Index Insights | Sustainable Investment – Fixed Income

Decarbonizing fixed income investment

FTSE Fixed Income ex Fossil Fuels Enhanced Index Series overview

August 2022

AUTHORS

Zarina Nasib
Senior Product Manager
Sustainable Investment Product
zarina.nasib@lseg.com

Alan Meng
Research Lead
Sustainable Investment Research
alan.meng@lseg.com

FTSE RUSSELL
An LSEG Business

Introduction

As investors increasingly look to manage the carbon exposure in their portfolios, it is critical that they have the right tools. There are many ways investors can address the carbon exposure in their portfolios, including explicit divestment, tilting, optimization, and shifting assets toward companies that are developing greener solutions.

The FTSE Fixed Income ex Fossil Fuels Enhanced Index Series represents the performance of the bonds in FTSE fixed income indices after the exclusion of issuers that have exposure to the Fossil Fuel sector, through direct involvement or company ownership. This includes companies involved in fossil fuel production, related products or services, as well as distribution, retail, and power generation. In addition, in accordance with FTSE Russell's Baseline Exclusions Consultation, the index excludes companies involved in tobacco production, controversial weapons, and those companies violating the UN Global Compact through controversial conduct.

This index series helps meet the rising demand for calibrating exposure to fossil fuels in fixed income portfolios and provides a solution for asset owners and asset managers seeking bond benchmarks that help meet the global push toward net-zero greenhouse gas (GHG) emissions.

In this paper, we discuss some investors' need to reduce or calibrate their exposure to fossil fuels and carbon intensive assets, and the principal design features of the FTSE Fixed Income ex Fossil Fuels Enhanced Index Series.

Contents

Managing fossil fuels exposure in investment portfolios

Amid growing concerns about climate change and carbon in investor portfolios, many asset owners and asset managers are looking to reduce or calibrate their exposure to fossil fuels and carbon intensive assets and seeking to reorient their investments away from businesses whose products and services contribute to rising GHG emissions.

However, based on various investment beliefs and ethical positions, investors have adopted different strategies. These range from underweighting assets based on their carbon intensity or fossil fuels reserves (so called tilting approaches), to making exposure to carbon intensive assets contingent transition efforts of companies, for example, by leveraging Transition Pathway Initiative's (TPI) analysis of how the most carbon exposed/intensive public companies are managing the climate transition.[1]

Although the most common practice is to exclude securities linked to fossil fuels from investment portfolios (sometimes referred to as 'divestment'), there is a variety of considerations and practices that may lead to different exclusion approaches (summarized in Exhibit 1). For example, some investors focus their exclusions relatively narrowly on companies that produce the most carbon intensive fossil fuels (such as coal or tar sands). In contrast, others apply fossil fuels exclusions much more broadly (e.g., including conventional oil and gas production) or may even include value chains such as dedicated transport infrastructure (such as pipelines), oilfield services companies, or refineries. Similarly, some investors apply exclusions based on *any* exposure, while others may prefer to apply a materiality threshold (e.g., by defining a minimum revenue exposure to an excluded activity before excluding a security).

Exhibit 1. Different types of fossil fuels exclusions

		Approaches		
		BAU	**Partial**	**Full**
Considerations	**Type of fossil fuels**	No exclusions	Some, but not all types of fossil fuels (e.g., only coal & tar sands)	All types of fossil fuels, including, but not limited to thermal coal, petroleum, natural gas, oil shales, tar sands, etc.
	Industry value chain	No exclusions	Some parts of the value chain (e.g., only exploration & production)	The full value chain, including the exploration, production transportation and utilization of fossil fuels
	Asset classes	No exclusions	Select asset classes (e.g., only applied to equities)	All types of asset classes, including, but not limited to, shares, commingled mutual funds containing shares, corporate bonds, or other assets classes
	Exposure	No exclusions	May not exclude parent and/or subsidiaries, or only apply above certain revenue thresholds	Parent and/or subsidiaries of a company that is involved in these activities are also excluded

When it comes to fixed income, there are additional considerations for investors in identifying the links between a bond issuing vehicle and its parent corporates, mapping entities within corporate issuer trees and finding a sustainability dataset that is best fitted to the universe of securities, enabling granularity, stability, and comprehensiveness.

1 FTSE TPI Climate Transition Index.

How FTSE Russell is approaching the fossil fuels exclusion challenge in fixed income

In the design of the FTSE Fixed Income ex Fossil Fuels Enhanced Index Series, we have started from the premise that there is no single right way to approach the sustainability and fossil fuel exposure challenge in fixed income.

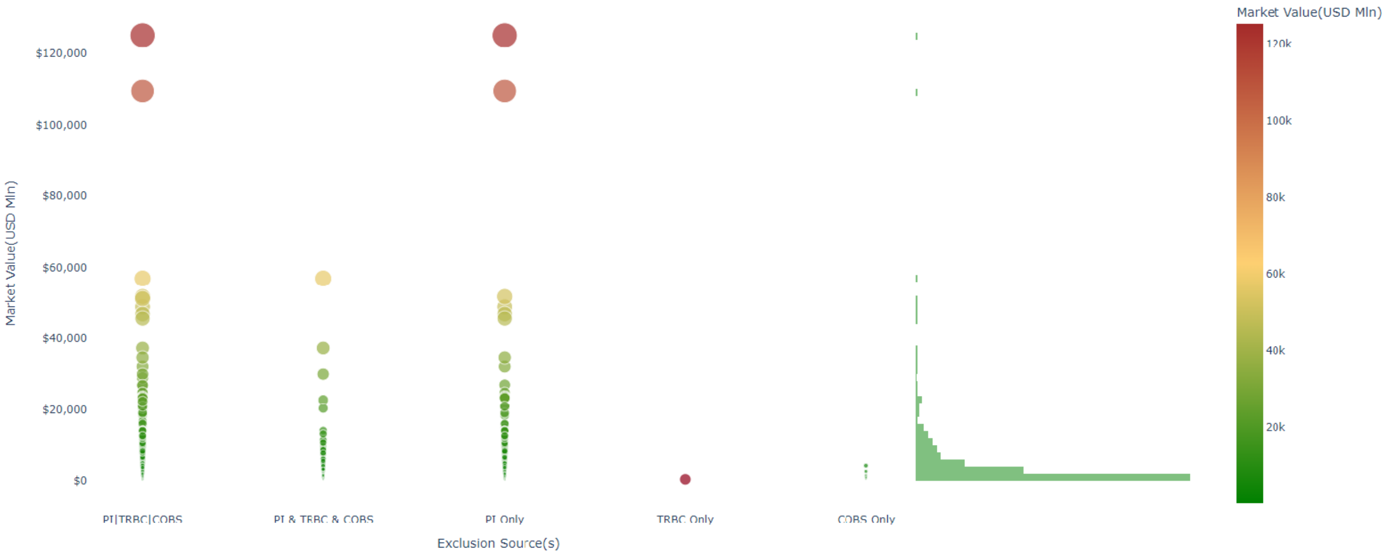
However, the index embeds the following key screening principles:

- The benchmark takes a conservative approach, excluding issuers that have exposure to the fossil fuel sector through direct involvement and company ownership. This includes issuers involved in production, related products or services, as well as distribution, retail, and power generation.
- Based on product involvement research, it removes companies that have any involvement in the respective categories of fossil fuels.
- It uses FTSE Russell's proprietary Corporate Bond Sector (COBS) and the LSEG TRBC Sector Classification (TRBC) datasets to screen further for possible exclusions.

While no dataset is perfect, these three screens (product involvement research, COBS and TRBC) help filter out bond issuers with involvement in fossil fuel-related activities and provide additional assurances to index users. In exhibit 2, we demonstrate the value that these multiple screens bring to the index.

The first column shows the total number of excluded companies based on all three datasets. We can see that most exclusions (unsurprisingly) come from product involvement research. However, columns 4 and 5 show the additional bond exclusions picked up by TRBC and COBS. Such additional exclusions are common in fixed income, where it's difficult to trace full ownership and there are often special purpose vehicles (SPVs) classified as financials. The overlap between the three datasets is captured in column 2.

Exhibit 2. Impact of Product Involvement Research (PI), COBS and TRBC datasets on index exclusions



Source: FTSE Russell.

FTSE Fixed Income ex Fossil Fuels Enhanced Index design

Below, we summarize the principal index design features of the FTSE Fixed Income ex Fossil Fuels Enhanced Index Series.

The first step is to screen bond issuers for fossil fuel-related activities, as described below. We then screen for involvement in other product and conduct categories:

Fossil Fuel Exclusion categories

- Oil and Gas
- Oil Sands
- Arctic Oil and Gas
- Shale Energy
- Thermal Coal

Additional Product Involvement Exclusion categories

- Tobacco
- Controversial Weapons

Controversial Conduct categories

Involvement in controversies related to the following United Nations Global Compact (UNGC)[2] principles:

- Human rights
- Labor
- Environment
- Anti-corruption

Product-related exclusions are determined by calculating companies' involvement in controversial activities, then excluding those bond issuers whose revenues in a particular product category exceed a maximum permissible revenue threshold (this threshold is set at zero percent in all fossil fuel categories, effectively ruling out issuer involvement). The product categories and exclusion thresholds are set out in the index ground rules.

The index series tracks companies' activity in certain products or services, not just in terms of direct involvement (where a company is directly involved in the production or distribution of a product, or in related services), but also in terms of indirect involvement through ownership.

[2] The UNGC supports companies wishing to do business responsibly by aligning their strategies and operations with Ten Principles on human rights, labour, environment, and anti-corruption. It also takes strategic actions to advance broader societal goals, such as the UN Sustainable Development Goals, with an emphasis on collaboration and innovation.

For example:

- If a company is indirectly involved in a product through the ownership of a majority stake (more than 10%) in an involved company, the parent company is considered involved in the same category as the subsidiary.
- In the case of a minority stake (less than 10%) in an involved company, the revenues of the subsidiary are not attributed to the parent(s), but the percentage of the ownership stake is captured in order to signal the level of control present in the relationship.
- In the conduct categories, the index series constituents are assessed as non-compliant, watchlist, or compliant by a dedicated oversight committee. The index then excludes companies that are assessed as non-compliant.

Exhibit 3. FTSE Fixed Income ex Fossil Fuels Enhanced Index Series controversial conduct screen

Companies are assessed as Non-Compliant, Watchlist or Compliant.

Assessments are approved by a Sustainalytics Oversight Committee.

Non-Compliant	Watchlist	Compliant
– Directly associated with severe and/or systematic violations – Inadequate response to address or remediate issues	– At risk of contributing to severe and/or systematic violations – Companies considered associated but unable to determine direct violation – Previously non-compliant but improving policies to prevent reoccurrence	– Not causing/contributing to severe and/or systematic violations of international norms and standards – Any allegations against the company have not met the criteria for Watchlist or Non-Compliant status

Eligible fixed income securities

The constituents of the FTSE Fixed Income ex Fossil Fuel Enhanced Index Series are derived from those of the underlying reference index (see exhibit 4), subject to the exclusions defined in the previous section.

Exhibit 4. FTSE Fixed Income ex Fossil Fuel indices and their underlying indices

FTSE Fixed Income ex Fossil Fuels Enhanced Index	Underlying Index
FTSE World Broad Investment-Grade Ex Fossil Fuels Enhanced Bond Index	FTSE World Broad Investment-Grade Bond Index
FTSE US Broad Investment-Grade Ex Fossil Fuels Enhanced Bond Index	FTSE US Broad Investment-Grade Bond Index
FTSE Euro Broad Investment-Grade Ex Fossil Fuels Enhanced Bond Index	FTSE Euro Broad Investment-Grade Bond Index
FTSE Australian Broad Investment-Grade Ex Fossil Fuels Enhanced Bond Index	FTSE Australian Broad Investment-Grade Bond Index

Corporate bond issuers with missing product and activity involvement data are excluded from the index series. Non-corporate issuers, such as governments, agencies, and supranational issuers are out of the scope of the exclusions and are therefore included, unless otherwise specified.

Data sources

Sustainable fixed income indices require robust, granular datasets to ensure the accurate representation of companies by their business activity and ownership. The following data sources are used in the construction of the FTSE Fixed Income ex Fossil Fuel Enhanced Index Series:

– **Product Involvement dataset**[3] is used in the FTSE Fixed Income ex Fossil Fuel Enhanced Index Series to verify bond issuers' product involvement and their compliance with the UN Global Compact.

– **LSEG TRBC Sector Classification (TRBC)** is a global, comprehensive, industry classification system owned and operated by LSEG. In the FTSE Fixed Income ex Fossil Fuels Enhanced Index Series, TRBC is one of the sources for identifying bond issuers' product involvement.

– The proprietary **FTSE Russell Corporate Bond Sector (COBS)** scheme is maintained for all bonds tracked by FTSE fixed income indices. In the FTSE Fixed Income ex Fossil Fuels Enhanced Index Series, COBS subsectors are used to screen the constituents of the underlying universe to determine fossil fuel issuers.

Index methodology

Once the FTSE Fixed Income ex Fossil Fuels Enhanced Index Series constituents have been screened, the remaining eligible securities are weighted by their market value, preserving the weighting scheme of the relevant underlying index.

Eligible Universe

– WorldBIG
– EuroBIG
– USBIG
– AusBIG

Fossil fuel screens

– LSEG D&A's industry classification system (TRBC)
– FTSE Corporate Bond Sector (COBS)
– Product Involvement dataset
– In addition, screens for Tobacco, Controversial Weapons, and Controversial Conduct

Market value weighted

FTSE Fixed Income ex Fossil Fuels Enhanced Index Series

The Product Involvement data is refreshed on a quarterly basis in March, June, September, and December. The latest sustainable investment data inputs are used for the periodic index rebalancing and the FTSE Fixed Income ex Fossil Fuels Enhanced indices are rebalanced on the same date as their underlying indices.

Index governance

FTSE Fixed Income LLC is the benchmark administrator for the FTSE Fixed Income ex Fossil Fuel Enhanced Index Series and is responsible for the daily calculation, production, and operation of the indices within the series, including:

– maintaining records of the index weightings of all constituents

– making changes to the constituents and their weightings in accordance with the index ground rules

– carrying out the periodic index reviews of the index series, and applying the changes resulting from those reviews

– publishing changes to the constituent weightings resulting from their ongoing maintenance and the periodic reviews

– disseminating the indices.

[3] Dataset provided by Sustainalytics.

Regional fixed income advisory committees, comprising senior market practitioners in the US, EMEA, and Asia Pacific representative of the appropriate sectors of the investment community, are convened on a regular basis to provide feedback that is used to evolve index methodologies.

Any proposals for significant amendments to the index methodologies will be subject to consultation with the FTSE Russell advisory committees and other stakeholders as appropriate. Any rule change decisions are ultimately taken by FTSE Russell.

Summary

The FTSE Fixed Income ex Fossil Fuels Enhanced Index Series helps investors decarbonize their portfolio by removing fossil fuel exposures within fixed income allocations. The index series also screens for revenues derived from tobacco and controversial weapons and for corporate conduct that is incompatible with the United Nations Global Compact (UNGC).

By means of a transparent, rules-based exclusion policy, the index series meets the rising demand for fixed income benchmarks that decarbonize by moving away from generation, refining, transportation, storage, distribution, sales and related activities in fossil fuels. Such benchmarks are increasingly used to help asset managers and asset owners meet their net-zero GHG emissions targets.

ABOUT FTSE RUSSELL

FTSE Russell is a leading global provider of index and benchmark solutions, spanning diverse asset classes and investment objectives. As a trusted investment partner, we help investors make better-informed investment decisions, manage risk, and seize opportunities.

Market participants look to us for our expertise in developing and managing global index solutions across asset classes. Asset owners, asset managers, ETF providers and investment banks choose FTSE Russell solutions to benchmark their investment performance and create investment funds, ETFs, structured products, and index-based derivatives. Our clients use our solutions for asset allocation, investment strategy analysis and risk management, and value us for our robust governance process and operational integrity.

For over 35 years we have been at the forefront of driving change for the investor, always innovating to shape the next generation of benchmarks and investment solutions that open up new opportunities for the global investment community.

CONTACT US

To learn more, visit lseg.com/ftse-russell; email info@ftserussell.com; or call your regional Client Service team office:

EMEA +44 (0) 20 7866 1810

North America +1 877 503 6437

Asia-Pacific

Hong Kong +852 2164 3333

Tokyo +81 3 6441 1430

Sydney +61 (0) 2 7228 5659

FTSE RUSSELL
An LSEG Business