

# ESG IN CREDIT SERIES: ESG INTEGRATION IN SOVEREIGN BONDS

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March 2, 2021  
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# PRESENTATION

**Ed Parker**

Head of EMEA Sovereigns,  
Fitch Ratings



# Climate Change Stranded Assets and Sovereign Ratings

## ESG Integration in Sovereign Bonds

Ed Parker

Head of EMEA Sovereigns

May 2021

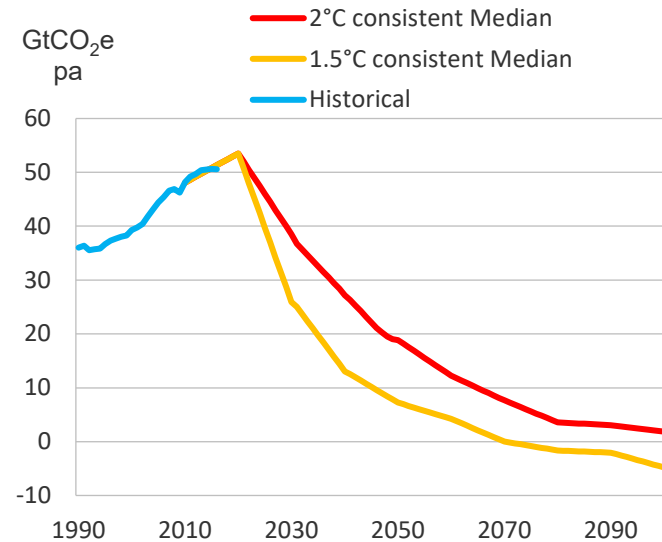




# Why Fossil Fuel Assets Will be Stranded

## Fossil Fuel Demand Must Slow

### GHG Emissions and Paris Targets



Source: Climate Action Tracker Project

## Drivers of Stranded Assets

- Global policy: GHG emission commitments and imperative to limit climate change
- Technological change: falling price of wind and solar energy alternatives
- Social pressure and sustainable investing

## What Are Stranded Assets?

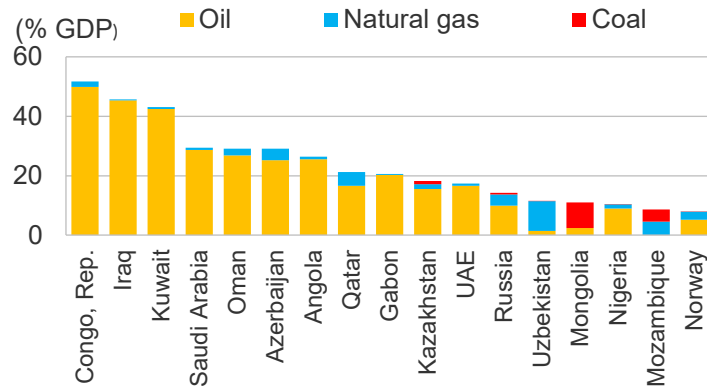
Natural resource endowments, investments, means of production and distribution, or other assets that will never be fully utilised or become prematurely obsolete owing to a transition to a greener economy.



# Major Fossil Fuel Producers and Exporters Are Most Exposed

## Importance to GDP

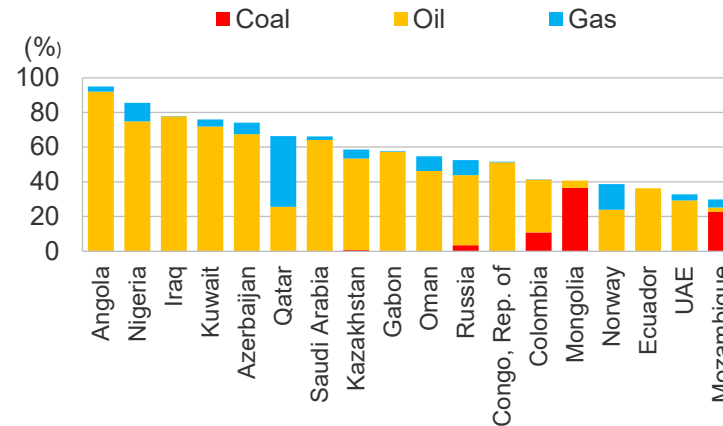
### Fossil Fuel Rents, 2018



Source: Fitch Ratings and World Bank

## Share of Exports

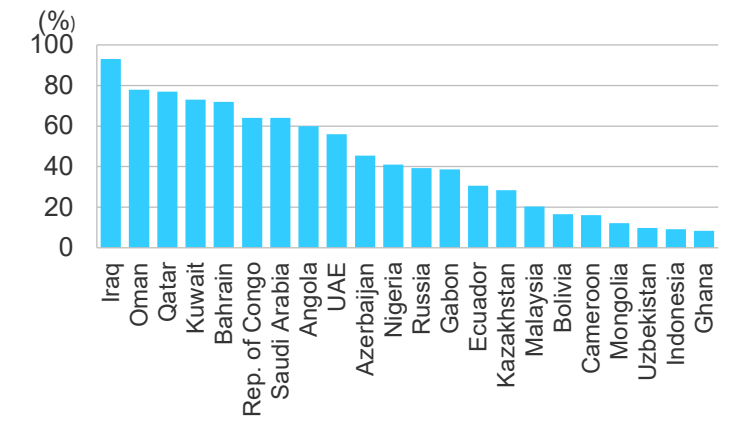
### Fossil Fuel Exports, % of Total, 2019



Source: Fitch Ratings and UNCTAD

## Share of Government Revenues

### Fossil Fuel Receipts, % of Total, 2019



Source: Fitch Ratings



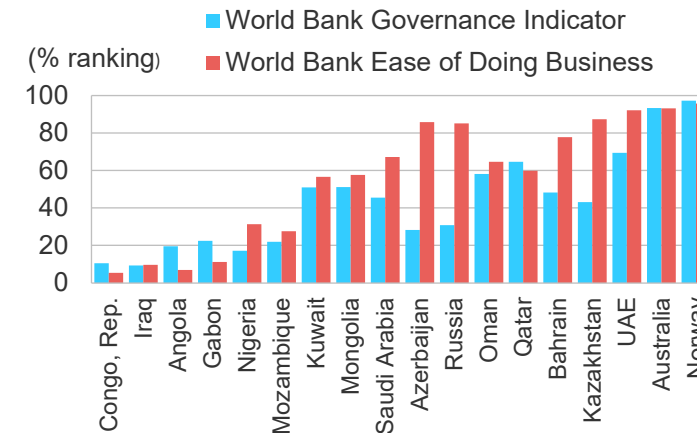
# Nuances Key to Overall Countries Vulnerability

## Key Issues

- Coal faces most complete and rapid transition, then oil; gas less so
- High-cost producers squeezed out first
- Diversification could provide partial offset, potential varies
- Fiscal adjustment capacity varies, SWF and other assets a buffer for some
- Political and financing risks
- Potential winners: green energy technology; lithium, cobalt etc endowments

## Diversification Potential Varies

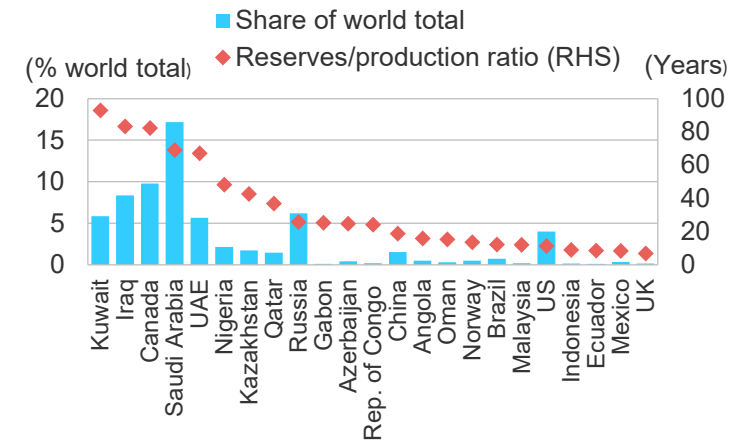
### Governance & Business Environment



Source: Fitch Ratings and World Bank

## Stranded Oil Reserves

### Oil Reserves, end-2019



Source: Fitch Ratings and BP





# Transition Risk Stranded Asset Heatmap

	Net fossil fuel exports (% GDP) 2019	Fossil fuel rents (% GDP) 2018	O/w coal	O/w gas	Fossil fuel exports (% total exports of goods & services) 2019	O/w coal	O/w gas	Fossil fuel tax receipts (% govt rev) <sup>1</sup> 2019	Oil & gas reserves (% world total) 2019	Coal (% electricity generation) 2019	Diversification potential <sup>2</sup> 2019
Rep. of Congo	45	52	0	2	52	0	0	64	0.1	0	8
Kuwait	41	43	0	1	76	0	4	73	3.8	0	54
Angola	37	26	0	1	95	0	3	60	0.3	0	13
Azerbaijan	35	29	0	4	74	0	7	45	0.8	0	57
Qatar	33	21	0	5	66	0	41	77	5.9	0	62
Iraq	32	46	0	0	78	0	0	93	5.7	0	9
Oman	28	29	0	2	55	0	8	78	0.3	0	61
UAE	27	17	0	1	33	0	3	56	4.6	0	81
Gabon	25	21	0	0	58	0	0	39	0.1	0	17
Saudi Arabia	23	29	0	1	66	0	2	64	11.5	0	56
Kazakhstan	21	18	1	2	59	1	5	28	1.6	72	65
Mongolia	16	11	9	0	41	36	0	12	n.a.	92	54
Russia	15	14	1	4	53	4	9	39 <sup>a</sup>	11.4	16	58

See "Climate Change 'Stranded Assets' Are a Long-Term Risk for Some Sovereigns", Fitch Ratings, February 2021

Source: Fitch Ratings, UNCTAD, World Bank, BP and Ember (2020)

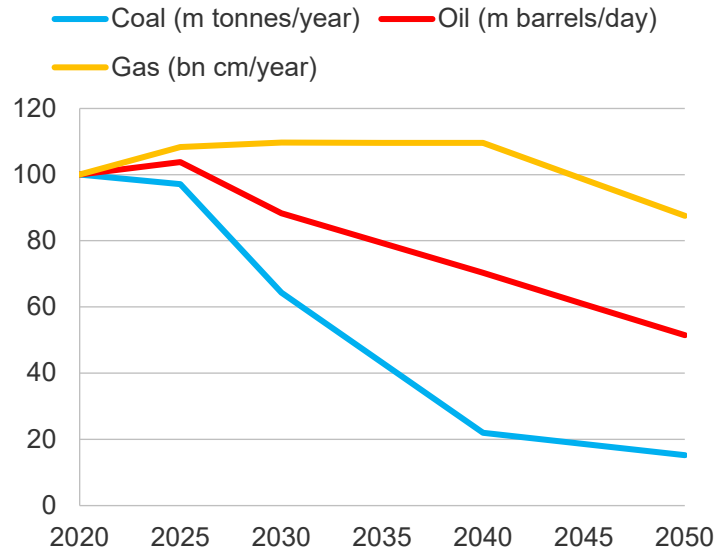




# Scenarios and the Materiality of Risk

## Fossil Fuel Demand to Drop

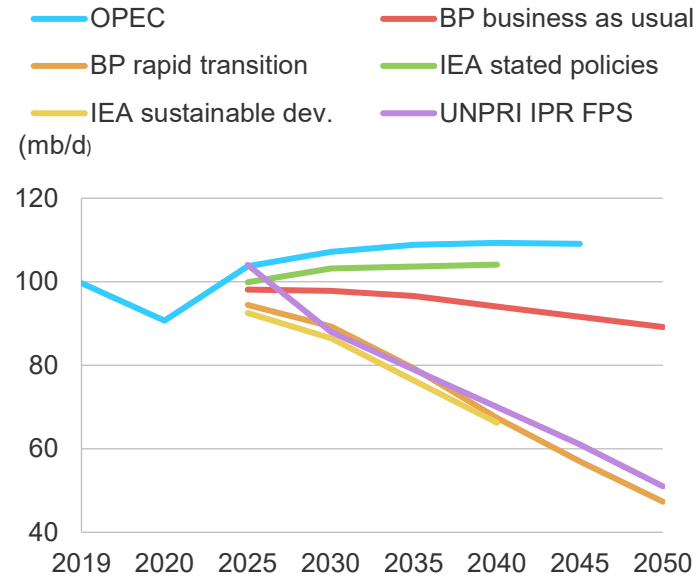
### Inevitable Policy Response Scenario (2020= 100)



Source: Fitch Ratings, UN PRI IPR FPS

## But Uncertain How Far and Fast

### Alternative Scenarios: Peak Oil



Source: Fitch Ratings, BP, IEA and OPEC



# Prices As Important as Volumes, Stress Test Lessons

## Oil Revenue Stresses

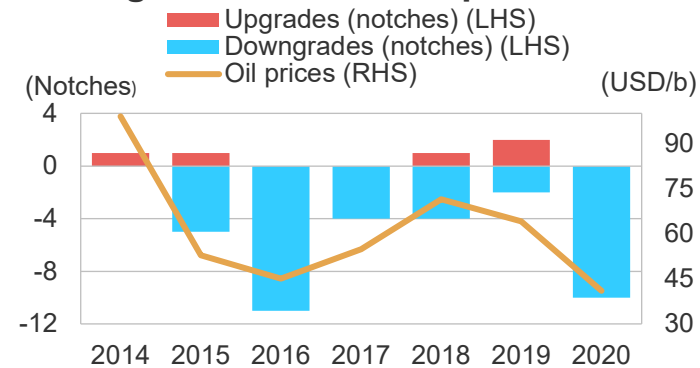
(% change)	Prices <sup>1</sup>	Volumes <sup>2</sup>	Revenues
2013-2016	-59	7	-56
2018-2020	-43	-18	-53
2025-2050	0	-48	-48

<sup>1</sup> Brent Crude;

<sup>2</sup> OPEC for 2013-16 and 2018-20 as global total boosted by the US  
Source: UN PRI IPR FPS, OPEC, BP, Datastream and Fitch Ratings

## Ratings in Recent Oil Stress

### 20 Largest Fossil Fuel Exporters (%GDP)



Upgrades and downgrades are net notch changes for each country per year across the 20 countries  
Source: Fitch Ratings and Datastream

## Key Messages

- 'Stranded assets' imply excess supply, and so downward pressure on prices
- Less incentive to cut volumes to support prices when 'peak oil' set by demand
- Of top 20 net fossil fuel exports (% GDP), 2 defaulted and a further 3 downgraded by at least four notches over 2015-2020.
- Green transition will be much slower, but permanent



# Sovereign Rating Model Impact Illustration

## Impact on Credit Variables

- Lower GDP pc and GDP growth
- Lower exports and current account balance, feeds through to net external debt/assets and FX reserves
- Lower tax receipts and budget balance, higher govt debt and interest/revenue
- Potential political risks

## Sources of Uncertainty

- Diversification capacity, policy response, multipliers and second round effects
- Offset from lower imports and remittance outflow; potential devaluation
- Fiscal adjustment ability, fiscal space, financing risks
- Degree of social resilience

## SRM Impact

Highly-stylised illustration based on parameters of major fossil fuel exporter:

SRM Output			
IPR Scenario, No change in real oil prices			
Year	2030	2040	2050
Notches	-0.4	-1.3	-2.7

Source: Fitch Ratings





# Factoring Climate Change Into Sovereign Ratings

i) Exposures/Relativities; ii) Mitigation & Adaptation Capacity; iii) Materiality; iv) Uncertainties and Time Horizons → Ratings

## Rating Criteria

### Sovereign Rating Model (SRM)

- Ex-post impact of physical, transition risks on GDP, public and external finances etc
- Ex-ante correlation: commodity dependence, share in world GDP, GDP per capita and governance indicators



### Qualitative Adjustments

- Forward-looking judgments where risks are sufficiently material

## Time and Rating Horizons

- More severe climate change effects to only build up or strike in the coming decades
- Ratings are forward-looking and take into account long-term risks
- But more weight on near-term developments than uncertain long-term projections ('discount rate')
- LT / tail risks more relevant for highly-rated
- Effect on ratings likely to build over time, can't robustly factor in everything now

## Uncertainty/Future Enhancements

- Global policy decisions, technology, social trends, data and analytics moving forward
- As uncertainty gaps narrow, we can better reflect risks in ratings
- Rankings and heatmaps only so much use: relativities vs materiality; 'weakest link' vs average of factors
- Even in MLT, simple answers from scoring models unlikely to be robust; enhanced qualitative judgments likely to play key role





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## PANEL DISCUSSION



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