FINANCE

FINANCE

EQUITABLE GROWTH, FINANCE & INSTITUTIONS NOTES

Headline Messages

A New Dawn – Rethinking Sovereign ESG

WORLD BANK GROUP

This note contains the headline messages 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

>>>

Headline Messages

I. Environmental, Social and Governance (ESG) investing has become part of mainstream finance.

With more than $40 trillion of funds under sustainable management, ESG investing is no longer niche investing, including in emerging market (EM) sovereign debt markets. A recent J.P. Morgan survey of EM sovereign debt investors indicates that ESG factors are increasingly being used as an input into investment decisions. This is not only true for investments in sovereign debt markets but also other investments on the national and subnational level.

II. ESG frameworks need improvement.

The motivation for sovereign ESG investment decisions has evolved from "ESG as input"— primarily a way to manage ESG-related risks—to also encompass "ESG as output", with investors seeking to affect ESG conditions positively. In the "ESG as input" view, ESG scores are used as additional inputs into financial decision-making, such as assessing the risk-return profile of an investment. In contrast, the "ESG as output" view considers an investment's impact on broader, nonfinancial issues, such as environmental and social systems. This report argues that both views are not mutually exclusive and that investors can balance both to achieve a "sweet spot." Sovereign ESG assessments should make it easier for investors to pursue traditional investment goals, while also contributing to measurable sustainable outcomes. The current ESG framework is not always conducive to this perspective.

III. The Sovereign ESG framework must overcome three challenges: Lack of clarity, the ingrained income bias, and poor environmental data quality.

Unclear terminologies, overlapping concepts, and opaque scoring methodologies raise fundamental questions about the outcomes of ESG investing compared with the stated goals. This lack of clarity hampers the ability of investors to balance the use of ESG for investment and risk management decisions with goals for investment impact. Investment goals and the purpose of ESG scores must be conceptually aligned. Distinguishing between weak and strong sustainability further complicates ESG investing.

IV. The ingrained income bias may incentivize capital flows towards high-income countries and away from countries where funding is needed most.

Leading sovereign ESG providers score countries consistently on Social and Governance issues but differ on the Environmental pillar. Unlike the documented "aggregate confusion," which describes the large differences among corporate ESG scores by various ESG providers for the same firm, sovereign ESG scores are generally consistent with each other. This consensus may appear desirable, but a deeper look reveals that this is not necessarily true. More-developed countries tend to have stronger institutions, more equality, and more prosperity. Therefore, higher income tends to be tied to better ESG scores, especially regarding Social and Governance issues.

Because of this ingrained income bias, about 90 percent of ESG scores can be explained by a country's gross national income. As a result, richer countries have better ESG scores. Whether this truly reflects sustainability in every country is debatable. Furthermore, the sovereign E pillar includes a host of information on a sovereign's environmental condition and has the smallest weight in overall sovereign ESG scores.

More concerning, the predominant role of income sets questionable investment incentives. The income bias could disguise the ESG risks of prosperous developed countries, while greatly exaggerating the risks in developing nations. This discrepancy sets potentially perverse investment incentives that drive capital away from lower-income toward higher-income countries. This relationship also has profound implications for other investment flows, such as infrastructure investment, as well as sovereign ESG indices, which are strongly dependent on sovereign ESG scores.

V. Poor environmental data quality stands in the way of better assessment of a country's sustainability.

Improving the underlying environmental data sources is essential. The current data landscape makes it difficult to accurately assess recent performance, consistently compare country performances or construct reliable investment indices. Compared to their scoring on Governance and Social issues, ESG providers score countries on Environmental issues much less consistently. This is due to disagreements on what "good" performance is on a conceptual level, but also due to data gaps, out-of-date statistics, and heterogeneous reporting standards, which often force providers to fill in and estimate missing values. Fortunately, recent advances in geospatial technologies, as well as pressure for more standardized national reporting and the newest version of the Changing Wealth of Nations data show promise for mending these gaps.

VI. Sovereign ESG needs to correct course towards a more transparent framework: Sovereign ESG 2.0

Greater overall clarity in sovereign ESG is needed to better align the use of tools with intended purpose. The Sovereign ESG 2.0 framework should improve on the existing framework along five guiding principles:

1. Clarity on investment objectives
2. Transparent scoring methodology
3. Improved data sources
4. Incorporation of forward-looking scenarios
5. Accounting for the ingrained income bias

VII. Capital market development efforts should continue and cooperation between the public and private sector remains important.

The very nature of the financial system, as well as the prevalence of benchmark investing in the sovereign emerging market 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 in deepening financial sectors and support developing countries' sustainable growth. Cooperation between MDBs and private institutions will need to grow to help EM issuers access capital markets. Further public-private cooperation (for example, IFC and Amundi, JPMorgan Chase Institute, among others) is essential for continuing the transformation of the financial industry toward greater sustainability.

VIII. The World Bank will continue to lead and support sustainable finance.

Sustainability is a complex topic. More good can be achieved if market practices that become embedded in the financial system are equitable and transparent for all. Both private and public sectors have key roles to play. ESG investors should explicitly articulate their investment goals, and ESG score providers should facilitate this through clarity on how they score. It is important that policy makers in MDBs and governments of advanced economies support middle- and low-income countries in their efforts to make their economies more sustainable. Finally, although sovereign debt markets are important, they may not always be the best way to achieve desired sustainability results. Taxation and regulatory changes may be a better way to encourage ESG-oriented capital.

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.

GPS Global Program on Sustainability

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.

Find out more on http://worldbank.org/gps

WORLD BANK GROUP