

# RESPONSIBLE INVESTMENT IN GOVERNMENT BONDS





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# 1 Introduction

Denmark and Danish enterprises are well-known for leading the way in terms of responsibility. This also applies to financial undertakings such as banks, pension funds and investment associations. The largest of these undertakings have adopted the UN-backed principles for responsible investment known as the PRI ("Principles for Responsible Investment") and they use these in connection with all types of investments. These guidelines deal with the specific challenges and dilemmas faced by investors when social responsibility is to be considered in decisions about investments in government bonds.

In summer 2012, there was focus on several Danish banks, pension funds, investment associations and municipalities with investments in government bonds from, in particular, eight African countries. The investments were criticised because the eight countries were widely suspected of serious violations of human rights, though they were not subject to international sanctions.

In the light of this, representatives from the investment sector met with the then Minister for Business and Growth, Ole Sohn (Socialist People's Party) on 22 June 2012, in order to discuss the issues related to investment in government bonds. The following initiative was amongst those agreed at this meeting:

"The Minister will request that the Danish Council for Corporate Responsibility prepare a guide concerning which criteria, in accordance with international guidelines, should be included in assessments of investments in government bonds, how to relate to the issues that this can involve, and how to provide information about policies and practices relating to such investments. The Council will coordinate its guidelines with work taking place within the PRI, and will involve all concerned organisations and other relevant parties."

There was also agreement on the need to ensure easily accessible and updated information regarding which countries are subject to UN or EU sanctions, and in particular sanctions which prohibit financial transactions, including investments in government bonds.

The Government's general guide on responsible investment from 2010 is already available and widely supported within the sector<sup>2</sup>. The guide is based on the PRI and illustrates how a number of Danish investors have implemented the PRI in practice. The guide and the PRI are not directed towards particular types of investments, but the specific examples of strategies are based on equity investments. More detailed guidelines have since been prepared under the auspices of the PRI, with focus on specific types of investments. However, there is still no guide available concerning investment in government bonds. Neither the Government's guide on responsible investment nor the PRI's guidelines describe the specific challenges that investors are faced with in connection with government bonds.

A working group to look in more detail at the challenges posed by investment in government bonds has now been established within the PRI<sup>3</sup>. Several Danish institutional investors are already participating in this work and the Council encourages all Danish investors to follow international developments in the area.

At the present time, it is not known when the working group under the PRI will publish recommendations concerning responsible investment in government bonds. Therefore, the Danish Council for Corporate Responsibility is publishing this guide now, but will evaluate the need for revision when the recommendations from the PRI are available.

### **Objective**

The guide outlines the considerations that an investor should take into account, from an ESG perspective, before investing in government bonds.

The guide also aims to create a common understanding of responsible investment in government bonds, with a view to strengthening dialogue between investors, NGOs and the political system.

### Target group

This guide is generally relevant for any investor. However, the guide is particularly relevant for institutional investors, including financial undertakings. The guide is also relevant for municipalities and other public investors.

### **Reading instructions**

The Council calls on the Government to integrate this guide on responsible investment in government bonds into the Government's existing guide on responsible investment, so that all guidance on responsible investment is consolidated in one place, regardless of whether it concerns investment in shares, government bonds or other types of investment. However, this guide is also intended to be read as an independent document.

- http://www.unpri.org/
- Guide to responsible investment (2010): http://samfundsansvar.dk/file/319139/ guide to responsible investment.pdf
- <sup>3</sup> The UN PRI Sovereign Fixed Income Working Group.

# 2 Main conclusions

- All investors should take social factors into account.
- Some institutional investors are required to manage funds on behalf of others with a view to achieving the best possible returns in the long term.<sup>4</sup> However, these investors should also take societal considerations into account, which is both legal and possible without compromising returns in the long term.

### **Challenges:**

- It is acknowledged that government bonds constitute a unique type of investment, which does not provide the same opportunities for active ownership, engagement and investor collaboration as, for example, investments in shares. Purchases of government bonds do not provide joint ownership or influence, as is the case with purchases of shares. This fact does not, however, relieve the investor of social responsibility, but it can lead to certain situations where it is necessary to exclude investments rather than aiming at influencing the situation.
- Ratings of countries based on ESG factors (Environmental, Social and Governance factors) consist of a number of different methods and are generally retrospective. If investors make use of these ratings, it is important that they are supplemented by assessments of current developments in the country concerned. In a country where there are problems with, for example, respect for human rights, then this should be considered in the assessment, but indications of positive developments should also be taken into account, or if it is judged that the investments will not contribute to a negative development.

- There can be good reasons for maintaining investments in government bonds out of consideration for the country's development. Exclusion should only take place after applying the precautionary principle and should be carefully considered when there are no international sanctions against trading in the country's government bonds. When excluding investments in government bonds from a given country, the investor should consider the consequences for other assets in the country concerned, for example, shares or projects owned or partly owned by the country's government.
- It can be difficult to balance ESG factors in relation to each other. However, serious violations of human rights must weigh heavily in the decision on exclusion of investments in government bonds.

#### **Investment principles:**

- International sanctions and bans from the UN and the EU must always be complied with.
- Investors must seek to ensure that international principles for CSR (Corporate Social Responsibility) are observed. For example, this applies to the UNGP and the OECD Guidelines for Multinational Enterprises that have a requirement for "due diligence" and where non-compliance could be referred to the Mediation and Complaints-Handling Institution for Responsible Business Conduct (MKI)<sup>5</sup>. This involves an obligation for investors not only to seek information on international sanctions but also, as far as possible, to examine conditions in countries where there is a significant risk of violations of human rights. It is recognised that in relation to operational

obligations, investors' due diligence will vary in complexity depending on factors such as the nature and context of the activities.

#### **Guidelines:**

 Information regarding which countries and regions are subject to international sanctions can be found on the Ministry of Foreign Affairs of Denmark's website<sup>6</sup>. The Ministry of Foreign Affairs of Denmark can enter into a dialogue with the industry about investments in Danida's priority countries (Danida

 Danish International Development Assistance).

### Communication and transparency:

- An investor's approach to investment in government bonds, and in other types of assets, should be transparent and should be communicated in order to ensure that the outside world accepts the foundation upon which the investment decision was based.
- Institutional investors are subject to requirements to report their CSR policies. This reporting should concern investors' core business, i.e. investment policy, implementation of the policy and the results achieved. This also applies to investment in government bonds.
- 4 Requirement for best possible return includes:
  - Insurance companies (life assurance and non-life insurance)
  - Multi-employer occupational pension funds
  - Company pension funds
  - ATP (Arbejdsmarkedets Tillægspension)
  - LD pensions
- 5 <u>http://businessconduct.dk</u>
- 6 http://um.dk/en

# **3** Government bonds and pricing

### 3.1. What is a government bond?

Governments issue government bonds in order to finance state expenditure or a state deficit. Apart from cases where an investor buys a government bond and keeps it until the bond matures, the return and risk will depend upon general developments in interest rates and other global macroeconomic conditions, and additionally upon an assessment of the creditworthiness of the country issuing the government bond.

There are also examples of special "thematic" bonds which finance environmental projects (green bonds) etc. However, government bonds are not generally earmarked for specific projects, so an investor typically does not know, and cannot influence, what the loan will be used for.

A bond is different from a share as the bond owner has entered into a debt agreement and thereby has no influence on the bond issuer's activities; this is unlike the purchase of a share, for example, where the investor becomes a joint owner of the enterprise.

# 3.2. Pricing and the significance of ESG factors

The pricing of a government bond is based to a great extent on the creditworthiness of the issuing country, but other factors also influence the price such as the liquidity of the bond, expectations of inflation, the underlying currency etc.

The creditworthiness of a country is determined on the basis of an assessment of the extent to which the country is willing to, and able to live up to its contractual obligations to pay the ongoing interest, and to repay the final loan sum on maturity of the bond. Such an assessment is based on the expected future cash flows to the state, which can be affected by factors such as the institutional strength of the state, which, in turn, have crucial bearing on whether the country is able to collect taxes effectively and execute any adjustments to taxes or duties.

If a country is no longer able to, or does not wish to manage its debt, in that it fails to make repayments or to pay interest, then the country could, in extreme cases, go bankrupt (national bankruptcy) or there could be a restructuring/impairment of the debt so that bankruptcy can be avoided. The reasons for this could be the consequences of insolvency and large debt, changes in government regime or termination of the state.

For this reason there are a number of ESG factors that are relevant for CSR in the assessment of a country's creditworthiness.

# ESG factors that can be included in the assessment of a country's creditworthiness:

- Respect for human rights
- Good governance, including level of corruption, political stability, the institutiona strength of the state and transparency
- Social conditions such as poverty, inequality and access to health and security
- Respect for labour rights
- Nature conservation and biodiversity
- Resource efficiency

The question of "good governance" is especially significant amongst the ESG factors for assessment of the extent to which the country is willing and able to live up to its contractual obligations to pay the ongoing interest, and to repay the final loan sum on maturity of the bond. Good governance concerns the level of corruption, political stability, the strength of state institutions and transparency in governance and in the exercise of public authority etc.

Social factors also have a great influence on the overall assessment of a country, as social factors can influence a state's expected future cash flows or they could lead to political instability, such as in the case of a popular uprising due to poor social conditions.

If a country is characterised by poor governance and widespread violations of human rights, this will typically lead to investment in the country's government bonds being associated with a greater risk than investments in countries where such conditions are not present. A high rate of interest and a high return on government bonds typically indicate that there is a high risk connected with the investments. A high interest rate does not necessarily indicate that a government bond is a good investment, as the interest must be related to the risk. This risk is heavily influenced by ESG factors. On the other hand, a high interest rate does not necessarily indicate a problematic investment.

It is particularly in relation to those states that are considered to be fragile that the identifiable trends in the development of ESG factors play an important role in the assessment of the country's creditworthiness. The Council notes that a number of investors have already incorporated important ESG factors and trends in their assessments of the creditworthiness of these countries.

# 4.

# Requirement to ensure the best possible return in the long term

The need to ensure the best possible return on investments in the long term is a basic condition for some institutional investors in Denmark. It is a condition that is established by law<sup>7</sup> and applies to all types of investments, including investments in government bonds.

Taking account of social factors in investments is not considered to be a limitation that reduces returns in the long term. The Danish Financial Supervisory Authority (Danish FSA) has described the possibility to take into account social considerations as follows:

"As it is not possible to determine in advance which investment strategy will be the most advantageous, then life-assurance companies and multi-employer occupational pension funds can, within this framework, see section 87 and sections 127a-129 of the Insurance Activities Act (lov om forsikringsvirksomhed), legally choose several investment strategies – including strategies that contain requirements for "ethical investments". This does not, however, affect the obligation to achieve the best possible return in the long term" (Highlighting by the Council)

It is therefore both legal and possible to choose investment strategies that include requirements to take social factors into account whilst at the same time meeting the need for the best possible return in the long term. This applies regardless of whether the social consideration is included for ethical reasons or as a part of an ESG risk assessment. In this connection

it is crucial that social factors such as consideration of human rights can be legally included, regardless of whether the motive is ethical or to balance the risk and return, provided the obligation to achieve the best possible return in the long term continues to be fulfilled.

On the basis of this, the opinion of the Council is that social factors should be incorporated in investment decisions.

In practice, there can be specific challenges regarding how to incorporate social factors when investing in government bonds.

- See for example, section 158 of the Financial Business Act, section 46 of the Supervision of Company Pension Funds Act, section 26 of the Consolidated Act on Arbejdsmarkedets Tillægspension, section 6 of the LD Pensions Act, sections 32 and 33 of the Investment Associations, etc. Act and section 18 of the Alternative Investment Fund Managers etc. Act
- Letter (in Danish) from 9 October 1997 to the Danish Insurance
  Association, ATP and LD Pensions respectively:\_
  www.finanstilsynet.dk/da/Nyhedscenter/Pressemeddelelser/
  Arkiv-PM/Presse-1997/Pensionskassers-oglivsforsikringsselskaber.aspx



# Challenges and dilemmas

# 5.1. Trade in the primary or secondary market: Is there a difference?

There is a difference between an investor buying a government bond that has already been issued from another investor (secondary market), and an investor buying a newly issued government bond from the issuing country (primary market). It is only in the latter case that the investor directly gives the issuing country liquidity. However, purchase of government bonds on the secondary market also brings problems and dilemmas in relation to CSR.

The lender who buys a government bond on the *primary* market has a responsibility to consider who the loan will be given to, and the societal consequences that such a loan might have, i.e. what the money will be used for.

There is no direct connection between lender and borrower when the government bonds are purchased on the *secondary* market, but the investor still has a responsibility. Purchase of government bonds on the secondary market can contribute to maintaining the terms of interest for the issuing country, and thereby ease access to credit for the government of the country.

When trading with government bonds on the secondary market, an investor should therefore always carry out a similar assessment of the issuing country as for trade on the primary market.

# 5.2. Challenges with the general, international principles for responsible investment

Most of the large international investors have joined the PRI<sup>9</sup>, which constitutes an international and widely accepted framework for responsibility in investment generally.

The principle of active ownership, a central principle of the PRI, is based on investors having joint ownership of, and thereby influence on, the enterprises in which they invest.

According to the principle of active ownership, it is a general recommendation that investors should attempt to influence rather than exclude individual investments.

This is inherently not the case with a government bond, which is a financial service in the form of a loan. Purchases of government bonds do not provide joint ownership or influence, as is the case with purchases of shares.

It is also more difficult to influence a country than a business enterprise. Further, there can be democratic considerations connected with attempting to influence a country's political decisions as well as socio-economic priorities as a possible investor with a financial interest in the country.

Even though the conditions for active ownership, commitment and influence are fundamentally different for government bonds compared with shares or corporate bonds — the PRI is still relevant. For a review of the PRI please refer to the existing guide on responsible investment.<sup>10</sup>

A fundamental principle is that investors should exercise due diligence to ensure that their investments do not have adverse societal impacts, including that investments do not contribute to violations of human rights.

The fact that it is difficult or impossible to exercise active ownership in connection with government bonds is not synonymous with a lack of responsibility.

The nature of government bonds compared with shares therefore has a primary significance for how investors tackle CSR. For example, it could be necessary to exclude certain government bonds from the portfolio.

What is important is whether the country concerned is deemed to be developing positively in relation to human rights, for example, and whether investments may contribute to this positive development.

If, on the other hand, there are gross violations of human rights and no indication of any significant improvements, then investments could be problematic. It is crucial that investors consider these issues and are open about their conclusions.

There is an awareness of the problem within the PRI, and for that reason (as mentioned in the introduction) a working group has been established to look in more detail into the challenges facing investors when investing in government bonds.

#### 5.3. Challenges of country risk rating

There are several different methods for systematically assessing the economic, political and ESG-related risks of running a business and investing in the almost 200 sovereign states in the world (country risk rating). Several of these countries are subject to ongoing monitoring of documented infringements of international conventions concerning the environment and human rights etc.

There is a dilemma in relation to ESG data as the data is retrospective and only represents the situation in a given country at a given time. However, the investor considering investing in a country's government bonds will typically be interested in future developments in the country.

If a country is judged to be in positive development, then an investment could be interesting for the lender and at the same time support the positive development in the country. But such an investment may be refused as long as the ESG data has not been updated.

- 9 www.unpri.org
- Guide to responsible investment (2010):

  <a href="http://samfundsansvar.dk/file/319139/guide">http://samfundsansvar.dk/file/319139/guide</a> to responsible investment.pdf</a>

When using the country risk ratings, it is important to carry out an assessment of the trend in a country's ESG data and additionally to ensure that the ESG data is as up-to-date as possible.

Having done this, it will depend on a specific assessment whether problematic ESG conditions in a country, such as in relation to human rights, should lead to the refusal of investments in government bonds issued by that country.

Greater or smaller ESG problems or infringements of international conventions can arise in a number of countries, including the largest countries and markets for government bonds in the world. What is important is whether the country concerned is deemed to be developing positively in relation to human rights, for example, and whether investments may contribute to this positive development.

If, on the other hand, there are gross violations of human rights and no indication of any significant improvements, then investments could be problematic. It is crucial that investors consider these issues and are open about their conclusions.

# 5.4. Government bonds in relation to investments in other assets

If, after considering the ESG factors, an investor decides to exclude government bonds issued by a specific country, this can create doubt in relation to other types of investment, such as corporate bonds or shares issued by enterprises from the same country. An investor should consider the extent to which the decision concerning government bonds has consequences for

the rest of the portfolio, with a view to maintaining a consistent investment approach.

It can be difficult to determine the extent to which an enterprise directly or indirectly supports a regime that may, for example, have a questionable human rights record. On top of this comes the question of how an investor can/should include conclusions about the country in relation to enterprises that are owned or partly owned by the state.

According to Danish foreign and development policy, support to the state budget (general budget support) should only be given to countries that fulfil a number of criteria in relation to: 1) human rights, democracy and the rule of law; 2) solid national policies and plans for good governance, sustainable development and combating poverty; 3) a stable macroeconomic framework; 4) a reasonable quality and capacity in public finance administration; 5) transparency and verification and control of the budget. Only very few of the Danish priority countries sufficiently fulfil these criteria.

In countries that do not qualify for general budget support, cooperation takes place through funding projects and programmes. In these cases there is ongoing assessment of the extent to which this can be carried out through funding government programmes or whether funding should be directed through the civil society or private sector, or through a mix of the two. Similarly, investments in specific projects or enterprises in certain countries can be ethical and incorporate ESG factors at the same time as investments in the country's government bonds are excluded on the basis of the same factors.

Therefore, that Denmark provides general budget support, has a collaboration programme, or finances specific assistance projects in countries where there are serious violations of human rights, cannot *in itself* be used as an indicator of responsible investment in government bonds or other assets in these countries.

It is therefore important in all cases that the investor undertakes an assessment of the extent to which it is responsible to invest in the particular government bonds and in other assets from the country concerned. The assessment may have different outcomes so that investments in government bonds may be ruled out whilst other investments are acceptable, for example, specific projects or enterprises are deemed responsible.

#### 5.5. Trade-off between ESG criteria

An investor can be compelled to decide which ESG criteria should be given the highest priority. An example of this could be a prioritisation of whether certain employment rights are complied with, or whether the government is fighting corruption.

It is not possible to prioritise all ESG factors equally and it is sometimes necessary to choose which criteria should be given the highest priority.

Gross violations of human rights should in all cases be afforded great significance, and it would be difficult for any positive development within other ESG factors to compensate for such violations to an extent to justify investment in government bonds.

The Office of the High Commissioner for Human Rights (OHCHR) considers the following to be gross violations: genocide, slavery, practices similar to slavery, summary or arbitrary executions, torture, abductions, arbitrary and long-term imprisonment and systematic discrimination<sup>12</sup>. Other forms of human rights violations, including economic, social and cultural violations, can also be considered gross violations if they are serious and systematic, and in cases such as where the violations are extensive and targeted at specific groups of the population.<sup>13</sup>

For more information on Danish bilateral aid to priority countries see: <a href="http://um.dk/en/danida-en/activities/countries-regions/priority-countries/">http://um.dk/en/danida-en/activities/countries-regions/priority-countries/</a>

<sup>&</sup>quot;The Corporate Responsibility to Respect Human Rights: An Interpretative Guide" United Nations (OHCHR), 2012.

<sup>13</sup> Ibid.

# Criteria for investment in government bonds

On the basis of the challenges and dilemmas mentioned above, the Council recommends that, when investing in government bonds, investors should consider: 1) the extent to which the issuing country is subject to international sanctions; 2) international and recognised principles for social responsibility. The Council notes that these elements are already widely incorporated into the investment policies of Danish institutional investors.

#### 6.1. International sanctions

The UN and the EU can adopt sanctions against a country; these could include trade restrictions, a ban on financial transactions in specific securities, visa or travel restrictions.

Sanctions can be approved by the UN Security Council through binding resolutions. The EU implements sanctions that are adopted by the UN, but can also establish independent sanctions. The purpose of sanctions is to change particular behaviours or policies, such as infringement of international law or human rights, or a policy that does not respect the rule of law or democratic principles.

Both the UN and the EU provide information on relevant international sanctions via specific sanctions databases accessible from their official websites<sup>14</sup>.

In Denmark, investors can find information on relevant sanctions on the website of the Ministry of Foreign Affairs of Denmark<sup>15</sup>. The Ministry of Foreign Affairs publishes information on which countries are subject to UN or EU sanctions. This also applies to sanctions

that prohibit financial transactions, including investments in government bonds.

An investor should always obtain updated information on relevant sanctions before an investment decision is made. It is a criminal offence to infringe prohibitions under international sanctions.

# 6.2. International and recognised principles for CSR

A general criterion for incorporation of ESG factors into decisions concerning investment in government bonds is that investors must ensure that international principles for CSR are observed. The following can be referred to in addition to the previously mentioned principles for responsible investment under the PRI<sup>16</sup>:

- The UN Guiding Principles on Business and Human Rights (UNGPs).
- The OECD Guidelines for Multinational Enterprises.
- The UN Global Compact (UNGC)

# UN Guiding Principles on Business and Human Rights (UNGPs)<sup>17</sup>

Investment in government bonds from governments where human rights violations occur entails the risk of indirectly contributing to the violations by financially supporting the regimes responsible.

The UNGPs were adopted by the UN Human Rights Council in June 2011 and Denmark has acceded to the UNGPs. The principles are relevant for all states and all enterprises, both transnational and others, regardless of where they are located and regardless of their size, sector, ownership or structure<sup>18</sup>. At the same time it is recognised that the scope and complexity of an enterprise's efforts to meet this responsibility can vary depending on the severity of the negative impact of the enterprise<sup>19</sup>.

What is special about the UNGPs is that it is the first time that such guidelines have been articulated at an international level with expectations for both governments and business enterprises, including institutional investors, and with wide support from all significant stakeholders such as governments, trade organisations, trade unions, NGOs etc.

The guidelines have become internationally known as the "the Protect, Respect and Remedy Framework":

- Protect: It is the responsibility of states to protect against violations of human rights by business enterprises.
- Respect: It is the responsibility of business enterprises to respect human rights.
- Remedy: If, despite this, there are still violations of human rights, then there is a common responsibility for states and business enterprises to provide remediation for those affected. In connection with this, the state must ensure that there is an effective institutional framework providing, for example, mediation and complaints mechanisms.

The "respect" part constitutes a framework for enterprises' (such as institutional investors) due diligence for CSR, with special focus on human rights.

In this case "due diligence" means that investors should exercise the necessary care to respect human rights, for example, in relation to their investments. Investors should take the necessary precautions to ensure that their investments do not contribute to violations of human rights, even though such violations may take place in the country concerned.

4 For EU sanctions see:

http://eeas.europa.eu/cfsp/sanctions/consol-list\_en.htm. For UN sanctions see:

http://www.un.org/sc/committees/index.shtml

- http://um.dk/en
- The six principles for responsible investment under the PRI are described in more detail in the Government's guide to responsible investment (Vejledning om ansvarlige investeringer (2010)).
- "Guiding Principles on Business and Human Rights", United
  Nations (2011): <a href="http://www.ohchr.org/Documents/Publications/GuidingPrinciplesBusinessHR">http://www.ohchr.org/Documents/Publications/GuidingPrinciplesBusinessHR</a> EN.pdf
- <sup>18</sup> Ibid. page 1 (General Principles).
- 19 Ibid. page 15 (Principle 14).

It is recognised that in relation to operational obligations, investors' due diligence will vary in complexity depending on factors such as the nature and context of the activities.

The "remedy" part is a shared obligation for both states and business enterprises. However, when this applies to investments in government bonds it can be difficult (in comparison to investments in shares in specific enterprises) to determine possible adverse impacts. It can also be difficult to focus efforts and to identify victims of any violations.

The relevance of the UNGPs is evident in Denmark in that, for example, an investor can be referred to the Mediation and Complaints-Handling Institution for Responsible Business Conduct<sup>20</sup> if it transpires that investments are contributing to violations of human rights. This is possible as the UNGP is fully integrated into the OECD Guidelines for Multinational Enterprises (see below) and it is therefore included in the foundation of the Institution's work.

How the principles will be used in practice, and the precise division of responsibility and obligations between the authorities, enterprises and investors according to the UNGP is as yet unknown, as there have been very few cases in an international context.

OECD Guidelines for Multinational Enterprises<sup>21</sup> In addition to human rights, there are other relevant international guidelines that incorporate a number of ESG factors such as corruption and the environment.

This applies to the OECD Guidelines for Multinational Enterprises, which comprise recommendations on responsible business conduct with relevance for all enterprises, regardless of the structure of the organisation, i.e. the guidelines are not only aimed at multinational enterprises.

Like the UNGPs and the PRI, the OECD guidelines are based on the principle of due diligence.

In this context, this means that investors should have policies and procedures in place to identify, prevent and remedy any negative impacts of their investments, and that investors should be able to account for any negative impacts.

The guidelines draw attention to the fact that an investor may be referred to the Mediation and Complaints-Handling Institution for Responsible Business Conduct<sup>22</sup>, if an infringement of the OECD Guidelines for Multinational Enterprises occurs, as these guidelines form the basis of the Institution's work.

#### The OECD guidelines concern:

- Reporting about CSR
- · Human rights
- Employment conditions
- The environment
- Anti-corruption
- Consumer interests
- Science and technology
- Competition
- Taxation

### UN Global Compact (UNGC)<sup>23</sup>

The UN Global Compact (UNGC) is amongst the most comprehensive and internationally recognised principles for CSR With over 10,000 participating enterprises and other interested parties spread over 130 countries, the UNGC is the world's largest voluntary initiative for CSR.

The UNGC is a strategic "policy initiative" for enterprises seeking to bring their activities and strategies in compliance with 10 universally accepted principles in the following areas: human rights, labour rights, environment and anti-corruption<sup>24</sup>.

The principles point out enterprises' responsibility to observe internationally recognised conventions entered into between states on human rights, labour rights, the environment and anti-corruption. For all enterprises this means that:

- **o1** Businesses should support and respect the protection of internationally proclaimed human rights.
- **o2** Businesses should make sure that they are not complicit in human rights abuses.
- **o3** Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining.
- **o4** Businesses should support the elimination of all forms of forced and compulsory labour.
- **o5** Businesses should support the effective abolition of child labour.
- **o6** Businesses should support the elimination of discrimination in respect of employment and occupation.
- **07** Businesses should support a precautionary approach to environmental challenges.
- **o8** Businesses should undertake initiatives to promote greater environmental responsibility.
- **o9** Businesses should encourage the development and diffusion of environmentally friendly technologies.
- **10** Businesses should work against corruption in all its forms, including extortion and bribery.

www.businessconduct.dk

<sup>21</sup> www.mneguidelines.oecd.org/text

www.businessconduct.dk

www.unglobalcompact.org

www.unglobalcompact.org/AboutTheGC/index.html

# Communication concerning investment in government bonds

### 7.1. CSR reporting in the annual report

According to section 99a of the Financial Statements Act, large Danish enterprises in reporting class C, listed companies and state-owned companies in reporting class D must account for their CSR policies, in the event that the enterprises have such policies. If an enterprise does not have such a policy, this must be stated.

Through executive orders from the Danish FSA, all institutional investors in Denmark are subject to similar regulations on CSR-reporting, regardless of the size of the financial undertaking.

Businesses should report the following:

- CSR policies, including any standards, guidelines and principles for CSR used by the business<sup>25</sup>.
- How the business translates its CSR policies into actions, including any systems or procedures used.
- The business' evaluation of what it has achieved as a result of CSR initiatives during the financial year, and any future expectations.

If an investor has not formulated policies for CSR, this should be stated. If there are no policies for human rights and climate, this should also be explicitly stated.

It is recommended that Danish institutional investors disclose their policies and practices for investment in government bonds in connection with reporting their policies for responsible investment in the annual report.

#### 7.2. Additional communication

It is very important that investors publish non-financial information and prepare and account for their policies for CSR. It is also important that the policies concern the investors' core business, i.e. investment policy and the incorporation of ESG factors within that policy. This is the only way to gain the acceptance of investment decisions from both stakeholders and the general public.

In relation to reporting and communication, investors should generally consider the following questions:

- How should we communicate our strategy for responsible investment in relation to government bonds – internally and externally?
- How do we ensure relevant and credible communication for investment in government bonds?
- How do we approach ongoing communication concerning the incorporation of ESG factors in investment decisions?
- How do we communicate externally if and when it is ascertained that specific investments do not comply with our policy on responsible investment?
- What have we learnt from our previous communication and are there things which we can improve in the future?

Relevant information on investment policy for government bonds includes, for example, details of excluded investments in government bonds on the basis of ESG factors.

<sup>&</sup>lt;sup>25</sup> Such as ISO 26000 Guidance on social responsibility

# **ANNEX**

# **Examples of screening models**

**Note:** These examples are intended to give inspiration for work with responsible investment in government bonds. They are only examples, the Council has not carried out any assessment of the models shown.



# PFA's country screening procedure for investments in government bonds

It is PFA's responsibility to invest in government bonds in a responsible manner. The investments must comply with the general and internationally recognised standards for responsible investments. For this reason, PFA screens countries parallel to the half-yearly screenings of corporate shares and bonds. The screening process consists of three steps<sup>26</sup> and includes a number of indicators and country-specific information which are relevant to the assessment of a country, the population's needs as well as the overall situation in the country.

Country screenings represent the implementation of criteria and process in accordance with PFA's guidelines for responsible investments in government bonds. The screening process incorporates international standards and is based on the most recognised indices. The screening forms a clear and fact-based basis of decision for PFA's RI Board, who decides whether a country is suitable for investment or not. PFA does not regard engaging in active ownership over foreign states as an opportunity for investors as this is a foreign policy issue.

#### A developing process

No fixed criteria or principles to assess countries exist. A working group in PRI as well as a working group from the Danish Business Authority are both addressing the matter. The Danish guide, which the Danish Council for Corporate Responsibility is assumed to adopt during the fall 2013, is expected to set the framework for which criteria that should be included in the assessment.

PFA has selected the criteria that are used in PFA' screening process. The process will be evaluated on an ongoing basis, and it will be adjusted to the extent necessary according to the future Danish guide for the subject.

#### Selection of criteria

In the screening process, PFA uses a combination of a sanction– and norm–based approach. This means that PFA screens for whether the country violates international sanctions, PFA's guidelines or the international standards which PFA has committed to comply with by signing UN Global Compact and PRI<sup>27</sup>.

At all three steps in the screening process, current events, which have not yet been included in the recognised sources, may be considered to be of such importance that PFA's RI Board may make a decision that deviates from the immediate screening result.

- The three steps only assess whether a country is suitable for investment according to PFA's guidelines for responsible investments and do not take the credit and investment analysis into account.
- The screening process is developed on the basis of the integration of the due diligence principle as described in the UN Guiding Principles on Business and Human Rights.

### PFA's country screening step by step

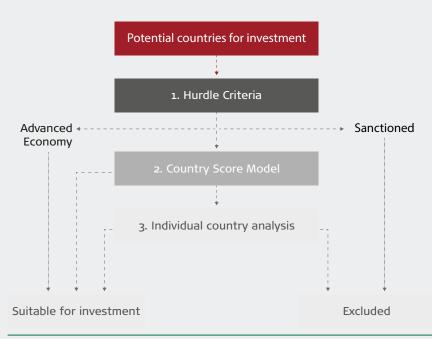
The three steps that form the basis of the screening are based on all countries in which it is possible to invest

It is possible to invest in approximately 2/3 of all countries. This means that it is not possible to invest in a number of countries, such as North Korea, Syria and Iran, along with a wide range of countries in which investments are not possible in practice because the countries have not issued any bonds or no market exists.

### First step - Hurdle criteria:

The first step includes both minimum and maximum criteria and thereby directly defines a number of countries which are immediately suitable or unsuitable for investment, respectively. The rest of the countries proceed in the screening process:

- A If a country is categorised as an "Advanced Economy" by the IMF, it will automatically be accepted as suitable for investment. This criterion means that countries which are approximately at the same level of development as Denmark are considered suitable for investment.
- **B** If any international financial or trade sanctions exist against the country, it will automatically be declared unsuitable for investment.



### Second step - Country Score Model

The second step, the Country Score Model, includes a number of internationally recognised indicators and indices, which covers both human rights, employee rights, the environment and anti-corruption. It is a quantitative assessment of the country based on a range of different indicators, which have been selected to evaluate the country's level according to the UN Global Compact's ten principles. As a starting point, the indicators used are based on official and recognised sources from the World Bank, IMF and UN. When using other sources, the nature and the purpose of the indexation are taken into account. Each country is ranked in category 1, 2 or 3 for each indicator in proportion to the other countries which are not categorised as an 'Advanced Economy' by the IMF.

Based on the results from the Country Score Model, PFA's RI Board assesses which countries should undergo a qualitative individual analysis.

### Third step - Individual country analysis

The third step, the country analysis, is based on a range of descriptive indicators from internationally recognised sources which contributes to identifying the country's and the population's situation and development in a number of areas, etc. The analysis assesses whether the situation in the country is improving, stabilising or worsening, and whether any special conditions or needs favour investing in the country's development and population. The analysis is based on a standard format which consists of a number of criteria that are reviewed based on different sources. The purpose of the country analysis is to look closer into those areas in which the country ranks the lowest in the Country Score Model. Thus, the analysis contributes to the assessment of whether the situation in the country is due to irresponsible behaviour or other causes.

Based on the analysis, PFA's RI Board decides whether the country is suitable for investment or not.

# The Country Score Model is based on the following indicators:

- Global Peace Index
- Freedom House Index
- Human Development Index
- Corruption Perception Index
- Worldwide Governance Indicators
- Press Freedom Index
- Doing Business Index
- Environmental Performance Index
- EIU Country Risk
  - EIU Democracy Index



# Responsible investment in government bonds

### Unipension's process model

The following outlines Unipension's management of responsible investment in government bonds. The model is currently being implemented, so there may be minor discrepancies between this description and the final approach.

Unipension invests around DKK 10 billion in Emerging Market Debt (EMD) using external investment managers with the required expertise and experience on the topic. EMD management is resource-intensive as it requires broad and extensive knowledge of each individual country and thus considerable analytical scale. The Unipension Fixed Income (FI) team selects and monitors the external managers, all of whom have signed the UN PRI. It is an in-house task to ensure that all investments are indeed undertaken in a responsible manner, since it is the ESG department and FI team who define the investment guidelines for the external managers. This warrants that investments fulfil the pension funds' requirements for responsibility and reflect the fund members' preferences in the best possible way.

The external managers' investment analysis is based on an integrated evaluation of financial risk, potential return, and the existing portfolio content. The risk assessment includes ESG factors that have a direct or indirect effect on a given country's creditworthiness, for example, institutional strength, political stability, risk of social unrest, corruption, and the consequences of these. A number of ESG factors are therefore already incorporated in the manager's assessment of a country.

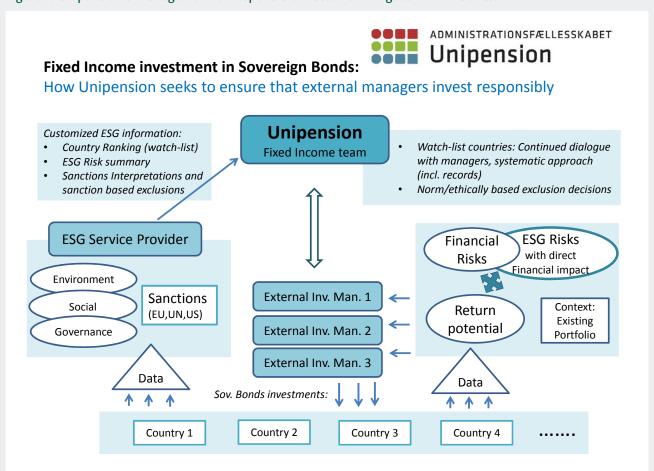
Unipension is currently finishing a due diligence process in connection with hiring an external ESG service provider. This ESG specialist will analyse ESG factors for each country as well as monitor and interpret the relevant international sanctions. This ESG analysis is more extensive than the external investment manager's risk analysis, which limits itself to factors that with a reasonable probability will affect a country's creditworthiness. The ESG specialist will provide Unipension with 1) a complete ranking of countries according to ESG performance and an ESG risk summary for each country, 2) a list of countries that should be excluded from the investment universe, either due to international sanctions or other reasons as defined by Unipension, and 3) a watch-list of particularly vulnerable, high ESG risk countries, that may be excluded from the investment universe if the current trends are not improved upon. The ranking of countries takes place using a weighting scheme for ESG factors which has been approved by Unipension, so that it reflects Unipension's preferences in terms of responsibility as accurately as possible.

It is the responsibility of the FI team to ensure that countries up for exclusion are timely and correctly dealt with by the external managers. The team monitors the watch-list countries closely and has an ongoing dialogue with the external managers on developments in these countries — especially if the external managers are seeking to enhance their positions in watch-list countries. The external managers are by definition

forward-looking in their assessment of countries, and there are positive synergies in comparing their perspectives with those of the ESG specialist, as the ESG specialist will tend to be backward-looking due to the natural lag in data. The dialogue with the individual managers is documented systematically so that

ESG-related decisions can be reconstructed and are easily accessible. The FI team executes norm-based exclusion decisions, which are made in close collaboration with the ESG team. This responsibility is placed in-house, where the pension funds' preferences are clearest, to ensure consistency across managers.

Figure 1: Unipension's management of responsible investment in government bonds.



## Nykredit

# Nykredit's guidelines for investment in government bonds

Nykredit's investment policy also includes investment in government bonds. The policy allows for international law and acknowledges that consideration for ESG can contribute to enhancing returns for investors. Investing in government bonds can have a positive impact on the development in the country concerned, but presupposes an informed investor. Nykredit's guidelines therefore fall in three parts:

- **o1** Exclusion of countries that are subject to financial transaction sanctions either against the country or leading individuals in the specific country.
- **o2** Inclusion of democracy and human rights in the investment process.
- **o3** The OECD's country risk classification is applied to monitor the investments regularly.

The OECD's country risk classification is based on financial as well as non-financial aspects. If a port-folio manager wants to buy a government bond from a country with the lowest or next lowest OECD country risk classification, Nykredit's committee for sustainable investments will decide whether the investment is in compliance with Nykredit's policy on the basis of a specific sustainability assessment of the country. If it is not, the country will be excluded.

Nykredit's external managers of government bonds from developing countries use general ESG ratings and assessments from think tanks and experts on corruption, social development, education etc. in an overall scorecard to determine whether the government bond is a good investment. Considerations made during the investment process as well as the result of the general monitoring are shared with customers through annual reports etc.



