THE PRINCIPLES FOR RESPONSIBLE INVESTMENT PODCAST TRANSCRIPT

SPOTLIGHT ON HUMAN RIGHTS: ADDRESSING SOVEREIGN BONDHOLDER STRUGGLES

WITH JASPER COX, INVESTMENT PRACTICES ANALYST, FIXED INCOME, CAMILLA OGUNBIYI, SENIOR SOVEREIGN ESG ANALYST, NORDEA ASSET MANAGEMENT AND JAMES LOCKHART SMITH, VICE PRESIDENT FOR MARKETS, VERISK MAPLECROFT

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Jasper Cox

Hello, and welcome to the PRI podcast. I'm Japer Cox, a Fixed Income analyst in the Investment Practices team at the PRI. We know that governments have a responsibility to uphold our human rights, but what does this mean for those investors that fund government? By lending them money for sovereign bondholders, thinking about human rights in the context of their investments can be challenging. The PRI's recent report on human rights in sovereign debt, laid out a process for investors to tackle the issue, including how to identify and assess human rights in a given country, how to decide whether to invest or divest and how best to engage with countries on the subject. But this is still a new area and best practice is evolving.

To discuss this, I'm joined today by Camilla Ogunbiyi, who is a senior sovereign ESG and for emerging market debt at Nordea asset management. And so we'll provide the perspective of an investor. Also joining me is James Lockhart Smith, vice president for markets at Verisk Maplecroft, the global risk analytics business.

I find this such a fascinating subject to delve into because it touches so many areas from political rights to public services, economic development, and it's also just so complex. And, and there's so many subtleties when you start to consider it from an investment perspective, as a starting point, we, the PRI argue that all investors have a duty to consider human rights, but beyond ethical or normative reasons. Why do human rights matter for sovereign debt investors? James, do you want to kick us off?

James Lockhart Smith

Sure. Thank you, Jasper. And, thanks very much for having me on the podcast. So, I'd certainly agree with you first on the relevance of the ethical or, but going beyond that, I guess there are two other reasons to pay attention. So, the first is around, the materiality of human rights. So, they do actually matter for borrowing costs, even when all other factors are controlled for, I think that the data on the materiality of the S in ESG, so to speak could previously been seen as being a bit weak essentially is not really mattering for borrowing costs once, you know, other macro factors and especially income per capita had been accounted for. There's been some really interesting work recently done by the World Bank and others on the income bias, baked into ESG ratings. And in that context, if you see the S part is highly correlated with income, then the inference would be that it isn't really driving price action markets at all, but those beliefs have tended to rest on social risk data.

That's been pretty focused around development metrics rather than individual human rights. And of course, those development metrics are really closely connected to income for obvious reasons. So at Verisk Maplecroft, we measure all aspects of human and labour rights across countries on a live or ongoing basis. And we recently actually published a research paper to go with the release of our new, sovereign ESG ratings that dug into the relevance of these rights for borrowing costs. So, what we found was really pretty striking. So if you look at the full hard currency, sovereign debt universe, one, you account for the standard macroeconomic drivers of credit risk, and for credit ratings themselves, you still have a situation where the best performers on human and labour rights have spreads on safe assets that are around half those of the worst performers. So that's a, a major, major difference, why that is probably needs further investigation.

But I think there's, you know, I guess there's a fundamental and a market preference element there. So on the fundamental side, human rights are one way in which social contracts are encoded and those social contracts do matter in all sorts of ways for economic decision making and ultimately for credit risk. And then on the market preference side, of course, if enough of the market from asset managers to asset owners are making normative decisions, you know, even if they couch those decisions as sort of risk based rather than explicitly ethical, then that's ultimately going affect borrowing costs. And I think that that kind of is a good segue into why you know, the second reason why you should pay attention to human rights. So essentially, we can see a set of really clear expectations around social risk and human rights embedded into the, so-called principle, adverse impact indicators for sovereigns in SFDR. So that means that whether or not to pay attention on some level to human rights is no longer an individual or fund level normative decision, but it's kind of an emerging requirement of the ecosystem that managers are going be operating in. So in other words, whether you care or not, you're going need to report in very straightforward in bold terms on your, uh, portfolio exposure. And those data points are going directly feed into client expectations and ultimately fundraising.

Jasper Cox

Thanks, James. And, and as an investor, would you think Camilla?

Camilla Ogunbiyi

Thank you, Jasper also, thank you for having me on the podcast. I guess to make it a bit more concrete, I can talk a bit about how we, in Nordea asset management and market that team look at human rights. And we do that in multiple ways, for example, for our flagship UC product. At the first level we, we apply a governance screen. So we expect governments to prudent spend the financing that we channel towards them. And, and checking for good governance is a good way for us to ensure that, in doing that, we capture directly the first-generation human rights, civil and political rights. But we actually also see that governance, more broadly is correlated with human right rights. So, so that's the first level where we capture human rights.

At the next level, we look at SDG data. And we do that to capture the, the second-generation human rights. So economic, social and cultural rights, met very neatly to a subset of the SDGs. And that helps us, kind of assess, economic and social progress, things like education and health other foundation for future economic growth. So, it matters from the credit perspective and the SDG data helps, assess this. It also gives us a sense of whether the countries that we're channelling financing to are countries where we as investors can make more impact. Of course it's difficult to talk about impact as a causality thing, but in relative terms, are we channelling financing to are the countries where living standards and human rights, improving trajectory and, and some of the examples we can see from, from our data, that are on a postage trajectory are particularly in Sub-Saharan Africa, a country like Angola and Cote d’Ivoire, for example, lastly also, the normative and ethical, perspective is important.

And, and we have a separate model where we kind of look at human rights in a more broad way to capture that. I think if I can just add and, and, and also building on the points James makes about the regulatory pressure that it's in important to keep in mind. And I think particularly when we're talking about human rights, that responsible investment is a broad concept. Um, so at one end of the spectrum, you can have looking at, or ESG integration as managing downside risk. In SFDR terms, maybe talking about the article six funds here, maybe even article eight funds, which are actively managed, but tracking a benchmark. And then at the other end of the spectrum, we have the more ethical and normative considerations that you would see perhaps more often in an article nine fund or in funds where you're not tracking an index that gives you, I guess, more space to consider the normative considerations. And, and in regulatory terms, we have these requirements that James talked about with the principal advert impact indicators and doing no significant harm. So, the reason I flagged this is that, uh, asset owners have different perspectives on what responsible investment is for them. And therefore, I think it's important to keep these distinctions into mind even though they can be difficult to distinguish between them in practice, if that makes sense

Jasper Cox

And particularly interesting to hear how you put into practice, some of those considerations that James mentioned in his answer. But can you give any specific examples of why investors should consider human rights in a systematic way?

Camilla Ogunbiyi

Yeah, I think, I mean, talking in spring of 2022, Russia provides a good topical example of why human rights matters, but also the correlation I talked about between governance and human rights, in our ESG analysis of Russia, we've not only seen the country fail the, good governance screen, but also for quite a long period, actually in our broader analysis of Russia, the country's been flagged for human rights violations. So I suspect that you would find that since the start of the year, again, talking, uh, sort of SFDR terms, you would find that article six funds have probably performed worse than, funds that take into things like good governance and, and significant harm for sovereigns. And some might that Russia is a unique or special case. But I think also if you look at, um, performance around the events in Belarus in 2020, you would see a on.

James Lockhard Smith

I definitely echo Camilla on Russia. I think that's a really good case study of the advantages of looking at ESG ahead of time. So, you know, Russia's long been one of the very worst G20 performers in our sovereign ESG ratings and especially on governance. So, in other words that, you know, there are quite a few emerging and frontier markets that are worse, but Russia was a standout outlier among the largest in the world. And, you know, it's ratings in our data are likely going to degrade in the coming quarters, but that's more to do with kind of the second order and third order effects of the invasion, you know, rather than the invasion itself. I think it's also the case that across the former Soviet union countries in Eastern Europe, we see a fairly clear association between ESG and borrowing costs except for Russia, where investors kind of gave it a pass because of its size and other factors, at least until February 24th.

So, you know, there's definitely not a one-to-one mapping between being very poor a very poor performer in ESG and invading a neighbouring country. But the point is that the two are kind of morally consistent with each other, and that's been the problem for the, the investment, the investment ecosystem in recent weeks. And, you know, hindsight is of course always easy, right? But it's a clear case where taking a step back and carefully reviewing the country and at least making a plan in case things went pear shaped with an extreme event, like we've seen would've born fruit. I think, you know, investors would've been slightly better able to respond to what happened in terms of perception, sanctions, and everything else that followed that we know about. And, you know, we don't want to make this all about Russia, right? I, the, the broader point for me is it's kind of more systemic, right?

Where's the next Russia? there are plenty of other countries with very questionable human rights and labour rights records where markets have found a way of kind of glossing over or accommodating those issues. You know, just one example might be, you know, as we were all following, with horror, what was going on in, Ukraine, you know, Saudi Arabia recently beheaded, a very large number of prisoners in one day. And you know, that past without a ripple or a blink in the markets, you know, I think the second reason, you know, why a systemic approach bears fruit is cause we're, we're kind of moving into a much more contested, geopolitical era where investors just can't take for granted that, you know, countries are on a positive trajectory when it comes to human rights. So if you look at the previous decade, I think a lot of best practice and rhetoric in, you know, emerging markets, sovereign debt was around gradual momentum and positive change on the basis that everybody was ultimately heading towards a common destination, but if that's not the case anymore, you know, what do you do?

And how gradual is, is too gradual in terms of year on year improvement in some of these metrics. And on the other side of the coin, as we've discussed with SFDR regulators in the west are pushing harder for human rights to be factored into investment processes. I do think that, you know, Brussels is at least partly flying the flag for a set of values, which it wants to encode in sort of the market ecosystem. And ultimately, you know, recent events have really placed the owners on EM investors to sort of demonstrate credibility on human rights. And I think it, it's ultimately too early to tell whether there's going be any lasting rethinking after this, or whether, you know, there'll be a kind of collective conclusion that, ‘Hey, you know, Russia and Ukraine was, was a one off’ and you know, we don't necessarily need to worry about it so much until, until the next crisis happens. Of course.

Jasper Cox

Yeah. And, and I, I think we've alluded to this in the discussion so far, but I just wanted to draw out in a bit more detail. What's different about when, when you are considering human rights in sovereign debt compared to corporate debt, what what's different about sovereign debt?

James Lockhart Smith

Well, with corporates, you're typically looking at a subset of labour rights risks, where the industry and activity, the nature of the commodities involved and so on the supply chain make those labour rights directly relevant to the corporates. So, you know, cliche examples could be child labour and occupational health and safety in construction, right? And, you know, looking beyond labour rights, there are also some isolated cases where the human security or human rights of a country become directly relevant to a corporate in terms of responsibility because the corporate is somehow associated. So, you know, for example, it's historically been very common in the case of extractive firms and some emerging or front arm to have state security forces, guarding mind sites, and potentially committing abuses that the company is then complicit in. But when we come to sovereigns, the main difference is that they are always directly responsible for a very broad range of human, civil and political rights and human security.

And then they're also actually the ultimate guarantors of the same labour rights that are relevant to corporates. So, you know, on that latter point, I mean, corporates bear responsibility, but governments are also ultimately setting the rules of the game for the companies. And in some of the countries that we research in, you know, in Maplecroft are also directly encouraging labour rights abuses or, or poor labour practices. So, you know, government ultimately have a much broader and deeper responsibility here. I think there are probably some other differences, but that I'd definitely highlight that as the main one.

Camilla Ogunbiyi

Yeah. I would use that to that. I think James is completely right that governments both set the rules and police those rules, and that's what we, as investors then need to assess both of those perspectives. In addition to that, I'd just come back to the point I made earlier about delivering public goods and raising living standards. It it's another important perspective on human rights in sovereign debt investing that we need to keep in mind and something I think sometimes get lost in the narrative around human rights considerations in investments. But something, I think investors are already very good at doing, given our focus in my team on emerging market debt. I'd also flag that states have very different capacities very different current situations that, that they're in, in terms of development.

And we should therefore be careful of, of judging all countries by the same standards. And I say that not to dismiss the universality of, of human rights, but just to remind ourselves of this developmental perspective, maybe sometimes we forget, you know, at what level of development we were in, in, in Europe, for example, before we ended practices such as slavery or child labour. And I think that's, that's just important for, to remember another important point where, where sovereign debt, in particular is, is different, for example, from equities investing. But to some extent, I think fixed income investing in is that our investment universe is, is small compared to when you invest in equities. And so having large scale exclusions can become more challenging, uh, because you, you simply then have a, a very narrow universe to, uh, to invest in and, and that can be challenging and in terms of diversifying risk and so on, again, here coming back to this article six, article nine distinction, and, and where, you know, if you are investing, tracking a benchmark, then, then these, um, large scale normative exclusions can be very difficult when you operate in a sovereign universe.

So, the nuance and complexity that you mentioned in your opening remarks, Jasper, I think is really important to keep in mind when we talk about human rights.

Jasper Cox

Thanks, Camilla, and key consideration there, the size of the investment universe. Moving on now to data, human rights. It's so sort of all encompassing and, you know, we read and watch so much news, which relates in some way or another to human rights every day. How can investors find and use data to make sense at all?

James Lockhart Smith

At Verisk Maplecroft. We, I guess, do our best to draw on the full range of sources that are available to try to create clear and robust data points for our users across, you know, really all human rights, labour rights, and also, you know, human security. That last one is also very important. We use a mix of methods and in particular, we rely heavily on massive consumption of unstructured, text data using, um, automated methods and machine learning. So, we actually used to have analysts coding countries manually, but we discovered we could get more robust results by using these other approaches. And that also brings, um, a lot of scalability. And then another advantage of that scalability is that, you know, I know that today's session is about sovereign debt, but we're actually looking below the sovereign level as well to score thousands of provinces sub nationally around the world.

So, the sovereign scores are kind of an aggregate of what happens at the local level. So we're looking at these issues through the lens of structure, process, and outcome indicators. And that's an approach which is aligned with, you know, what's been mapped out by the office of the UN high commissioner for human rights. So by structure, we really mean national legislation and international treaty commitments of states. So, to what extent, the question we're asking is to what extent is there a legal structure in place that recognises human or labour rights as existing and deserving protection. By process, which is the second leg of the stool as it were - we mean everything that the state is then supposed to do to actually implement protection of those rights. So what we're asking is like what institutions and enforcement mechanism exist? You know, how well funded are they, are there any other factors like, um, you know, corruption, for example, especially security force corruption that undermine effective implementation and so on and so forth.

And then by outcome, we mean the actual rights violations themselves. Now the outcomes typically get a, they do get a high weighting in our indices, but we regard structure and processes absolutely crucial. So, you know, remember here that we're producing measures of risk that are supposed to guide action before a crisis. We're not looking to, you know, produce noisy and volatile outcome scores after the event. So, you know, it's often the case with our data, at least that when some particular crisis hits the news, um, it doesn't always involve a downgrade because both the surrounding structure and process, uh, uh, data points and also the actual stream of previous events recorded in the outcome data had effectively sort of baked what has just happened into the scores. And, you know, just by way of example, I mean, we actually saw that happen with, again with Russia on security, for horses and human rights, their outcome score on that particular index of ours was already so close to the bottom that, you know, when, when the country moved into Ukraine and began doing what it did, you know, that actually gave that particular data point limited further and to fall.

So, yeah, hopefully that gives you a picture of, you know, how, at least how, you know, it Maplecroft were thinking about, you know, taking, all of the data that's out there and turning it into, um, hopefully decision useful signals for investors.

Camilla Ogunbiyi

Maybe I can just add to that, that, you know, as an investor, it's incredibly helpful to have data providers who do that work, you know, cancel out the noise as James mentioned, but generally, I think, and particularly with your rights, the data out there is, is unstructured data and having a data provider who can structure that data in a way that minimises subjectivity in the assessment is incredibly helpful, sorry. As an investor, maybe one thing I'd add to it. I mean, games already talked about the gradual nature of change. But, um, one thing that we, I think as investors need to be careful of when we rely on data is that the data can be lagged when tracking positive trajectories. And, and there's good reason for that, you know, progress is slow and, and it's not necessarily linear.

The one step backwards is sometimes kind of noticed more than, than the slower two steps forward. And a good example of that. I think we saw in, in Uzbekistan where in 2016, when the current president came to power, he very short, the afterwards promised to end this practice of state sponsored, use of forced labour in the cotton industry, but it's taken more than five years for the country to get to a point where the cotton campaign has ended that boycott of Uzbek cotton. So it tells us how, how slow the progress is. And in that period, maybe what, what the biggest new stories have been has, has been when, you know, we've had documented examples that actually forced labour was still happening. Um, so data's really important, but, but having nuanced assessments, uh, particularly when it comes to positive trajectory and, and kind of forward looking analysis, I think is, is really important as well.

Jasper Cox

Thanks, Camilla and I've got one final question for you. We, we argued in our paper that investors should work to engage more with governments on human rights as an investor. Do you think that's feasible?

Camilla Ogunbiyi

Yes. I think it's very important for investors to engage with sovereigns in general and also specifically on human rights at the same time, I think we need to be realistic about the limitations, if you like on, on sovereign engagement generally. And, and perhaps particularly on these contentious issues like governance or human rights, it's a complex exercise to do sovereign engagement. We have issues like the political legitimacy of foreign investors coming to tell democratically elected governments, how, uh, how they should do things or how they should think about things. Um, and, and in the emerging markets, basically also the challenge that engagement on USD grounds is a form of kind of 21st century soft imperialism, where Western investors come and tell countries how they should perceive of environmental or social issues, for example.

So, we need to keep those challenges and sensitivities in mind, but I think it's very important for investors particularly to leverage the existing avenues of engagement, roadshow events, and one-to-one investor calls are very good opportunities to bring up these concerns that you might have as an ESG focused investor. And you can gauge the reaction of, of the government. So, you have the benefit of signalling the importance of the issue, but you also get a sense of whether the government understands that there's challenges with respect to the issues that you raise and whether they would be willing to engage on the topics. So I think there's a actually a lot of scope for investors to do more of that. And then at the other end of the spectrum, you could consider the kind of bigger collaborative engagements where investors come together to flag issues and engage with sovereigns. I think again, we need to, to be careful of how we frame those types of engagement, being mindful of, complexities and, and the sensitivities that I mentioned before. But certainly something to consider going forward.

Jasper Cox

Mm yeah. So you'd say sort of lot to think about in terms of choosing the right moments and the rights, time and place.

Camilla Ogunbiyi

Exactly. Yes.

Jasper Cox

Thank you both for your time today, Camilla. and James. You can find links to our resources on human rights and sovereign debt in the episode description, and also at the PRI sovereign debt websites, which is www.PRI.org/sovereign-debt. Please also take a unpri.org/fi.Thanks for listening and tune in next time.