CORRUPTION AS AN INDICATOR OF CREDITWORTHINESS

SIGNATORY TYPE
Investment Manager

ASSETS UNDER MANAGEMENT
EUR 250 bn

OPERATING COUNTRY
Germany

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Union Investment is the asset management company of the cooperative financial network in Germany, managing a volume of around 250 billion euros for institutional and retail investors. The assets that Union Investment manages on behalf of institutional investors – including pension funds, insurance companies, industrial corporations, banks and non-profit organisations such as charitable foundations and associations, both inside and outside Germany – total more than 140 billion euros.

The PRI's Fixed Income Case Study series highlights examples of interesting and innovative approaches to responsible investment. Written by fixed income practitioners from around the world, the case studies cover topics such as integrating ESG, negative and positive screening, thematic investment and engagement.

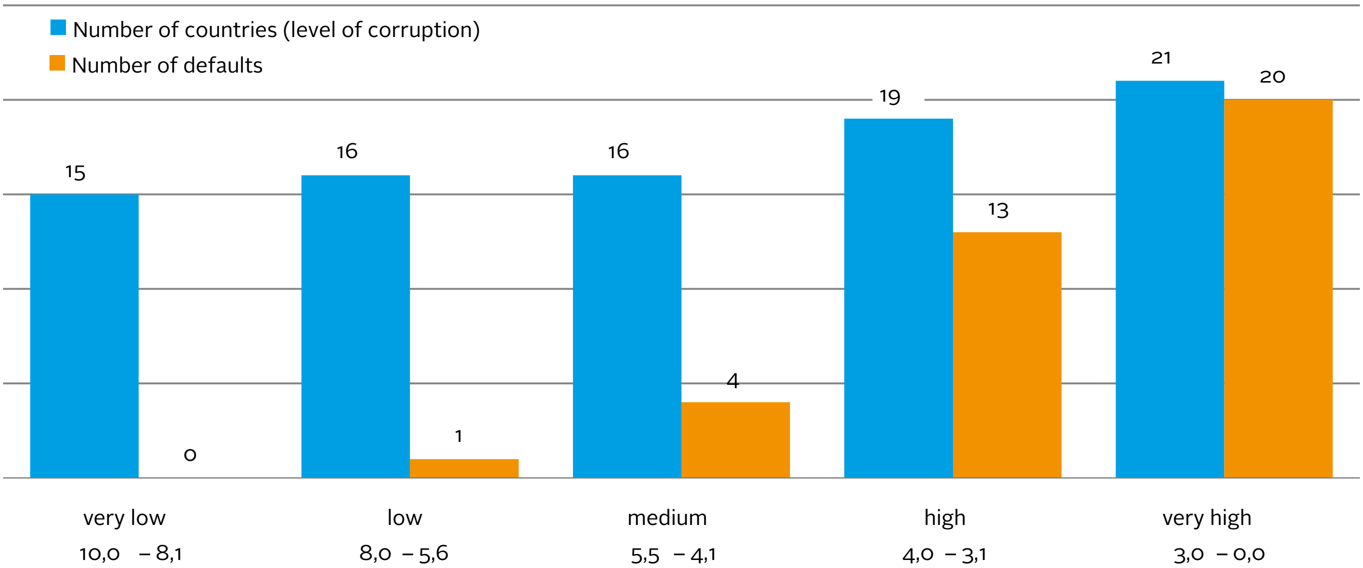
Sharing these examples will enable investors to collectively build a concept of emerging good practice. The PRI aims to publish a set of these short pieces every quarter. If you would like to learn more or contribute your own case study please contact us.

WHY MEASURE CORRUPTION LEVELS OF SOVEREIGN BOND ISSUERS?

Union Investment analyses corruption in its assessment of the creditworthiness of sovereign bond issuers. After analysing economic data to assess the *ability* of a country to repay its debt, we believe that corruption is a good proxy for assessing the *willingness* of a country to make those repayments. This conviction is backed up by historical analysis going back to 1970 covering 87 countries. It shows a high correlation between corruption and sovereign defaults:

In our 2014 report "Corruption and the risks of losses on government bonds", we identified a series of negative spillover effects from corruption that could in turn affect debt repayment:

Figure 1. Corruption levels and sovereign defaults since 1970. Source: Union Investment, Transparency International, Reinhart & Rogoff (2008),(2009),(2010),Sturzenegger & Zettelmeyer (2007).



- **Corruption fosters the growth of shadow economies and therefore tax fraud.**
  The shadow economy restricts a country's scope for action within the fiscal system, and therefore its ability to control revenue with which to repay its debts. Corrupt public servants can make it more difficult to set up businesses, forcing business into the shadow economy where they then don't pay taxes. The risk of flouting tax laws is also lower if inspectors accept bribes.
- **Corruption increases the risk of statistical manipulation.**
  Fundamental economic data is typically compiled by national authorities and institutions making it impossible for an investor to rule out the figures having been manipulated. Exerting influence in this way is particularly critical in countries where the economic situation deteriorates.

By its very nature, statistical manipulation is difficult to prove because there are no systematic records of manipulated data which could be compared with levels of corruption, but examining proven cases of fraud (e.g. Greece, Argentina, and Venezuela) underlines that they were part of a bigger picture of prevalent corruption.

- **Corruption leads to economic mismanagement.**
  Corruption weakens institutions that are responsible for macroeconomic management. For instance, a central bank may be set up to be independent, but in fact pursue individual interests as a result of corruption. The same applies to public spending restraint.
- **Corruption limits political reforms.**
  Especially during times of crisis, it is necessary for a society at large to support political and economic reforms required to reduce debt levels and foster economic growth. High corruption limits a country's ability to implement such reforms because it undermines public trust in its leadership.

HOW WE USE CORRUPTION FOR ASSESSING CREDITWORTHINESS

We have developed our own rating system for government bond issuers which also includes corruption data from Transparency International and the World Bank. This aims at assessing the countries` willingness to pay and the overall rating generates research signals that are being used by Union Investment's portfolio managers. While the more traditional fundamental research process is capturing the mere issuers´ ability to pay back debt, the adjusted rating adds the aspect of corruption and its impact on sovereign creditworthiness. We therefore combine data from our economic analyses and with our findings from the corruption indices. In doing so we refine our sovereign rating and provide additional insight for our portfolio managers. The research signals are primarily used by fixed income teams in order to enhance their investment decisions with additional analytic data. However, the data is taken into consideration by equity portfolio managers just as well as country risks may pose severe risk to commercial enterprises, too.

CASE STUDY: APPLYING THE MODEL

Applying our rating system to countries results in a number of significant upgrades and downgrades: Russia receives a three-notch-downgrade from BBB+ to BB+, while the Netherlands receives a three-notch upgrade from A to AA.

	UI sovereign rating(fundamental)	Premium/discount (due to corruption data)	UI sovereign rating
Germany	A+	+3	**AA+**
Netherlands	A	+3	**AA**
France	BBB	+2	**A-**
USA	BBB-	+2	**A-**
UK	BBB-	+2	**A-**
Chile	A	+2	**AA-**
Brazil	BBB-	0	**BBB-**
Mexico	BBB+	-1	**BBB**
Russia	BBB+	-3	**BB+**