The IIGCC Net Zero Bondholder Stewardship Guidance provides corporate bondholders with a foundational framework to enhance their climate stewardship practices, building on IIGCC’s Net Zero Stewardship Toolkit for listed equities and practical steps aligned with the Net Zero Investment Framework (NZIF). The Guidance identifies and addresses key challenges and opportunities across different bond types, highlights best practices in bondholder stewardship and investors’ ability to achieve long-term outcomes.

The centre piece of the Guidance outlines bondholder specific considerations for engagement and the importance of alignment between the issuance, the issuer’s climate transition strategy and net zero alignment over time. The Guidance emphasises the importance of a long-term approach across the financing lifecycle and engaging across the ecosystem.

**Bondholder Engagement Guidance Highlights**

**A long-term financing lifecycle-based approach**
- **Pre-issuance engagement** based on financed emissions, refinancing pipeline, and net zero alignment
- **Issuer and Issuance alignment** of climate and net zero commitments, targets and covenants, and monitoring this alignment over time
- **Collaborative approach across the bond market ecosystem** including issuers, investors, Debt Capital Markets (DCM) syndicate, banks, SPOs, rating agencies, index providers, regulators and policymakers
- **Engagement progress and outcomes** to clearly link stewardship to investment decisions, and steer responsible capital allocation

**Actionable Engagement and Escalation Support for Bondholders**

- Analysis and engagement guidance tailored across investment grade, high yield, emerging markets (including state-owned enterprises), private companies and securitised bonds
  - Integrating bondholder considerations into equity engagements
  - Issuer level covenants linked to climate and sustainability considerations
  - Disclosure and transition plan guidance for private companies
  - Stakeholder mapping and customised approaches for emerging markets engagements
  - Physical risk assessment for securitised products

- The IIGCC Bondholder Stewardship Hub will allow investors to flag upcoming climate engagements with high-emitting issuers, including the agenda, rationale and intended outcome to promote further collaborative engagement opportunities for bondholders.

IIGCC’s approach to Bondholder Stewardship includes an actionable long-term engagement and escalation approach to corporate bonds with best practice examples, covered in the current guidance, and sustainability linked issuances which will be examined in future guidance. This document focuses on climate stewardship while providing the foundation for bondholder stewardship on broader sustainability considerations.

**Bond market ecosystem**

- **Disclosure, Engagement and Stewardship**
- **Bond Issuer**
- **Lending Bank**
- **Bond Underwriter and Issuer Counsel**
- **Prospectus Disclosure**
- **Credit Rating Agency**
- **Green / Up / SLB labels & third party verification**
- **Issuance Proceeds**
- **Bond Investor**
- **Active**
- **Buy & Hold**
- **Distressed**
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# Acknowledgements

IIGCC Team: Laith Cahill, Annabel Clark, Oliver Grayer and Peter Taylor

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For more information visit www.iigcc.org
Introduction

The immense size of the global bond market; its importance to companies’ capital structures and the real economy, the constant cycle of financing and refinancing, the wide range of participants in the corporate bond ecosystem, and bondholders’ role in providing transition capital, makes bondholder stewardship a critical element of climate and net zero stewardship, with significant potential.

The opportunities for bondholder stewardship take an exciting number of shapes. Bondholders may engage at the entity and at the issuance level, by seeking to encourage the company to transition its business in line with net zero pathways, or diving into the granular details of how climate risk is reflected in the use of proceeds, structure and covenants of the bond itself. Bondholders can also opt to adopt an ecosystem approach to engagement that includes the issuer and various participants across the corporate bond ecosystem ranging from banks, credit rating agencies, regulators and others.

As bondholder stewardship evolves, net zero targets rush closer, and the physical and transition risks posed by climate change make themselves felt, investors are seeking new ways to engage on their corporate fixed income holdings to support the transition and effectively manage the risk in their portfolios. Engaging with companies to support the transition helps promote long-term sustainable growth and minimise financial risk. Failure to consider shifting weather patterns, for example, could leave issuers with unexpected impaired assets and increased likelihood of default. Better stewardship and engagement can lead to a better understanding of how the changing climate impacts the issuers’ creditworthiness, which may otherwise go under the radar.

The IIGCC Bondholder Stewardship Working Group, comprising asset owners and asset managers and led by Railpen, was established to unlock the potential of improved stewardship. This Guidance, the first output from the working group, builds on IIGCC’s Net Zero Stewardship Toolkit (the Toolkit) and Net Zero Investment Framework (NZIF). Under the NZIF, it is recommended that investors individually set an engagement goal for the coverage of assets aligned or under active engagement at >70% of financed emissions from material sectors for listed equities and corporate fixed income. The Net Zero Stewardship Toolkit provides a six-step framework (Table 1) to enhance stewardship and engagement practices, but mainly focuses on listed equities.

This Guidance focuses on publicly listed corporate debt. It identifies and addresses key challenges and opportunities across different publicly listed corporate bond types, highlights best practices in bondholder stewardship and investors’ ability to achieve long-term outcomes. The centre piece of the Guidance outlines bondholder-specific considerations for engagement and the importance of alignment between the issuance, the issuer’s climate transition strategy and net zero alignment over time. The Guidance emphasises the importance of a long-term approach across the financing lifecycle and engaging across the ecosystem.

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1 Global long-term fixed income issuance was $26.8 trillion in 2021, compared to $1 trillion in global equity issuance – Capital Markets Fact Book 2022

2 The Guidance focuses on climate stewardship for publicly listed corporate debt. While State Owned Enterprises (SOE) are considered, specialised guidance is required for sovereign debt and is not the focus of this guidance. While this guidance focuses on climate stewardship, the steps are broadly applicable for bondholders across other pillars of sustainability and ESG.
Table 1: Net Zero Stewardship for Bondholders

<table>
<thead>
<tr>
<th>Net Zero Stewardship Toolkit Key Steps</th>
<th>Additional Considerations for Bondholders</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Undertake Portfolio Analysis, Set Portfolio Net Zero Alignment Goals and Develop a Stewardship Prioritisation Framework</td>
<td>• Using debt relevant metrics for prioritisation</td>
</tr>
</tbody>
</table>
| 2. Set Net Zero Alignment Criteria, Alignment Levels and Time Bound Engagement Objectives | • Implementing a stewardship approach across the financing lifecycle, from issuance to refinancing to maturity  
• Setting time bound objectives extending beyond issuance maturity dates, with milestones along the way |
| 3. Develop an Engagement Strategy for Priority Companies | • Priority company approach including bondholder specific approaches to stewardship implementation including dialogue and escalation.  
• Progress assessment, recalibration and ongoing capital allocation strategy |
| 4. Baseline Engagement and Voting Approach | • Feed views into equity stewardship teams where applicable  
• Voting on consent solicitations |
| 5. Asset Owner and Manager Alignment on Net Zero Goals | • Asset owner expectations for fixed income stewardship |
| 6. Transparency | • Similar to equities |

Ultimately, the Guidance provides corporate bondholders with the foundational tools, best practice recommendations and case studies to enhance their climate stewardship activities in line with the Net Zero Stewardship Toolkit and deliver on their individual net zero/climate commitments. By enhancing bondholder stewardship, investors are better able to steward their debt capital investments, protect long-term value for clients and help finance the path to net zero.

It is a foundational principle of how IIGCC and its members work together that the choice to adopt guidance, best practice tools or tactics prepared by IIGCC is always at the discretion and unilateral decision of individual investors based on their own decision making. The aim of this document is to provide a framework that can be used by corporate fixed income investors, all of whom will have differing mandates and starting points from which they make their own decisions to take account of differing contexts, strategies and aims and the fact that jurisdiction, regulation and best practice will determine the approach that can be taken by an investor.
Key Challenges

While bondholder stewardship presents opportunities for investors, challenges remain, including:

**Voting Rights**
- Bondholders do not have the same rights as shareholders, notably the ability to hold companies to account with regular votes on company governance.

**Bond Documentation**
- Bond prospectuses, covenants and indentures typically only cover debt management considerations rather than the overall business and climate strategy.
- Green, Social, Sustainable and other labelled bonds (GSS+) rely on voluntary principles which also have limitations on stewardship support.

**Heterogeneity of Issuer Universe**
- Debt is issued by all types of issuers, from publicly listed companies, private companies to sovereigns and state owned enterprises (SOEs), each with their own specific nuances for stewardship.

**Issuance Timelines**
- Despite the need for a long term and consistent approach to ongoing bondholder engagement, engagement has been traditionally limited to pre-issuance with the window being constrained in recent years due to short marketing periods and significant passive demand. Currently typical pre-issuance engagements tend to be restricted to group conference calls and sometimes meetings with a restricted investor audience and inconsistent follow-up action post-issuance.

**Data Disclosures and Quality**
- Climate data disclosure, especially emissions profiles, are typically at the issuer level and not included in bond documentation outside of labelled bonds.
- Data availability is scarce in emerging markets and for private companies.

**Perception**
- Stewardship and engagement have traditionally been considered the remit of shareholders, largely because of the overemphasis importance placed on proxy voting, and ownership considerations.

**Access**
- Bondholders seeking to engage with issuers are typically only granted initial access to the CFO, Treasury and investor relations teams, rather than the CEO and the Board.

**Collaborative Sector Engagement**
- Initiatives such as Climate Action 100+ have historically focused on equity engagement.
Stewardship and the Financing Lifecycle

A Long-Term Approach to Stewardship Across the Financing Lifecycle

The debt financing lifecycle can broadly be divided into four phases: pre-issuance, issuance (allocation), post-issuance (holding and secondary market) and maturity/refinancing.

**Figure A: The Issuer Debt Financing Lifecycle**

Debt issuers can issue bonds directly or approach banks for short term warehouse facilities which are then termed into the bond or loan markets.

Prior to new issuance, when the bond is being structured, Stewardship will involve:
- Issuer Net Zero disclosure update
- Issuer Net Zero alignment assessment
- Issuance use of proceeds assessment
- Issuer – Issuance alignment
- Covenants and KPIs

While the bond has been issued, stewardship in the timeline between secondary trading and maturity, will involve:
- Issuer Net Zero disclosure – ongoing monitoring
- Periodic issuer Net Zero alignment assessment
- Assessment of use of potential refinancing proceeds and alignment with Net Zero
- Collaborative engagement and escalation of key areas of misalignment

Covered under the current IIGCC Bondholder Engagement Framework and Best Practices Guidance document.

This Guidance recommends that effective bondholder climate stewardship consists of a strategic and holistic long-term approach spanning the entire debt financing lifecycle. This long-term approach extends beyond the term of the existing bond holdings and allows for consistent engagement on climate risks, creating a clear alignment between an issuer’s ongoing bond financing, its climate transition strategy and net zero alignment over time. For more, see the Chapter 3: Net Zero Stewardship Toolkit – Steps for Bondholders.
### Step 1 – Undertake Portfolio Analysis, Set Portfolio Net Zero Alignment Goals and Develop a Stewardship Prioritisation Framework

#### Outcomes

At the end of this step, a bondholder will be able to identify a list of companies as ‘high priority’ to achieving their portfolio net zero alignment and decarbonisation goals.

The NZIF is underpinned by increasing the alignment of assets to net zero pathways across portfolios. To achieve this, NZIF recommends the adoption of governance practices including Board and management awareness, skillsets and capabilities on climate risks, policies and incentives, systems and tools and investment, stewardship and engagement strategies aligned with portfolio-wide and fund-level goals consistent with achieving net zero emissions by 2050 or sooner.

Investors are encouraged to conduct portfolio analysis to assess asset class level alignment and identify which companies account for the majority of financed emissions. The Toolkit subsequently recommends that investors develop a prioritisation criteria to identify which companies offer the most potential to both deliver portfolio alignment goals and materially impact real world emissions.

<table>
<thead>
<tr>
<th>NZIF Alignment Maturity Scale</th>
<th>i) Not aligned</th>
<th>ii) Committed to aligning</th>
<th>iii) Aligning towards a NZ pathway</th>
<th>iv) Aligned to a NZ pathway</th>
<th>v) Achieving NZ</th>
</tr>
</thead>
<tbody>
<tr>
<td>NZIF Corporate alignment criteria</td>
<td>At, or close to, net zero emissions</td>
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<td>3 Emissions performance*</td>
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<td>6 Capital allocation alignment</td>
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<td>5 Decarbonisation strategy</td>
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<td>4 Disclosure*</td>
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<tr>
<td>2 Targets*</td>
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<td>1 Ambition</td>
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</tbody>
</table>

*Additional criteria a company must meet to move to that alignment category

*Alignment criteria that lower companies need to meet
General factors for consideration when establishing a prioritisation criteria include the role of the company and the wider sector in driving or hindering the transition, (e.g. stimulating demand for lower carbon services, facilitating fossil fuel expansion), the resulting GHG emissions, the relevance of climate to the business operations, including climate-related financial risk levels, potential financial restraints to address these challenges, the impact of the business on climate, and where the company has demonstrated a willingness to be a leader on climate or there are existing strong relationships between investor and issuer. A full list of key general considerations for all investors is outlined in the Toolkit.

Bondholders will want to take a dynamic approach to identifying priority issuers, focusing first and foremost on how climate materially impacts the issuer credit risk and mitigating downside risk. Bondholders may also want to consider:

<table>
<thead>
<tr>
<th>Bondholder Stewardship Prioritisation Considerations</th>
</tr>
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<tbody>
<tr>
<td><strong>Issuer Leverage/Reliance on Debt</strong></td>
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<tr>
<td><strong>Refinancing Pipeline</strong></td>
</tr>
<tr>
<td><strong>Bond Index Considerations</strong></td>
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<tr>
<td><strong>Issuer Approach to Financing</strong></td>
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<tr>
<td><strong>Sector Debt Reliance</strong></td>
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<tr>
<td><strong>Debt Type</strong></td>
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<tr>
<td><strong>Ability to Leverage Equity Engagements</strong></td>
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<tr>
<td><strong>Existing Disclosure Practices</strong></td>
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</tbody>
</table>

³ For private companies, bondholders may use book value of equity or market cap in place of EVIC although this is not a perfect proxy.
Neuberger Berman’s approach to engagement prioritisation is a function of the following considerations: severity of ESG concern as assessed by its proprietary ESG scoring system, called the NB ESG Quotient, economic exposure to identified risks and its relative level of influence within a company’s capital structure. The goal of this prioritisation is to be proactive in order to avoid downside risks in the portfolio.

### Step 2 – Set Net Zero Alignment Criteria, Alignment Levels and Time Bound Engagement Objectives

**Outcomes**

At the end of this step, a bondholder will be able to set out:
- Time bound objectives for engagement for each company in scope (milestones towards delivering each five-year goal).

The next step recommended by the Toolkit is to determine how priority companies will be assessed and set time-bound objectives to support the delivery of portfolio goals and enhance net zero alignment. Any chance of achieving net zero by 2050, consistent with a 1.5°C pathway, will require steep emission reductions from companies in the short-term.

Time-bound objectives will typically be set on an annual basis, with longer-term goals set along an escalating ‘alignment staircase’. The alignment staircase can be adjusted to reflect levels of influence as holders of bonds through the financing lifecycle. It may also be adjusted to reflect different stages of development by asset class and the level of influence held by the investor. For instance, smaller companies, such as those typically found in high yield markets, may need more time to institute large scale changes.

As different corporate fixed income instruments (e.g. each with different characteristics in terms of coupon, maturity, where it fits in the capital stack) can be issued by a single issuer entity, the assessment of net zero alignment is best made both at the issuer level and the issuance level. However, time-bound objectives will typically be set at the issuer level – allowing bondholders to set criteria independent of, and extending beyond, individual issuances and their maturity dates. Ultimately, a long-term lifecycle approach to stewardship allows bondholders to build long-term issuer relationships and set objectives on time horizons beyond their initial holdings, protecting the value of future investments.
### Illustrative High-Level Example of a Net Zero Alignment Criteria Staircase

<table>
<thead>
<tr>
<th>Criteria / Milestone</th>
<th>Milestone 1 Committed (To be delivered within 1 year of engagement)</th>
<th>Milestone 2 Aligning (To be delivered within 2 years of engagement)</th>
<th>Milestone 3 Fully Aligned (To be delivered within 3 years of engagement)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Ambition</strong></td>
<td>Net Zero ambition covering all Scopes</td>
<td>Net Zero ambition covering all Scopes</td>
<td>Net Zero ambition covering all Scopes</td>
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<tr>
<td><strong>Targets</strong></td>
<td>Medium-Term Target (at least aligned with Beyond 2°C Scenario [B2DS])</td>
<td>Medium-Term Target (at least aligned with Beyond 2°C Scenario [B2DS])</td>
<td>Medium-Term Target (at least aligned with Beyond 2°C Scenario [B2DS])</td>
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<td></td>
<td>Revised Short, Medium and Long Term targets aligned with IEA Net Zero Emissions by 2050 scenario (NZE)</td>
<td>Revised Short, Medium and Long Term targets aligned with IEA Net Zero Emissions by 2050 scenario (NZE)</td>
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<tr>
<td><strong>Governance</strong></td>
<td>Board capabilities and competencies to manage climate change</td>
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<td>Board member nominated responsible for climate oversight</td>
<td>Board member nominated responsible for climate oversight</td>
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<td>Board member nominated responsible for climate and Net Zero oversight</td>
<td>Board member nominated responsible for climate and Net Zero oversight</td>
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<td>Climate metrics linked to executive remuneration</td>
<td>Climate metrics linked to executive remuneration</td>
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<tr>
<td><strong>Core</strong></td>
<td>Current emissions intensity metric disclosed and consistent with trajectory needed to reach emissions targets</td>
<td>Current emissions intensity metric disclosed and consistent with trajectory needed to reach emissions targets</td>
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<td><strong>Emissions Performance</strong></td>
<td>Scope 1, 2 and 3 emissions reporting</td>
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<td>Emissions measurement and reporting system in place</td>
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<td>Emissions measurement, verification and reporting system in place</td>
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<tr>
<td><strong>Emissions Data Disclosure and Verification</strong></td>
<td>Climate Strategy Disclosure as per TCFD recommendations</td>
<td>Climate Strategy Disclosure as per TCFD recommendations</td>
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<td>A quantified plan setting out measures to be deployed to deliver GHG targets, (% of green revenues, use of neutralising actions such as CCUS and Offsets clearly disclosed)</td>
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<td>Milestone 3 Fully Aligned (To be delivered within 3 years of engagement)</td>
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<td>Core</td>
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<td>Capital Allocation</td>
<td>Quantified target delivery plan</td>
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<td><strong>Generating and disclosing ‘green revenues’ and their share in overall sales.</strong></td>
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<td><strong>Targets to increase the share of ‘green revenues’ in overall sales.</strong></td>
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<td><strong>Capital expenditure plans set out and consistent with decarbonisation strategy, and disclosed methodology. Disclosed investment in fossil fuel based assets and reducing rapidly and disclosed investment in “green” energy capacity.</strong></td>
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<td>Climate Policy</td>
<td>Disclosure of climate lobbying position and all direct lobbying activities and its Paris alignment</td>
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<td>Additional</td>
<td>Climate-related issues included as CAM/KAM in auditor reports</td>
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<td>Accounting judgements and consistency with other sustainability reporting (impairments, asset useful lives and retirement obligations)</td>
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<td><strong>Inclusion of climate assumptions in financial accounts and auditor reports</strong></td>
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<td><strong>Effect of climate targets on financial accounts and audit reports</strong></td>
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</table>

Step 3 – Develop an Engagement Strategy for Priority Companies

Outcomes

At the end of this step, a bondholder will be able to:

• Plan and prepare a bondholder stewardship strategy.
• Determine the core approach for bondholder engagements for priority companies.
• Escalate and recalibrate the engagement approach as necessary.

Priority companies are typically subject to an enhanced programme of engagement; sustained across multiple years and supplemented by engagement ‘sprints’ on urgent and material objectives.

In developing and implementing an engagement strategy, the Toolkit recommends that investors follow three sub-steps:

• Stewardship strategy planning and preparation
• Engagement and escalation
• Progress assessment and recalibration

Prior to engagement, any stewardship strategy involves internal planning and resourcing. For fixed income investors, this includes ensuring that the analyst/portfolio manager teams are adequately resourced with either trained on-desk or dedicated stewardship personnel. This is especially important in fixed income teams where climate-related stewardship practices are still relatively nascent. Where applicable, this process can be accelerated through the integration of fixed income stewardship into existing equity stewardship teams.

**Engagement and Escalation**

Engagement and escalation are critical to effective bondholder climate stewardship. Ongoing dialogue with issuers on climate-related disclosure, the issuers’ net zero alignment and its financial materiality can serve to improve issuer actions and oversight of climate-related credit risks and issuance quality. Dialogue begins by identifying how climate risks are material to the investor and issuer.

Bondholders can challenge the misconception that management team access is only necessary for equity investors. The importance of climate considerations to bondholders means that access beyond the typical CFO/treasury/investor relations team is also important.

Dialogue may range from flagging economic benefits to overall cost of capital from climate and broader sustainability actions, net zero commitments, targets, transition planning, investment in green economic activities, taxonomy alignment and associated disclosures, to highlighting the potential negative implications, especially for high emissions sectors, of fossil fuel expansion and asset stranding risks, avoiding mass divestment and cost of capital implications. This is a process that is mutually beneficial for investors and issuers.

Engagement is most effective where it is meaningfully tailored to the issuer’s business model and the asset class, and timed appropriately. The below explores the opportunities for integrating bondholders into existing equity engagements and for bondholder-specific collaborative engagement. It subsequently sets out engagement opportunities and approaches across the financing lifecycle.

**Integration with Equity Stewardship**

Bondholder stewardship relies on many of the same inputs as equity stewardship: access to data and disclosures, and engagements with company decision-makers. For climate stewardship, equity and credit investors are often aligned in their pursuit of decarbonisation strategies as the materiality to either investment is relatively similar.

The Toolkit recommends integrating bondholder stewardship into existing equity engagements and stewardship strategies as a first step to increasing the effectiveness of bondholder stewardship. This can be a powerful tool, whereby all teams can leverage and ultimately benefit from the engagement activities conducted across the various asset classes, and bondholders can lean on the experience and additional rights of shareholders.

For instance, where appropriate and permissible, bondholders may wish to communicate concerns and instances of misalignment identified in the course of their engagement with their shareholder colleagues to help inform equity voting policies and decisions.
Benefits of Equity Integration

Combining the expertise of equity and fixed income teams, whether in joint meetings, or in research, can have a number of benefits:

**Engagement** – Including fixed income teams in engagements with C-Suite and board members, who typically engage more with shareholders, helps to demonstrate that fiduciary duties and concerns around climate risks extend beyond equities. This can also help bondholders benefit from collaborative engagement opportunities, such as CA100+, typically open to shareholders.

**Escalation** – Combining the insights of equity and fixed income investors magnifies the influence and voice of both parties. Equity investors could potentially integrate bondholders into their voting decisions, for example, holding the board accountable for an inadequate climate financing strategy and voting against the re-election of board members.

**Development** – Joint engagement meetings provide a valuable opportunity to help train corporate credit investment professionals on engagement practices which they may not have previously been involved in.

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Collaborative Engagement

The use of collaborative engagements has been a key stewardship strategy for equity investors, with a proven track record for effective and efficient engagement. For instance, three quarters of the 166 Climate Action 100+ focus companies have now set a net zero commitment, compared to just five when the initiative began. Bondholders may want to consider joining existing collaborative engagements, where possible, even where focused on equities. IIGCC is exploring opportunities, for instance, for bondholders to join CA100+ engagements.

Specific bondholder collaborative engagement has been rare to date, but motivation is building for a range of shared initiatives. Bondholders of private companies can encourage the inclusion of private companies in collaborative engagement initiatives. Collaborative engagement can also go beyond issuers – see Chapter 5: Stewardship Across the Ecosystem.

IIGCC intends to support collaborative bondholder engagement with issuers through its Bondholder Stewardship Hub. Through this, IIGCC members will be able to:

- Flag significant upcoming financing/re-financing points, as publicly available and not constituting material non-public information, for high-emitting issuers to facilitate pre-issuance engagement on climate issues.
- Flag upcoming climate engagements with high-emitting issuers, including the rationale and intended outcome.
- Flag links to emerging markets climate research and collaborative engagements.

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4 Climate Action 100+ Progress Update 2022
Climate Action 100+ is an investor-led initiative which aims to ensure the world’s largest corporate greenhouse gas emitters take action on climate change. Over 700 investors, representing over US$ 68 trillion in AUM, are engaging companies on improving climate change governance, cutting emissions and strengthening climate-related financial disclosures. In 2020, Petroleos Mexicanos (PEMEX), a 100% state-owned Mexican oil & gas company, was added to the list of CA100+ focus companies. This was a significant development at the time, as focus companies had tended largely to be equity listed ones. The engagement with PEMEX under CA100+ is coordinated through the PRI Global Group, with participating investors including the BlueBay fixed income platform (‘BlueBay’) of RBC BlueBay.

PEMEX has been rated poorly across a number of ESG areas by various external ESG rating providers, including on climate-related matters. Engagement with PEMEX to step up its climate efforts, particularly on its methane emissions management and in terms of its carbon reporting, has been challenging due to the timing coinciding with a difficult financial outlook and limited resources to address these, as well as key management changes. The investor group has met with management over several occasions since 2020, with constructive interactions and enhanced public disclosure more recently indicating a positive trajectory – and the engagement remains ongoing.

Whilst there is still meaningful scope for progress on climate-related matters, the investor group remains encouraged, and will continue to review and evolve their engagement strategy. Keeping the engagement cohort open to additional investor signatories has been helpful to increase the proportion of outstanding PEMEX debt that the group represents. In addition, the involvement of domestic Mexican investors to the investor coalition has further facilitated dialogue. Engaging State-Owned Enterprises (SOEs) poses potential unique challenges to investors, as in many cases, policy makers are the main channel for any change in an SOE’s operations and strategy, therefore, adding difficulty to any company-level executive led change. In recognition of these challenges, CA100+ has created additional support for investors who are engaging with SOEs in the form of a State-Owned Enterprises Working Group. The working group provides a useful forum for investors to share knowledge and experiences, so to improve engagement effectiveness and efficiency.

Complementing its collaborative efforts with PEMEX, BlueBay has also maintained its own bilateral engagements with PEMEX over the years, reinforcing messages on climate change that are aligned to those under CA100+, as well as highlighting other ESG considerations where more effective management could mitigate both financial and reputational risks.
Engagement Across the Financing Lifecycle

This section explores engagement approaches across the financing lifecycle.

**Pre-Issuance** – Engaging prior to issuance is critical for bond investors seeking to set expectations for issuers and upcoming issuances, setting clear expectations on delivery to secure financing. Pre-issuance is typically the most fruitful period for investors for engagement, with relatively strong management access, at roadshows or otherwise, and potential for extended collective engagement with syndicates and lead managers, as explored later in the Guidance.

Pre-issuance climate engagement for bondholders typically focuses on:

- The issuer’s overall net zero climate strategy
- How the debt strategy, including specific issuances, supports the overall net zero climate strategy
- Linkages between climate risks and credit risks

Engagement pre-issuance typically involves discussions on the issuer’s climate strategy, net zero alignment and investor expectations for climate disclosures, including TCFD and transition plan reporting. Investors providing clear guidance to the issuer on what investors see as ‘good’ or ‘optimal’ disclosures in the context of submitting an order can be helpful in demonstrating the link between climate alignment and demand from the investor at issuance.

This can be accompanied by granular focus on the issuance itself, including the use of proceeds, bond covenants and KPIs, and its alignment with the issuer’s climate targets and transition plan. NZIF recommends that investors engage issuers to secure the issuer’s decision to align issuances with the issuer’s net zero commitments, including the potential use of covenants and KPI linked bonds as mechanisms to ensure climate alignment criteria are met during the lifetime of the bond.

Incorporating climate considerations into the bond documentation in the pre-issuance stage can make a significant difference to the provision of climate-related disclosures during the life of the bond and provides an accountability mechanism for investors. As part of the UK Stewardship Code, for instance, fixed income investors are expected to explain their approach to “seeking amendments to terms and conditions in indentures and contracts; seeking access to information provided in trust deeds; impairment rights; and reviewing prospectus and transaction documents”. The IIGCC Bondholder Stewardship Working Group will seek to provide further guidance on bond documentation and financing frameworks. In the meantime, IIGCC supports the Investment Association’s recommendation that issuers include an index of ESG disclosures in the Offering Memorandum.

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5 Under Principle 12 of the UK Stewardship Code signatories are expected to “actively exercise their rights and responsibilities”.

6 Investment Association – Improving Fixed Income Stewardship Report
Railpen: Incorporating Climate into Debt Covenants

Covenants are legally enforceable rules that borrowers and lenders agree upon at new issuance. Covenants can enumerate what issuers are required to do (affirmative covenants) and what they are prohibited from doing (negative covenants). Bond covenants linked to climate, sustainability and related disclosures have been used in GSS+ issuances but are still not part of mainstream bond structures and are not linked to the issuer’s transition plan framework at the entity level.

Railpen has undertaken work on expanding the covenants currently being used in the high yield bond market. This is proposed at the issuer level to align with and supplement the work done by ICMA on ESG covenants in the SLB space. Examples include:

1. **Reporting Covenants**
   Historically used to provide access to financial information, with climate being a major financial risk, this covenant can be amended to incorporate climate reporting with KPI’s linked to the issuer’s transition plan. This may be particularly important for holders of “144A” bonds not registered by the SEC or required to file financials on the EDGAR system.

2. **Investment Covenants**
   A key risk for investors is issuers making investments that materially impact the volatility and default risk of their bonds. There are several provisions in conventional credit agreements to protect lenders against risky investments. This includes an Investments Covenant, which involves restrictions on permitted acquisitions, asset sales, and sale/leasebacks, with carve-outs for “permitted investments”. For issuers committed to decarbonisation, this could be replicated to prohibit investments in high emissions businesses with transition risk which are not aligned with the issuer’s overall stated climate transition strategy. For such issuers, where the use of proceeds is defined as “General Corporate Purposes”, restrictions on investing in new fossil fuel developments could be a sensible way forward.

3. **Line of Business Covenants**
   This covenant can be used to limit an issuer’s future scope of business while offering stakeholders protection on an issuer’s approach to proactively managing material risks. Without such a covenant, an issuer can change its management policy or strategic direction from its core business to riskier undertakings with higher earnings volatility or even to a new sector entirely different from what bondholders had evaluated when making their investment decision. The Line of Business Covenant can be amended linking it to the issuer’s climate transition plan to include restrictions on new emissions intensive lines of business.

4. **Uncapped Debt-Financed Capex**
   This is the amount of debt-financed capital expenditures that the issuer can undertake uncapped. By introducing caps on non-green capital expenditure, this covenant can potentially be linked to an issuer’s climate transition plan and provide a broad steer to its capital allocation strategy.

By incorporating these covenants with regular alignment assessments, bondholders can ensure effective use of their capital to track, align and steward issuers to their climate and net zero goals.
At Issuance – The point of issuance is typically not conducive for substantive engagement given the short time window. However, as explored below, the point of issuance is a key juncture for bondholder stewardship. Expectations set, and information obtained, during pre-issuance engagements can be used to inform investment decisions. Communicating these decisions to the company with a clear rationale linked to engagement, where appropriate, creates a tangible link between engagement outcomes and investment decisions, and over time, helps clear the runway for the climate transition. For more on the responsible allocation of capital, see the end of Step 3.

Post Issuance – Holding Period – Ongoing engagement is critical to providing oversight of existing bonds and company actions. This helps to build a long-term relationship with the issuer, create better understanding between investor and issuer, and set the stage for future issuances.

Issuers are sensitive to the trading levels of their secondary bonds and related yields and often look to bond investors for colour on why their bonds are trading cheap/expensive compared to peers. To the extent that there is room for improvement on climate, bondholders can communicate adjustments that could change market sentiment.

Stewardship at this stage involves ongoing engagement with the issuer on their material climate-related activities and disclosures, including:

- Net zero disclosure updates (e.g., TCFD and/or transition plan) and improvements.
- Net zero alignment assessment updates (e.g., TPI, CA100+) and improvements.
- Use of proceeds and their alignment with the issuer’s climate strategy.
- Impact reporting on labelled bonds to be publicly accessible and updated regularly (typically quarterly or annually).

This ongoing dialogue also helps investors highlight areas of misalignment with the climate commitments and net zero assessments at issuance and consistently encourage and empower the climate transition.

Post Issuance – Maturity/Refinancing – Refinancing existing debt is a key engagement opportunity for bondholders as issuers constantly return to investors for new funding. For investors with existing holdings in the issuers, a refinancing can potentially provide an escalation opportunity where climate expectations have not been met.

Understanding the financing lifecycle and leveraging the specific stewardship opportunities, both on an initial and ongoing basis, at each stage of the lifecycle, is crucial to investors maximising their bondholder stewardship impact.
<table>
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<th>Stewardship Strategies</th>
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<th>Key deployment considerations for bondholders</th>
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<td><strong>Private dialogue/letters</strong></td>
<td>Writing to the Board with a summary of investor expectations, engagement progress and requested changes.</td>
<td>All Stages</td>
<td>Providing notice of expectations, asks and intentions to escalate can help concentrate Board thoughts without creating public pressure.</td>
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<td><strong>Direct engagement meetings with issuers on focused climate topics.</strong></td>
<td>In-person meetings are time-intensive but can create stronger relationships and more effective dialogue between issuer and investor.</td>
<td>All Stages</td>
<td>As explored above.</td>
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<td><strong>Collaborative engagement</strong></td>
<td>Collective engagement has proven successful in equity stewardship and can be a more efficient method for engagement.</td>
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<td><strong>Engaging with equity holders</strong></td>
<td>Include bondholders in equity engagement for inputs in net zero alignment assessments</td>
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<td><strong>Inclusion of climate transition considerations in bond indentures and prospectuses</strong></td>
<td>Inclusion of net zero and climate alignment assessment statutes in indentured. Embedding climate related KPIs in agreements.</td>
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<td>This creates an accountability mechanism for climate considerations in the bond documentation.</td>
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<td><strong>Consent solicitations</strong></td>
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<td><strong>Public dialogue and statements</strong></td>
<td>Sharing concerns and details of a lack of progress with other investors and stakeholders through own website and media channels.</td>
<td>All Stages</td>
<td>Timely and appropriate communication of investor expectations and progress of engagement can give impetus to engagement, help companies to make progress more rapidly and can highlight issues to other investors.</td>
</tr>
<tr>
<td><strong>Ecosystem engagement</strong></td>
<td>Engaging with other market participants</td>
<td>All Stages</td>
<td>See ecosystem chapter.</td>
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Responsible Allocation of Capital

While NZIF and the Toolkit identify engagement as one of the primary methods to deliver on investor net zero commitments, capital allocation decisions (i.e. the choice to buy) are part of the stewardship process and may be an important part of escalating bondholder engagement.

As part of the responsible allocation of clients’ money, bondholders practice sell discipline: choosing to sell a position because it no longer meets the investment criteria. This criteria may include having a credible plan for avoiding stranded assets and thriving amid the transition to net zero.

Particularly in the fixed income space, capital allocation decisions and stewardship decisions are mutually reinforcing. In line with this, NZIF recommends that investors consider selective divestment:

• As a consequence of climate financial risk assessment.
• As a consequence of escalation following engagement.
• For companies whose primary activity is no longer considered permissible within a credible pathway towards global net zero emissions, identify exclusions over relevant timeframes.

In cases where the investor has clear red lines or policy positions (such as the Net Zero Asset Owner Alliance’s oil and gas infrastructure policies7), investors may screen out new issuances and may use this to open up a stewardship conversation to drive changes in corporate practice that would return the issuer to the investable universe. Similarly, debt denial may occur at the end of a structured escalation timeline, following robust engagement, coupled with equity escalation, policy approaches and public dialogue.

While equity investors divest from the entirety of the company, fixed income investors can take a targeted approach to capital allocation: continuing to finance certain green projects (e.g. through green use of proceeds bonds) or support issuances with sustainability targets (e.g. through sustainability-linked bonds) while potentially foregoing the general issuances of companies that are not responding to the climate risks. In so doing, investors will want to conduct due diligence on the alignment of the financing to the wider transition strategy of the issuer. This approach, where supported by engagement and clear messaging, sends a signal to companies while providing the capital needed to transition high-emitting companies to net zero.

Ultimately, any decisions to divest of an issuance or issuer must be made according to the investors’ individual decision making and their fiduciary duty to clients and beneficiaries.

In 2021, Aviva Investors launched a Climate Engagement Escalation Programme which aims to engage with corporate issuers in the oil and gas, metals and mining and utilities sectors. The programme included asks within 5 key themes: climate targets, transition plans, management incentives, climate disclosures, and climate lobbying. The programme is conducted over a three-year period, with a commitment to divest bond and equity exposure in issuers that fail to demonstrate sufficient progress. Issuers were prioritised based on their emissions profile and the programme does include significant bond issuers including fully and partially state-owned issuers.

The engagement approach with issuers has been collaborative, with ESG, and Credit Teams leveraging their shared knowledge, experience, and contacts at issuers to gain access to issuers either as an individual investor or alongside peers through initiatives like Climate Action 100+. This type of holistic engagement approach has proven effective in mobilising change across targeted areas. Insights and progress identified from engagements has been used to support issuer level assessments, which are monitored and tracked within the programme.

Aviva Investors has witnessed progress made against its asks, with issuers taking steps to broaden and strengthen targets, clarify strategy and capex allocation plans, and address reporting gaps in climate-related disclosures.

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7 Net-Zero Asset Owner Alliance Position on the Oil and Gas Sector
Step 4 – Progress Assessment and Voting Policy Approach

The fourth step in the Toolkit is to assess progress and link company level objectives and outcomes with voting actions for all companies.

Progress Assessment and Recalibration

At the end of each annual cycle, company and portfolio alignment assessment should be carried out to determine which companies have progressed sufficiently, escalating actions to be taken where progress is insufficient, to affirm their status as a priority company and/or include new priority companies to the extent applicable. Tracking the frequency and quality of engagements, focused on outcomes generated, is largely the same for bondholders as it is for equity investors. For more please see the Net Zero Stewardship Toolkit.

For bondholders, this review period can be an important opportunity to integrate stewardship into the investment process and consider how the climate actions of the company are reflected in financing and refinancing decisions.

Voting Policy Approach

As bondholders do not retain a vote on AGMs, this step rarely factors into bondholder stewardship. However, in more limited instances, there may be scenarios where debt investors have exposure to this (e.g. converts, swapping debt for equity in the case of restructuring and defaults). Where these scenarios do not exist, as previously discussed, investors may want to consider how bondholders feed their climate engagement insights into equity voting decisions.

In addition, bondholders retain a vote through consent solicitations on the bond should the issuer seek technical changes to documentation, early bond redemptions and financial restructuring, which are typically unrelated to climate considerations. However, as climate-related considerations become more important in bond documentation, investors can potentially engage on climate transition and impact through these votes. For instance, some issuers have sought to convert outstanding, non-labelled bonds into green bonds.

Step 5 – Asset Owner and Manager Net Zero Alignment and Engagement

The fifth step in the Toolkit is to ensure asset owners and asset managers are aligned on their net zero goals, ensuring that engagement activity from an asset manager delivers what asset owners require to align their portfolios with net zero.

Asset owners play a critical role in encouraging bondholder stewardship. Under initiatives such as Paris Aligned Asset Owners, many have already committed to implementing a stewardship and engagement strategy “consistent with an objective for all assets in the portfolio to achieve net zero emissions by 2050 or sooner”. Clearly communicating the expectation that stewardship is extended to their fixed income holdings is critical.

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8 A blog published by Freshfields Brukhaus Deringer notes that a consent solicitation gives issuers “the opportunity to engage with their investors specifically on their ESG or sustainability strategy…as the conversion process is about existing bonds and does not involve the raising of new money, this allows for the dialogue between the issuer and the investors to focus on the issuer’s ESG strategy rather than broader business performance”.

9 The FRC’s 2022 Review of Stewardship Reporting provides further details on setting expectations for managers.
Stewardship in Different Forms of Corporate Debt

This section explores engagement across different forms of corporate debt, including labelled bonds, high yield, private companies issuing publicly listed debt, securitised issuances, and emerging markets.

Labelled Bonds

Labelled bonds, in the form of Green, Social, Sustainability and Sustainability-linked (GSS+) bonds, play a critical role in providing the finance needed to transition to net zero and provide enhanced climate engagement opportunities, typically at the point of first issuance, where issuers seek investor input into the bond parameters.

Issuers can create a more constructive process by seeking investor input early and maintaining an ongoing dialogue, supported by impact reporting, as part of their sustainable finance strategy.

The benefits of a longer term engagement strategy focused on green bond issuance and ongoing impact reporting are clear in the case of Berlin Hyp: (i) there are increased opportunities for investors to engage on sustainability matters; (ii) in accepting the process as a journey, investors are able to accommodate framework and corporate sustainability strategy weaknesses early in the process and hold management to account if they are not tightened up over time; and (iii) the interlinkages that bind the framework and sustainability strategy with credit quality have time to evolve.

Case Study  
Jupiter Asset Management: Long-Term Engagement on Labelled Bonds

Berlin Hyp, a German real estate and mortgage bank, issued its first green bond in 2015, followed by further issuance every successive year and more recently sustainability linked bonds and social bonds. The bank engaged with investors from the beginning of the process, in many cases developing new relationships with green and ESG focused investors. It understood concerns investors might have regarding green bond additionality and was quick to implement a novel feature whereby it would commit to (and report on) future green investment, standing out from other bank issuers that only focus on historical investments at time of issue.

The success of its early green bond issues emboldened its Board of Management to aggressively step up its corporate sustainability commitments and shift lending activity towards greener buildings at a more rapid pace. It did so with a number of initiatives such as the promotion of energy efficiency and linking remuneration to green lending targets. These actions have in turn supported the growth in green assets required for future green bond issuance. In the debate on market additionality, Berlin Hyp stands out as an example of institutional benefits arising from its sustainable financing strategy.

Berlin Hyp’s green financing framework and corporate sustainability strategy has continued to evolve and improve over time since its inaugural green bond issue.

Case Study  
PIMCO: Labelled Bonds Engagement

PIMCO engages with issuers on best practices for ESG-labeled bonds and evaluates these instruments, mapping them across a spectrum based on strategic fit, potential impact, and red flags and reporting, resulting in PIMCO’s proprietary impact score for green, social, sustainability, and sustainability-linked bonds. For example, it assesses the alignment of the issuers’ decarbonisation and net zero strategies with the bond’s objectives and use of proceeds as well as the evidence of significant positive outcomes compared to “business as usual”, including likely emissions reductions in the real-economy.

Background: A German-Czech Republic commercial real estate company, CPI Property investment in Central and Eastern Europe, a region that is still in the early stages of ESG investing compared to Western Europe.

Engagement: Following interactions about CPI’s green bond program and ESG strategy, PIMCO shared guidance on best practices when issuing sustainability-linked bonds, including an explicit link to ambitious GHG emissions reduction targets.

Progress to Date: In January 2022, CPI issued its inaugural Sustainability-Linked Bond, with a strong focus and comprehensive scope on reduction in carbon emissions. The company subsequently obtained validation by the Science Based Targets initiative (SBTi) that its emissions reduction goal is aligned with the well-below 2°C scenario by 2030.
Ascent Resources is a private, natural gas E&P that focuses on development opportunities and operations in the Utica Shale in Ohio. Neuberger Berman is a large bondholder of Ascent Resources issuances and has developed a strong relationship with the company. The relationship between Neuberger Berman and the issuer led to over 10 discussions with the issuer's management team including the CFO. The issuer is focused on reducing its environmental intensity through emissions and water use but can improve disclosure into its impact and strategy by expanding reporting and establishing medium-term targets.

Specifically, Neuberger Berman encouraged Ascent to disclose scope 2 emissions, reduce emissions intensity, and establish emissions reduction targets, and substantially increase water use efficiency and establish freshwater usage reduction and water recycling goals.

In the company’s 2021 ESG report published in August 2022, they disclosed scope 2 emissions for the first time. Ascent publicly committed to achieve net zero emissions across scope 1 and scope 2 by 2025. Neuberger Berman continues to monitor the company in its progress towards this goal as well as encourage more transparent reporting on gross emissions reduction versus the use of carbon offsets to achieve this target. Specifically, Neuberger Berman encouraged the issuer to report aligned with TCFD standards. While the company has not set a quantitative long-term goal related to water use, the issuer did announce investments in infrastructure to improve water re-use, and the company has materially improved on water intensity metrics and doubled its water recycle rate in the past 3 years.

### High Yield

As with all bonds, the high yield market is diverse, with no single stewardship approach applicable across the market. Generally, however, high yield companies can provide the opportunity to be a large bondholder in the company and engage with company senior management, which can be helpful for credit underwriting and also for dialogue on climate and ESG topics. Although every issuer is different, high yield companies are typically issuing in the market regularly, value capital access, and can be responsive on ESG inquiries. Smaller companies tend to be more prevalent in high yield and may have less resource to focus on an ESG strategy and providing the supporting data and disclosure. Stewards of smaller companies should support management teams to understand investor priorities and the most material data and disclosure.

### Private Companies (Issuing Public Bonds)

Bondholders have a unique opportunity to try to influence private companies. Given that there are no public shareholders, creditors have a potentially strong voice: the company may depend on bond investors for capital more than is typical for public companies with access to a broader investor base. Private companies are, generally, smaller, potentially providing bondholders easier access to senior management.

Many investors use the European Leveraged Finance Association’s (ELFA) ESG Fact Sheets which aim to provide specificity and consistency for borrowers in terms of ESG information requests from investors. This helps to minimise requests from investors for ESG data in multiple different formats, which should help to reduce the burden on smaller, more resource-constrained companies. Increasingly, borrowers are completing some or all of the survey. Investors are able to use this data to generate an ESG score for the company.

The key challenge for investors in publicly listed corporate debt from private companies is disclosure. Private companies face different reporting requirements and pressures from stakeholders leading to reporting on climate-related issues being much weaker than publicly listed peers. Private companies generally have weaker climate-related disclosures, coverage from third party climate and ESG data providers. The focus of stewardship for private company may therefore focus on due diligence and encouraging standardised climate reporting.
Insight Investment has a long-standing engagement with a private investment grade Singaporean holding company on climate-related issues. The company owns a large portfolio of companies, including companies in sectors which are materially exposed to climate risk, as identified by the TCFD.

Insight first engaged with the issuer in 2018 due to a lack of transparent disclosures on climate change, to better understand:

- How the issuer was systemically identifying and managing climate-related risks
- How the issuer was taking climate change into consideration when making investment decisions
- How the issuer was mitigating relevant climate risks
- Whether the issuer had any targets to reduce emissions
- Who was responsible for climate change at a senior level
- How the issuer was working with portfolio companies to improve their own management of climate-related risks

The initial engagement in 2018 provided an opportunity to deliver feedback to the company from Insight’s review of their disclosures and approach to climate change. Insight also summarised its expectations in terms of improvements the holding company could make to their climate change strategy, risk management and disclosures.

The issuer was receptive to feedback and Insight has had several productive conversations on this topic over the past five years, with the most recent engagement in Q4 2022. Progress includes:

- The company appointed a Chief Sustainability Officer
- The company has set a net zero by 2050 target and has developed decarbonisation pathways to support this target
- The company now reports against TCFD and conducts scenario analysis against three NGFS scenarios
- The company has set an internal carbon price, which increased by 20% in the past year

Whilst some disclosure gaps remain compared with publicly listed peers, the actions implemented by the issuer over the course of our multi-year engagement highlight the importance that the company is increasingly placing on climate change. As appropriate structures around climate risk management and reporting have been implemented, Insight has shifted its focus to the issuer’s engagement with portfolio companies to understand how it is helping them to transition to a low carbon world.
To the extent an investee company is owned by a private equity sponsor, bondholders may also want to use this route to engage. Some private equity sponsors enjoy the expertise of large sustainability teams, as well as the ability to direct strategy of their portfolio companies. Many institutional investors already have strong relationships with PE sponsors so one route may be to expand conversations to cover stewardship on climate topics using the same methods as described for bondholder stewardship more generally, to the extent possible.

For more guidance on private companies, please see IIGCC’s Net Zero Investment Framework for Private Equity Industry.

**Securitised Issuances**

Securitisations are issued by bankruptcy-remote vehicles and therefore bond investors can use pre-issuance engagement to better underwrite deal structures, assess issuer quality and cash flow stability, and ultimately enhance debt repayment capacity. Labelled securitised offerings provide an opportunity to ask for more ex-ante transparency on underlying collateral than might otherwise be feasible to provide.

As with private companies, securitisations often have a sponsor that can be engaged on a pre-issue basis.

Securitised issuances can be diverse and idiosyncratic, creating challenges with third party data coverage and development. As a result, a bottom-up approach to climate and ESG integration is needed.

**Case Study: Royal London Asset Management: Residential Mortgage-Backed Securities**

For residential mortgage-backed securities (RMBS), RLAM focuses primarily on the lending policies and practices of the bank writing the mortgages, including a review of how environmental considerations are integrated into the bank’s lending decisions. Similarly, for a commercial mortgage-backed security (CMBS), RLAM’s focus is on the ESG performance of the underlying assets, which can vary from City office buildings, retail or industrial units, and infrastructure assets.

RLAM regularly engages with new issuers prior to investing to understand how environmental impact is managed – providing essential information for assessing how issuers are preparing their assets to cope with climate change and the potential impacts on asset life and sustainability of cash flow.

While it’s rare that any one identified risk will singularly drive an investment decision, more informed risk identification hones the integrity of lending decisions, providing vital context for the evaluations of bond pricing and structure, and overall portfolio positioning.

**Emerging Markets**

Emerging markets (EM) engagement is particularly bespoke given the physical climate risks, energy transition challenges and opportunities resulting from reliance on revenues from commodity exports and/or carbon-intensive manufacturing and consumption for economic growth. The benchmark constituents in EM have a larger representation of heavy emitting sectors with EMs representing over 60% of current emissions and projected to represent 90% of global emissions growth to 2030.

Discussing climate with EM issuers can often begin with engagement on governance practices. Without the right governance in place, creating change on climate concerns may not be feasible.
Engaging with State Owned Entities

EM debt disproportionately includes issuances from State Owned Enterprises (SOE), which form a key part of EM corporate bond indices. While this Guidance is geared towards corporate bonds, SOE debt engagements are ones that involve a detailed understanding of the sovereigns, revenue mix, economic growth drivers, energy mix and the policy landscape.

Depending on the specific political and economic context around the SOE, a key recommended first step to SOE stewardship is to identify and map the various stakeholders who are key parties to the sovereign and the SOEs energy transition strategy. This will include but is not limited to SOE management and Board, the respective sovereign central bank and treasury contacts, who are key to setting the sovereign energy transition strategy, and other such participants, including key domestic investors. Identifying and establishing these contacts, determining the sovereign energy transition strategy, identifying areas of overlap and using these to shape the engagement agenda is a recommended approach for high impact.

Bond investors also have an opportunity to approach EM sovereigns and central banks who have strong regulation on some aspects of climate change and use that for deeper engagement with the sovereigns, SOEs and corporates on themes like deforestation, forestry, agriculture, and food production. One example of this is the Investor Policy Dialogue on Deforestation (IPDD) Initiative which is an investor-led deforestation initiative aiming to halt deforestation in the most vulnerable biomes of the world. Collaborative engagement initiatives are also possible, as demonstrated by the Emerging Markets Investor Alliance.

The net zero transition will likely play out very differently across developed markets (DMs) and emerging ones. And there will need to be attention paid to ensuring a just transition, with regional-specific pathways on a fair share principle to reach net zero. It is therefore critical that EM engagement is tailored to the individual circumstances of each region, market and company. This may mean amending engagement objectives, timelines and red-lines. For example, as described below, Insight Investment made allowances in their coal divestment policy to support a South African company’s coal phase out in recognition of its commitment to engage and South Africa’s reliance on coal for its developmental requirements.

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10 See, for instance, the ICMA Climate Resilient Debt Clauses for Sovereign Issuances
11 See, for instance, the ICMA Climate Resilient Debt Clauses for Sovereign Issuances
12 [https://www.climatefairshares.org/](https://www.climatefairshares.org/)
Insight Investment’s position on thermal coal is that it believes that thermal coal does not present a long-term viable fuel source in a world which needs to cut its carbon consumption. As a result, on pecuniary grounds, it has committed to phase out its exposure to thermal coal mining and thermal coal power generation companies by 2030 in OECD countries and 2040 in non-OECD countries, in line with the IEA’s 2050 Net Zero scenario. This difference in exclusion dates highlights the importance of taking into consideration the differences in energy mix, energy infrastructure and demand requirements in developed markets vs. emerging markets.

Where companies have been identified to have material exposure to thermal coal and making sufficient progress to exit coal by the dates outlined in the policy, Insight undertakes a structured engagement programme with clear annual progress targets, set against the actions needed to achieve overall phase-out in line with relevant time-scales.

Failure to adhere to demonstrate sufficient progress on decarbonisation may lead to an investment being placed on a ‘divestment watchlist’ with a period of 12 months to move back in line with the expected trajectory. Divestment will be analysed on a case-by-case and maturity-relevant basis with a focus on pecuniary impairment. In the analysis process there is some flexibility if the company is showing improvements but faces significant challenges to meet the requirements outlined in the policy.

During Q2 2022, Insight initiated an engagement with a South African utility on the company’s high coal exposure and lack of clear targets regarding coal phase out. Electricity supply in South Africa derives largely from coal deposits in the north-east and phasing out of coal is challenging for the country due to the increasing energy demands from the population.

Insight focused its engagement on the issuer’s divestment plans for coal and public commitments to phasing out. It encouraged the issuer to set interim carbon reduction targets and placed significant focus on the company’s approach to the Just Transition, as the company’s shutdown of coal assets will have profound social impacts on the country’s population.

Insight agreed that due to South Africa’s reliance on coal and the country’s developmental requirements, it would monitor and continue to engage with the company on its coal exposure and targets despite the issuer not implementing phase out dates that are consistent with Insight’s Coal Policy. Insight may continue to hold the company’s bonds if the company stays actively engaged on the topic and shows signs of improvement over time. Due to the challenges that the country faces in terms of energy mix and energy access, Insight has allowed additional flexibility in order to support the company on its low carbon journey and will continue to monitor progress.
<table>
<thead>
<tr>
<th>Characteristics</th>
<th>Challenges</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fixed income asset class</strong></td>
<td><strong>Typical company size</strong></td>
</tr>
<tr>
<td>Investment Grade (IG)</td>
<td>Large</td>
</tr>
<tr>
<td>High Yield (HY)</td>
<td>Small</td>
</tr>
<tr>
<td>Emerging Market (EM)</td>
<td>Varied</td>
</tr>
</tbody>
</table>

\(^{13}\) MSCI – Why is Climate-Transition Risk High in High Yield  
\(^{14}\) Amount outstanding as of 27th April 2023 (BBG Global Credit Index)  
\(^{15}\) MSCI – Why is Climate-Transition Risk High in High Yield  
\(^{16}\) Amount outstanding as of 27th April 2023 (BBG Global High Yield)
<table>
<thead>
<tr>
<th>Characteristics</th>
<th>Challenges</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fixed income asset class</strong></td>
<td><strong>Public Bond Issues from Private Companies</strong></td>
</tr>
<tr>
<td>Typical company size</td>
<td>Varied</td>
</tr>
<tr>
<td>Liquidity</td>
<td>Varied</td>
</tr>
<tr>
<td>Default risk</td>
<td>Case by case</td>
</tr>
<tr>
<td>Resources / disclosures</td>
<td>Varied but typically less climate resources</td>
</tr>
<tr>
<td>Sector Bias &gt; Climate Exposure</td>
<td>Lead times</td>
</tr>
<tr>
<td></td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td>Index Size / ownership</td>
</tr>
<tr>
<td></td>
<td>Case-by-case depending on breadth of the overall company investor base</td>
</tr>
<tr>
<td></td>
<td>Leadership access</td>
</tr>
<tr>
<td></td>
<td>Varied and usually dependent on credit quality of the issuer being IG or HY</td>
</tr>
<tr>
<td></td>
<td>Covenants</td>
</tr>
<tr>
<td></td>
<td>Available in prospectuses and largely linked to asset performance</td>
</tr>
<tr>
<td></td>
<td>Market idiosyncrasies</td>
</tr>
<tr>
<td></td>
<td>Heterogeneous market mainly dominated by residential and commercial mortgages, consumer and commercial finance. Other esoteric asset classes range from aircraft ABS to solar panel ABS</td>
</tr>
<tr>
<td></td>
<td>Diverse and idiosyncratic market requires bottom-up approach to ESG integration</td>
</tr>
<tr>
<td><strong>Securitised issuances</strong></td>
<td><strong>Securitised Issuances</strong></td>
</tr>
<tr>
<td>Varied</td>
<td>Varied by asset class and tranche specifics. Typically senior tranches from mortgage and asset backed securities are most liquid</td>
</tr>
<tr>
<td></td>
<td>Case by case depending on asset class issuer and tranche specifics</td>
</tr>
<tr>
<td></td>
<td>Asset / mortgage backed nature of assets and typically off-balance sheet SPV issuance leads to poor disclosure at issuer level but strong disclosure on asset characteristics with potential for physical climate risk disclosure</td>
</tr>
<tr>
<td></td>
<td>Commercial and residential mortgage portfolios face physical climate risk exposure dependant on locations. The space also provides potential to fund renewables assets and energy transition investments</td>
</tr>
<tr>
<td></td>
<td>Treasurer/CFO at best; in many cases it is with the servicer who may or may not be the same entity as the issuer/sponsor</td>
</tr>
<tr>
<td></td>
<td>Available in prospectuses and largely linked to asset performance</td>
</tr>
<tr>
<td>Fixed Income Asset Class</td>
<td>Frequency of Issuance</td>
</tr>
<tr>
<td>-------------------------</td>
<td>----------------------</td>
</tr>
<tr>
<td>Investment Grade (IG)</td>
<td>High</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>High Yield (HY)</td>
<td>High</td>
</tr>
<tr>
<td>Emerging Market (EM)</td>
<td>Varied based on geography, sector and credit quality</td>
</tr>
<tr>
<td>Private</td>
<td>Varied based on sector and credit quality</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Fixed Income Asset Class</th>
<th>Frequency of Issuance</th>
<th>Crossover with Equity</th>
<th>General</th>
<th>Equity Engagements</th>
<th>Collaborative Engagements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securitised issuances</td>
<td>High for smaller issuers without credit ratings, asset intensive businesses and challenged capital access</td>
<td>Alignment with equity engagements does not apply and engagement traction depending on asset class type, extent of physical and transition risk, and need for assistance on climate transition disclosure and planning. Bond investors can use engagement to better understand deal structures, assess issuer quality and cash flow stability, and improve issuer ESG credentials and climate resilience.</td>
<td>Generally non-recourse issuances from an SPV mainly relying on the underlying asset/mortgage cash flows for repayment. Hence the concept of an 'Issuer' for engagement is vastly different from an IG or HY bond. Bond investors can use engagement to better understand deal structures, assess issuer quality and cash flow stability, and improve issuer ESG credentials and climate resilience.</td>
<td>For sponsors with public equity who use structured products to diversify funding, bondholders may want to use this route to engage. Smaller issuers may be more amenable to engagement while issuers with large commercial and residential mortgage portfolios may be more amenable to systematic reporting.</td>
<td>Engagement with third parties and climate data providers who may be able to assist with physical risk disclosures for the issuer portfolios.</td>
</tr>
</tbody>
</table>
Stewardship across the Ecosystem

Along with engagement with issuers, practicing ‘systems’ or ‘macro’ stewardship can be critical to overcoming some of the challenges to bondholder stewardship outlined in this Guidance.

Engaging across the capital markets ecosystem can be a valuable and effective form of stewardship, creating the right environment for the responsible allocation, management and oversight of an investor’s bond portfolio.

The below explores how and why bondholders may engage with banks, credit rating agencies and other market actors to further their climate stewardship activities.

**Banks**

Approximately 64% of new capital for the oil and gas sector comes from bank loans, followed by 26% from bonds, with equities representing just 10%.

Banks play a pivotal role when corporates seek to issue bonds, advising on the structure and design of the debt and underwriting issuances. In this capacity, banks can function as a natural liaison between issuers and investors, providing further opportunities for investors to communicate their expectations. Depending on the exact path to public markets issuance, the participants in the ecosystem will vary, ranging from the lending banks, structuring and arranging banks, and debt capital markets syndication.

Banks can also educate issuers on the public climate commitments and performance from peers within and outside their sector and relay the incremental value of providing climate disclosures in how the market views their issuances. Banks and DCM teams can use their relationships with issuers to encourage improved corporate-level climate performance and strategies (e.g. to set 1.5°C aligned carbon reduction targets), assist in designing issuances that meet net zero standards, or communicate base-level requirements before a company issues a green bond (e.g. setting a net zero target, comprehensive reporting of scope 3 emissions etc.). Investors can play an important role in setting climate expectations for banks on the issuances they assist come to market. This can be done specific to an upcoming issuance level but is also effective when done on a general level.

Many banks have their own net zero commitments. Some are now beginning to commit to aligning their financing with the goals of the Paris Agreement, including their capital markets activity. Where investors can further encourage banks to include capital markets activity in their net zero commitments and targets, this could have a real impact on the issuances that come to market.

In addition, bondholders can engage with banks to:

- To make introductions between issuers and investors and facilitate engagement on their impact bond frameworks and net zero strategies more broadly;
- Encourage issuers to conduct regular roadshows, not just prior to issuance, to increase engagement opportunities;
- Encourage specific improvements/best practice points with issuers, including the adoption of best practice standards for labelled bonds and GSS+ issuances, including ICMA principles and Climate Bonds Initiative standards; and
- Gain an understanding of trends in the impact bond market to inform issuer-level engagement through update meetings, requested by the investors or organised by the banks.

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17 ESG Investor: A New System for Stewardship
18 Aviva Investors: Macro Stewardship An Introduction
19 Does the Fossil Fuel Divestment Movement Impact New Oil & Gas Fundraising?
Case Study: Federated Hermes: Engagement with Banks as an Escalation Technique

Dialogue with the company is a prerequisite for a productive engagement. Occasionally, efforts to initiate an engagement can be met with a resounding silence from the company’s side. When faced with this situation, Federated Hermes has successfully used a bank as a conduit for establishing a conversation. Banks are in a unique position between issuer and investor and are attuned to the expectations of bondholders, as potential buyers of future bond issues.

In 2022, Federated Hermes was trying to initiate a new engagement with an emerging market telecommunications company. It had made several unsuccessful attempts to contact the company and had reached a point where some form of escalation was required. Fortunately, Federated Hermes had participated in a new bond issue the previous year. As a result, analysts at Federated Hermes had contacts at the investment bank that had been the global coordinator for the new issue. Federated Hermes asked the bank to make a formal introduction to the unresponsive issuer and explain the context behind the engagement request.

The company responded quickly and a first engagement meeting was arranged for later that year. As a small, emerging market issuer, it was rare for the company to have calls specifically discussing ESG risks. However, the engagement proved productive, with the company bringing the CEO and CFO who presented their vision for the company and the beginnings of an ESG strategy. Through the engagement it emerged that the company was planning to publish a sustainability report and set targets for key areas. Federated Hermes was also able to learn more about the company’s plans for using solar panels and lithium-ion batteries to reduce its carbon emissions and also make its operations more resilient compared to the intermittent power supplied by the grid. Federated Hermes will continue to engage the telco now the bank has helped to establish the conversation.

IIGCC Net Zero Banks Standard

IIGCC’s Net Zero Banks Standard encourages banks to set targets covering both their financed (e.g. lending) and their facilitated (capital market) activities. Setting targets for capital market activities is important as they can represent a large portion of banks scope 3 emissions, and therefore climate-related risk exposure.

ESG Data/Second Party Opinion Providers (SPOs) and Credit Agencies

For bondholders seeking to better align their credit and climate risk, ratings agencies are a critical participant in the ecosystem. Data and Second Party Opinion Providers also play an important role in verifying the net zero alignment of an issuer and their respective issuances. By engaging with these market actors, bondholders can promote a well-functioning debt ecosystem, where issuances are supported by more robust climate data and a more holistic approach to climate and credit risk.

NZIF encourages investors to engage with market actors including credit rating agencies and data and service providers to ensure that their assessments, data and products are based on alignment criteria, robust methodologies, and consistent with net zero emissions by 2050.
Credit rating agencies provide a good example of collaborative engagement with non-issuers in the bond market. In particular, the PRI’s ESG in Credit Risk and Ratings initiative facilitates a dialogue between credit rating agencies and investors to “cultivate a common language [and] discuss ESG risks to creditworthiness”. The initiative is supported by more than 180 investors with over $40 trillion of AUM and 28 credit rating agencies and recognises that “ESG factors can affect borrowers’ cash flows and the likelihood that they will default on their debt obligations”. Credit rating agency signatories of the PRI initiative have committed to evaluate the extent to which factors such as climate are credit relevant for different issuers.

IIGCC also supports the Investment Association’s recommendation for debt issuances, that data and rating agencies should be clear about how any rating provided for a specific issuer is rolled up to the relevant parent or subsidiary, so that investors are able to match data/rating points with particular investment holdings and better align their portfolios.

**Index Providers**

The past decade has seen a significant rise in passive investment strategies and therefore an increase in financial flows into index funds, which have become significant ‘auto-allocators’ of capital. Bond indices therefore play a critical role in assigning new capital, and, given that the IEA and UN state there is no room for new fossil fuels in a 1.5°C aligned world, investors in benchmark products have a major role to play in ensuring global investments are aligned to net zero.

Bondholders with passive investment strategies may want to consider how their index providers are considering the real economy/emissions implications of their benchmark methodologies and consequent primary market allocations.

As outlined in the IIGCC Net Zero Benchmarks Guidance, through embedding climate performance-related signals into the construction methodology, (i.e. Net Zero Investment Framework’s alignment criteria) and communicating these to potential constituents, bondholders can engage with index providers to help reduce real world emissions and further align portfolio’s with the NZIF alignment maturity scale. For more on engaging with index providers on benchmarks, including considerations for fixed income investors, please see the IIGCC Net Zero Benchmarks Guidance.

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20 Debt Issuance in the Era of Passive Investment
21 IEA ‘Net Zero by 2050 – A Roadmap for the Global Energy Sector’
Case Study: Jesus College in the University of Cambridge: Engagement with Index Providers

In recognition of the challenge presented to asset owners by the rise in passive investment strategies, namely the lack of indices on the market that focus on corporate activities instead of disclosure, a team of researchers at the University of Cambridge is developing a 1.5°C aligned corporate bond index. Led by Lily Tomson and Dr Ellen Quigley, they are soliciting proposals from major global index providers and undertaking co-development with global asset owners.

This reflects the latest meta-study which concludes that “disclosure is not indicative of performance”, supporting the assertion that poor environmental performers have higher motivations to increase their level of disclosure than strong performers. It also seeks to address the lack of off-the-shelf offerings to address a 1.5°C alignment goal, particularly in relation to fossil fuel expansion financing and facilitation.

The project aims to be the first corporate bond index to exclude fossil fuels, power utilities, banking and insurance sector issuers whose actions would result in a world of dangerous heating above 1.5°C (currently most, if not all, of them) – while maintaining a pathway for re-entry where issuers achieve alignment with the framework.

The index will be overseen by a global group of leading academics with expertise in corporate decarbonisation pathways who will scrutinise ‘edge case’ issuers: those companies liable to be admitted or removed due to alignment or misalignment with our framework. The project aims to be a systems-level demonstrator of an alternative way of diverting capital flows and modelling effective engagement in debt markets.

Regulators and Industry Bodies

Bondholders are also encouraged to engage with regulators in their respective jurisdictions to ensure that the policy environment supports and facilitates bondholder climate stewardship.

The regulatory environment can have a dramatic impact on the effectiveness of bondholder climate stewardship. For instance, a range of regulatory initiatives are being proposed or implemented that are designed to prevent greenwashing in the bond market, and to make it easier for investors to identify and fund green bond projects. For example, the EU recently reached a political agreement on a Green Bond Standard, which sets out uniform requirements for bonds that align with the EU Taxonomy. Responding to consultations and retaining ongoing dialogues with regulators can significantly impact the bonds that come to market – and bondholders’ capacity to effectively perform stewardship.

Investors can also engage with various industry bodies such as IIGCC, PRI, ELFA, ICMA and the Climate Bonds Initiative to help encourage further development of best practices.

Conclusion

This Guidance aims to support investors in the context of their own individual and differing mandates, contexts, strategies and aims, to try to use their influence as bondholders and as appropriate to meet their clients’ and their own climate objectives. With thanks to the Bondholder Stewardship Working Group, this Guidance has included a number of case studies and is intended to be practical in nature. We look forward to working with and supporting bondholders who choose to implement the Toolkit steps and create further opportunities for bondholder engagement to deliver the rapid acceleration in real-world decarbonisation required and meet individual investors’ commitments to their clients.