Tuesday the 21th of June, 2022

In recent years, the practice of considering environmental, social, and corporate governance (ESG) factors in investment decision-making has become more widespread. While the term ESG is used interchangeably with sustainable or responsible investing, it denotes an investment approach in which the analysis goes beyond using traditional financial metrics.

The financial system's interest in sustainable investing has increased significantly because ESG issues can manifest themselves in market, credit, legal, and reputational risks if an issuer does not manage them properly. The occurrence of environmental disasters and the transition to a low-carbon economy as well as the possibility of social controversies and governance deficiencies within a firm could affect not only an issuer's ability to receive financing and repay its debts, but also investors' perception of its ability to generate returns in the long term which could affect the safety and profitability of its assets.

Over the past two decades, the practice of considering ESG criteria in investment management has gained acceptance among institutional investors. In the central banking community, there is a growing interest in adopting sustainable investment policies in the management of foreign reserves. However, since this issue is still under development, the implementation of these types of measures is relatively low. Graph 1, published by the World Bank in October 2021, shows that only 17% of the central banks include ESG criteria in their reserve investment policy while 45% do not yet do so and the remaining 37% are evaluating or starting to incorporate it into their overall financial investment policy framework[1].

Graphic 1. Central banks that include ESG factors in investment policy

Source: World Bank, Central Bank Reserve Management Practices: Insights into Public Asset Management, Third RAMP survey.

Some of the challenges that make it difficult for central banks to consider ESG factors are:

- **Lack of standardization:** there are no collectively accepted standards for definitions, regulation, or disclosure of ESG information, so data is mixed, and this makes systematic comparison between issuers difficult.
- **Risk of greenwashing:** some organizations may give the false impression that their products or projects are environmentally responsible when in fact they are not, and this would be reflected in the fact that the bonds issued by them would be erroneously classified as "green."
- **Concentration of foreign reserves in public debt bonds:** the most widely used strategies for considering ESG factors have focused on the variable income market. For fixed income instruments, especially public and supranational debt, which are the predominant asset classes in reserve portfolios, the scope is more limited because these instruments tend to finance a variety of tasks that the issuing public entities carry out. Among these, some that meet ESG sustainability criteria may coexist with others that do not.
- **Few investment alternatives:** the market for impact instruments, such as green bonds, is still relatively small, concentrated, and less liquid than the conventional bond market.

Likewise, the potential for including ESG considerations in an investment policy is tied to its compatibility with portfolio objectives. To this end, there are two types of objectives that can be pursued when ESG criteria are involved: financial or extra-financial. The former seek to reduce exposure to investments with environmental or social risks or bad corporate practices that may affect their financial profitability. The purpose is to improve the risk-return profile of the portfolio by considering financially material ESG risks. The latter seek to generate a positive impact on the environment or society by investing in sustainable companies or projects, with less emphasis on financial profitability.

In the case of *Banco de la República*, the foreign reserves portfolio under management has a mandate dictated by law and must be managed with the traditional financial criteria of security, liquidity, and profitability. These criteria are in line with the objectives of maintaining foreign reserves such as protecting the country from external shocks and facilitating government and private sector access to international capital markets. Therefore, any strategy that seeks to involve ESG factors in the investment and monitoring processes of foreign reserves must be compatible with these criteria.

Currently, within *Banco de la República's* foreign reserves management framework, there are policies and procedures that favor investments aligned with ESG factors:

- Entities that are eligible for the foreign reserves to be invested in must have high credit standards as determined by the credit ratings of the world's most renowned credit rating agencies. These agencies have incorporated ESG criteria into their credit analysis methodologies for assigning their ratings. In this regard, credit ratings address ESG considerations that may result in material risks to the entity.
- Green bonds that meet the investment guidelines are eligible for portfolio managers to purchase if deemed appropriate, and multiple green bonds have been held within the investment portfolio.
- The external managers hired by *Banco de la República* have extensive experience including ESG criteria in their investment processes.
- *Banco de la República* is an investor in the BIS Investment Pool Y, which is managed by the Bank for International

Settlements and was structured to provide central banks with access to the corporate bond market. This fund takes ESG criteria into account when defining eligible issuers and assets.

[1] Proportions do not add up to 100% due to rounding of figures in the original source table.