Cameron Hume

Fixed Income Specialist

ESG factors in sovereign bonds

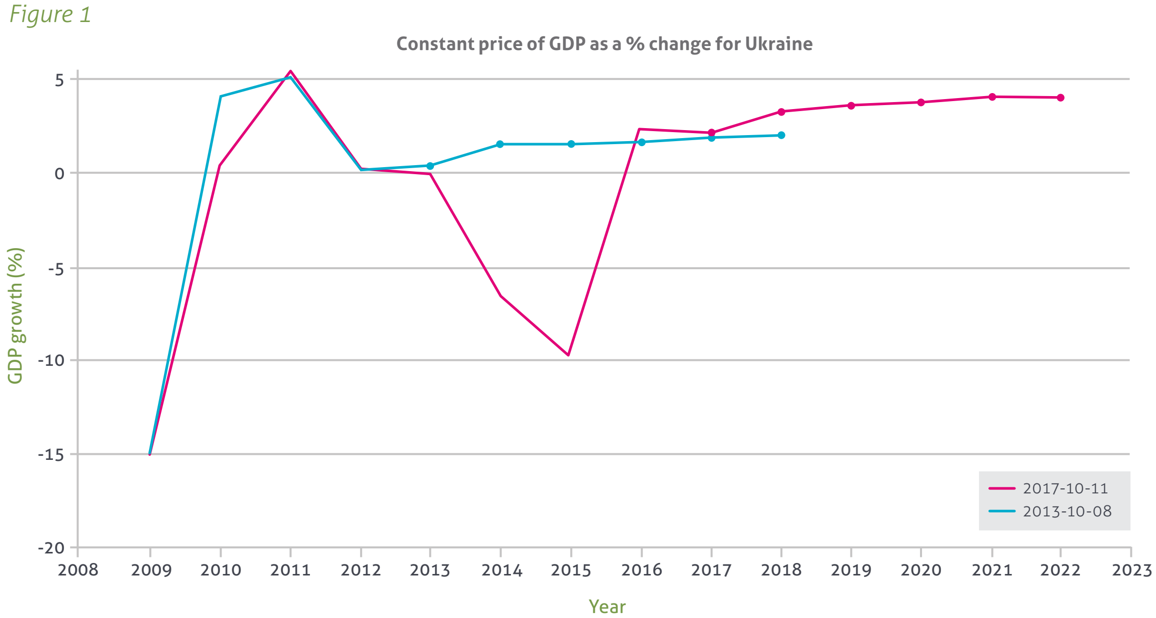
We are frequently asked how we apply ESG factors to our investment in sovereign bonds, for example do we use ESG factors to weigh the relative merits of the environmental or social policies of the Swedish or Australian government? Our brief answer (which, as is the nature of brief responses, says everything and nothing) is that we consider ESG factors to the extent that they affect the issuer's ability and willingness to service their debts. In this paper we aim to provide a fuller example of how ESG factors influence investment decisions in sovereign bonds. We hope to demonstrate that ESG factors can influence the market pricing of bonds as well as a country's economic fundamentals and its prospects for sustainable growth.

To begin: a bond is a contract and for it to be binding then contract law requires all parties to have entered into it freely. For a sovereign issuer, the government of the day is committing future generations of tax payers to service its debt. In what sense have future tax payers entered into this obligation freely? One test for this is whether the country is a representative democracy. If the government has not been democratically elected, elections were biased, or the government is corrupt, then the legitimacy of the government and hence the enforceability of the contract is open to question. As such, this is an ESG risk factor, primarily because it means the bond contract could be challenged, which, in itself, may influence the issuer's willingness to repay.

More broadly, the quality of a nation's institutions is widely accepted as having a profound influence on the sustainability of growth[1]. The sustainability of growth will positively influence a country's ability to service its debt and a prosperous and equitable country is more likely to be willing and able to service those same obligations. Reflecting this and as part of its commitment to the UN Sustainable Development Goals, the IMF will generally make its loans conditional on institutional and economic reform. The IMF thus integrates ESG into the consideration of its investments, and could indeed be considered the leading example for debt-based responsible investment.

A current example of the IMF's approach is its Ukraine programme. Ukraine was close to collapse after the 2014 revolution, the annexation of Crimea and the subsequent default, and so the government sought assistance from the IMF. Figure 1 shows the IMF's most recent forecasts of annual GDP growth and those made before the crisis. The GDP of Ukraine fell by more than 15% in the two years following 2013 and is nearly 20% lower than the IMF's pre-crisis forecast.

Figure 1



[1] Why Nations Fail: The Origins of Power, Prosperity, and Poverty, Acemoglu and Robinson (2012)

Cameron Hume
Exchange Place 1, 1 Semple Street
Edinburgh EH3 8BL
www.cameronhume.com

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The loan programme agreed by the IMF and Ukraine is conditional on a list of reforms that Ukraine must implement for subsequent loan tranches to be released. The following is an excerpt from the IMF's mission to Ukraine in May 2017.

"... the mission held constructive discussions with the authorities on reforms needed to improve productivity, attract investment, and continue to strengthen public finances. As envisaged under the program, discussions focused on the pending pension and land reform and on measures to speed up the privatization process and ensure concrete results in anticorruption efforts." [2]

The programme is working, and accordingly Figure 2 shows that Ukraine bonds' yield spread over US Treasuries has fallen from 12% immediately after the debt restructuring to close to 4% in December 2017. Ukraine was able to capitalise on its progress in September 2017 by issuing a $3bn dollar bond. The Ukrainian government was delighted: the Economist magazine quoted the finance minister as saying "We're back; we transformed the country."[3] However, some see dangers in this development. The new bond reduces Ukraine's reliance on the IMF and this greater independence may allow some in the government to resist implementing the reforms agreed with the IMF. The Economist raised such concerns in September and worryingly, in December 2017, less than three months from the bond issue, the US State Department issued a statement saying "recent events… raise concerns about Ukraine's commitment to fighting corruption."[4]

However, one should not overstate the degree of independence that the bond issue has secured Ukraine: the government is expected to have a fiscal deficit for at least the next three years and growth is expected to be a modest 2.5%. The Country has a long way to go and the continuing positive affirmation of the IMF will be vital to secure funding for the deficit and to bolster the recovery. So, for the foreseeable future Ukraine's politicians will have to respect the IMF's conditions, limiting their freedom to pursue a different path.

Figure 2

The example of Ukraine shows that the implications of ESG factors for sovereign issuers and their country's economic well-being are both important and, at times, subtle. The IMF is uniquely well-placed to promote (sustainability enhancing) institutional change and the public debt markets can reward sovereigns by allowing them gradually to become independent. However, if bond investors are less aware of ESG risks than the IMF, then they may discourage some of the reforms that the IMF is pursuing. Alternatively, we could question the motives of bond investors: are they seeking to encourage further reform by rewarding progress, seeking to profit from the improving institutional arrangements in Ukraine, or are their motives malign? Different owners will have different objectives. Nonetheless ESG factors such as corruption and the quality of institutions undoubtedly influence the creditworthiness of sovereign issuers and investors should weigh them appropriately.

[2] *https://www.imf.org/en/News/Articles/2017/05/26/PR17192-Ukraine-Statement-at-Conclusion-of-IMF-Mission*

[3] The Economist, September 21st 2017. Ukraine's return to the debt markets worries economic reformers. *https://www.economist.com/news/finance-and-economics/21729461-it-may-ease-pressure-government-make-painful-adjustments-ukraines-return* - Accessed on December 5th 2017.

[4] *https://www.rferl.org/a/us-state-department-cites-concern-ukraine-backtracking-fight-against-corruption/28897255.html* - Accessed on December 5th 2017

Contact

Keith Logan
keith.logan@cameronhume.com
T +44 (0) 131 603 6988
M +44 (0) 7860 925 131

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