“Double materiality:” Bringing a social and environmental impact lens to sovereign debt investing

Rhys Petheram, manager of the Jupiter Global Ecology Diversified fund, and Laura Conigliaro, Governance and Sustainability Analyst, explain how they developed a framework that goes beyond just risk assessment to consider the real social and environmental outcomes of sovereign green bonds.

- The challenge of assessing the environmental, social and governance (ESG) factors of a government issuing a green bond is uniquely different to assessing those of a company.
- While sovereign ESG investment risk analysis is evolving,[1] we feel the market is less advanced in developing frameworks for sovereign engagement, divestment and exclusion policies based on the social and wider environmental impact of government actions.
- The broad and universal elements of the UN Global Compact meant extending this framework beyond corporates to the sovereign debt holdings was a natural choice.
- We must show responsibility for the ESG impacts of our investments – both how they affect an asset internally, and how the asset affects its environment externally. This means if there does not exist a willingness to improve or engage, the conclusion we must draw from this is a decision to exclude.
- By sharing our approach, we hope to encourage a dialogue about the social and environmental impacts relating to sovereign green bond issuers.

As the sovereign green bond market grows, so do social and environmental considerations

Issuance from the sovereign green bond market accelerated in 2020 with bonds issued from both developed and emerging market countries. This growth appears set to continue this year, as requirements to provide updated climate commitments ahead of COP26 are a likely catalyst for governments to issue green bonds in an effort to illustrate their contributions. Indeed, the governments of the UK, Spain, Italy, Canada, and Vietnam have all indicated their intent to issue green bonds,[2] while many existing issuers have committed to ongoing programs. The stronger liquidity characteristics of these instruments versus corporate green bonds should be welcomed by sustainable fixed income portfolio managers in need of enhancing liquidity profiles in a backdrop of deteriorating financial market structure.[3]

As the market grows, a key challenge for investors will be to demonstrate they are giving due consideration to the social and environmental actions of the issuers they are supporting. This is particularly pertinent in the face of the regulatory push to consider ‘Do No Significant Harm’ criteria within the investment process.[4] We believe these considerations are especially relevant for labelled bonds, such as green bonds, where the proceeds of issuance typically do not in practice directly finance or refinance their nominated projects but instead are more of a ‘virtual’ interpretation of the ‘use of proceeds’ terminology.[5] This fungibility of proceeds increases the need for greater analysis of the broader actions of issuers.

For example, Egypt’s issuance of a green bond in September 2020 attracted an order book five times greater than the amount they raised ($750m). The nominated projects within the green bond framework capture many of the environmental themes that sustainability investors are focused on. However, how was the Egyptian government’s human rights track record and its environmental policies factored into investor criteria of sustainability funds? According to Human Rights Watch, Egypt is experiencing its worst human rights crisis in decades[6] and in the view of experts lacks adequate environmental consideration in its economic growth strategy.[7]

While sovereign ESG risk analysis tools and techniques are evolving,[8] we feel the market is less advanced in its development of frameworks for sovereign engagement, divestment and exclusion policies based on the social and wider environmental impact of government actions, rather than solely an evaluation of ESG investment risk. Divestment and exclusion policies within sovereign bond investing present a number of challenges, notably constraining an already limited investable universe and the danger of restricting access to finance for regions most in need from a sustainable development perspective. Nevertheless, some of the authorities benefiting the most from the financing of government debt are explicitly engaged in negative social, climate-related and other environmental activity in a manner that would never be tolerated in a corporate investment framework.

In the rest of this article, we would like to share our approach and learnings from our process of developing such a sovereign framework, evidencing the strategy’s ESG outcomes for clients and with the hope of encouraging industry action.

A complex Issue: Green and sustainability bonds are not always issued by countries with the strongest human rights and environmental policies.

Figure 1: Green bond issuing countries mapped against human rights and environmental responsibility indicators

CHART

Applying the UN Global Compact to sovereign debt investing.

Jupiter’s Ecology range has a long history in ESG innovation. It includes the UK’s first green unit trust, which launched in 1988, just a year after the WECD’s seminal ‘*Our Common Future’* report had been published. Renowned for establishing the guiding principles for sustainable development and now commonly referred to as the Brundtland Report after the Commission’s Chairwoman, this report outlines the guiding principles of sustainable development. It emphasises the vital role of all stakeholders: that actions are necessary not solely among ‘people in all walks of life’ – individuals and civil society – but also from business and governments to meet sustainable objectives.

Accordingly, the UN SDGs and the UN Global Compact (“UNGC”) have been a mainstay for Jupiter’s sustainable investment funds and is indeed used across the industry as a framework for assessing the track record of potential portfolio companies against environmental and social standards. The UNGC, established in 2000 – the same year as the SDGs predecessor, the UN MDGs – is a framework for businesses based on 10 Principles guided by 4 pillars of (i) human rights, (ii) labour, (iii) the environment and (iv) anti-corruption.

This approach answers for the contributions of businesses. But what about governments – in investment terms, sovereign debt investments?

How have we built on this process for investing in government bonds?

1. We found a suitable framework for sovereign debt

Our starting point was to establish a good fit framework for sovereigns. Coincidentally, the broad and universal elements of the UNGC meant extending this framework beyond corporates to the sovereign debt holdings in the portfolio was a natural choice in terms of consistency and applicability. In our view this broad, global framework can be viewed as encapsulating the more specific principles within the EU Sustainable Finance Disclosure Regulations such as DNSH.

However, there was more than that: acknowledging the unique differentiators of sovereigns, not just in financial terms but in the world of ESG engagement, was a driving factor.

The UN PRI outlines how terms such as 'active ownership'[9] often do not transfer directly in a sovereign debt context: investor engagement must be carried out sensitively to avoid any misinterpretation as interference in a government's policy choices.[10] As a result, framing engagements around ESG disclosure and existing policy commitments can serve as non-controversial starting points, for example the Paris Climate Agreement or the UN SDGs.[11]

The UN Global Compact, itself based on international declarations and conventions by multilateral organisations to which nearly all countries in the world are already signatory or party to, fits in this category. For example, all International Labour Organisation (ILO) member countries – 187 – have an obligation to respect the ILO Declaration on Fundamental Principles and Rights at Work,[12] which forms the basis for the four UNGC Principles covering the Labour pillar. Moreover, 175+ countries have signed the Rio Declaration on Environment and Development, the basis for Principles 7-9.[13]

2. We developed a set of guiding principles

Next, we established three principles to guide the implementation of this framework into our investment process. Each of these principles were selected according to the specific realities of investing in sovereign debt.

These are: **impartiality, authenticity, and scope.**

Impartiality: In alignment with the different way in which active ownership is interpreted in sovereign debt, we wished to remove our own views from the process by relying on robust, publicly available third-party indexes: a data-driven approach. In total we consult 15+ data sources.

Authenticity: In our data selection process, we sought to consult sources which measure the lived experiences of individuals and communities, as well as the actual environmental and anti-corruption practices present in a particular country rather than what has been officially signed on to. Key theories in this space, such as Sen's Capabilities Approach, were a consideration here. Using the example above, simply signing the Rio Declaration is an important signal for global norms and cooperation – we certainly would not be better off without it – but this alone is not enough: we seek to measure whether its contents are being applied in practice. For example, consideration of a country's use of capital punishment – or where more relevant, munis – was integrated as one measure. Rather than consider it on a binary basis of whether or not capital punishment is technically possible in the legal books, we applied our authenticity guiding principle by consulting data on country practices, choosing not to exclude where capital punishment had not been applied for ten years or more, or where a change of government is due to take place where policy statements indicate it will be ceased.[14]

Scope: Like the Brundtland Report, we recognise the government is but one stakeholder among many inside a country. There can be situations, particularly in lower-income countries, where despite the government's best efforts there are certain events or even territory that it can endeavour to remedy but are not fully within its control.

An example of this principle is in our selected data source for UNGC Principle 4 concerning forced labour. ILO statistics show a startling amount of individuals affected worldwide, the majority in South and Southeast Asia and certain countries in Africa,[15] as researchers increasingly acknowledge the link between poverty and forced labour.[16] What's more, estimates find nearly half of the profits of forced labour are won by high income countries via their supply chains, even though actual prevalence in these regions is lower – highlighting the importance of modern slavery legislation and investor monitoring of company value chains in countries such as the UK, and Europe. To address this contradiction, when choosing the datapoint for this principle we selected an index measuring level of government response – including factors such as supply chains – rather than simply a measure of prevalence.

The outcome

With our framing and guiding principles in hand, we implemented our approach. The outcome was a set of lists, highlighting potential concerns regarding compliance with a particular UNGC principle for reference in future engagements. Countries considered in breach of the principles and in turn viewed as failing of one of the four core pillars are explicitly excluded from investment unless a viable engagement strategy with tangible outcomes can be implemented.

We recognise clients may be curious about the incorporation of exclusions in our ESG integration for sovereigns. This is particularly relevant given the correlation between countries with higher income levels and their ESG performance – this is seen across all the sovereign ratings we have come in contact with, and despite our efforts in scope, our outcomes are not free from this trend: the stronger performers on the list begin with countries in Northern and Western Europe, and many – though not all – of our exclusions are lower income countries. One may question this outcome, especially for a sustainable strategy: isn't it in fact these countries who need financing the most?

We contemplated this matter extensively and did consider ideas such as a physical risk overlay, where exceptions could be made for countries of high climate vulnerability. But ultimately, we decided against it. As investors with sustainability embedded in our investment objective, we believe that we must show responsibility for the ESG impacts of our investments – both how they affect an asset internally, and how the asset affects its environment externally. This means if there does not exist a willingness to improve, or engagement is seen to be ineffective, the conclusion we must draw from this is a decision to exclude – in this case, to refuse to finance government budgets where these challenges of highest severity exist. We see this as a fund-level choice made following specific considerations of our strategy and role, and we understand other market actors may take a different view on this.

However, this doesn't mean access to finance cannot be of help. In our view, in circumstances where our ability to engage is limited, other financial market actors are better placed to assist when sovereigns are facing very severe difficulties. For example, project financing undertaken by development banks and other DFIs: namely, actors who hold very extensive understanding of the challenges and often have in-country operations. By investing in the bonds of these institutions we can act as a stakeholder in supporting their direct actions in these more challenged regions. We believe a development bank financing the construction of a school represents a different contribution for countries in these situations than an institutional investor adding funding to the state budget.

For the remainder, we look forward to playing our role as sustainable, long-term investors in sovereigns working to solve important sustainability challenges, generating sustainable financial, environmental, and social returns for our clients.