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ESG Engagement in Sovereign Debt: Key Questions That Must be Asked

INSIGHTS

When it comes to emerging markets sovereign debt, successful engagement often comes from asking the right questions and monitoring the right metrics.

Kawtar Ed-Dahmani
Managing Director,
Emerging Markets Sovereign Debt

Engaging with sovereigns on environmental, social and governance (ESG) topics is distinctively different from engaging with companies—and in most cases, less straightforward. There are key considerations that raise complicated (but necessary) questions for the investment community. For example, what does it actually mean to engage with sovereigns on ESG? Should it be about lecturing finance ministers and central bank governors on issues related to freedom of the press, violence against minorities, or lack of progress on environmental issues?

Reflecting on this has led us to think about further fundamental questions around what ESG engagement means for sovereign debt investors—including if there is a best way to engage, what topics to engage on, and whether the process is actually worth it.

Why Sovereign ESG Engagement is a Category of Its Own

Large asset managers hold power in the financial markets, and the broader economy, when they decide where to allocate capital. In corporate asset classes (equity and fixed income), asset managers hold the equity or debt of companies on behalf of clients—they effectively own the company, at various levels of seniority. The increasing focus on ESG engagement and stewardship in general in the asset management industry acknowledges this influence. It aims to ensure the industry can generate value for clients while also positively impacting wider stakeholders. Moreover, in equity and corporate fixed income classes, it is often easier to establish that good performance in terms of environmental, social and governance practices has the potential to boost financial returns. As a result, it tends to be easier to align ESG interests between investors and companies, and to make ESG engagement more successful in those asset classes.

However, this framework does not apply to sovereigns. Sovereign debtholders (fortunately) do not own the countries they invest in, and there is no consensus on what it means for countries to be "good performers" in terms of ESG. Moreover, investors do not have the means to effect direct and immediate change on a country's policies. Therefore, sovereign ESG engagement raises questions that do not exist for corporates in terms of effectiveness, format, scope and legitimacy.

The Question of Effectiveness: Is Sovereign ESG Engagement Worth It?

As we have navigated the space of key concepts in ESG engagement, we have realized that sovereign engagement needs to be clearer about several important points. For example:

MATERIALITY

What does it mean for an ESG issue to be material for a sovereign? Should we target the ESG dimensions on which the country scores the worst? And whose point of view should be taken—the investor's, the government's, or that of the Sustainable Finance Disclosure Regulation's authorities? This raises the non-trivial question of hierarchy between ESG issues for a sovereign. Investors have their views on ESG dimensions and priorities, but the government may have other ideas. Whose dimension is the most material?

TIMELINESS

Stewardship encourages investors to set milestones and focus on engagement opportunities that have the highest likelihood of materializing over a specific time horizon, particularly the short and medium term. This is very difficult to achieve at the sovereign level. Considering a country's decarbonization strategy provides an example—investors can engage with a government on their strategy, their nationally determined contributions, and their carbon intensity, but whether the targets will be reached, by what date and the institutional enforcement mechanisms to make it happen are widely beyond the government's control. Additionally, many factors can derail the strategy, from a war that affects energy volumes and prices, to domestic political changes, to natural disasters. Indeed, the timeline to achieve the end goals and intermediary targets can dramatically change in a short period, and the path from start to finish is unlikely to be straightforward.

THEORY OF CHANGE

Focusing on how policy recommendations will translate into better ESG outcomes is a central dimension of engagement and impact investing in general. When dealing with a corporation, the chain of command is relatively straightforward—and while the decision-making that translates into outcomes can be complex, it is relatively clear. Sovereigns are very different. When investors discuss an ESG-improving policy with a government representative, it then has to be discussed within the cabinet, drafted into law, passed in the parliament, implemented by the relevant ministry, and then monitored over years and across various regions to assess the results. For this reason, there are countless factors that can derail or accelerate the process during the period. Even the policies that have the widest political consensus can be affected by exogenous phenomena. Poverty reduction can be halted by floods or a global pandemic, for instance, or it can be alleviated by increased remittances, somewhat exogenous to the government's actions.

IMPACT EVALUATION

As mentioned, measuring the impact of a policy can be difficult and time consuming.[1] Measuring the success and impact of an ESG engagement is even more elusive. It has been striking for us to observe that industry standards mimicked from corporate engagement practices are increasingly encouraging sovereign debt investors to assess whether their engagement has been successful or not. Because of the difficulty in establishing causality and the extreme complexity we are dealing with when it comes to engaging with a sovereign, assessing whether your discussion or correspondence with a government minister on an ESG issue has had any policy impact, let alone ESG outcome, is often impossible.

While the above challenges should not discourage the aspirations for ESG engagements with sovereigns, they do raise important questions to the investment community around what engaging with sovereigns on ESG actually means—and suggest quality should be prioritized over quantity and box-checking exercises.

The Question of Format: Is There a Best Way to Engage?

The question of how to engage with sovereign issuers is also a difficult one. In the corporate engagement space, investors can talk to investor relations or company management as well as employees, they can ask to integrate ESG on a company site visit, and they can cast votes if they are equity holders. But sovereign debtholders face three fundamental issues that do not exist for corporate engagement:

1. Sovereign debtholders tend to be a much smaller component of the government's financing mix than is the case for corporates.
2. It takes much more effort to have a precise understanding of sovereign ESG issues. While sovereign debtholders can and should select relevant and reliable ESG indicators, their ability to conduct ESG due diligence on the ground is much more limited compared to corporate investors.
3. The natural interlocutors are the officials from the ministries of finance, the central banks, and the debt management offices. While some investors, including ourselves, make the effort to reach out to the policymakers that are in charge of implementing ESG-relevant policies (including ministry of health, ministry of environment, and ministry of energy), many investors are more limited in their ability to engage with these parties. Instead, they simply have to express their ESG concerns or recommendations to the officials in charge of financial and macroeconomic management.

These limitations often force sovereign debt investors to consider alternative engagement formats such as:

- Collective action, which is more efficient than individual action but requires coordination between peers and industry-wide organizations to undertake the engagement more effectively.
- Communication and coordination with stakeholders—like the civil society—that have more insights on the ground, or those like the World Bank or IMF, which as large creditors have more power with the government than individual investors.
- Lobbying for ESG clauses in government debt contracts, which is limited for bond investors but can sometimes be done during pre-deal roadshows, debt restructurings or labelled bonds structuring.

1. We have published on the relevance of ESG indicators in a previous publication: https://www.barings.com/perspectives/viewpoints/finding-the-right-sovereign-esg-indicators-a-greek-tragedy

The Question of Scope: What Should Investors Engage On?

We have touched upon the fact that ESG sometimes means different things to different investors. The same goes for ESG engagement. For example, one of the questions we have fiercely debated within our team is whether discussing with the government how to achieve macroeconomic stability counts as ESG engagement. While the answer is easier for a firm's financial stability versus ESG outcomes, it is less evident for sovereigns. As an example, one question we may encounter is whether engagement on sovereign macroeconomic policies and performance counts as ESG engagement? We think it does, for several reasons:

- The economic literature shows that political and macroeconomic stability are pre-requisites of sustainable growth and development.
- Current examples of countries that have led unsustainable economic policies (such as Lebanon or Sri Lanka) are now struggling in terms of ESG performance: social outcomes are deteriorating (poverty, security, violence), environmental resilience is not the priority, and governance deteriorates (political instability, business environment, policy consistency, public transparency).
- Governments have strong budget and administrative constraints; specifically, achieving better fiscal efficiency and lower financing costs means more resources for health and education spending.

Therefore, recognizing that economic stability is a precondition for prosperity makes it almost de facto an ESG governance metric for sovereigns. Just as having strong institutions helps both environmental resilience and social policy effectiveness, a stable country has a greater likelihood of performing better on ESG than one where there is a policy-induced economic collapse.

There can also be legitimate concerns. For instance, including macroeconomic stability recommendations in the scope of ESG engagements has its own caveats—it can lead to suspicions of "green washing" or "social washing," or it can be seen as based on the premise that macroeconomic stability is a necessary but insufficient condition for good ESG performance. This also raises the question of engagement with countries that are already economically stable. However, we think that investors can mitigate these concerns through enhanced ESG analysis, disclosure and reporting.

The Question of Legitimacy: "Who Are Investors to Tell a Sovereign Government What to Do"?

Some of the points mentioned above underscore the lack of legitimacy that investors may struggle with when engaging with sovereign issuers on ESG topics. Additionally:

- Investors and sovereigns might have different ESG priorities.
- Investors are just one stakeholder among many others that are arguably more important to a government.
- Investors are often not qualified to make ESG recommendations or advice. They are not experts on climate change, poverty reduction and tackling corruption, especially when compared to academics, the civil society, specialized international organizations and governments themselves.

However, these objections should not disqualify investors from conducting any ESG engagements. First, there are areas where investor interest is more clearly and directly aligned with the government, the civil society and citizens overall, such as increased fiscal data transparency. Second, investors have direct access to senior government officials in a way that many academics, civil society players and citizens do not (and with greater access comes greater responsibility). Finally, it is in the spirit of ESG to increase education among investors and involve them in making progress on ESG topics. In some instances, the most successful engagement is not giving recommendations or making comments, but rather asking the right questions and monitoring the right metrics.

The Future of Sovereign ESG Engagement

We are aware that this short paper raises more questions than it provides answers. We have chosen to express the questions we are grappling with in order to show the complexity of this space, and we have given a clear answer to the points we feel strongly about.

Unfortunately, we have sometimes encountered too much certainty and assertiveness about what ESG engagement entails. The industry cannot spare a deep debate on the questions above before starting to set the standards of sovereign ESG investment. This is therefore a call for engagement among asset managers, asset owners, regulators and issuers to lead ESG stewardship in the right direction for the future.

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