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Credit Worthy: ESG Factors and Sovereign Credit Ratings



Emerging Markets Investors Alliance Webinar

Presenters

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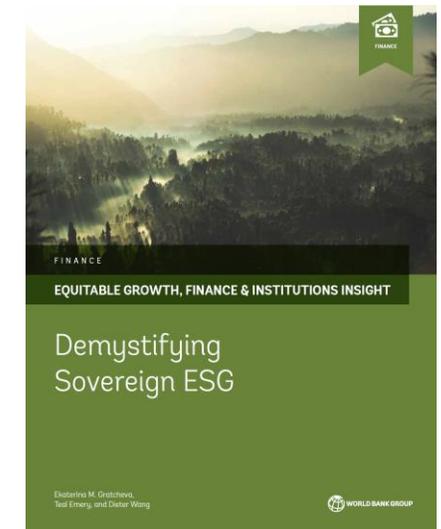
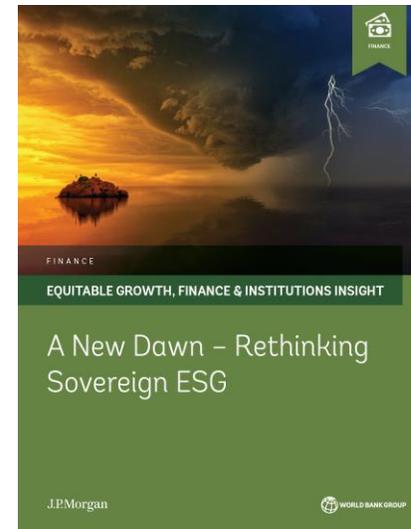
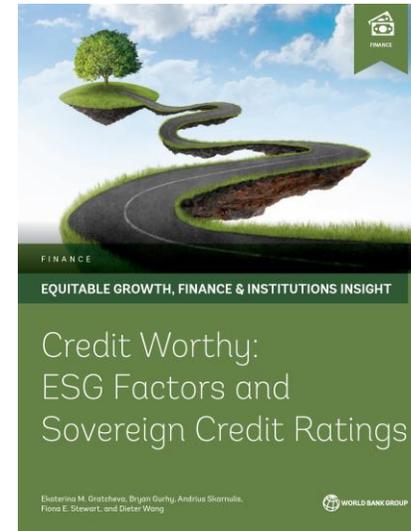


Overview

Publication part of WB's GPS
“demystifying” series on ESG in sovereign
debt

We will cover

1. Backdrop and policy takeaways
2. Insights into the Analysis



Part I

Backdrop and policy takeaways

Presenters

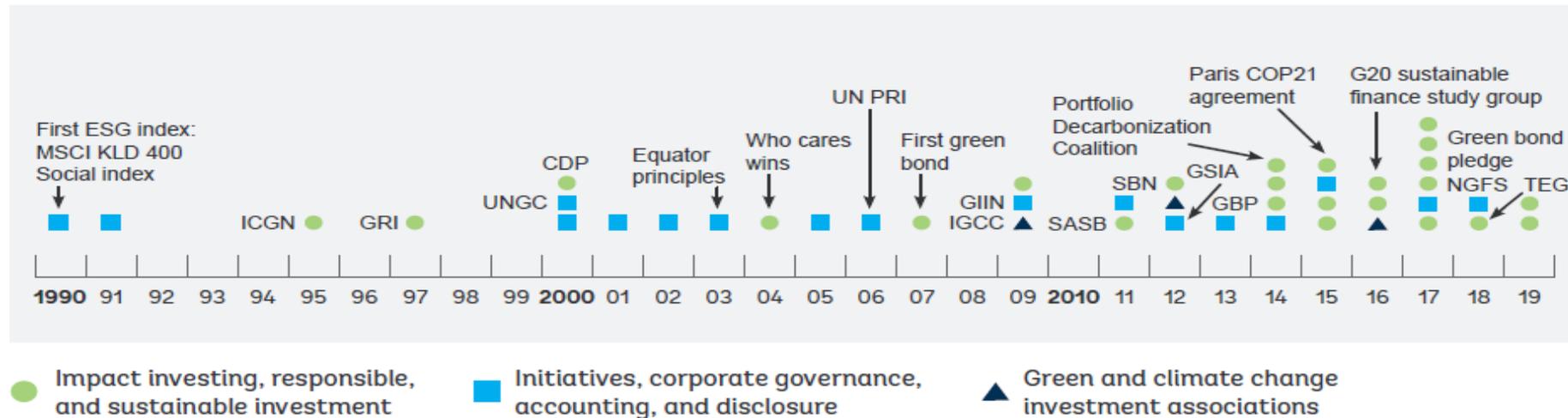
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Shifting perspectives

- Many standards, codes, data sources and methodologies
- Financial architecture shifting- “ESG” lens becoming more embedded

Changing financial sector ecosphere



Source: IMF 2019, based on MSCI; Sustainability Accounting Standards Board; Refinitiv Datastream; WhoCaresWins; World Bank; and International Monetary Fund staff.

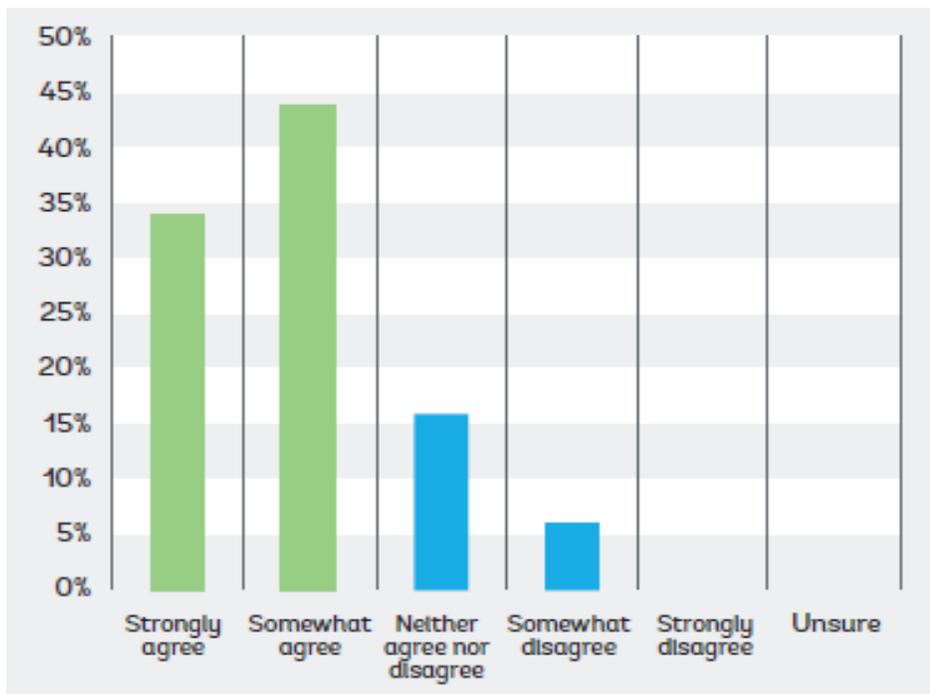
Note: CDP = Carbon Disclosure Project; COP21 = 21st Conference of the Parties; ESG = environmental, social, and governance; GIIN = Global Impact Investing Network; GBP = Green Bond Principles; GRI = Global Reporting Initiative; GSIA = Global Sustainable Investment Alliance; ICGN = International Corporate Governance Network; IGCC = Investor Group on Climate Change; NGFS = Network for Greening the Financial System; SASB = Sustainability Accounting Standards Board; SBN = Sustainable Banking Network; TEG = EU Technical Experts Group on Sustainable Finance; UNGC = UN Global Compact; UN PRI = UN Principles for Responsible Investment.

Source: World Bank, 2020, "[Riding the Wave: Navigating the ESG Landscape for Sovereign Debt Managers.](#)"

Asset owners driving change

- Investors increasingly focusing on a broader definition of sustainability
- Current investor views challenge traditional perceptions
- However, an issuer's default risk could be independent of an issuer's ESG characteristics (S&P 2021)

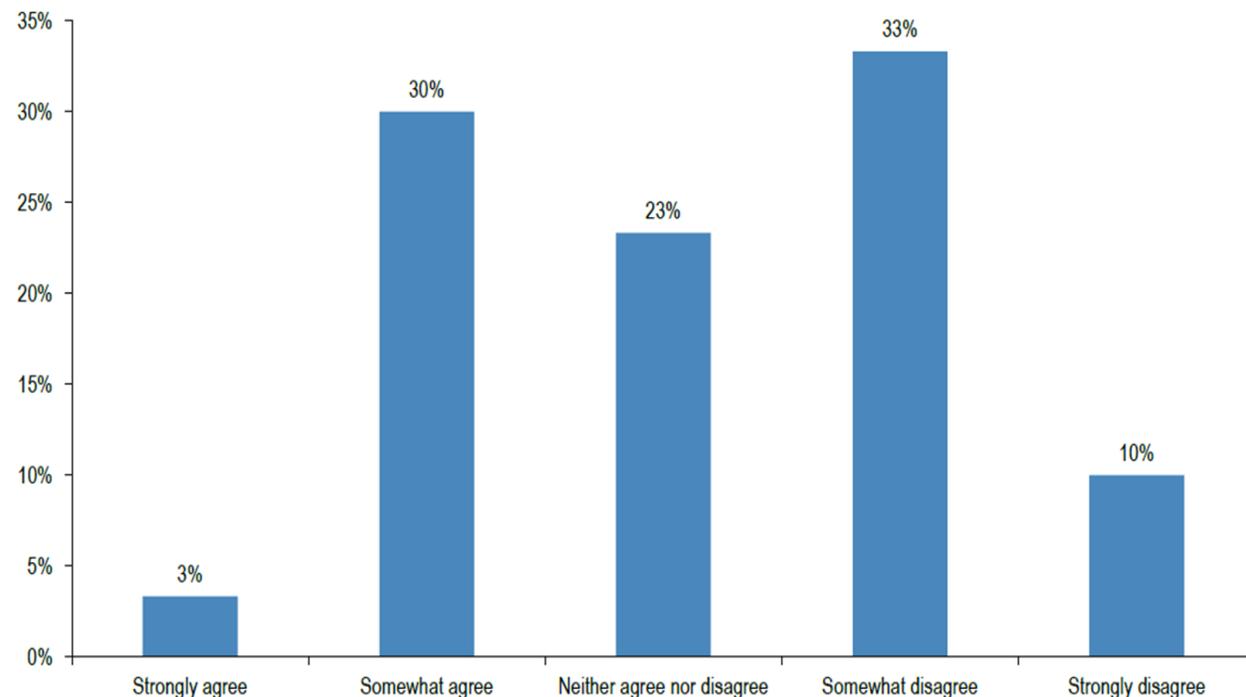
To what extent do you agree with the statement "improving ESG fundamentals will lead to lower sovereign credit risk"



A New Dawn- Rethinking Sovereign ESG

Credit Worthy: ESG Factors and Sovereign Credit Ratings

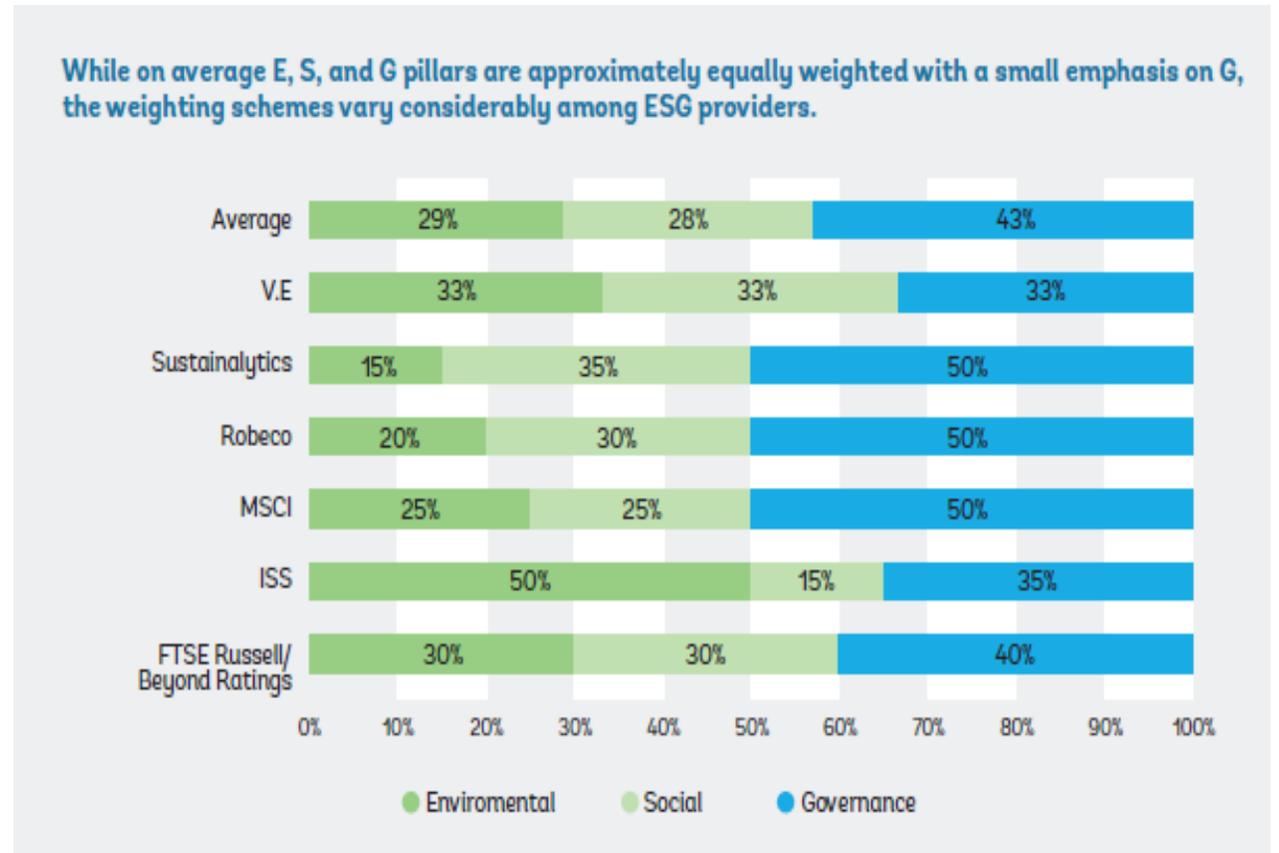
Do you think that climate risk is adequately reflected in sovereign credit rating assessments?



Investor survey- December 2021

Advent of ESG providers also reflect CRAs not doing “enough”

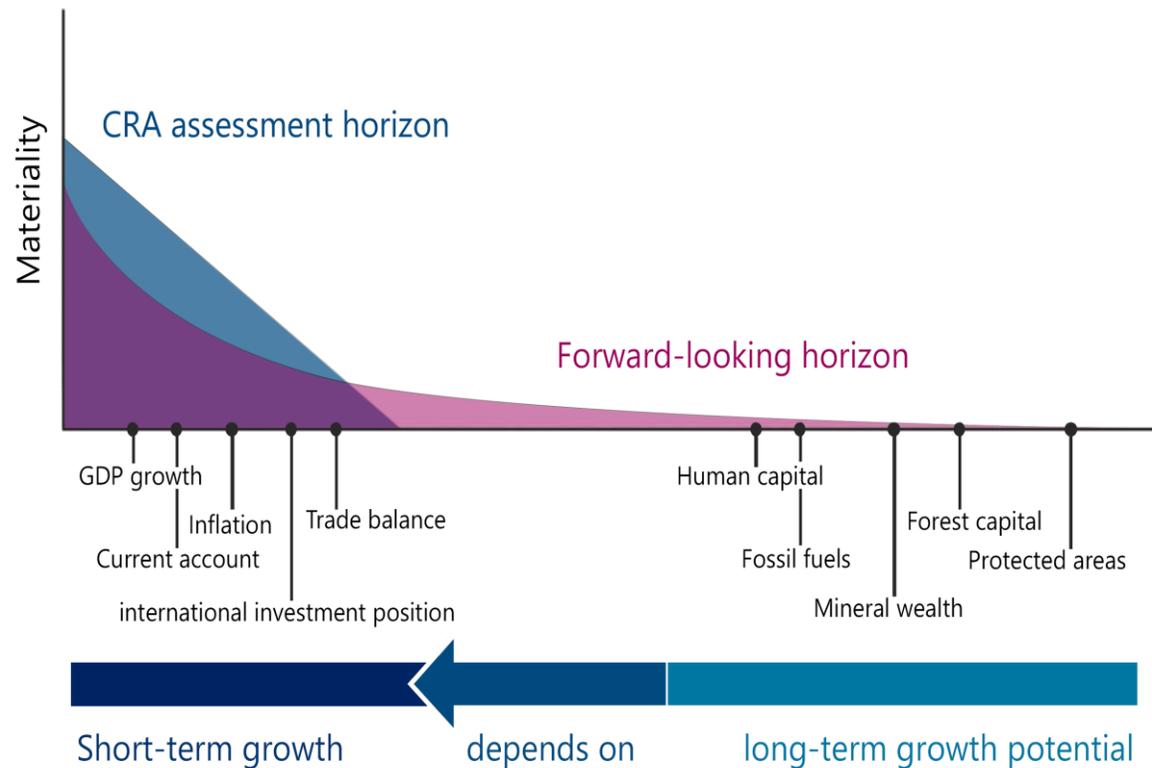
- ESG ratings industry has grown in response to market demand for sustainability related data
- ESG providers model differs from CRAs- driven largely by investors
- No explicit definition of what sovereign ESG scores measure
- Increased investor interest, key reason for CRAs to change “tact”
- 2 industries co-exist- but some expect “convergence”



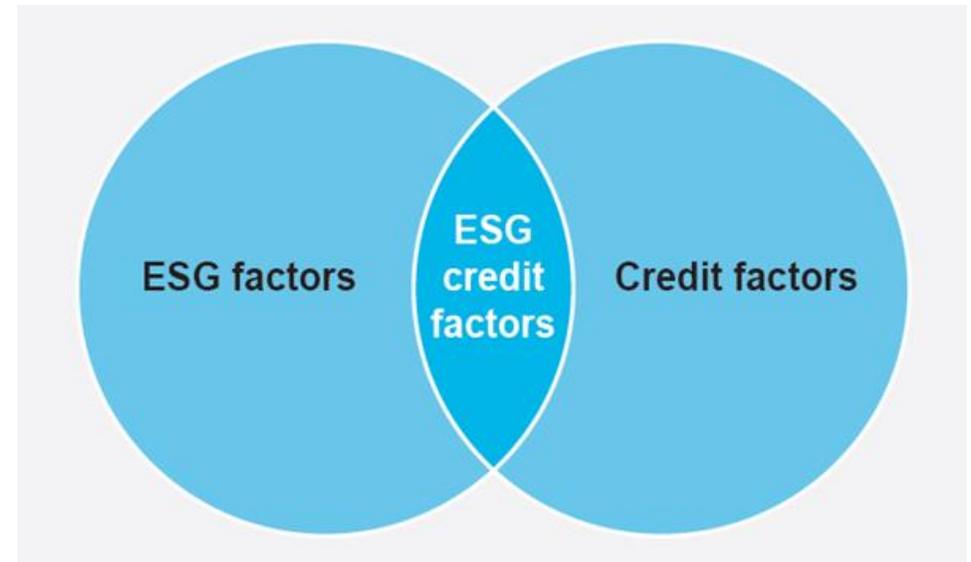
Source: Demystifying Sovereign ESG

Two key issues from credit perspective

1. Time horizon



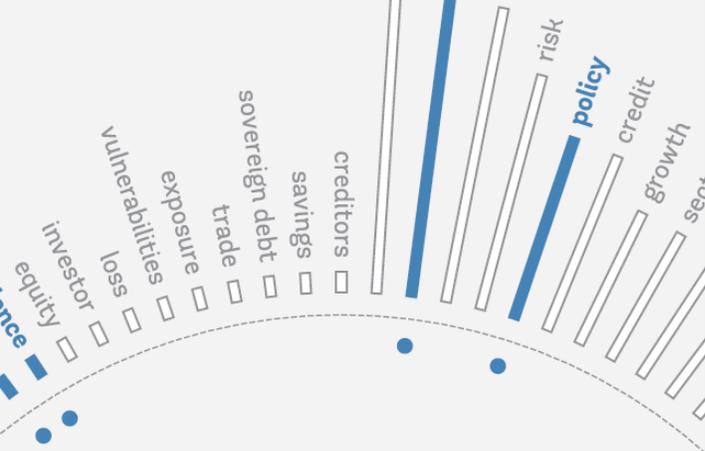
2. Materiality



Source: Adapted from S&P 2021

Nevertheless - some space for CRAs to improve

- 1. Data.** WB wealth accounting data, risks & opportunities related to stranded assets
- 2. Transparency.** Sovereign CRA methodologies could be strengthened by introducing an ESG pillar
- 3. Granularity.** As well as providing more granularity on ratings- particularly for lower rated sovereigns
- 4. Engagement** of issuers and policy makers also important – CRAs can play a key role here



Top 100 most-mentioned terms in methodology documents

3 Environmental terms

7 Social terms

24 Governance terms

66 Economic & Financial terms

Part II

Insights into the Analysis

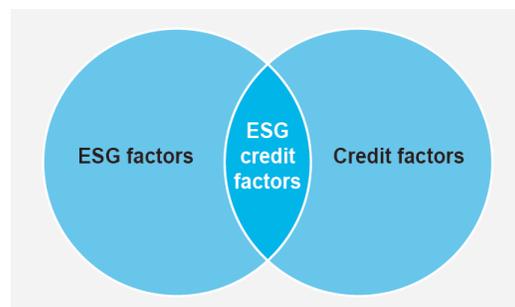
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What do credit ratings reflect?

ESG scores



Wealth accounting



Preparedness

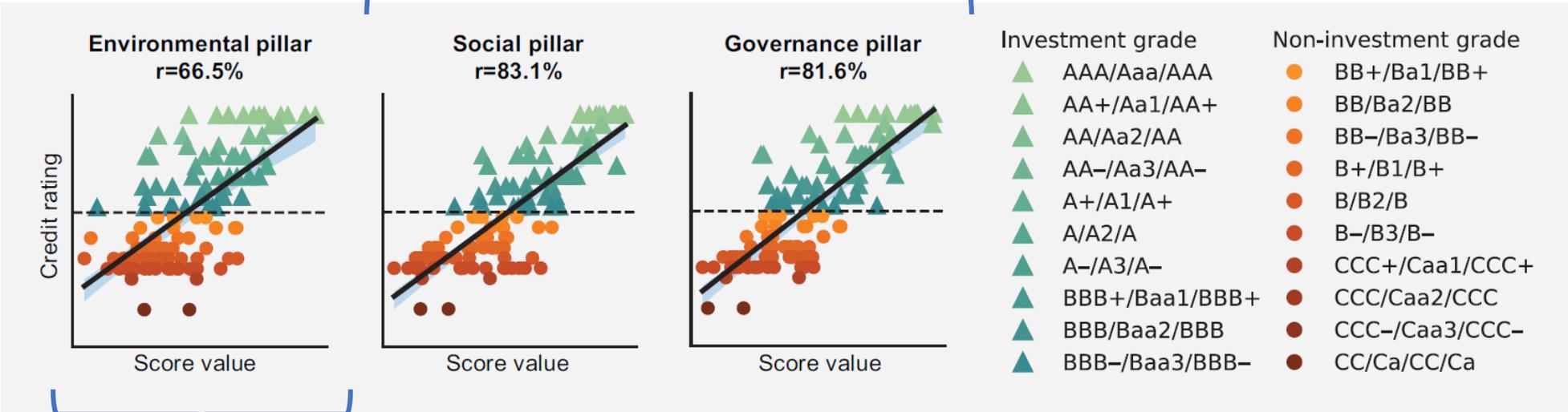


What are ESG scores?

Computed as the average, standardized ESG score of 133 countries by FTSE Russell/Beyond Ratings, ISS, Moody's ESG (formerly V.E), MSCI, RepRisk, Robeco, Sustainalytics.

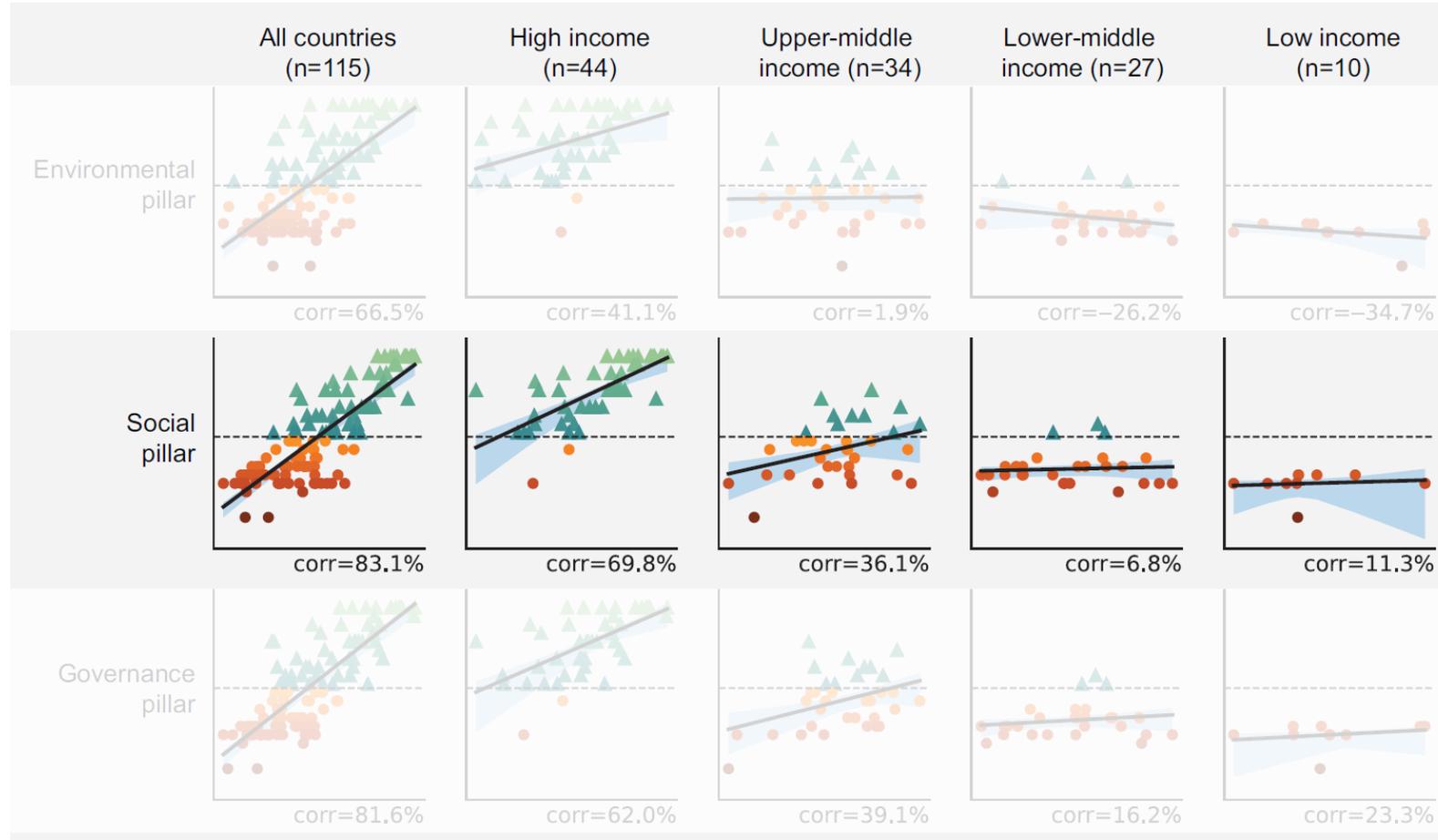
Better ESG = better ratings?

Social and Governance scores are highly correlated with credit ratings



Environmental scores are only weakly associated

Better ESG = better ratings? Income groups



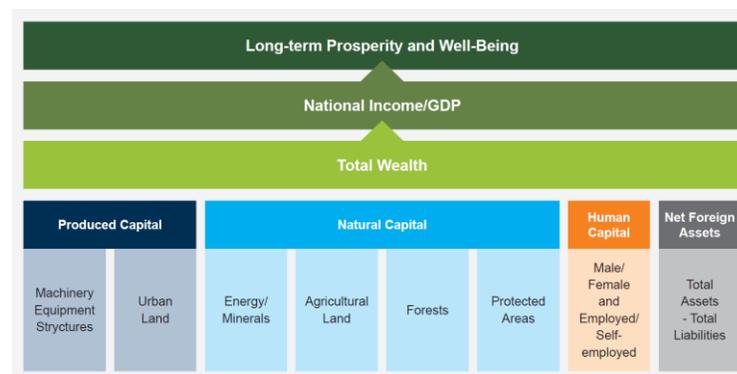
1. As we go from high to low income countries, the relationship weakens.
2. Low income countries have the same credit rating, regardless of ESG score.
3. Relationship dips into the negative for the Environmental pillar

What do credit ratings reflect?

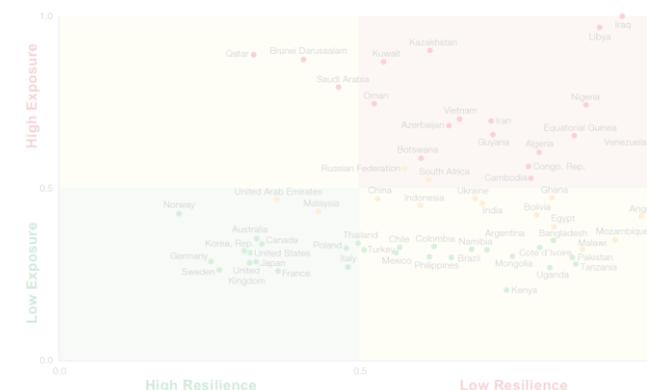
ESG scores



Wealth accounting



Preparedness

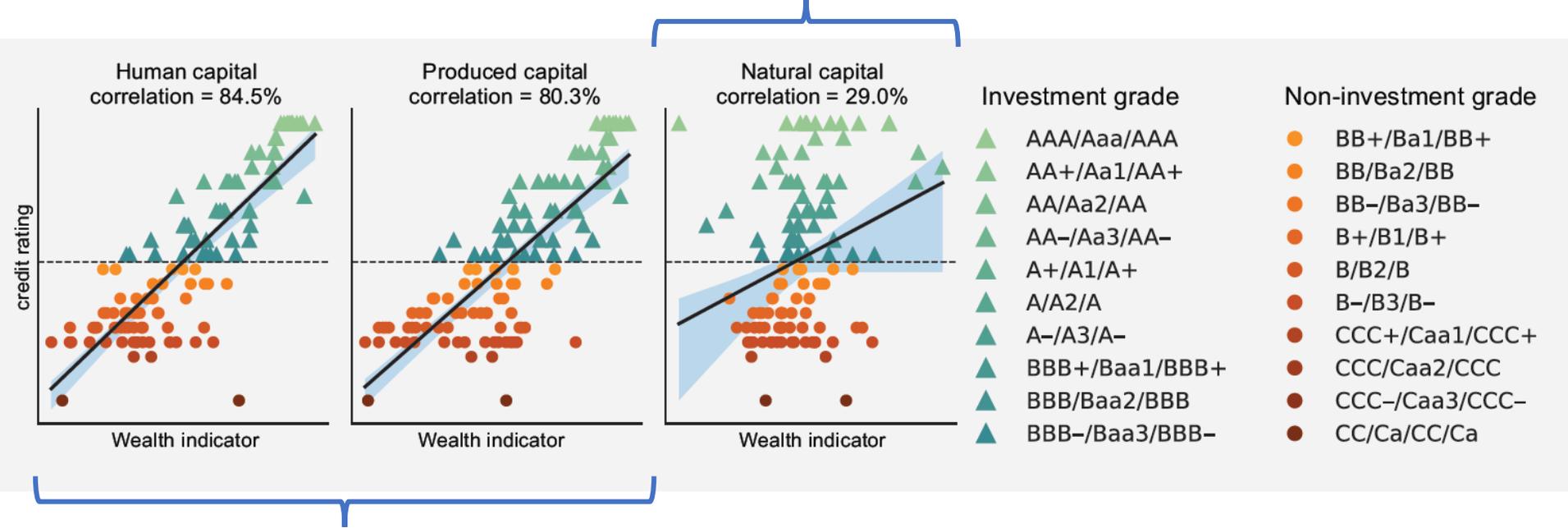


What is wealth accounting?

wealth = discounted “life-time earnings” of a country’s assets. The life-time duration depends on extraction vs. regeneration rate. Wealth is a forward-looking measure of growth potential and well-being.

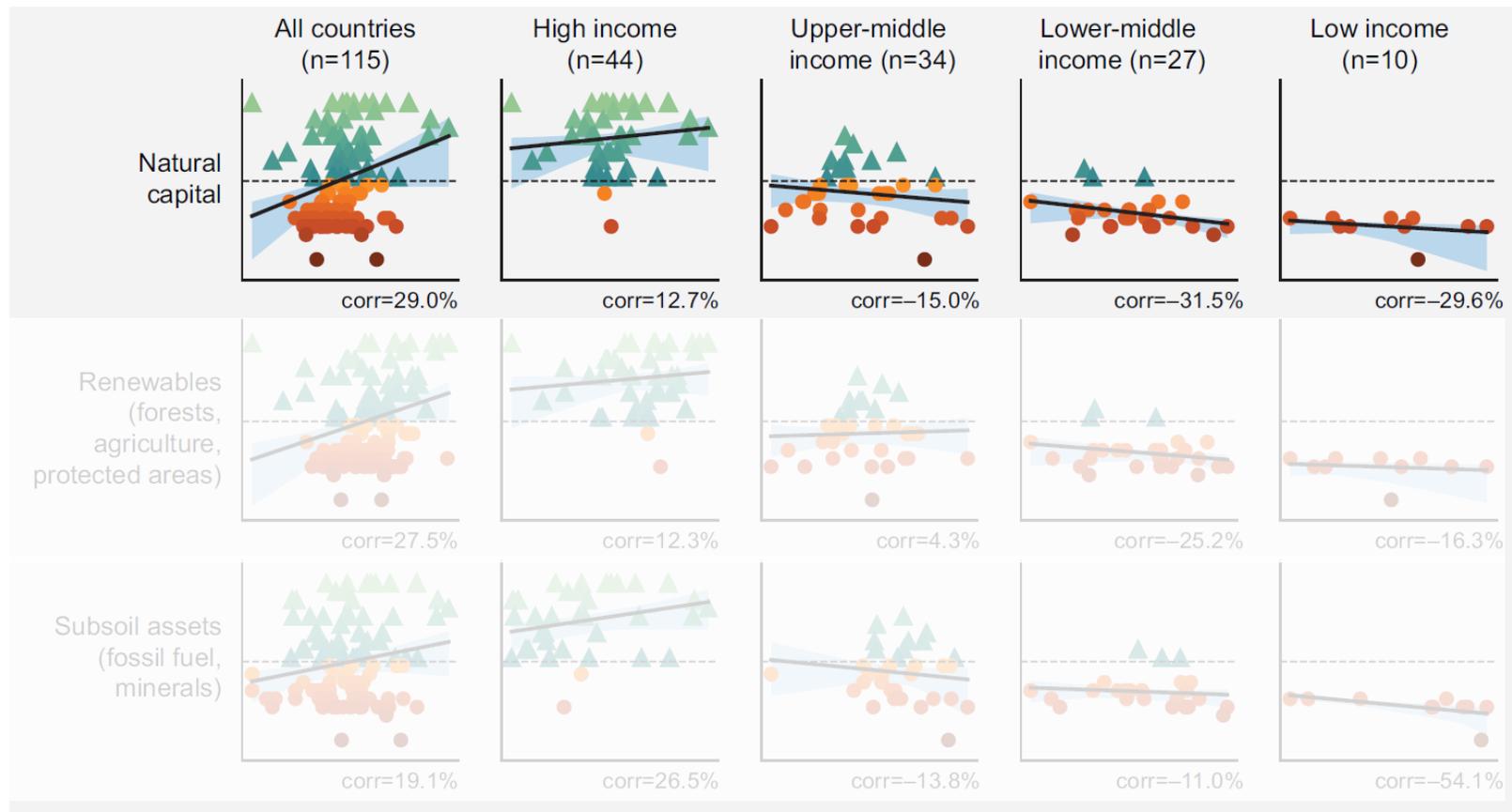
More wealth = better ratings?

Natural capital is almost uncorrelated, half of the Environmental score (66%)



Human and produced capital are strongly correlated with ratings.

Natural capital and ratings



1. Natural capital is almost completely unrelated with ratings
2. Mainly because of high income countries, where it barely matters.
3. For middle and lower income countries, the relationship is negative

➔ Natural resource curse?

What do credit ratings reflect?

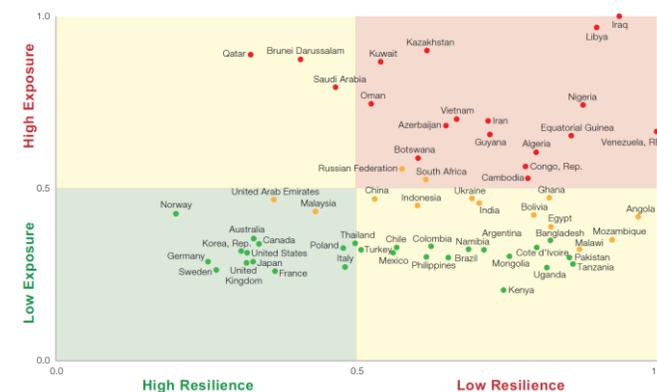
ESG scores



Wealth accounting



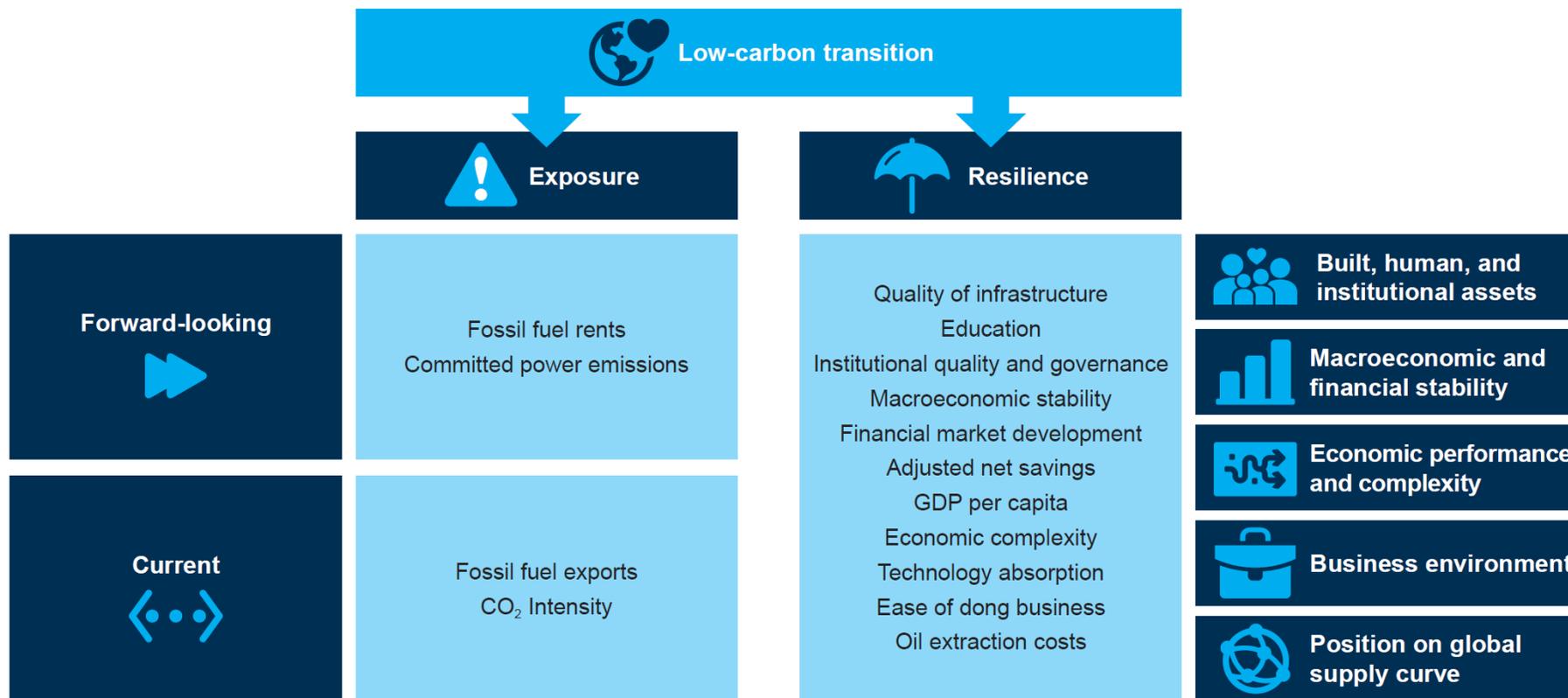
Preparedness



What is “preparedness”?

Assesses the exposure and resilience of a country regarding the low-carbon transition. Exposure measures a country’s exposure to transition risks. Resilience reflects a country’s ability to adapt to the transition.

Resilience and exposure



investor
ity
Top met
3 En
7 Soc
24 G
66 E

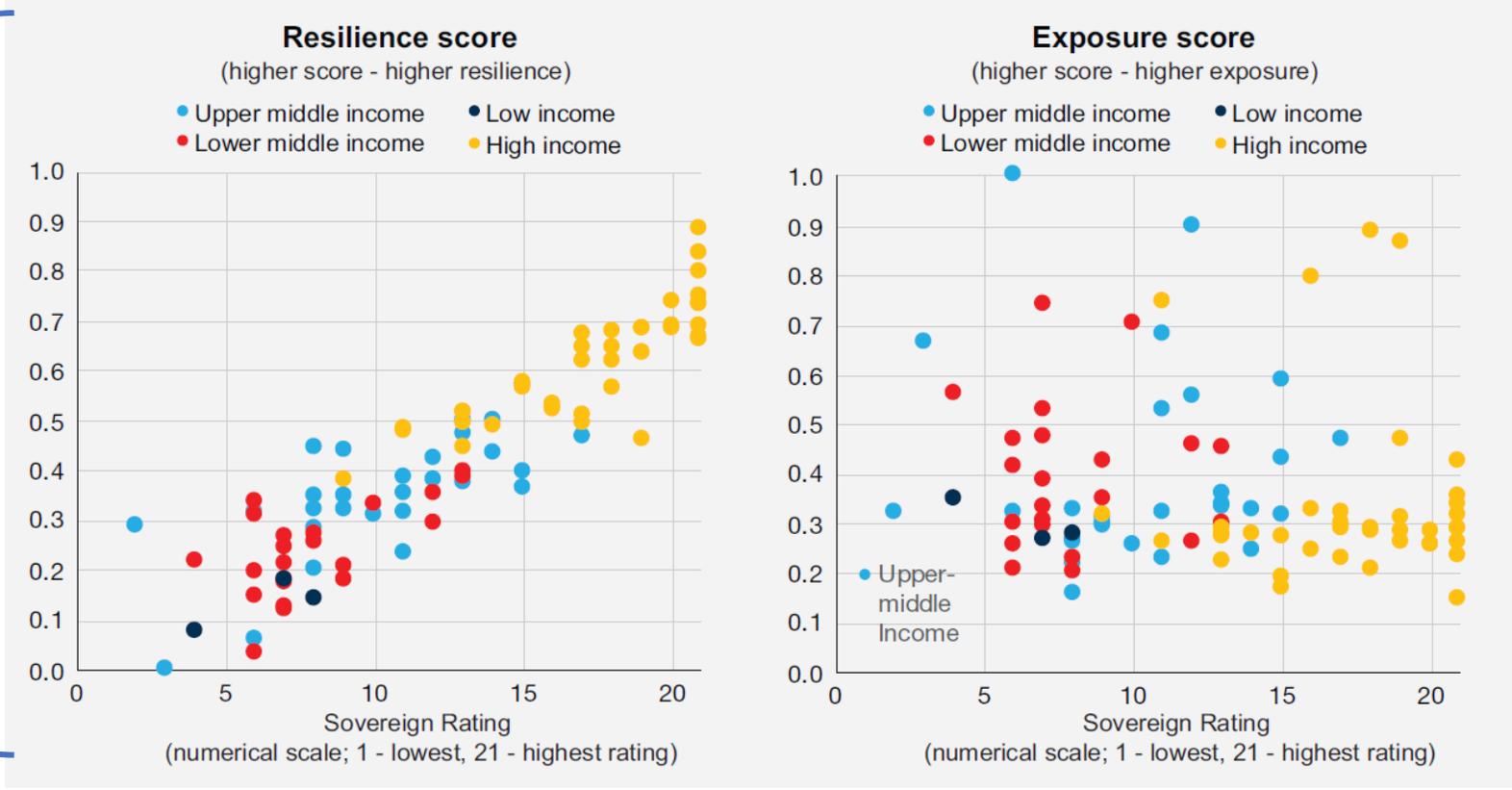
ruption

Resilience and exposure

investor
ity
Top met
3 Env
7 Soc
24 G
66 E

Correlation between ratings and resilience score

High-income	0.84
Upper-middle income	0.71
Lower-middle income	0.63
Low income	not enough data



Correlation between ratings and overall preparedness score
= only significant for high-income



Thank you, for your attention

Our work on sustainable finance



“[A New Dawn - Rethinking Sovereign ESG](#)” proposes improvements to the sovereign ESG framework and builds on findings and recommendations discussed in other papers in the series.

[Link to report](#)



“[Demystifying Sovereign ESG](#)” focuses on comparing sovereign ESG methodologies of leading sovereign ESG providers and presents structural challenges with the current sovereign ESG framework.

[Link to report](#)



“[Riding the Wave: Navigating the ESG Landscape for Sovereign Debt Managers](#)” provides a thorough discussion of sovereign ESG from a debt management office perspective.

[Link to report](#)



“[Paving the Path: Lessons from Chile's Experiences as a Sovereign Issuer for Sustainable Finance Action](#)” provides a focused study of Chile's ESG focused issuances to date and relevant lessons.

[Link to report](#)



“[Spatial Finance: Challenges and Opportunities in a Changing World](#)” in partnership with WWF discussed challenges with the E data, including at the sovereign level, and explores the use of satellite data to address the quality and availability of E data.

[Link to report](#)



“[Natural Capital and Sovereign Bonds](#)” builds the case that countries' level of development dominates ESG-related metrics. “[1% Growth in Natural Capital: Why It Matters for Sovereign Bonds](#)” quantifies materiality of natural capital and its impact on sovereign bonds by adjusting for ingrained income bias.



The chapter “[Natural Allies: Wealth and Sovereign ESG](#)” from the book “[The Changing Wealth of Nations 2021: Managing Assets for the Future](#)” focuses on challenges in ESG data, and discusses solutions with the application of the World Bank Wealth data.

[Link to report](#)



“[Natural Capital and Sovereign Bonds](#)” introduces the concept of ingrained income bias and presents evidence that sovereign bond yields reflect a country's various types of natural capital.

[Link to report](#)

Credit Worthy: ESG Factors and Sovereign Credit Ratings
Key takeaways for policy makers

Appendix

What is wealth accounting?

In a nutshell: wealth = discounted life-time earnings of an asset

146 countries | 1995-2018 | annual frequency

Main characteristics

1. well-founded framework on **economic theory**
2. a **forward-looking** measure of growth potential
3. expressed **economic materiality** in **dollar values**

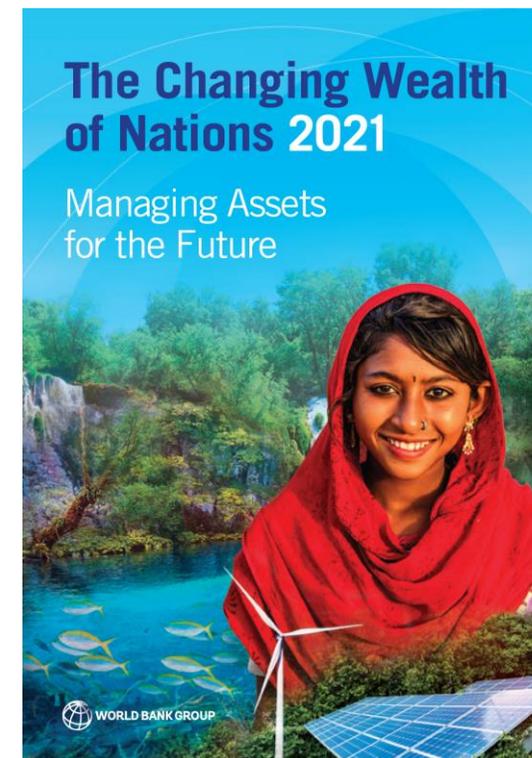


Illustration: Forest capital

Every year, a resource produces rents ...



Year 1



Year 2



Year 3



Year 4

...

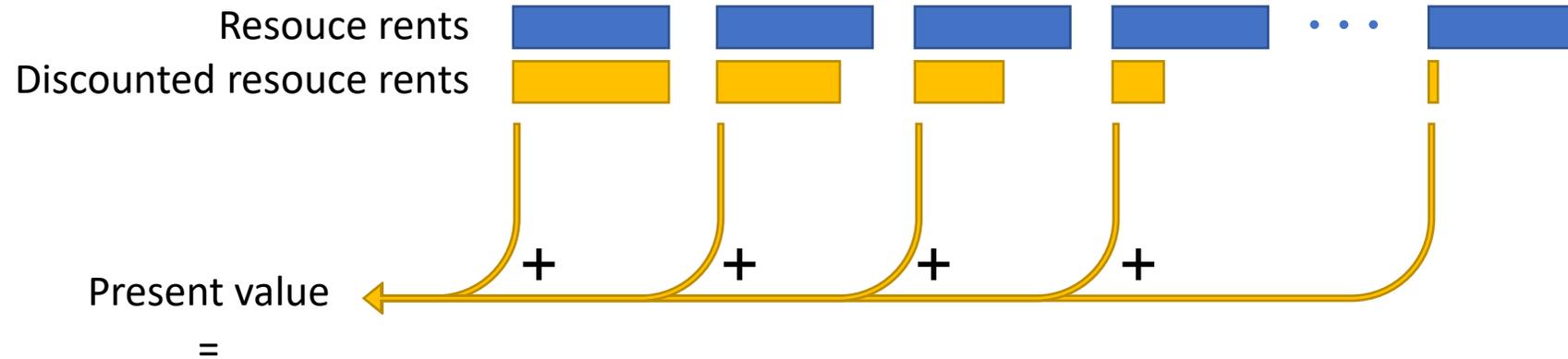


Year N



Year N+1

...until it depletes



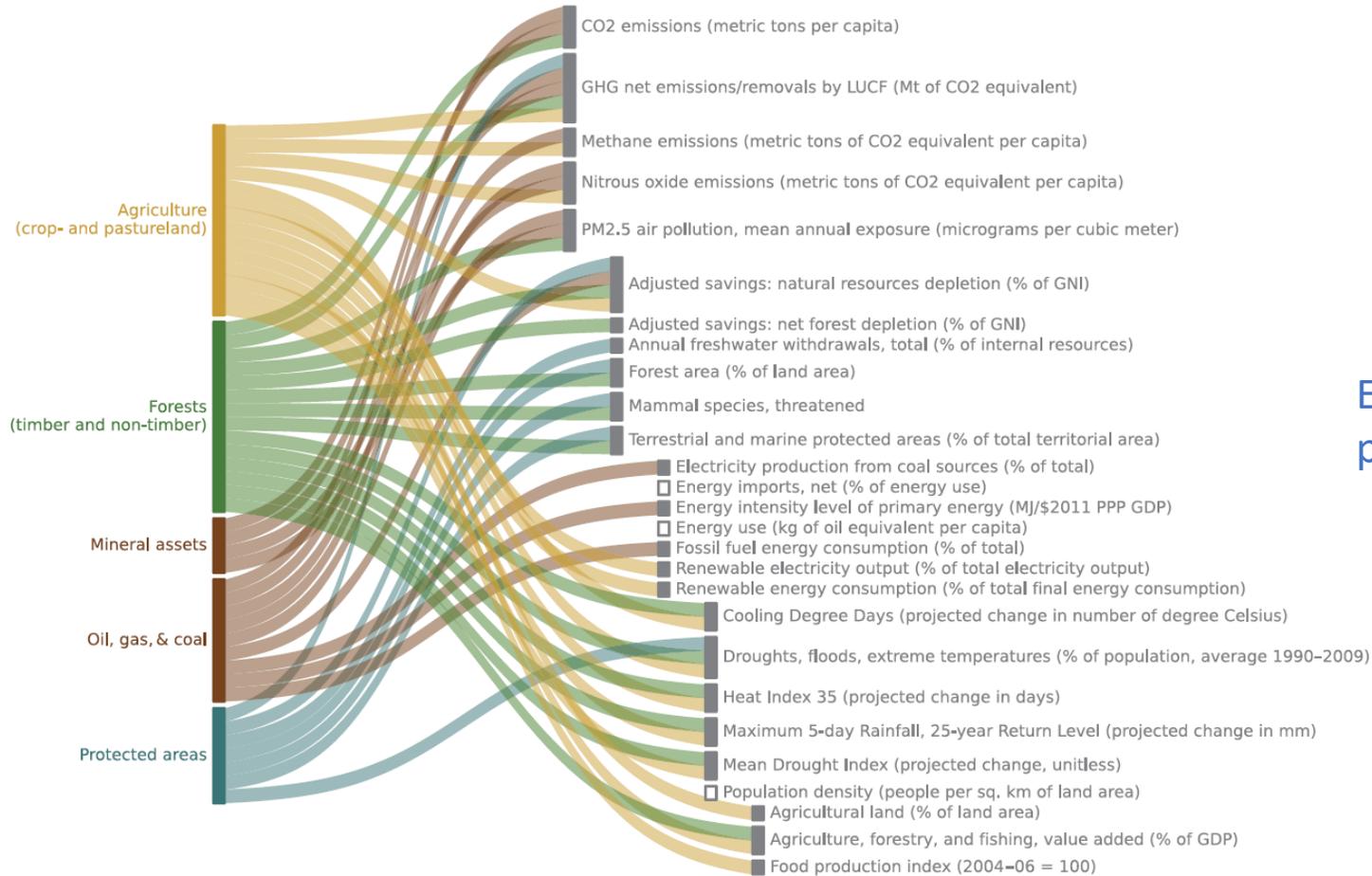
Forest capital

Important

- For non-renewables (e.g. oil, minerals) the horizon N depends on **depletion rate**.
- For renewables (e.g. forests, cropland) the horizon N depends on **depletion rate** and **regeneration rate**.

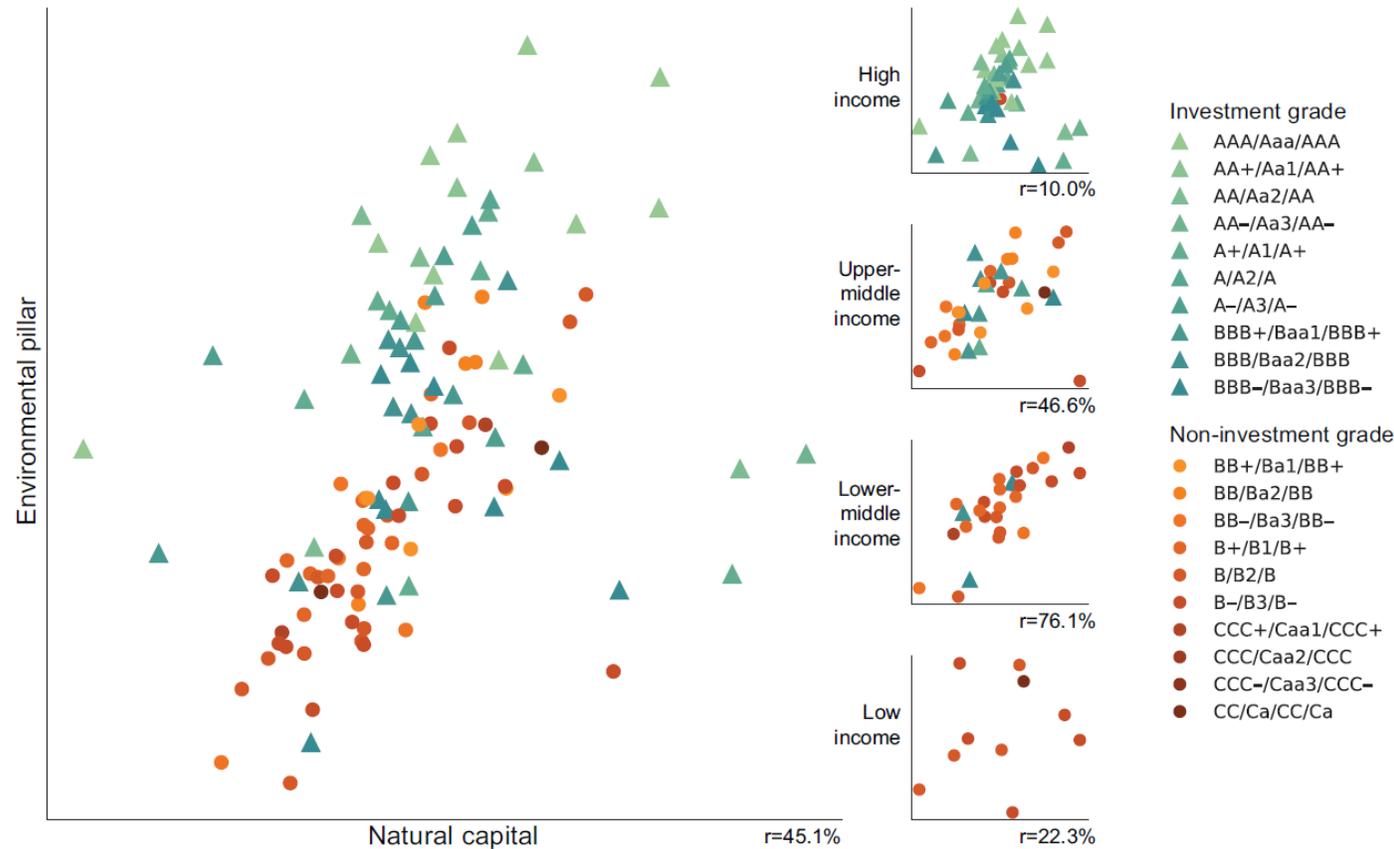
Natural capital and E score are conceptually related...

Natural capital



Environmental pillar

...but it doesn't translate into a statistical relationship



- This is because natural capital is only part of the Environmental score
- The E-pillar also reflects a country's resilience and exposure