EXPERT OPINION

YES, WE CARE ABOUT #18

ESG assessments and practices for Public issuers and Sovereigns

by ***Mariana Pombo***

Introduction

In the past 10 years, social and sustainable bond markets have been among the most innovative success stories of the financial sector in its efforts to participate in the transition to a sustainable economy.

Among the lessons learnt over those years is the necessary alignment or consistency between the **issuance and the issuer's global commitment to sustainability**. Investors are then increasingly looking at how—beyond the issuance and the use of proceeds of a thematic bond—**a debt issuer is managing sustainability in the present and planning for the future**. In other words, this refers to the ESG profile/ESG rating or ESG assessment of the issuer.

I Care co-authored a study that tries to shed a light on the nascent universe of the **ESG assessments for debt portfolios, focusing on public entities and Sovereigns of the LAC region**. This study supports the Inter-American Development Bank (IDB) major efforts on educating its beneficiaries on ESG topics, alongside its role of promoting better ESG practices among issuers, namely by addressing the following questions:

- What is an ESG profile or an ESG performance assessment for a public issuer?
- What are investors focusing on when assessing a public issuer sustainability profile?
- Which tools and services are available, and what are their limitations?
- What are some key considerations for public issuers who decide to participate, understand, and potentially improve their ESG profile?

The report showcases current practices and data considerations regarding ESG assessments in the bonds market. This expert opinion summarizes **some of its key findings** and **I Care views on the topic**, with particular attention to the LAC market' specificities and success cases.

The full report can be found here.

February 2022

1 ESG assessments of public debt issuers: why and how?

ESG evaluations first emerged in the equity markets

The high growth of sustainable investments over the last decade has triggered the rapid development of specialized ESG data and ESG research, providing investors with numerous ESG evaluation products and services applicable to companies, industry sectors, and countries.

ESG data and ESG evaluations first emerged in the equity markets, specifically, the listed equity markets, which saw sustainability metrics and sustainability reporting frameworks multiplied (GRI, IIRC, etc.). **These ESG assessments are now beginning to appear in debt markets as well, and are likely to grow**.

Major drivers expecting to continue supporting the demand for ESG profiles (i) the increasing green and social bond markets, the (ii) ESG regulatory push across financial system[1] and (iii) the raising academic and empirical research on ESG & credit risk analysis. The later although yet in its infancy is robustly making a case for the ESG integration into the debt investing field.

ESG assessments: which differences among public issuers?

Sovereign and sub-sovereign bond issuances represent more than half of the outstanding issued volume.

Despite the public nature and mandate of NDBs and SOEs, that can have an impact on their risk profile and overall sustainability strategy, they are overall assessed like their private sector peers: the analysis is focused on the **material ESG factors identified for the relevant industry**. Therefore,

- NDBs share several similarities with the financial sector with respect to ESG. The two pillars deemed to be the most material for financial institutions are the **governance** (ex. business ethics, corporate governance) **and social** (ex. customers and stakeholders' transparency, employment diversity) ones; as these have been associated with most reputational issues and financial losses in the financial sector.
- SOEs in the utility sector will face the ESG exigences posed to the sector: besides the typical governance issues, occupational health & safety, and community relations; the focus in on the climate and transition strategies and environmental performance of these actors.

ESG assessments of sovereign bond issuers are yet in its infancy, but expected to grow while research develops further

Contrary to equities, sovereigns do not report their environmental and social performance, Also, the impact of ESG factors on a sovereign's ability to repay its debt is quite different than for a corporate, and is still a subject of discussion by the academic world and the investment community. **Despite the heterogeneity of methodology and perimeter of academic papers addressing ESG and Sovereign bonds performance, some convergence elements can be highlighted.**

[1] See further information on I Care Expert Opinion - SFDR and Article 29 here.

Some key findings of ESG research to date

- A majority of research papers conclude that there is in some way or another a positive relation between ESG performance at country level and lower funding costs for countries.
- Good ESG performance translates into higher market resilience during financial crisis (a finding that also been established for corporates and proves to hold during the COVID crisis).
- Research papers focusing on either data transparency or low level of corruption consistently highlight these factors as having a significant positive impact on countries borrowing costs.
- Sovereign ESG counter performance is not only impacting Sovereign borrowing costs but also spills over to the private sector, as Sovereign creditworthiness strongly influence national corporates ratings. This is particularly sensitive for countries already facing higher interest rates and with lower fiscal margin, for which increased costs of funding will impact both the private sectors and government's investment capacities on education, health and infrastructure.
- Emerging Market countries are frequently highlighted as being more sensitive to ESG factors overall than developed countries. Social and environmental criteria play a bigger role for them than for developed countries.

For details on each study main findings please refer to "Annex 1. Academic Literature Review Table" of the IDB Report (2021).

Credit Rating Agencies are increasingly exploring ESG Sovereign factors in credit risk analysis

Since 2016, several CRAs (Moody's, S&P, Fitch Ratings etc.) committed to look at ESG considerations in a systematic and transparent way.[2]

To be noted however, that saying that "ESG factors are captured directly or indirectly in sovereign credit analysis" (Moody's) is not the same as being effectively integrated. Certain ESG factors are being perceived as financially material, and ESG integration is becoming mainstream. The ESG analysis currently conducted by CRAs does not directly impact sovereign credit ratings.

The financial materiality of each ESG factors for sovereigns is becoming increasingly relevant: Governance-related factors have traditionally had a predominant position, but the materiality of Social and Environmental are increasingly being looked at, as more data sources and research is becoming available.

[2] PRI Statement on ESG in Credit Ratings.

2 ESG investors practices into sovereign portfolios

Although ESG integration for equities is becoming mainstream, few investors have a systemic approach to ESG integration in debt portfolios, and namely in sovereign debt.

Investors and CRAs have traditionally regarded governance as the most material ESG factor. i.e. Sound governance, which consists of government stability, effective policies, and regulations, is associated with a solid economy. **Good governance is associated with both higher per capita GDP and higher GDP growth over time.** Social factors have been recognized material to sovereign risk analysis for a while now, with **OECD studies highlighting the importance of human capital as a key determinant of economic growth,** for example it finds correlation between falling income inequality and faster economic growth (Cingano,2014). The global sanitary crisis has notably reinforced the importance of social factors, such as the healthcare infrastructure and social inequalities.

The main challenges for investors are **the identification of ESG factors and the decision about their materiality.** Thus, some investors have start developing their **in-house materiality frameworks and methodologies to fit their ESG strategies.** They are partially based on the ESG data/products provided by third parties, internal research and **as various as each institutions' views on materiality, and investment' beliefs**. **Values-based investors** might want to consider indicators such as the existence of the death penalty, the political regime, or the breach of international treaties as exclusionary factors; while investors favoring a **value-based approach** will overlook these indicators because they cannot be associated with financial materiality.

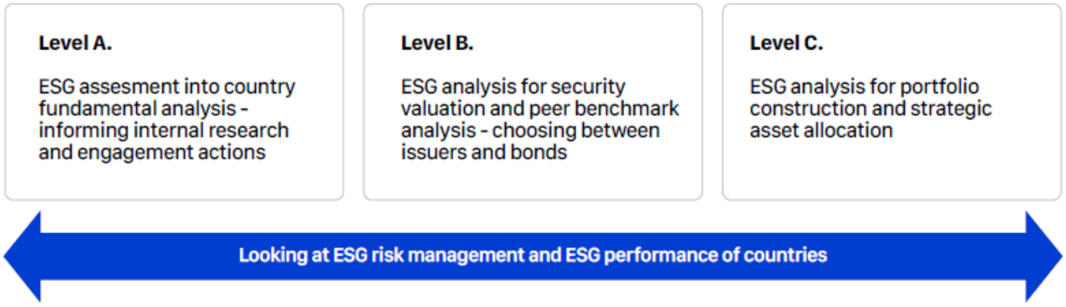
That being said, there is a lack of convergence in the ESG sovereign approaches, well detailed in PRI work: an indicative list of ESG factors for sovereigns' assessments is proposed by the PRI.

Overall, there **are three main levels of** analysis and integration of ESG factors[3]:

- Level A - **Fundamental analysis:** the simpler and most common use observed to date
- Level B - ESG analysis used in **peer-benchmark analysis** of yields, volatility, and risk: an investor may upgrade the security valuation of a country with better ESG profile. Each country can be compared to peers, by taking each ESG score and analysing it against respective sovereign credit spreads. This informs r**elative valuation but may also enable analysts to understand whether all of the risk factors are priced in** (e.g., if there are deviations of actual credit spreads versus those implied by a regression model based on an ESG score of another kind of ESG performance assessment).
- Level C - Very few cases, to our knowledge, are running **ESG sovereign analysis in portfolio construction or strategic asset allocation (SAS)**. This is considered a more robust approach to date.

[3] More cases studies can be found in PRI dedicated website.

Fig.1 Levels of Analysis of Sovereign Debt where ESG Factors can be incorporated



Source: Sustainable Issuance versus Sustainable Issuer, IDB, 2021

Climate and biodiversity: two essentials of E factors … and sovereign risks assessment

Environmental factors have been the least integrated by investors, mostly because environmental data tend to be collected less than other types, and because the financial impact of environmental risks is much more difficult to evaluate. However, this trend is changing in light of the international response to reduce GHG emissions to meet the commitment of the Paris Agreement and to achieve the Sustainable Development Goals (SDGs).

Environmental governance, NDCs, and natural capital protection policies have a direct impact on institutional assessment of sovereigns. **Countries are at risk of losing markets and seeing exchange rates and debt increase if they do not develop appropriate policies to protect natural capital at risk of degradation or to mitigate climate change impacts.**
Political risk may rise following natural disasters, via a loss of economic output and increasing vulnerability of the population.

Also, Central banks and financial supervisors worldwide *recognize that climate risk impacts financial stability and* are becoming mindful of the opportunities of responsible investment for market stability and effective management of government reserves. A good example is the Network for Greening the Financial System (NGFS) launched in 2017 at the One Planet Summit. Furthermore, the European Insurance and Occupational Pensions Authority (EIOPA) has recognized the need to monitor and assess climate-related financial risks. In 2019, EIOPA published the first climate risk assessment of the sovereign bond portfolio of European insurers. **This assessment may set the tone for further developments around climate in sovereign risk assessment.**

Climate-related data collection is expected to increase, mostly driven by **risk considerations, regulatory requirements, asset owner initiatives** (such as the United-Nations-convened Net-zero Asset Owner Alliance) and **international frameworks** (TCFD, UNPRI reporting, etc.), as well as growing demand for climate solutions and related financial products. **Both physical and transition risks of climate change are material for sovereigns in multiple ways and over multiple horizons**.

Moreover, impact investors[4] have been looking for nature-based solutions, and the number of thematic funds dedicated to nature and biodiversity issues has increased (e.g., funds pursuing environmental impacts land degradation neutrality, sustainable oceans, conservation, etc.). **Natural capital and biodiversity protection have garnered increasing attention in last years**, due to their role in adapting and preventing further negative impacts from climate change and the essential service they provide to many businesses on which society depends. The development of indicators and methodologies to integrate conservation and biodiversity factors into business and investment practices is now in the agenda of international organizations and G20 economies.

[4] To learn more about Impact Investing, see our Expert Opinion here.

3 ESG assessments, ratings and data: what is available for investors and the main challenges

ESG ratings for bond issuers began around 2010, with several ESG data providers developing services to conduct ESG ratings for bond issuances, and therefore, for sovereign debt issuers. ESG firms, credit rating agencies, index providers, universities, nongovernmental organizations (NGOs), and international organizations are now participating in the offer.

The ESG sovereign-related products available at this stage in the market can be classified under the following main four groups:

Overall ESG Assessment

ESG Performance-oriented products

ESG Data: Offsets of ESG data (raw data with few treatment) that investors buy according to internal objectives and to enrich their ESG integration procedures.

ESG Risk Assessment Focus: Focus on ESG risk analysis and reflects higher level of analysis mostly focused on relationship to economic and financial risks. Some might be highly specialized in one particular topic, such as governance issues or the impact of physical climate risks.

ESG Scores: (also called ESG ratings) More sophisticated forms, result of aggregation of several layers of ESG data, criteria and metrics. Mostly proprietary models developed by ESG specialists firms, using both quantitative and qualitative analysis.

Credit risk analysis with ESG

ESG-Aumented credit risk score: **Products that integrate ESG into credit risk analysis and ratings**: this is the case for example of ESG-Augmented Credit Risk Score for Countries developed by Beyond Ratings (now LSEG): a pure quantitative scoring model built to provide a comprehensive credit risk analysis including traditional economic and financial indicators as well as ESG indicators.

ESG analysis by CRAs: **Credit Rating Agencies** are developing increasing ESG-related research and country analysis. While they tend to recognize that ESG risks relate to credit rating, ESG is normally seen as a complement to understanding their impact on the creditworthiness of the sovereign. ESG factors are therefore observed within the formal credit rating process, but not yet a variable in the rating development *a priori*.

ESG Sovereign Indices & ETFs

ESG indices (benchmarks): It is a combination of ESG scores computed with indexing rules. Following the ESG investing trend, passive managers and ETF experts have been developing new and innovative ESG indices, mostly on the equities side. Regarding countries, in the emerging market space, there is the J.P. Morgan ESG Index (JESG), and its emerging market series (JESG EMBI).

ESG Sovereign ETFs: Still very few, for example DWS, UBS, and BlackRock funds—all using the J.P. Morgan ESG EMBI Global Diversified Index.

Thematic Bond assessment oriented

Second Party-opinions (SPOs): **Second Party Opinions** on Green, Social and other Sustainable Bonds are available both for corporate and sovereign issuers. These services are mostly provided by ESG data specialists and focused not only on the issuer but also on the **use of proceeds**, the **"sustainability/greenness of the issuance"**

The financial community face several challenges regarding the data they need to analyse the ESG performance of their investment portfolio: **overall, available ESG data are still not aligned with investors' needs.** This is also the case for ESG Sovereign-related data.

ESG Sovereign data. Main challenges in a nutshell

AVAILABILITY

availability of sovereign ESG data breaks down into **frequency** and **consistency** problems.

Most macroeconomic data are updated monthly or quarterly, while sovereign ESG data are **updated yearly or lag two to three year behind, due to statistical processes**. For certain indicators illustrating emerging ESG issues, **historic time series availability might be limited**, generating constraints to implement back testing modelling of their impact. While GDP data are available for 2019, the most recent data available on CO^2 emissions per capita or number of hospitals beds per 1,000 inhabitants' lags by four years (2015) in some LAC countries.

The availability of ESG data varies greatly: across indicators, E, S, and G pillars (e.g., the same country might have lots of environmental data made public, but not social), but also across countries (e.g., a limited number of countries publish consistent performance metrics).

QUALITY

the lack of global reporting standards affects the quality of ESG sovereign data

As per the lack of global reporting standards on this matter, statistical methodologies and current resources might vary **across countries to produce a similar indicator**. Therefore, the quality of ESG sovereign data has yet to be improved.

RELEVANCE AND COMPARABILITY

the loss of relevance when aggregating multidimensional factors

When building ESG-aggregated scores for countries, ESG service providers will consider a large array of ESG indicators: as many as 300 in some cases (approximately 100 per pillar). This raises an issue of **statistical relevance** as soon as these indicators are scored and aggregated. How should the scores be weighted? inter- and intra-ESG pillar?

The most basic approach is to weight them equally. This might, however, prove misleading as many indicators might be strongly correlated. Some indicators such as energy consumption per capita prove to be correlated with per capita income.
Also, to what extent is it **relevant to compare countries on ESG performance if they are at different stages of development** (high-income vs. low-income countries, for example)?

In order to overcome some of these issues, the **World Bank** and **other development institutions have made their databases public**. See for example:

- In October 2019, the World Bank launched the **Sovereign ESG Data Portal**, which provides users with sovereign-level ESG data.
- In April 2021, the IDB and IDB Invest launched the **Green Bond Transparency Platform** (GBTP) – an innovative digital tool aiming at supporting efforts to harmonize and standardize Latin America and the Caribbean (LAC) green bond reporting.[5]

[5] IDB and IDB Invest launch the Green Bond Transparency Platform, 2021

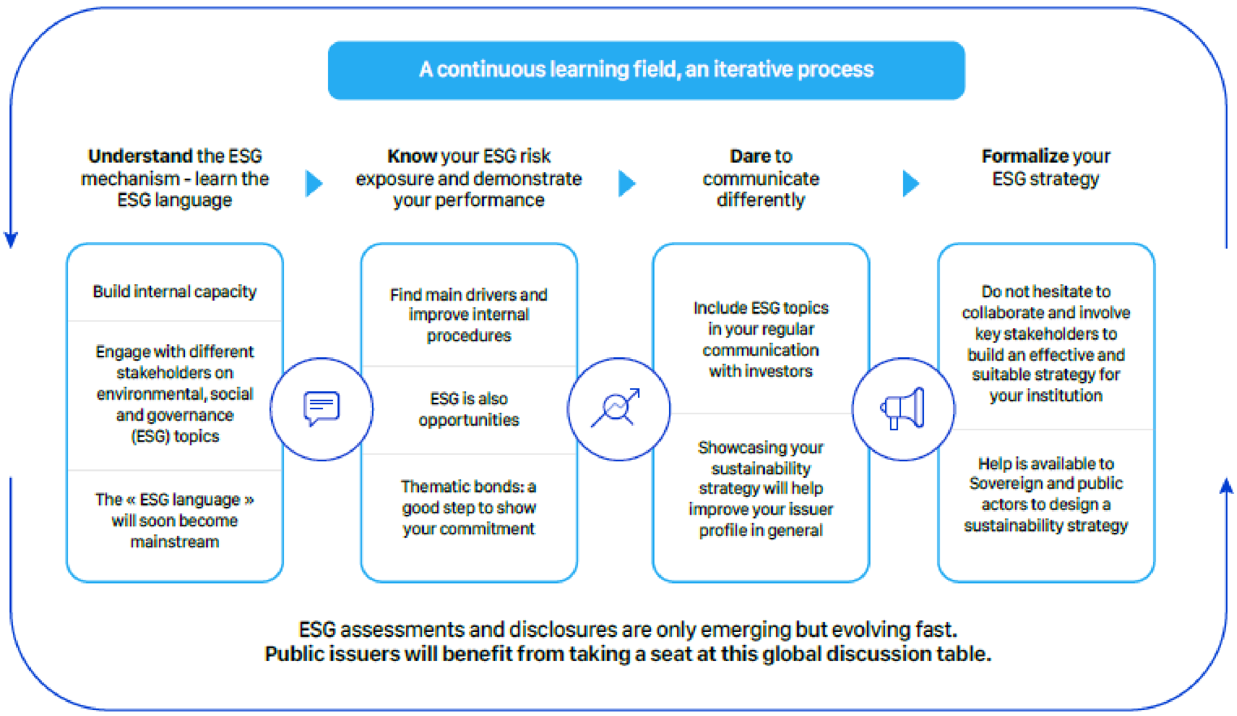
4 Public Entities and Sovereigns in Latin America: leading the way in the region

In Latin American and the Caribbean (LAC), sustainable bond markets are expanding at a much faster rate than in other international markets. Considering all types of thematic bonds together, **new issuances have increased to US$6.13 billion in 2019, compared with US$2 billion in 2018 (an increase of 200 percent).** National Development Banks (NDBs), State-owned Enterprises (SOEs), and Sovereign issuers have stood at the forefront of **thematic bonds in this region.**

A roadmap towards the integration of ESG factors into a public entity debt issuance strategy is then proposed that all public issuers might consider to follow:

1) **Understand the ESG Mechanisms**: Learn the ESG Language, Build Internal Capacity
2) **ESG Performance Is a Combination of Risk Exposure and Risk Management**: Knowing your risks allows to identify opportunities and improve ESG performance
3) **Start to Communicate Differently**: Engage with Investors on ESG-Related Matters and other stakeholders will help your institution highlighting what might be already ESG material
4) **Develop and Communicate on a Clear Sustainability Strategy**, including start developing ESG reporting strategy. External support is highly available from international cooperation fronts and local consultancies

Fig.2 Proposal for a Roadmap for Integrating ESG factors into debt strategy



Source: Sustainable Issuance versus Sustainable Issuer, IDB, 2021

For these issuers, this has been an opportunity to improve ESG practices while paving the way into the ESG space of Global Markets and diversifying their funding sources. Details of success stories can be found in the report:

- The first **Sovereign green bond** issued by Chile in 2019
- The first **green bond** on protected agriculture issued by FIRA in Mexico in 2019
- The first **Sovereign social bond** issued by Ecuador in 2020
- The first **Sovereign sustainable bond** issued by Mexico in 2020
- The first **gender bond** issued by FIRA in Mexico in October 2020

Conclusion

In LAC, as in all other parts of the globe, ESG integration in sovereign debt is gaining momentum due to the increasing presence in thematic bonds market, the regulatory push and ongoing academic and empirical research.

Governance factors have traditionally had a predominant position; however, an increasing number of investors recognizes the relevance of **climate and nature-related risks** in debt investing, and that is particularly true for sovereign investors **who tend to have long-term horizons** – the same horizons of materialization for many of these risks.

The integration of ESG risks is progressing and will also soon become the norm for bond market investors, despite the lack of a common methodology to date.

The participation of all kind of stakeholders in the debate has shown the need of convergence of standards as well as coordination of public policies and supervisory measures, driving innovative financial mechanisms and products aligned to transparency and reallocation needs.

It is an opportune time for countries to become involved as well, given the opportunity to access funding to support their strategy to meet the UN Sustainable Development Goals (SDGs) and their climate change Paris Agreements. Countries and governments should also play a role by promoting ESG data disclosure, its production, collection and monitoring.

Only by taking an action and learning on the go we can improve and succeed. As a Spanish poet Antonio Machado said:

"Caminante, no hay camino, se hace camino al andar"[6]

[6] *Translation: "Walker, there is no path, you make the path as you go".*

References

Battiston et al. 2019. Climate Risk Assessment of the Sovereign Bonds Portfolio of European Insurers. EIOPA Financial Stability Report, December 2019. Frankfurt, Germany: European Insurance and Occupational Pensions Authority (EIOPA)

Berg, F., J. F. Kölbel, and R. Rigobon, 2020. Aggregate Confusion: the Divergence of ESG Ratings. SSRN

Capelle-Blancard, C., M.-A. Diaye, R. Oueghlissi, and B. Scholtens, 2016. Environmental, Social and Governance (ESG) performance and sovereign bond spreads: an empirical analysis of OECD countries

Cingano, F. 2014 Trends in Income Inequality and its Impact on Economic Growth. OECD Social, Employment, and Migration Working Papers No. 163. Paris, France: OECD Publishing.

Han, X., H. Khan, and J. Zhuang. 2014. Do Governance Indicators Explain Development Performance? A Cross-Country Analysis. ADB Ecopnomics Working Paper Series 417. Manila, The Philippines: Asian Development Bank.

Bocquet R., Braly-Cartillier I., Pombo M., De Salins A., IDB Monograph, 2021. Sustainable issuer versus sustainable issuance: providing public issuers of sustainable bonds in Latin America and the Caribbean with insight into the nascent universe of ESG ratings

Network for Greening the Financial System. Technical document, 2020. Guide to climate scenarios analysis for central banks and supervisors

Principles for Responsible Investment (PRI), 2019. A practical guide to ESG integration in sovereign debt

Principles for Responsible Investment (PRI) 2013. Sovereign bonds: spotlight on ESG risks

UNEP FI (United Nations Environment Programme Finance Initiative) and United Nations Global Compact. 2019. An Introduction to Responsible Investment for Asset Owners. Geneva, Switzerland: UNEP Finance Initiative and United Nations Global Compact

ABOUT THE CONSULTING GROUP I CARE

I Care is a leading consulting company in the environmental field. Since 2008, I Care assists companies, financial institutions, and public organizations in their transition towards a low environmental impact society.

From strategic thinking to operational solutions, I Care offers innovative solutions to a wide range of environmental challenges with the objective of helping society to move to a sustainable economy.

HQ: 28, rue du 4 septembre, 75002, Paris, France

I Care
Because our **impact** matters

France (Paris & Lyon) – Brazil (Belo Horizonte)

+33 (0)1 43 66 87 27

contact@i-care-consult.com