Ninety One

Investing for a world of change

EM sovereign debt: taking stock of the sustainable bond market

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This growing and evolving emerging market (EM) investment universe provides a compelling long-term opportunity for investors to balance sustainability and return objectives, and a direct way to participate in a just transition.

While opportunities abound, a careful assessment is crucial. Nicolas Jaquier and Peter Eerdmans chart the evolution of the market – where EM issuers are increasingly pushing boundaries – and provide insights and pointers for investors.

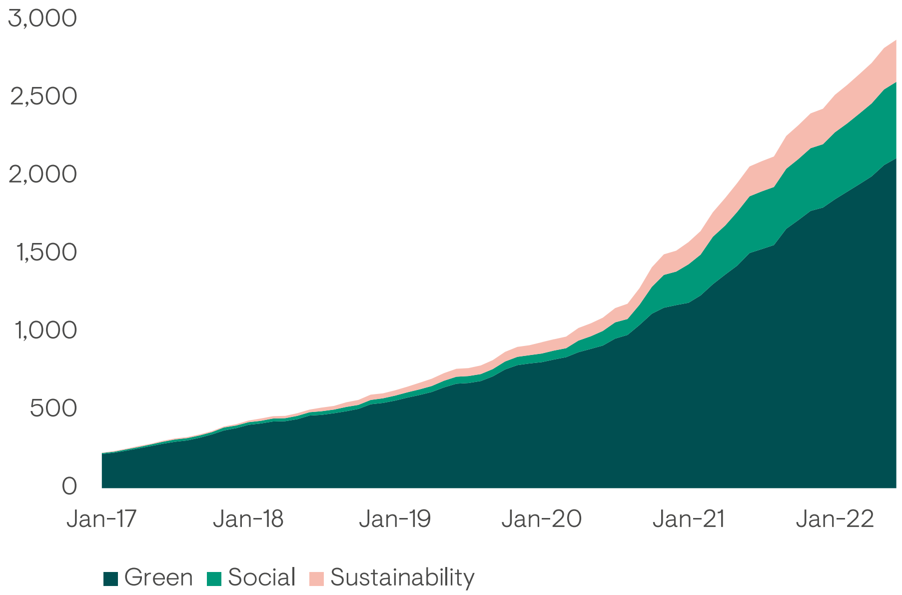
A maturing market, with EM increasingly leading the way

Green, social and sustainable (GSS) sovereign bond issuance has grown rapidly in recent years, but these bonds still only account for 5% of total outstanding sovereign debt. Sovereigns have been relatively late entrants to sustainable bond markets - following corporates and supra-national entities (such as the World Bank and the European Bank for Reconstruction and Development), which issued the first green debt securities in the mid-2000s. Poland and France were the first governments to issue green bonds in 2016 and 2017 respectively.

The market has been maturing rapidly since then, with the development of social and sustainable bond issuance and then sustainability-linked bonds (SLB) more recently, as we discussed here (adding an extra 'S' to GSS). We provide definitions for each of these in the Appendix.

Social bond issuance picked up significantly in 2020 as governments implemented large support programmes and allocated bond proceeds to address the health crisis caused by COVID-19. Since then, countries have begun to tap the broader GSSS bond market – e.g., in 2022, the Philippines issued its first sustainable bond, the proceeds of which are earmarked for a number of green projects as well as targeted social projects aiming to improve the country's healthcare, education system and food security. Looking ahead, vast sums of money will be needed for the global energy transition, making transition finance a key focus of the GSSS market.

Amount outstanding, by instrument (US$ billions)



Source: Sovereigns and sustainable bonds: challenges and new options, from BIS Quarterly Review, September 2022.

The number of countries establishing a presence in sustainable bond markets has grown to 38 globally. Some EM countries have become leaders in this field. For instance, Chile has grown the proportion of sustainable debt to over 30% of its total debt stock and is aiming to increase this to over half within the next two to three years. This is encouraging, as the capital required to achieve the energy transition predominantly needs to go to EMs yet that's where allocations are currently lowest. Tapping the growing GSSS bond market can help plug that gap, while presenting investors with compelling risk-return potential. In addition, sovereigns play a central role in setting the path for energy policy and establishing a presence on GSSS markets that often opens the door for green issuance from domestic corporates and raises standards for sustainable issuance.

A more inclusive and diverse universe

Typically, the GSSS market has been dominated by issuance in hard currency (US dollars or euros), although an increasing number of sovereigns have now started to issue in local currency (for instance Colombia, Chile and Thailand). This is encouraging, as sovereigns, especially smaller/frontier markets, cannot rely exclusively on foreign currency debt to finance the energy transition and need to be able to borrow in their local currencies to mitigate risks and adapt to climate change. In addition, this helps them to develop sustainable finance in their home markets. We expect continued growth and diversification in this sector.

Another challenge facing small and frontier economies relates to their ability to source enough green projects to package into a benchmark-size bond issue. This is where the sovereign SLB market can help. In contrast to GSS bonds, SLBs do not attach proceeds to fund specific projects. Instead, the issuer commits to reaching sustainability targets at the risk of incurring a financial penalty (higher coupon payments) if these are missed. These are powerful funding instruments that can have a far-reaching impact when the sovereign issuer meets the embedded targets (such as tonnes of CO_2 reduced/avoided[1], energy savings or number of additional beneficiaries of targeted social programmes). SLB issuance sends a strong signal of a country's commitment to reach climate targets and allows even small sovereign issuers to establish a presence on sustainable finance markets.

It is noteworthy that **the only two sovereigns to have issued an SLB to date are emerging markets** – another sign of the pivotal role that emerging markets will play in this growing asset class. Chile and Uruguay made commitments to curb emissions, increase the share of renewables in energy generation and protect native forests, in line with their Nationally Determined Contributions (NDCs). We expect more countries to follow.

Navigating the opportunity set

Rapid growth in GSSS issuance doesn't come without challenges for investors. These so-called 'labelled' bonds can stand accused of 'greenwashing' if a robust sustainable framework is not in place. Therefore, it is important for investors to be selective and test these frameworks not only against established standards such as The International Capital Market Association's (ICMA) Green Bond Principles, but also against market best practice. For instance, we believe GSSS frameworks should ensure strict exclusion lists that are relevant to the issuer, some independent oversight in the project selection process, and a critical assessment from a reputable third-party provider - such as Sustainalytics or Moody's ESG Solutions.

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1. Carbon avoided: producing lower carbon emissions than the status quo. Carbon reduced: activities that reduce greenhouse gas emissions.

At Ninety One, our in-house framework for assessing GSSS bonds is aligned with Emerging Markets Investors Alliance's enhanced labelled bond principles and includes a focus on the strength and ambition of key performance indicators (KPIs). We use a proprietary Net Zero Sovereign Index for this purpose.

Standards have improved significantly as the market has matured, and sovereigns have typically led the way in promoting best practices. It is also important to monitor allocation and impact reports, which are now starting to be published (see here for an example). These are useful resources to monitor progress ex-post and confirm adherence to ex-ante commitments included in the initial bond frameworks. They include updates on progress towards specific key performance indicators that funded projects are expected to improve.

A useful avenue for engagement

Although GSSS bonds only represent a small (but growing) share of total debt markets, selected sustainable bonds play an important role in our EM debt portfolios at Ninety One and currently account for around 40% of our EM Sustainable Blended Debt strategy. Engaging in conversations with sovereigns to help structure and assess their sustainability targets is important - it helps to establish a dialogue and ensure allocations in the new issue market where supply is still limited relative to the pool of demand, with issues generally highly oversubscribed and hence well-funded.

Example engagement

In early 2022, Ninety One's EM debt team engaged with a country's head of Debt Management Office (DMO) during a roadshow call relating to its first SLB issuance. In addition to finding out more details of the planned framework – including KPIs – we shared our Net Zero Sovereign Index with the DMO to help provide insights. We followed up with the DMO earlier this year when our engagement focused on the country's NDCs. The head of the DMO informed us that the NDC GHG emission reduction targets are now also absolute (vs. only GHG intensity of GDP previously). This was something we had strongly encouraged in the lead-up to the SLB issuance, as having GHG intensity reductions still allows for higher absolute emissions, which is incompatible to achieving Paris goals. We will continue to monitor the NDCs and will look out for the first SLB report.

Conclusion

The GSSS bond market in EMs provides investors with a growing investable opportunity set across an increasingly diverse range of countries and regions. It presents a compelling long-term opportunity for investors to balance sustainability and return objectives and a direct way to participate in a fair transition by allocating capital to where it is most needed and will have the largest impact. Bonds such as SLBs have explicit links to countries' NDCs, so have a natural role to play in portfolios that seek alignment with the goals of the Paris Agreement. That makes it important for investors to assess the level of ambition of these commitments; we use a proprietary Net Zero Sovereign Index for this purpose. The development of GSSS bonds also provides investors with an avenue for in-depth and specific engagement with sovereigns as they transition.

Appendix

Defining the opportunity set

Use-of-proceeds bonds

The issuer commits to allocating all the proceeds to specific projects, generally complying with a taxonomy such as ICMA's Green Bonds Principles or the EU's Green Bond Standard:

- Green bonds: all proceeds are allocated to green projects, such as renewable energy, green transport, green building or water management.
- Social bonds: all proceeds are allocated to social projects, such as increasing access to quality education, providing adequate pension services and healthcare or supporting low-income households and minorities.
- Sustainable bonds: all proceeds are allocated to a mix of green and/or social projects with the ratio either disclosed ex-ante or published ex-post as part of an allocation report.

While the proceeds from standard green and social bonds are allocated to projects that are often mapped to the UN's Sustainable Development Goals (SDGs), a few countries also issued SDG-bonds (Benin, Mexico), raising funds for projects that are expected to have a direct impact on key developmental targets.

Sustainability-linked bonds (SLB)

In contrast to use-of-proceeds bonds, SLBs do not attach proceeds to specific green or social projects but have set sustainability targets (KPIs) that must be achieved in future, such as reducing greenhouse gas emissions in line with the country's NDCs, increasing the use of renewables or protecting tracts of forest. If targets are missed, the issuer incurs a penalty in the form of increased coupon payments, making sure that financial incentives are aligned with sustainability objectives.

Related reading

A disorderly transition

Evidence suggests the transition to a low-carbon economy will be disorderly. By allocating to 'transition assets', investors can mitigate some of the disorder, while potentially generating positive outcomes for their portfolios. This paper makes the case for transition investing, and explains how to identify a true 'transition asset'.

Planetary Pulse: The rise in Transition Finance

Based on a survey of 300 senior professionals at asset-owner institutions and advisors around the world, including pension funds, insurers, endowments, foundations, central banks, sovereign wealth funds, and consultants, Planetary Pulse reveals the findings from new primary research into transition finance. The link allows you to explore the webpage, infographic and the full report.

The following pieces drill into the detail of our approach to assessing environmental opportunities and risks:

Sustainability and satellites

WWF and Ninety One joined forces to assess the potential uses of geo-spatial research — both to measure environmental risk in sovereign debt portfolios, and to facilitate engagement with governments to encourage fiscal agendas that serve people and the planet.

Net zero: no one left behind

If the world is to achieve net zero, current approaches to allocating capital must change. We examine the flaws in interpretation, which has led to portfolio-level carbon targets that will stymie global net zero ambitions. This paper also introduces and explains our Net Zero Sovereign Index.

Climate & Nature Sovereign Index

This paper, also a collaboration between WWF and Ninety One, introduces a framework for a clear assessment of environmental sustainability and risk on a country-by-country basis. It also introduces the Climate and Nature Sovereign Index.

EM sovereign debt: on track for net zero?

A year on from the launch of our Net Zero Sovereign Index, our EM Debt team explains how it now measures alignment with Paris climate goals and what that means for investors.

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