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Responsible Investment in Rates

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1. Introduction

As a long-term investor, PGGM Vermogensbeheer B.V. (PGGM Investments, hereinafter PGGM) is committed to investing responsibly. PGGM manages its clients' interest rate products – sovereign bonds; supranational, sub-sovereign and agency (SSA) bonds, interest rate derivatives and mortgages – in order to contribute towards a stable pension for their participants while also taking into consideration the impact these investments are having on the world around us. PGGM recognises that environmental, social, and governance (ESG) factors can have a material impact on the financial performance of the portfolio, especially in the longer term. PGGM's interest rate products are mostly very long-term instruments. As such, integrating ESG issues into investment analysis and decision-making processes is part of PGGM's fiduciary duty.

This guideline addresses how PGGM's Rates team invests responsibly. The guideline is a further refinement of PGGM's Responsible Investment Framework and its implementation guidelines and the relevant fund prospectus and ancillary documentation. It is consistent with clients' Responsible Investment policy. In addition, the obligations arising from compliance with legislation and regulations apply. The guideline covers all investments made by the Rates team, effective as of 1 January 2021.

2. Investment approach & strategy

The primary objective for the interest rate investments is to provide a low-risk hedge for the interest rate sensitivity present in pension funds' liability structures. Financial return is not the main objective of the investments by the Rates team. However, through a careful instrument selection process it is possible to add value while maintaining an effective interest rate hedge.

There is limited scope for ESG integration when investing in low-risk interest rate products with a primary risk management focus. Examples of these products include AAA and AA government bonds and interest rate derivatives. Still, PGGM Rates' objective is to be a best-practice investor with regards to ESG within the strict boundaries defined for client mandates.

The team's objective is to continuously improve on transparency, knowledge and interaction with market participants regarding ESG issues while positively increasing the societal impact of investment portfolios.

By having in place a transparent responsible investment guideline for interest rate products, as further outlined in this document, and by actively taking into account ESG-related performance in investment decisions, PGGM Rates believes that it offers a positive contribution that is best practice and in line with client objectives.

PGGM Rates team aims is to be fully compliant with obligations arising from legislation and regulations. Some of the applicable (ESG) legislation and regulations, or relevant standards, codes of conduct or (inter)national initiatives which have an impact on interest rate products are discussed below. Minimum ESG standards and practices are enhancing rapidly and, hence, PGGM monitors these developments closely. For more detailed information please see PGGM Investments website.

Besides implementing client policy and complying with rules and regulations, PGGM Rates believes it can and must make a positive contribution through its investment decisions. Interest rate products represent a significant allocation in PGGM's clients' balance sheets.

Moreover, PGGM Rates sees it as its responsibility to capture the value in and mitigate the risk related to ESG factors. ESG studies bring additional insight, complementing fundamental macroeconomic analysis, into the growth and risk prospects of a debt issuer. Typically, there is only a thin line between ESG and fundamental analysis. However, the addition of often-overlooked non-financial indicators can prove to be a valuable input into debt investment decision making. ESG analysis is therefore integrated into the research framework for the interest rate products PGGM invests in. The objective is to seek opportunities, but more importantly, to avoid medium-term risks. In summary, PGGM Rates believes that integrating ESG factors into the investment process leads to better-informed investment decisions.

3. Implementation

3.a. ESG-integration

PGGM defines ESG integration as systematically taking into account those ESG factors that have a material effect on investment risk and return. Across its entire portfolio PGGM uses the Materiality Map of the Sustainable Accounting Standards Board (SASB) as the framework to identify material ESG issues per sector. Similarly, PGGM Rates takes SASB Materiality Map into account when analysing ESG risks and opportunities in the investment process. ESG risks are defined as risks for the financial returns from material ESG factors.

The investable universe for PGGM's Rates team is defined by clients. As a general rule, pension fund clients do not include risky government debt issuers in the part of the balance sheet dedicated to hedge the interest rate risk of their liabilities. These investments also serve to preserve capital in times of financial distress, when riskier investment categories tend to underperform.

As a consequence, the investable universe consists of bonds with an AAA or AA credit rating. Credit ratings and ESG ratings of these issuers tend to be strongly correlated, resulting in a universe with relatively high ESG ratings.

The allocation to different debt issuers, governments and SSAs, in the investment mandates of the Rates team is determined through a top-down as well as bottom-up analysis. The team analyses financial markets and the macroeconomic environment to develop an understanding where credit spreads or the yield curve may be heading. Biannually, PGGM Rates thoroughly analyses the fundamental credit drivers of every debt issuer it invests in. This analysis focuses not only on economic developments and structural reforms, but also on ESG factors similar to the SASB Materiality Map.

Sovereign issuers in developed markets tend to exhibit comparatively high ESG scores as well as GDP per capita. The level of indebtedness of developed sovereigns also tends to be higher than that of emerging markets. A heavy debt burden can act as a drag on growth. ESG factors have the power to unlock structural reforms which in turn may act as a catalyst for growth.

In line with PGGM's beliefs, Capelle-Blancard et al. (2017) show that countries with good ESG performance tend to have less default risk and thus lower bond spreads.[1] Moreover, the economic impact is stronger in the long run, suggesting that ESG performance is a long-lasting phenomenon. Social, but primarily governance factors have a financial impact on government bonds according to their research, and this effect happens to be the largest in the euro area.

The team makes use of research by MSCI ESG and Sustainalytics when analysing ESG factors influencing debt issuers. Moreover, traditional credit rating agencies (Moody's, S&P) are increasingly focusing on ESG factors in their credit analysis. Research by the European Commission, the International Monetary Fund, the Sustainable Development Report and the World Economic Forum are also of particular help in the bottom-up analysis conducted by the team.

The portfolio is mostly invested in euro-denominated government bonds with AAA or AA ratings, which are exposed to interest rate risk but very little default risk. ESG issues could in theory affect interest rates and, hence, market prices of these bonds. However, the portfolio is invested in high investment-grade countries and SSAs only, the ESG ratings are very high as well, indicating very low ESG risk. This can be visualized in Figure 1, which shows the correlation between sovereign credit ratings and ESG ratings.

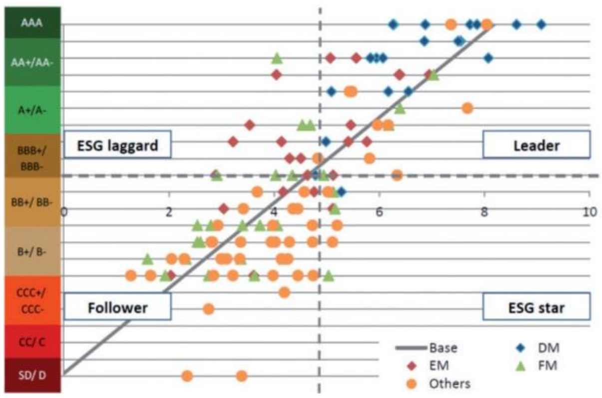

Figure 1: country credit ratings vs MSCI ESG scores (source: allianz global investors)

Despite this, the most prominent ESG risks for PGGM Rates are: flooding; unrest / riots due to e.g. inequality or red tape. These could lead to lower growth and/or higher government deficits potentially affecting government bond yields. Other effects observed in empirical studies are related to S, e.g., changes in the quality/availability of education, health care, security, etc., affecting economic growth in the medium to long run. But these effects are more pronounced in emerging markets, where conditions can suddenly change, for instance with a change in government. In addition, the portfolio has a small allocation to supranational, sub-sovereign and agency (SSA) issuers with rather similar risk characteristics - except that an SSA would not need to suffer in case of flooding, as long as its assets are in a dry part of the country.

Transitional and physical risks deriving from climate change are considered a sub-set of ESG risks and are therefore covered by the ESG integration process of PGGM Rates.

1 Gunther Capelle-Blancard et al. (2017), Environmental, Social and Governance (ESG) performance and sovereign bond spreads: an empirical analysis of OECD countries, Université de Paris Ouest Nanterre La Défense Working Paper.

3.b. Impact

In addition to a better-performing portfolio, PGGM Rates seeks to enhance the positive impact of its investments and to minimize adverse impacts even when they do not directly affect the financial performance.

1. Positive impact: investing in the SDGs

In 2016 PGGM and APG defined Sustainable Development Investments (SDIs) as "investments that yield market-rate financial returns while generating a positive social and/or environmental impact" (i.e. contribute to the Sustainable Development Goals). In 2020 Australian Super, British Colombia Investment Management Corporation joined APG and PGGM in the SDI-Asset Owner Platform which owns a taxonomy of products and services (solutions) that contribute to the SDGs. With a set of decision rules the taxonomy forms the basis for the classification of investments as 'SDI'. PGGM largest client's ambition is to increase the SDI volume to 20% of the total portfolio by 2025.

In low-risk interest rate markets, there are two types of instruments through which PGGM contributes to the SDGs. PGGM Rates invests in green and social bonds issued by governments, local governments, supranational or agencies. In addition, the Rates team invests in climate mortgages designed for energy-efficient houses and upgrades. Green bonds and mortgages for energy-efficient houses contribute to the PFZW (PGGM's largest client) focus theme climate change.

The Rates team has developed an internal framework for green and social bonds. This framework answers the main question 'How does PGGM define a green or social bond?' The framework has been developed in cooperation with PGGM's Responsible Investment department, so that an investment in a green or social bond, if it adheres to the criteria below, can be earmarked as an SDI. Characteristics of proper green and social bonds, in PGGM's opinion, are threefold:

- The issuer must adhere to the International Capital Market Association's (ICMA) green or social bond principles.
- The proceeds of the bond must align with the ESG policy of the issuer. This condition was added by PGGM to avoid misuse of the green and social bond market, or so-called green washing.
- The proceeds of a green or social bond must have a clear, measurable and significant impact on the SDGs. For a green or social bond to qualify as an SDI, at least 75% of proceeds must be allocated to the SDGs.

According to the SDI methodology, interest rate investments can contribute to six focus SDGs: 2 (zero hunger), 3 (good health and well-being), 6 (clean water and sanitation), 7 (affordable and clean energy), 11 (sustainable cities and communities) and 13 (climate action). To estimate and monitor the impact on these focus SDGs, the indicators suggested by the Working Group on SDG impact measurement of the DNB-facilitated Sustainable Finance Platform are used.

2. Adverse impact: minimise negative impact

The social and environmental impact of the capital entrusted to PGGM by its clients is significant. PGGM can stimulate a positive contribution to a sustainable world and has the responsibility to minimise adverse impact. Adverse impacts refers to negative impacts (harm) to individuals, workers, communities and the environment.

As from 1 January 2022 at the latest, PGGM shall avoid new investments in companies that are in very severe violation of the OECD Guidelines for Multinational Enterprises (hereinafter OECD guidelines) and/or the UN Global Compact principles. When feasible, PGGM shall undertake best efforts to divest existing exposures to these companies all together and/or shall engage with the companies, or a selection thereof, that are in (very) severe violation of the OECD guidelines and/or the UN Global Compact principles.

Based on its high likelihood and severity, climate change as a driver of adverse impact its prioritized. Clients of PGGM's have committed themselves to the Dutch Climate agreement[2] and to the Paris Climate Agreement to align policies consistent with the objective to limit the global temperature rise to a maximum of 1.5 °C. The ambition is to have a climate neutral investment portfolio by 2050 - in line with the ambition of the European Union and the Paris objectives.

The direct carbon footprint of eligible sovereign bonds and SSAs is very limited. It encompasses the emissions of sovereign assets (such as public buildings) and activities (such as police, army). It does not, however, include the emissions of private entities domiciled in the country. The priority for reducing the carbon footprint of PGGM's clients' portfolios is therefore with asset classes with higher emissions per euro invested. Although PGGM does not yet measure the carbon footprint of interest rate investments, it is committed to gathering data allowing for the measurement of portfolio emissions.

2 In Dutch "Klimaatakkoord"

3.c. Stewardship (engagement, voting, litigation)

Sovereigns are the key stakeholders to channel economies towards sustainable development pathways. They negotiate international treaties (peace, labour, trade, environment) and set national laws and fiscal frameworks. As an institutional investor with large interest rate mandates, PGGM is in frequent contact with debt issuing departments (DMOs) of both governments and SSAs. In these conversations, PGGM stresses the importance of social returns in addition to the financial aspects of investments. By emphasising that ESG is taken into account when evaluating issuers, PGGM incentivises the issuer to improve on these metrics. Finally, PGGM Rates is pushing green bonds issuance. Green bond road shows and investments provide an opportunity to engage on environmental concerns and align issuer activities with the values of PGGM and its clients.

In addition, the Rates team is in constant dialogue with counterparties on their ESG policies. Counterparties are ranked annually on an ESG scale. Of all transaction costs that PGGM bears, the biggest chunk comes from trading in interest rate products. Bond and swap transactions form a significant part of these costs. These transactions are predominantly not done on an exchange but in a bilateral relationship. Integrating ESG in PGGM's counterparty policy is thus a logical consequence.

For the interest rate portfolios, the responsibility for counterparty policy is delegated to PGGM's Trading department.

3.d. Exclusion

The [PGGM Implementation Guidelines on Exclusion] are applicable to the investments in all asset classes, including interest rate products. PGGM's Exclusion List consists of a list of specific product-related listed companies as well as government bonds from sanctioned countries which PGGM refrains from investing in. The PGGM-wide product-based Exclusion List consists of companies engaged in controversial weapons, tobacco, tar sands as well as thermal coal utilities and mining companies.

By excluding companies on the basis of the above elements, PGGM seeks to prevent PGGM-managed investments contributing financially to practices incompatible with the standards and values of PGGM, its clients and their beneficiaries.

Sovereign bonds and SSAs from countries submitted to sanctions of the UN Safety Council or the European Union are excluded from the investable universe for PGGM's Rates team. In practice, these countries tend not to be part of the Rates team's investable universe anyway. Thus, although the team adheres to PGGM's exclusion policy, the policy does not have any material effect for the Rates portfolios.

4. Transparency

Each quarter PGGM Rates provides an update of its responsible investment activities in quarterly reports to its clients. This includes information regarding impact investing and integration of ESG factors in investment decisions. Also, any relevant negative impacts and monitoring of these impacts are reported. In addition, the Rates team contributes to PGGM Investments annual Integrated report and reports on responsible investment activities in the Principles of Responsible Investment (PRI) annual survey.

5. Annex

Please note that there is an Annex applicable for this ESG-guideline. This Annex forms an integral part of this ESG-guideline and may be updated from time to time. The applicable Annex is available on our website.

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