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THE ROLE OF ESG FACTORS IN THE COUNTRY'S ANALYSIS

The rapid pace of economic development, along with the depletion of natural resources, political and social crises, globalization processes and the long-term impact of current decisions, have led to new goals of social interest and sustainable development. Investors have realized that it is necessary to take into account their impact on society and the environment, and this impact should lead to a positive result. Therefore, investors began to consider not only a certain rate of return, but also compliance of the object of investment with a number of social, environmental criteria and standards of corporate governance. So it is becoming more and more common to take into account the so-called ESG factor when making investment decisions.

The ESG approach involves assessing the risks and opportunities identified by analyzing factors related to the environment, social sphere and governance for the analyzed company or country (table 1). The majority of the relevant studies focus on identifying the influence of ESG indicators on the cost of corporate bonds. However, there is a linkage between ESG rate and country's investment attractiveness and cost of borrowings. Considering not only macroeconomic and financial factors in the investment process can bring comparative advantages in terms of improved profitability and better risk management.

Table 1. **Sovereign ESG Data Framework**

Sovereign ESG factors		
Environmental	*Social*	*Governance*
• Emissions & Pollution • Natural Capital Endowment and Management • Energy use & Security • Environment/Climate Risk & Resilience • Food Security	• Education & Skills • Employment • Demography • Poverty & Inequality • Health & Nutrition • Access to Services	• Corruption • Institutions • Human Rights • Stability & Rule of Law • Economic Environment • Gender • Innovation

Source: based on [1, 3]

Investors use country's ESG indicators as a potential extra-guard against losses. Before making a decision on investing financial resources together with the investment analysis of the company or country, the investor analyzes the ESG performance. For example, if a company or country shows poor results after valuing and analyzing ESG factors, an investor may decide to sell the securities of such a company or country or refrain from investing. Governments with low ESG scores should present a higher risk of sovereign default and investors would then charge a higher interest rate on debt.

In addition, analysis of ESG indicators can be a determining factor in choosing investments between companies or countries with similar financial performance. All other things being equal, the investor will choose a company or country with higher ESG.

In fact, it is about taking into account the social and environmental consequences of the country's activities (both positive and negative) and integrating them into the classical investment decision-making process. The main reason for focusing on ESG criteria is that investors and government agencies believe that the application of these criteria allows identifying non-financial factors that can have a long-term impact on the country's development and ability to generate budget income and pay its debts.

Sovereign debt investors tend to pay more attention to the analysis of social and governance rather than environmental aspects associated with a particular country, in particular as these factors become more relevant in the longer time horizon of investing in sovereign debt. Special attentions potential investors and creditors pay to such factors, as level of corruption in the country and quality of institutions. The investor who assumes a link between the level of corruption and the willingness of a state to meet its debt obligations can, based on these assumptions, adjust the credit rating and projections, which, in his opinion, did not initially reflect the level of corruption in that state. Also through appropriate political institutions, a government may have a broad support, useful when it decides to carry out fiscal policy. The ability to implement a stabilization program in difficult periods hence creates a reputational wealth for the government that can ultimately affect its sovereign risk.

To conclude, ESG factors are now more and more often considered by investors and creditors. According to the results of a joint study by CFA Institute and PRI, survey participants believe that ESG factors affect the price of stocks, corporate bonds and sovereign debt securities, and in nearest years their influence will become even more noticeable. Therefore, an important task of governments, including Ukraine, is to introduce best practices in regulating areas related to the ESG and increase the attractiveness of the country for potential creditors and investors.

References:

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2. Guidance and Case Studies for ESG Integration: Equities and Fixed Income. URL: https://www.cfainstitute.org/-/media/documents/survey/guidance-case-studies-esg-integration.ashx.

3. Sovereign ESG Data Framework. URL: https://datatopics.worldbank.org/esg/framework.html.