Uncut gems: The evolution of ESG in EM sovereign debt

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There are few asset classes upon which ESG factors have a more visible and profound impact on financial outcomes than in emerging market sovereign debt. However, effective ESG integration in the space remains inconsistent.

- **The lack of a systematic means of integrating ESG factors into the processes that underpin EM sovereign debt investment has led to a widespread overdependence on exclusions and quantitative data – which is often backwards looking – and typically fails to reflect the realities on the ground.**
- **In this paper, we look at challenges EM sovereign debt investors face and outline our progress in integrating ESG factors into our portfolios. Our process, as we explain, seeks to move beyond the industry's overdependence on quantitative data and exclusions, employing a forward-looking approach that targets mispriced risks and improving fundamentals.**

The road to effective ESG integration in emerging market sovereign debt has been littered with misconceptions, missed opportunities and hard stops.

In this paper, we look at challenges emerging market (EM) sovereign debt investors face and outline our progress in integrating ESG factors into our portfolios. Our process, as we explain, seeks to move beyond the industry's overdependence on quantitative data and exclusions.

The landscape for ESG-conscious investors remains opaque, inconsistent and in need of standardisation.

There are few asset classes upon which ESG factors have a more visible and profound impact on financial outcomes than in EM sovereign debt. Despite the direct relationship between ESG ratings and credit spreads in the sovereign space[1], the landscape for ESG-conscious investors remains opaque, inconsistent and in need of standardisation.

With the industry lacking systematic means of integrating ESG factors into investment processes, there is widespread overdependence on exclusions and quantitative data – which is often backwards looking – and typically fails to reflect the realities on the ground, leaving a raft of missed opportunities in its wake.

[1] Pricing ESG risk in sovereign credit, Federated Hermes, 2019.
[2] Pricing ESG risk in sovereign credit II, Federated Hermes, 2020.
[3] Pricing ESG risk in sovereign credit II, Federated Hermes, 2020.

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It's not that developed market ESG standards are weak, but they may not necessarily put enough emphasis on effective federal governance, strength of national institutions, economic stability, and access to basic amenities. Such factors vary enormously across the 77 sovereign issuers in our universe. Yet they are vital determinants of economic growth and government financing costs. This mismatch highlights the importance of effective ESG analysis for investors in the asset class.

ESG is key to EM sovereign debt

Industry and academic studies have consistently evidenced a direct link between country-level ESG performance and EM sovereign credit spreads. On average, the countries with lower ESG scores have the widest credit spreads, while spreads for issuers with high ESG scores tend to be tighter[2].

The link between these variables remains intact even after factoring in the risks that are reflected in credit ratings, suggesting that these ratings do not sufficiently explain sovereign credit spreads.

As stated in a paper published by Federated Hermes in 2020[3]:

> *The relative financial weakness of some EMs leaves them more vulnerable to deteriorating ESG factors, which translates directly into credit risk. Consequently, extra financial risks seem to be more important for EMs than DMs [developed markets] given the former's higher exposure to ESG shocks and the long-term effects that it could have on sovereign-risk metrics for those countries.*

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While there is a lot that can be appropriated from ESG approaches used in the EM corporate debt space, they do not give enough weight to macroeconomic factors or political upheavals, which can profoundly affect a government's ability to repay sovereign debt commitments.

The challenges of ESG integration

An ESG component is often implied in the non-financial and macroeconomic considerations made in the research, valuation and selection of EM sovereign debt. For example, political risk is a standard country-level input in the EM space irrespective of whether the investor is running an ESG-aware portfolio or not. While such considerations have long been part of EM investment processes, systematic ESG integration at a sovereign level lags that of many other asset classes. The reasons for this include:

- Limited availability and access to ESG data
- Issues surrounding data paucity and accuracy
- Lack of transparency of government practices
- Inconsistencies in the definitions and measurements of material ESG risks
- Lack of industry standardisation in ESG scoring
- Less developed ESG integration tools and techniques.

The evolution of the approach

Given the challenges listed above, some asset managers choose to employ a sustainable benchmark framework, in effect delegating their ESG views to a third-party index provider. Many other managers take an exclusionary approach whereby issuers with poor ESG scores are omitted from the investment universe. Such approaches, when applied in EM, often overlook the nuances of the asset class, depleting the opportunity set.

An exclusions-focused approach tends to be backwards looking and often fails to capture positive trends and improvements among individual issuers. Investors that adopt this style may forfeit the opportunity to gain exposure to countries where the most ESG progress is being made as upward trajectories are scarcely priced into securities in a timely way.

At Federated Hermes, we employ a forward-looking approach that targets mispriced risks and improving fundamentals. We score the ESG trajectory of each issuer on the basis that ESG improvers are more likely to be mispriced by the market.

The strategy aims to ensure that less-developed countries that are making positive relative progress on the ground are not penalised for the low ESG scores they have at the present time. Similarly, we see this approach as an early warning system for longer-term risks associated with higher-scoring countries that may have deteriorating fundamentals.

An overview of our methodology

Our proprietary dynamic ESG sovereign scoring methodology is a key component in our objective to outperform the conventional JP Morgan EMBI Global Diversified Index over the cycle. Our methodology involves identifying material ESG risk drivers using 18 different data fields across the three pillars of ESG. We believe these fields complement our fundamental sovereign macro vulnerability analysis and enhance our understanding of EM sovereign credit risks.

This approach is predicated on the understanding that higher sovereign ESG scores are associated with lower macro vulnerabilities and lower EM credit spreads and borrowing costs. Our database covers 77 countries and the aggregate score weighs each individual ESG pillar according to its impact on material sovereign risks.

We believe that governance and social factors can have the greatest impact on sovereign distress or default.

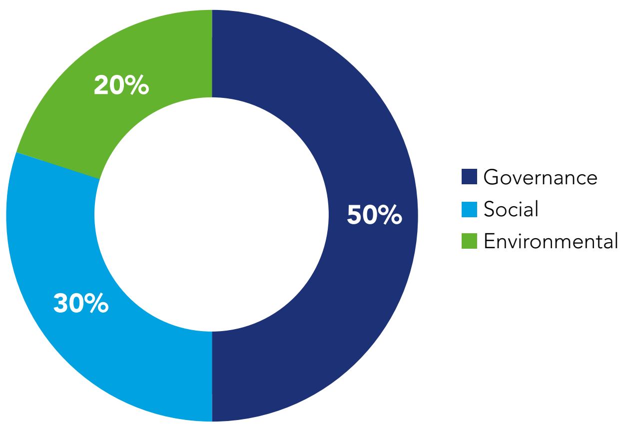
The 'governance' pillar carries a 50% weighting, followed by 'social' with a 30% weighting and 'environmental' which 20%. This split reflects the clear, almost-linear relationship between governance scores and EM sovereign credit spreads.

The reason we give governance a 50% weight is that, in the absence of good leadership and administration, a country will not be able to formulate and implement good policies in other areas, such as addressing social and environmental concerns.

Ineffective governance and social strife, for example, can hinder a population's access to basic amenities and education – which are more reliable indicators of sovereign risk than environmental considerations, which are inherently longer term.

As a result, we believe that governance and social factors can have the greatest impact on sovereign distress or default.

Figure 1: Federated Hermes' weighting for the three ESG pillars



Source: Federated Hermes

In the following section, we break down the 18 data fields or themes against which we score each sovereign issuer in the universe along with the associated data sources:

Pillar 1: Governance

Across the three pillars, governance carries the largest weighting of 50%, because this factor has the strongest bearing on sovereign distress and directly influences the other two pillars.

Governance (50%)	
Theme	Rule of Law
	Control of Corruption
	Political Stability, Violence & Terrorism
	Government Effectiveness

(Data sources include the World Bank; Natural Resource Governance Institute; Brookings Institution; Bertelsman Stiftung & Sustainable Development Solutions Network)

For two decades, Mozambique was one of the world's top ten fastest-growing economies

Governance case study: Mozambique – the demise of an EMD darling

For two decades, Mozambique was one of the world's top ten fastest-growing economies, attracting 10-15% of all foreign direct investment (FDI) inflows into sub-Saharan Africa. In 2016, the international media reported on the existence of several state-backed loans, guaranteed without parliamentary approval, and amounting to 12% of gross domestic product (GDP).

While the loans were provided by three international banks and earmarked for the building of shipyards, development of tuna fishing, and policing the coast, the funds were in fact pocketed by a small clique of government officials. The fallout of the disclosure caused the government to default on its debt in 2016 before triggering a protracted economic crisis in the country that saw inflation rise sharply and GDP halve in the subsequent three years[4].

Pillar 2: Social

Our scoring methodology assigns a 30% weight to the social pillar. This pillar mainly focuses on the ability of EM countries to develop human capital which is vital to achieve sustainable growth over the long-term and close the development gap.

Issues related to health and education as well as access to food and water are considered in this pillar, along with gender-related income disparities. We see this pillar becoming increasingly important for investors in the coming years.

Social (30%)	
Theme	Human Rights
	Access to Food
	Access to Water
	Gender Equality
	Education
	Health
	Life Expectancy
	Infrastructure Development
	Income
	Development and Deprivation

(Data sources include the World Bank; Freedom House; Index for Risk Management; Bertelsman Stiftung & Sustainable Development Solutions Network)

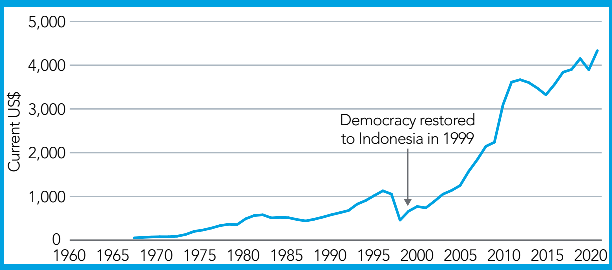
Social case study: Indonesia – positive progress on poverty

Indonesia is a good example of an EM country that has achieved positive social developments which have contributed to its overall sovereign credit profile.

Indonesia is the world's fourth most populous nation and 10th largest economy in terms of purchasing power parity[5]. The government's medium-term development plan has delivered significant gains in the sphere of human capital formation, cutting the poverty rate by more than half since 1999[6].

Over the past seven years, the proportion of households that live in inadequate housing and slums has declined from 45.9% to 40.39%[4]; while the proportion of the population with access to safe drinking water and sanitation stands at 87.8%, and 74.6% respectively[4]. There has also been significant progress on healthcare which was critical to the country's robust response to the Covid-19 pandemic and the successful deployment of a vaccination programme. Finally in the field of education, the KIAT Guru scheme, which aligns teachers' compensation with student attainment levels has raised standards across the country's schools, especially in rural areas.

Figure 2: Indonesia GDP per capita



Source: World Bank

[4] World Bank (https://blogs.worldbank.org/africacan/mozambiques-hidden-debts-turning-crisis-opportunity-reform).
[5] World Bank 2022.
[6] World Bank 2022.

Pillar 3: Environmental

We assign an overall 20% weight to environmental factors in our ESG sovereign scoring model. While this is the lowest-weighted pillar, the importance of climate and environmental vulnerabilities cannot be overestimated. Several EM countries are exposed to risks of drought, floods, climate change, and natural disasters, however, the relationship between the environmental dimension and credit spreads is the least linear on the spectrum. Such risks can be difficult to quantify, and their time horizon tends to be less certain.

Environment (20%)	
Theme	Air Pollution
	Water Efficiency
	Environmental Policy
	Carbon Emissions

(Data sources include the World Bank; Yale University; UN Sustainable Development Report; Global Carbon)

Environmental case study: Brazil – progress on remedying past offenses

Looking at Brazil's place on the global carbon heatmap, investors may be forgiven for thinking that the country's contribution to global warming remains minor. However, the country has, in the past, struggled to reign in its chief carbon-emitting industries, which cause the majority of the country's negative environmental impact.

In recent years, the Brazilian authorities have taken steps to address the vast carbon footprint of the industrial sector and the World Economic Forum has cited the country's continued progress on decarbonisation[7]. At present, 46% of energy uses are powered by renewables. Last year, Brazil was ranked 45th on the WEF's Energy Transition Index recognising the strides the country has made by engaging with industry via a range of public-private partnerships, collaborations and innovative financing schemes.

Dynamic scoring: identifying trends and incorporating key developments

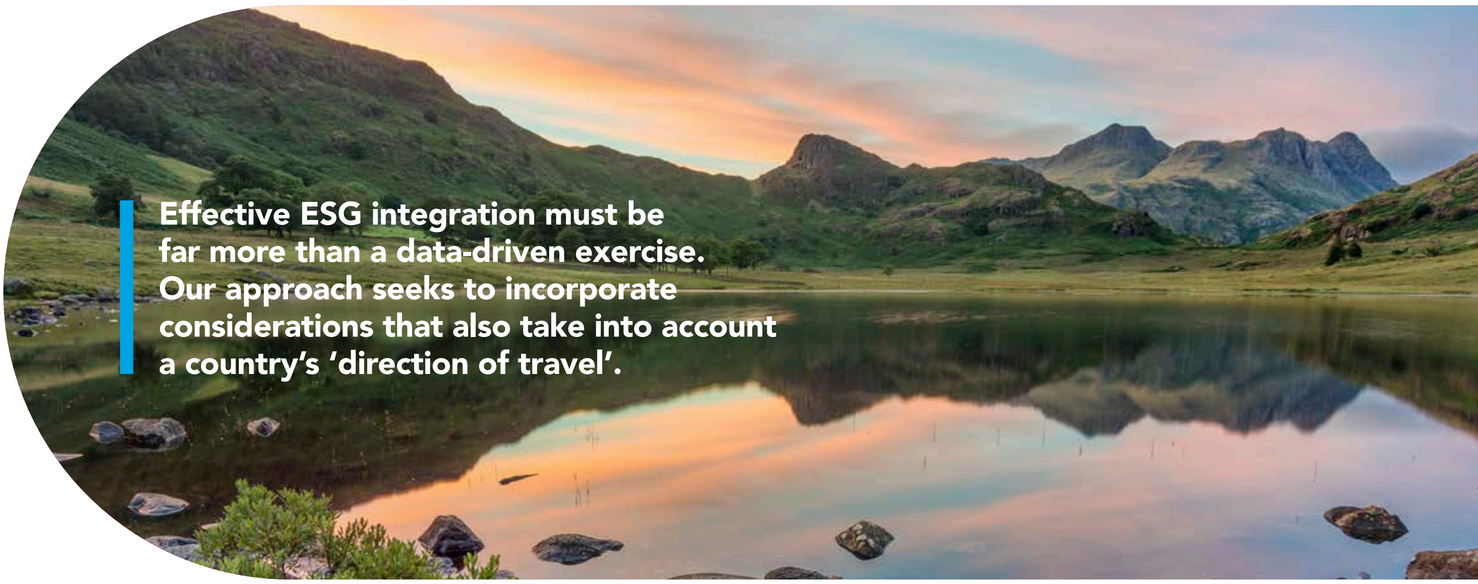
It is important to recognise that an ESG scoring approach based solely on quantitative data will be backward looking and subject to various types of bias such as the propensity for more-developed countries to have high ESG scores by virtue of data availability. For example, a positive change in government policy on the social and environmental front may not become obvious in the data for some time. Hence, a positive trajectory could be missed by investors.

Also due to data constraints in EM, most of the data fields collected for our three pillars' sub-scores are collected annually with some degree of latency. To consider various trends and the latest developments, our analysts can adjust a pillar score to the magnitude of 40% of underlying score for comparison and due diligence purposes.

Engagement: the next frontier

As highlighted throughout this paper, effective ESG integration must be far more than a data-driven exercise. Our approach seeks to incorporate considerations that also take into account a country's 'direction of travel'.

Engagement – the long-term active dialogue between investors and governments on environmental, social and governance factors – is crucial to the development of robust ESG analysis in the EM sovereign space. At Federated Hermes, we seek to meet regularly with government representatives across the markets we cover. We have also participated in industry and organisational working groups as we believe that investors collectively have a critical role to play in advocating on key ESG issues to the benefit of the environment, communities and our clients.



Effective ESG integration must be far more than a data-driven exercise. Our approach seeks to incorporate considerations that also take into account a country's 'direction of travel'.

[7] World Economic Forum, March 2021.

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