KEN Associates

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Contents

Sustainable Finance in Emerging Markets

Executive summary

Environmental and social issues pose arguably the biggest societal challenge for most Emerging market (EM) or developing countries. Yet, they provide immense opportunities for making transformational improvements in these societies through deployment of available capital to sustainable economic activities.

This report analyses the current conditions in the EM sustainable bond market in the context of global capital markets and the potential for growth of impact investments. It then discusses the main barriers for the faster development of the sustainable debt market in developing countries and explores actions that issuers, investors and policymakers can take to overcome these barriers.

EM countries, accounting for 86% of the world population, face greater environmental and social challenges than most developed countries. The adverse impact of climate change is particularly pronounced in Africa, South and South East Asia, which are mostly populated by low-income countries with limited adaptation capacity. Social issues such as high unemployment, lack of access to education, clean water and healthy food, add up to the acute problems that impede the sustainable development of many EM countries.

According to the United Nations (UN), the financing gap to achieve its Sustainable Development Goals (SDG)[i] in developing countries is estimated to be USD 2.5 – 3 trillion per year - around 1% of global capital markets. Investments in sustainable bonds and loans globally reached USD 765 billion in 2020, a 65% increase from USD 464 billion in 2019[ii]. Still, outstanding sustainable bonds accounted for just 1.4% of the global bond market as of year-end 2020. Issuance of green, social and sustainability bonds (see the Definitions page for a classification of these instruments) by EM sovereigns, financial and non-financial corporates amounted to USD 69 billion[iii] in 2020, or only 11% of the global total. Clearly, this level of sustainable bond investments is not comparable to developed countries, and it is only a fraction of the aforementioned UN estimate of the funding gap.

We expect sustainable investments growth to continue in EM countries. The pace of the growth, however, will be uneven across countries and regions, depending on a number of factors that affect investors' interest to allocate capital to and issuers' propensity to issue sustainable bonds. In this regard, transparency, accountability and enhanced awareness of risks and opportunities in EM sustainable debt is paramount for all stakeholders. Other important factors in this area include policies and regulation by national governments to promote economic and financial sustainability, technical assistance to issuers in developing frameworks for bond issuance, provision of credit enhancements, public–private partnership (PPP) and blended finance with multilateral development banks (MDB) and other impact investors.

Definitions[iv]

Sustainable Finance

Sustainable Finance incorporates climate, green and social finance while also adding wider considerations concerning the longer-term economic sustainability of the organisations that are being funded, as well as the role and stability of the overall financial system in which they operate.

Green Bonds

Green Bonds are any type of bond instrument where the proceeds will be exclusively applied to finance or re-finance, in part or in full, new and/or existing eligible Green Projects and which are aligned with the four core components of the Green Bond Principles.

Social Bonds

Social Bonds are any type of bond instrument where the proceeds will be exclusively applied to finance or re-finance in part or in full new and/or existing eligible Social Projects (see section 1 Use of Proceeds) and which are aligned with the four core components of the Social Bond Principles.

Sustainability Bonds

Sustainability bonds are bonds where the proceeds will be exclusively applied to finance or re-finance a combination of both green and social projects.

Sustainability-Linked Bonds

Sustainability-Linked Bonds (“SLBs”) are any type of bond instrument for which the financial and/or structural characteristics can vary depending on whether the issuer achieves predefined Sustainability/ ESG objectives. In that sense, issuers are thereby committing explicitly (including in the bond documentation) to future improvements in sustainability outcome(s) within a predefined timeline. SLBs are a forward-looking performance- based instrument.

Responsible or ESG Investing

Responsible Investing, also known as ESG Investing, refers to strategies and practices that incorporate material environmental, social and governance (ESG) factors in investment decisions and active ownership with a view to minimise risks and maximise returns. It can be pursued by all investors as part of their fiduciary duty on the basis that ESG factors are considered as having a material impact on returns.

Environmental and social challenges of EM countries

EM countries make up 86% of the world population and 41% of the global GDP (measured by market exchange rates); and these shares will continue to rise over this decade making EM ever more important in global environmental, social and economic ecosystem.

Climate change, loss of biodiversity, air pollution, income and gender inequality – to name a few of environmental and social issues – are acute global challenges. The negative impact of environmental problems is especially severe for developing countries – from degradation of the Amazon rainforests to droughts in Africa to floods in South and South East Asia. These regions are mostly populated by low-to-middle income countries with limited adaptation capacity.

Inadequate awareness of climate risk at large parts of society, both in developing and developed countries, limits the extent of response to this fundamental problem from governments and businesses. In this respect, the findings of a survey[v] conducted by PWC with 5050 CEOs across the world early this year are quite revealing. In particular, 27% of CEOs responded being 'not concerned at all' or 'not very concerned' about climate change. And 60% of CEOs have not yet factored climate change into their strategic risk management activities.

Social issues such as high unemployment, lack of access to education, clean water and healthy food, especially for millions of refugees from the conflict-torn regions in the Middle East, Africa and Asia, add up to the grave issues that impede the sustainable development of many EM countries.

2020 marked the start of the Decade of Action announced by the UN. The Decade of Action calls for accelerating sustainable solutions to all the world's biggest challenges by 2030. Despite some progress, actions taken so far are not sufficient to meet the SDGs.

Mark Carney, the former governor of the Bank of England, explained the lack of adequate action to address climate risk by "a Tragedy of Horizons": "the catastrophic impacts of climate change will be felt beyond the traditional horizons of most actors – imposing a cost on future generations that the current generation has no direct incentive to fix. That means beyond the business cycle; the political cycle; and the horizon of technocratic authorities, like central banks, who are bound by their mandates." The tragedy being that "once climate change becomes a defining issue for financial stability, it may already be too late".

Current conditions and potential for sustainable investments in EM

According to the Business and Sustainable Development Commission (BSDC), the SDGs have the potential to create at least USD 12 trillion in opportunities for the private sector globally, covering such diverse economic systems as food and agriculture, cities, energy and materials, and, health and well-being. Yet, the level of sustainable financing in EM is grossly incompatible with its economic potential and environmental and social challenges.

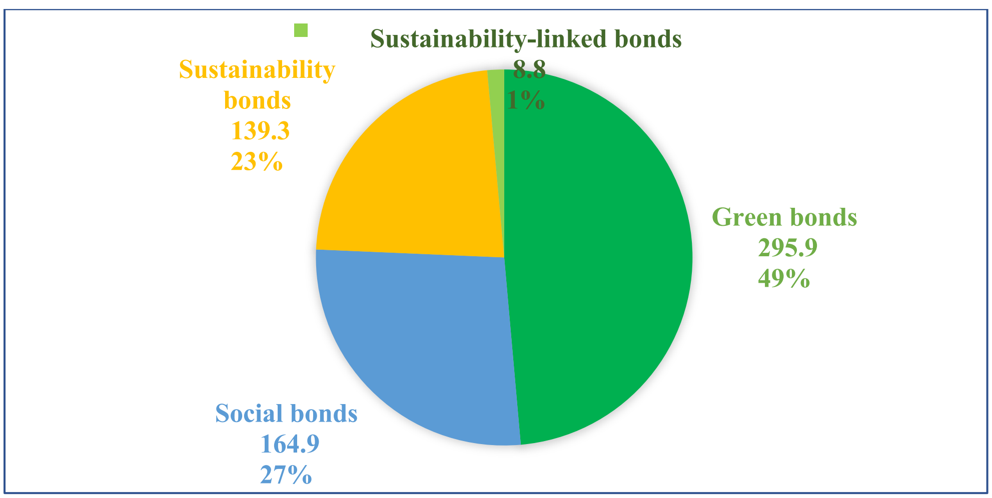
International Finance Corporation (IFC) estimates total global demand for "impact investing assets" at USD 26 trillion. More than 3000 organizations with combined assets under management in excess of USD100 trillion have signed the UN Principles for Responsible Investing (PRI), indicating their willingness to channel capital to sustainable investments. These trends reveal the immense opportunities and available financial resources for private sector capital flows to EM countries.

Global sustainable bond markets

While developed market countries continue to be the leading bond issuers, the share of EM countries has risen steadily. From just USD 1.5 trillion, or 3% of the global bond market, in 2004, EM countries grew their total bond market size to USD 22.1 trillion in 2019, accounting for nearly 20% of the global market.

The still nascent global sustainable debt market has been growing exponentially over the past two years. Investments in sustainable bonds and loans globally reached USD 765 billion in 2020, a 65% increase from USD 464 billion in 2019. According to the Environmental Finance Bond Database, total sustainable (green, social, sustainability and sustainability-linked) bond issuance surpassed USD 600 billion in 2020 – nearly double the USD 326 billion issued in 2019. This follows a 53% year-on-year growth reported in 2019 compared to the USD 214 billion issued in 2018.

Global sustainable bonds issuance in 2020, in billion USD and % share

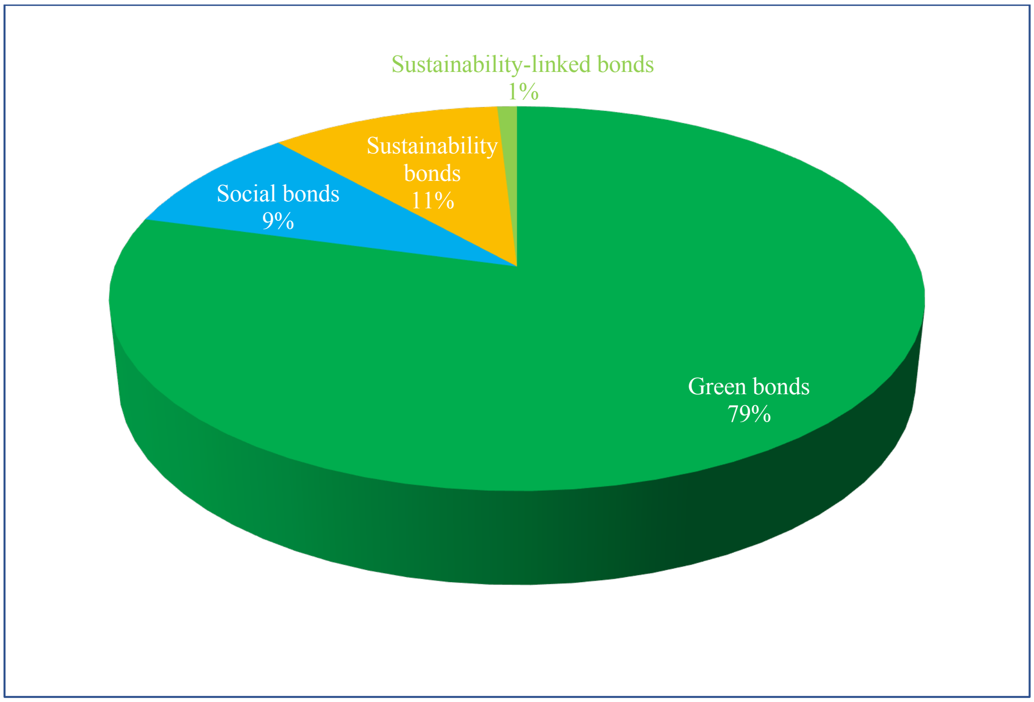


Source: Environmental Finance

Green bonds, the most entrenched type of sustainable bonds, accounted for almost half of total placements in 2020. Social bonds issuance soared nine-fold to USD 165 billion, driven by the Covid-19 pandemic as many governments and MDBs tapped the markets to finance social and economic support measures across the world. Sustainability bond issuance also tripled to USD 140 billion in 2020. The largest issuers of sustainable bonds in 2020 were the European Union (EU), the World Bank (IBRD) and the German government.

As of year-end 2020, the value of outstanding sustainable bonds reached USD 1,74 trillion, or 1.4% of total global bond market. Green bonds still dominate the sustainable bond market with a 79% share in total.

Composition of global outstanding sustainable bonds at year-end 2020, % share



Source: Environmental Finance

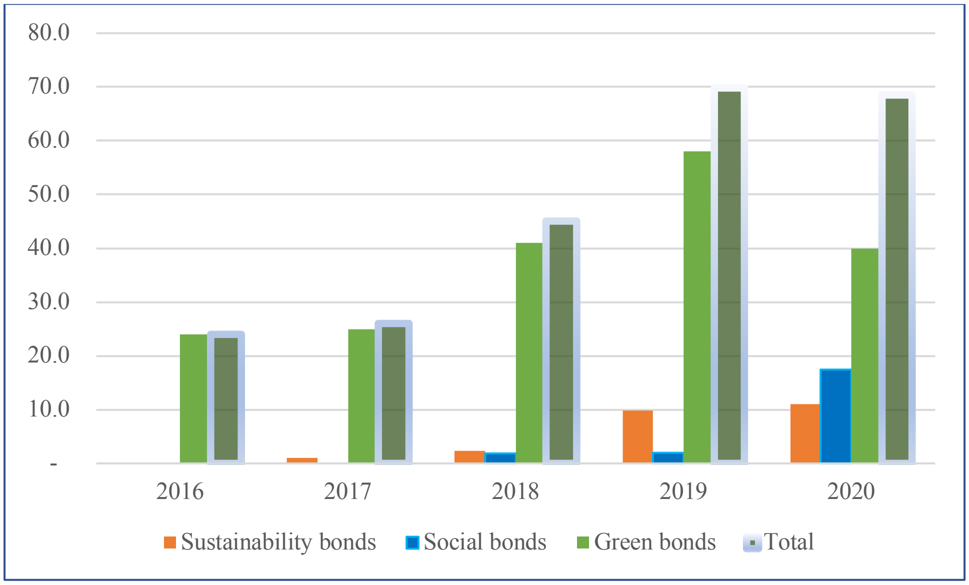
EM sustainable bond markets

We estimate outstanding EM sustainable bonds at USD 230 billion, or 13% of the global total as of year-end 2020. EM sustainable bonds accounted for 1.1% of the total EM debt, while this indicator for developed markets was 1.4%. As of December 2020, green bonds accounted for 58% of EM sustainable bonds vs 79% global average.

Since 2017, the annual volume of EM sustainable bond issues has almost tripled to USD 69 billion in 2020. It is noteworthy that the market stalled in 2020. Social bonds placements exploded to USD 17.5 billion from just USD 2 billion in 2019, mainly driven by pandemic related borrowings.

However, green bonds issuance declined to USD 40 billion from USD 58 billion in 2019, largely due to issuers' focus on tackling the economic fallout of Covid-19. We believe that this is a temporary setback for green bonds and the issuance levels will recover in 2021 and beyond, not least driven by the broadly accepted "Build back better" agenda that assumes first of all an economic recovery driven by investments in environmentally friendly activities.

Sustainable bonds issuances by EM corporates and sovereigns, in billion USD



Sources: Pictet Asset Management, Bloomberg

Sustainable bonds issued by EM sovereigns made up 24% of the total in 2020, whereas banks accounted for the majority of corporate issuances. In terms of regions, bond issuance is concentrated in the middle-income countries, led by China. This means that the lower-income developing countries need significantly more sustainable investments just to close the funding gap with the wealthier nations.

It is important to note, that a large part of sustainable or impact investments into EM countries is provided by loans from MDBs, which are not part of the aforementioned statistics of bond placements.

What can policymakers, regulators, investors and issuers do to foster sustainable finance

We expect sustainable investments growth to continue in EM countries driven by environmental, social, technological and regulatory developments. Growing awareness of ESG risks by policymakers and society at large, together with continued progress in green technologies will result in a larger share of available capital to be deployed to activities that delivery positive environmental and social outcomes. The pace of the growth, however, will be uneven across countries and regions, depending on the actions taken by issuers, investors and governments to embrace environmentally and socially responsible practices and secure long-term sustainability of individual businesses and economies.

The following table is drawn based on our engagement with issuers and investors, as well as publicly available surveys, detailing the key issues that investors and issuers encounter in sustainable debt market in EM countries.

Most common barriers to entering sustainable debt markets in EM countries

Issuer perspective	Investor perspective
Absence of standardised classifications or taxonomy to select and report eligible assets	Low transparency and low confidence in issuers' or issue's sustainability credentials
Lack of expertise to set up a framework for sustainable bond issuance	Lack of large enough issuances
Additional costs associated with independent verification of bonds and subsequent reporting	Limited supply of green or social bonds in G10 currencies
Immaterial or no price premium vs conventional bonds	Low liquidity of secondary markets of EM sustainable bonds

Later in this section, we discuss currently available solutions and explore actions that key stakeholders of the sustainable investment market can take to overcome the aforementioned barriers.

Absence of standardisation in classification; low transparency and risk of greenwashing

These two barriers that are on top of issuers and investors lists, are applicable to developed markets as well. Hence, policy and business response in these areas should be provided across the world and on a global basis. A number of ground-breaking achievements have been made in this area over the past decade, led by the UN and other international organizations. These milestones include the definitions of the 17 SDGs, which are often used by issuers as a framework to identify specific sustainable activities to which the proceeds of the green, social or sustainability bonds will be directed.

The Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) is a comprehensive set of recommendations on measuring and reporting companies' climate-related activities. These disclosures, together with other information, are used by issuers of climate bonds. TCFD can be applied by **national governments and issuers** as a blueprint for developing regulations and reporting on climate-related activities. Last November, the United Kingdom announced[vi] that it would be the first country in the world to make TCFD-aligned disclosures mandatory. Similarly, **EM countries (regulators and issuers),** can use the EU Taxonomy for Sustainable Activities to develop their own classification systems.

There are currently several other international frameworks for sustainability/ESG reporting. Sustainability Accounting Standards Board (SASB) and Global Reporting Initiative (GRI) have developed some of the most widely adopted disclosure frameworks, that are applied by many companies in producing their corporate social responsibility (CSR) reports. International efforts are under way to develop a single set of globally accepted sustainability reporting standards. Such standards would bring harmonisation and comparability in ESG disclosures, reduce the risk of greenwashing and consequently boost investors' confidence in companies' sustainability credentials.

In the meantime, **EM companies planning to issue sustainable bonds**, may consider to improve their ESG transparency by applying one of the main available disclosure frameworks. To establish and maintain strong credibility with investors, regulators and other stakeholders, it is key for companies to ensure materiality and verifiability of their environmental and social accomplishments. Equally important is embedding sustainability in companies' corporate strategies and aligning financial objectives with sustainability targets. Businesses should be transparent and provide a forward-looking assessment of their ESG risks and measures taken by companies' management and boards to manage such risks.

Lack of expertise to set up a framework for sustainable bond issuance

Companies with limited expertise in sustainable bonds and planning their debut issuance typically start the process about one year before the target issue date. This will allow for sufficient time to (1) engage with deal advisors (consultancies or MDBs), investment banks, regulators and potential anchor investors such as development banks and other impact investors; (2) select the eligible assets and obtain external verification; and (3) move the issuance date if market conditions worsen.

Policymakers can facilitate this process by engaging with international consultants and MDBs to introduce technical assistance programs to local companies that would likely issue sustainable bonds. Such consultations will also benefit government officials for developing effective regulations and policies to foster issuance of and investments in sustainable debt.

Lack of large issuances and low liquidity in the secondary market

Sovereigns will continue to be the providers of the largest issuances of EM sustainable debt. In addition, **governments'** more active engagement with the private sector and MDBs through public–private partnerships, guarantees and blended finance transactions could provide a much-needed impetus to sizable sustainable bond issuances and investors' interest in them.

In the financial and non-financial corporate space, we expect a rise in issue sizes. Large banks and corporates in the carbon-intensive industries will be joining the ranks of existing issuers.

Sustainability bonds are rising in popularity as they give greater flexibility to companies to issue such bonds. Since sustainability bonds allow to use the proceeds for both green and social projects, companies can pull together more eligible assets and issue bonds in larger amounts. These instruments will be especially useful for **banks** that have diverse sustainable loan portfolios and can pull these loans more easily compared to green or social bonds.

Larger-size issuances will increase the liquidity in the secondary markets to some extent as there will be more investors on this market. However, due to sustainable investors propensity to hold their investments for longer periods, we expect that liquidity of sustainable bonds will remain lower than that of conventional bonds.

In non-financial corporate space, we believe in a broader adoption of sustainability-linked bonds, especially among carbon-intensive insurers in **oil and gas, cement and mining industries**. Unlike green, social and sustainability bonds, sustainability-linked debt issuers do not have to use the bond proceeds specifically for green or social projects. The proceeds of the bond can be used for general business purposes; however, the issuer must meet specific environmental or social targets (KPI) over a specified period of time in order not to pay extra coupon for the bonds.

We note, that **investors and regulators** should pay close attention to the terms of these bonds to mitigate the risk of greenwashing. Specifically, if the KPIs are not ambitious enough and are to be met over a long period of time, i.e. 10 years, there is a risk that the purpose of the bond sale is simply to convey a false message of the company's ESG commitment. For example, a KPI for a steel manufactures to reduce its total carbon footprint by 15% in 10 years could be a greenwashing attempt as it is likely that due to technological progress (independent of the issuing company) the cost of energy used in steel manufacturing will be cheaper; and the total steel output could be lower owing to increased levels of recycling. Therefore, shorter periods for setting KPIs is more reasonable for **investors** to effectively monitor the performance of sustainability-linked bonds' issuers.

Additional costs associated with independent verification of bonds and subsequent reporting

Issuers incur additional costs for setting up sustainable bonds' framework, selecting eligible assets, obtaining external verification (second party opinion or certification) and preparing subsequent reporting, usually annually. These costs can indeed be material for first-time issuers, however, they should not hold back companies from issuing. In this area, technical assistance from **MDBs and other donors** can substantially reduce the burden on issuers.

Immaterial or no price premium vs conventional bonds

While most investors morally support environmental and social objectives of sustainable bonds, they price these instruments based on their intrinsic credit risks. As such, green or social bonds typically trade in line with an issuer's "brown" bonds of the same seniority and tenor because they have the same credit risk.

In the past two years, due to rising demand for sustainable bonds, these instruments have often been placed at a price premium ("greenium") over conventional bonds of the same issuer. We expect that issuers with established ESG credentials will continue to see stronger demand for their sustainable bonds compared to other issuers. However, in the long term, "greenium" itself is not sustainable and will likely be either very small or non-existent. Nonetheless, in some future scenarios, "greenium" may persist and even become bigger, for example, if central banks give them a preference in their asset purchase programs; or if financial regulators allow for lower capital charges for banks and insurers against their sustainable bond holdings. These scenarios, however, will require extensive policy debates and legislative changes.

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About KEN Associates

KEN Associates is a UK-based consulting firm. We help companies, investors, governments and development institutions across the world to meet their sustainability goals with cutting-edge research and consulting solutions.

To learn more about our work and explore opportunities for collaboration, please visit our website at www.kenassociates.co.uk or send an email to adallakyan@kenassociates.co.uk

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