PGGM Responsible Investment in Rates

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Adopted by PGGM Vermogensbeheer BV
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1. Introduction

On behalf of its clients, PGGM Investments manages interest rate products, e.g. sovereign bonds, green bonds, interest rate derivatives and mortgages. These fixed income investments typically form a significantly share of our clients’ total investment portfolio. Within the Fixed Income department, the Rates team is responsible for those. PGGM recognizes the impact these investments may have on the environment and society and vice versa. This document addresses PGGM’s management of environmental, social and governance (ESG) issues with regard to interest rate instruments.

The guideline is part of PGGM Investments’ Responsible Investment Framework and its implementation guidelines. These are a more detailed elaboration of the PGGM Beliefs and Foundations for Responsible Investment, which we share with our clients. Furthermore, the PGGM Implementation Guidelines on Exclusion are applicable to the investments in government bonds.

The rationale for formulating a set of specific responsible investment guidelines for interest rate instruments is that ESG analysis has increasingly been applied to equity investments, while this kind of analysis has been put to the test much less in the $58 trillion sovereign debt market. The euro crisis, especially fraud in Greece on deficit numbers, created an impetus to increase focus on ESG analysis as a risk analysis tool for sovereign bond investments in developed markets. Finally, the green bond market for (sub) sovereign and supranational issuers has significantly taken off the last couple of years. In 2012 only $3 billion of green bonds were issued worldwide. This has grown to $81 billion in 2016 and is expected to grow further through the advent of sovereigns issuing green bonds and China becoming the largest country issuing green bonds.

As a founding signatory of the UNbacked Principles of Responsible Investment (UNPRI), PGGM has committed to integrating ESG issues into investment analysis and decision-making processes and to promote acceptance and implementation of the Principles within the investment industry.

This document sets out the approach used to identify and manage ESG risks within the investment process, with the goal to embed ESG-related analysis more clearly in the decision-making process and enable oversight of ESG risk exposures. The scope of these guidelines covers investments in interest rate instruments managed internally by PGGM Investments’ Rates team which is part of the Fixed Income Department. It will be effective as of September 2017.

With the introduction of these guidelines PGGM Investments aims to effect an overall improvement in transparency and governance. PGGM follows relevant developments closely and will update the guidelines when necessary. This policy does not confer any rights to any third parties.

2. Vision

Definition

Instruments for responsible investment are split in three categories within PGGM (figure 1).

![PGGM's Instruments for Responsible Investment](image)

*Figure 1: Triptych with instruments for responsible investment*¹ (source: PGGM)

These three categories can be defined for the Rates team as follows:

1. PGGM defines an exclusion list for government bonds it does not want to invest in.
2. Integrate ESG factors in the analysis of the debt issuers PGGM Rates invests in.
3. Make a contribution to the four defined solutions areas through interest rate investments, for example green bonds.

ESG variables encompass those environmental, social and governance factors in a society which are not purely financial but still have an effect on growth and risk prospects. These variables can be regarded from a medium to longterm risk perspective, e.g. corruption which will limit the ability to repay government debt, as well as growth-enhancing opportunities. Countries that improve on ESG indicators tend to see similarly a

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1 Direct exclusions reflect client policies agreed on in participant meetings.
higher GDP per capita.

Beliefs
PGGM believes that sustainable development is necessary in order to generate good and stable investment returns for our clients in the long term. PGGM Rates’ fixed income instruments are mostly very long term investment instruments.

PGGM believes that by leveraging the driving force of investments for our clients it can and must make a positive contribution to sustainable development through its investment decisions. The allocation to interest rate products is a significant part of our clients’ balance sheets.

PGGM believes that ESG factors can have a material impact on the financial performance of its investments. PGGM sees it as its responsibility to capture the value and mitigate the risks related to ESG factors. An ESG study offers additional insights, besides fundamental macroeconomic analysis, into the growth and risk prospects of a debt issuer. Often there is only a thin line between ESG and fundamental analysis, however the addition of often overlooked nonfinancial indicators can prove to be a valuable input into decision-making on debt investments. Therefore ESG analysis is integrated into the research framework for the interest rate products we invest in. The objective is to seek opportunities but mostly to avoid medium term risks. To summarize, we believe that integrating ESG factors into our investment process leads to better informed investment decisions.

3. Objective

The primary goal for the interest rate investments of our clients is to provide a low-risk interest rate hedge for the interest rate sensitivity present in pension fund’s liability structures. Financial return is consequently not the chief aim of the investments by PGGM’s Rates team, however by a careful instrument selection process it is possible to add value for our clients 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 are AA(A) government bonds and interest rate derivatives. PGGM Rates’ objective however is to be a best-practice investor with regards to ESG within the strict boundaries defined for the client mandates.

Our objective is to continuously improve on transparency, knowledge and interaction with market participants regarding ESG issues while positively increasing the societal impact of our portfolios.

4. Implementation

The next paragraphs will detail how PGGM implements the instruments for responsible investing within the Rates team. The next paragraph will detail how we implement the instruments for responsible investing in the Rates team. What we do not want, what we want to improve and finally what we want to stimulate.

Exclusions
The investable universe for PGGM’s Rates team is defined by our clients. As a general rule, it is fair to state that nowadays pension fund clients are not willing to include more risky government debt issuers in that part of their balance sheet which is intended to provide an interest rate hedge. Investments in interest rate products have normally also the aim to preserve capital in times of financial distress, during which the more risky investment categories tend to underperform.

As a consequence of the above the investable universe consists of government bonds with a AAA or AA credit rating. There tends to be a strong correlation between credit ratings and ESG ratings of governments, resulting in an investable universe with relatively high ESG ratings.

PGGM’s exclusion list consists of those countries that are submitted to sanctions of the UN Safety Council and/or the European Union. These countries tend not to be part of our investable universe, thus although we adhere to PGGM’s exclusion policy it does not have any material effect for the Rates portfolios.

Integration
ESG analysis
The allocation to the different debt issuers, governments and SSA’s, in our investment mandates is determined both through a top-down and bottom-up analysis. We analyse financial markets and the macroeconomic environment to develop an understanding where credit spreads or the yield curve is heading. Next to this PGGM Rates thoroughly analyses biannually 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 environmental, social and governance factors.

Figure 2: S&P country credit ratings vs. MSCI ESG scores (source: Allianz Global Investors)

2 SSA: Supranational, Subsovereign and Agency
Sovereign issuers in developed markets tend to exhibit comparatively high ESG scores as well as GDP per capita (figure 2). The level of indebtedness of developed sovereigns also tends to be higher than for 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 can act as a catalyst for growth.

In line with PGGM’s beliefs, Capelle-Blancard et al. (2016) show that countries with good ESG performance tend to have less default risk and thus lower bond spreads. 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 Eurozone.

We rely, next to our own understanding, on research by MSCI ESG and Sustainalytics when analysing the ESG factors influencing debt issuers. Also the traditional credit rating agencies (Moody’s, S&P) are focusing increasingly on ESG factors in their credit analysis. Research by the European Commission, the IMF and the World Economic Forum are also of particular help in our bottom-up analysis.

Engagement
Sovereigns are the key stakeholders to channel economies towards sustainable development pathways. They negotiate international treaties (peace, labour, trade, environment). They set national laws and fiscal framework. As an important institutional investor with large interest rate mandates, we are in frequent contact with the debt issuing departments (DMOs) of both governments and SSAs. In these conversations we stress the importance for our clients of the social returns that are expected next to the financial aspects of our investments. By stressing that ESG is taken into account when evaluating issuers, we incentivize the issuer to improve on these metrics. As a PRI signatory, we have stated that we will engage with government officials. Finally, PGGM Rates is pushing issuers for emitting green bonds. Green bond road shows and investments provide an opportunity for us as an investor to engage on environmental concerns and align issuer activities with our values.

Counterparty policy
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.

Counterparties are yearly ranked on an ESG scale by the various relevant departments within PGGM (figure 3). The objective of this sustainability ‘ladder’ is to be in constant dialogue with our counterparties on their respective ESG policy. Through dialogue and engagement activities with our financial counterparts PGGM is working towards a more stable and sustainable financial system.

Investing in solutions
Within the low risk interest rate markets there are two types of instruments through which we contribute to social returns in our defined focus areas (Climate, Water, Health and Food). PGGM Rates invests in green bonds issued by governments, local governments, supranationals or agencies plus we invest in climate mortgages that are designed for energy efficient houses and upgrades.

Green bonds
The green bond market celebrated its 10th anniversary in 2017 and has taken off substantially since ICMA defined the green bond principles (GBP) in 2014. In the final quarter of 2016 the first sovereign green bond was issued by Poland, quickly followed by France. The SSA sector, mostly development banks, has been a key issuer of green bonds over the last decade.

PGGM Fixed Income has developed an internal framework regarding green bonds. This framework answers the main question ‘How does PGGM define a green bond?’. The framework has been developed in cooperation with PGGM’s Responsible Investment department, so that an investment in a green bond, if it adheres to the below criteria, automatically can be earmarked as an investment in solutions. Characteristics of proper green bonds, in our opinion, are threefold:

- A green bond has to adhere to ICMA’s green bond principles.
- The objective of the proceeds of a green bond should align with the ESG policy of the issuer of the bond. This addition has been made by PGGM to avoid misuse of the green bond market, or so-called ‘green-washing’.
- The proceeds of the green bond should have a clear, measurable and significant impact on the focus areas as defined by PGGM and its clients (Climate, Water, Health and Food).

When analysing green bonds and their respective issuers, the Rates team partly depends on the ESG research done by MSCI ESG and Sustainalytics but also on second party opinions regarding the green bond issue. These so-called secondparty opinions are common today and made by specialized parties like
Cicero, Oekom or Sustainalytics. Next to the social return, we believe an investment in green bonds would not have to detract from financial risk/return aspirations. This means that a green bond investment primarily has to adhere to the main purpose of a low-risk effective interest rate hedge instrument.

Sinzer is used to track the actual impact measurement of PGGM’s green bond investments. Sinzer is an online database application in which every investment team gathers the investments in solutions which have been approved as accountable towards the four focus areas. Impact measures, e.g. CO2 reduction, are determined yearly, currently generally based on reporting by the issuer or conversation with the issuer.

Mortgages
Governance
The Rates team is responsible for the mortgage mandates, although the origination and servicing of the mortgages is implemented by an external manager. ESG factors form an integral part in the scoring during the selection process (and monitoring framework) of an external manager. Particularly governance aspects are relevant when selecting and monitoring an external manager.

Social
PGGM, in 2015, has developed a PFZW-specific brand mortgages called Attens. These mortgages are designed with a social target. The mortgages are explicitly only available for participants in PFZW’s pension plan. The specific requirements to obtain an Attens mortgage are tailored to suit labour market conditions in the healthcare sector. Compared to traditional mortgage providers, Attens is for example more lenient regarding flexible working hours and temporary contracts. For people in the healthcare sector that face these specific challenges for obtaining a mortgage, Attens might be a solution.

Environment
Heating of houses contributes 10% to total CO2 emissions in the Netherlands. According to a report by the Environmental Planning Bureau (Planbureau voor de Leefomgeving, 2014) CO2 emissions can be reduced by 50-80% by 2050 through energy savings. Energy savings are the most effective way to reduce CO2 emissions, the planning bureau finds. The objective of the Dutch National Energy Accord (Nationale Energieakkoord) is to have a climate neutral housing stock by 2050.

Attens provides climate mortgages with the objective to contribute to the much needed energy savings in the housing sector. Attens contributes to the climate through the following two measures:
1. 0,4% discount on the mortgage rate for a €25.000 part of the mortgage when the house either has an energy label A or better, or has an Energy Performance Coefficient (EPC) value of 0.6 or lower. Similarly when energy saving measures are financed to achieve those targets this discount is obtained.
2. Possibility to upsize the total mortgage from 101% loan-to-value to a maximum of 106% loan-to-value when this additional borrowing is used for energy saving measures. This provides a relatively cheap line of credit for financing energy saving measures with a long maturity.

For consumers, these measures lead to a positive balance of financial benefits from energy savings versus costs.

5. Bibliography