Investor Stewardship of Sovereign Debt Portfolios

Jamie Linsley-Parrish[1,*], Dr Felicia Liu[2,**], Dr Ben Caldecott[1,***]
1. School of Geography and the Environment, University of Oxford, OX1 3QY
2. Department of Environment and Geography, University of York, YO10 5NG
*james.linsley-parrish@oriel.ox.ac.uk **felicia.liu@york.ac.uk ***ben@caldecott.net

UNIVERSITY OF OXFORD

Background

Institutional investors such as pension funds and endowments attempt to manage risk and provide real-world, positive societal outcomes through *stewardship,* defined as 'the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society' (FRC 2022).

The efficacy of stewardship in providing positive real-world outcomes is hotly debated, with key contentions such as being able to prove causality and additionality, adhering to fiduciary duty, and the level of impact achievable in secondary markets.

It is clear that engaging with individual companies is insufficient in contributing to the **systemic** change necessary for climate change mitigation and adaptation. In order to affect system-level change, investors need to target system-level actors; policy-makers.

We investigate how investors can use their sovereign debt investments to affect change at the system level, focussing specifically on environmental outcomes. We seek to answer three research questions:

Research Question 1*: How can investors provide positive, real-world impact through their stewardship of sovereign debt portfolios?*
Research Question 2*: How do the impact mechanisms established in the literature apply to the sovereign debt asset class?*
Research Question 3*: What are the nuances particular to this asset class that investors must take into account (but may not be) when pursuing engagement with governments to optimise outcomes and avoid serious negative externalities?*

Theoretical Framework

- Mechanisms for impact – adapted from Kolbel et al., (2020) framework and applied to country impact, rather than company impact

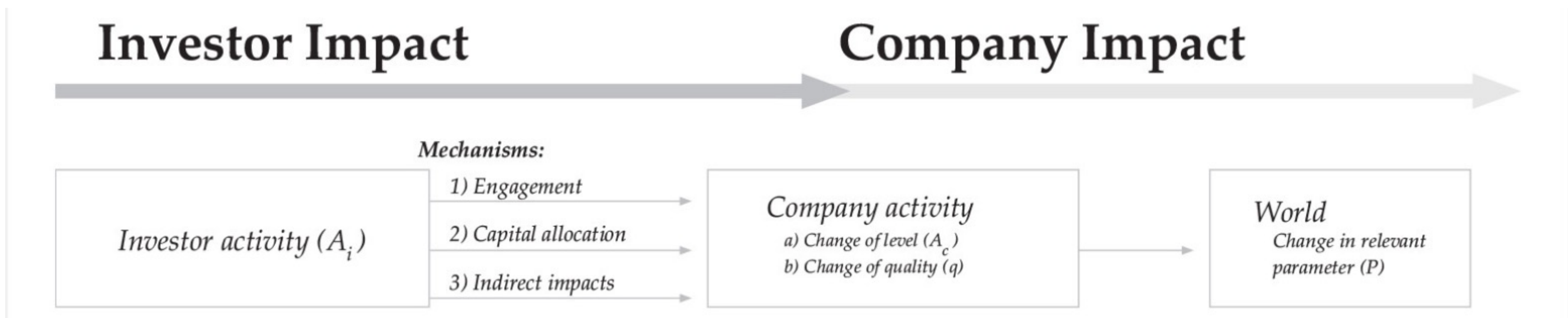

Figure 1, from Kolbel et al., 2020

- Relationship dynamics determined from agency capitalism theory, agency theory, stakeholder theory, and universal ownership theory.
- Salience theory (Mitchel et al., 1997) refers to the power and leverage available to investors seeking to make change; how does this apply when seeking to change country policy?

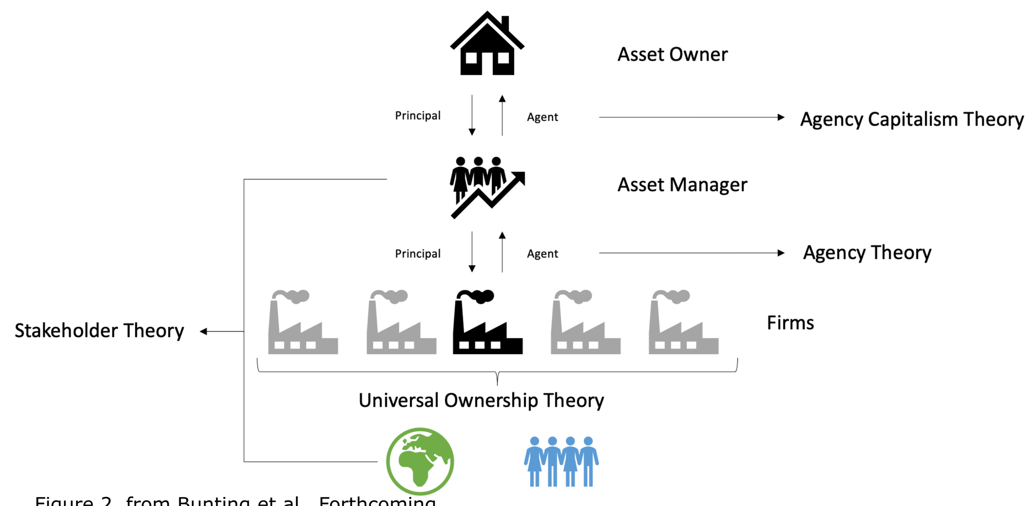

Figure 2, from Bunting et al., Forthcoming

Methodology

A preliminary document analysis of white papers, policy documents, and NGO reports was undertaken to provide insights into the landscape, ecosystem, and key themes of sovereign stewardship. Semi-structured interviews were subsequently undertaken with 20 experts from the industry, which were recorded, transcribed, and coded according to iteratively-developed themes.

Number Assigned	Month/Year of Interview	Sector	Location
1	07/23	Asset Manager	UK
2	07/23	Bank	UK
3	07/23	Asset Manager	US
4	07/23	Asset Manager	Netherlands
5	07/23	Asset Manager	UK
6	07/23	Asset Manager	France
7	08/23	Asset Manager	UK
8	09/23	NGO	Switzerland
9	09/23	Multilateral	Australia
10	10/23	Academia	Sweden

Number Assigned	Month/Year of Interview	Sector	Location
11	11/23	Regulator	UK
12	12/23	Sovereign Wealth Fund	*
13	12/23	Asset Manager	UK
14	12/23	Asset Manager	UK
15	03/24	Asset Owner	Australia
16	04/24	NGO	Switzerland
17	05/24	NGO	UK
18	05/24	Asset Owner	UK
19	06/24	Asset Owner	UK
20	06/24	Bank	UK

*Redacted to maintain confidentiality

Results and Discussion

Capital Allocation

Divestment is logistically difficult due to mandates, risk tolerances, and lack of substitute investments. Attempting to push up a country's cost of capital through divestment can be counterproductive, as it makes their transition more costly, and ethically questionable, as the population bear the cost.
Divestment may not have a significant effect on a country's cost of capital, yet even a small shift can be critical for governments.

Labelled Bonds

- **Sovereign Use-of-Proceeds bonds** are rarely additional and concerns remain over greenwashing. Despite this, investors see these products as being able to create impact through signalling.
- **Sovereign Sustainability-Linked bonds** (SLBs) are desired and in-demand. Investors are directly asking for further issuances, citing their ability to link bond terms to long-term policy and price in risk as key reasons for positivity.
- A number of key barriers to their scaling issuance were raised:

Key Barriers to Issuance	Reason
Lack of Data	Data, and data governance, lacking at a country level
Government Structure	Multiple (often many) ministries/departments must agree and align
'Gaming' Triggers	Countries not on course to meet climate goal could 'game' the data to ensure no financial penalty
Pricing Difficulties	SLBs, particularly those with step-down structures, are complicated to price
Regulatory Environment	Concerns that SLBs would not be classified as a 'sustainable' investment under SFDR

- None of these barriers are considered insurmountable by investors.

Engagement

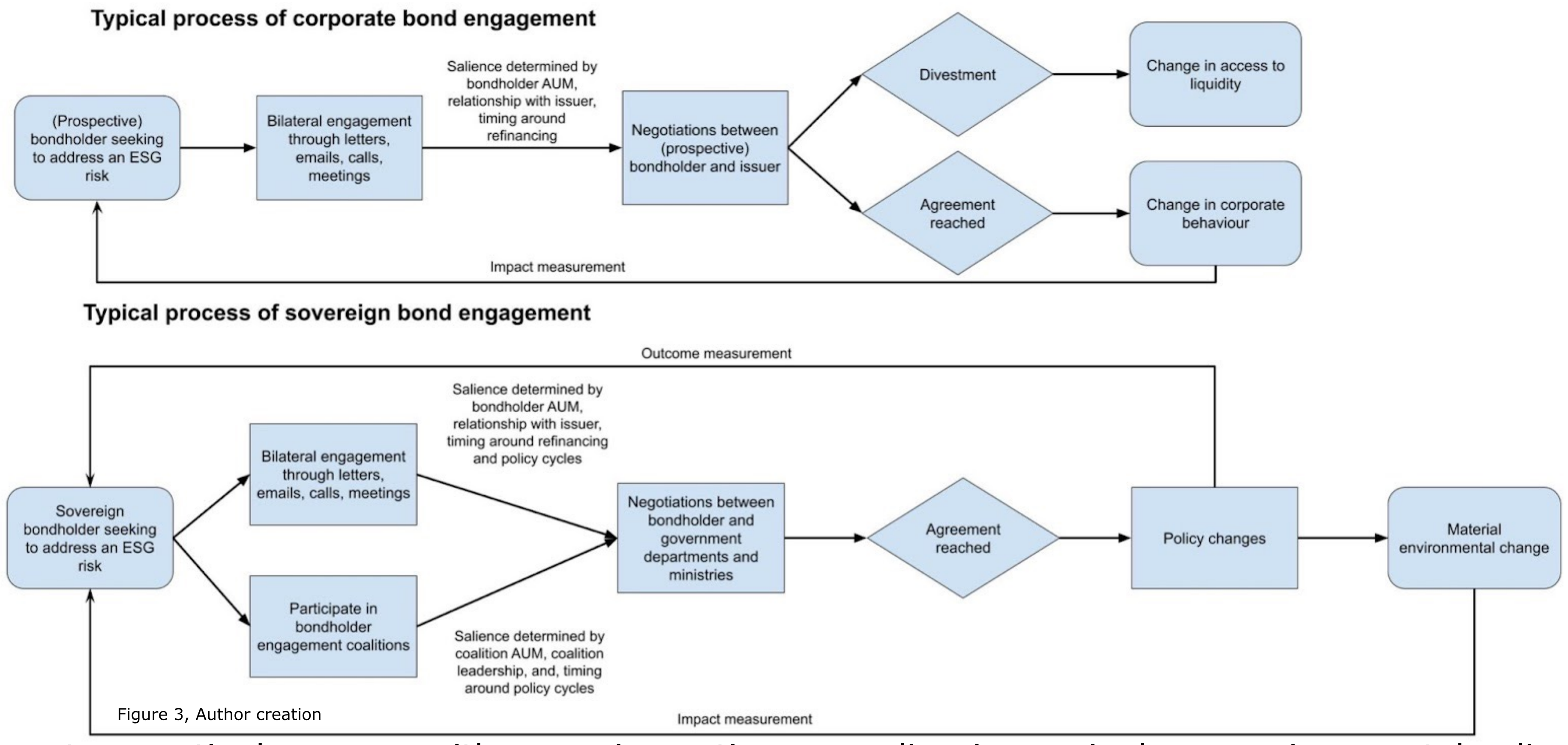

Figure 3, Author creation

- Investors routinely engage with sovereign nations on policy, increasingly on environmental policy
- Governments of all sizes and political structures are targeted for engagement.
- Secretariats play critical roles for collaborations, particularly where investors engage with foreign governments and the secretariat provides local knowledge.
- Access is correlated with AUM.
- Government structure and lack of expertise is a barrier to effective engagement.
- No effective escalation strategies.

Ethics

- **There is a severe risk of infringing on a nation's sovereignty when engaging.**
- The power dynamics of a Global North investor engaging a Global South country are particularly problematic.
- Some ethical concerns can be circumvented in the case of an investor engaging the government of the nation in which it is domiciled, assuming its clientele is also based in that country.
- Engagement with the country of domicile can be particularly powerful as beneficiaries gain dual benefits.

Conclusions and Further Work

RQ1: Investors do have the potential to contribute to positive, real-world impact through their stewardship of sovereign debt portfolios
RQ2: Each of the mechanisms analysed can be utilised to generate impact, to differing degrees.
RQ3: Difficulty proving additionality mutes the impact an investor can claim, and concerns over infringing on sovereignty necessitate careful consideration being given to the nuances of engaging in this asset class

Future research should focus on the additionality of sovereign labelled bonds and their structuring, case study analysis of the small number of major collaborative sovereign engagement campaigns (most notably the Investor Policy Dialogue on Deforestation and the UNPRI-led engagement in Australia), and the ethics of engagement with sovereigns.
The lead researcher's immediate future work will focus on a theory of change model for analysing efficacy of investor stewardship, followed by a quantitative analysis of the effects of impact mandates on portfolio construction and strategic asset allocation.

Acknowledgements & References

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