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Emerging Sovereigns and Sustainability

Environmental, social and governance (ESG) considerations are becoming more important for many investors, and in some cases asset owners demand explicitly that the traditional return objective is complemented by advancement in sustainability goals. At Neuberger Berman, we do not consider sovereign bond issuers an exception to these ESG demands.

We acknowledge the challenges involved in assessing and ranking sovereigns through the lens of sustainability, especially in the emerging world. However, given the relationship between ESG and credit ratings, and the critical role that sovereigns must play to overcome some of the world's biggest challenges, in this paper we conclude that neglecting sovereign sustainability is simply no longer an option.

Executive Summary

- The growing importance of emerging markets to the global economy means that global sustainability cannot be achieved without sustainability in the world's poorer countries.
- But there are big challenges: slow progress on the UN Sustainable Development Goals has been set back again by the COVID-19 pandemic; and it will continue to be held back by a lack of reliable data, biases in existing data, a lack of focus on the most critical SDGs, a lack of consistent regulatory guidance for investors and a lack of a coherent framework for approaching sovereign sustainability.
- We describe an approach that aims to deal with these challenges by taking a holistic view of the concept of sovereign sustainability, with the aim of bringing it somewhat in line with the better-established concept of corporate sustainability:
  - Fully understanding the role and particular challenges of sovereign engagement
  - Minimum standards and exclusion policies
  - Taking a country-specific approach to particular environmental and social sustainability goals
  - How to think about sovereign "labelled bonds"

There is no question in our minds that sovereign debt markets are crucial for the global sustainability agenda. By 2019, fixed income investments in sovereigns, sub-sovereigns and agencies (SSA) by the signatories of the United Nations' Principles of Responsible Investment amounted to more than $18 trillion, or 21% of the total $86 trillion in signatories' assets under management.[1] That gives investors significant ability to influence the sustainability considerations of sovereign issuers.

The role of emerging and developing SSAs is crucial. Data suggest that emerging countries contain around 80% of world's population, contribute around 60% of the world's GDP and generate two-thirds of its carbon emissions. Regarding environmental development alone, HSBC has estimated that China needs to invest RMB200 trillion, or 200% of its current GDP, to achieve its target of net-zero emissions by 2060.[2] Bank of America reckons that India has more than $400 billion of investment lined up for emissions reduction in the current decade.[3]

But time is of the essence. Back in 2015, all UN member states set 17 concrete sustainability goals for 2030, known as the UN Sustainable Development Goals (SDGs), which aim to end poverty, improve health and education, reduce inequality, and spur economic growth—all while tackling climate change and working to preserve our oceans and forests. But the global pandemic has not only blown us off course for some of these SDGs, in certain cases it has taken us back below the base lines set in 2015. For example, the UN's 2020 report on the SDGs reveals that childhood vaccination programmes have stalled in 70 countries, and that school closures kept 90% of the world's students—more than one and a half billion children—out of formal education during the worst of the crisis in spring of 2020.[4]

Big Challenges Require Even Bigger—And Active—Solutions

The challenges are formidable, and investors can play a vital role in solving them. But investors face their own challenges.

First, there are major gaps in the growing tide of sustainable business and investment regulation. There is the challenge of managing regulatory fragmentation and divergence, as European Regulation via the Sustainable Finance Disclosure Regulation (SFDR) and the

[1] Anna Georgieva and Justin Sloggett, CFA, *A Practical Guide to ESG Integration in Sovereign Debt*, Principles of Responsible Investment, 2019.
[2] Qu Hongbin, "China needs green tech boost" at https://www.gbm.hsbc.com/en-gb/feed/innovation-and-transformation/beijing-needs-green-tech-boost.
[3] Amish Shah, CFA, "India ESG Series Part 1: De-carbonization efforts on track; major cos stepping up" at https://rsch.baml.com/adareport?q=ReEpEPh7nDqf7LBvrYhZ!Q&e&ps=true&pv=validated.
[4] United Nations Economic and Social Council, *Report of the Secretary-General: Progress towards the Sustainable Development Goals*, July 2020.

E.U. Taxonomy attempts to set a global benchmark, while some regions, notably the U.S., have yet to commit fully to a framework. And even in the draft regulatory technical standards of SFDR, while Principle Adverse Impact (PAI) indicators are a key step in the "do no significant harm" test for a sovereign, there is no guidance on whether or how PAI violations should be disclosed, leaving asset managers and owners to draw their own conclusion on whether a violation is relevant or need not be disclosed. The current state of regulation represents a sensible start, but does it go far enough against a backdrop of such pressing urgency and demand from investors?

Secondly, a systematic or purely quantitative approach to integrating ESG factors into an emerging sovereign investment process presents real difficulties.

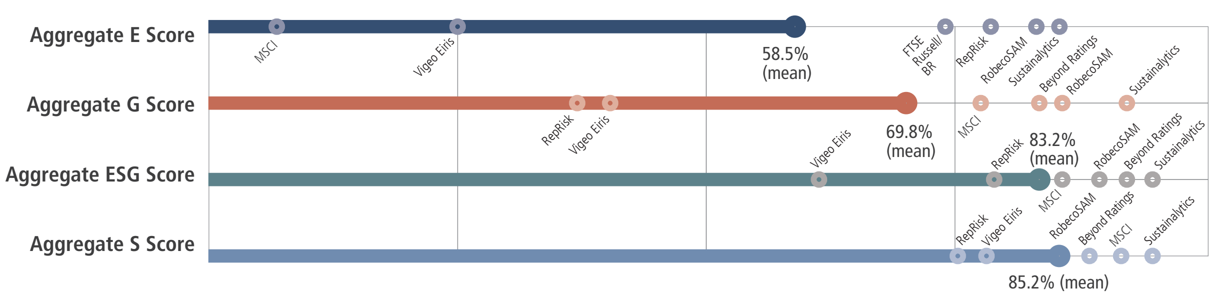
As an active manager, we have a long-standing belief that material ESG factors are an important driver of long-term investment returns, and we take a comprehensive approach that includes the integration of ESG criteria into our investment processes, including in sovereign bonds.[5] The challenges grow when it comes to promoting sustainability objectives. Firstly, sovereign issuers are multi-dimensional. Because they make policy and regulate industries, the sustainability of a country's public sector is only one aspect of their impact. In our view, to be an informed sustainable sovereign debt investor requires a deep understanding of a country's business and economic profile, as well as its evolving legal and regulatory context. This approach to ESG integration continues to focus on the impact of ESG factors on current and future asset price and risk, while also considering the material impact of the issuer on a much broader set of stakeholders than would typically be considered for a corporate issuer, as well as the environment in which those stakeholders operate and live.

Moreover, we believe that systematically relying on standard ESG scores can be misleading or even harmful in the world of emerging sovereigns. Relatively richer countries tend to have stronger institutions and lower social inequality, which unsurprisingly translates into higher ESG ratings. The World Bank has calculated that 90% of the variation in ESG scores from seven providers across 133 countries can be explained by differences in per-capita national income (Figure 1). If money follows ratings, richer countries tend to get richer and poorer countries miss out on the funding, which hurts their ability to meet their SDGs. That can be a big disincentive to progress. Furthermore, this leads to a strong correlation between high ESG scores and higher credit ratings,[6] raising the risk that investors who follow ESG ratings end up with a portfolio skewed toward investment grade issuers and away from those high yield names that punch above their weight on sustainability.

FIGURE 1. CORRELATIONS OF ESG-RELATED INDICATORS WITH NATIONAL INCOME

Income and sovereign ESG scores of six providers

The E, S and G individual scores and combined ESG scores are correlated with GNI per capita to varying degrees, depending on the ESG provider. The S scores are most correlated with little variation across providers, while the E scores are least correlated with large discrepancies among providers.



Source: Ekaterina M. Gratcheva, Teal Emery, and Dieter Wang. "Demystifying Sovereign ESG" EFI Insight-Finance. Washington, DC: World Bank, 2020. Data providers: FTSE Russell/Beyond Ratings, ISS, MSCI, RepRisk, Sustainalytics, and Vigeo Eiris.

[5] NB Emerging Markets Debt Team, "ESG Factors in Sovereign Debt Investing," July 2013, at https://www.nb.com/documents/public/en-us/n0273_esg_factors_in_sovereign_debt_investing.pdf and Kaan Nazli, "ESG Enhancements in EM," June 29.2021 at https://www.nb.com/en/global/insights/nb-blog-esg-enhancements-in-em.

[6] Jan Hyman, Barclays Capital, "Performance of ESG-Tilted Portfolios of Sovereign Bonds," 26 January 2022 at https://live.barcap.com/PRC/publication/DR/FC_TEJ-bGJfMTYzMjE0NTQ4MTQxM34gfiB-IH4g_2638142.

Finally, we think it is important to acknowledge the complexities and idiosyncrasies of prioritizing SDGs within emerging countries. Data availability and transparency, although improving rapidly, still hinders investors from establishing clear, measurable targets for judging the progress issuers are making toward all the SDGs. Furthermore, not all SDGs are equal, and this can be especially the case in emerging countries, where some require more acceleration today to propel other goals in the future. For example, accelerating SDG 4, Quality Education, is pivotal for progress on SDG 5, Gender Equality.

Given all these challenges, we believe in an approach that incentivizes and supports increased emerging market sovereign sustainability domestically, as well as supporting their contributions to sustainability goals globally. We seek to build dynamic tools, such as the NB Sovereign Sustainability Framework described below, which allow us to increase transparency and analyse more SDGs and broader sustainability goals over time, and to better prioritise our analysis and engagement efforts in local contexts. And when measuring the progress and success of sovereigns, we recognize that it is imperative not to rely on a simple, current-best-in-class approach, but instead to take equal account of direction of travel—to be forward-looking and not backward-looking. With that in mind, we believe investors can benefit from a balance between countries with high current absolute ESG scores and countries with low absolute ESG scores but strong ESG momentum and likelihood of improvement. When we consider environmental and social criteria, we believe in seeking to identify the top-quartile performers but also the top improvers among the second-quartile performers.

The Growing Universe of "Labelled" Bonds

The universe of labelled bonds (Green, Social, Blue, Sustainable, SDG, Transition (low carbon) and Sustainable linked (KPIs)) has grown massively in recent years in emerging markets credit, from just below $28bn outstanding in 2017 to $216bn currently.[1] This market was in fact pioneered by emerging sovereigns back in 2017, with Poland the first sovereign green bond issuer in hard currency and Nigeria in local currency.

Sovereign bonds make up a fifth of the labelled bond market, at just over $40bn. In 2021, 15% of new sovereign bond issuance carried an ESG label. We estimate that sovereign ESG bond issuance in 2022 will dwarf even this, moving from $20bn to $60bn, mostly in green bonds.

We think ESG-labelled bond issuance will play a significant role in raising the capital needed for the global sustainability objectives. ESG-labelled bonds can also be a useful showcase for issuers' sustainability credentials, and we welcome any additional disclosure and reporting which is provided as part of the labelled bond issuance.

That said, the speed and magnitude of the growth of this market requires significant diligence and care. We believe investors should always consider sustainability at the issuer level, rather than the instrument level, and submit labelled bond issuers to internal vetting rather than relying on third-party analysis. As a result, in our own processes for portfolios that carry an explicit sustainability objective as well as those that don't, a labelled bond does not receive any preferential dispensation over and above a vanilla bond issued by the same company or sovereign. We also think investors should encourage sovereigns to structure these bonds in ways that commit capital to objectives and projects beyond government terms in office, to raise the probability of long-term impact beyond the whims of a particular administration.

This raises the question on how to handle ESG bond issuance from the countries that fail the equivalent of our "Do No Harm" screening in the sustainable funds. Should a country that is a large GHG polluter issue a green bond, how would we view this issuance? We advocate for investors to take a case-by-case approach to analysing labelled bonds, while emphasizing that the bar should be very high for issuers with poor track records on key ESG issues, especially for the human rights violators.

[1] Fabian Harold, Andreas Kolbe and Charlotte Edwards, CFA, Barclays Capital, *EM ESG credit snapshot*, October 27, 2021 at https://live.barcap.com/PRC/publication/DR/FC_RU1BSUxfRlVMTF9SRVBPUlR-bGJfMTYzMjE0NTQ4MTQxM34gfiB-IH4g_6178676da4709e167c02bd6b.

The NB Sovereign Sustainability Assessment Framework

Neuberger Berman considers a variety of sustainability indicators when measuring progress on a sovereign's environmental and social goals. Here we present just a couple of examples, with country-specific case studies.

1. Environmental Goals—Assessing Preparedness and Resilience for Climate Transition Risks

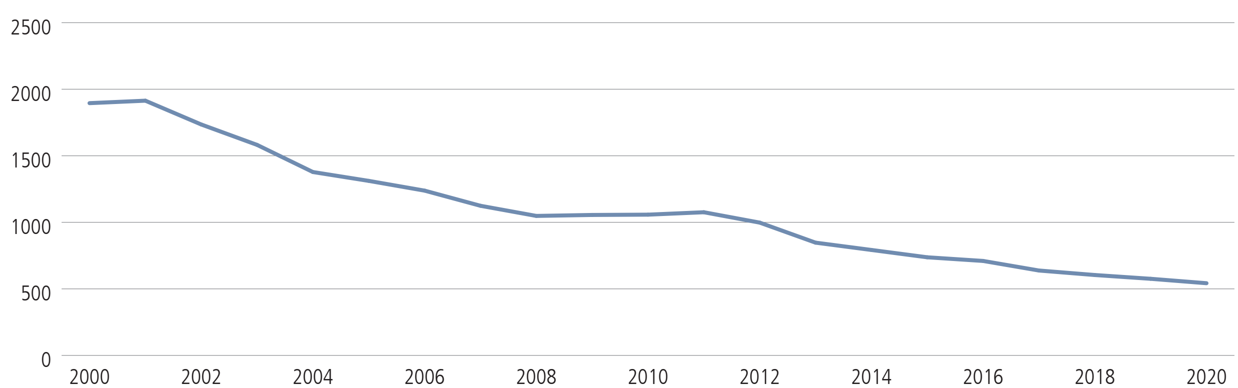
We consider climate change adaptation and mitigation as a crucial area for sustainable development. We centre our analysis on the Notre Dame Global Adaptation Initiative Country Index (ND-GAIN), which measures climate vulnerability and adaptation readiness based upon 45 indicators, adjusted for GDP per capita. We also assess territorial net greenhouse gas (GHG) emissions, adjusted for national income and GDP to isolate genuinely high-emitting countries relative to their economic footprints, and to avoid penalizing smaller or poorer economies. For the full picture, to better assess a country's vulnerability and readiness to adapt to climate change, we also consider data from the following sources:

- Global Forest Watch
- Institute for Health Metrics and Evaluation
- International Energy Agency
- OECD
- Potsdam Institute for Climate Impact Research
- Yale Center for Environmental Law and Policy

Case Study: Ukraine

We see Ukraine as a leading progressor on climate adaptation and mitigation and other environmental metrics since its independence, modernizing an economy that was reliant on inefficient and polluting heavy industry. Net GHG emissions, though still high, have dropped steadily to roughly a quarter of 2000 levels (Figure 2). Ukraine's recently updated Nationally Determined Contribution (NDC) targets a 65% reduction below 1990 levels by 2030—a significant improvement from the previous target of 40%, though still short of what is needed to achieve the 1.5°C goal.[7] Adjusted for income, the country performs strongly on climate change adaptation, outperforming most of its peers in Central and Eastern Europe (Figure 3).

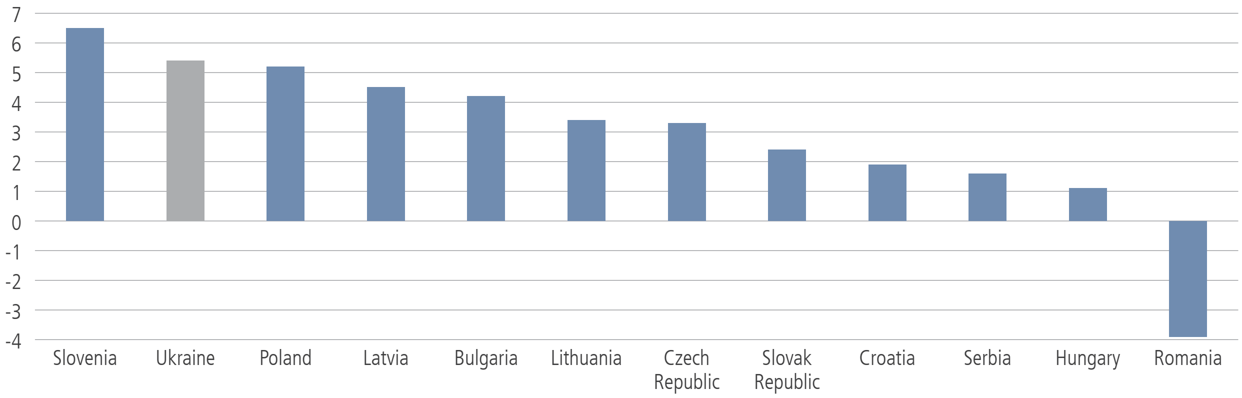
FIGURE 2: UKRAINE'S NET GHG EMISSIONS PER GDP (MILLION MTCO$_2$E/$MILLION GDP; 2000 – 2020)



Source: S&P Global Trucost.

[7] Climate Action Tracker, Ukraine Country Summary, September 15, 2021, https://climateactiontracker.org/countries/ukraine/.

FIGURE 3: INCOME-ADJUSTED ND-GAIN SCORES (2019)



Source: University of Notre Dame. Higher score denotes better performance. The countries listed are the sovereign bond issuers in Central and Eastern Europe.

2. Social Goals – Assessing Progress on Human Development

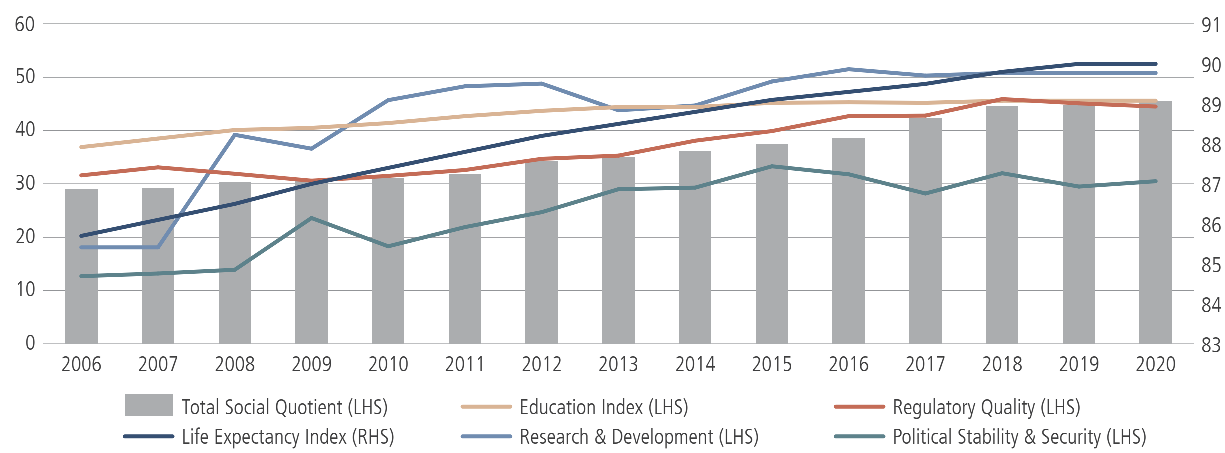
In the emerging world, social goals, and particularly public health and education, are key—because they create the essential foundations for enhancing so many of the other SDGs. Here we rely on data from various international development organizations, such as the OECD, United Nations Development Programme, UNICEF and the World Bank, as well as the Sustainable Development Report by Bertelsmann Stiftung and the Sustainable Development Solutions Network (SDSN).

Case Study: Ivory Coast

The Ivory Coast doesn't seem like a sustainability leader at first glance. It took armed conflict for the loser of the 2010 presidential election to concede, and political stability remains a challenge. The country experienced mutiny by a part of the army as recently as in 2017, and President Alassane Ouattara's decision to seek a third term, after his preferred successor died unexpectedly, has raised questions over constitutionality.

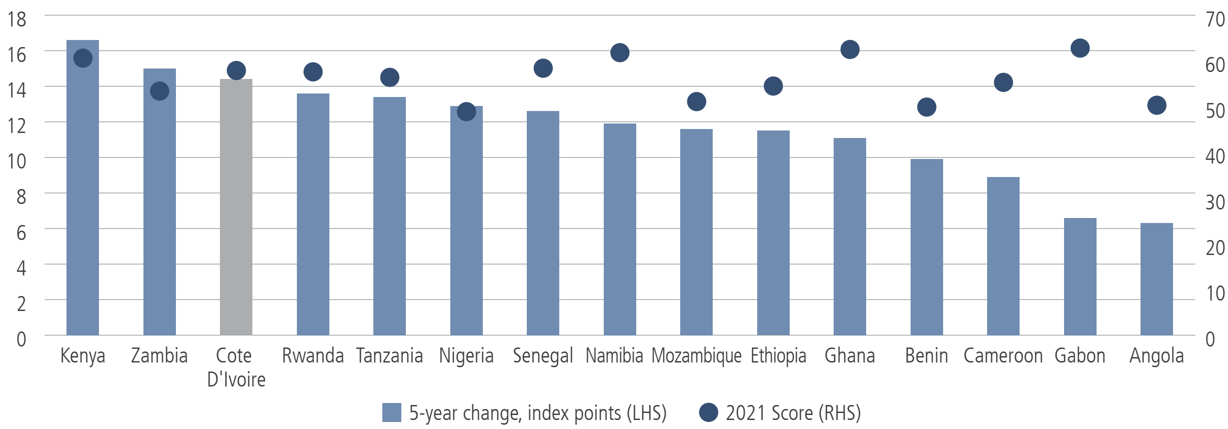
Despite these challenges, data indicate that the country is making remarkable progress on many social metrics, including steady improvements in life expectancy (from already relatively high levels) and in expected and realized years of schooling (Figure 4). According to the Bertelsmann Stiftung and the SDSN, among sub-Saharan African sovereign debt issuers, only Kenya and Zambia achieved greater improvement in its Sustainable Development Report Index scores over the five years to 2020 (Figure 5).

FIGURE 4: NB SOVEREIGN ESG QUOTIENT SOCIAL INDICATORS FOR IVORY COAST (2006 – 2020)



Source: Neuberger Berman, UNDP, World Bank.

FIGURE 5: SUB-SAHARAN AFRICA SUSTAINABLE DEVELOPMENT REPORT INDEX SCORES (0 – 100)



Source: Bertelsmann Stiftung and the Sustainable Development Solutions Network. The countries listed are sovereign debt issuers in the Sub-Saharan Africa region.

3. Minimum Standards—"Do No Harm" Principle

We believe the ability to assess sovereign impact will continue to improve over time, but in the meantime, in an imperfect system we think a prudent approach is to set minimum safeguards.

Our "Do No Harm" principles seek to isolate sovereign issuers that are:

- ranked in the bottom decile based on Neuberger Berman's proprietary ESG assessment, with no near-term improvement prospects
- ranked in the bottom quartile and deteriorating, based on human rights or rule of law shortcomings, with additional considerations for countries with the death penalty, or where top officials have been sanctioned by the UN Security Council for human rights violations
- assessed as having high and increasing greenhouse gas intensity
- non-compliant with the standard put forth by the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes or are classified as a high-risk jurisdiction subject to a call for action by the Financial Action Task Force (FATF).

There are currently 20 sovereign issuers, accounting for a quarter of the sovereign issuers in the EMBI Global Diversified Index, that we would not expect to see in a sustainable emerging markets debt portfolio based on these principles.

Engagement with Sovereigns

Assessing the social and environmental sustainability of a sovereign, and its potential for progress, is one thing. Actively engaging with governments and other institutions to build a more holistic picture beyond the data, to help improve things and to accelerate progress is another—and, in our view, it is crucial not only for sustainability enhancement, but also for generating long-term excess returns. Neuberger Berman's Emerging Markets Debt Team engaged with 22 sovereigns during 2020, with most focus on tackling corruption, and dealing with the public health and socioeconomic challenges created by the COVID-19 pandemic.

The ability to access a sovereign is not comparable to that of a corporate issuer, but it is certainly not impossible, and where opportunities arise, we always look to engage. We think it is important for investors to focus on the UN SDGs, while also seeking to advance the narrative around NDCs, as well as country-specific issues such as anti-money laundering, corruption, labour and human rights, financial terrorism or child labour, to name just a few. One key advantage of focusing on the UN SDGs is that many countries take it upon themselves to announce their own goals, which enables investors to engage on those self-identified issues with much less risk of the engagement seeming or becoming politicized. We also think collaborative engagements through industry initiatives such as Transition Pathway Initiative and the Principles for Responsible Investment, as well as at investor conferences and bond roadshows, are key to improving results on the ground.

The sovereign issuers' path to sustainability will vary based on geographical, historical, demographic and socioeconomic factors, and as a result, progress can be slow and modest. We believe the greatest impact can often be achieved by focusing on issues within countries where performance is poor, but clear improvements can be made—but that means investors must be ready to exclude an issuer from their investable universe should engagement fail to be met with measures to address severe violations.

Case Study: Ukraine/Belarus

In recent years, we have been in dialogue with Ukrainian government officials, mostly from the Ministry of Finance and the central bank, but also with the Presidential Office, including a group meeting with the country's President in October 2020. During these conversations, the authorities have been open about the country's political challenges, and about the vested interests that complicate progress in these areas.

They have nonetheless shown progress:

- Passing a banking law that ensures the takeovers of fraudulent banks under the previous administration would not be reversed
- Re-criminalizing false asset declarations by public officials after this measure was struck down by the Constitutional Court
- Passing legislation to allow independent and non-partisan experts a meaningful say in the formation of top judicial institutions

There is still a lot of work to be done, particularly in ensuring proper corporate governance in state-owned enterprises and the proper enforcement of the anti-corruption institutions. We continue to monitor developments and engage with the authorities and multilateral donors on these issues.

We have also been in dialogue with Belarusian government officials in the autumn of 2020 following the presidential elections in August of that year that were declared not free or fair by a large part of the international community and triggered large-scale domestic protests. We searched for indications that the government would take meaningful steps to engage the opposition, it has instead continued a tough clampdown, thereby isolating the regime further from the international community and impairing its access to capital markets. Seeing no prospect of a genuine dialogue, we judged that the isolation could only get worse and began divesting our holdings, exiting them completely when the government announced a non-representative body for constitutional changes, which were promised to end the impasse.

Conclusion: Don't Let Perfect Be the Enemy of Good

If COP26 taught us anything, it's that the private sector and private capital will be critical in leading where policymakers are lagging. Developed nations have failed miserably on their 2009 commitment to distribute $100bn a year in climate finance to the developing world.

So how should investors play their role, particularly when it comes to financing the activities of the emerging world's sovereign authorities?

The approach described here is what we would call a "best endeavours" approach, which attempts to counter the challenges of data limitation and data biases, and lack of consistent regulatory guidance for both issuers and investors, to bring the concept of sovereign sustainability somewhat in line with the better-established concept of corporate sustainability.

Within that, we advocate a focus on the UN SDGs, not least because these goals were developed for sovereigns. But we also recognize that, in the emerging world, achieving or even making meaningful progress on all 17 SDGs is an overwhelming challenge, and that some SDGs are therefore "more equal than others"—particularly those social goals that create the foundations for progress on many other goals. We think investors need to be realistic in their ambitions and adaptable, so that they can incorporate more SDGs into their processes as we all get more comfortable that the relevant data genuinely provides a reliable sustainability signal.

The approach described here is not intended to provide a rubber stamp certifying that a sovereign is sustainable (or not), or that the risk/return profile of the investment is attractive. Rather, the aim is to provide a holistic view of a country's contribution to sustainability factors today, and progress toward sustainability tomorrow, both domestically and globally, and how that will impact investors. In doing so, we recognize how important it is, for both sustainability and financial reasons, to guard against misallocating capital to sovereigns committing significant harm.

As the saying goes, that which is not measured is not managed. We believe that the more we focus on sustainability of sovereigns, the more progress we will see on improving data and transparency, and the more impact our investment decisions will make on the pursuit of both the risk-return and the global sustainability goals of our clients.

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