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Abridged Version

A New Dawn – Rethinking Sovereign ESG

WORLD BANK GROUP

This is the abridged version of the full report "A New Dawn – Rethinking Sovereign ESG" by Ekaterina M. Gratcheva, Bryan Guhry, Dieter Wang available here.

E-mail contact
Ekaterina M. Gratcheva
egratcheva@wordbank.org

Bryan Guhry
bguhry@worldbank.org

Dieter Wang
dwang5@worldbank.org

Executive Summary

Sovereign environmental, social, and governance (ESG) investing is quickly becoming *ordre du jour*. There remains, however, considerable "noise" around the sovereign ESG framework, industry practices, and the definition of sustainability itself. This World Bank publication consists of two independent reports. The first part is written by the World Bank and takes stock of the current sovereign ESG investing framework and proposes improvements, while the second part presents a survey on ESG practices among Emerging Market (EM) sovereign debt investors conducted by J.P. Morgan (JPM), who launched the first EM sovereign ESG index in 2018. This publication is a result of the World Bank's proactive engagement with stakeholders on pertinent sovereign ESG issues and is part of a publication series under the auspices of the Global Program on Sustainability (GPS).[1] This series focuses on ESG issues related to sovereign debt investing and disseminates practical, evidence-based recommendations for market participants that include institutional investors, sovereign issuers, credit rating agencies, and ESG data and service providers, among others.[2]

The JPM survey emphasizes that ESG considerations are no longer a niche topic for investors in EM sovereign debt, but the level of penetration of ESG considerations into EM sovereign debt investing remains mixed. About 65 percent of respondents report that less than one-fifth of their assets under management (AUM) have explicit ESG considerations. Furthermore, when asked to assign a weight to ESG versus traditional investment factors such as inflation, interest rates, and debt-to-gross domestic product (GDP) ratios, more than 60 percent of participants assigned a weight of 20 percent or less to ESG. In a similar vein, more than 75 percent of respondents say that dedicated ESG funds make up less than one-fifth of their overall EM sovereign strategy. On the other end of the spectrum, about one-fourth consider ESG factors for more than 80 percent of their AUM. Most respondents interested in sovereign ESG strategies are in Europe, 6 percent are in the United States, and 4 percent are in the Asia-Pacific region. Most of these are pursing ESG integration,[3] while a significant number are also pursuing exclusionary screening and engagement or stewardship.[4] Half of respondents, though, reported that they don't engage with sovereign issuers enough and want to improve.

The investment objective—whether motivated by achieving a certain risk adjusted return, having an investment impact, or some combination of both—is a key consideration when assessing how ESG factors are included in the investment process. For decades, ESG factors, such as governance and to a lesser extent social factors, have been a foundational tenet of sovereign credit analysis. It has been only in recent years that ESG investing as a consolidated "package" has become a more explicit part of the investment process, driven by the changing financial sector ecosphere, in response to demand

[1] In response to market demand, the World Bank launched a sovereign ESG data portal in 2019 with publicly available curated data comparable across 139 countries and 67 metrics. The World Bank's analysis reveals that up to 80 percent of data used for sovereign ESG scores by the major ESG providers rely on the sovereign ESG data available through the portal.

[2] The series is a knowledge product of GPS Pillar 3, which aims to promote high-quality data usage and sustainability analysis to better inform decisions made by governments, the private sector, and financial institutions. GPS Pillar 3 is led by the World Bank's Finance, Competitiveness, and Innovation (FCI) Global Practice (GP) in collaboration with World Bank Treasury (TRE), the Development Economics Vice Presidency (DEC), and other GPs.

[3] ESG integration is the practice of incorporating ESG-related information into investment decisions to help enhance risk-adjusted returns, regardless of whether a strategy has a sustainable mandate.

[4] Exclusionary screening involves excluding from the investment process certain sovereigns involved in activities deemed unacceptable or controversial from an ESG perspective. Engagement/stewardship involves investor discussions with key country officials, organizations, and the like. By participating in engagements, investors learn about important initiatives and upcoming policy changes that may affect the sovereign, and such engagements may also influence government policies/information provision.

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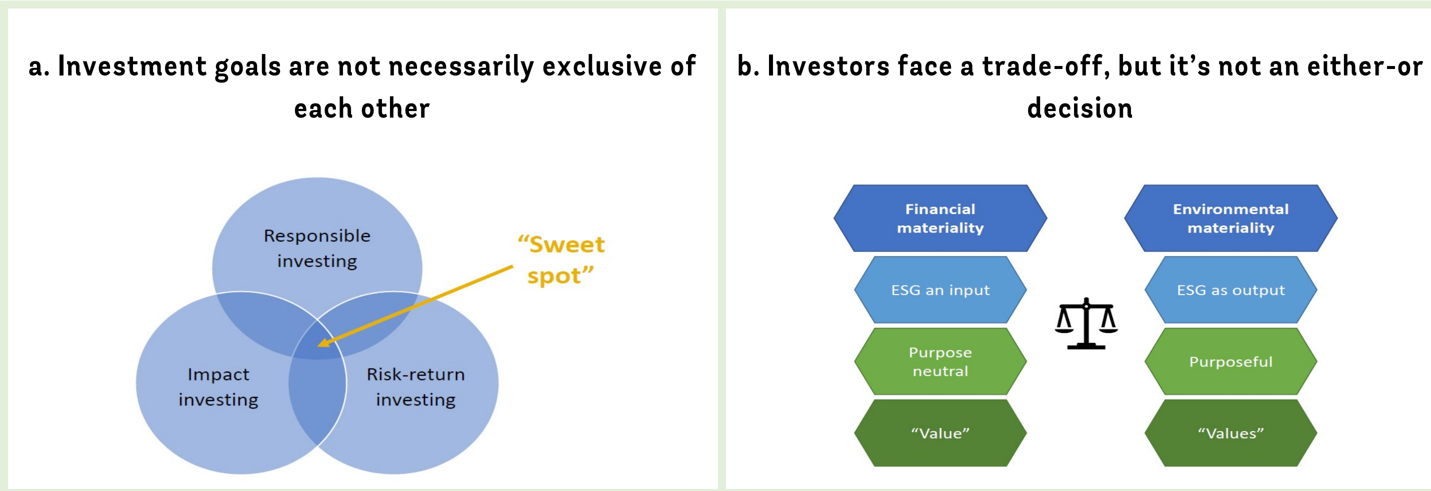
FIGURE ES.1 - Overview of ESG investing approaches



from society at large. Although ESG investing initially focused on equity and corporate debt asset classes, given the size of the sovereign debt market it's no surprise that ESG inve sting is becoming a stable part of the investment process for sovereign debt investors. However, the sovereign issuer is fundamentally different from a corporate entity, and this paper documents the many issues at play that mean that the framework adopted for corporates may not necessarily fit the framework needed for a sovereign issuer.

The rise in ESG investing has seen the advent of sovereign ESG scores, which are designed to quantify a country's resilience to material ESG risks. Although sovereign ESG providers offer different ways of conceptualizing their ESG products and different aggregation methodologies, they tend to focus on providing aggregated datapoints that have some demonstrated financial materiality in addition to standard sovereign credit risk analysis. Moreover, market practice incentivizes portfolios with higher aggregated ESG scores. This *purpose-neutral* approach only considers ESG as an input in the investment process but does not necessarily consider how an investment contributes to ESG outcomes.

Investors are beginning to focus on ESG factors as an output metric from investment decisions.[5] This *purposeful* approach considers an investment's impact on wider nonfinancial systems, measured along the three ESG dimensions. This view of ESG as an "output" of the investment process is closely related to impact investing paradigms. This is also observable in the JPM survey, in which 30 percent of respondents said that sustainability is integral to their sovereign ESG framework, while 60 percent have a separate but complementary SDG framework and 10 percent assess sustainability separate from the ESG framework. The authors of this paper argue that it is possible to have a "sweet spot" (figure ES.1a) that allows an investor to maximize return while also contributing to measurable sustainable outcomes.

ESG investing requires more clarity in its terminology to better articulate its investment purposes. Figure ES.1b groups various terms that are often used to describe the trade-off investors face according to their relationship to financial, social, and environmental materiality. Questions regarding materiality or impact are central to this confusion and there is need for further efforts at a global level to streamline both investment terminology and methodologies.

For example, investors who consider only financially material ESG risks in the investment process may not in fact contribute to sustainable outcomes. Indeed, sustainability has different shades, ranging from weak sustainability, which assumes complete substitutability between the different capital stocks, to strong sustainability, which assumes no substitutability so that all-natural capital must be conserved. This backdrop complicates ESG investing further. There is also a clear regional distinction between interpretation of the role of fiduciary duty and ESG investing, as well as regulatory approaches to ESG across regions.

The transmission channels of investing in sovereign debt to sustainable outcomes are complicated and are defined by the nature of the asset class. The nature and scope of sovereign bonds, the primary vehicle for sovereign ESG investing, obscures how an investment achieves ESG output. The rise in sovereigns issuing thematic bonds may help in part alleviate some investor concerns. In the JPM survey, most asset managers do not currently see the link between sovereign debt and sustainable outcomes as a major problem (only 16 percent do). The survey found that the current primary concern for investors is the lack of ESG standardization (42 percent) and the prevalence of greenwashing (24 percent). **[[AQ: Will the readers know what greenwashing is?]]**

Sovereign ESG performance sets a benchmark for subnational investment decisions and is increasingly a driver of capital allocations. [6] Similar to how market performance or country factors are used to evaluate performance and shape portfolio construction, sovereign ESG scores do not only serve to profile sovereign-level instruments, such as

government bonds. Sovereign ESG scores also trickle down to subnational entities, such as municipalities and corporations. Especially in countries where data coverage and quality are lacking, country-level indicators are often used to fill in missing values for smaller entities. Furthermore, a reliable and transparent sovereign ESG framework is in high demand, as it would also enable a fairer comparison of corporates across borders.

The paper identifies two structural challenges with the current sovereign ESG framework. First,

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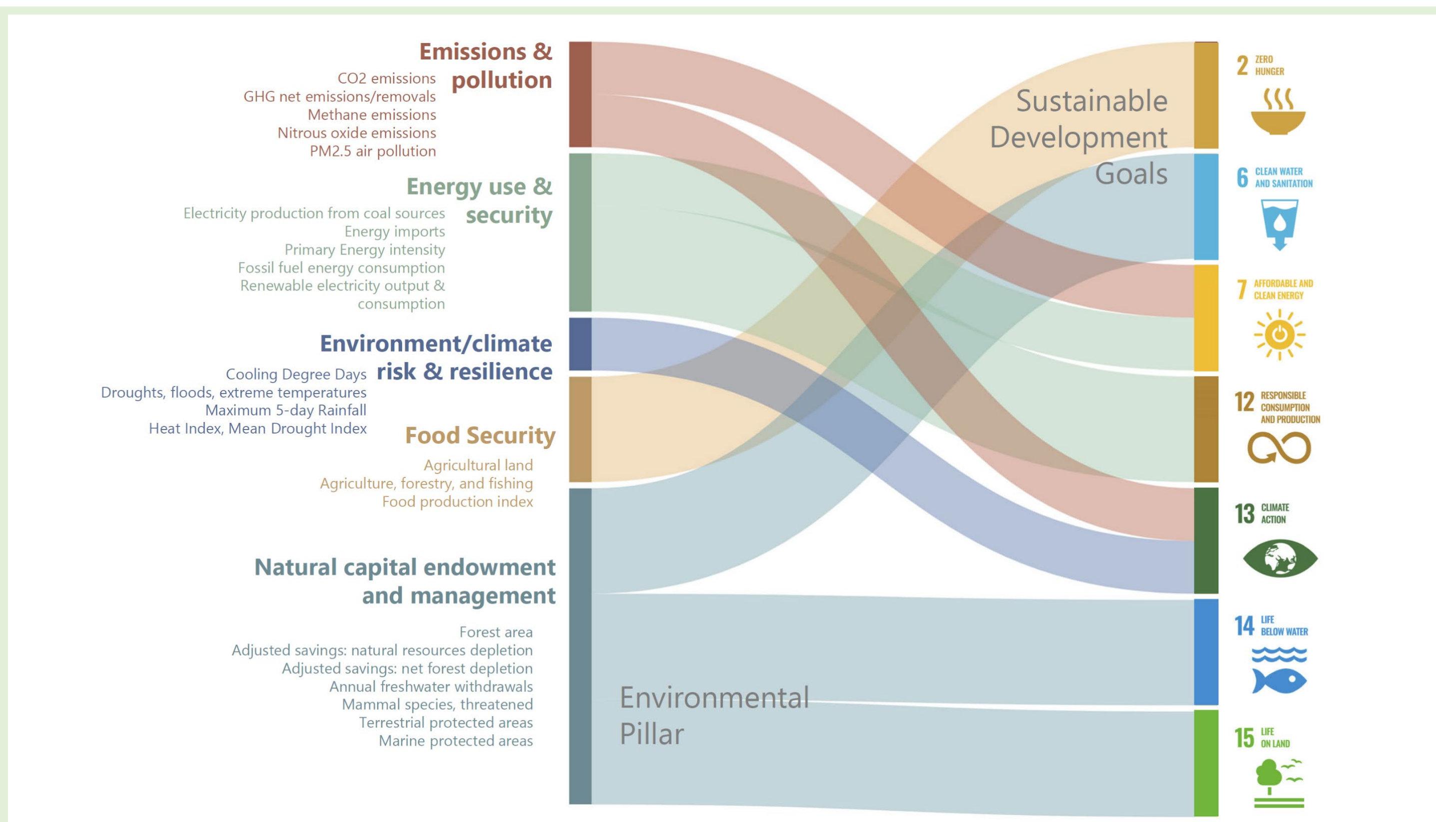
FIGURE ES.2 - Sovereign ESG environmental pillar has many facets that are difficult to measure



[6] See, for example, ISS 2019.

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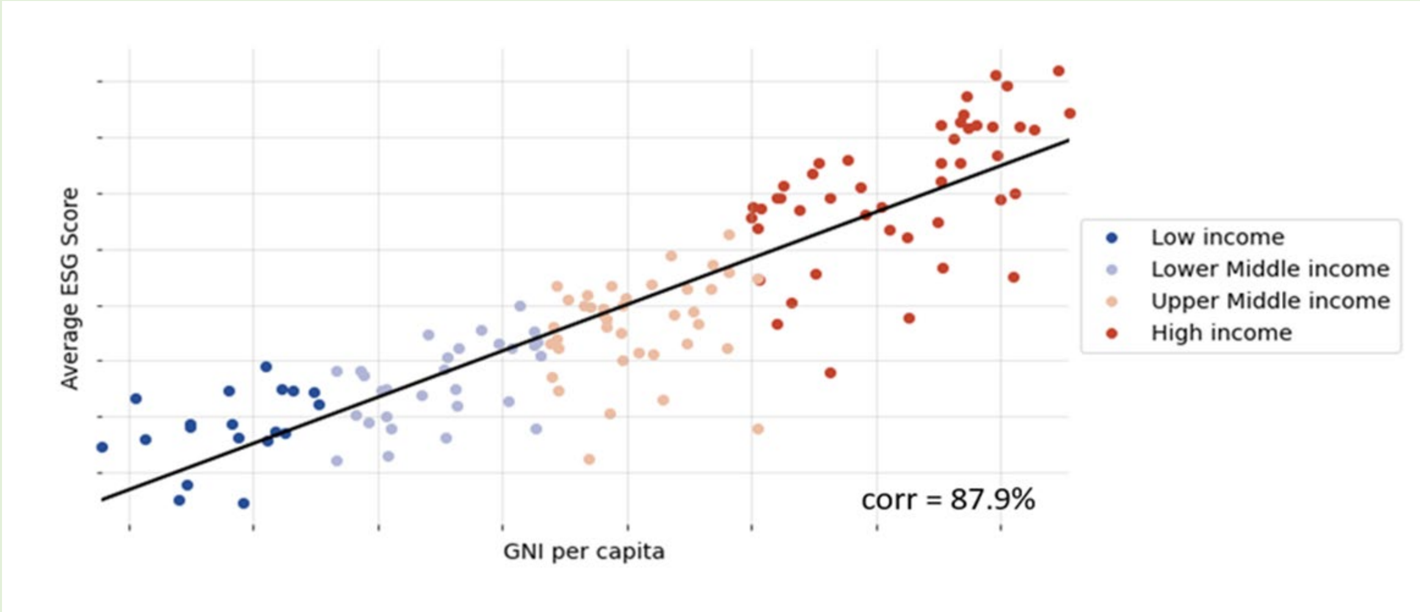
FIGURE ES.3 - Strong income bias in sovereign ESG scores



sovereign ESG providers, who have laid the foundation for the operationalization of ESG investing in sovereign fixed income markets, converge on measuring good sovereign performance on governance (G) and social (S) issues but not on measuring the environment (E) pillar at the sovereign level. One of the main reasons for disagreement on the E pillar is the complex question of what a "good" environmental performance is. The five major environmental themes from the World Bank's sovereign ESG data portal, for example, are directly linked with at least seven of the United Nations Sustainable Development Goals (figure ES.2). This close relationship highlights the importance of accurately measuring environmental indicators but also the challenge. This is also manifested in the JPM survey: 70 percent of the respondents underrepresent the E pillar because of data challenges, whereas 26 percent underrepresent the S pillar and only 4 percent underrepresent the G pillar.

The second challenge is that while sovereign ESG providers converge on what good sovereign ESG performance is, that ideal is driven by an *ingrained income bias*. About 90 percent of sovereign ESG scores are explained by a country's national income, thus richer countries have better ESG scores. Whether this truly reflects sustainability can be debated. However, current sovereign ESG scores set questionable incentives. For example, the level of income in developed countries could disguise ESG risks that could lead to misallocated capital and the potentially perverse incentive of driving capital away from low-income countries toward rich ones. This relationship also has important implications for sovereign ESG indices and other investment flows, which are influenced to a varying extent by sovereign ESG scores. The JPM survey emphasizes that this issue is also a focus for the asset manager community: 24 percent of respondents listed it as the most dominant concern about sovereign ESG investing.

As seen in figure ES.3, average ESG scores across seven ESG providers correlate closely with gross national income per capita across 133 countries. The regression line exhibits a significantly positive slope.

Path Forward

As a result of these structural challenges, the current sovereign ESG framework needs to correct course and become more transparent. We list guiding principles for a Sovereign ESG 2.0. framework that should provide a solid foundation for future developments and avoid the structural challenges of the current framework (figure ES.4). Five key areas that both the World Bank and other stakeholders can focus on are identified. These are (a) clarity on investment objective (b) transparent methods, (c) improved data, (d) incorporation of forward-looking scenarios, and (e) unbiased from a country's level of income.

Foremost, investors need to be able to clearly define their preferred investment approach, whether that be purpose-neutral or purposeful ESG investing or some combination of both. Investors and asset managers need to clearly articulate (a) their financial and sustainability objectives, (b) the mechanisms by which they will be achieving these objectives, (c) the metrics by which they will measure success or failure, and (d) the approach for balancing these objectives when they are not aligned. Transparent methods are also critical to allow stakeholders understand what is being measured. More transparency in rating approaches and data sources employed facilitates a constructive dialogue between data providers, rating agencies, and investors.

Availability of data is a critical issue to advance the sovereign ESG framework. For example, to analyze the recent performance of sovereigns on ESG issues requires more frequent and recent data coverage. A reliable data environment also makes the construction of rules-based investment indices feasible. Despite good progress (World Bank

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FIGURE ES.4 - Key areas to focus on for Sovereign ESG 2.0

sovereign ESG data portal, World Resources Institute data platform, advances in geospatial data), significant shortcomings remain, particularly on the environmental side. Large data gaps and lags mean that it is often necessary to impute missing data or extrapolate data forward. Advances in geospatial data collection as well as machine learning methods offer a promising way forward, but they also require significant technical expertise and support to be more broadly and publicly available.

World bank wealth data are a promising source for additional data insight. The purpose of wealth data largely overlaps with the goals of sovereign ESG scores, but the latter have adopted wealth data only to a limited degree. The economic materiality, forward-looking perspective, and long history of consistently curated data suggest that wealth data could be a potential input for better-quality data. Wealth data address two major shortcomings of current sovereign ESG data. First, wealth data assign an economic value to environmental resources and, second, the comparatively long history of wealth data allows focus on recent developments in environmental performance.

Forward-looking assessments are also critical because the risks from climate change are expected to be more frequent and larger in the future than in the past. Traditionally, financial materiality has been determined by looking at statistical relationships in past data. With the consequences of environmental degradation and climate change looming on the horizon, E indicators need to not only represent the value of the environment today but also capture the value of its protection and the costs of its loss for future generations. Looking at nature from this perspective also sheds light on the risks and opportunities that stem from natural assets.

The ingrained income bias is a fundamental challenge for sovereign ESG investing. Recognizing and adjusting for this bias is a key requirement for Sovereign ESG 2.0. Ideally, ESG scores should give an accurate representation of a country's sustainability that is not primarily a result of its level of income. However, removing this bias is not a simple exercise, as any adjustment method rests upon assumptions about what ESG scores should represent and what "good" ESG performance is.

While some practitioners have advocated income adjusting by using a regression adjusted for GDP per capita, the authors of this paper argue that this may lead to overcorrection and would fail to capture the nonlinear nature of income's impact. We therefore propose two alternative approaches (momentum and peer group scoring) that may serve the goals of income adjustment better. We also discuss the drawbacks of these methods, such as additional data requirements and the sensitivity of peer group selection.

The level of capital market development is a binding constraint for operationalizing a more equitable sovereign ESG framework. The very nature of the financial system as well as the prevalence of benchmark investing in the sovereign emerging market (EM) universe means that only a few EM sovereigns can attract meaningful flows to their local currency sovereign debt market. Multilateral development banks (MDBs), such as the World Bank, continue to play an important role with respect to financial sector deepening, contributing to efforts to support developing countries' sustainable growth. The World Bank's Finance, Competitiveness, and Innovation (FCI) and Treasury global practices also provide technical assistance and advisory services on bond market development as well as on thematic sovereign bond issuance. Cooperation between MDBs and private institutions will need to grow to help EM issuers access capital markets. Further public-private cooperation (including IFC and Amundi, JPMorgan Chase Institute, and others) is essential to continue to also transform the financial industry collectively toward greater sustainability through, among other things, design of new financing instruments and development of market-ready practices and frameworks.

The World Bank will continue to work with key stakeholders on the issues identified in this paper. The guiding principles identified provide a solid foundation for future work, and the World Bank will continue to play a proactive leading role. The paper highlights that sustainability is a complex topic and that the current sovereign ESG framework may in fact disadvantage poorer countries. It is also important that policy makers and key stakeholders are cognizant of these dynamics and that MDBs and governments of advanced economies support middle- and low-income countries in their efforts to make their economies more sustainable. This work may or may not be through the sovereign debt market. Although sovereign ESG investing is certainly one lever to attract ESG-orientated capital, other methods such as taxation and regulatory changes could also help and be relatively more effective in lower-income countries.

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J.P. Morgan ESG Investor Survey

J.P. Morgan's Emerging Markets (EM) Research Team and Global Index Research Group conducted a survey of dedicated EM investors with sovereign debt strategies. The survey aimed to gauge investor opinions on a range of topics related to environmental, social, and governance (ESG) strategies, focusing specifically on EM sovereigns rather than corporates, including but not limited to their ESG investment and sustainable finance investment philosophy, the materiality of ESG factors, the trade-offs between fiduciary duty and sustainability goals, and issues around ESG scores for EM sovereigns.

The survey was small by design, our intent being to start with a small sample size with the potential to grow in the future. The survey was designed to take the temperature of a relevant group in order to better understand investor attitudes toward sovereign ESG approaches and to begin the conversation regarding both challenges and opportunities. The survey received a response rate of 70 percent, representing investors with almost US$650 billion in assets under management (AUM), indicating the high level of interest by managers looking to grow their ESG-aligned funds. More details on their characteristics are in Table ES.1.

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TABLE 1 - Survey participants

Dedicated Emerging Markets AUM	$645 bn
Real Money	96%
Hedge Fund	2%
Asset Owners	2%
# Responses from Europe	51%
# Responses from US	35%
# Responses from Asia	14%

Source: J.P. Morgan

Key Takeaways

1. **Investors that manage ESG-aligned funds are primarily motivated by their own respective mission statement rather than the evolution of the regulatory landscape**. Most investors consider ESG integration to be within their fiduciary duty. Results show that 90 percent of client interest and inflows currently originate from Europe, followed by North America (6 percent) and the Asia-Pacific region (4 percent).

2. **Emphasis on the E and S in ESG strategies is growing, but G remains the most important when conducting sovereign assessments.** One-quarter of investors selected the E pillar as the most underrepresented pillar in sovereign ESG data. Data challenges could contribute to the difficulty in integrating social factors into sovereign assessments.

3. **Investors generally agreed that better ESG fundamentals should lower sovereign credit risk, but there remains uncertainty if implementing ESG investing would sacrifice returns.** Investors believe that sovereign ESG should support the development journeys of EM countries rather than rewarding only high performers, highlighting a key tension within current frameworks.

4. **Investors overwhelmingly rely on external data vendors to assess ESG factors, MSCI and Sustainalytics being the most commonly used providers.** The third top provider was Verisk Maplecroft. A minority of vendors have an entirely in-house EM sovereign ESG approach.

5. **Most investors believe that they are not engaging enough with debt management offices (DMOs), which are seen as having a critical role in providing sovereign ESG data to investors**.

Selected Figures from the Survey

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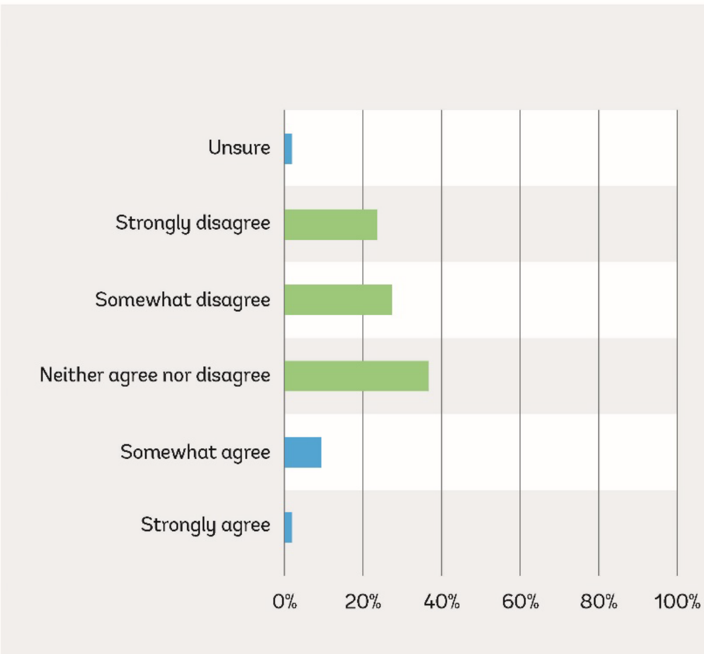
QUESTION 3: To what extent do you agree with the statement: "Implementing an ESG strategy sacrifices investment returns compared to a market benchmark"?



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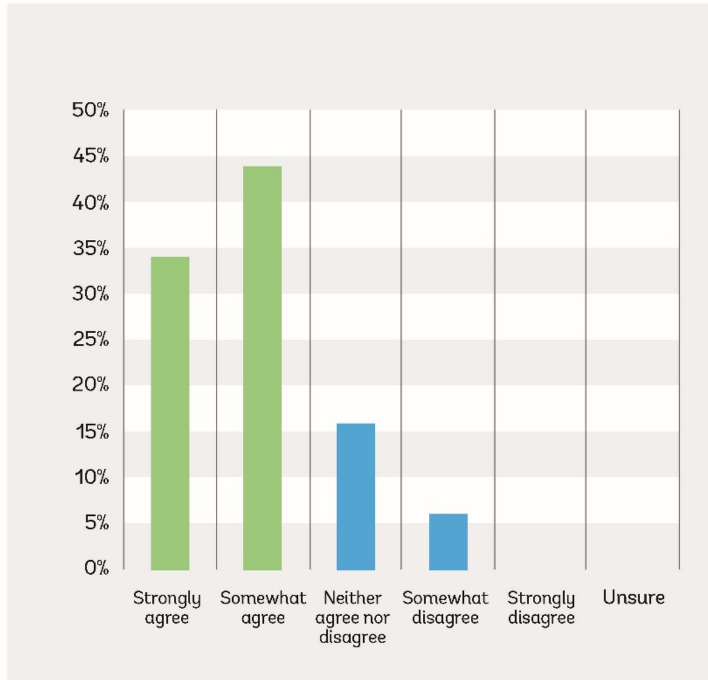
QUESTION 11: To what extent do you agree with the statement "improving ESG fundamentals will lead to lower sovereign credit risk?



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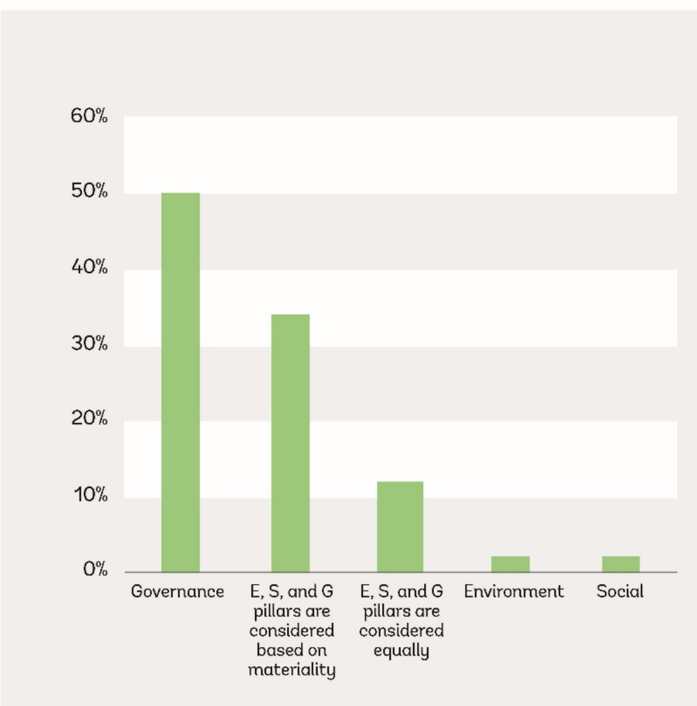
QUESTION 15: Which pillar (if any) within ESG is most important when conducting EM sovereign assessments?



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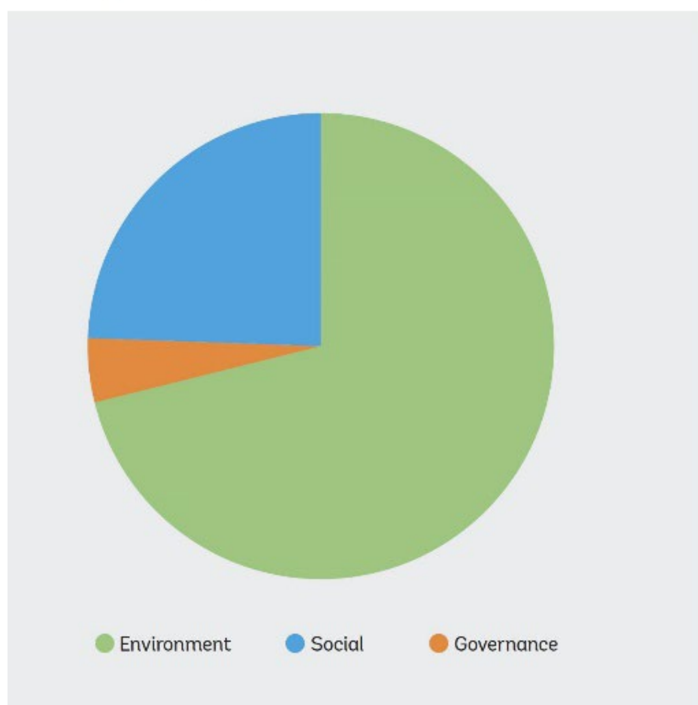
QUESTION 16: Which pillar (if any) of ESG is underrepresented due to data challenges at the EM sovereign level?



Other insights into **sustainable finance** you may be interested in

- *Riding the Wave: Navigating the ESG Landscape for Sovereign Debt Managers.* by S. Boitreaud, E. Gratcheva, B. Gurhy, C. Paladines and A. Skarnulis
- *Demystifying Sovereign ESG.* by E. Gratcheva, T. Emery and D. Wang
- *A New Dawn - Rethinking Sovereign ESG*. by E. Gratcheva, B. Gurhy, T. Emery and D. Wang
- *Credit Worthy: ESG Considerations in Sovereign Credit Ratings.* by E. Gratcheva, B. Gurhy, F. Stewart, A. Skarnulis and D. Wang
- *1% Growth in Natural Capital: Why it Matters for Sovereign Bonds.* by E. Gratcheva, B. Gurhy and D. Wang
- *Natural Allies: Wealth and Sovereign ESG*, in: *The Changing Wealth of Nations 2021: Managing Assets for the Future.* by E. Gratcheva and D. Wang
- *Natural Capital and Sovereign Bonds.* by D. Wang
- *Spatial Finance: Challenges and Opportunities in a Changing World* by WWF and World Bank.

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The Global Program on Sustainability (GPS) promotes the use of high-quality data and analysis on natural capital, ecosystem services, and sustainability to better inform decisions made by governments, the private sector, and financial institutions.

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