

Morgan Stanley

INVESTMENT MANAGEMENT

# 2023 Fixed Income Engagement Report

FIXED INCOME | 2023

MARKETING COMMUNICATION

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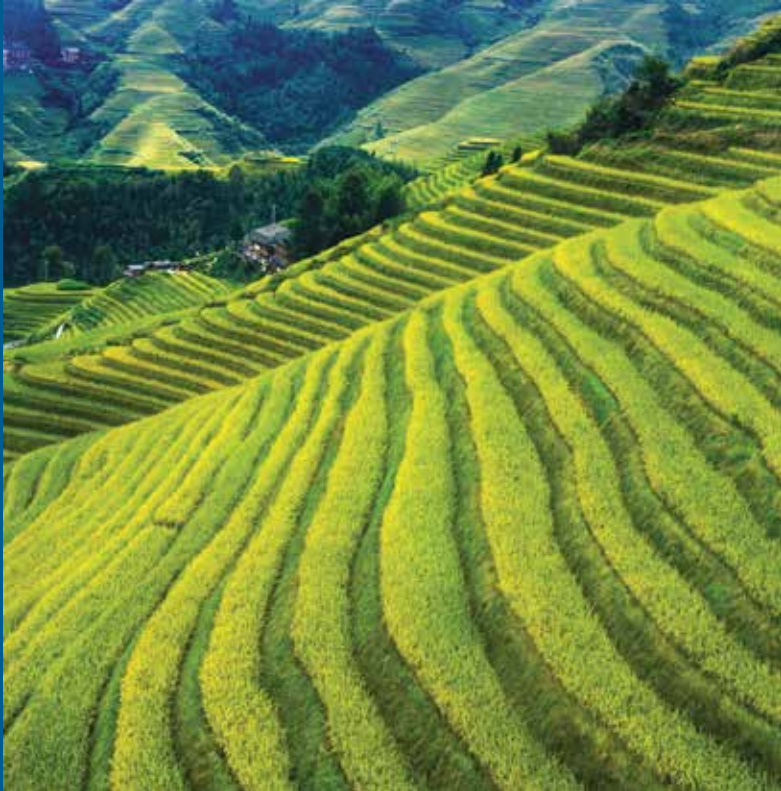
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These examples represent how the portfolio management team(s) generally implements its investment process under normal market conditions. Individual funds and client accounts may have specific ESG related goals and restrictions. Please refer to governing documents of individual vehicles to understand their binding ESG criteria.

# Foreword

“Fixed income investors should play an active role in engaging with the breadth of bond issuers they have access to, seeking to promote transparent credit markets and positive sustainability outcomes.”



**BARBARA CALVI**  
*Executive Director,  
EMEA Head of Fixed Income  
ESG Strategy and Research*

Integrating environmental, social and governance (ESG) considerations into fixed income portfolios is a growing priority for many fixed income investors seeking to broaden their alignment with the Paris Agreement and the United Nations (UN) Sustainable Development Goals (SDGs). In the same spirit, industry platforms like the Principles for Responsible Investment (PRI)<sup>1</sup> and the UK Investment Association<sup>2</sup> emphasise the need for fixed income investors to catalyse sustainable transformation by engaging with debt issuers.

At Morgan Stanley Investment Management (MSIM), we believe it is intrinsic to our mandate as long-term, active investors to maintain a constructive dialogue with issuers across their capital structure and support them in aligning with material sustainability objectives that can help generate better financial outcomes. Our Fixed Income organisation has a long history of credit-related engagement. Since 2020 — when we first

published our Fixed Income Engagement Strategy<sup>3</sup> — we have been supplementing that with a structured approach to ESG-focused engagement across corporates, agencies and sovereigns.

Over the 12-month period from July 2022 to June 2023, the investment teams within the Fixed Income organisation conducted over 160 engagement meetings with selected bond issuers, continuing to focus on the theme of decarbonisation and adoption of science-based emissions reduction targets. Nevertheless, macroeconomic issues such as the Russia-Ukraine conflict and its implications for energy access and cost, inflationary pressures and the rising costs of living around the world led to a growing focus on social inclusion, labour and human rights, and good governance.

Looking ahead to the rest of 2023, we plan to further evolve socially-related engagement as part of our bilateral meetings with issuers, as well as through selected collaborative initiatives with other investors.

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<sup>1</sup> [Responsible investment in fixed income](#)

<sup>2</sup> [The Investment Association, Improving fixed income](#)

<sup>3</sup> [Fixed Income Engagement Strategy](#)



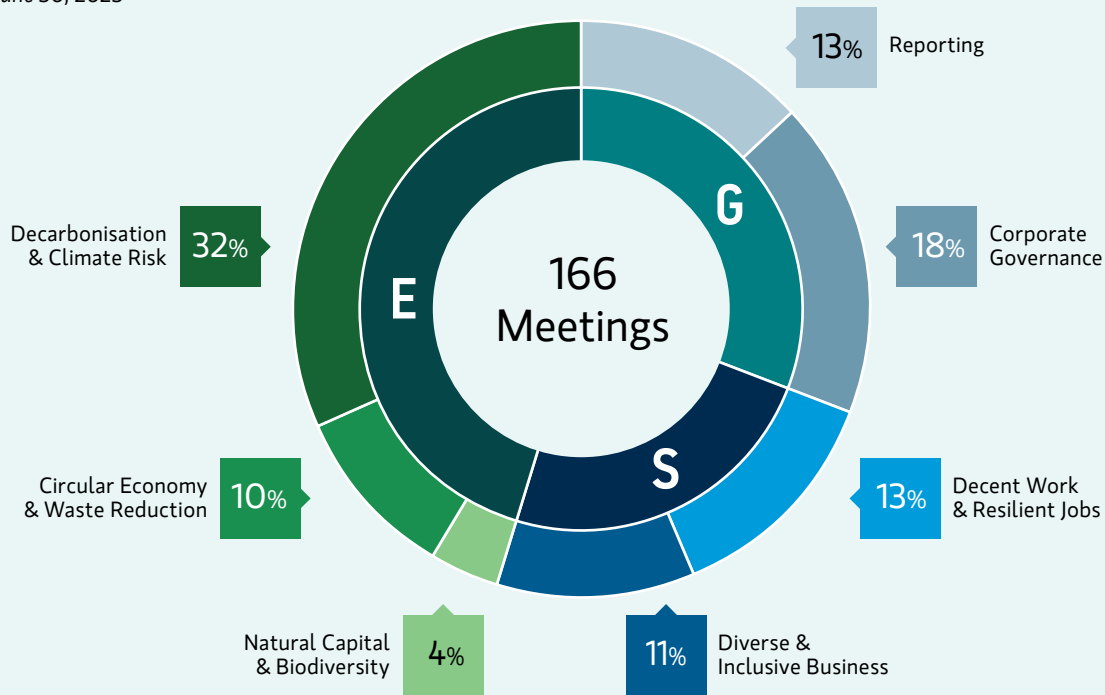
INTRODUCTION

# Engagement by the Numbers

DISPLAY 1

## Thematic Breakdown<sup>4</sup>

As of June 30, 2023



Over the past 12 months, issuers’ responses to climate change have dominated our ESG engagements. But other aspects of sustainability, particularly on the governance side, have been gaining prominence.

Decarbonisation and climate risk mitigation continued to be the most widely discussed topic in our engagement meetings over the past year. This reflects regulatory requirements for enhanced climate-related disclosure and scenario analysis, but also emerging opportunities resulting from policymaking across jurisdictions, such as the US Inflation Reduction Act and European Green Deal. We also aimed to cover the social side of the transition, including governance mechanisms to protect communities and workers, as well as wider social issues such as the promotion of equitable and decent work, as appropriate. We enhanced our focus on this topic through a thematic engagement series on the Just Transition with energy and utility companies (see section [‘Powering the Just Transition’](#)).

<sup>4</sup> This is based on MSIM’s thematic framework and refers to the predominant themes covered during the engagement; however, our dialogues normally cover multiple ESG issues. Data refers to number of themes covered across all engagements. In 2023, we have started tracking Natural Capital & Biodiversity as a theme in our engagements. Numbers may not add up to 100% due to rounding.

In 2023, MSIM added Natural Capital & Biodiversity to the Firm’s thematic engagement priorities, seeking to support business models that promote biodiversity, in line with the spirit of the Global Biodiversity Framework. Biodiversity was at the centre of a growing number of our engagement meetings, particularly following the COP15 conference, which culminated in targets to restore, conserve and manage at least 30% of degraded terrestrial, inland water, and marine and coastal ecosystems by 2030.<sup>5</sup> Notably, the COP15 conference recognised the role of indigenous people and communities in the protection of biodiversity, embodying the rise in global awareness of climate justice and the protection of those most hard-hit from the effects of climate change. We therefore engaged with issuers, particularly in the food & beverage sector but also in utilities and financials, on the recommendations from the Taskforce for Nature-related Financial Disclosure (TNFD) and other initiatives to protect and promote biodiversity, as appropriate, in order to help mitigate climate-related risks to the companies and identify opportunities that could benefit their business.

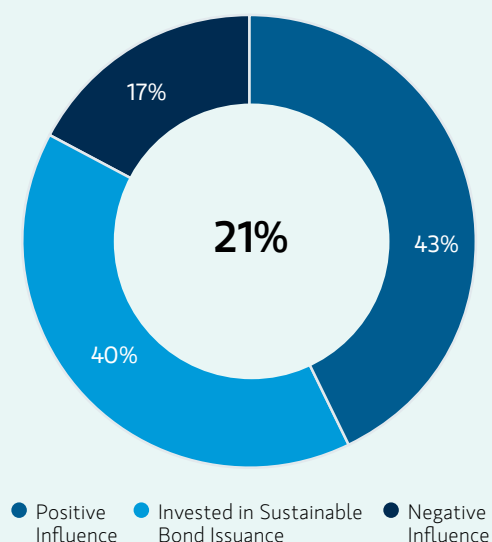
We aim to engage with purpose, and may rely on the additional insights from such meetings to inform research and investment views. In the past 12 months, about 1 in 5 engagement meetings had some influence on our views (see *Display 2*). Our fundamental research analysts deemed those issues to potentially impact the financial performance of the issuer. This may lead us to either increase our exposure to issuers making positive progress, or conversely, to decrease or sell our investments in cases where an issuer fails to respond to our recommendations. These influences are related to issues including (but not limited to) the publication of ESG policies, the setting of sustainability goals and targets, and remediation mechanisms for controversies.

In our engagement with certain green and other labelled bond issuers, we continued to encourage the alignment of sustainable financing frameworks with the International Capital Market Association (ICMA)’s Green Bond Principles and other market standards, and we scrutinised impact reporting associated with these investments. We suggested specific improvements on the structure of green bonds, with a particular emphasis on eligible projects and reporting practices.



**DISPLAY 2**  
**Breakdown of Engagements Influencing Investment Views<sup>6</sup>**

*As of June 30, 2023, in relation to engagement meetings conducted over the previous 12 months*



<sup>5</sup> Kunming-Montreal Biodiversity Framework

<sup>6</sup> “Invested in Sustainable Bond Issuance” refers to engagements on an issuer’s labelled Green/Sustainable bond framework, where the engagement meeting contributed to our decision to invest in a new issuance or to hold/increase exposure to an existing one. Numbers may not add up to 100% due to rounding.



# Raising Our Standard of Engagement





66%

### Investment Grade

Investment grade issuers tend to be the primary target of our engagement as they have, in general, larger quantifiable externalities, and the resources to rapidly react to market stakeholders' feedback. They tend to be the first entities to fall under the scope of new regulatory sustainability disclosure obligations, providing room for us as investors to not only conduct more in-depth ESG analysis, but also to guide them on best practices.

19%

### High Yield

We have been growing our engagement with high yield bond issuers, reflecting greater investor attention to ESG factors in this asset class and the increase of labelled sustainable high yield bonds. In some cases, our large bond holdings play as levers of influence. We emphasised the importance of alignment with industry guidelines, such as those on ESG disclosure for high yield issuers from the [European Leveraged Finance Association](#) (ELFA).

10%

### Emerging Markets

Issuers in emerging markets also accounted for a higher proportion of our engagements this year. As discussed in our [ESG Outcomes in EM Debt](#) paper, our efforts are concentrated around improving market openness and efficiency, the accountability of institutions and corporate governance, and promoting countries' financing of their sustainable development priorities.

The sector breakdown of our engagements reflects how we continue to prioritise dialogue with hard-to-abate, carbon-intensive sectors like utilities & energy - focusing on the decarbonisation of fossil-fuel based activities.

In the past year, we have also increased our engagement with financial institutions, which accounted for 19% of our

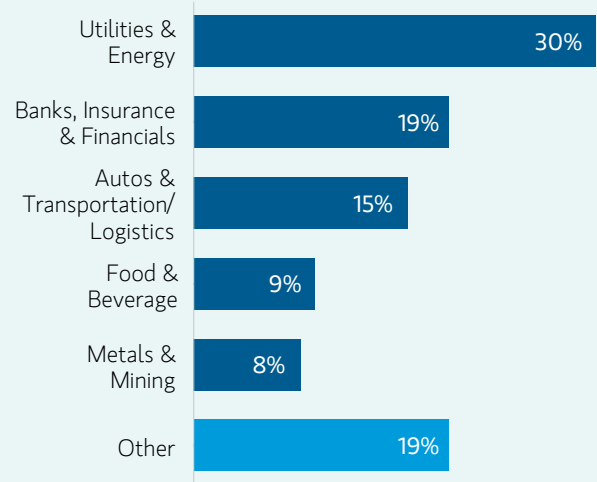
meetings. We recognise the role of financial institutions in mobilising capital towards sustainable solutions, and to engage with their clients on their transition to reduce financed emissions. In our 'Sector Spotlight' on financials, we share take-aways from our engagement with banks around their climate-related policies, and how they have worked to remain consistent with their sustainability commitments while providing capital during a global energy crisis.

Finally, our focus on metals & mining companies continued to grow. This was supported by MSIM's participation in the PRI Advance stewardship initiative, launched in December 2022. Through this initiative, we have started to engage with a number of mining and renewable companies around human rights, to seek to align their business practices with international norms and help mitigate financial risks from controversies.

#### DISPLAY 3

### Sector Breakdown

As of June 30, 2023. Numbers may not add up to 100% due to rounding.



## Key Areas of Engagement

Consistency between business strategy and sustainability objectives

Adoption of science-aligned emissions reduction targets

Robust governance & oversight systems

Comprehensive sustainability disclosure & reporting

Percentages represent the percentage of total engagements dedicated to a specific sector.



# Building a Robust Platform for Sustainable Development





Demonstrable sovereign alignment with the UN Sustainable Development Goals (SDGs), or positive momentum towards the goals, can make sovereign credits more attractive from a risk-return perspective. We believe that sovereigns who set ambitious and robust sustainable development policies are more likely to capitalise on social and economic development and to maintain access to financing at better terms compared to lagging peers, potentially enhancing the longer-term value of their bonds.

Over the reporting period, we expanded the geographical distribution of our engagements. In particular, we increased our focus on Latin America (see *Display 4*).

Whilst engagements in EMEA and the US continue to comprise the majority of our engagements across varying sectors, our dialogues in LATAM have been concentrated on metals & mining and food & beverage companies. We generally encouraged improved disclosure and reporting across the supply chain on topics such as human rights and biodiversity.

5%

### Sovereigns, Supranationals and Agencies

Our unique position in fixed income to engage beyond corporates has resulted in an ongoing focus on sovereigns, and government-related issuers. Here, we

engage on improving sustainable financing frameworks and assess alignment with the [SDGs](#).

In 2022, green and other sustainable bonds issued by sovereigns constituted c.14% of total new labelled bond issuance<sup>7</sup> highlighting countries' growing reliance on these instruments to help raise financing for their socio-economic development and climate investment needs. Sustainable bonds can be particularly helpful for emerging market sovereigns to raise long-term financing, leveraging the greater transparency and discipline usually associated with allocation management and reporting for labelled bonds.

However, labelled issuance still represents only c.2% of the sovereign bond market<sup>8</sup> hence it is important to engage with sovereign issuers beyond the scope of sustainable bonds. Governments have an inherent mandate to promote economic and social development within their countries, and sustainability factors can be material to their credit profile and bond pricing.

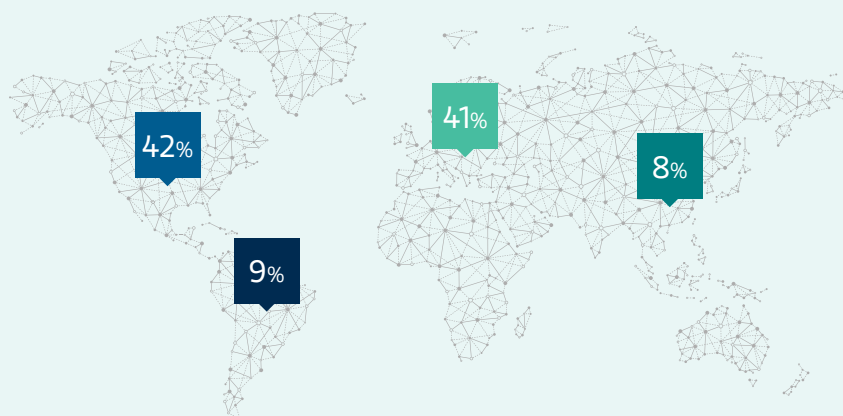
Some ways to engage with such large players, mindful of political sensitivities, include establishing a constructive dialogue on their plans to achieve existing commitments and frameworks, notably climate-related pledges like the Paris Agreement, and encouraging them to be consistent, especially when their targets fall short of science-based net-zero aligned pathways.

We also engaged with a number of emerging market sovereigns on their progress towards lagging SDGs, and, more broadly, on how countries can provide more frequent sustainability disclosure and impact-focused data.

#### DISPLAY 4

### Regional Breakdown of Engagements

As of June 30, 2023



<sup>7</sup> Sustainable Bonds Insight 2023, Environmental Finance.

<sup>8</sup> [How Large is the Sovereign Greenium? IMF](#)



An aerial photograph of terraced rice fields on a hillside. The fields are arranged in concentric, curved patterns, creating a rhythmic, wave-like appearance. The rice is in various stages of growth, showing shades of green and yellow. In the background, there are traditional wooden houses with dark roofs, and power lines run across the landscape. The overall scene is lush and green, with a mix of natural and human-made elements.

## Case Studies

“Our engagement on the Just Transition theme is driven by the aim to minimise the risks arising from the lack of outreach to core stakeholders, potentially affecting workforce productivity, relationships with communities, and ultimately financial performance. An equitable transition provides an avenue for companies to thoughtfully shape their initiatives to achieve positive sustainability outcomes in the longer term.”

—Rachel Smith (Analyst, Fixed Income ESG Strategy)



CASE STUDY

# Decarbonising the Utility & Energy Sectors in an Inclusive Manner: Tracking “Just Transition” Metrics over Time



We believe it is critical that the transition to a low-carbon economy occurs in a way that is equitable and socially inclusive, a concept commonly referred to as the “Just Transition”. This involves ensuring that workers, communities and nations are not harmed as companies embark on their decarbonisation pathways; instead, focusing on identifying inclusive opportunities for these stakeholders. In our view, that dialogue on the “Just Transition” must be contextualised and relative to the communities and regions in which an issuer operates. For instance, a power company operating in various emerging markets may need to be mindful of cultural heterogeneity in its construction of a just decarbonisation and fossil fuel phase-out strategy.

In 2023, we kicked off a Just Transition engagement series with select utility and energy companies—seeking to evaluate, on an ongoing basis, how these companies are navigating the impact of the low-carbon transition for the workforce, supply chain and communities. We believe that our key asks for these companies, framed around dialogues with affected stakeholders and the setting of time-bound targets, have potential to advance climate change mitigation and adaptation, improve socio-economic inclusion, and enhance the value of our investments.

Our series was structured around four salient areas based on the World Business Alliance’s Just Transition Assessment, to track each company’s progress over time:<sup>9</sup>

<p><b>1</b></p> <p>Labour Rights, Green Job Access &amp; Reskilling Opportunities</p>	<p><b>2</b></p> <p>Human Rights &amp; Engagement with Local Communities</p>	<p><b>3</b></p> <p>Supply Chain Management</p>	<p><b>4</b></p> <p>Disclosure, Regulation &amp; Policy Advocacy</p>
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## Tracking Key Just Transition Indicators to Assess an Issuer’s Momentum

COMPANY	CURRENT PERFORMANCE				MOMENTUM				MSIM RECOMMENDATIONS
	WORK-FORCE	LOCAL COMMUNITIES	SUPPLY CHAIN	DISCLOSURE & ADVOCACY	WORK-FORCE	LOCAL COMMUNITIES	SUPPLY CHAIN	DISCLOSURE & ADVOCACY	
European Energy Company	●	●	●	●	➡	➡	➡	⬆	<ul style="list-style-type: none"> <li>Disclose percentage of internal hires for new green positions.</li> <li>Disclose number of new green jobs created.</li> </ul>
US Energy Company	●	●	●	●	➡	⬆	➡	➡	<ul style="list-style-type: none"> <li>Disclose figures on employee reskilling.</li> <li>Include Just Transition categories and data in future sustainable credit facility agreements.</li> </ul>

Current Performance/Momentum Scale: ● Positive ● Neutral ● Negative

The Case Studies are provided for illustrative purposes only. There is no assurance that the engagements will be successful and/or result in positive investment outcomes.

<sup>9</sup> [Just Transition Assessment 2021, World Benchmarking Alliance.](#)

## CASE STUDY

# Powering the Just Transition



“As part of our Just Transition engagement series, we requested to meet with an energy company, considered a ESG leader in the oil & gas space, to assess the impact of the company’s transition on the workforce, supply chain and broader community.”

—Sam Rodiger (*Senior Associate, Fixed Income ESG Research Specialist*)

### BACKGROUND

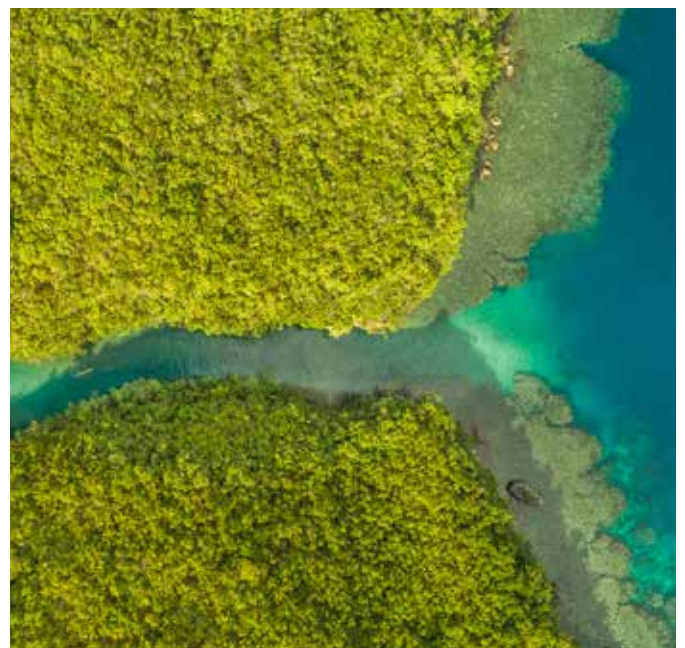
When it comes to the Just Transition, many utilities and energy companies may not necessarily walk the talk in terms of setting time-bound, measurable net-zero targets, whilst ensuring the protection of the human rights of employees and other stakeholders. This formed the purpose of our engagement with a hydrocarbon production company that is considered a leader in carbon capture and storage and has a low-carbon transition process that is assessed as advanced according to the [Transition Pathway Initiative](#) (TPI) framework.

### COMPANY RESPONSE

- The company had conducted an outreach to the wider community, educating residents on the difference between carbon capture assets and the activities of typical pipelines. The interaction evidences the company’s commitment to stakeholders in the energy transition.
- However, the company did not set a clear strategy relating to workforce or community engagement, or the transition of employees towards low-carbon business segments. For example, the company did not include workforce engagement related KPIs in their sustainable credit facilities, only focusing on environmental and carbon capture KPIs.
- Even with operations in low-carbon technologies, energy companies will face increasing difficulty in attracting skilled talent to critical roles in what is viewed as a declining industry. The company stated that they will not be introducing new transition-related roles, instead planning to extend existing high-skill roles to include a transition focus. The company relies on independent, often lower-skilled, third-party contractors for critical drilling and carbon capture infrastructure operational roles. These contractors are not included in the transition strategy.

### RECOMMENDATIONS & OUTCOME

- We strongly encouraged the company to explicitly disclose figures on employee reskilling in relation to energy transition activities. We provided examples to the company of transition data metrics, such as the number of new jobs created and employee turnover statistics.
- We also recommended that in the case of any asset divestments, the issuer contractually ensures that efficient operations and community relations will continue under new ownership.
- Given the significant transition and social risk associated with a lack of workforce and community engagement, which can result in enhanced financial risk to the company, we aim to follow-up after the company’s next reporting cycle to monitor our suggested action points.





## CASE STUDY

# Tackling Supply Chain Greenwashing



“This interaction is evidence of how we endeavour to conduct targeted and meaningful engagement with a company to evaluate material controversies and deepen our understanding of how issuers manage their relationships with stakeholders. The information gained serves as a quality input to our evaluation of an issuer.”

—Henry Mason (*Vice President, ESG Research Specialist*)

## BACKGROUND

We asked to meet with a high yield biomass power company in Q1 2023 to assess the actions taken by the company in relation to a biodiversity-related controversy, claiming that the company uses imported wood pellets sourced from primary and environmentally important forest.

## COMPANY RESPONSE

- As a result of bioenergy-related operations, the company is reliant on government subsidies to maintain earnings, leading to greater regulatory risk and potential weaning of government support in the case of controversies around pellet procurement. The company clarified that they depend on pellet suppliers to provide them with data on the quality of logs procured, with the suppliers being required to justify their classifications to auditors.
- On the future of biomass power, the company stated that the energy crisis triggered by the Ukraine-Russia conflict had strengthened support for the use of bioenergy with carbon capture and storage (BECCS)—due to the ongoing need for baseload power despite a regulatory backdrop of coal and gas phase-out. The company reiterated that the only credible pathway to meet regional net-zero targets and decarbonisation pathways would be to use their own facilities.

## RECOMMENDATIONS & OUTCOME

- Our analyst recommended that the company improve disclosure on the following aspects, in their next report:

1. Forestry certifications and environmental externality management;
  2. Emissions intensity figures across all three scopes; and
  3. Sourcing, to help investors understand what requirements fall under the company's direct operational control and where the company must partner with upstream or downstream suppliers to fulfil regulatory obligations.
- In Q2 2023, the energy regulator in the company's jurisdiction announced a formal investigation into the accuracy of the company's sustainability reporting data, namely whether their sourcing of wood pellets is in breach of sustainability requirements.
  - Currently, we have decided to divest from the company's bonds given multiple controversies surrounding the company's wood pellet sourcing processes, and potential greenwashing of sustainability data, mitigating our exposure to linked regulatory and financial risk. We aim to monitor whether the company has adopted our recommendations on disclosure.
  - We approach engagement as an on-going process, particularly given the real-world constraints that many energy companies face in the low-carbon transition, and we remain open to the possibility of future investment in the company if it can achieve the ESG standards that we expect from investee companies.







## CASE STUDY

# Engaging on Responsible Governance and Inclusion in Complex Value Chains



88% of disclosed emissions derived from the food sector are generated in the supply chain<sup>10</sup>

### BACKGROUND

In the second half of 2022, we conducted our second engagement meeting with an emerging market meat-processing company that was rated as a laggard by third-party ESG data providers, primarily due to poor governance. The objective of the engagement was to encourage improved disclosure of upstream considerations of human rights, and increased ambition on labour management diversity, to secure the business's license to operate. Our first meeting with the company, earlier in the year, had focused exclusively on environmental issues.

The meeting was conducted in collaboration with MSIM's Global Balanced Risk Control Team (GBaR).

### COMPANY RESPONSE

- The company provided details on some of their recent initiatives to strengthen social inclusion and labour management. This included the appointment of a new global chief ethics and compliance officer, and creation of a Global Executive Ethics & Compliance Committee to ensure a more robust oversight of management and employee behaviour.
- They had also launched a fund to support indigenous communities around their operating areas, including initiatives to enhance connectivity. A refugee training programme had also been started, given the recent growth in migration flows, to enable refugees to enter the workforce. However, the company did not refer to quantitative diversity targets.

- Shortly after our second meeting, the company hired their first global Chief Sustainability Officer, in order to improve the governance of the sustainability strategy and accelerate progress on environmental and social initiatives.

### RECOMMENDATIONS & OUTCOME

- We asked that the company improve their reporting practices. We suggested that they set quantitative diversity targets and publish additional data on health and safety in their operations across geographies. We were pleased that the company had also highlighted their continued monitoring of environmental issues, following our previous engagement. Given that the company is a leading global meat-processing player and one of the largest employers in their country, we believe it is critical to remain engaged with them to push for further progress. Enhanced disclosure can help us make more informed investment decisions.
- Following both engagement meetings, the company improved its performance on the CDP 2022 Climate Change Report with a change in its score from "B" to "A-" (best practice), positioning themselves as a leader within their industry. The shift can be linked to the expansion of projects and disclosure promoting the circular economy and use of renewable energy in production and operational processes. We plan to continue to monitor their social and governance progress based on our recommendations.

<sup>10</sup> 88% of Emissions from food value chain companies are sourced outside their direct control (scope 3 emissions), [Carbon Disclosure Project \(CDP\): Hungry for change: Are companies driving a sustainable food system?](#)





An aerial photograph of a lush green field with several trees and their shadows cast across it. The scene is captured from a high angle, showing the texture of the grass and the dense foliage of the trees. The lighting suggests a bright, sunny day, with long, dark shadows stretching across the field.

## Sector Spotlight

“Financial institutions have the unique opportunity to be influential stewards of the transition to a low-carbon economy, further driven by the rising risks in failing to do so. Given the sector’s rate of change, we conducted a series of meetings with banks and other financial institutions, to assess alignment with industry standards on climate stress testing and data availability, and to identify leaders and laggards.”

—Chiara Sirani (*Associate, Fixed Income ESG Research Specialist*)



## CASE STUDY

# Engaging with Financials to Reduce Financed Emissions



### Too Big to Fail?

As financiers of emissions through their lending activities, financial institutions can play a key role in facilitating the net-zero transition, and in supporting their clients' adoption of sustainable practices. This was reiterated in the [Sharm el-Sheikh Implementation Plan](#), an achievement of the COP27 conference on climate change, which called on financial institutions to align and increase sustainable financing addressing the climate emergency.

We believe that prudent supervision of climate risks is an increasingly relevant consideration for banks in mitigating potential financial, shareholder and other transition risks. Regulatory developments have echoed this call, with the European Central Bank requiring banks in its jurisdiction to carry out climate stress testing to ascertain the banks' weaknesses and resilience in the case of climate-related risk.<sup>11</sup>

On the issue of climate-risk management, we noted similarities in financials' consideration of climate stress testing, but variation in definitions of high-risk sectors and regions, and little preparedness in terms of capital allocation. While institutions have been upgrading financed emissions reduction targets, the scope of this target varied to include only loan books, and/or facilitation activities. This formed the basis of our recommendations to increasingly disclose these metrics to investors as capabilities are developed.

### Background

In early 2023, we requested an engagement meeting with a bank to evaluate measures taken in response to a climate-related lawsuit brought against them, relating to the bank's financing of companies developing oil & gas projects. As a European-headquartered financial institution, the bank operates in a context of enhanced stakeholder and regulatory scrutiny around climate change. A second objective of the engagement was to examine the extent of coverage of the bank's emission intensity reduction targets for its oil & gas lending practices.

### Company Response

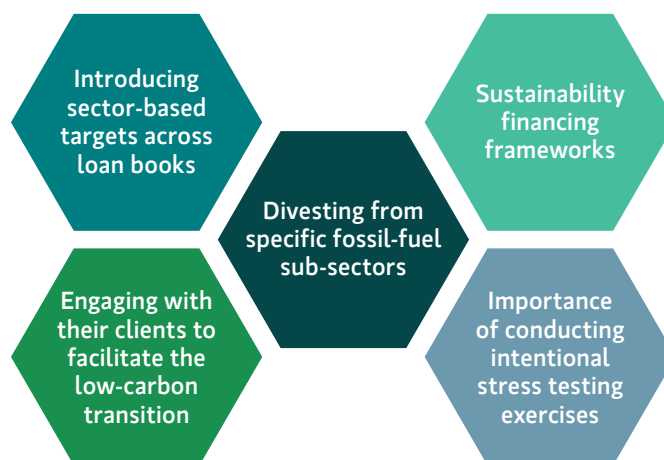
- The bank's representatives, from the Investment Banking and Capital Market divisions, noted that they were the

first commercial bank to exit the financing of unconventional oil & gas projects, with the target of an 80% absolute reduction in the financing of upstream oil & gas by 2030. The bank has set sector-specific targets for reducing GHG emissions, and we were pleased that methane gas has been included in the target given that it is a major source of GHG emissions.

- The bank described how their decarbonisation efforts have placed them ahead of their peer group, including a stringent deforestation policy, multiple datasets to identify laggard clients, and quarterly client engagements. Representatives believed that climate litigation risk will exponentially increase in Europe.

### DISPLAY 5

#### Engagement Topics with Financials



### Recommendations & Outcome

- Our analysts considered it positive that the bank had set sector-specific emissions targets, and recognised the measures taken to resolve the ongoing climate litigation. We encouraged them to extend the scope of their carbon-reduction targets to cover downstream oil & gas activities, as well as their capital markets division.
- The following quarter, the bank announced they will no longer provide financing for the development of new oil & gas fields, regardless of the financing methods. Our analysts found this outcome to be productive, with the bank strengthening its previous commitments.

<sup>11</sup> [2022 Climate Risk Stress Test, European Central Bank](#).

## CASE STUDY

# Driving More Transparent ESG Disclosure in Debt Collection

 **60,300** EU and non-EU companies will be subject to the Corporate Sustainability Reporting Directive requiring ESG disclosure.<sup>12</sup>

### BACKGROUND

In early 2023, the High Yield team initiated an engagement with a private debt collector that had poor ESG reporting and was unrated by third-party providers. The key ESG issues at the core of this engagement were fair customer treatment, privacy & data security, and overall corporate governance. Given the Fixed Income organisation's significant bondholding in this company, we intended to seek to mitigate any potential controversy-related risks to our investment.

### COMPANY RESPONSE

- Our team was concerned about the social and regulatory risk arising from misaligned incentives between the debt collection company and their customers, often making this business activity the target of consumer protection authorities. On the other hand, the company claimed to be best-in-class from an ESG perspective within their industry, citing previous audits which did not demand any remediation measures.
- The company outsources 60% of their collections to third parties, but reviews logged complaints and samples of customer calls to monitor interaction with customers. However, overall customer satisfaction is not systematically assessed.

### RECOMMENDATIONS & OUTCOME

- We recommended that the company conduct a materiality assessment of ESG issues, defining priorities and action points based on results.
- We advised them to work on developing customer treatment and third-party vendor policies, and to start with publishing an ESG report. The company agreed to internalise our feedback and to develop an ESG summary, to be made initially available to investors only.
- In Q2 2023, the company responded to the team's ask and provided investors with an initial ESG presentation and a selection of ESG metrics, including numbers on customer satisfaction. We appreciate the company's proactiveness and found this to be a highly satisfactory first milestone of our engagement. The team intends to build on this positive momentum, encouraging the development of new policies and publication of a full ESG report aligned with sustainability disclosure standards.



<sup>12</sup> [How many companies outside the EU are required to report under its sustainability rules?, Refinitiv.](#)



## CASE STUDY

# Encouraging an Outcomes-Focused Sovereign Sustainability Bond Framework



“Sovereigns pave the way for corporates to tap the sustainable bond market, especially in small, emerging market countries where climate-related financing is incipient. Engaging with sovereigns allows us to assess their sustainability priorities against gaps in SDG progress, encouraging best practices that can generate positive spillovers as the market develops.”

—Mariana Jordao (*Vice President, Fixed Income ESG Research Specialist*)

### BACKGROUND

We met with economic officers of a European sovereign issuer’s Ministry of Finance to discuss national environmental priorities on carbon taxation and energy efficiency. The government was looking at issuing debt in labelled sustainability bond format, with use of proceeds mostly allocated to social projects.

### SOVEREIGN RESPONSE

- A new government had recently been elected. We asked whether this would influence current ESG policy and learnt that the government expects to ramp up the pace of environmental change. The government is already providing subsidies for households to increase energy efficiency and/or use of solar panels.
- We raised the possibility of introducing carbon taxation on polluters, to which the representatives clarified that no draft bill on this matter had been tabled. Introduction of further green incentives and/or taxation will likely be in coordination with the EU Commission and be fiscally neutral.
- On the proposed sustainability bond issuance, the officers stated that the proceeds will be mostly allocated towards social projects, as climate projects are predominantly funded through international financial institutions. Rating agencies’ increased interest in ESG

partly contributed to the sovereign’s desire to issue in sustainable format.

- The Ministry intends to track impact indicators such as number of beneficiaries and jobs created. They have set up a committee responsible for monitoring progress and implementation. We recommended that in the sovereign’s impact reporting, the satisfaction of the beneficiaries, as well as indicators related to living standards in the target areas, should be considered to maintain an outcome focus, versus reporting only the number of beneficiaries (output).

### RECOMMENDATIONS & OUTCOME

- Our team found positive momentum, given the new government’s intention to be more ambitious with respect to their sustainability plans.
- The sovereign issued their inaugural sustainability bond the week after our engagement meeting. Our analysts found the framework to be material given the country’s high reliance on the service industry, with a high likelihood that the issuer will continue to originate eligible projects.
- We decided to participate in the new issuance, and plan to assess whether our recommendations have been onboarded following the publication of the country’s impact report.

Morgan Stanley Investment Management is a signatory of the PRI since October 2013. The Fixed Income organisation is also a supporter of the PRI-led “ESG in Credit Risk and Ratings Initiative.”

As part of the 2021 PRI assessment, MSIM Fixed Income received 5/5 stars and scored well above the median scores in the following modules:

MODULE NAME	MSIM AND MEDIAN SCORES (/100)	MSIM STAR SCORE (1 TO 5)
Direct - Fixed Income - Sovereign, Supranational, Agency	98 / 50	★★★★★
Direct - Fixed Income - Corporate	98 / 62	★★★★★
Direct - Fixed Income - Securitised	98 / 55	★★★★★

Source: PRI Assessment Report for Morgan Stanley Investment Management, 2021. Signatories report on their responsible investment activities by responding to asset-specific modules in the Reporting Framework. Each module houses a variety of indicators that address specific topics of responsible investment. Signatories’ answers are then assessed and results are compiled into an Assessment Report. The Assessment Report includes: indicator scores—summarizing the individual scores achieved; module scores grouping similar indicator scores together into modules (e.g. policy, assurance, governance) and comparing them to the median scores; and an aggregation of all the indicator scores within a module to assign a rating of 1 to 5 stars. PRI Score Methodology: do not do ESG/scored 0 to 25%: 1 star; > 25 ≥ 40%: 2 stars; > 40 ≥ 65%: 3 stars; > 65 ≥ 90%: 4 stars; > 90 ≥ 100%: 5 stars; More information is available on PRI website at <https://www.unpri.org/reporting-and-assessment/how-investors-are-assessed-on-their-reporting/3066.article>

These ratings apply to the firm and not that of any specific investment. Ratings are relative and subjective and are not absolute standards of quality. Ratings do not remove the risk of loss.

**For MSIM’s 2021 Transparency and Assessment Reports please follow the corresponding [link](#).**

## Meet the Team

**For more information on MSIM Fixed Income Engagement, please contact:**



**BARBARA CALVI**  
Executive Director,  
EMEA Head of Fixed Income  
ESG Strategy and Research



**RACHEL SMITH**  
Analyst,  
Fixed Income ESG Strategy

**For more information on MSIM sustainable investing activities, please visit: [Sustainable Investing \(morganstanley.com\)](#).**



# Risk Factors & Considerations

## Risk Considerations

ESG ratings are relative and subjective and are not absolute standards of quality. Ratings apply only to portfolio holdings and do not remove the risk of loss. There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to **market risk**, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events.

**ESG Strategies** that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance. **Fixed-income securities** are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest

rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes. Certain **U.S. government securities** purchased by the strategy, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the U.S. It is possible that these issuers will not have the funds to meet their payment obligations in the future. Public bank loans are subject to liquidity risk and the credit risks of lower-rated securities. **High-yield securities (junk bonds)** are lower-rated securities that may have a higher degree of credit and liquidity risk. **Sovereign debt securities** are subject to default risk. **Mortgage- and asset-backed securities** are sensitive to early prepayment risk and a higher risk of default, and may be hard to value and difficult to sell (**liquidity risk**). They are also subject to credit, market and interest rate risks. **Municipal securities** are subject to early redemption risk and sensitive to tax, legislative and political changes. The **currency market** is highly volatile. Prices in these markets are influenced by, among other things, changing supply and demand for a particular currency; trade; fiscal, money and domestic or foreign exchange control programs and policies; and changes in domestic and foreign interest rates. Investments in **foreign markets** entail special risks such as currency, political, economic and market risks. The risks of investing in **emerging market** countries are greater than the risks generally associated with foreign investments. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, and correlation and market risks. **Restricted and illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). Due to the possibility that prepayments will alter the cash flows on **collateralized mortgage obligations (CMOs)**, it is not possible to determine in advance their final maturity date or average life. In addition, if the collateral securing the CMOs or any third-party guarantees are insufficient to make payments, the portfolio could sustain a loss.

## UN SUSTAINABLE DEVELOPMENT GOALS

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A separately managed account may not be appropriate for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing. A minimum asset level is required.

For important information about the investment managers, please refer to Form ADV Part 2.

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