Section 7
Asset level targets: Alignment and Engagement Sovereign bonds

Produced by IIGCC, supported by AIGCC, Ceres, and IGCC

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Sovereign bonds

For further detail, references and citations, investors can revert to the IIGCC's Sovereign Bonds and Country Pathways discussion paper and target setting guidance.

Asset Alignment Target

For sovereign bonds, the asset alignment target is defined as:

- A 5-year target for increasing the percentage of sovereign bonds allocation to issuers that are categorised as 'aligned' to a net zero pathway or 'achieving net zero'.

Given the limitations of aligning sovereign bond portfolios with net zero pathways, a 2040 target of 100% of assets being aligned is not required. More detail is provided in the discussion paper.

1 Setting the scope

For the asset alignment target, investors are recommended to include sovereign bonds of all maturities issued in domestic or foreign currencies.

The asset alignment criteria applies to issuers exclusively; labelled bonds or climate-related issuances should not be allocated an alignment status. Providing that they meet external validation and safeguards, labelled bonds and other climate related issuance can be considered under the climate solutions objective.

Table 28: Setting scope recommendations for sovereign bonds

Issuer	Recommendations for inclusion
National government	■ All sovereign issuance from national governments is considered in scope for the asset alignment target, including holdings required for liability matching, regulatory purposes, or cash management. ■ However, inevitable restrictions are likely to exist that will affect the practical extent that these assets can be aligned. Any restrictions are recommended to be disclosed.
Sub-sovereigns, municipal or state authorities and supra-nationals	■ Such bonds are not expected to be included in alignment targets, although investors may apply similar concepts on a best effort basis. ■ Labelled and climate-related instruments issued by these entities may be considered under the Climate Solutions Objective.
Publicly (majority) owned company (i.e., State-Owned Enterprises)	■ Investors are recommended to include these companies in the corporate fixed income alignment target.

2 Assessing alignment

Investors are recommended to develop an approach to assessing the alignment of sovereign bonds within their portfolios, while incorporating 'fair share' considerations in line with the Common but Differentiated Responsibilities and Respective Capabilities (CBDR+RC) principles of the Paris Agreement. In doing so, investors are recommended to refrain from implementing strategies that lead to systematically rebalancing away from emissions-intensive emerging markets that are making efforts towards a fair transition.

This section outlines key considerations for investors when developing an approach to alignment assessment.

Consider 'fair share'

When assessing issuers against the criteria, investors are recommended to consider 'fair share' elements underpinning the distinction between developed and developing economies in terms of historical emissions responsibility and current capability.

See step 4 of the portfolio decarbonisation reference objective for sovereign bonds section for an explanation of 'fair share'. See Appendix A to understand how the alignment criteria can be adjusted for Emerging Market and Developing Economies (EMDEs) to account for 'fair share' considerations, as well as the additional four criteria which investors may consider using in their engagement interactions.

Assign a CBDR+RC category

Investors are recommended to assign a CBDR+RC category for every sovereign in the portfolio. This means distinguishing between developed economies with higher historic emissions liability and EMDEs that require more time to reach peak emissions, as well as external support to meet their mitigation goals. Investors are encouraged to disclose the frameworks of reference chosen for this categorisation (e.g., Annex I and Annex II Parties of the UNFCCC, OECD membership,[1] World Bank income categorisation,[2] or others for example by private vendors).

Integrate appropriate net zero pathways

Multiple net zero pathways have been developed on a country level which aim to consider equity elements. Investors are recommended to disclose the decarbonisation pathway used as a benchmark to assess the alignment of the sovereign bonds. For 'High Income' or 'Developed Markets', a relatively more ambitious net zero pathway may be considered. For EMDEs, a 'fair share' pathway may be considered.

Specifically, when assessing sovereigns against the emissions performance criterion, it is recommended investors assess if this is a satisfactory performance, relative to a specified country or regional decarbonisation pathway. Investors can find more guidance on country pathways in Step 4 of the portfolio decarbonisation reference objective section for sovereigns.

Assign NZIF alignment maturity metric

The table below outlines the alignment criteria for sovereign issuers and which criteria is recommended to be met to move up the maturity scale. Investors are recommended to use the criteria below to determine the alignment category of the issuer.

1 Parties and observers (2024), UNFCCC

2 World Bank country classifications by income level for 2024-2025 (2024), World Bank

Table 29: Criteria underpinning alignment assessment

Criteria	Committed to aligning	Aligning to a net zero pathway	Aligned to a net zero pathway	Achieving net zero
Budget/capital allocation alignment: A clear demonstration that the budgeting actions of the country are consistent with global net zero goals (e.g. climate budget tagging, where an ambitious share of the budget is green).				✓
Emissions performance: Current absolute GHG emissions trend is at least equal to a relevant net zero pathway, or converging in a manner that is satisfactory.			✓	✓
Decarbonisation plan: A robust quantified plan setting out the measures that will be deployed to deliver GHG targets (LT-LEDS), and how the sovereign is enacting the policies necessary to deliver against its NDCs.		✓	✓	✓
Disclosure of emissions: Comprehensive and timely disclosure of emissions (e.g. data quality, historical data, LULUCF, etc).		✓	✓	✓
Targets: Short and medium term emissions reduction targets aligned with global net zero goals. These are set at the production emissions level (scope 1) and should be consistent with the Paris Agreement (NDCs).		✓	✓	✓
Ambition: A long term goal consistent with the global goal of achieving net zero by 2050, as well as interim goals and targets that are coherent with it (NDCs absolute emissions targets).	✓	✓	✓	✓
To account for 'fair share' considerations, investors can relax some of the criteria for the countries they classify as EMDEs. For example, countries that are currently carbon sinks do not need to satisfy the other criteria to be considered as 'Achieving net zero'.	Additional alignment criteria to be met to move to that alignment category			

Tools

There are multiple tools available to support investors in assessing countries against the alignment criteria.

Table 30: Tools for assessing country alignment

Tool		Description
ASCOR Fair share pathways	**ASCOR**[3]	▪ **Assessment tool** specifically created by investors to support sovereign engagement and investment decision-making. ▪ **Coverage:** 25 countries initially (to be expanded to 70 in 2024). ▪ **3 pillars:** Emissions pathways, climate policies, climate finance. ▪ Investor-driven, all from public sources, fully transparent and replicable methodology.
CCPI Climate Change Performance Index	**Climate Change Performance Index**[4]	▪ **Ranks, rates and scores countries'** climate policies and climate performance. ▪ **Coverage:** 63 issuers + EU. ▪ **3 pillars:** Policies and actions, emissions reduction target, climate finance. ▪ Scores available since 2005, easy to understand. Commercial use possible with a licence.
Climate Action Tracker	**Climate Action Tracker**[5]	▪ **Ranks countries'** climate policies and climate performance. ▪ **Coverage:** 40 issuers, including EU. ▪ **4 pillars:** Current emissions, energy usage, renewable energy, and climate policy progress. ▪ Solid scientific base plus 'fair share' considerations. Commercial use possible with a licence.

Furthermore, the Net Zero Tracker[6] focuses on emissions accounting and reporting, and includes data for several cities and states. The Green Future Index[7] offers a comparative annual ranking of 76 nations and territories on their progress and commitment toward building a low-carbon future.

Beyond these tools, there are other data sources that are commercially available. For example, Bloomberg's Government Climate Scores (GOVS) measures 140 governments' decarbonisation transition efforts across +100 metrics, including forward looking data. This can be used by investors to analyse each country's progress and preparedness in meeting the global Paris Agreement goals, relative to their peers.

3 Assessing Sovereign Climate-related Opportunities and Risks (2024), ASCOR

4 Climate Change Performance Index (2024), CCPI

5 Climate Action Tracker (2024), Climate Action Tracker

6 Net Zero Tracker (2024), Net Zero Tracker

7 MIT Technology Review (2023), Green Future Index

3 Setting the target

Once an approach to assess and classify sovereign issuers in the alignment scale has been established, investors can set a target to scale up the proportion of aligned assets:

- A 5-year target for increasing the percentage of sovereign bonds allocation to issuers that are categorised as 'aligned' to a net zero pathway or 'achieving net zero'.

Inevitable restrictions are likely to exist that will affect the practical extent these assets can be aligned. Any restrictions (such as due to liability management and or cash management) are recommended to be disclosed.

4 Delivering the target

Acknowledging nuance

IIGCC recognises achieving net zero targets for sovereign bond portfolios will be particularly challenging. Such challenges are outlined in the table below, and can be disclosed by investors when setting out net zero strategies for sovereigns.

Table 31: Challenges in integrating sovereign bonds into net zero strategies

Challenge	Description
Regulatory and mandate constraints	Regulatory requirements and specific mandates can limit cross-country investments. Most sovereign bond portfolios operate under liability management restrictions.
Limited number of issuers and concentrated nature of the market	A limited and concentrated market (<150 issuers vs. thousands of corporate issuers) means that reducing the exposure to some sovereigns in the portfolio may force others to be overweighted, potentially leading to concentration risk and other material risks.
Risk management	Sovereign bonds often play a critical role across portfolios in terms of duration management, FX exposure, hedging and cash management, among others. In the context of fiduciary duty, this can make exclusions, optimisations or tilts a sensitive approach.
Data availability and quality	Availability and quality of data on emissions and alignment efforts varies greatly across countries. Gaps remain, for example, in accounting for consumption-based emissions and LULUCF emissions.
Internal capacity constraints	The ability of a country to gather and aggregate data requires significant resources and coordination amongst relevant ministries, resulting in data gaps creating challenges for index providers and investors.
Concerns around engagement	These include limited opportunities for investor engagement, the non-credible threat of exit, the complex and multifaceted nature of sovereign entities, a lack of metrics to assess causation, and the ability to assess impact and 'fair share' considerations.
Electoral cycles	Sovereign policy is prone to changes due to electoral cycles. These cycles can materially impact commitments and progress of countries, as well as hinder engagements, which could result in sudden unintended portfolio misalignment.
Flaws in global frameworks	Stemming from inconsistency in definitions among countries' NDCs, a lack of accountability for targets set, discrepancies between commitments and the goals of the Paris Agreement, as well as ambition and implementation gaps.
Lack of regulation	Limited regulation for assessing and reporting on sustainability issues, such as taxonomies which are available for assessing corporates. Reporting standards for public sector entities are also lacking.

Despite the limitations, more resources are increasingly available to facilitate discussions between investors and sovereigns, and to support the delivery of an asset alignment target for sovereign bonds. These include new assessment tools and better data, improved granularity in sectoral and regional decarbonisation pathways, new opportunities to engage, and enhanced target setting and implementation guidance for sovereign bonds.

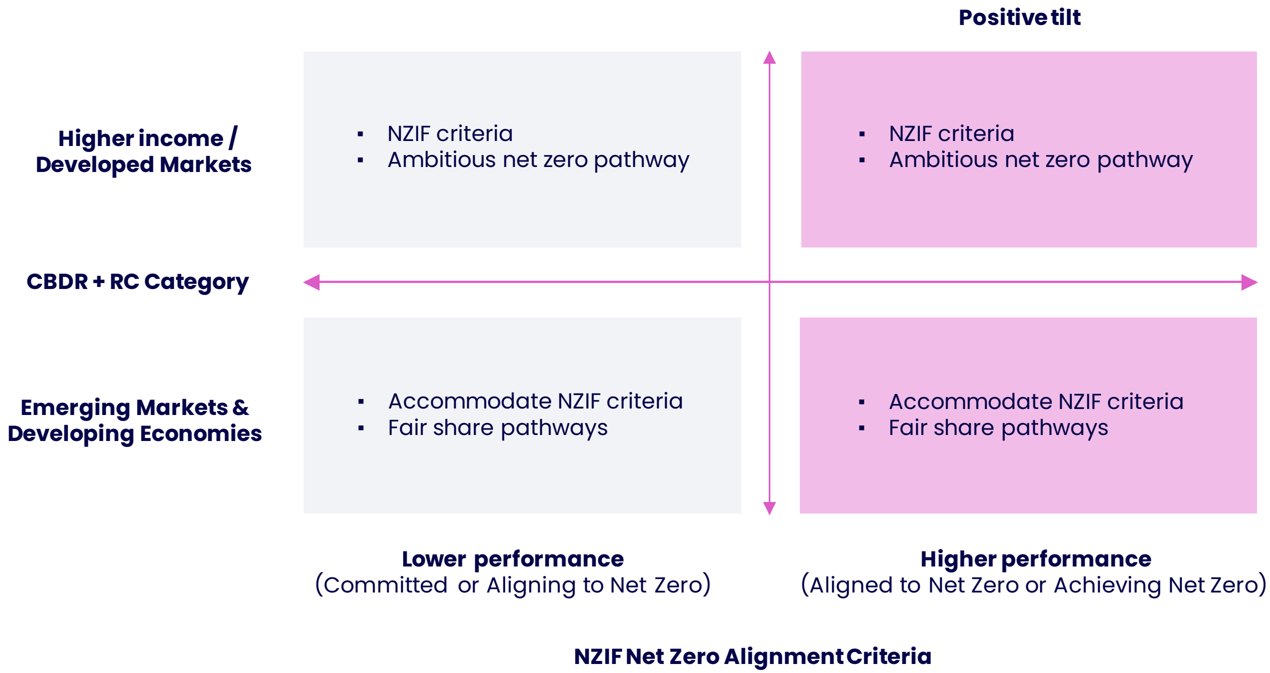
Capital allocation

While acknowledging the multiple potential limitations to exercise portfolio allocation decisions for this asset class, over time the framework seeks to incentivise portfolio tilts towards climate high-performing issuers, while qualifying the alignment criteria for EMDEs to consider CBDR+RC and 'fair share' principles.

Engagement

While the sovereign engagement toolkit is currently relatively limited compared to corporate assets, investors have a growing range of actions available for engaging with policymakers to boost the necessary climate action of governments. See the engagement threshold section below for further guidance.

Figure 21: Tilting towards high sovereign performers



5 Monitoring the target

Review categorisations

Investors are recommended to establish a process to periodically review the categorisation of sovereign issuers, at least once a year, and commit to update with any new information, such as an update to NDC commitments.

Disclosure

To enhance transparency, investors are recommended to disclose relevant information relating to the development of their alignment approach and setting of targets. This includes:

- Data sources used
- The criteria used for CBDR categorisation
- Alignment assessment methodologies implemented
- Targets, including updates to targets
- Restrictions, such as holdings required for liability matching purposes
- Exceptions, such as due to data limitations and the methods used to fill information gaps

Case studies: Sovereign bond alignment

Challenges around a lack of available methodologies and data have hindered investors developing alignment methodologies for sovereign bond portfolios. However, some investors have tackled such barriers, developing innovative products and strategies for sovereign alignment, including:

- A fair assessment of governments' transition to net zero: Ninety One's Net Zero Sovereign Index

Engagement Threshold Target

Investors are recommended to develop an engagement threshold target for their sovereign bond assets, defined as:

- A threshold of financed emissions from sovereign bonds in a portfolio and undertake engagement actions with the relevant countries and territories.

Stewardship and engagement strategy

When developing a stewardship and engagement strategy, investors are recommended to integrate and report on the following actions:

Prioritisation: Seek active engagement with highest impact sovereigns or largest exposures that do not perform well against the criteria.

Direct and indirect engagement: Participate in engagement efforts both directly with governments or indirectly through networks such as IIGCC, AIGCC, Ceres, and IGCC.

Labelled bonds: Engage with issuers, investment banks and development agencies to increase issuance of labelled bonds, including SLBs with Paris-aligned KPIs, and other climate solutions.

Early engagement: Commence engagement well in advance of the issuance process and seek opportunities to shape bond characteristics, such as KPIs for SLBs, in a manner that enhances climate ambition.

Engaging on data: Advocate for data providers to develop indicators to assess criteria set out by the asset alignment target methodology.

Engaging on pathways: Advocate for pathway tools to incorporate and make explicit the inclusion of 'fair share' principles within national level assessments.

Engaging on disclosures: Engage to enhance and standardise national disclosures based on the alignment criteria set out, improve quality and consistency of LULUCF and methane emissions reporting, and improve quality and consistency of consumption emissions disclosures.

Engagement: Seek opportunities for dialogue between investors and debt management offices and other national and subnational entities on the links between sovereign bond issuance, sovereign risk, and climate risk.

Appendix

Appendix A: Adjusted alignment criteria for EMDEs for sovereign bonds

This table shows how NZIF's alignment criteria could be adjusted for sovereign bonds to acknowledge the principle of 'fair share' when assessing sovereign alignment to a net zero pathway.[8]

Table 32: Adjusted alignment criteria for EMDEs for sovereign bonds

NZIF Criteria	Definition	Criteria adjusted for EMDEs -> 'Fair share' considerations
1. Ambition	**A long term 2050 goal consistent with achieving global net zero.** (NDCs with absolute emissions target)	Medium term goals may be acceptable. Alignment with a 2°C scenarios or reaching Net Zero post 2050 may be acceptable.
2. Targets	**Science-based short- and medium-term emissions reduction targets aligned with global net zero goals.** These are typically set at the production emissions level (scope 1) and should be consistent with the Paris Agreement (NDCs).	Consider ambition in context
3. Emissions performance	**Current absolute GHG emissions trend is at least equal to a relevant net zero pathway,** or converging in a manner that is satisfactory.	Fair share pathways are acceptable as benchmark. Increase in absolute emissions may be acceptable in the near-term.
4. Disclosure of emissions	**Comprehensive and timely disclosure of emissions** (e.g., data quality, historical data, consumption emissions, LULUCF, etc)	Consider data quality and ambition in context
5. Decarbonisation strategy	**A robust quantified plan setting out the measures that will be deployed to deliver GHG targets** (LT-LEDS), and how the sovereign is enacting the policies necessary to deliver against its NDCs.	Consider data quality and ambition in context
6. Capital/ budget allocation alignment	A clear demonstration that the **budgeting actions of the country are consistent with achieving global net zero goals.** (e.g., adequate climate budget tagging, an ambitious share of the public budget is green).	Consider data quality and ambition in context
7. Climate Policy Engagement / Climate finance	A Paris-aligned climate position and alignment of its direct and indirect international lobbying and finance activities	Consider in context
8. Climate governance	Clear oversight of net zero transition planning linked to delivering targets and transition	Consider in context
9. Just Transition	Considers the impacts from transitioning to a lower carbon economy on its workers and communities	Consider in context
10. Climate risk and accounts	Provides disclosures on risks associated with the transition, in issuance legal documentation, other type of sovereign reporting, and incorporates such risks into its financial accounts	Consider in context

8 IIGCC (2024), Sovereign bonds and country pathways – target setting guidance

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