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Sustainable Finance and Sovereign Debt: The Illusion to Govern by Contract

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ABSTRACT

Sovereign debt markets are rapidly venturing into the world of sustainable finance. Sovereign and sub-sovereign borrowers increasingly use 'green', 'social', and 'sustainability' bonds and loans to finance their domestic sustainability agenda. The rationale behind those instruments is to leverage the power of financial markets to incentivize public borrowers to pursue sustainability reforms and projects that would otherwise be difficult to implement. At the same time, given its clear objective to influence domestic policies, some see sovereign sustainable finance as an invasion of national sovereignty and a new form of private conditionality. This article assesses these claims. It sets out a theory of sovereign sustainable bonds that highlights the incentives of the two contractual parties—institutional investors and sovereign borrowers—to use finance as a tool for domestic sustainability reforms. I demonstrate that neither of the two parties has any incentive to use debt instruments to pursue a change in domestic policies and sustainability practices. A lack of financial incentives for investors and constitutional and political limitations on the sovereign borrower's side make the environmental, social, and governance (ESG) contractual bargain very difficult to negotiate and implement. At the same time, both parties share the common goal of tapping into the ever-expanding ESG market. This results in a sustainable bond structure that only superficially addresses the sustainability objective for which it is marketed to investors.

I. INTRODUCTION

'Sustainable finance' is the financial industry's response to the United Nations (UN) Sustainable Development Goals (SDGs).[1] It defines the incorporation of environmental, social, and governance (ESG) factors into the investment strategies of financial institutions acting as investors in sustainable assets and financers of sustainability-related projects.[2] The objective is to use finance to incentivize corporations and the public sector to adopt more sustainable practices and policies.[3] Recent data from the Bank for International Settlement show that assets under

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[1] UN, *Transforming Our World: the 2030 Agenda for Sustainable Development*, Resolution adopted by the General Assembly on 25 September 2015 (21 October 2015).

[2] For a quick overview of the history and purpose of sustainable finance, see IMF, 'Sustainable Finance' Chapter 6, in *Global Financial Stability Report: Lower for Longer* (Washington, DC: International Monetary Fund, 2019), at 81–92.

[3] Jesse Griffiths, 'Financing the Sustainable Development Goals (SDGs)', 61 Development 62 (2018).

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management in ESG funds have increased by almost 20 times in only 5 years[4] to around US$2.9 trillion by June 2022.[5] According to some analyses, the value of ESG investments will reach the staggering sum of US$53 trillion by 2025.[6]

From an international economic law viewpoint, sustainable finance is becoming increasingly important as a source of finance for sovereign and sub-sovereign borrowers. While the sustainable finance market has mainly targeted corporates, investors are showing a growing interest in governments.[7] According to experts, the demand for sovereign 'green', 'social', and 'sustainability' bonds has reached US$1 trillion in 2021 and is expected to increase by 20–50% by the end of 2022.[8] For simplicity, we might define the adoption of ESG considerations to sovereign financing as 'sovereign sustainable finance'. The market is currently dominated by developed country issuers and is primarily focused on environmental-focused sovereign bonds. However, more emerging and low-income economies are tapping into this market to finance their sustainability agenda.[9] Moreover, the reach of sustainable finance, which was usually limited to environmental sustainability and climate finance, is quickly extending to investments targeting social and governance objectives.[10] These objectives include critical government policies like gender parity, rule of law, health, labour rights, and education, similarly deemed to carry long-term economic and social benefits.[11]

At the foundation of the sovereign sustainable finance market lies the idea that international investors can leverage their position as suppliers of capital to incentivize sovereign and sub-sovereign borrowers to invest in sustainable projects or adopt more sustainable domestic policies.[12] Sovereign sustainable bonds (and loans) are vital tools to achieve this objective.[13] They do so by adding a sustainability target component to the bond contract's standard legal and financial framework. The idea is to mix in the same debt instruments, the standard financial obligations of a debt contract, together with specific ESG targets borrowers have to meet. Depending on the type of instrument, these targets could be the implementation of a sustainable project, like the development of a new hydropower plant, or the improvement of specific ESG policies, like a reduction in the corruption index or improved environmental quality.

The rise of sovereign sustainable finance offers an interesting case study for international economic law as it adds further complexity to the long-standing debate on the relationship between international finance and national sovereignty.[14] The broader reach of sustainable finance and the use of sovereign bonds and loans as a mechanism of domestic governance potentially give investors a powerful tool to influence governments in critical areas of domestic policy. In theory, this could help governments to promote difficult political reforms. However, critics argue that

[4] Michela Scatigna et al., 'Achievements and Challenges in ESG Markets', BIS Quarterly Review (December 2021), at 86.

[5] Gong Cheng, Torsten Ehlers, and Frank Packer, 'Sovereigns and Sustainable Bonds: Challenges and New Options', BIS Quarterly Review 47 (September 2022).

[6] Bloomberg Intelligence, 'ESG assets may hit $53 trillion by 2025, a third of global AUM' (23 February 2021); Climate Bond Initiative argues that the market for short-term climate bonds is already worth US$55 trillion. See, CBI, 'Certification of Short-Term Debt Instruments', CBI Discussion Paper (18 July 2022).

[7] World Bank, 'Greening Capital Markets: Sovereign Sustainable Bonds', in *World Development Report 2022* (Washington, DC: World Bank, 2022), at 241–248.

[8] Philip Moore, 'Greenium Set to Stay, Say Sovereign Debt Issuers' (7 February 2022), https://www.omfif.org/2022/02/greenium-set-to-stay-say-sovereign-debt-issuers/ (visited 15 September 2022).

[9] Principles for Responsible Investment, 'Human Rights in Sovereign Debt: The Role of Investors' (2022); Steven Kim Park, 'Social Bonds for Sustainable Development: A Human Rights Perspective on Impact Investing', 3 Business and Human Rights Journal 233 (2018).

[10] See Scatigna et al., above n 4.

[11] International Regulatory Strategy Group and KPMG, 'Accelerating the S in ESG—A Roadmap for Global Progress on Social Standards' (2021).

[12] Principles for Responsible Investment, 'Why and How Investors Should Act on Human Rights' (2020), at 14–16.

[13] The sustainable debt market covers a large variety of instruments, which include also derivatives and leveraged finance.

[14] For an overview of the literature, see, Federico Lupo-Pasini, *The Logic of Financial Nationalism: The Problems of Cooperation and the Role of International Law* (New York: CUP, 2017); Benn Steil and Manuel Hinds, *Money, Markets and Sovereignty* (Council on Foreign Relations, 2009); Odette Lienau, *Rethinking Sovereign Debt: Politics, Reputation and Legitimacy in Modern Finance* (Harvard University Press, 2014), Claus Zimmerman, *A Contemporary Concept of Monetary Sovereignty* (CUP, 2014).

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it might become a new form of private conditionality: a tool allowing international investors to coerce governments into adopting policies that fit their interests and social preferences, thus disregarding local stakeholders. As Park succinctly put it, this hybrid contract-governance financial model risks turning investors into regulators.[15]

The critical question this essay wants to answer is to what extent those contracts can actually achieve the sustainability change for which they are designed, marketed, and sold to investors. In other words, can investors use sovereign sustainable bonds and loans to have a say in governments' domestic policies? Given the novelty of the phenomenon and the lack of data, all we have is a theory of regulatory influence based on untested postulates. This article aims to provide a theoretical framework to test this theory based on the analysis of contract design. I will argue that there is currently little evidence supporting that claim. Sovereign sustainable bonds are currently designed to minimize the influence of international investors on the formulation of domestic policies. The ecosystem supporting sustainable bonds is built only to increase the cosmetic appeal of those instruments to retail investors but with minimal prospect of promoting any real sustainability change.

The article will be structured as follows: in the next section, I introduce the concept of sovereign sustainable finance and explain how sovereign sustainable bonds work; Section III introduces the academic debate on their function and impact on national sovereignty. In Section IV, I set out a theory of sovereign sustainable finance that shows the incentive structure underpinning institutional investors and sovereign borrowers' contractual commitments in a sovereign sustainable bond. In Section V, I focus on the compliance mechanisms in a sovereign sustainable bond, particularly on the economics of ESG breaches and their incentive structure. Section VI looks at the legality of ESG commitments from a constitutional and administrative law perspective. The final section analyses the role of third-party monitors and verifiers and the peculiar problems of corporate capture they suffer from.

II. GOVERNING BY CONTRACT

Sovereign sustainable finance is the segment of the sustainable finance market that targets sovereign and sub-sovereign entities. At the outset, it is important to stress that sovereign sustainable finance is a private industry initiative independent of the development financing activities of multilateral or regional development banks such as the World Bank, the International Monetary Fund, or the European Bank for Reconstrucion and Development.[16] The market comprises private financial institutions like hedge funds, banks, pension funds, asset management firms, exchanges, rating agencies, and retail investors.

Sovereign sustainable finance entails the integration of ESG factors in the investment decisions of financial institutions investing in public debt.[17] The impact of sovereign sustainable finance on the domestic policy choices of public borrowers largely depends on the effectiveness of institutional investors' sustainable investment strategies. This is achieved in two ways.

[15] Stephen Kim Park, 'Investors as Regulators: Green Bonds and the Governance Challenges of the Sustainable Finance Revolution', 54 Stanford Journal of International Law 1 (2018).

[16] Multilateral and regional development banks too issue sustainable bonds to finance specific projects. However, since the issuers are not governments, the potential for those instruments to affect domestic policies is lower. See also, Celine Tan, 'Private Investments, Public Goods: Regulating Markets for Sustainable Development', 23 European Business Organization Law Review 241 (2021), at 263.

[17] You can see in Table 1 a sample of policies from BlackRock—one of the biggest asset managers investing in ESG. BlackRock, 'Sustainability: The Bond that Endures: Tools and Insights for ESG Investing in Fixed Income', BlackRock Investment Institute Global Insights (November 2019), at 9; Lionel Martellini and Lou-Salomé Vallée, 'Measuring and Managing ESG Risks in Sovereign Bond Portfolios and Implications for Sovereign Debt Investing', EDHEC-Risk Institute (2021), at 6; Allianz Global Investors, 'ESG in Sovereign Bonds' (2017).

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Table 1. BlackRock government ESG framework

Environmental	Social	Governance
• Electricity production from coal sources • Renewable electricity output • Annual freshwater withdrawals • Droughts, floods, and extreme temperatures • Mean annual exposure to air pollution • Natural resources depletion • Population density • CO_2 emissions per capita	• Fertility rate • Income share held by lowest 20% • Access to electricity • School enrolment • Net migration • Share of seats held by women in national parliaments • Mortality rate (under 5 years old) • Poverty rate	• Control of corruption • Government effectiveness • Political stability and absence of violence/terrorism • Regulatory quality • Rule of law • Voice and accountability • Ease of doing business • Government expenditure on education

First, indirectly, by picking and choosing public debt instruments with a high sustainability score and, conversely, by increasing borrowing costs for those sovereigns whose ESG policies are deemed unsustainable. Financial institutions adopt proprietary investment frameworks that identify and classify assets—typically sovereign and municipal bonds—according to their sustainability profile.

Second, by using novel financial instruments like sovereign 'green', 'social', or 'sustainability' bonds and loans. Using bonds, loans, and sometimes more complex financial instruments for sustainability purposes is arguably one of the critical innovations in sustainable governance.[18] First used by a few western countries and state-owned enterprises to finance their energy transitions, sustainable financial instruments are now used by a third of governments worldwide for various projects and policies also in the social and governance segments of the ESG framework.[19]

This article will focus on this second strategy.

A. A primer on sovereign sustainable bonds

First, it is essential to briefly illustrate how sovereign 'green', 'social', and 'sustainability' bonds and loans work. While the ESG component is mainly structured in the same way for both loans and bonds, for simplicity, I will limit the analysis to the latter instruments as they occupy a larger share of the sustainable sovereign finance market. As we will see, there are differences between the various types of bonds. For ease of reference, when referring to these instruments collectively, I will define them as 'sustainable bonds'.

1. The challenge of exerting control in sovereign finance

Sustainable finance aims to promote a sustainability change in the target entity. In a sovereign sustainable bond, that entity would be the sovereign or sub-sovereign issuer. From a sustainable investor perspective, implementing an activist investment strategy with a public entity is much more complex than what would typically be if corporates were the target. Indeed, while sustainable investors in corporates can use their equity positions in the target company to push a sustainability change through voting rights and annual general meetings, the same is not possible

[18] For an overview of the different types of bonds, see, Aaron Franklin et al., 'Green, Social and Sustainability Bonds', Practical Law UK Practice Note (2022). See also, Lloyd Freeburn and Ian Ramsay, 'Green Bonds: Legal and Policy Issues', 15 Capital Markets Law Journal 418 (2020).

[19] World Bank, above n 7, at 242.

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with public entities.[20] Sovereign bonds do not give investors a 'voice' in the running of the country but instead limit their control over the financial aspect of the deals, namely the payment of principal at maturity and the periodical coupons. In addition, compared to corporate issuers, public entities typically offer a much lower level of engagement with investors, further complicating their impact activist strategy.[21]

How can investors push a sustainability change when 'voice' is not an option? Financial markets have answered this question by adding an ESG stipulation to the standard bond contract. This element consists of an autonomous ESG target that the borrower has to achieve as part of the condition of the agreement, in addition to the usual financial obligations connected to the payment of the principal and coupon.[22] This target can consist of a specific sustainability project to be completed or a policy improvement according to one of the various ESG metrics available. Given their clear focus on ESG issues, these contracts suit activist investors determined to influence sovereign borrowers' sustainability policies that need improving.

Depending on the underlying ESG obligations, sustainable debt instruments are typically divided into two main types: project-specific bonds and sustainability-linked bonds (also called key performance indicator (KPI) bonds).

2. *Project-specific bonds*[23]

In a project-specific bond, the issuer (a government or a municipality) commits to use the proceeds to finance a project aligned with specific ESG targets.[24] This project could be anything from building a new hydropower plant to developing a new school district or building a hospital in a rural area. Project-specific sovereign finance is not new, especially in developing countries, as this is how multilateral and regional development banks finance their members.[25]

Before the offering, the issuer sets a general framework to define which areas are open to sustainable finance and which projects are eligible for financing. For example, in 2020, Chile published a framework that included support for victims of human rights violations and access to education and health care.[26] The same year, Mexico issued a bond to finance projects linked to the UN SDGs covering education, agricultural development, health care, and sustainable infrastructure.[27] Once the project is approved by an external evaluator, funds are disbursed, and the project is then monitored and subject to periodical reporting.[28]

3. *Sustainability-linked (or KPI) bonds*[29]

Much more complex are sustainability-linked bonds. These bonds do not tie the proceeds to a specific project. For this reason, they give the borrower much more flexibility in using the funds.[30] However, the borrower agrees to achieve pre-determined sustainability policy targets as part of the financial conditions of the bond.

[20] On this, see, Iain MacNeil and Irene–Marié Esser, 'From a Financial to an Entity Model of ESG', 23 European Business Organization Law Review 9 (2022).

[21] Principles for Responsible Investment, 'ESG Engagement for Sovereign Debt Investors' (2020), at 8.

[22] Georg Inderst and Fiona Stewart, *Incorporating Environmental, Social and Governance (ESG) Factors into Fixed Income Investment* (Washington, DC: World Bank, 2018).

[23] Freeburn and Ramsay, above n 18.

[24] The International Capital Markets Association has issued specific guidelines on how to structure those bonds. See ICMA *Green Bond Principles* (2018) and ICMA *Social Bond Principles* (2020).

[25] See *The World Bank Impact Report 2020, Project-by-Project Reporting* (2020).

[26] Government of Chile, *Chile's Sustainable Bond Framework* (November 2020).

[27] Juan Giraldez and Stephanie Fontana, 'Sustainability-Linked Bonds: The Next Frontier in Sovereign Financing', 17 Capital Markets Law Journal 8 (2022), at 12.

[28] On the problems associated with reporting, see, Paul Rose, 'Certifying the Climate Bonds', 14 Capital Markets Law Journal 59 (2018).

[29] For a quick overview, see Giraldez and Fontana, above n 27.

[30] The International Capital Markets Association has developed voluntary guidelines to guide industry participants in structuring those instruments. See International Capital Markets Association, *Sustainability-Linked Bond Principles* (2020).

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Table 2. Sample ESG indicators

Indicator	Source	Description
ENVIRONMENT		
Climate Action Tracker	Climate Analytics, New Climate Institute, and Ecofys	Measures countries' progress towards climate change targets
Climate Change Performance Index	Germanwatch, the New Climate Institute, and the Climate Action Network	Monitors countries' climate protection performance
Environmental Democracy Index	World Resources Institute	Measures countries' transparency on environmental policy and measures
Environmental Performance Review	OECD	Monitors countries' progress towards environmental and sustainability targets
SOCIAL		
Better Life Index	OECD	Compares countries across 11 essential quality-of-life indicators
Gini Coefficient of Income Inequality	OECD	Measures income inequality in various countries
Human Capital Index	World Bank	Measures human development indicators in various areas
Human Development Index	UNDP	Measures human development indicators in various areas
GOVERNANCE		
Corruption Perception Index	Transparency International	Measures public perception of corruption in the public sector
Ease of Doing Business	World Bank	Measures administrative barriers affecting business
Global Competitiveness Index	World Economic Forum	Measures countries' economic competitiveness across various indicators
Women, Business and the Law	World Bank	Measures gender inequality and tracks barriers to women's economic participation

In this type of bond, the issuer selects a specific ESG target that needs improvement called KPI.[31] In Table 2 are some indicators for each ESG area proposed in 2019 by the *Principles of Responsible Investment*.[32] Those targets are more generic. They can be linked to environmental indicators (such as climate emissions), governance indicators (like corruption), or social indicators (such as gender parity). Once the KPI is set, the issuer must select the target level and the timing to achieve it. In other words, it must identify the level of policy improvement necessary to meet its contractual ESG obligations. The 'calibration' of the targets is a particularly delicate phase in the contract design as it indicates more than any other aspect the extent to which the bond functions as an agent of policy change.[33] For example, an issuer might decide to improve its gender equality framework as the main ESG objective. To do so, it might select the World Bank's 'Women, Business and the Law' index as the broad indicator. To narrow down it further,

[31] Giraldez and Fontana, above n 27, at 15–19.

[32] Some of those indicators are no longer active. The list is not exhaustive. For a full list, see Principles for Responsible Investment, *A Practical Guide to ESG Integration in Sovereign Debt* (2019).

[33] The *Principles* recommend calibrating the level according to some criteria, including the issuer's own performance in the past 3 years, its positioning vis-à-vis its peers (in this case, other sovereigns), and with reference to credible scientific scenarios or international standards like the Paris Agreement or the SDGs.

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the issuer might choose the 'Pay' indicator (measuring legislation on gender pay gap) and the 'Marriage' indicator (measuring legal constraints on marriage and divorce) as the KPIs. The calibration requires the issuer to commit to improving its KPIs within a specific time frame (let us say, 8 years) and by implementing specific measures identified in the KPI—let us say, by issuing new laws allowing women to obtain a divorce judgement the same way as men or by enacting an equal remuneration.

III. FRAMING THE DEBATE

Sustainable financial instruments carry substantial hype for their promise to promote sustainability change. For the same reason, they have attracted criticism for their alleged intrusion over national sovereignty.[34] This is particularly true for sustainability-linked bonds as they contractually require that the borrower implements policy changes to meet the specific ESG objectives. Before moving to the analysis, it is helpful to introduce the academic debate on this topic.

The economic rationale for sustainable finance is to use financial markets to generate positive societal externalities.[35] The 'Principles for Responsible Investment', the UN sustainable finance arm, argued that investors have a fiduciary obligation to engage on sustainability topics with sovereigns.[36] Incorporating ESG considerations into public sector finance will help lenders better assess the long-term financial implications of ESG-related domestic policies on their sovereign debt holdings.[37] Second, investors can provide a social benefit by channelling funds to projects and policies that bring long-term benefits to society.[38] From a sovereign borrower's perspective, engaging with sustainable investors will signal the country's positive sustainability path and enhance its credibility, thus reducing its cost of finance.[39]

There is less literature on the actual effects of sustainability-linked or project-related financial instruments. In the absence of any evident price incentive associated with the instrument, the promise to achieve a sustainability change through contract is at the centre of sovereign sustainable bonds and is a fundamental element in the marketing strategy of investors and issuers. The main argument is that the incorporation of ESG targets in the bond contract allows investors to create a dialogue with stakeholders and governments that incentivizes sustainability reforms and projects. In other words, sovereign sustainable bonds permit governments to finance projects or policy transitions that would otherwise not be achievable through ordinary debt financing.

Despite the market's growth, there is widespread scepticism about the actual ability of sustainable finance to achieve its goals. ESG frameworks might embed an inherent bias towards developed market sovereign issuers, leading to increased financing costs for emerging markets.[40] On a more structural level, from a development perspective, some commentators worry that the rise of sovereign sustainable finance will reduce the role of official lenders such as the International Monetary Fund (IMF) or the World Bank and increase the influence of private

[34] Park, above n 15.
[35] Dirk Schoenmaker, 'Investing for the Common Good: A Sustainable Finance Framework.' Bruegel Essay and Lecture Series (2017); IMF, *Global Financial Stability Report: Lower for Longer* (Washington, DC: International Monetary Fund, 2019), at 81; Principles for Responsible Investment, 'The SDG Investment Case' (2017).
[36] Principles for Responsible Investment, above n 32.
[37] Allianz Global investors, 'An ESG Framework for EM Sovereign Bonds', Allianz Insights (3 December 2019).
[38] Scatigna et al., above n 4, at 87.
[39] Jan Anton van Zanten, Bhavya Sharma, and Malene Christensen, 'Sustainability Integration for Sovereign Debt Investors: Engaging with Countries on the SDGs', Journal of Sustainable Finance and Investment 1 (2021); Paula Margaretic and Sébastien Pouget, 'Sovereign Bond Spreads and Extra-Financial Performance: An Empirical Analysis of Emerging Markets', 58 International Review of Economics & Finance 340 (2018).
[40] Soledad Lopez et al., 'ESG in Sovereign Fixed Income Investing: Identifying Opportunities, Correcting Biases', Morgan Stanley Fixed Income Investment Insights (2020), at 4.

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markets.[41] Daniela Gabor defined it as the 'Wall Street Consensus' to show the paradigmatic change in the development agenda posed by sustainable finance, which progressively transfers to private investors the sustainable development functions played by official lenders.[42] She argues that the shift from official finance to sovereign sustainable finance might expose emerging and least-developed sovereign borrowers to undue pressure from private markets. This is due to a combination of factors. The accountability mechanisms and institutional back-ups in official sector finance are not present in sovereign sustainable finance.[43] This is especially important in the event of a sovereign debt restructuring. Indeed, the pressure on borrowers to implement creditor-friendly structural reforms could give investors a disproportionate power but without the political checks that official lenders are subjected to.[44] Moreover, sustainable investors' increased power to influence domestic policies could be seen as a new form of private conditionality.[45] While the parallel between IMF conditionality and sustainable finance is not totally accurate, sustainable investors could indeed force borrowers to implement ESG policies as a condition for their lending or during a restructuring.[46] We already saw that during the 2021 Belize restructuring, where a portion of the restructured bonds was used to fund Belize's marine conservation projects.[47] Moreover, there is a worry that pressure from international investors would reduce transparency and public interest safeguards in capacity-constrained developing countries.[48]

The two opposing views on the benefit and risks of sovereign sustainable finance are based on the shared notion that financial markets' increased focus on key domestic policy areas will trigger a positive regulatory change towards more sustainable policies. In other words, they both assume that markets can directly influence sovereign borrowers' policymaking towards their sustainability objectives. In the rest of the paper, I will analyse this key assumption and demonstrate that it is largely unfunded.

IV. AN ECONOMIC THEORY OF SUSTAINABLE DEBT CONTRACTS

The literature on sustainable finance explains the benefits of this novel governance mechanism by focussing on the aggregate positive externalities generated by investing in sustainable assets.[49] Yet, while the positive externalities of sustainability are unquestionable, it is more complicated to explain what motivates investors and borrowers to enter the sovereign sustainable debt market. To appreciate the analysis of sovereign sustainable bonds, it is helpful to sketch out an economic theory of sovereign sustainable bond contracts that explains the objectives and constraints of the two parties concerning the bond's ESG component.

[41] Joywin Mathew, 'Shades of Green in Financing: a Discussion on Green Bonds and Green Loans', 33 Butterworths Journal of International Bank and Financial Law 311 (2018); UNCTAD, *Trade and Development Report 2019: Financing a Global Green New Deal* (2019).

[42] Daniela Gabor, 'The Wall Street Consensus', 52 Development and Change 429 (2021).

[43] Tan, above n 16, at 263.

[44] Karina Patricio Ferreira-Lima, 'Sovereign Solvency as Monetary Power', 25 JIEL 424 (2022); Vassilis Paliouras, 'The Right to Restructure Sovereign Debt', 20 JIEL 115 (2017).

[45] Park, above n 15.

[46] While the ultimate objective of ESG investments is to improve the long-term outlook of the borrower either from an environmental, governance, or social perspective, the scope of IMF conditionality is simply to address the very tangible underlying problems that led the borrower to an unsustainable balance of payment situation. On the vast conditionality literature, see, IMF, *2018 Review of Program Design and Conditionality* (2019); Randall Stone, 'The Scope of IMF Conditionality', 62 International Organization 589 (2008); Irfan Nooruding and Joel Simmons, 'The Politics of Hard Choices: IMF Programs and Government Spending', 60 International Organization 1001 (2006); Axel Dreher, 'IMF Conditionality: Theory and Evidence', 141 Public Choice 233 (2009); Rosa M. Lastra, 'IMF Conditionality', 4 Journal of International Banking Law and Regulation 167 (2002); Barry Eichengreen and Ngaire Woods, 'The IMF's Unmet Challenges', 30 Journal of Economic Perspectives 29 (2015).

[47] Patrick Bolton, Lee Buchheit, Mitu Gulati, Ugo Panizza, Beatrice Weder di Mauro, and Jeromin Zettelmeyer, *Climate and Debt*, Geneva Reports on the World Economy 25 (2022), at 81–82.

[48] Tan, above n 16.

[49] Schoenmaker, above n 35; IMF, *Global Financial Stability Report: Lower for Longer* (2019), at 81; Principles for Responsible Investment, 'The SDG Investment Case' (2017).

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A. From the investors' perspective

The critical issue in sovereign sustainable bonds, much like in all sustainable finance, is to explain why rational profit-seeking investors should be interested in pursuing sustainability change as part of their investment strategy. The motivations behind investors' sustainability strategies are a long-standing argument for debate in financial and corporate social responsibility scholarships.[50]

Sustainable finance sceptics argue that corporations' need to maximize profits will always trump non-financial considerations.[51] Thus, sustainable finance will always remain limited to investments that primarily guarantee the targeted financial return instead of investments that mainly provide a public good with lower individual returns. The claim is not moral but based on a basic reading of most funds' charters.[52] Notwithstanding investors' desire to contribute to the public good, portfolio managers in charge of the fund's investment strategy have a fiduciary duty to comply with the investment mandate approved by the fund's board. Typically, the mandate is to make a financial profit for the investors.[53] The achievement of secondary objectives such as promoting sustainability, when contemplated at all, is always subordinate to achieving the main financial goal, profit, for which funds are created.

If we agree with the notion that investors need to focus primarily on returns, the question then is to assess whether sovereign sustainable bonds do offer a financial incentive to investors either as additional profit or as reduced risk. Thus, the focus of the analysis has to converge on the borrower's ESG obligations. However, it is very unclear how to exactly categorize a sustainable bond's ESG objectives from a financial perspective.

On the one hand, it is very difficult to imagine that the non-completion of a project or the borrower's failure to improve ESG ranking would be seen and priced as an additional risk for investors. As long as the borrower meets its primary payment obligations—separate from the ESG element of the bond—the ESG commitments are immaterial to the financial return investors expect.[54] As I will argue below, the marginal increase in interest payment that borrowers have to pay in the event of a breach of ESG commitments mainly serves to maintain the 'sustainability' certification rather than reducing a real financial risk for the lender.

On the other hand, considering the attainment of ESG targets as a positive return for investors is much more in line with the framework for sustainable investment, which sees investors as agents of change. Yet, even in this case, it is challenging to see which kind of financial return investors should expect from the borrower's achievement of the ESG target as it does not benefit investors directly but borrowers. Only borrowers will reap the benefits of sustainability change in their country. The literature argues that investors would get a return in the form of lower default risk from the borrower. The idea is that an improved sustainability position will be reflected in a stronger fiscal position. If that was the case, investors ought to accept a lower yield on the investment in the form of reduced interest—the so-called 'greenium'. Yet, evidence suggests that investors rarely reduce the cost of lending for sustainable debt instruments.[55]

[50] See MacNeil and Esser, above n 20; Lucian Bebchuk and Roberto Tallarita, 'The Illusory Promise of Stakeholder Governance', 106 Cornell Law Review 91 (2020).

[51] See, Tariq Fancy, 'The Secret Diary of a Sustainable Investor', (August 2021), https://medium.com/@sosofancy/the-secret-diary-of-a-sustainable-investor-part-1-70b6987fa139 (visited 15 September 2022).

[52] See, Max M. Schanzenbach and Robert H. Sitkoff, 'Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee', 72 Stanford Law Review 381 (2020).

[53] Ibid.

[54] This statement must be qualified by a caveat. As we will see later, the violation of ESG commitment does lead to increased coupon payments to investors.

[55] Affirmative Investment Management Partners Limited, 'Greenium—Fact or Fiction?'(2021), https://affirmativeim.com/greenium-fact-or-fiction/; Climate Bond Initiative, 'Sovereign Green, Social, and Sustainability Bond Survey 2021' (2021), at 14. UNDP, 'Identifying the Greenium', UNDP Blog (22 April 2022), https://www.undp.org/blog/identifying-greenium (visited 15 September 2022).

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Ultimately, a good sustainability metric is nothing more than a public good—a positive externality for the entire society—the borrower's stakeholders above all. But like most public goods, it struggles to be framed as a private profit. The core problem at the centre of sustainable finance is that the industry is expected to find a way to turn a societal return into a private financial return. But that is almost impossible.

B. From the borrower's perspective

From the borrower's side, it is also similarly unclear why a government should commit to a sustainability change through contract. The philosophy behind sustainable bonds is based on the notion that financial incentives offered by sustainable debt instruments might encourage sovereign borrowers to implement sustainability reforms. Not only would the sovereign borrower receive precious funds to finance its public budget, but it would also use them to implement sustainability reforms that arguably would not have been possible otherwise due to political or economic reasons.

Yet, fundamental constraints prevent borrowers from explicitly committing to achieving specific ESG targets as part of a commercial contractual bargain. As I will explain below, governments cannot commit to a policy change that has not been already approved according to the local constitutional and administrative requirements.[56] In most cases, the commitment might be found ultra vires. Secondly, even if committing to policy change were to be legal under domestic law, it would be unwise for issuers to promise it. Delivering policy outcomes as a part of a contractual bargain is more complicated than repaying the principal or the coupons on time, as politics inevitably gets in the way. Multiple ministries, agencies, and local governments must be involved and so must the local business community and civil society.[57] Even with the best intentions, several invisible barriers might stand in the way of achieving the policy change objective at the soul of the debt contract.

Indeed, a quick look at the political economy literature suggests that the 'Faustian bargain' that sees governments trading money for policies is extremely rare. Since the 1990s, political scientists have worked on theories demonstrating why governments would enter into treaties requiring domestic policy changes.[58] The literature indicates that governments agree to implement policy changes only when the agreement offers additional incentives to the incumbent government to support already planned reforms. Scholars suggest that governments might use treaty obligations (and the threat of sanctions) to entrench commitments to specific policies and raise the costs of non-compliance.[59] Sometimes, international agreements can be used to speed up the process of policy change by sidelining domestic opposition to political reforms.[60]

We can see this very well with international trade law.[61] The political economy of services trade shows that governments are generally reluctant to exchange future domestic reforms for market access abroad. Free trade agreements show that governments commit to domestic services liberalization only when regulatory reforms have already been planned and approved

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[56] See Section VI.

[57] Principles for Responsible Investment, above n 21.

[58] Robert O. Keohane, *International Institutions and State Power: Essays in International Relations Theory* (New York: Westview Press, 1989); Helen Milner and Keiko Kubota, 'Why the Move to Free Trade? Democracy and Trade Policy in the Developing Countries', 59 International Organization 107 (2005); Beth Simmons, 'International Law and State Behavior: Commitment and Compliance in International Monetary Affairs', 94 American Political Science Review 819 (2000).

[59] Leonardo Baccini and Johannes Urpelainen, 'International Institutions and Domestic Politics: Can Preferential Trading Agreements Help Leaders Promote Economic Reform?', 76 The Journal of Politics 195 (2014).

[60] Walter Mattli and Thomas Pluömper, 'The Internal Value of External Options: How the EU Shapes the Scope of Regulatory Reforms in Transition Countries', 5 European Union Politics 307 (2004).

[61] Trade policy negotiations are structured as transactions involving a commitment to liberalize domestic economic sectors in exchange for increased market access abroad. This mainly now consists of implementing domestic regulatory reforms to dismantle monopolies or reduce regulatory and administrative barriers preventing foreign competition. See, Bernard Hoekman and Michael Kostecki, *The Political Economy of the World Trading System* (Oxford: OUP, 2009).

internally.[62] In other words, governments agree to commit to policy changes in binding international agreements only after domestic negotiations have already taken place and after reforms have been approved internally. Trade liberalization locks in domestic reforms but does not promote them.[63]

In sovereign debt relations, economic reforms in exchange for cash usually are part of debt restructuring deals under the IMF conditionality policy.[64] However, overwhelming evidence suggests that governments do their best to resist the IMF intervention and ultimately agree to official financing only when all other options fail.[65] Leaving debt restructuring aside, there seems to be no incentive for a government to commit to ambitious policy changes unless these were already part of a political programme. This is supported by the fact that sovereign borrowers decide autonomously, and before issuing the debt, which specific ESG areas and projects are eligible for funding.[66]

C. The importance of the ESG label

Given the above-mentioned limitations and lack of incentives, one would expect the sovereign sustainable market to be non-existent. And yet, it is the opposite—a fast-growing and increasingly huge market. What explains it? The answer is that the sovereign sustainable finance market exists because issuers and investors want to satisfy a demand for sustainable finance products. The uniqueness of this market is that it responds to an external demand.

More specifically, the sovereign sustainable finance market does not seem to originate from the mutual incentives of two parties—institutional investors and governments—to trade sustainability for profit. Instead, it exists because of the external demand for sustainability products created by societal expectations and political and regulatory interventions to create a market. To put it bluntly, the sovereign sustainable finance market is the financial industry's reaction to political pressures from international organizations, the G20, national regulators, and environmental groups—an initiative that was very successfully reflected in growing actual demand from retail investors for sustainability products.

Pressure from retail investors pushes asset managers in charge of portfolio strategies in hedge funds, pension funds, and banks to incorporate ESG considerations into some of their fund strategies.[67] For instance, most pension funds need to show a sustainability element as part of their investment strategy. Large asset management firms too list an ESG fund as part of their funds' offer.[68] Also, the pressure from regulators to disclose unsustainability risks drives the push for sustainability products. In the European Union, for instance, various sustainability directives are now pushing investment firms to adopt an ESG strategy.[69]

Crucially, asset managers still enjoy much freedom to design their own sustainability strategy. They can freely decide whether a bond is sustainable and easily masquerade its ESG credentials

[62] See, for instance, Jappe Eckhart and Hongyu Wang, 'China's New Generation Trade Agreements: Importing Rules to Lock in Domestic Reforms?', 15 Regulation and Governance 581 (2021).

[63] Bernard Hoekman, Aaditya Mattoo, and André Sapir, 'The Political Economy of Services Trade Liberalization: A Case for International Regulatory Cooperation?', 23 Oxford Review of Economic Policy 367 (2007).

[64] See, IMF, *2018 Review of Program Design and Conditionality* (Washington, DC: International Monetary Fund, 2019).

[65] See, IMF, *Sovereign Debt Restructuring—Recent Developments and Implications for The Fund's Legal and Policy Framework* (Washington, DC: International Monetary Fund, 2013), at 15–36; Eduardo Borensztein and Ugo Panizza, 'The Costs of Sovereign Default', IMF Staff Papers 56 (2009).

[66] Nevertheless, they are encouraged to consult with institutional investors through trade fairs or other marketing initiatives. See Principles for Responsible Investment, above n 21.

[67] These investment firms are the main buyers of sovereign bonds. Christopher Geczy, 'How Far Could Pension Funds Drive Sustainable Investing?', Knowledge at Wharton (21 May 2021), https://knowledge.wharton.upenn.edu/article/far-pension-funds-drive-sustainable-investing/ (visited 15 September 2022).

[68] See, Tania Lynn Taylor and Sean Collins, 'Ingraining Sustainability in the Next Era of ESG Investing', Deloitte Insights (April 2022).

[69] For a quick overview, see, Dirk A. Zetzsche, Marco Bodellini, and Roberta Consiglio, 'The EU Sustainable Finance Framework in Light of International Standards', 25 JIEL (2022).

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under complex sustainability metrics.[70] At present, no common regulatory framework guides investors when assessing the ESG profile of a particular investment. The European Union, China, and a few other countries have adopted taxonomies that set the essential criteria for an investment to qualify as 'sustainable'.[71]

The freedom asset managers enjoy is essential for two reasons. First, it allows contractual parties to design sovereign sustainable bonds that only superficially include sustainability as an objective. Second, it makes the 'sustainability' label fundamental. Only an impartial certification can give the modicum of credibility that sovereign sustainable bonds need to be marketed as 'sustainable'. This certification is provided by third parties called 'verifiers' that examine and monitor the sustainability character of the bonds.

As I will demonstrate in the rest of the article, the complex mix of internal and external incentives is very well reflected in the design structure of sovereign sustainable bonds. First, the ESG element of the contract does not carry much weight in the broader financial mechanics of the debt instruments. Second, the sustainability certification given by third parties is plagued by problems of transparency, regulatory inconsistency, and industry capture. This results in a debt contract that achieves very little actual change but very much cosmetic appeal. In the following three sections, I will develop further the analysis of sovereign sustainable bonds in the light of the above theory.

V. THE ECONOMICS OF ESG BREACHES

It is a widely accepted theory in the literature on the economics of contract law that remedies serve as incentives for the parties to comply with their contractual commitments.[72] Thus, analysing contractual remedies is instrumental to understanding the seriousness of the contractual bargain. In this light, a close look at the remedial system related to the breach of ESG obligations is particularly indicative of the likelihood that these instruments will be able to incentivize the sustainability change promised to investors.

A. Two types of breaches

Contractual parties have many options to minimize the risk of non-compliance. Depending on the severity of the breach, a violation of a contractual provision can either lead to a minor financial penalty being imposed on the breaching party or to a termination of the contract with substantial legal and financial consequences.

From the perspective of a sovereign borrower, sustainable debt contracts entail two fundamentally different sets of obligations: the financial obligations connected to payment and credit risks and the ESG commitments. The difference between the two is striking and, above all, indicative of the real objective of a sustainable bond.

1. Payment-related breaches

In sovereign finance, the key contractual objective is to guarantee investors the stipulated financial returns on their investment.[73] In a bond, this is typically the periodical coupon payment and the repayment of the principal at maturity. The entire contractual architecture of sovereign loans

[70] The lack of binding standards has in many cases raised the suspicion of 'greenwashing'. See, Florian Berg, Julian F. Koölbel, and Roberto Rigobon, 'Aggregate Confusion: The Divergence of ESG Ratings', Review of Finance 1 (2022).

[71] Torsten Ehlers et al., 'A Taxonomy of Sustainable Finance Taxonomies', BIS Papers No 118 (October 2021); Zetzsche et al., above n 69.

[72] For a quick overview, see, Robert Cooter and Thomas Ulen, *Law & Economics*, 6th ed. (New York: Addison Wesley, 2012), at 307–341; See also Ariel Porat (ed.), *The Economics of Remedies* (London: Edward Elgar, 2012); Lewis Kornhauser, 'An Introduction to the Economic Analysis of Contract Remedies', 57 University of Colorado Law Review 683 (1985–1986).

[73] Stephen J. Choi, Mitu Gulati, and Eric A. Posner, 'Political Risk and Sovereign Debt Contracts', University of Chicago Institute for Law & Economics Olin Research Paper No. 583, University of Chicago Public Law Working Paper No. 370 (2011), https://ssrn.com/abstract=1962788.

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and bonds is built to maximize the achievement of this primary and essential goal and, therefore, to minimize the lender's credit risks.[74]

A sovereign sustainable bond is no different. Indeed, both project-focused and sustainability-linked bonds require the investor to pay the principal at maturity and a periodic coupon payment like in any regular debt instrument. The violation of financial commitments is typically treated as 'an event of default'. While the precise formulation of events of default varies from contract to contract, it typically leads to the contract's termination and the acceleration of the outstanding payments.[75] Legal consequences aside, a default would unleash immediate reactions in capital markets such as automatics credit downgrades, the termination of derivatives' positions, and widespread capital outflows. Events of default clauses are typically used to protect the lender against increased credit risk, typically a missed payment by the borrower. Very often, a default can also occur with the violation of non-payment-related clauses, such as negative pledge clause, the fiscal agency agreement, and even the cessation of the IMF membership. The breach of any of these clauses would raise an alarm on potentially worsening credit risk for the lender.[76]

2. ESG-related breaches

ESG commitments are treated very differently. Whether they entail the use of proceeds for a specific project or the attainment of ESG policy targets, they are almost invariably treated as secondary stipulations whose violation does not amount to an 'event of default'.[77] Instead, the current practice in sovereign sustainable finance is to treat non-compliance with ESG commitments with an increase in the borrowing costs in the form of higher coupon payments—the so-called 'margin ratches'.[78]

Often found in corporate bonds or loans, these provisions tie the cost of debt—mainly the interest rate—to the borrower's performance against pre-determined objectives or criteria.[79] While margin ratchets could, in theory, work both ways, thus reducing the interest rate if targets are met or increasing it if they were not, in practice, they are mainly used as penalties for the non-attainment of ESG targets. Industry guidelines like the Climate Bond Standards might also withdraw the ESG certification depending on the type of instruments.[80]

In sum, the violation of ESG commitments does not allow lenders to terminate the contract or trigger acceleration clauses but simply to demand an increased coupon payment from the sovereign debtor. From a contractual perspective, the non-attainment of the ESG objectives is, therefore, not fundamental for the enforcement of the contract. The only real risk for the lender is that the instrument might lose the 'sustainability' certification necessary to market it and sell it to investors.

B. The puzzle of margin ratchets

The absence of meaningful consequences for violating the ESG commitment and the financial structure of margin ratchets is puzzling if we assume that sustainable bonds are meant to achieve a sustainability change. At the same time, it is perfectly rational if we think that neither borrowers nor investors have any actual interest in structuring the financial bargain around the ESG objectives.

[74] For a quick overview, see, Ugo Panizza, Federico Sturzenegger, and Jeromin Zettelmeyer, 'The Economics and Law of Sovereign Debt and Default', 47 Journal of Economic Literature 651 (2009); Mitu Gulati and George Triantis, 'Contracts Without Law: Sovereign Versus Corporate Debt', 75 University of Cincinnati Law Review 977 (2007).

[75] See, Eugenio Bruno, 'Sovereign Debt Restructuring: Covenant and Default Clauses in Sovereign and Corporate Bonds and How the Difference among Them Impacts in the NML case against the Republic of Argentina in New York', (14 June 2013). https://ssrn.com/abstract=2279461.

[76] See, William W. Bratton, 'Bond and Loan Covenants, Theory and Practice', 11 Capital Markets Law Journal 461 (2016).

[77] For a sample, see Egypt 2020 Green Bonds (due 2025); Benin 2021 Social Bond (issued July 2021). For a discussion on those clauses, see, Mark Weidemaier and Mitu Gulati, '(Why) Are ESG Sovereign Bonds (Such) Scams?', Credit Slips Blog (9 July 2021); Bolton et al., above n 47.

[78] Practical Law, 'What's Market: Sustainability-Linked Loans', Practice Note 2–020-8513 (31 December 2021).

[79] Baker and McKenzie, 'ESG Margin Rackets', Leveraged Finance Newsletter (November 2021); see Republica de Uruguay 2022 Sustainability Linked Bonds (due 2023).

[80] Freeburn and Ramsay, above n 18, at 440–441.

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1. *From a sustainability perspective*

Suppose we start from the assumption that sovereign sustainable bonds serve to incentivize policy change. In that case, it is unclear why the ESG clause is treated as a mere ancillary stipulation whose violation only slightly increases the cost of debt for the borrower.

The presence of ESG targets is the key element of sustainable financial contracts and arguably what differentiates them from standard sovereign loans or bonds. It is essential to bear in mind that investors specifically purchased sovereign sustainable debt instruments with the primary purpose of contributing to sustainability. Otherwise, they would have invested in other, less complex sovereign debt instruments. If sustainability is the main objective of the contract—the aim for which it is marketed and sold to investors—it is unclear why this objective is not protected through more serious commitment devices that would increase the costs of non-compliance. In a recent study, the Bank for International Settlement argues that the low penalty may reduce the credibility of governments' ESG commitments and suggest setting it at a higher level seen as material by the public.[81] Expanding 'events of default' clauses to ESG stipulations would certainly scale up the trade-offs associated with the performance of the ESG commitments and enhance their credibility as tools for sustainability change.[82]

Moreover, ESG contract design is puzzling because it goes against what the ESG industry claims in most publicly available research papers on sustainable finance. Various studies by the financial industry suggest a high degree of correlation between positive ESG factors and economic growth.[83] The lower the sustainability metrics of a given country, the lower its economic growth. If that were indeed the case, we would expect this to be reflected in a harsher penalty for violating ESG objectives, as these would signal an increased credit risk for the lender. For instance, if there is a direct correlation between high social inequality and low economic growth, we expect the contract to treat the violation of ESG commitments in that area as a signal of increased credit risks for the borrower. On the contrary, the lack of meaningful consequences attached to the violation of ESG commitments indicates that lenders are not truly convinced that a bad ESG performance would have material credit implications on the financial sustainability of the debt. Whether more precise methodologies and data availability will change this in the future is yet to be seen. However, so far, evidence in support of this correlation beyond climate risks is limited.[84]

2. *From a borrower perspective*

From a borrower's perspective, there is minimal incentive to agree to a financial bargain that binds the government's policy space under the threat of a default. Even more so if we consider that most sovereign sustainable bonds do not offer a greenium—thus, a reduced cost of debt. In this light, structuring ESG breaches as light penalties instead of events of default is fundamental to preserving regulatory sovereignty.

Undoubtedly, ESG commitments are unique in many ways. This may be why sovereign borrowers would push to treat them more leniently. First, from a public debt management perspective, it can be challenging to precisely set the timeline of the various legal and administrative steps to achieve the target. Public debt management is typically allocated to specialized offices or independent agencies, which manage the day-to-day external debt obligations of the country. While ESG targets are part of the debt issuance, they fall outside the comfort zone of

[81] Cheng et al., above n 5, at 54.
[82] Ibid; see also, Tony Berrada, Leonie Engelhardt, Rajna Gibson, and Philipp Krueger, 'The Economics of Sustainability Linked Bonds', ECGI Working Paper n 820/2022 (March 2022).
[83] For a good review of the literature, see Martellini and Vallée, above n 17, at 26–34; see also Raphael Semet, Thierry Roncalli, and Lauren Stagnol, 'ESG and Sovereign Risk: What is Priced in by the Bond Market and Credit Rating Agencies', Amundi Asset Management Working Paper 115–2021 (2021), at 7–14.
[84] Weidemaier and Gulati, above n 77.

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public debt management offices, as they might involve human rights, environment, transport, labour, education, and health policies assigned to different ministries. Coordination between various ministries could be challenging. In addition, parliamentary squabbles and party politics might derail or postpone the approval of even the most sensible policy or project. Small interest groups could mount legal challenges, thus delaying the implementation of the policy/project. Finally, the policy change might take longer to show its result. Indeed, there is evidence that there is a time lag between the length of the contract and the period over which the ESG targets materialize.[85]

C. Margin ratchets and ESG certification

From the analysis above, it emerges that ESG commitments are not perceived as particularly fundamental for investors. The breach of ESG obligations does not carry an existential risk for the life of the contract similar to that of a financial default. Similarly, from a borrower perspective, given the absence of a greenium and the additional complexity of coordinating the government's administrative machine to achieve ESG targets, there is little incentive to commit to hard ESG obligations.

The real purpose of margin ratchets is not to protect a financial risk for the lender or to incentivize real sustainability change. Instead, they minimize the risk that the non-attainment of ESG targets would lead to a withdrawal of the ESG certification. The ESG label is fundamental for the entire structure of sovereign sustainable bonds as it is the only element that gives credibility to the sustainability pledges. Margin ratchets, therefore, reflect the cost investors would incur for withdrawing the ESG certification if the borrower does not attain the contractual ESG targets.

VI. THE LEGALITY OF ESG COMMITMENTS

Even assuming that ESG commitments were to become hard obligations, a fundamental question remains: can sovereigns commit themselves to deliver policies as part of their commercial contractual bargain? This issue concerns sustainability-linked bonds and loans primarily. Providing a payment as the core obligation of a debt contract is very different from delivering policy change. Indeed, there are fundamental constitutional, administrative, and conflict of laws implications connected with trading money in exchange for policies. While the analysis is quite complex, it is helpful to highlight a few key legal issues.

Policy commitments are not new in sovereign debt negotiations. For instance, as part of debt restructuring deals, sovereigns often commit not to change their domestic laws to undermine investors' rights. In other words, to issue laws that retroactively make the debt commitment invalid or to settle with creditors as Argentina tried to do with its infamous 'Lock Law'.[86] Similar commitments—called 'stabilization clauses'—are also sometimes found in the investment agreements that states sign with FDI investors.[87] However, one thing is to commit not to change existing laws that have been lawfully enacted according to the state's constitutional and administrative frameworks. Another is to commit through contract to passing a set of laws that have not been approved yet. Can debt management offices' contractual determinations prevail over those of the parliament?

The first question is whether states have the legal capacity to commit to delivering specific policy improvements or use proceeds of the bonds for specific ESG projects.[88] In sovereign debt,

[85] Inderst and Stewart, above n 22.

[86] See, Hayk Kupelyants, *Sovereign Defaults Before Domestic Courts* (Oxford: OUP, 2018), Chapter 5 'Unilateral Modification of Sovereign Domestic Law Bonds', at 141–170.

[87] See Practical Law Glossary, 'Stabilization Clause'; see also Practical Law, 'Understanding Stabilization Clauses in International Investment Agreements', Practice Note.

[88] Cheng et al., above n 5, at 51. See also, Marta Domínguez-Jiménez and Alexander Lehmann, 'Accounting for Climate Policies in Europe's Sovereign Debt Markets', *Policy Contribution* 10/2021, Bruegel (2021).

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the capacity of governments to oblige themselves to pay investors is found in the public debt law and, sometimes, in the constitution. These two laws set the basic legal framework that governs the capacity of public debt management offices to borrow on behalf of the state and, ultimately, to bind the state to a contractual obligation to pay.[89] It is unclear whether public debt laws permit negotiating policy targets or bind governments to use bond proceeds for pre-determined purposes, thus bypassing the routine legislative procedures.[90]

For such an eventuality, the public debt management office must be given specific powers and clear instructions to legislate. These could be found, for example, in the sustainability prospectuses and frameworks issued before a bond issuance. For instance, Mexico's 2021 SDG Sovereign Bond Framework clearly indicates the government's sustainability plan and targets at the federal and state levels, the primary legal framework applicable to sustainable bonds, and possible indicators and metrics.[91] Spain also issued a similar framework for green bonds in 2021.[92] However, sustainability frameworks do not guarantee legislative action as they simply state the long-term ESG goals of local and central governments. Thus, without full constitutional backing and adequate statutory anchors, the commitment to enact specific policies without prior administrative and legislative approval would be invalid as ultra vires.

A more complex issue would arise if the ESG target was already planned as part of the state's international commitment but still waiting to be officially approved by the parliament. Most long-term ESG objectives are contained in the Paris Agreement or the UN SDGs, but they would be too generic for the ESG stipulation of debt contracts. More specific agreements such as the Aichi Biodiversity Targets[93] or the San José Principles[94] would give a more precise indication of the actual legislative targets of the government. Unless the international agreement has a direct effect, the lack of proper authorization will give rise to the same ultra-vires problems.

Ultimately, a court-proof contract must rely on a legislative agenda that has already been approved by the parliament or that forms part of an already approved international commitment. The latter option is the safest and a good way to synchronize the official global sustainability agenda with private markets.[95] However, this is the opposite of the classical ESG philosophy. Essentially, a government would try to sell to investors already approved or soon-to-be enacted reforms. But that would defy the very purpose of sustainability-linked debt instruments, which are supposed to incentivize reforms, not to free-ride on them to please institutional investors.

VII. THE PROBLEMS WITH VERIFIERS

In the previous sections, I have argued that neither of the two parties of a sustainable bond contract has any real incentive to use this instrument to promote an actual sustainability change. Yet, both issuers and investors share a common interest in tapping into the growing ESG market.

In the absence of real incentives on both sides to commit to sustainability change through binding bilateral commitments and the common need to qualify the debt as sustainable, the only option is to outsource the certification of the sustainability label to a third party. The 'green'

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[89] Kupelyants, above n 86, at 196–201; see also, Mark Weidemaier and Mitu Gulati, 'Unlawfully-Issued Sovereign Debt', 61 Virginia Journal of International Law 553 (2021).

[90] Cheng et al., above n 5, at 51.

[91] Gobierno de Mexico, 'SDG Sovereign Bond Framework: United Mexican States Building Prosperity: Financing SDGs for an Inclusive Economy' (2021), https://www.finanzaspublicas.hacienda.gob.mx (visited 15 September 2022).

[92] Tesoro Publico, *Green Bond Framework* (July 2021).

[93] See *Aichi Biodiversity Targets*, https://www.cbd.int/sp/targets/ (visited 15 September 2022).

[94] *The San Jose Principles*, https://cambioclimatico.go.cr/sanjoseprinciples/ (visited 15 September 2022).

[95] The PRI recommends this option. See Principles for Responsible Investment, above n 21, at 22.

label is the central element of a sustainable contract. It allows institutional investors to market those products to their retail clients eager to buy into sustainable finance and guarantees issuers a broader investor base. Not surprisingly, sovereign borrowers are increasingly keen to qualify their debt as 'sustainable'. In the absence of real discounts on the cost of debt, the slightly broadened and diversified investor base those instruments offer is the only motivation sovereign issuers cite for their decision to enter the market.[96]

Yet, as I will argue in this section, in the absence of regulation, the practices and the incentive structure underpinning this industry are not well aligned with the stated purpose of improving ESG policies.

A. The role of verifiers

In the architecture of sustainable bonds, verifiers occupy a pivotal role as information intermediaries and compliance mechanisms. When issuing a bond, sovereigns need to appoint an external reviewer to assess compliance with existing ESG metrics, the ambition level and the targets' feasibility. The reviewer assesses the issuer's sustainability framework's credibility and how the bond fits into this. Once the contract is in force, the issuer must provide periodical reports to investors. At the same time, an external independent verifier audits the country's progress in meeting the target. Crucially, the reviewer assesses whether the ESG commitments have not been met, thus triggering the margin ratchet clause.[97] In a sustainability-linked bond, the progress monitoring is often carried out by the entity in charge of the ESG indicator itself. Finally, depending on the type of bond and the verification process chosen, very often the verifier has the right to withdraw the certification if targets are not met.

Recent studies show that sovereign sustainable bonds are all using verifiers to certify the bond's ESG credentials.[98] Yet, the certification and verifier industry is not yet structured and regulated in such a way as to maximize the powerful role it could play to incentivize true sustainability reforms. At present, it is still subject to incentive conflicts that reduce the credibility of their certifications among the public.

B. Conflict of incentives and capture

ESG verifiers act as independent referees on the progress and quality of the borrower's specific ESG policies, no differently than what credit rating agencies do with the borrower's credit risk.[99] Like credit rating agencies, those organizations are supposed to work not only for the two parties of the debt transaction but also in the interests of financial consumers, to whom the instruments are ultimately sold. From the perspective of retail investors, the work of verifiers is fundamental as it gives credibility to the sustainable investment market.

Yet, like credit rating agencies, verifiers are plagued by an inherent conflict of interests favouring issuers over retail investors. The literature on rating agencies argues that those entities have various incentives to remain neutral and impartial in their valuation of a financial instrument or a company. Their credibility rests on the quality of their analysis. Schwarcz argued that 'their profitability is directly tied to their reputation.'[100] Yet, this argument ignores that verifiers—much

[96] Climate Bond Initiative, 'Sovereign Green, Social, and Sustainability Bond Survey 2021' (2021), https://www.climatebonds.net/resources/press-releases/2021/01/sovereign-green-social-and-sustainability-bond-survey-2021 (visited 15 September 2022).

[97] Giraldez and Fontana, above n 27, at 13.

[98] Cheng et al., above n 5, at 52.

[99] On the parallel between verifiers and rating agencies, see, Daniel Cash, *Sustainability Rating Agencies vs Credit Rating Agencies: The Battle to Serve the Mainstream Investor* (London: Palgrave, 2021); Cristina M. Banahan, 'The Bond Villains of Green Investment: Why an Unregulated Securities Market Needs Government to Lay Down the Law', 43 Vermont Law Review 841 (2019).

[100] Steven L. Schwarcz, 'Private Ordering of Public Markets: The Rating Agencies Paradox', 1 University of Illinois Law Review 26 (2002).

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like rating agencies—are paid directly by the two parties of the transaction that have the incentive to push for the ESG certification—the issuer and the institutional investors.[101] Ultimately, the only reputation that matters for verifiers is the one they have with their clients. It is not inconceivable to assume that, despite the pledge of neutrality, verifiers tend to favour valuations that do not disrupt their relationship with the clients.[102]

The influence of investors and issuers over the ESG monitoring system extends also to the corporate control or political influence they can exert on those entities. The influence is not limited to the verifiers' monitoring function but can extend to the benchmarking function inherent to the ESG rating and indicators. Like credit rating agencies, indicators are private institutions subject to governance, political, and financial incentives.[103] While international organizations like the World Bank or the OECD, active as prime benchmark setters in various indicators, should be independent and impartial, it is well known that they both answer to their stakeholders. Political pressure from key stakeholders can influence organizations' decisions and tweak member rankings.[104] As a well-known example, the World Bank was found to have manipulated the 'Doing Business 2018 and Doing Business 2020' reports following pressure from China and Saudi Arabia.[105]

Private indicator-setting organizations and monitors, which typically act as charities or trusts, are perhaps subject to even higher pressures. Indeed, they not only lack the widespread stakeholder representation that might counterbalance the influence of some members, but they also lack the more robust governance mechanisms in place in the more structured international organizations. In addition, private organizations usually lack an institutional funding mechanism that consistently and reliably provides financial support to the organization's activities. Thus, they are more susceptible to financial incentives from donors or private commercial activities.[106]

The credibility of verifiers is crucial for the existence of the sovereign sustainable finance market. Given the already well-known accusation of greenwashing that most investment funds with a sustainability objective face, it is imperative to address them as a matter of priority. It is not the purpose of this paper to discuss solutions to this problem as they would take an entirely different study. It is nonetheless important to mention that regulators in the USA and Europe are currently working on setting stricter parameters for ESG ratings.[107]

VIII. CONCLUSION

This article argued that sovereign sustainable bonds largely fail to live up to their expectations as tools for policy change for sustainability. Few elements support the notion that contractual incentives might encourage sovereign borrowers to implement sustainability reforms that would otherwise not have been possible. Hence, the idea that sovereign sustainable finance constitutes an intrusion into national sovereignty is similarly unfounded.

Flaws in the contractual mechanics of ESG commitments render the ESG dimension just an embellishment to a standard sovereign bond contract. Neither sovereign borrowers nor

[101] Freeburn and Ramsay, above n 18; Banahan, above n 99, at 852–853; On the incentive-incompatibility of issuer-paid credit ratings, see e.g. Norbert Gaillard and Michael Waibel, 'The Icarus Syndrome: How Credit Rating Agencies Lost their Quasi-Immunity', 71 Southern Methodist University Law Review 1077 (2018).

[102] Rose, above n 28, at 72–73.

[103] Sarah Dadush, 'Impact Investment Indicators: A Critical Assessment', in Kevin E. Davis, Angelina Fisher, Benedict Kingsbury, and Sally Engle Merry (eds), *Governance by Indicators* (Oxford: OUP, 2012), 392–434.

[104] On this, see, Kevin Davis, Angelina Fisher, Benedict Kingsbury, and Sally Engle Merry (eds), *Governance by Indicators: Global Power through Quantification and Rankings* (Oxford: OUP, 2012).

[105] See the commissioned investigative report by WilmerHale LLP, 'Investigation of Data Irregularities in *Doing Business 2018* and *Doing Business 2020*: Investigation Findings and Report to the Board of Executive Directors' (15 September 2021).

[106] Berg et al., above n 70.

[107] Adrienne Klasa, 'Regulators Take Aim at ESG Ratings in Fight against Greenwashing', Financial Times (28 May 2022).

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investors have any real incentive to link the price of the debt instruments—hence, the cost of financing—to meaningful ESG objectives. The only motivation common to both parties is to market the debt instruments as 'sustainable' to please the demand from retail investors eager to buy into this asset class.

Ultimately, the sovereign sustainable debt market seems to be built on dangerous connivance between institutional investors, sovereign borrowers, and certifiers to artificially create a market with very little reason to exist. Without regulation addressing the incentive problems in the certification and monitoring phase of the debt and the legal structure of ESG commitments, sovereign sustainable finance will lack credibility.

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