Corporate debt and responsible investment

January 2025

COLUMBIA THREADNEEDLE INVESTMENTS®

Corporate debt and responsible investment guidelines

The relevance of fixed income instruments, as well as other asset classes as a component of sustainable investment, was identified in the UN Principles for Responsible Investment, originally launched in 2006. While much of the focus in responsible investment to date has been on equities, increasing attention is being paid to other asset classes — in particular corporate debt.

Shareholders play a particular stewardship role by exercising their ownership rights, including voting, to encourage companies to pay appropriate attention to the management of material ESG risks. However, it is also the case that a firm's creditors and bondholders are key financial stakeholders and, thus, share a common interest with shareholders for the company to manage ESG risks and contribute to strong long-term financial performance.

Fiduciary responsibility for fixed-income as well as equity assets

We engage with portfolio companies, as both a shareholder and creditor, to encourage companies to pursue policies and practices that enhance the long term economic sustainability of all corporate asset classes.

This interest has been motivated in part by greater recognition from pension funds and their trustees that fiduciary responsibility to address long-term ESG risks is relevant for bond investments as well as for equities. This is particularly the case for clients whose portfolio de-risking has resulted in the shifting of asset allocation from equities into bonds.

Why ESG issues are relevant to bondholders

In most companies and in most sectors, debt forms a core part of a company's long-term permanent capital. This is particularly true in the case of financial institutions and many utilities. In this context, a company's providers of debt capital share a similar exposure to long-term material ESG risks as its shareholders.

However, while creditors are theoretically more protected from financial problems than shareholders, both are affected by a company's ability to generate long-term operating profits and cash flows to allow for debt service, dividend payments and capital appreciation. Financial, operational, and reputational risks relating to ESG factors can affect a company's ability to generate stable cash flows to honor its financial obligations.

Indeed, there is a clear convergence among corporate creditors and shareholders on many issues affecting a company's management of risks relating to ESG performance.

It is also worth noting that compared to equity investors, creditors have relatively more limited upside potential in investment returns, as income is fixed, not variable. This can cause creditors to be relatively risk-averse and focus on companies avoiding the downside – namely the possibility that their financial contracts will not be honored. In this regard, robust identification and management of material ESG risks is a form of enterprise risk management that serves to promote the long-term stability of the company and ultimately protect creditor interests, including the value, performance, and liquidity of fixed income portfolios.

What we expect from bond issuers

As an investor in bonds and other forms of corporate debt instruments, we expect debt issuers to conduct their business in a way that protects creditor interests. This includes showing proper respect for shareholder interests, as a sustainable company must maintain access to both equity and debt capital.

Our fixed income engagement focuses on those aspects of governance that reflect a company's overall risk profile, a key concern for creditors. These include:

1. **Clarity on financial policy.** Companies should be transparent to both creditors and shareholders regarding their financial policies. Particularly with regard to creditors, a company's reporting should include a policy statement on the use of debt and the level of credit quality the company wishes to utilize. It may be appropriate for a company to pursue a higher-risk strategy involving debt finance. This strategy, however, should be clear to both existing and prospective debt investors so that it can be reflected both in pricing and the fundamental investment decision.
2. **Risk management.** The company's risk management and risk governance are fundamental concerns for both creditors and shareholders. This not only relates to basic internal controls, but also to risk management in the broadest enterprise-wide context – incorporating financial, operational and reputational factors. In this context, ESG factors can present significant risks to the company and its investors.
3. **Board effectiveness.** Bondholders want boards to be aware of creditors' interests and to demonstrate appropriate regard for maintaining and building the long-term financial health of the company. Creditors also want strong and effective boards that are able to oversee company management and provide appropriate checks and balances to prevent abuse.
4. **Audit process.** A particular focus of creditors is a robust audit process, including an independent audit, appropriate accounting policies and high standards of transparency and disclosure in financial reporting.
5. **Compensation.** Performance metrics reflecting a company's own financial strength and stability can (and should) be reflected in company incentive structures. Such metrics may include relevant ESG metrics and feature as a component of a balanced scorecard guiding annual bonus awards.

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