THE INVESTMENT ASSOCIATION

IMPROVING FIXED INCOME STEWARDSHIP

November 2022

ABOUT THE INVESTMENT ASSOCIATION (IA):

The IA champions UK investment management, supporting British savers, investors and businesses. Our 270 members manage £9.4 trillion of assets and the investment management industry supports 114,000 jobs across the UK.

Our mission is to make investment better. Better for clients, so they achieve their financial goals. Better for companies, so they get the capital they need to grow. And better for the economy, so everyone prospers.

Our purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital

The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks and shares ISAs. The UK is the second largest investment management centre in the world, after the US and manages over a third (37%) of all assets managed in Europe.

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1. EXECUTIVE SUMMARY

THE IA'S MEMBERS COLLECTIVELY MANAGE £9.4 TRILLION FOR SAVERS AND INSTITUTIONS, SUCH AS PENSION SCHEMES AND INSURANCE COMPANIES, IN THE UK AND AROUND THE WORLD. THEY PLAY A KEY ROLE AS STEWARDS OF THEIR CLIENT'S CAPITAL, ENSURING THAT IT IS INVESTED FOR THE LONG-TERM AND USING THEIR RIGHTS AND RESPONSIBILITIES AS OWNERS OF SECURITIES TO MANAGE RISKS. INVESTMENT MANAGERS UNDERTAKE A RANGE OF STEWARDSHIP ACTIVITIES TO PROMOTE AND ENHANCE LONG-TERM RETURNS FOR THEIR CLIENTS.

Over the last two decades, changes in regulations, tax incentives and the de-risking of pension assets in response to maturing populations have led to a significant shift in asset owners' asset allocation away from equities, and towards fixed income and other assets. We have also seen a shift in the way in which companies finance themselves, with a growing preference for debt over equity given the historic low interest rate environment, the Covid Pandemic and an increasing role for capital markets to supply this financing.

As stewards of their clients' capital, investment managers oversee and manage the assets they invest in to encourage, develop and support behaviour that will lead to sustainable long-term returns. While historically this role has been associated with listed equities, it is clear that to deliver-long-term value on behalf of clients and beneficiaries, effective stewardship needs to cover the full range of asset classes in which they invest.

The importance of fixed income stewardship was emphasised by HM Treasury's Asset Management Taskforce in its 2020 report, *Investing With Purpose: Placing Stewardship at the Heart of Sustainable Growth*. The report recommended that bondholders make full use of the rights available to them and encouraged investors and debt issuers to facilitate a culture of engagement and collaboration. The Taskforce recommended that the IA produce guidance on how stewardship in fixed income could be improved. To aid the IA in this endeavour, in 2021, the IA established a Fixed Income Stewardship Working Group which has supported the production of this guidance.

Whilst recognising that there is a pressing need to encourage better practice across all forms of fixed income, the guidance and recommendations within are solely focused on investors in, and issuers of, corporate debt. Some of the principles will also apply to sovereign debt, asset-backed securities, and other forms of fixed income securities. But the very different characteristics of those investments will require more specific attention, which the IA intends to focus on in the future.

This guidance aims to outline the importance of stewardship in corporate debt to investment managers, their clients, regulators, and companies.

In this guidance, we set out investors' expectations for issuers of corporate debt, covering both investment grade and high yield and how such issuers can meet fixed income investors' evolving stewardship expectations, including:

- **Articulating a coherent debt strategy** – Investors want companies to clearly articulate how their debt strategy supports the wider capital management strategy of the company including with respect to managing material ESG risks and opportunities.

- **Appropriately ring-fencing Environmental, Social, and Governance (ESG) labelled debt to its stated sustainability objectives** – In the absence of ring-fencing, investors expect transparency on the usage and timeline for the use of proceeds at issuance/refinancing.

- **Improving disclosures** – Including how bond covenants and documentation can reflect ESG metrics and the information required for investors to fulfil their stewardship obligations.
- **Creating long-term relationships** – Issuers should proactively seek to build and cultivate long-term relationships with investors beyond the life of a particular issuance.
- **Improving engagement** – Issuers should facilitate an improved culture of engagement, including promoting better bond investor access to the board and senior leadership team as well as ensuring investor relations teams are appropriately informed on ESG issues.

Taking these steps will be of benefit to issuers in the short term and will equally enable investment managers to conduct more effective stewardship which contributes to long-term value creation. As discussed in greater detail in section 3, investors expect improved disclosure, so providing this proactively will make it easier for issuers to access capital potentially at a lower cost, as well as providing access to a wider investor base. Fostering an improved relationship with investors and providing greater bondholder access may mean that existing investors are more likely to support future new issuances. Finally, improving the frequency and quality of bondholder-company engagement will provide for constructive dialogue through which issuers can better understand investor appetite for material risk and opportunity, and equally investors can gain insight into a company's risk management processes.

There is, therefore, a pressing need to encourage corporate debt issuers to commit to actions to better facilitate investor stewardship. By addressing the prevalent issues within fixed income stewardship, this guidance endeavours to facilitate better practices and outcomes for issuers, investors, and ultimately the end-savers. Through setting standards and providing explanations on the overarching

benefits of increased disclosures and openness to engagement, we hope the recommendations provided act as a pertinent starting point for issuers of corporate debt.

We also make several recommendations regarding the actions that IA members should take to make fixed income stewardship more effective:

- **Bondholders should be engaging for influence not just information** – there should be an increased focus on engagement with issuers for influence and impact, to ensure that engagements are contributing to long-term value for clients.
- **Bondholders should be engaging on long-term issues, not just those that impact the issuer during the term of the bond** – notwithstanding the need to address short-term issues such as sudden covenant changes, to consider how their engagement and stewardship approach is focused on the long-term behaviours of company management, and not only the behaviours over the term of the bond.
- **Stewardship should be more effectively integrated across debt and equity holdings, looking for opportunities to collaborate** – to encourage more integration of the engagement and ESG research approach between debt and equity holdings, in particular with respect to collaborative engagements.
- **Conflicts of interests should be effectively managed** – investment managers should have effective governance in place to manage any conflicts of interest with respect to fixed income stewardship.
- **Bondholders should collaborate more effectively at debt origination.**

Investors will continue to take these actions to improve practices in fixed income regardless of whether issuers make the improvements suggested in the previous section. However, without action from both investors and issuers, investor actions will not have the same impact on the long-term value of the underlying investments, and will not, therefore, produce the best outcomes for end clients.

The guidance also covers the role of a number of other stakeholders across the investment chain, such as Credit Rating Agencies (CRAs), banks, and ESG data providers, who all play a crucial role in supporting effective stewardship in fixed income.

This is only the first step in improving fixed income stewardship. The IA commits to work with its members to explore other areas of fixed income stewardship and produce further guidance for its members on the actions they can take and improvements to be made.

2. WHAT IS FIXED INCOME STEWARDSHIP?

Historically, stewardship has been associated with listed equities. The UK's first Stewardship Code was published in 2010 and concentrated on the "quality of engagement between institutional investors and companies to help improve long-term returns to shareholders".

However, in the 2020 Stewardship Code, stewardship is now defined by the Financial Reporting Council (FRC) 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".*

For fixed income investors, stewardship often focuses on capital preservation. Bondholders want to ensure that the company issuing the debt will generate the cashflow to meet their coupon payments and will be able to repay their invested capital when the bond matures. With the upside potential on debt investments already capped, downside risks are prioritised. These downside risks include a wide range of financially material risks, including ESG factors. Different managers may take a different view on which issues are most material for different companies or sectors. Companies that do not account for a wide range of material risks, including ESG issues, are exposed to externalities that undermine their financial performance. This can increase downside risks and ultimately jeopardise performance and returns for investment managers' clients.

The way in which investment managers approach stewardship can differ but it can include the following approaches:

- Investment choices
- Engagement
- Exercising Rights and Responsibilities

INVESTMENT CHOICES

Stewardship starts with making investment choices. Investment Managers research and assess which companies will help meet their client's investment objectives. They will consider a wide range of risks and opportunities in their analysis including ESG factors. This pre-investment research is particularly important in fixed income, where bondholders do not have the same rights to hold the company to account on an ongoing basis as equity owners (e.g. voting rights). Investors rely on the bond prospectus to provide sufficient information to make an informed investment decision. They will also want to ensure that the terms and conditions set out in the bond covenants provide sufficient protection to bondholders before making an investment decision. The extent to which these are in place may vary between investment grade and high yield issuers. They are looking for assurance that the company will be able to service the debt. Investors continue to research and monitor the company through their holding and may choose not to support a re-issuance cycle where they identify significant risks to the long-term value of the asset or where their expectations on ESG issues are not being met.

ENGAGEMENT

A key opportunity for engagement is at the debt origination stage. This is the stage at which investors will have the greatest ability to exercise effective engagement. Through requiring certain disclosures and commitments as a condition of providing capital, investors have the greatest leverage to influence corporate outcomes. It also allows prospective investors to apply further due diligence by meeting with company management. Investors also engage with issuers to better understand the company's performance and to push for action to mitigate potential risks to repayments. There are a number of purposes of engagement:

- Engaging for information or monitoring – where investment managers seek information or updates on the company performance or risks, as they review the risks of the bonds held in their portfolio.

- Engaging for influence and impact – changes in company behaviour are deemed necessary to protect the value of the asset, or ensure it is investible in the first place and meets the manager's mandate.

- Escalation – where progress isn't made on identified risks, investors can decide to sell the investment and find a suitable alternative. If the investor chooses to stay invested, they may escalate their concerns through public statements and collaborative engagement with other bond or equity holders.

Bondholders are often focused on business strategy, solvency, cash flow and leverage for their engagement in addition to how the company is managing ESG risks and opportunities. These engagements can sometimes be focused on issues which arise during the term of the bond, which can be short-term rather than long-term. There is no set list of issuers which bondholders will engage on; effective stewardship is about engaging on the right issues for the right company or asset at the right time.

EXERCISING RIGHTS AND RESPONSIBILITIES

Different investment securities have different rights and responsibilities associated with ownership. This leads to different stewardship opportunities for fixed income investors. They have several rights and responsibilities that they may use to hold bond issuers to account. This may include:

- Seeking amendments to terms and conditions in indentures or contracts;

- Seeking access to information provided in trust deeds;

- Impairment rights; and

- Reviewing prospectus and transaction documents[1].

Bondholders do occasionally have the right to vote on certain issues at bondholder meetings as will be set out in the terms of the bond in the documentation or trust deeds – typically on proposed changes to key terms of the bond or in the event of restructuring e.g. a debt for equity swap. Convertible bondholders may also have an underlying interest in the Annual General Meeting (AGM) and General Meeting (GM) votes normally available to equity shareholders.

IA MEMBERS COLLECTIVELY MANAGE

£9.4TRN

FOR SAVERS AND INSTITUTIONS

[1] FRC – Stewardship Code (2019)

3. THE IMPORTANCE OF FIXED INCOME STEWARDSHIP

There are several drivers which are increasing the importance of fixed income stewardship, including:

- **Financial materiality** – Investors are incorporating ESG considerations into their investment process across all asset classes, including fixed income, impacting the cost of capital for issuers.
- **Company capital structure** – Company balance sheets increasingly consist of large amounts of debt as one of their primary sources of financing, increasing the importance of fixed income stewardship to promote long-term value on behalf of clients.[2]
- **Expectations from clients** – Institutional investors have significantly increased their allocation to fixed income securities in recent years. They are also increasingly seeking positive non-financial outcomes from their investments and seeking exposure to debt instruments that support their sustainability goals.
- **Net Zero** – Debt markets will play a key role in financing the ambitious projects and interventions needed across the economy and by individual companies to meet Net Zero targets and the Paris Agreement.
- **Regulatory requirements** – Increased regulatory focus on sustainable finance and stewardship such as TCFD reporting and the Stewardship Code has resulted in increased requirements for stewardship on asset owners and managers across the full range of asset classes, including fixed income.

FINANCIAL MATERIALITY

Fixed income investors consider a wider range of material risks when assessing the creditworthiness of an issuer. Investment managers are integrating ESG factors into their credit assessments of companies, with a focus on enhancing risk adjusted returns and especially minimising downside risk. While equities and fixed income represent fundamentally different asset classes, the issues that investment managers engage with them on, particularly in respect of ESG issues, often align. Bondholder expectations on ESG risks do not necessarily differ materially from those of equity investors, however, there may be instances where these risks impact on equity and debt holders differently, including over a different time horizon, and therefore require different disclosures.

ESG risks and opportunities are becoming an ever more important factor in a company's credit rating; in 2020, nearly a third of S&P's total rating actions in the corporate sector were affected by ESG factors.[3]

In addition, multi-asset investors are increasingly combining fixed income stewardship with their existing equity stewardship activities, whether formally or informally. Some investors have combined their ESG research across both debt and equity and others are taking a multi-asset perspective when engaging with corporates.

> Investment managers are integrating ESG factors into their credit assessments of companies, with a focus on enhancing risk adjusted returns and especially minimising downside risk

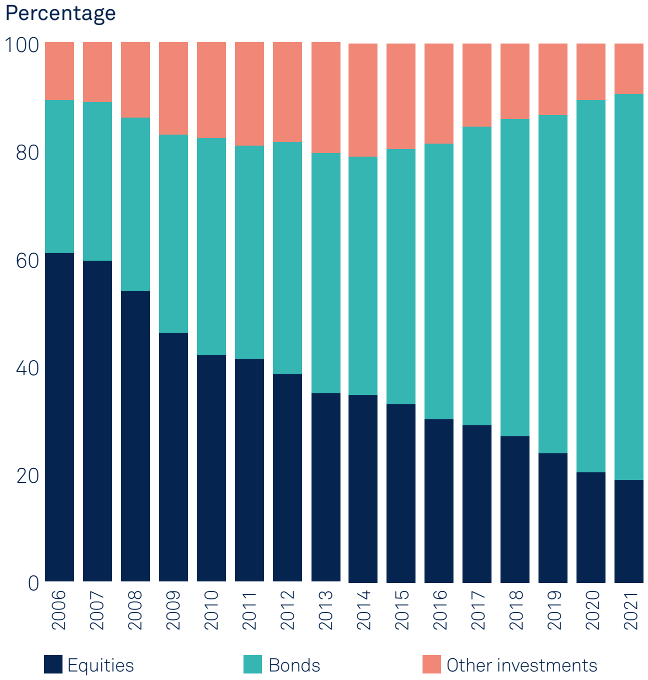
[2] "All of the net increase in UK corporate debt between the end of 2008 and the end of 2020 has come from market-based finance.": *Assessing the resilience of market-based finance | Bank of England*

[3] *ESG and Credit Rating Agencies: The Pressure Accelerates – ING*

Issuers that do not provide disclosures and explicitly address fixed income investors' concerns will, therefore, not be providing adequate information to investors and rating agencies to assess and understand elements of their risk profile. This will adversely impact on an issuer's ability to attract a broad investor base, and could increase the cost of capital for some issuers.

Conversely, providing greater transparency to investors on these risks and signalling to investors a willingness to engage in continuing to provide disclosures (or allowing those investors to assess the nature of the risks affecting creditworthiness) may lead to a broader base of investors subscribing to the issuance and lowering the cost of capital.

FIGURE 1: UK DB SCHEMES ELIGIBLE FOR PPF COMPENSATION: WEIGHTED AVERAGE ASSET ALLOCATION IN TOTAL ASSETS



Source: PPF

ASSET ALLOCATION

Over the last two decades, changes in regulations, tax incentives and the de-risking of pension assets in response to maturing populations have led to a significant shift in asset owners' asset allocation from equities to fixed income and other asset classes. Likewise, there has been a significant shift in the way in which companies finance themselves, with a growing preference for debt over equity. Both these factors have increased the importance of stewardship of fixed income assets.

Figure 1 shows how Defined Benefit pension funds, one of investment managers' largest client groups, have more than doubled their asset allocation towards bonds in the last 15 years, from 28% in 2006 to 72% in 2021[4].

EXPECTATIONS FROM CLIENTS

The investment industry's purpose is to generate sustainable value and to meet their client's investment objectives. These clients are individual retail savers and institutions like pension funds, insurers, charities, and governments. Investment objectives are usually financial, for instance having enough money to live on in retirement, but can also include non-financial elements, such as to invest in companies, governments or projects that deliver social or environmental benefits or that "do no significant harm".

Clients expect investment managers to effectively manage material ESG risks and opportunities and to exercise effective stewardship to generate sustainable value on their behalf. Many institutional clients, such as pension funds, are expected to demonstrate the effective integration of stewardship and ESG factors into the investment process.

Both retail and institutional clients are also increasingly seeking positive social and environmental impacts from their investments. Responsible investment funds saw a net retail inflow of £71 million in June 2022. Responsible investment funds under management stood at £84 billion at the end of June. Their overall share of industry funds under management was 6.1%.[5] Clients are looking for exposure to securities that will support these sustainability objectives across both equity and debt.

[4] https://www.ppf.co.uk/sites/default/files/2021-12/PPF_PurpleBook_2021.pdf
[5] https://www.theia.org/media/press-releases/funds-hit-ps45-billion-outflows-amidst-intensifying-economic-uncertainty

ESG labelled debt, for example, Use of Proceeds (UOP) bonds, and Sustainability Linked Bonds (SLBs) have proliferated in recent years[6] in response to this demand and form a small but growing proportion of overall fixed income issuances.

Investment managers have an important role to play in supporting these issuances from companies. They can engage with company management to express demand for ESG labelled debt in line with their client's objectives. They can also play a role in engaging with the company at debt origination to ensure that these securities are set up in a robust way to meet their client's sustainability and financial objectives. Once invested, they have a role to play to continue to engage with companies and hold them to account on the use of proceeds and to support the company to be well positioned to meet any sustainability Key Performance Indicators (KPIs). There is an important role for investor's engagement with issuers in the design of these securities to ensure they are robust in meeting their client's sustainability goals and that issuers can be held to account on delivery against these sustainability objectives.

NET ZERO COMMITMENTS

Climate change is one of the single biggest systemic risks facing society and the planet today. IA calculations show that investment managers with Assets Under Management of more than £7trn in the UK have now joined the Net Zero Asset Managers initiative. To bring about Net Zero greenhouse gas emissions by 2050 and to achieve the Paris Agreement goals, significant change will have to occur across the entire economy. Debt issuers will need to carefully consider the impact of climate change on their business and their ability to return capital to investors when it is due. Debt financing may be needed to transition their business model to a more sustainable footing. There is an important role for traditional corporate debt to play in supporting companies to transition their business model to be more sustainable, particularly with regards to supporting them to make changes to their operations to reduce their carbon emissions.

The structure of fixed income assets allows issuers and investors to target green projects, activities and outcomes in the asset's terms. There are now a range of products that take advantage of this aspect of the asset class. For instance, Use of Proceeds bonds are earmarked for projects that will have a positive impact on the environment (e.g. green gilts can be used to finance green government projects; sustainability-linked bonds tie their financial and, or structural characteristics to whether the issuer achieves predefined sustainability/ESG objectives).

REGULATORY REQUIREMENTS

Regulatory expectations for investors and asset owners continue to expand and further the requirements to integrate stewardship into the investment process and across different asset classes. Under the UK Stewardship Code 2020, signatories to the Code are now required to consider asset classes beyond listed equities in their stewardship activities.

The UK government published its Greening Finance Roadmap[7] in October 2021, which set out the government's long-term ambition to green the financial system and how it intends to do this, including through the new economy-wide Sustainability Disclosure Requirement (SDR). Investment products will need to set out consumer-focused disclosures showing the impact, risks and opportunities of the activities they finance on sustainability. In addition, for climate change specifically, investors will be required to set out client-facing Taskforce for Climate related Financial Disclosures (TCFD) -aligned disclosures from 2023 as outlined in the FCA's ***PS21/14***[8]. These new sustainability disclosures will require information on the ESG characteristics of different assets within investment portfolios, including of debt securities.

Under the Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations, pension trustees are formally required to set out their approach to stewardship as part of their Statement of Investment Principles (SIP), and how they have met these Principles in yearly implementation statements. Given the significant ownership of debt by pension fund and insurance clients, this has led to managers facing increased scrutiny on their approach to stewardship of fixed income assets. Similarly pension funds are required to produce reports in line with TCFD, covering all their assets under management.

[6] https://www.world-exchanges.org/storage/app/media/WFE%20Annual%20Sustainability%20Survey%202021%20Final%20v2.pdf
[7] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1031805/CCS0821102722-006_Green_Finance_Paper_2021_v6_Web_Accessible.pdf
[8] https://www.fca.org.uk/publication/policy/ps21-24.pdf

4. IMPROVING FIXED INCOME STEWARDSHIP

Bondholders are not 'owners' of the companies they hold debt in, and they have no right to vote on the re-election of directors or any other resolution at the company's AGM. It can be considered harder therefore for fixed income investors to undertake effective stewardship. Whilst bond holders are not the ultimate owners of the company, they provide substantial amounts of capital, and should be a critical voice in shaping stakeholder-engagements regardless of whether the company also issues public equity or not. There is significant opportunity for bondholders to engage with debt issuers and use the rights and responsibilities that are available to them to hold issuers to account:[9]

- Investors can hold companies to account on the terms and conditions as set out in the bond covenants (for green bonds this can include the use of proceeds for a UoP bond or the calibration of sustainability performance targets for SLBs). Investors can also use the leverage they have to set implicit expectations of management as conditions for providing capital at both debt origination and on an ongoing basis.

- Investors can engage with company management to understand the issuer's approach to managing risks to repayment over the life of the bond. Investors can do so both publicly, by asking ESG-related questions in the quarterly & annual results presentations, and through direct engagement on ESG topics with management. This need not be limited to the treasury department but can also include engagement with senior management, including the CEO, CFO, or non-executive members of the Board.

- When engaging with companies as part of a multi-asset investment firm, investors can leverage both their equity and bond holdings to influence company management through alignment of messaging. Any conflicts of interest between these securities need to be effectively managed.

- Bondholders can participate in collaborative engagements with the company. These can be in collaboration with other debt and equity holders focused on companywide issues which impact on the debt strategy of the company or targeted engagements regarding specific bond issuances. The Investment Association's Special Committee[10] process can be used to provide a structured format for collaborative engagement between bond issuers and investors.

- The increasing role of debt on company balance sheets, and preference from companies for securing funding through debt over equity issuances, gives fixed income investors increasing influence over companies with respect to debt origination and reissuance.

- Issuers will want to engage with their bondholders when they are approaching the limit of their debt facilities, or are at risk of breaching their covenants. Investors will need to carefully consider which outcomes represent the best long-term value for the end-client. The IA's Special Committee process can provide a useful resource for bond-holders wishing to engage with issuers who are at risk of breaching their covenants.

- Participating in bondholder votes at bondholder meetings or seeking a bondholder meeting. However, the opportunities to requisition a bondholder meeting are limited to a small number of circumstances.

Whilst bondholders are well versed in engaging with issuers in distress, many of the practices in wider stewardship are nascent and different investment managers are on a journey to enhancing their stewardship practices in fixed income. To support more effective fixed income stewardship, we recommend that industry concentrates efforts on the following areas:

BONDHOLDERS SHOULD BE ENGAGING FOR INFLUENCE NOT JUST INFORMATION

Stewardship works best when it is focusing on the right issue for the right company at the right time. Different investors may take a different view on which issues are most material for different issuers or sectors. There is no single prescribed hallmark of 'good stewardship'; it does not consist of a set list of activities that achieve good outcomes in every situation.

[9] See also: Principles for Responsible Investment: ESG engagement for fixed income investors
[10] For FAQs on Special Committees see: https://www.ivis.co.uk/media/11172/Rebranded-Special-Committee-FAQ-3-June-2015-.pdf

Investment managers have differing reasons for and approaches to engagement, from engaging for information (getting a better understanding of the current position or future prospects of the issuer or updates on specific issues affecting the issuer) to proactive engagement on a specific theme (such as climate change or Board governance) or specific risk appropriate to the individual issuer. Finally, an issuer may itself seek engagement to update bondholders on a specific issue or update on performance.

There is significant engagement for information and monitoring in the fixed income market. Such engagement plays an important role in the stewardship process through allowing investors an opportunity to better understand the main risks within the company. However, this is dependent on the investment manager's approach to engagement on thematic risks or the risks which emerge from the manager's analysis of the issuer. Bondholders should take appropriate opportunities to focus on engagement with bond issuers for influence and impact on specific issues or themes. These stewardship activities should ensure that engagements are contributing to long-term value for clients. Bondholders should be using these examples to demonstrate their stewardship outcomes to clients and regulators.

BONDHOLDERS SHOULD BE ENGAGING ON LONG-TERM ISSUES, NOT JUST THOSE THAT IMPACT THE ISSUER DURING THE TERM OF THE BOND

As highlighted previously, stewardship in equities is usually focused on long-term issues, given the perpetual nature of equity. Engagement time horizons for bondholders can be influenced by the maturity of the bond held (e.g. short dated or long dated) and whether the issuer/bond represents a core strategic allocation or a tactical, opportunistic one. Institutional investors will often hold different tranches of the issuers debt, if the issuers has multiple bonds in issuance, or they may hold debt for multiple issuance cycles and are often the first port of call when companies seek refinancing options. It is important therefore for bondholders to consider how their engagement and stewardship approach is focused on the long-term behaviours of the company and its management, and not only the behaviours over the term of the bond. Investment managers should be taking a longer-term approach to their stewardship activities aligned with the time horizons of their clients, and not just focussing on the issue affecting the company over the life of the bond.

STEWARDSHIP SHOULD BE MORE EFFECTIVELY INTEGRATED ACROSS DEBT AND EQUITY HOLDINGS, LOOKING FOR OPPORTUNITIES TO COLLABORATE

Many investment houses are coordinating their stewardship activities including engagements with companies across both their debt and equity holdings. This collaboration can take place at a number of levels, from research and analysis, setting expectations and engagement.

This coordination practice is to be encouraged not only in direct engagements, but also on collaborative engagements with other investors, so that companies are hearing from a diverse range of investors on critical issues to long-term value. Collaborative initiatives on thematic issues such as climate should ensure they incorporate debt as well as equity holders in their engagements.

CONFLICTS OF INTERESTS SHOULD BE EFFECTIVELY MANAGED

It is important to note that conflicts of interest between bond and equity holders can arise and need to be effectively managed. While equity and debt holder interests may be aligned on the need to manage and reduce downside risks, it is possible that the time horizon for engagement for debt and equity holdings are misaligned or that equity engagement strategies encourage companies to pursue ventures that could impact negatively on their short/medium term financial position and may lead to rating downgrades. Investment managers should have effective governance in place to manage these conflicts where they arise.

Ultimately, portfolio managers of debt or equity portfolios are guided by their fiduciary duty to act in the best interests of their clients. As with all company engagements, investment managers need to ensure they have appropriate governance and controls in place for the handling of information within the confines of Market Abuse Regulations (MAR).

BONDHOLDERS SHOULD COLLABORATE MORE EFFECTIVELY AT DEBT ORIGINATION

There are emerging opportunities for bondholders to work together more effectively to influence behaviours at companies that will lead to long-term value. Bondholders should collaborate more at debt origination to support consistent disclosures and terms of the bond. More effective collaboration between investors at the debt origination stage will support more effective engagement by investors over the lifetime of the bond. This practice is more accessible in some fixed income asset classes than others and is challenging in a very liquid market for debt, however, this is a key area where investors can collaborate to ensure there is better accountability between bond investors and issuers.

Clear and consistent communication from different prospective investors about their ESG disclosure expectations should support better information to ensure efficient cost of capital. There are opportunities also to ensure that the terms and conditions set out in bond covenants are sufficiently robust and accountable. Strong covenants are equally as important for ESG labelled debt as they are for other classes of fixed income securities. There are practical and legal considerations for collaborative engagement in this manner, including in relation to market abuse and competition law regulations. Seeking regulatory clarity on the legal and regulatory risk is prudent for investors to enable constructive collaboration. The IA will monitor how the market for ESG labelled debt develops and consider how the Investment Association's Special Committee process can be used to provide a structured format for collaborative engagement between bond issuers and investors for these issuances.

5. INVESTOR EXPECTATIONS AND RECOMMENDATIONS

Effective engagement between debt issuers and investment managers can support them to address sustainability challenges and support them to deliver long-term value on behalf of their clients. Companies that facilitate effective engagement with their investors will be better positioned to reap the benefits of enhanced investor relations. When refinancing debt, issuers that are proactive in addressing investor expectations will find a diversified and loyal investor base more willing to reinvest, ultimately providing access to cost-effective capital.

Considering the significant drivers for fixed income stewardship discussed above, investment managers are increasing their expectations of debt issuers to better facilitate investor stewardship. The IA has developed recommendations for debt issuers in collaboration with its members, including:

- Articulating a coherent debt strategy.
- Improving disclosures, bond covenants and documentation to reflect ESG metrics and other information required by investors.
- Developing long-term relationships between investors and issuers.

ARTICULATE A COHERENT DEBT STRATEGY

Investors expect companies and management to take a holistic and coherent approach to their capital management strategy and provide a coherent narrative across both debt and equity issuances. Investors want to understand how management are efficiently utilising the capital provided to create sustainable, long-term value. This includes understanding how a company is investing in its future, how it makes key decisions to adapt to sustainability challenges and opportunities, and how it seeks to mitigate long-term risks, including material ESG risks. Ongoing dialogue between investment managers and company management is critical in building understanding about the companies' capital allocation decisions.

Investment managers want issuers to articulate how their debt strategy fits within their wider approach to capital management – *"to explain the approach taken to managing its capital, provide assurance that it is allocating capital efficiently, and demonstrate that it is acting in a manner that is consistent with [investor] interest in sustainable, long term value creation"*.[11] Material ESG risks and opportunities should be incorporated into the company's strategy and wider approach to capital management and therefore companies should clearly articulate how any debt issuance supports the company to meet its strategy including the management of material ESG risks and opportunities.

For standard corporate debt issuances, issuers should be clear about how the financing will help meet the overall strategy of the company, including with respect to managing material ESG risks and opportunities. Where ESG labelled bonds are issued, companies should be clear about how these are appropriate to the broader debt strategy. A one-off ESG labelled bond issuance that is not linked to the company's wider approach to sustainability risks the issuer being accused of 'greenwashing' – being opportunistic in its use and lacking any real substance and commitment to ESG. For bondholders there is also opportunity, and responsibility to adequately monitor the issuers' use of proceeds as well as ensuring green labels are fit for purpose.

Issuers should seek to ensure that proceeds from UoP bonds are ringfenced for their stated sustainability purposes. Investment managers will be engaging with issuers to ensure stricter use of terminology in bond prospectuses and to introduce requirements, penalties and incentives in covenants to ensure that the proceeds are properly linked to the nominated projects. Consistently, the IA encourages issuers to align with existing bond frameworks principles such as ICMA's Green Bond Principles[12], which recommend that *"an issuer's management of proceeds be supplemented by the use of an external auditor, or other third party, to verify the internal tracking method and the allocation of funds from the Green Bond proceeds".*

Investors would also like to see Second Party Opinion Providers provide a more holistic assessment of the issuer's sustainability characteristics, considering not only the characteristics of the issuance but also how consistent this is with the company's wider sustainability characteristics and whether any conflicts arise.

[11] The IA's *Long Term Reporting Guidance*
[12] https://www.icmagroup.org/assets/documents/Sustainable-finance/2022-updates/Green-Bond-Principles_June-2022-280622.pdf

IMPROVING CORPORATE REPORTING

Investors are keen to see greater transparency from corporate debt issuers on the full range of material risks and opportunities, including on ESG issues. Investors rely on annual reports and accounts and other performance data to monitor their investments. To meet the growing number of ESG related regulations, investors will need ESG data from all the assets they invest in, including with respect to corporate debt to evidence the ESG characteristics of their investment portfolios. Investors also expect companies to include an ESG update within their standard quarterly reporting and for companies to be prepared to answer questions on ESG issues at Q&A sessions. For issuers, disclosures can have an impact on investor confidence, pricing in secondary markets, and the ability to attract a broader investor base. Transparency about the approach to the wide range of material risks identified by investors will impact on company's creditworthiness and their ability to raise capital.

Location of disclosures

Material ESG disclosures should first and foremost be appropriately reflected in the annual report. Debt investors will consider the risks and opportunities of the issuing companies. ESG disclosures related to a particular debt issuance should be clearly located and publicly available. Issuers should publish all relevant information and key disclosures on a dedicated part of their website such as an "investor relations" page. Beyond this, issuers can show a wider commitment to sustainability issues by including disclosures prominently on their corporate website and within general news and updates pages.

When issuing debt to the market, issuers should include an index of ESG disclosures in the Offering Memorandum.

Standardised Reporting & Sector Specific Metrics

Issuers should seek to use investor-approved disclosure frameworks to ensure a consistent approach and facilitate benchmarking. There are multiple frameworks used to promote better reporting by companies on the wider range of strategic and non-financial information. The IA supports frameworks such as TCFD and the SASB/Value Reporting Framework and has endorsed efforts towards the global harmonisation and coordination of sustainability reporting standards by the IFRS Foundation's ISSB, through the establishment of the International Sustainability Standards Board. These frameworks can help issuers determine what will be of material interest to investors.

Issuers should ensure that disclosures are relevant to their sector to facilitate investor comparisons. Without sector-specific metrics, the comparability of information, and therefore its utility, is limited. The Value Reporting Framework's sector specific sustainability standards and ELFA's sector ESG guides provide useful starting points.

Disclosure advice for first time issuers, sub-investment grade issuers, and issuers without publicly listed equities

The IA encourages sub-investment grade issuers to use the European Leveraged Finance Association (ELFA) and Principles for Responsible Investment's (PRI) sector-specific ***guidance*** on ESG disclosures. The ESG ***Fact Sheets*** outline key considerations for issuers on general and ESG disclosures, with the related policies, processes, controls and associated metrics that could be relevant to an investment decision.

First time issuers and issuers without a public listed equity should be especially focused on providing sufficient disclosures to investors who will not have had the chance to build a relationship with the company or engage with disclosures previously.

First time issuers may also want to seek third party ESG ratings to bolster investor confidence in their disclosures.

DEVELOP LONG-TERM RELATIONSHIPS BETWEEN INVESTORS AND ISSUERS

Investors undertake engagements with companies for information and monitoring; for influence and impact; and sometimes to escalate concerns. Issuers should provide investors with opportunities to conduct all forms of engagement and ensure appropriate personnel are present.

Building relationships with bondholders outside of the issuance cycle

Issuers should proactively seek to build and cultivate long-term relationships with investors beyond the life of a particular issuance. Such relationships give issuers time to understand and address any issues/concerns raised by investors, build a rapport, and make refinancing easier, with the potential to reduce the cost of capital as a result. On the other hand, where long-term relationships are not developed, material risks that extend beyond the life of the bond may not be adequately addressed at the appropriate time, detrimentally affecting the cost of capital in future years.

Companies may wish to seek engagement with potential significant investors to understand why they did not participate in a particular issuance. This is especially important for issuers with multiple outstanding bonds, and who are likely to want to access the bond market on a repeated basis.

Pro-Active and Regular Engagement

Issuers should seek to pro-actively engage with investors throughout the life of the bond. Issuers should avoid only engaging with investors where there are corporate actions, roadshows, or at a crisis point. The IA recommends that issuers hold regular quarterly bondholder update calls to give investors the opportunity to ask questions, this is especially important where there are significant updates to strategy. Issuers may want to consider assigning a portion of their earnings call to a wider sustainability update or establishing a separate annual call dedicated to the company's sustainability strategy.

Roadshows

Investor roadshows (whether related to an upcoming deal or not) are a key opportunity for investors to engage with the company. Roadshows should cover the full range of material risks to the company and its creditworthiness. Deal specific roadshows often leave little time for issuers to address any investor concerns or implement suggestions. For this reason, issuers should seek proactive non-deal related engagement with investors. Roadshows prior to fixed income issuances should also cover the impact of long-term risks including ESG risks on the company. Company representatives should also be broadened so there are individuals present to speak on more strategic matters, including on material ESG issues.

Access to Board and Senior Management

Companies should facilitate engagement at the executive team and board level for bondholders and ensure this engagement is both strategic and long-term in nature. Having access to the management personnel that is responsible for the wider strategy of the company allows investors to engage on a broader range of strategic and ESG issues, which typically fall outside the treasury department's remit.

Investor Relations, CSR and Sustainability Teams

Fixed income investor relations teams should be prepared to speak to the financially material risks and opportunities for the company, and how they relate to the debt issuance including with respect to material ESG issues. There should be considerably more join-up between equity and debt investor relations teams with respect to ESG issues.

6. ROLE OF OTHER STAKEHOLDERS

There are several other stakeholders that play a key role in facilitating effective stewardship of fixed income assets. These include data and rating providers and advisory and originating banks as well as credit rating agencies. These actors can all take actions to support effective stewardship and especially play a key role in supporting investors to have access to sufficient information to make informed investment decisions. Recommendation 19 of the Asset Management Taskforce Report 'Investing with Purpose; placing stewardship at the heart of sustainable growth' states that all service providers in the stewardship investment chain, including data providers, should demonstrate how they support effective stewardship, and encourages them to do so through becoming signatories to the UK Stewardship Code.

ESG Data Providers

ESG data providers play an important role in supporting investors to obtain accurate ESG data on debt issuers. The accuracy and transparency of methodology around the output of ESG data has a material effect on capital allocation decisions by investors. In addition to their own in-house research this data can support investment managers to make investment decisions that reflect material ESG risks and opportunities faced by companies. The IA has called for ESG data providers to have appropriate governance, adequate transparency and management of conflicts of interests[13]. For debt and equity investors it is essential for ESG data providers to be clear about what they are measuring, the methodology for producing any scoring and the ultimate objective of any ratings.

For debt specifically, it is important for data and rating agencies to be clear about how any rating provided for a specific issuer is 'rolled up' to the relevant parent or subsidiary. This is essential for investment managers to match any data or rating points with particular investment holdings.

Credit Rating Agencies

Credit Rating Agencies (CRAs) can support the quality of disclosures by producing clearer expectations for companies to make ESG disclosures and highlight whether these have been provided for investors.

CRAs need to be transparent about their methodology and the extent to which ESG issues have been factored into the ratings. Particularly important is the time frame over which the agency is looking at material ESG issues. IA members are concerned that agencies currently struggle to price ESG risks beyond a three-to-five-year horizon and often resort to making overly optimistic assumptions about the company's ability to overcome ESG risks in the future. The PRI's statement on ESG in Credit Ratings[14] provides several useful principles that CRAs should adhere to.

Banks

Syndicating banks and other debt underwriters are a pivotal stakeholder in the process given their role as facilitators for issuances that come to market. They can also play an important role in facilitating engagement between issuers and investors, particularly via non-deal roadshows. Banks will also often have an important role in co-ordinating investor expectations.

Investors expect the banks to proactively facilitate greater information flow between issuers and investors at both the origination and post-issuance phase, reinforcing the ESG disclosure expectations of investors for all corporate debt (not only ESG labelled debt).

Financial Regulators

Financial regulators have an important role to play in supporting a focus on stewardship in fixed income and other asset classes. In addition to supporting market led initiatives, regulators can support this by:

- Ensuring that debt issuers provide the right information to meet investor's needs – we welcome recent efforts by the FCA to consider the responsibilities of debt issuers to enhance climate related disclosures to the market.

- Ensuring regulatory oversight of asset owners and managers' stewardship responsibilities is proportionate with respect to the asset classes in investors' portfolios.

[13] *https://www.theia.org/sites/default/files/2021-09/IA%20Final%20Response%20FCA%20CP21-18.pdf*
[14] *Statement on ESG in credit risk and ratings (available in different languages) | PRI Web Page | PRI (unpri.org)*

7. CONCLUSION AND NEXT STEPS

Investment managers, issuers, and a range of other actors are on a journey to improving their approach to fixed income stewardship, to support long-term value on behalf of clients and beneficiaries. Considering the essential role of debt in the effective functioning of the economy, it is critical that all actors make efforts to evolve their approach.

The IA will continue to work with members of its Fixed Income Stewardship Working Group and with regulators and other stakeholders to embed the recommendations in this report, maximising its impact. In addition, we will continue to work with the group to promote the development of and implementation of stewardship in fixed income. A key area that will require continued focus is how investment managers can support more effective market engagement with issuers at debt origination, particularly with respect to ESG labelled debt.

The Working Group was set up as a 'Task and Finish' working group with its principal task being the production of this document. However, in the course of its discussion the group also identified several areas which warrant further consideration:

- The need for industry infrastructure to facilitate greater investor participation and collaboration in fixed income market and particularly at debt origination – in particular with respect to ESG labelled debt, so that investors can set consistent expectations on disclosures, terms and conditions and continue to hold issuers to account. We will provide more detailed guidance on how investors can support fixed income stewardship.
- How to improve stewardship in fixed income beyond corporate debt, and especially in sovereign debt. This will necessitate a specific focus on how engagement with sovereigns might be structured and addressing ESG data issues.
- Finally, to accompany the growing regulatory focus on fixed income stewardship there needs to be a regular dialogue between the FCA and investors. Investors need to provide consistent feedback to the FCA on its role in promoting better stewardship outcomes through encouraging greater sustainability disclosures by debt issuers as well as supervising and monitoring the market for ESG labelled debt.

In order to address these issues the IA will be establishing a permanent Fixed Income ESG/ Stewardship Working group. This group will be derived from the fixed income stewardship group that produced this guidance, but the composition will be reviewed and it will include further representation from the IAs membership.

With thanks to members of the IA's Fixed Income Stewardship Working Group

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Sora Utzinger	Aviva Investors
Gareth Hall	Barings
My-Linh Ngo	BlueBay Asset Management
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