RBC BlueBay
Asset Management

Unlocking the bondholder's voice: ESG engagement

For Professional Investors Only | Marketing Communication

Lucy Byrne
Senior ESG Analyst,
ESG Investment

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"What bondholders lack in voting rights, they make up for in size and therefore potential ability to influence."

As environmental and geopolitical risks continue to rise, threatening economic stability, ESG considerations have become as important for fixed income investors as they are for equity holders.

They're shaping the way we all invest, shifting the focus from pure upside potential to a broader outlook that factors in long-term sustainability for people and the planet.

For bondholders, this has led to a big shift in the area of investor engagement. Equity buyers have traditionally been the ones to engage with the companies they invest in. As shareholders – and therefore part owners of the business in question – they enjoy proxy voting rights, which give them the opportunity to influence corporate governance and directly engage with management teams on how the company is run.

Bondholders are lenders, not owners, and do not have a direct legal mechanism of influence. But the importance of ESG in the investment community has changed this dynamic, unlocking the bondholder's voice. What bondholders lack in voting rights, they make up for in size and therefore potential ability to influence. As individuals or a collective, bondholders have the power to financially back or withdraw support for new issuance, with the associated ability to drive up borrowing costs.

In the past, if one bond investor skipped an issue on ESG concerns, another would likely buy the bonds, maintaining demand. But as ESG factors become central to clients' mandates, the industry as a whole is shifting towards a more scrupulous operating model. Poor ESG practices are becoming less tolerated. A company with little regard for ESG considerations could be met by a lukewarm appetite for its issuance, with those who are willing to buy the debt pushing up the cost of borrowing to compensate for heightened ESG risks.

How to engage

Bondholder engagement requires an active management approach. Index tracking and passive algorithms do not factor in all the nuances associated with engagement. Digging into a company's values, culture and ESG practices requires a hands-on approach.

Withholding capital by not buying a company's bonds provides a blunt way of expressing a negative ESG view, but it won't necessarily lead to change. Without a voting option, bondholder engagement typically takes the form of dialogue – through meetings, calls and letters. Asset managers can engage as individuals or work together to harness some of the collective clout of the bondholder universe. Press exposure can also assist in driving up the power of a bond investor's message.

We believe ESG engagement isn't limited to one business area. Depending on the nature of the initiative, our dedicated ESG investment team might lead efforts or work in tandem with specific investment teams. Issuer and sector-level collaborative engagement usually involves investment and ESG investment team members, while issue or industry level efforts are primarily fronted by the ESG investment team.

Understanding engagement across fixed income

Driving change is rarely easy, meaning bond and equity holders alike face challenges in getting their voices heard. Within fixed income, there are many nuances that can shape how effective engagement methods are – some represent potential roadblocks, others opportunities.

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Corporates vs. sovereigns

- Barriers and challenges to engagement with sovereigns can be more common than corporates.
- The focus of sovereign engagement is typically to generate insights, but there can be opportunities to engage for influence, such as improving fiscal transparency and ensuring an operating environment that gives investors confidence.

Sub-asset class differences

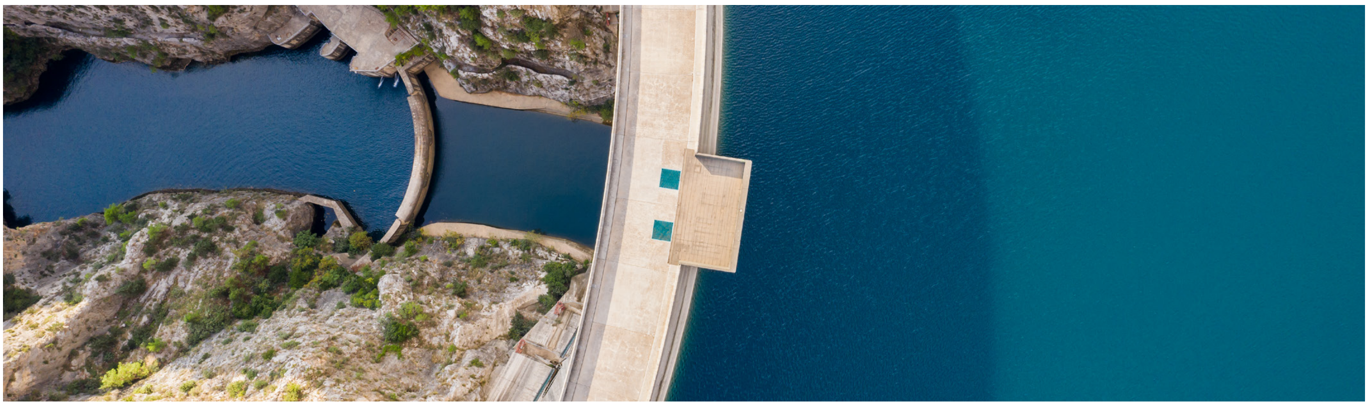
- It can be easier to engage with investment-grade issuers more so than high yield, due to the typically large size and resources of the issuer and its ability/need to engage on topics such as results.
- Engagement with high yield issuers can be helpful in terms of generating insights and better understanding ESG practices and risk management, particularly when there is a lack of third-party data available and limited public disclosure.

Emerging vs. developed markets

- Gaining access to emerging market (EM) issuers can be an engagement challenge, both for corporates and sovereigns.
- Engagement with EM issuers can be particularly useful in understanding ESG practices where disclosure is weak, as well as to drive positive change and best practices.

Conventional public debt vs. securitized credit

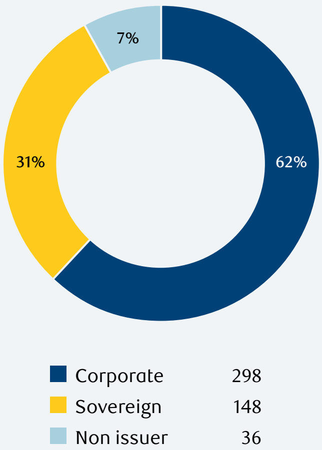
- Engagement is possible in securitized credit but the nuances of the asset class mean careful consideration must be applied to the methods used, the level at which engagement is possible (e.g. with the manager) and the degree to which there can be engagement for influence purposes (opposed to purely for insight).



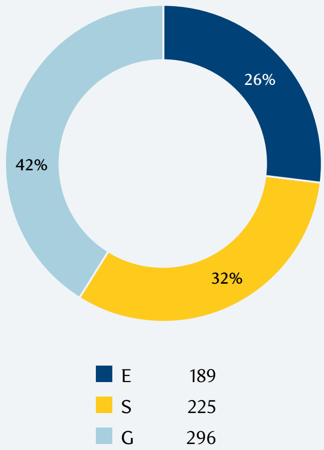
Our 2022 engagement activities

We use a centralised engagement log on our proprietary research platform, Alpha Research. The system documents instances of engagement, logging methods used, topics raised and views post-engagement, including those pertaining to ESG. We are constantly developing this technology to capture more granular data, including monitoring progress against objectives and timelines. In 2022 we had 484 ESG engagements comprised of 311 unique issuers. Further breakdowns are provided below.

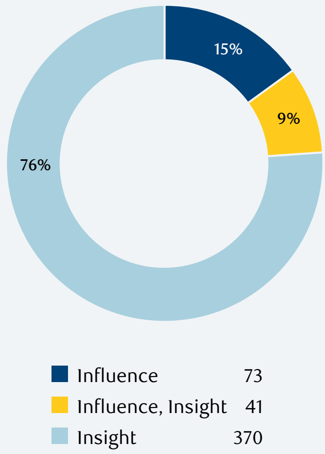
ESG engagements by issuer type



ESG engagements by E, S and G pillars (risks and opportunities)



ESG engagements by driver



*Disclaimer: Data includes ESG engagements only for the period 01/01/22 - 31/12/22. ESG engagements may have multiple risk and opportunity pillars and cover multiple risk and opportunity topics. Insight engagements are undertaken to gain further understanding to inform on investment decisions. Influence engagements are undertaken to facilitate change. Issuer engagements include corporates and sovereigns. Non-issuer engagements includes civil society and policy makers.

Collaborative ESG engagement

Collaborative engagement can offer a powerful mechanism for debt investors to influence issuers on improved ESG practices. These can be broad or specific, with a collective often having more sway than individual efforts.

We are committed to playing our role in collaborative engagement and driving ESG best practice forward through stewardship activities. Collaborative approaches can sometimes yield change that may not be possible as an individual, or which would have taken much longer to achieve alone. In some circumstances, we may undertake individual and collaborative action on an issuer for maximum impact.

We are members of numerous industry bodies and initiatives in order to inform and develop our internal ESG practices and to advance ESG thinking across the fixed income investment universe.

Case studies: sovereign

Focus: Ukraine

Engagement aim: Actively engage on various ESG issues surrounding the Russia/Ukraine conflict.

Engagement overview

- We engaged on the ESG issues surrounding the Russia/Ukraine conflict in 2022 through various mechanisms:
  - Produced a position paper for the UK government discussing the Ukraine reconstruction and the potential role of the private sector, as well as a position paper for CMI, the Martti Ahtisaari think tank, on Ukraine's economic needs in war and reconstruction.
  - Co-sponsors and participants of the Ukraine reconstruction conference organised by Wilton House and held in Warsaw, which brought together over 60 Ukrainian and Western policy makers focusing on Ukraine reconstruction.
  - Participated in various seminars and calls focused on Ukraine, reconstruction efforts and sanctions, and actively participated in discussions surrounding the financial market's role with respect to sanctions on Russia and Russia's exclusion from various investment indices (EMBI and MSCI) following the invasion of Ukraine.

Outcome

We are currently working with the official sector on a donor conference to talk about innovative debt solutions for Ukraine and other low income countries (LICs), and continuing our efforts of raising GBP3.5m plus for a Ukraine related charity.

Focus: Brazil

Engagement aim: Encourage policymakers in Brazil at federal and state level to make greater progress in tackling deforestation in the Amazon and other key biomes.

Engagement overview

- Since July 2020 we have been co-chair of the Investor Policy Dialogue on Deforestation (IPDD), a global collaborative investor engagement initiative which aims to highlight to sovereign issuers the dangers of failing to tackle forest loss.
- We also lead the IPDD's Brazil work stream and thus are now refocusing our approach away from persuasion of a sceptical Bolsonaro administration to encouragement of a much more sympathetic Lula government, which took office at the start of 2023.
- Many of our new counterparties in the ministry of environment and national development bank, for example, previously participated in education sessions for our work stream to help us to understand the challenges and policy options around reducing deforestation.
- Meanwhile, at the state level and at the autonomous Central Bank, the counterparties remain the same, but we hope to encourage faster progress towards the transparency and data sharing that will allow for greater scrutiny of supply chains and therefore better commercial incentives for protection of forest cover.

Outcome

- We revised our Investment ESG Score for the Brazil sovereign up from -2 to +1 (on a scale of -3 to +3) in January following the inauguration of Luis Inacio (Lula) da Silva as President, premised on a dramatic shift away from the policies and rhetoric of the Bolsonaro administration.
- Although he will need to negotiate from a position of weakness in Congress, Lula's policy instincts will be markedly more ESG-friendly than his predecessor, particularly in his approach to deforestation, and in collaboration with bilateral and multilateral partners internationally around climate change and nature.

Case studies: corporate

Focus: An automotive company

Engagement aim: Re-assess our ESG Fundamental Risk Rating

Engagement overview

- Following previous accusations regarding the use of illegal 'defeat devices' to cheat emissions tests carried out on diesel vehicles, the company has been an improving ESG story with many managerial and structural changes within its organisation and increased focus on electric vehicles.
- Yet we view that the improvements on the 'G' side have been lagging, as its ownership is limited to outside investors, creating an opaque structure. Moreover, allegations of forced labour of Uyghur minorities at their Xinjiang automotive plant led MSCI to assign a red flag controversy, and United Nations Global Compact status of Fail.
- As a result, we engaged with both the company and MSCI to understand their respective viewpoints. Conversations left the impression that there will be no quick solution or remedial measures that could be taken to change the downgrades. Regarding MSCI, we have also asked for further clarification on the downgrades to this specific automotive company, given that other companies operating in the region facing similar allegations have not been downgraded.

Outcome

- We have taken our Fundamental ESG (Risk) Rating assessment from High to Very High and will be reducing our exposure in all our funds that are classified as Article 8 under the Sustainable Finance Disclosure Regulation (SFDR).
- We will continue to monitor and engage directly with the company and MSCI as appropriate.

Focus: A Canadian iron ore producer

Engagement aim: Investigate their approach to health and safety, labour relations, human resources, human rights and community relations.

Engagement overview

- The Nunavut Impact Review Board (NIRB) recommended against the corporation's application to increase exports from 6 mtpa to 12 mtpa (and eventually 18 mtpa) for its port Rail Expansion project.
- The company's management were surprised by the NIRB ruling and, post our engagement, we estimated that the base case probability was that the Federal government would rule in favour of the company.
- However, the rationale for the NIRB ruling highlights that the management has inadequately addressed the local Inuit community concerns over the past few years and that progress has stalled on mitigating their main environmental and social risk factors.

Outcome

With the negative ESG trajectory of the issuer we took the decision to eliminate exposure across both ESG-aware and ESG-orientated strategies at the end of May and early June 2022.

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