GEF/C.55/13
December 4, 2018

55th GEF Council Meeting
December 17-20, 2018
Washington, D.C.

RESPONSIBLE INVESTMENT FOR THE GEF TRUST FUND AS PART OF THE WORLD BANK TRUST FUND POOL

(Discussion Note prepared by the Trustee)

Recommended Council Decision

The Council reviewed the document GEF/C.55/13, *Responsible Investment for the GEF Trust Fund as part of the World Bank Trust Fund Pool* and takes note of the progress made by the World Bank as Trustee of the GEF Trust Fund in developing Responsible Investment Guiding Principles and acknowledges the World Bank's proposal to identify Environmental, Social, and Governance Integration as the overarching approach for the GEF Trust Fund as part of the World Bank Trust Fund Pool, subject to approval within the World Bank's governance structures.

I. Background

1. The World Bank manages the GEF Trust Fund assets according to the provisions of IBRD's and IDA's General Investment Authorizations[1] (GIAs), which are approved by the World Bank's Board of Executive Directors. The GIAs determine the framework under which the World Bank as Trustee provides investment management services for the GEF Trust Fund and specify the types of transactions and eligible investments in which the World Bank is authorized to transact.

2. All trust fund assets held in trust by the World Bank, including those of the GEF Trust Fund, are maintained in a commingled investment portfolio (the "Trust Fund Pool"). The Trust Fund Pool is comprised of Model Portfolios with differing investment characteristics to accommodate the specific investment objectives and risk tolerances of individual trust funds.

3. The primary investment objective being capital preservation, the Trust Fund Pool has a conservative risk tolerance and, accordingly, the assets of the Pool are largely invested in high quality fixed income instruments including securities that are issued by sovereign governments, government agencies, as well as multilateral and other official institutions. In addition, eligible instruments include asset-backed and agency-guaranteed mortgage-backed securities, as well as swaps and derivative instruments to manage market risk.

II. Responsible Investing

4. Responsible Investment including Socially Responsible Investing (SRI), Ethical investing, and Environmental, Social, and Governance (ESG) investing, are different terms used to describe investment practices where ethical, social or environmental factors are considered alongside, in addition to, or on top of traditional financial considerations. ESG investing refers to various modalities of how investment managers and asset owners think about incorporating ESG factors in the process of making investment decisions, including analysis, selection and management of investments. There are multiple issues, or factors, under each category of E, S and G, which could be considered in creating investment portfolios. For example, climate change, carbon emissions, biodiversity etc. under Environmental; human rights, labor standards, health, diversity and inclusion under Social; and corporate governance, corruption, rule of law under Governance.

5. ESG investing has gained traction since the nineties and owes its origin to the equity markets where investors initially focused on religious, value-based, and thematic investments. Since the nineties, the Responsible investment trends in financial industry have evolved from basic exclusion lists (negative screening), via positive screening and engagement, to ESG Integration and impact investing lately. ESG factors can have an impact on the risk and return characteristics of investments while acknowledging that the materiality of the ESG factors and, consequently, the size of that impact can differ across asset classes. While the progress in, and

[1] General Investment Authorization for IBRD (Resolution No. 97-1, adopted on April 18, 1997); General Investment Authority for IDA (Resolution No. 2001-1, adopted on January 23, 2001).

impact on, equities as an asset class, has been notable, asset owners and asset managers are in the early stages of researching and benchmarking the impact of ESG factors in the fixed income asset class.

III. ESG Consideration for GEF Trust Fund Portfolio

6. The GEF Council appreciated the options presented[2] by the Trustee in June 2016 for diversification opportunities and requested the Trustee to present options with respect to SRI across the existing GEF Trust Fund Portfolio.

7. During the GEF-7 replenishment negotiations, participants requested the Trustee to develop options to incorporate ESG factors in the GEF liquid asset portfolio. As such, the GEF-7 policy recommendations[3] reflect that *"Recognizing the GEF's unique role and mandate in the global environment architecture and the increased emphasis on integration and sustainability in GEF-7, Participants request the Trustee to develop options for a responsible investment strategy for the financial management of the GEF funds held in trust, for consideration by the Council and consistent with international best practice for environmental, social and governance (ESG) standards".*

IV. Approach to Responsible Investing

8. The World Bank aims to bring a holistic perspective with respect to Responsible Investment when applied to the Trust Fund pool including the GEF liquid asset portfolio. As such, ESG-oriented investment strategies need to be in line with applicable investment authorizations and guidelines of the World Bank.

9. In that respect, the World Bank has been working on defining Responsible Investment Guiding Principles (the "Principles") which aim to complement the existing documentation governing investment activity for the World Bank by considering and incorporating ESG factors in a pragmatic, yet holistic manner, across investment processes.

10. The primary objective of the Principles will be to ensure that consideration of ESG factors contribute to sustainable investment strategies and informed decision making, while aligning the investment management business with the Bank's core values and mission on the Environmental, Social and Governance agenda.

11. Current research shows that market participants and investors follow several approaches (see below) to incorporate ESG considerations into the investment decision making process. It should be noted that these approaches are not mutually exclusive and may be applied together.

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[2] Paper titled "Investment Strategy Review of the GEF Trust Fund" at the 50th GEF Council meeting, GEF/C.50/12 (https://www.thegef.org/sites/default/files/council-meeting-documents/EN_GEF.C.50.12_Investment_Strategy_Review_of_the_GEF_Trust_Fund_0_0.pdf)

[3] GEF-7 Replenishment Policy Recommendations, GEF/R.7/18 (https://www.thegef.org/sites/default/files/council-meeting-documents/GEF-7%20Policy%20Recommendations%20-%20GEF_R.7_18.pdf)

- *Negative/Exclusionary Screening*: This process involves excluding securities of specific industries or sectors as per the norms and standards the investor intends to bring into the ESG consideration. Examples: excluding weapons industry, tobacco industry, fossil fuels or industries/sectors/companies with poor labor standards, and legal compliance.
- *Positive Screening/Best in Class selection*: This process means positive selection of companies or countries which have better or improving ESG performance compared to peers. This can also be implemented through overweighing such companies or countries in the portfolio.
- *Active Ownership/engagement/voting/stewardship*: This involves entering into dialogues with companies and countries to effect change on ESG issues. Investors here use "ownership rights" when they have voting power or "voice" when they do not have voting power.
- *ESG Integration*: This involves systematic inclusion of ESG factors into investment decision making including investment analysis, portfolio construction, and risk management.
- *Thematic Investing:* This involves basing the investment process around specific themes which are of interest to the investor. Examples include: climate, sustainable forestry, clean technology, renewables.
- *Impact Investing:* This relates to the process of striking a balance between economic and social return. Investors typically aim to generate measurable social and environmental benefits along with financial return. In this respect, Impact Bonds have received special interest from investors.

V. ESG Integration for the World Bank Trust Fund Pool

12. Over the past two years, the World Bank has been exploring the establishment and implementation of Responsible Investment Guiding Principles for inclusion of ESG factors. Following consultations with stakeholders and having spent significant time and resources researching the most appropriate way to reflect the World Bank's beliefs in its investment approach, the World Bank Treasury has determined that it will implement ESG Integration described above as the overarching approach to responsible investment guided by the Responsible Investment Guiding Principles.

13. ESG Integration approach is more appropriate for the management of assets administered by the World Bank, including the Trust Fund Pool as it would involve having ESG considerations reflected in the entire investment process such that resulting portfolios reflect a wider responsible investment approach as opposed to targeting a single issue.

14. ESG Integration is an extension of traditional financial analysis to explicitly consider ESG risks and opportunities in investments, and as such is an additional tool intended to improve financial outcomes for portfolios. In the context of World Bank Treasury's asset management activities, and with due consideration of the fiduciary duties and the mix of mandates it manages for internal and external clients, ESG Integration is considered the

approach that provides an appropriate balance of ambition with respect to alignment with the World Bank's operational ESG agenda, the World Bank's fiduciary duty, and practicalities of implementation.

15. The implementation of responsible investment strategies within the Trust Fund Pool poses challenges as well as opportunities for the individual portfolios managed in the Pool. Whereas the Pool comprises a diverse client base, meaning there may be disparate responsible investment aims and aspirations expressed, the overall development goals and investment objectives are similar. Therefore, ESG Integration, as an extension of the existing processes and procedures, will allow for the current efficiencies of scale associated with the Trust Fund Pool to be maintained and propagated across other portfolios that the Bank manages for itself and for its clients.

VI. Challenges in ESG Incorporation

16. ESG Integration for fixed income portfolios is challenging due to several reasons, among them is the lack of global standards with respect to the ESG factors since each region, area or country is different and has different standards for environmental, social and governance related issues. The lack of availability of quality data, particularly from emerging markets, further exacerbates the problem.

17. While there is no dearth of equity ESG indices available, there is a lack of availability of choices of indices for fixed income portfolios. There is also a scarcity of ESG-focused products with demand far outstripping supply. Also, engagement with sovereign issuers to effect change on ESG issues is difficult and cumbersome.

18. The costs associated could be higher as additional measures and resources are often needed to screen issues, conduct research, and report findings. It is also worth mentioning that currently there is no consistent way of reporting on ESG performance, which makes comparing the results difficult.

VII. Next Steps

19. World Bank Treasury is in the process of having the Responsible Investment Guiding Principles formally approved within the Bank's governance structure by the end of FY19 with the aim of having the Principles come into force at the start of FY20.

20. Implementation of the Principles is a complex path, which entails some challenges externally and internally (from budgetary constraints, training and staffing, to underlying data quality and selection, scoring methodologies, etc.). It is expected that early stages of implementation of the Principles will involve consultations with the stakeholders to take into account advances in understanding, data and technology availability, and ease of implementation.

21. As noted above, all options and strategies presented in this note and their adoption or implementation are subject to approval within the World Bank's governance structures. Any changes or modifications would be appropriately communicated to all clients including the GEF Council.