consider the social credentials of their derivate usage more directly, utilising positive outcomes as a means to achieve improved terms. There have been numerous examples recently of derivative pricing being directly linked to ESG factors. For example, hedging transactions undertaken by UK energy firm Drax have been priced to benefit from compliance with carbon intensity reduction targets [25]. This type of transaction will almost certainly be extrapolated in the future to instruments beyond currency derivatives (UK pension funds make extensive use of rates instruments) and to a plethora of different ESG factors.

Similarly, selecting execution counterparties based on the strength of their ESG credentials, rather than price alone, can offer an interesting alternative influence mechanism beyond equity or fixed income investment. By opting to drive flow to counterparties with stronger ESG scores, investors can lead by example, however at least in the short term they will be giving up some pricing benefit, which could make the approach inconsistent with fiduciary obligations. Over the longer term one could expect this approach to generate improvements in these counterparties pricing, due to the improved position enjoyed by those preferred counterparties in the marketplace.

Cash holdings can also be utilised for positive social outcomes. For example, investing cash in Community Development Finance Institutions (CFDIs) can allow investors to participate in socially responsible projects – investment in underserviced regions - while also generating a modest return. Innovation is rife in the CFDI space with numerous routes available. While capital loss is a material risk with this kind of investment, historic performance has been impressive, for the large part.

[25] https://www.reuters.com/business/finance/sustainable-finance-scramble-reaches-currency-derivatives-market-2021-05-18/