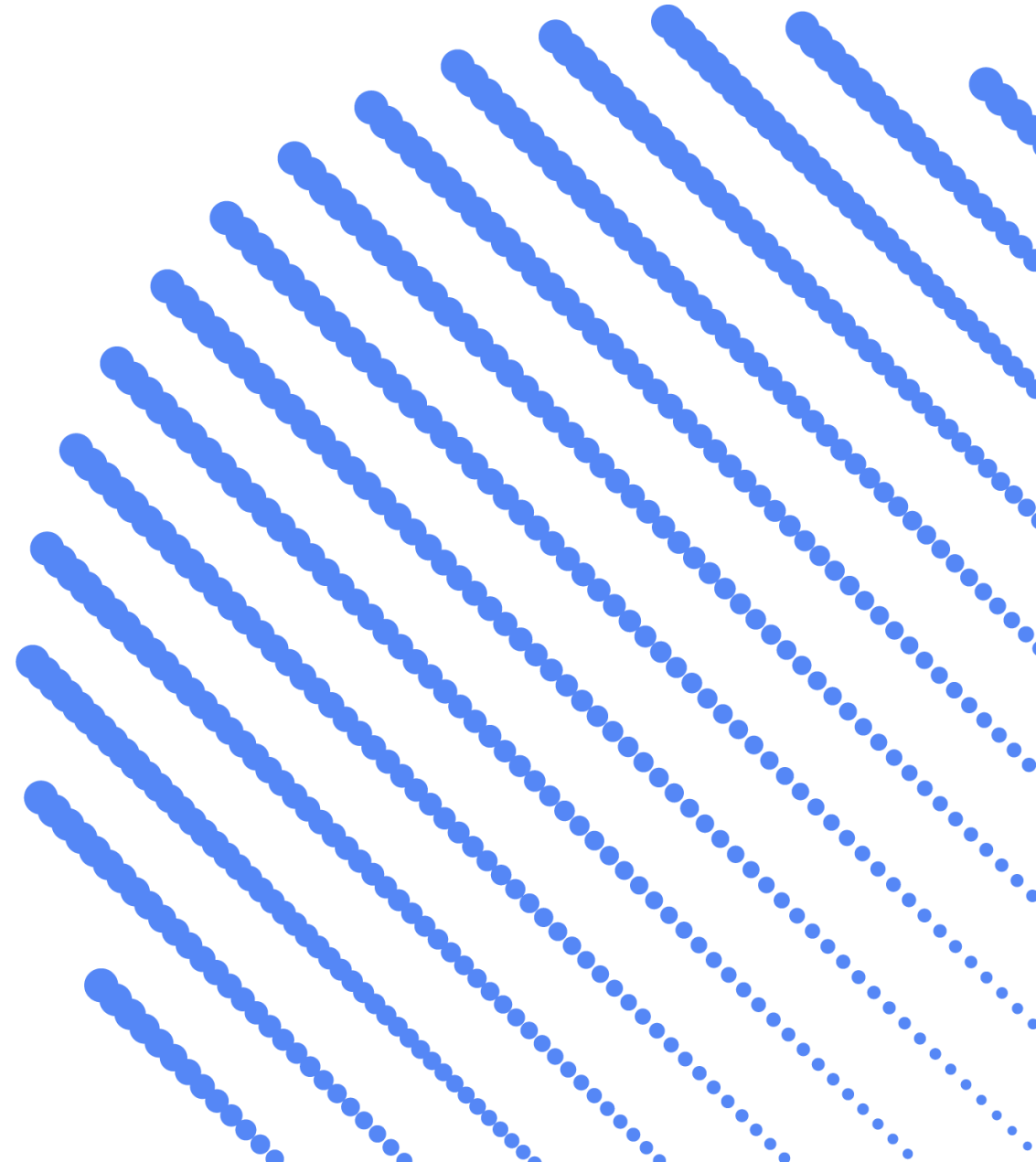




Transition
Pathway
Initiative

Developing a TPI Framework for Corporate Fixed Income: Consultation Findings

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Acknowledgements

This project was funded by Brunel Pension Partnership.

The project was chaired by Faith Ward (Chief Responsible Investment Officer at Brunel Pension Partnership and Co-Convenor of the TPI).

The technical lead was Dr Rory Sullivan (CEO, Chronos Sustainability and Chief Technical Advisor to TPI).

Nadine Viel Lamare (Director, TPI) and Joanne Lewis (TPI Secretariat) provided technical support and analysis.

We would like to thank all of the organisations and individuals who responded to the consultation, and the TPI Steering Committee for its comments on an earlier draft of this report.

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Summary

Overview of Findings

1. Strong support for the proposal that TPI apply its management quality and carbon performance methodology to fixed income issuers.
 - Most respondents agreed that assessments should focus on the corporate entity rather than the bond.
 - Some suggestions on additional fixed income-specific indicators.
 - Acknowledgement of the gaps in company disclosures but: (a) companies with poor disclosures simply receive a lower management quality rating, (b) while the issue is more significant in high yield, respondents suggested TPI should start with investment grade.
2. Different views on which should be priority sectors for analysis.
 - Respondents highlighted (a) Carbon intensive sectors, (b) index constituents, (c) banks/financials (although the difficulty of assessing banks and financials is recognised).
3. Many useful suggestions on the future development of TPI.
 - These suggestions will be included in TPI's 2020/2021 planning process.

Coverage

1. We have reviewed the universe of companies covered by TPI to assess the overlap with major investment grade and high yield indices.
 - The main indices are quite similar in terms of their coverage.
 - In investment grade, we have good coverage in terms of management quality. We, however, have limited coverage in high yield.
 - In investment grade, the main sectors are financials, telecoms, pharma, IT, oil and gas and electricity utilities. We have carbon performance methodologies for oil and gas and electricity utilities (generation, but not for distribution).
 - There are a number of significant names in the investment grade universe that are not currently assessed for carbon performance. These include: Sinopec, Ryanair, and Vattenfall.
2. We will discuss the roll out of the TPI methodology to corporate fixed income as part of the TPI 2021 planning process.

About the Consultation

Consultation Questions

TPI's core proposal was that the methodology for assessing management quality and carbon performance would be the same as for equity issuers.

The consultation focused on the following questions:

No	Question
1	Do you think TPI should develop a framework for evaluating corporate fixed income issuers?
2.	Do you agree with the proposal that TPI should use its existing management quality and carbon performance frameworks for assessing corporate fixed income issuers?
3.	Do you have any specific comments on the suitability or relevance of the TPI management quality indicators for assessing corporate fixed income issuers?
4	Do you have any specific comments on the suitability or relevance of the TPI carbon performance framework for assessing corporate fixed income issuers?
5	If TPI extends its coverage to fixed income, are there priority sectors, issuers or universes that TPI should focus on?
6.	Are there any other issues we should consider in the development of the TPI framework for corporate fixed income issuers?
7.	Have you used TPI in assessing the climate change performance of your fixed income portfolios?

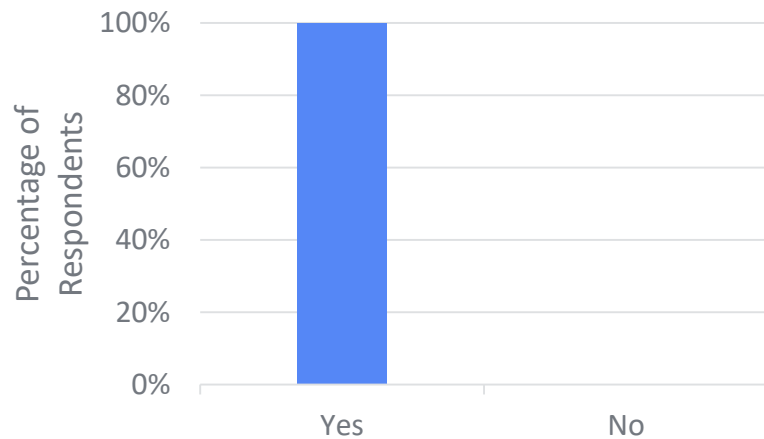
Responses



1. The consultation ran in April-May 2020.
2. Posted on TPI website and announced in TPI newsletters and on social media.
3. 31 respondents in total – 28 to the consultation and 3 prior to the consultation. These comprised:
 - 17 asset managers.
 - 7 asset owners.
 - 7 other respondents: proxy voting agency (1), investment consultant (1), consultant (1), index provider (1), investment bank (1), engagement provider (1), investment industry network (1).

The Consultation Results in Detail

1. Should TPI develop a framework for evaluating corporate fixed income issuers?



Strong support for the proposal, with many respondents highlighting the much greater attention from clients and in the market in climate change and fixed income.

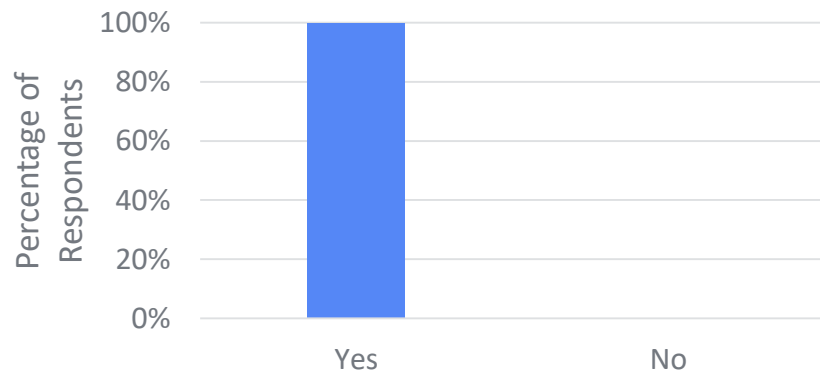
“We welcome and support the proposed expansion in coverage of the TPI framework to corporate fixed income issuers. If we are to effectively engage the private sector in tackling climate change, it is critical that corporate fixed income issuers are included more explicitly and prominently.”

“The expansion of the TPI framework will also encourage greater transparency and accountability by corporate fixed income issuers.”

“Most of our bond issuer clients now have to cover ESG in investor presentations/dialogue as a matter of course.”

“We believe large issuers exposed to climate change risks and opportunities should be captured by TPI, regardless of the type of security.”

2. Should TPI use its management quality and carbon performance frameworks for corporate fixed income?



Many respondents emphasised the importance of consistency in assessment frameworks and in investor expectations.

“This is important as it sets a common benchmark for assessing companies on their carbon practices... the characteristics of some corporate fixed income issuers means that they will find it difficult to be assessed as progressive. For instance, smaller private/loan issuing companies will tend to be capital constrained and securing funding for some of the carbon initiatives identified as progressive would be more difficult to do.”

“We believe it is desirable to have commonality in the framework for evaluating companies whether they be debt or equity issuers.”

“What about areas where the interests of equity and bondholders diverge? For example, if remuneration includes climate performance and incentives are based on shareholder returns, but not on maintaining credit quality.”

“It makes sense to use the existing framework. The company is being assessed based on the decisions the management of the company is making which doesn’t distinguish between debt and equity.”

3. Suitability of the TPI management quality indicators for assessing fixed income issuers?

Potential new indicators/subject areas

- Green bond financing and use of proceeds
- Whether the company has issued green bonds or sustainability-linked bonds
- Percentage of capex directed to low carbon solutions/products.
- EU taxonomy and green revenues.

General consensus that the same indicators should be used but some suggestions on potential new indicators and flagging of disclosure issues.

“It is appropriate to use the same criteria and measurements for an entity, regardless of where that asset is in the capital structure.”

“Fixed income should replicate equities, potentially with more specificity in areas like GHG emissions reduction targets and how fixed income projects align with the company’s goals.”

“Company disclosure is more limited in the corporate bond universe.”

“[for quasi-sovereigns, particularly in Emerging Markets] Investors’ engagement to encourage more transparency can be quite difficult.”

“It is simpler to focus on the parent company and let investors map this to underlying issuers. The task is very complicated if you are going to assess individual issues, specialist/green bonds, and the use of proceeds.”

“Within our internal ESG analytics research we have found data vendor coverage to be poorer within fixed income.”

4. Suitability of the TPI carbon performance framework for assessing fixed income issuers?

Technical considerations

- “The framework ignores the capital structure, which might be relevant to bond investors. For example auto manufacturers issue bonds from both their manufacturing and sales finance subsidiaries.”
- “Absolute reduction targets and performance would have merit, as intensity metrics are sensitive to denominator changes.”

Strong support for TPI carbon performance (and, specifically, carbon intensity) but some suggestions on additional metrics and on importance of looking at companies’ capital structures.

“We believe the carbon performance framework as it stands is equally appropriate for equity as well as fixed income issuers.”

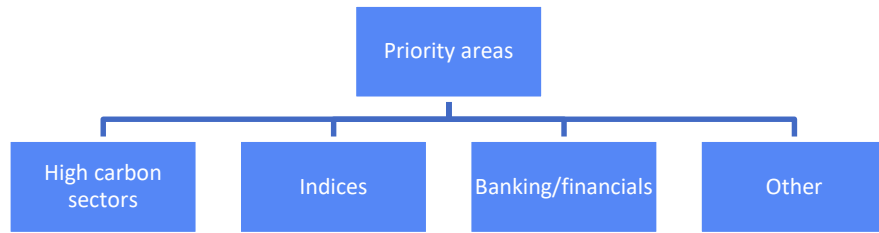
“The measure of carbon per unit of activity allows a direct comparison between the carbon efficiency of operations.”

“There are problems with disclosures in terms of scope. A fixed income instrument may be for a particular project/division/region.”

“Whether a company issues green bonds and how these proceeds are used may be a way to incorporate their activities into the TPI framework.”

“The most useful element of the TPI work is the quantified decarbonisation trajectory datasets for companies, comparing their track record and forward plans with the curves implied by the Paris sub-2/1.5 degree curves. We regularly refer to these in dialogue with potential green bond issuers.”

5. Are there priority sectors, issuers or universes that TPI should focus on?



High Carbon/High Transition Risk Sectors

- The following were commonly identified: oil & gas, utilities, autos, steel, transportation, fossil fuel extraction, mining, airlines, shipping, cement, aluminium, pulp and paper, chemicals, petrochemicals., pipelines and oil and gas services.
- Some called for “research into less well covered, but high emitting sectors, such as food & agriculture, real estate, apparel.”

Indices:

- Major debt indices: IG (e.g. Bloomberg Barclays Global/Euro Aggregate), HY (e.g. BAML Global/European High Yield Constrained) and EM (e.g. JP Morgan Corporate Emerging Market Diversified).
- “Investment grade would likely have the best coverage of data, so may be worth starting there.”
- “Prioritise issuers with the most bonds outstanding in the marketplace.”

Other

- Unlisted companies (e.g. airports, infrastructure finance).
- High emitting companies in emerging markets.
- Sovereigns.
- State-owned enterprises.

5. Are there priority sectors, issuers or universes that TPI should focus on? Banking

Questions to ask the banking sector

- Does the company conduct climate risk assessments on (a) its lending and securities portfolios, (b) its collateral?
- Does the company have restrictions on the most carbon intensive sectors (e.g. thermal coal, tar sands)?
- Is the company active in TCFD-aligned industry initiatives?
- Does the company have requirements for financing or underwriting to address GHG emission reduction targets?

Banking identified as a priority, but practical questions about how the sector is to be assessed.

“We would view the commencement of an effort to extend TPI methodology into the finance as a high priority. It is a very difficult but important task to lay out.”

“The number one priority should be the finance sector and in this sector the very first priority should be the banks.”

“No reason in principle not to apply TPI methodology to finance sector, but this is much more difficult as the finance sector is more of an ‘indirect contributor’, and there is much complexity involved in linking CO2 emissions to finance flows.”

“Applying the TPI methodology to finance would be valuable, as even though lending to carbon-intensive industries is limited on bank balance sheets, they contribute materially to the system-wide issue.”

6. Are there other issues to consider in the development of the TPI framework for corporate fixed income issuers?

Green Bonds

Two issues raised by many respondents:

- **Green (and similar) bonds.**
- **Bond timeframes and their place on the capital structure and how these might affect a TPI assessment.**

Green Bonds: Important but no consensus on how to integrate into TPI assessments

“Issuing ESG labelled bonds provides a sense of the company's overall debt strategy and could indicate a commitment to business transition. Issuing green bonds is not the only indicator of commitment or action. Issuers should not be penalised if they do not issue such instruments.”

“Corporate capital structure is relevant when determining what carbon performance measure to use. The issuing entity may not be directly linked to the issuer ultimately engaged in the economic activity.”

“The idea of accounting for carbon performance in covenants is interesting and worth exploring.”

“There is a case for different bonds having their own ratings, e.g. when a given bond is issued specifically for alternative energy projects).”

“While green bonds may support green endeavours, they also free up other funding to focus on non-green activities.”

6. Are there other issues to consider in the development of the TPI framework for corporate fixed income issuers?

Timeframes

Two issues raised by many respondents:

- **Green (and similar) bonds.**
- **Bond timeframes and their place on the capital structure and how these might affect a TPI assessment.**

Timeframes and capital structure: No consensus on how to address these

“TPI could account for relative risk exposure to carbon transition risk by segmenting the total debt outstanding of an issuer by the maturity of their bonds. Arguably those issuers with a greater portion of their total debt outstanding maturing in the medium to long-terms face higher transition risks than those with more near term ones.”

“Investing in a 10 year bond rather than a 2 year bond should not have an impact on assessing management quality and carbon performance.”

“TPI should apply equally to senior and subordinated bonds as well as to commercial paper or 30 year issuance. The maturity or seniority of the bond is less relevant.”

“Timeframes might be interesting if you can distinguish carbon performance at different stages of the climate trajectory. But, because of the scope for refinancing, it likely comes back to the performance of the issuer as a whole.”

7. Have you used TPI to assess the performance of your fixed income portfolios?

Fewer than one-third of respondents use TPI data to assess and manage their fixed income portfolios.

They key reasons were:

- Lack of coverage (limited number of issuers covered).
- Lack of accessibility (TPI requires the researcher to map equity identifiers to the underlying legal entities and hence to the individual securities).

One third of respondents indicated that they are considering how they might use TPI in fixed income.

Investors can use TPI data in their fixed income portfolios in a number of ways including. Examples presented by survey respondents included:

- Using TPI to assess issuers' carbon performance relative to their sector peers and how (mis)aligned the issuer is with different climate scenarios.
- Engaging with issuer management to discuss and address gaps (e.g. "we engage with those that have weak disclosure and/or those that are laggards in Management Quality").
- Investment decision-making (e.g. "to compare our credit analysts' assessment of an issuer's practices with respect to management accountability and carbon outcomes.")
- Products (e.g. one respondent stated that was looking at "how to adapt the existing TPI scores into a Paris-aligned credit exclusion list.")