

Our approach to monitoring ESG issues in sovereign debt research



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Key takeaways

- We believe that considering potentially material environmental, social and governance (ESG) issues in sovereign debt investment research is an important part of assessing the ability of a government to repay bond investors.
- Our recent review found a significant relationship between emerging market (EM) sovereign debt spreads and the metrics used in our sovereign monitoring framework.
- We also conducted backtests on additional datasets — including sovereign emissions and transition targets data. We found that these metrics are not currently priced in EM sovereign debt spreads.
- Although these metrics do not appear to be currently priced in and are not covered by our sovereign ESG monitoring framework at this time, we believe their relationship with EM spreads could evolve over time. We have therefore incorporated sovereign emissions and access to ASCOR's transition data into our proprietary EM Live platform to enable closer tracking.

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Introduction

Across the industry, environmental, social and governance analysis is taking on a more prominent role in sovereign bond investment research.

At Capital Group, our approach to ESG integration is one of financial materiality. We analyze material ESG issues as part of our investment research to better understand long-term risks and opportunities as we strive to maximize results for our clients. In sovereign debt, we believe that ESG considerations are an important part of assessing the ability of a government to repay bond investors.

Issuers can be affected by numerous E, S and G risks. For example, social cohesion, the rule of law, low levels of corruption and effective governance can set the stage for economic resilience. Conversely, from a bond investor's perspective, less favorable indicators could suggest greater risk of financial, social or political upheaval that may cause a government borrower to struggle to meet its debt obligations.

This view is supported by a growing body of research. Recent analysis published by the International Monetary Fund,¹ for example, demonstrates the relevance of ESG considerations in explaining emerging market spread movements. Furthermore, governance and social data have shown positive correlations with credit ratings — above 0.81, according to one analysis published by the World Bank.²

See page 8 for referenced footnotes.



Monitoring ESG issues in sovereign debt

Monitoring is a key aspect of our ESG integration process, where we complement in-house research and analysis with monitoring of third-party ESG data to surface external views of potentially material ESG risks. Of course, while this process can serve as a helpful input, investment decisions are based on a long-term view, engagement and analysis — never on monitoring alone.

Our monitoring process for sovereign bonds draws on data from three sources — the Notre Dame Global Adaptation Initiative Climate Vulnerability Index (E), UN Human Development Index (S) and World Bank’s Worldwide Governance Indicators (G) — to monitor and flag holdings across the sovereign universe. Data providers and example metrics are outlined in the table below.

Third-party data sources used in our sovereign bond monitoring process

Data provider	Example metrics
Environmental Notre Dame Global Adaptation Initiative Climate Vulnerability Index Measures a country's exposure, sensitivity and capacity to adapt to the negative effects of climate change	Measures overall vulnerability by considering six life-supporting sectors: <ul style="list-style-type: none"> — Food — Water — Health — Ecosystem services — Human habitat — Infrastructure
Social United Nations (UN) Human Development Index Summarizes achievement in key dimensions of human development: life expectancy and education	<ul style="list-style-type: none"> — Life expectancy (years) — Education (average and expected years of schooling)
Governance World Bank’s Worldwide Governance Indicators Indicators for countries across six dimensions of governance	<ul style="list-style-type: none"> — Government effectiveness — Rule of law — Control of corruption — Voice & accountability — Political stability — Regulatory quality

Sources: Notre Dame Global Adaptation Initiative, United Nations and World Bank.

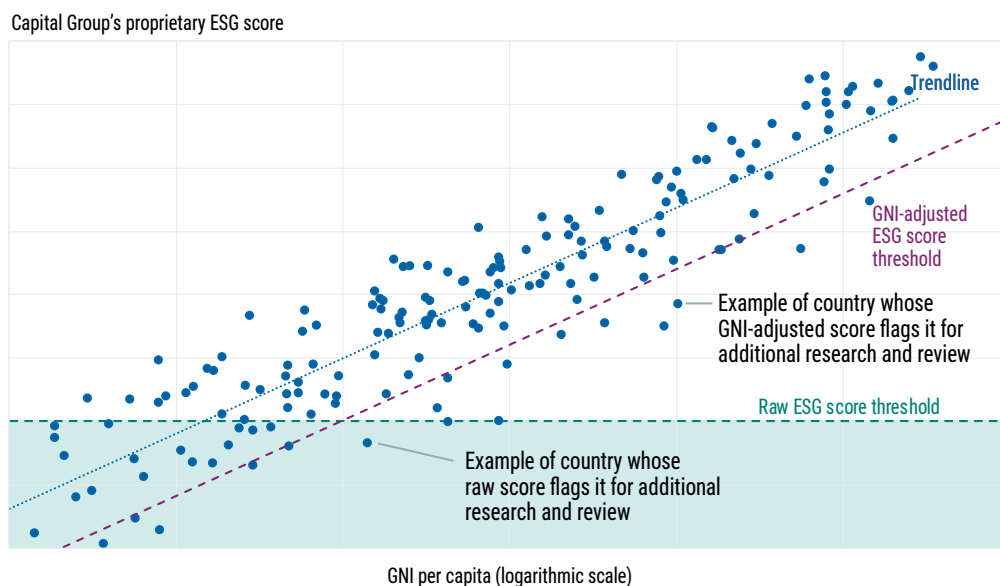
Our proprietary methodology blends indicators from these third-party data sources to calculate an absolute ESG score. Governance metrics are presently assigned greater weight than environmental and social metrics. Countries which pursue best practices in governance standards may have a lower cost of capital, as governance indicators can directly relate to a sovereign's ability to repay its financial obligations.

Our methodology also calculates a gross national income (GNI)-adjusted score to better understand how issuers manage ESG risks relative to their wealth and available resources. Issuers with the lowest scores in either category are flagged for additional analyst review. (See the exhibit below.)

We find this adjustment to be important for addressing inherent income bias. According to research from the World Bank,³ average sovereign ESG metrics across data providers are highly correlated with GNI per capita, which can overly penalize poorer countries based on their level of development and resources. GNI adjustment also allows us to evaluate an issuer's performance relative to its level of economic development. Improvements in ESG-related metrics are often a natural part of a country's economic development.

Sovereign monitoring in action: Issuer universe screening visualization

Illustrative example of issuer scores



Sources: Notre Dame Climate Adaptation Initiative, UN Human Development Index, Worldwide Governance Indicators, and the World Bank.
Data as of February 2025.

Our monitoring process is built into Ethos, Capital Group's in-house ESG research tool. Investment analysts can view and resolve monitoring flags within Ethos. For issuers that are flagged, analysts share information and perspectives on material ESG risks and how those may affect their investment theses.

See page 8 for referenced footnotes.

We also integrate ESG data into our sovereign investment process through tools on our proprietary data analytics platform, EM Live. In EM Live, our investment professionals can track and analyze the underlying data in our sovereign monitoring process to explore how an issuer compares with peers across several dimensions. They can also access additional indicators used in analysis of sovereign risks. ESG data are therefore part of a broader array of data and analytics that our investment professionals use in their investment decision making.

The exhibit below includes a snapshot of sample data from EM Live for one Asian country and some similarly rated peers.

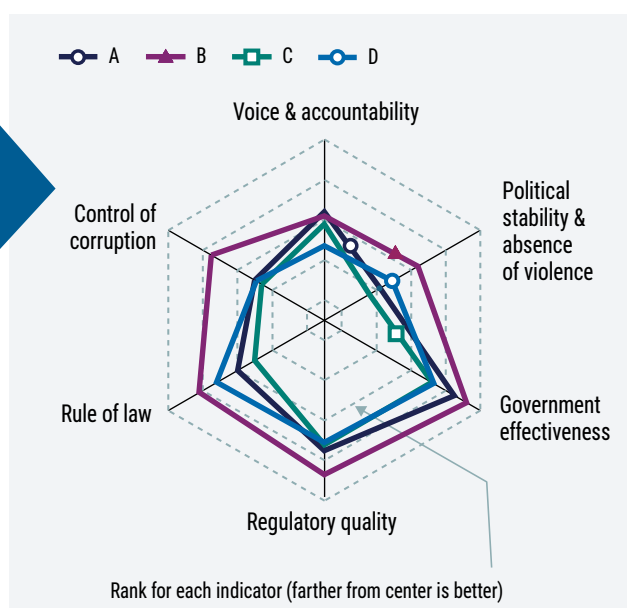
Sovereign monitoring in action: Deep dive on tracking underlying indicators

Illustrative example (Asian issuer: Country A)

Country A's percentile rankings for select ESG indicators relative to broader sovereign issuer universe

Data provider	Indicator	Percentile
Governance (World Bank Worldwide Governance Indicators)	Government effectiveness	75%
	Political stability & absence of violence	32%
Social (UN Human Development Index)	Life expectancy (years)	31%
	Mean years of schooling	40%
Environmental (Notre Dame Global Adaptation Initiative Climate Vulnerability Index)	Food	37%
	Water	21%

Governance indicator percentile rankings for Country A and select regional peers



Sources: Capital Group and World Bank. All data is latest available as of September 2025.

Note: This is a sample output with a selection of the underlying data points analyzed as a part of our sovereign ESG process, represented as percentile ranks among countries worldwide from 0 (lowest) to 100. Spider chart is based on percentile ranks from 0 to 100 for six governance indicators. Country plot points closer to the outside indicator markers represent stronger governance scores; plot points closer to center indicate weaker governance scores.

To understand the relevance of governance metrics for DM issuers, we also examined the relationship between governance scores and sovereign spreads in eurozone issuers. We found that issuers with higher governance scores have often traded at lower spreads. A historical regression analysis comparing these issuers' spreads to their governance scores found an average annual R-squared of 0.65, indicating a strong relationship between good governance and lower spreads over time.

"Governance is one of many important considerations in my analysis of sovereign issuers," says fixed income investment analyst Jason Davis. "In a recent assessment of one eurozone issuer, renewed political stability — alongside other factors — led me to conclude that its relative valuation could improve," he explains.

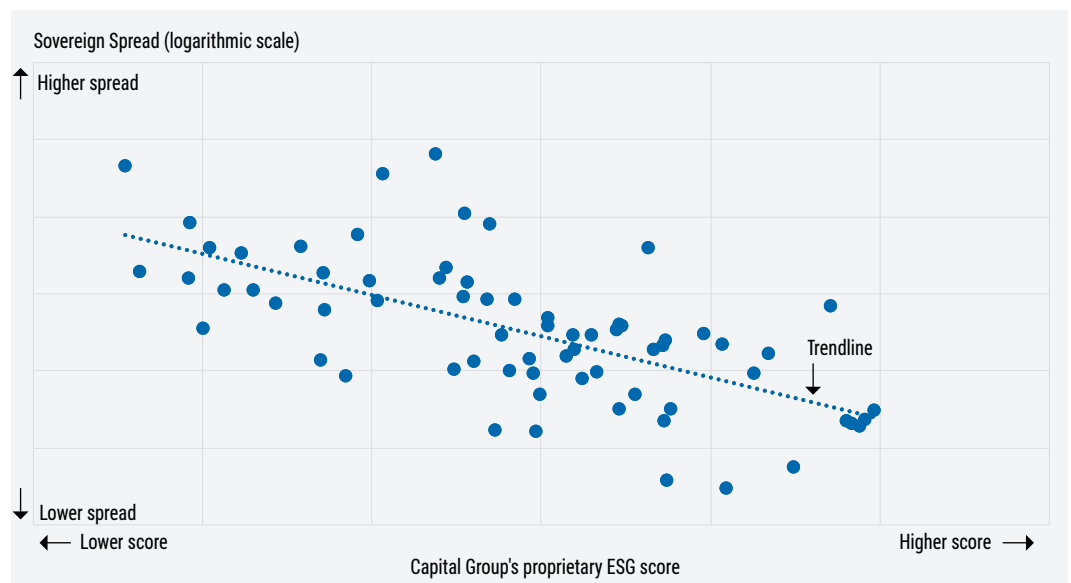
Review of our sovereign monitoring methodology

Given the rapidly evolving ESG data landscape, we undertook research in 2025 to assess if datasets used in our framework still show a strong relationship with sovereign spreads, and if any new datasets on other ESG considerations should be included in our framework.

Our review confirmed that our sovereign monitoring methodology remains robust, with absolute ESG scores continuing to demonstrate a significant relationship with the spreads of sovereign issuers in the JPMorgan Emerging Market Bond Index (EMBI). (See the list of metrics used in our methodology on page 3.) We focused on EM issuers as they are disproportionately affected by ESG issues due to the income bias in sovereign ESG data. As the exhibit below shows, sovereigns with higher ESG scores generally trade at lower yields.

Issuers with higher proprietary ESG score tend to have lower spreads

Illustrative example



Source: Capital Group. Data as of November 2025. Each dot represents an issuer with sovereign bonds included in the EMBI index. EM sovereign spread refers to blended spread calculated by JPMorgan, which shows the yield difference over U.S. Treasury of the same maturity. The spread represented in the graphic is the average daily spread for the first nine months of 2025.

Assessment of new E and S datasets for EM issuers

Assessing ESG risks for sovereign issuers remains challenging due to data limitations, analytical complexity and inconsistent views on financial materiality. However, the breadth and quality of available sovereign ESG datasets, including those related to emissions, energy transition and certain social topics, have improved in recent years, providing a wider set of potential inputs for analysis. We reviewed this expanded data landscape to try to identify new information that could help quantify the impact of ESG considerations on sovereign spreads.

Our review showed that developed market (DM) issuers have been the focus of research on some of these new datasets, such as those related to emissions and transition targets. The literature we reviewed generally found that DMs with lower exposure to transition risks benefitted from lower borrowing costs and/or higher credit ratings.

Given the limited research on EM sovereigns, we tested whether additional datasets could help explain EM spreads. We prioritized datasets that our proprietary research had identified as potentially financially material, with robust point-in-time and historical coverage across sovereign issuers in the Bloomberg Global Aggregate Bond Index and the JPMorgan Emerging Market Bond Index (EMBI). To ensure they were relevant and practical for our investment process, we focused on datasets updated at least annually and subject to minimal reporting lag.

Based on our review, we selected several datasets to backtest their historical relationship with sovereign yield spreads. Below, we present examples that are particularly relevant for assessing sovereign energy transition risk — an area not currently covered in our framework. We also evaluated selected social metrics, such as female labor participation and old-age dependency ratio, but found no strong relationship between these specific metrics and EM sovereign spreads.

Example sovereign energy transition risk datasets backtested for potential inclusion in the ESG sovereign monitoring methodology

Data source	Issue or area	Details
MSCI	Sovereign carbon emissions	<ul style="list-style-type: none"> • Production emissions absolute: sovereign carbon emissions from sources located within the country, including emissions from exported goods and services. • Production emissions intensity: production emissions normalized by purchasing power parity (PPP)-adjusted GDP. • Consumption emissions absolute: sovereign carbon emissions associated with the consumption activities within a country. This includes emissions from the production of goods and services consumed by the residents of that country, regardless of where the production occurs. • Consumption emissions intensity: consumption emissions normalized by population size (tCO₂e/capita).
ASCOR	Emission trends and targets	<ul style="list-style-type: none"> • Emissions trends: evaluates a country's emissions profile over the past 5 years and relevant details (such as emissions trends and alignment to the country's 1.5°C benchmark). • 2030 Targets: evaluates whether the country has set a 2030 emissions target and relevant details (such as alignment to the country's 1.5°C benchmark and use of carbon credits). • Net zero targets: evaluates whether the country has set a net zero emissions target and relevant details (such as target year and alignment with a global 1.5°C scenario).

Sources: MSCI and ASCOR Tool/Transition Pathway Initiative.

Our analysis found these metrics are not reflected in EM sovereign spreads. For example, our regression analysis comparing EM issuers' spreads to their sovereign production emissions intensity found an average annual R-squared value of 0.03 (based on data from 2005 to 2023), indicating a lack of historical relationship between the two.

Similarly, our backtests of other emissions metrics and climate targets found no evidence that these factors are reflected in EM sovereign spreads. Accordingly, we have decided not to incorporate these datasets into our sovereign ESG monitoring framework at this time. We will, however, continue to assess their materiality and relevance for potential future inclusion.

Final thoughts

Even as our research indicates that emissions and transition targets are not currently priced into EM sovereign spreads, we believe the relevance of these datasets could increase, depending on the pace of energy transition. For example, under the International Energy Agency's Stated Policies Scenario, which reflects policies that have been adopted or planned, global demand for oil is projected to peak around 2030 and for gas around 2035. Under such a scenario, sovereigns that rely on revenues from carbon-intensive sectors could face slower growth, weaker fiscal revenues and potentially higher borrowing costs. But under the IEA's Current Policies Scenario, oil and gas demand is not expected to peak before 2050, implying lower near-term transition risks but higher physical risks.

With the uncertainty around energy transition in mind, we have added certain MSCI sovereign carbon emissions metrics in EM Live, our proprietary data analytics platform to help our investment professionals monitor risks related to energy transition. We have also included access to ASCOR's tool for assessing emissions trends and policies.

ESG data can offer valuable insights, but many datasets used in our methodology are backward looking and published with a lag. As part of their fundamental research and analysis, our investment professionals also seek to identify forward-looking risks through detailed analysis and, where appropriate, engage with government officials and policymakers on broad topics such as debt management, government spending plans and financial regulation, as well as ESG-related issues that we view as material. This way, ESG integration helps us surface issues that, alongside traditional research and financial analysis, inform our long-term investment outlook.

Footnotes/Important information:

¹IMF. "Do ESG Considerations Matter for Emerging Market Sovereign Spreads?" April 2025 working paper. Spread measures the difference between a bond's yield and a (theoretically) risk-free rate with a similar maturity.

²World Bank. "Credit Worthy: ESG Factors and Sovereign Credit Ratings," 2022. Correlation measures the relationship between two variables; a positive correlation indicates both variables tend to move in the same direction. Correlation ranges from -1 to 1. A positive correlation close to 1 implies that as one variable moved, either higher or lower, the other moved by a similar magnitude, in the same direction.

³World Bank Group. "A New Dawn — Rethinking Sovereign ESG," pp. 18–19. 2021.

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