

# INVESTING IN PLANETARY SUSTAINABILITY

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## Why the fate of the Amazon is a growing issue for investors in sovereign bonds



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# WHY THE FATE OF THE AMAZON

IS A GROWING ISSUE FOR INVESTORS IN SOVEREIGN BONDS

## Investor Statement

Investors have recently added their voice to the chorus of concern about the fires in the Amazon [1].

80,000  
FIRES



The 80,000 fires that have broken out in the Brazilian Amazon rainforest this year [2] come at a time when the climate crisis and the accelerating loss of nature is rising to the top of the financial agenda.

246  
INVESTORS



17.5 \$  
TRILLION

In response, 246 investors with US\$17.5 trillion in assets have signed a global statement that calls on the companies they own to eliminate deforestation from their supply chains. Investors are demanding that companies disclose and implement zero deforestation policies with quantifiable and time bound commitments, establish transparent monitoring and verification systems for supplier compliance and report annually on deforestation risk exposure and management.

## Market Signal

The investor statement is another sign of the growing willingness of investors to use their voice to press for improved environmental, social and governance practices. It sends a market signal that reinforces the actions by leading companies such as VF Corp [parent to brands such as Vans, Timberland and North Face] and H&M which have announced a halt in their leather purchases from Brazil. On the financial sector side, KLP – Norway's largest pension fund – has also announced the possibility of divesting from commodities traders operating in Brazil that are contributing to deforestation [3].

## Support for Private Sector

Importantly, the investor statement was clear that it was supporting efforts from Brazil's own private sector to promote sustainable practices in the Amazon. The Brazilian Business Council for Sustainable Development (CEBDS) has also issued a statement defending deforestation control as the most efficient strategy to reduce greenhouse gas (GHG) emissions [4]. The Coalition on Climate, Forests and Agriculture – a group bringing together agribusiness, environmental groups, the financial sector and academia – called in September 2019 for a halt on deforestation on public lands.



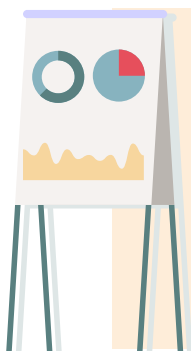


# SHARES ARE NOT THE ONLY ASSET AFFECTED BY DEFORESTATION



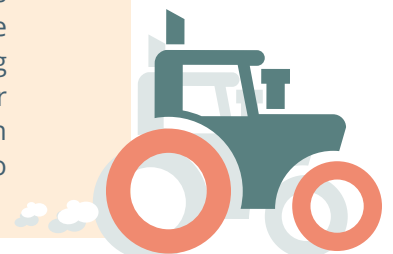
To date, the investor focus has been on the links between the stocks and shares they own and deforestation. But Nordea Asset Management took its actions one step further and quarantined its purchases of Brazilian sovereign debt. This fits with accelerating efforts by investors to understand how sustainability factors impinge on the \$66trn market for the sovereign debt issued by governments [5].

In September 2019, the Principles for Responsible Investment (PRI) issued its first guide to how environmental, social and governance (ESG) factors can be integrated into sovereign debt risk [5]. The guide builds on the growing research and analysis conducted by signatories to the PRI. Earlier this year, for example, BlueBay Asset Management and VeriskMaplecroft published research which highlighted that markets are not yet pricing environmental or climate change risks into the prices of sovereign bonds. In fact, markets seem to incentivise economic expansion at the expense of natural capital in those countries with higher natural resource stock, with the potential to set up such markets for an abrupt repricing in relation to climate change [6]. Based on emerging experience, the PRI guide recommends investors undertake in-house country-level research and develop materiality frameworks that can highlight red flags and define the need and process for engagement.

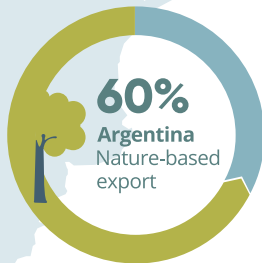


**CREDIT RATING AGENCIES** are also working on linking climate risks to the vulnerability of sovereign bonds. As early as 2014, S&P Global Ratings defined climate change as a megatrend for sovereign credit risk, affecting countries' creditworthiness through diverse channels and with poorer and lower rated sovereigns to be affected the hardest [7]. Since then, credit rating agencies' focus on climate change and sovereign credit quality has increased further, catalysed in part by the PRI's [ESG in Credit Risk and Ratings Initiative](#) which the agencies support.

**MOODY'S** Investors Service has developed a [heat map](#) identifying that small, agriculture-reliant sovereign issuers are most susceptible to climate change [8]. The agency has also highlighted that ESG factors can affect sovereign credit ratings in multiple ways [9]. Fitch Ratings has published relevance scores public finance and global infrastructure ratings [10]. More recently, the three major credit rating agencies have started being more explicit about ESG considerations into their sovereign credit ratings analysis, but environmental factors still feature low in credit rating opinions themselves. Moreover, these efforts have not extended to deforestation as yet.



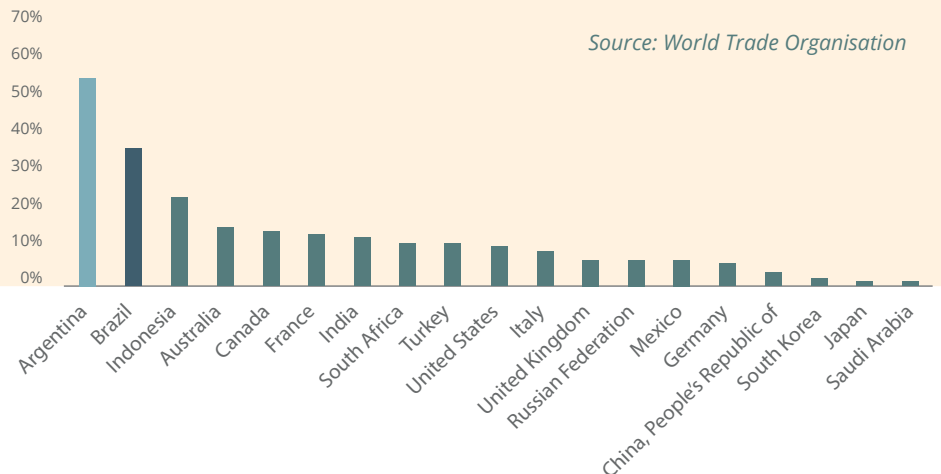
# REASONS FOR INVESTOR ACTION



**Agricultural exports within total goods exports**



There are many reasons why investors in sovereign bonds should place increasing attention on the links with deforestation. A place where investors should start is by recognising the potential connections between agri-business, natural capital loss, such as deforestation and reduction in water availability, and the value of sovereign bonds. For example, in terms of agricultural trade, Argentina and Brazil are the two G20 nations most dependent on nature-based exports, many of which have historically been linked to deforestation.



As sustainability expectations rise in capital markets, it will be important for investors to trace the chain of impact between these keystone sectors in the economy and the future health of sovereign bonds.

There is also a strong stewardship motivation. There are also important questions regarding the legality of the deforestation events that preceded the fires this year. Brazil has a relatively strong regulation aiming to curb the loss of its natural capital, but its monitoring and enforcement is insufficient. Law enforcement is clearly the responsibility of the government, with rule of law and institutional effectiveness a key criterion of both credit rating scores and investor frameworks for evaluating sovereign bonds.

Investors are also calling on governments to strengthen their climate commitments to avoid catastrophic damage to the global economy. As a G20 nation, Brazil is the focus of investor efforts to put in place the policies that are needed to deliver the goals of the Paris Agreement [11]. Although investors are often nervous about getting involved in what could be seen as political debates, dialogue between investors and issuers of sovereign bonds is ever-present and is increasingly including expectations on sustainability performance.

This dialogue is now being influenced by a new set of expectations that governments will introduce abrupt and disruptive climate measures in the mid-2020s, as stated in the [Inevitable Policy Response \(IPR\)](#) work. This work and its [Forecast Policy Scenario \(FPS\)](#) shows that by 2030 deforestation will be largely eliminated as a result of domestic policy as well as national and international payments to support nature-based solutions. As carbon dioxide removal will be essential to achieve climate targets and afforestation, reforestation, restoration of degraded land, soil carbon sequestration and bioenergy with carbon capture and storage are the only alternatives with understood sequestration potential and with the potential to be deployed at scale. The question for investors is whether Brazil's sovereign bond ratings are aligned with this future shock.





# THREE STEPS

## SOVEREIGN INVESTORS COULD TAKE

# 1

The first step that investors can take is to evaluate in greater depth the health of sovereign bonds from countries impacted by deforestation, such as Brazil. This could involve an assessment of the quality of environmental governance as well as more quantitative analysis of how deforestation could impinge on a country's credit risk over the next decade – the period covered by the IPR forecast. To this end, investors could develop their in-house sovereign risk assessments or collaborate with other organisations to carry out these analyses.

# 2

A second step would be to communicate the results of this analysis to the issuers of sovereign bonds in a calm and measured way: collaborative efforts would prove the most effective here. One example of such collaborative efforts is the Emerging Markets Investors Alliance (EMIA) [\[13\]](#). Investors might need to assess the need for, shape of and vehicles for engagement with sovereign debt issuers. Depending on the answers they receive, investors could alter their asset allocation.

# 3

A third step would be for investors to signal to issuers such as Brazil their willingness to invest in sovereign bonds dedicated to regenerating the country's natural capital. Globally, the green bond market is expanding strongly in 2019 and 12 countries have now issued green sovereign bonds [\[14\]](#). Brazil has recently called on rich country governments to pay billions to protect the Amazon [\[15\]](#). A complementary approach would be for Brazil to issue a green sovereign bond, with the proceeds ringfenced to curb the illegal fires, halt deforestation and support sustainable development in the Amazon. Chile recently issued its own sovereign green bond and earned the lowest rate of interest in its history. For Brazil, a sovereign green bond focused on ending deforestation would mobilise capital markets behind positive action and ensure that the Brazilian government would have 'skin in the game'.

## COMING IN 2020

*LSE's Grantham Research Institute and Planet Tracker are collaborating on in-depth research examining the links between natural capital and sovereign bonds, focusing initially on Argentina and Brazil and will publish results in early 2020.*



[www.planet-tracker.org](http://www.planet-tracker.org)

### For further information

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FOUNDATION



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