WHITEPAPER

Use your influence

Overcoming the challenges of sovereign engagement

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AVIVA INVESTORS

Contents

In summary

- **Global sovereign bond markets are roughly the same size as public equity markets, yet investors' willingness to engage is significantly lower**
- **Investors face a range of structural and economic/political challenges when attempting to engage with sovereign issuers, which can make engagement more difficult compared to other asset classes**
- **Many investors are mandated to hold sovereign debt with a limited ability or incentive to divest. Engagement is therefore crucial for investors to fulfil their regulatory and fiduciary duties**
- **COVID-19 has significantly increased the need for sovereigns to access public markets and represents a material opportunity for investors to engage with issuers on ESG issues**

Why it matters

Engagement has long been an important part of responsible investing, helping drive positive changes from issuers. However, while sovereign debt accounts for approximately 68 per cent of the global bond market, according to the International Capital Market Association, engagement between investors and issuers is far less common than for credit and equity markets.

In fact, a report in 2020 by the Principles for Responsible Investment (PRI) showed that 58 per cent of PRI signatories did not engage with sovereign, supranational or agency issuers.[1] Investors are missing a significant opportunity to use their collective power to increase the consideration given by sovereign issuers to ESG factors.

Investors have often looked to include some assessment of governance factors alongside their more traditional fundamental analysis of an issuer's credit quality and outlook. However, environmental and social factors, which can be crucial to long-term economic growth and macro stability, have typically received far less attention from sovereign debt investors.

The increased focus on ESG factors by clients and regulators, and a greater understanding of how they can influence asset prices, should incentivise investors to build a more structured and in-depth framework to integrate ESG considerations. Engagement between sovereign debt issuers and investors can play a key role in this process.

Engagement and transparency with investors can also be powerful tools to attract capital and lower funding costs for issuers. For example, improved ESG transparency can impact demand through the inclusion or exclusion from indices. This is becoming increasingly important given the growth in ESG "optimised" indices and lower risk premiums attached to issuers perceived to be making positive progress on ESG issues.

> Engagement and transparency can be powerful tools to attract capital and lower funding costs.

1. Carmen Nuzzo and Anna Georgieva, 'ESG engagement for sovereign debt investors - 2020', Principles for Responsible Investment, November 2020.

Rising social issues led to widespread civil unrest and falling asset prices in Chile

In 2019, a decision to hike metro prices in Santiago, Chile, sparked months of civil unrest driven by rising wealth inequality (the largest in the Organisation for Economic Co-operation and Development (OECD)). While the cause of the protests was a social issue, it had a significant impact on asset prices, with Chilean sovereign debt significantly underperforming as the protest movement took hold.

Figure 1. **Chile index yield versus local currency index yield**

Source: Aviva Investors, JP Morgan. December 31, 2020.

Benefits of sovereign engagement

> Engagement can bring benefits for investors, issuers and society.

Despite the challenges of engagement with sovereign issuers, it can bring significant benefits for investors, issuers and society.

We believe a constructive dialogue between investors and sovereign representatives can be mutually beneficial. It enables sovereigns to articulate their approach to managing sustainability risks while a deeper and more common understanding of those risks can enable better policy outcomes. Engagement also enables us to voice our support for action on sustainability commitments and gather insight on progress to inform investment decisions.

Improved disclosures and conversations with policymakers can improve investors' understanding of risks and opportunities. Ultimately, this can create a more efficient market for emerging market debt, where informational advantages can be more easily exploited.

Challenges with sovereign engagement

Engaging with sovereign issuers presents some unique challenges.

Fixed income investors regularly maintain a dialogue with corporate and sovereign issuers to better inform their investment decisions. For sovereign investors, the focus has not just been on assessing the ability of issuers to repay debt, but also their willingness to honour financial commitments given the limited recourse available if an issuer defaults.

For corporate debt, there has historically been a greater ability or willingness from investors to raise ESG issues alongside more financially motivated concerns. In part, this can be explained by some of the key structural and political/economic differences between sovereign and corporate debt markets and their investor base.

Corporate debt has historically seen a greater willingness from investors to raise ESG issues.

Figure 2. **Structural issues with sovereign engagement**

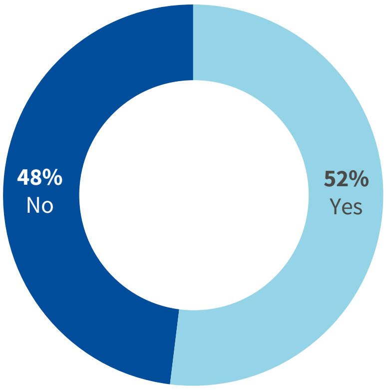
Sovereign	Corporate
Legal	
• Less explicit covenants and default clauses • Varied set of institutions and political/governance structures	• Legally binding rules and objectives, investors protected by covenants • Bondholder expectations can provide guidance to issuers and influence management actions
Issuer obligations	
• Limited recourse available for investors in the event of a default • Market access less severely impacted by credit events	• Bondholder seniority usually defined at issuance. Defaults can restrict future market access and pricing • Established legal procedures exist in the case of default or bankruptcy
Access to issuers	
• Issuer contact points vary across multiple departments/institutions/DMO/Treasury/central bank • ESG-relevant government officials spread across multiple departments, creating access issues • Shorter-term political cycles can hamper appetite for solving longer-term ESG concerns	• Clearly defined management hierarchies • Regular and established access to investor relations/C-suite execs • Stable tenure of executive teams allows for continuity of leadership and strategy

Source: Aviva Investors and Principles for Responsible Investment, 2022.[2]

The structural challenges that have historically made engagement with sovereign issuers more difficult are unlikely to disappear any time soon. However, issuers are becoming more aware that their investor communications need to incorporate ESG factors.

2. 'A practical guide to ESG integration in sovereign debt', Principles for Responsible Investment, 2022.

Figure 3. **Share of sovereign issuers that have changed their comunications and outreach to incorporate ESG factors**



Source: 2020 World Bank Sovereign Debt Manager Survey.

Political/economic limitations to engagement

Alongside the structural issues that can limit investors' ability to influence sovereign issuers, there are also political and economic considerations.

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Political interference

Engagement or publicly voicing concerns about an issuer's policies can be seen as a political statement, with investors perceived as meddling in the politics of the countries they are investing in.

Framing engagement around international commitments issuers may have already signed up to, such as the UN Sustainable Development Goals or Paris Agreement, can be used to facilitate engagement discussions and may minimise the appearance of political meddling.

Engagement can be mutually beneficial for issuers, who get access to international expertise and a greater understanding of which factors investors are most concerned about, while investors get to understand what steps issuers are willing to take to address ESG asks.

An emerging markets only issue?

ESG sovereign risks often tend to be associated with emerging markets (EM), with some investors viewing more liquid and often less risky developed market (DM) issuers as less relevant for engagement activities. However, ESG factors are applicable for both. The main reason for the difference in view is that EM countries tend to be less able to deal with the consequences of ESG issues. Climate change is a particularly good example of an issue that spans both EM and DM issuers. While EM issuers are generally more susceptible to the immediate consequences of climate change given their weaker economic position, DM issuers also face considerable risks.

Impact of extreme weather events on Japan

In October 2019, Japan was hit by Typhoon Hagibis, one of the most devasting typhoons to hit the country in over 60 years. Overall, nearly 100 people died, over 230 were injured, and 13,000 houses were destroyed or damaged.

In September 2019, Japan had already been hit by Typhoon Faxai, which left over 900,000 homes without power.

The economic damage caused by the two typhoons is estimated at $25 billion or 0.5 per cent of GDP.

Source: David Eckstein, Vera Künzel, and Laura Schäfer, 'Briefing paper: Global climate risk index 2021 - Who suffers most from extreme weather events? Weather-related loss events in 2019 and 2000-2019', Germanwatch, January 2021.

Investor size and forced ownership

Direct engagement between sovereign investors and issuers can result in meaningful change. However, given the size of global debt markets, individual investors may feel they lack the size to influence sovereign issuers' behaviour, especially in DM markets. However, collaboration between investors can make engagement with sovereign issuers more effective.

Many investors, especially companies like banks, will be mandated to hold a fixed percentage of assets in sovereign bonds. As a consequence, investors have to be willing to engage with issuers to drive change given the limited ability to divest.

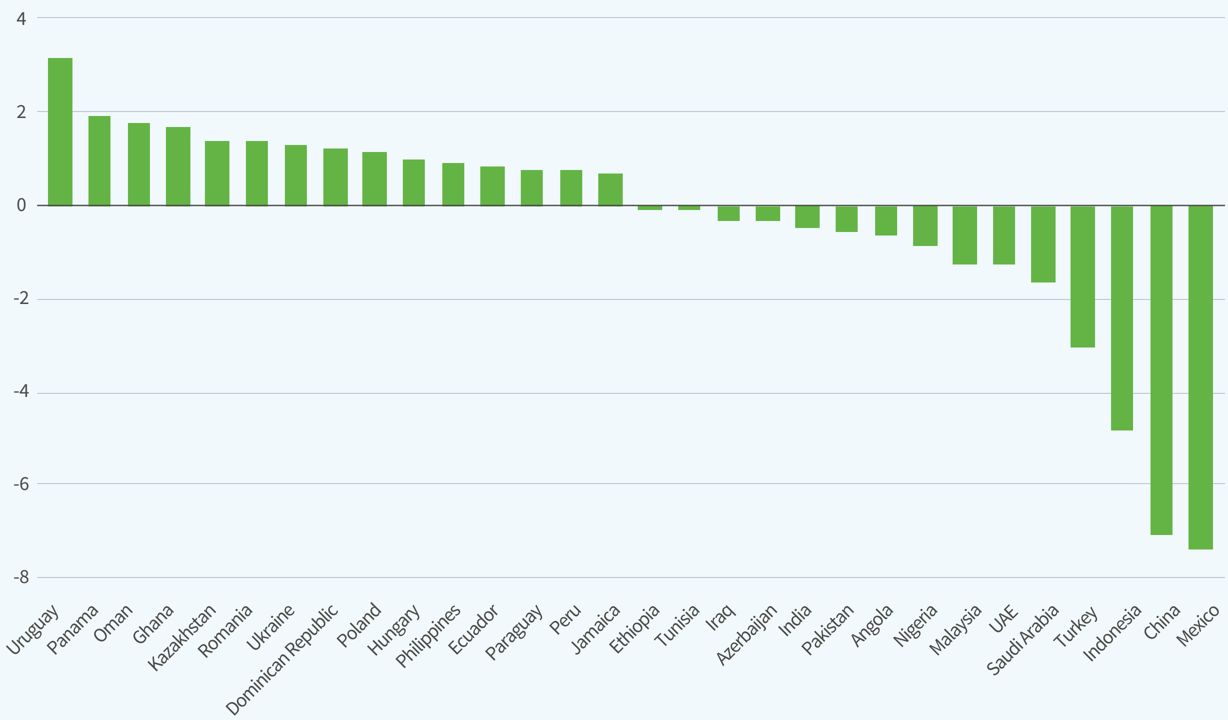
Furthermore, index inclusion can result in a significant amount of forced buying by passive and some active investors. And while technical factors can be a significant driver, ESG is likely to have a significant influence over longer-term performance. The growing trend for ESG-optimised portfolios and indices is likely to increase the technical pressure on issuers that see their index weightings fall as a result of ESG concerns.

The growing trend for ESG-optimised portfolios and indices is likely to increase the technical pressure on issuers.

ESG optimised indices offer technical support for issuers

The chart below shows how the weightings for certain index constituents are different between the ESG and standard versions of the most widely followed EM hard currency index.

Figure 4. **Changes in index weight between standard and ESG indices (per cent market value)**



Note: Weighting difference greater or less than 0.5 per cent included.
Source: J.P. Morgan, 2021.

Methods of engagement

Engagement is likely to require a more coordinated approach across multiple institutions.

For corporate investors, engagement with issuers is usually relatively straightforward and can be facilitated by investor relations teams. However, engagement by sovereign investors requires a more-coordinated approach across multiple institutions.

Broadly, these can be grouped as issuer stakeholders and non-issuer stakeholders:

- Issuer stakeholders can include all or some of the following: debt management offices (DMO), treasury departments or finance ministries, and central banks
- Non-issuer engagement can help inform the investment process, giving investors a holistic view of developments within a country while also providing a way of confirming data and information gained through official channels
- Non-issuer stakeholders include opposition political parties, NGOs, multilateral institutions such as ratings agencies, ESG or index data providers and media organisations

How investors can engage with sovereign issuers

There are several established methods for engagement, including:

- **Direct engagement:** Investors are increasingly looking to influence policymakers through direct requests
- **Unveiling of fiscal plans:** Provides the opportunity to hear from and question policymakers
- **Roadshows:** Provides direct access to issuing authorities and opportunities to question issuers about ESG initiatives
- **Ad-hoc events:** IMF and World Bank meetings provide investors with access to multilateral institutions that have a significant influence over the behaviour and domestic policies of issuers, especially those seeking international support
- **Country research trips:** Offer opportunities for investors to see the situation on the ground. These trips can be used to validate official information sources
- **Investor collaboration:** A common tactic among equity investors to influence management behaviour. Sovereign debt investors are increasingly looking to collaborate to raise ESG concerns with issuers

Investors are increasingly looking to collaborate to raise ESG concerns with issuers.

Stepping up sovereign engagement

Issue: Climate change poses a major threat to long-term growth and prosperity. Mitigation and adaptation are therefore essential for the safeguarding of our investments and delivery of long-term returns, including for sovereign debt. Ukraine, for example, is vulnerable to the impact of droughts and needs to transform its economy and energy system to meet emission reduction targets. Finance ministries and central banks will have pivotal roles to play in meeting these challenges.

Action: At the start of 2021, Aviva Investors' CEO Mark Versey for the first time set out annual sovereign engagement priorities in a letter to finance ministers and central bank governors from over twenty countries in which material sovereign investments were held.[3]

In a crucial year for climate policy, all three priorities centred on climate change. The letters were tailored and actionable, making the case for membership of and engagement in the Coalition of Finance Ministers for Climate Action, the Network for Greening the Financial System (NGFS), and for active engagement in the preparation of ambitious, updated national climate plans (NDCs).

3. 'Responsible investment', Aviva Investors, 2022.

ESG and investment teams followed-up on these priorities at every opportunity, raising them at investor roadshows and through outreach to individual issuers, including during a call with the Ministry of Finance of Ukraine, one of the letter recipients.

Outcome: Over the course of the year, Ukraine delivered across all three priority areas. In February, the central bank joined the NGFS and, in July, Ukraine submitted a climate plan with stronger emission reduction targets. Most notably, after a targeted follow-up by an ESG analyst and emerging market portfolio manager in the Autumn, the Ministry of Finance of Ukraine decided to apply for membership of the Coalition and thanked us for playing a facilitating role.

Since joining in October, the Ministry has begun to benefit from the sharing of best practice on taking climate change into account when forming macroeconomic and financial policy. Ultimately, that will support the Ministry's ability to accelerate a just transition to a low-carbon and climate-resilient Ukrainian economy.

The process helped strengthen our relationship with the sovereign, enabling a deeper understanding of sustainability risks. It also highlighted the unique role investors can play in engaging with governments on sustainability practices.

Our 2022 sovereign engagement priorities

Following on from our climate engagement programme in 2021, in February 2022 we set our sovereign engagement priorities with central bank supervisors and finance ministers in key countries where we have material holdings.

Selected examples of our engagement priorities include:

1. **Climate change: Strengthen Nationally Determined Contributions**
   Nationally Determined Contributions (NDCs) embody the actions each country will take to reduce national emissions and adapt to the impacts of climate change. Collectively, the level of ambition and delivery of those actions will determine whether the long-term goals of the Paris Agreement are met.
2. **Business and human rights: Actively contribute to the enacting and updating of the National Action Plan on Business and Human Rights**
   National Action Plans (NAPs) on Business and Human Rights are policy documents that articulate a country's priorities and actions it will adopt to protect against adverse human rights impacts by businesses. NAPs provide roadmaps for addressing gaps, promote greater policy coherence, facilitate stakeholder dialogues to build trust and ultimately drive implementation and accountability.
3. **Biodiversity: Play a constructive role in supporting the agreement and subsequent delivery of an ambitious post 2020 global biodiversity framework**
   More than half of global GDP – around $44 trillion – is reliant on biodiversity and our ecosystems. The protection, restoration, and promotion of the sustainable use of ecosystems is therefore necessary to underpin economic activity, financial stability, and the delivery of the UN SDGs.

> COVID-19 has created an opportunity for investors to encourage positive actions from issuers.

COVID-19: Building back better

The fallout from the COVID-19 pandemic has seen a significant increase in fiscal expenditures across both EM and DM economies, as countries have sought to bolster social safety nets alongside healthcare.

For higher-rated issuers, access to external sources of finance has remained relatively open; however, for lower rated issuers, access has been more challenged and many countries have had to turn to multilateral institutions such as the IMF to finance their deficits.

In many ways, COVID exacerbated pre-existing social inequalities in many EM and DM countries. As we emerge from the global pandemic, it is more important than ever for governments to consider social factors in their spending decisions and for investors to push for greater impact.

The significant increase in issuance needed to help countries deal with the economic consequences of COVID-19 has created an opportunity for investors to encourage positive actions from issuers. Bondholders can encourage countries to consider ESG factors in their fiscal plans and post-COVID-19 recovery measures, or go even further by making the terms of refinancing contingent on the attainment of sustainability targets. Not only can this improve the ability of countries to hit their sustainability pledges, it can also increase their ability to cope with future crises.

At a more practical level, the increased use of video/tele-conferencing and virtual country visits has increased the ability of investors and policymakers to meet outside of formal event schedules or new issue roadshows that have previously driven engagement activities. In addition to making engagement easier, it is significantly cheaper for issuers and investors.

Where next?

While issuer engagement is a relatively established part of credit and equity investors toolkits, sovereign engagement is likely to become more prevalent. This will be driven by several factors, including:

- Increasing client demand for ESG-aware or integrated strategies, with assets under management (AUM) in sustainable funds topping $1 trillion in 2020
- Increased regulation such as the EU’s Sustainable Finance Disclosure Regulation (SFDR), which will require asset managers to provide greater disclosure over how ESG factors are integrated into their portfolios
- A greater understanding of the mutually beneficial nature of engagement
- Increased appreciation of how crucial government action is to tackle major sustainability challenges
- Potential for greater investor coordination on engagement activities

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