Sector Briefing:

Sustainable finance

June 2023

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DEFINITION

- The European Commission says sustainable finance refers to the process of taking environmental, social, and governance (ESG) considerations into account when making investment decisions in the financial sector, leading to more long-term investments in sustainable economic activities and projects.
  - **Environmental considerations** - might include climate change mitigation and adaptation, as well as the environment more broadly, for instance the preservation of biodiversity, pollution prevention, and the circular economy.
  - **Social considerations** - could refer to issues of inequality, inclusiveness, labour relations, investment in human capital and communities, as well as human rights issues.
  - **Governance considerations** - the governance of public and private institutions, including management structures, employee relations and executive remuneration, plays a fundamental role in ensuring the inclusion of social and environmental considerations in the decision-making process.

MAIN VEHICLES

- US-based fund Green Environment Facility says the two main financial instruments in sustainable finance are equity and debt. Debt and equity funds are investment vehicles of choice in environmentally related finance. A vehicle combines several projects that may have a different focus, such as land use, forestry, and agriculture. Whatever their focus, they have the same level of maturity (either early stage development, proven concept or mature).
- More specifically, debt financing can come in the form of loans or bonds. While a loan is a transfer of money from a bank to a company/individual, a bond is a transfer of money from the public/market to a company that issues a bond. Unlike loans provided through bank debt, bonds traded on public debt markets tend to involve larger amounts of capital (typically US$100m and above) and are open to the general public for investments. Bonds in the green finance field have been targeted more at qualified investors. However, certain types of notes (e.g. promissory or structured notes) have also been made accessible and affordable to retail investors because they require less upfront investment.

USE OF PROCEEDS VS. SUSTAINABILITY-LINKED

- The universe of sustainable debt consists of an evolving realm of financial instruments falling primarily within two debt financing categories: **use-of-proceeds**, and **sustainability-linked debt**. (Harvard Business School, Aug-22)
- ***Use-of-proceeds (or activity-based) finance*** is any type of bond or loan instrument where proceeds are exclusively made available to finance or re-finance eligible environmental and/or social projects. Many thematic labels have emerged over time, including green bonds/loans, social bonds/loans, as well as sustainability and transition bonds. Harvard Business School defines these as:
  - **Green bonds** - activity-based bonds issued to finance projects with the goal of positive environmental change. Green bonds guarantee that money is used to finance green projects. Ventures like renewable energy efficiency, clean public transportation, and pollution prevention all qualify for green bonds, as they focus on improving climate conditions or sustainable energy. Although green bond issuance does not yet have a market standard, financers refer to the Climate Bond Standard and Certification and Green Bond Principles (GBP). Sustainable debt investors should be familiar with these guidelines when considering green projects, since these bonds make up over half of sustainable debt in the market.
  - **Blue bonds** – a subset of green bonds, a debt instrument issued by governments, development banks or others to raise capital from impact investors[1] to finance marine and ocean-based projects that have positive environmental, economic, and climate benefits.
  - **Green loans** - activity-based loans that operate similar to green bonds, but with one exception - they exist within the private market. Green loans were first introduced to encourage homeowners to make energy-saving improvements to their property, such as installing solar panels. Green loans are intended to motivate businesses to adopt green policies by introducing environmentally friendly services and products. The primary sources for green loans are commercial lenders or peer-to-peer lending.
  - **Blue loans** - a subset of green loans but focusing on financing marine and ocean-based projects that have positive environmental, economic and climate benefits.

[1] An investment fund that specifically seeks to support beneficial social or environmental outcomes, in addition to generating financial returns.

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- **Sustainability bonds** – are activity-based bonds intended to finance or refinance a combination of green and social projects. These projects must be aligned with the core principles of the International Capital Market Association (ICMA). ICMA guidelines follow the same standards as the Social Bond Principles (SBP) and the Green Bond Principles (GBP).
- **Social bonds** - are activity-based and intended to finance or refinance projects targeting positive social outcomes, such as affordable housing, LGBTQ+ rights, and education equity. As with green bond issuance, social bonds depend on guidelines provided by the Social Bond Principles (SBP). These guidelines equip investors with the knowledge and insight to assess investments' risks and desired outcomes.

- ***Sustainability-linked (or behaviour-based) finance*** is any type of bond or loan instrument that aims to incentivise material environmental and/or social achievements by linking the financial terms of the bond or loan (e.g. loan interest rates) to predefined entity-level sustainability performance targets (SPTs) measured by key performance indicators (KPI). Unlike the use-of-proceeds model, sustainability-linked debt proceeds can be used for general corporate purposes.
  - **Sustainability-linked bonds (SLBs)** - are behaviour-based bonds. Their funding is based on whether an issuer achieves sustainability goals by a certain deadline. For example, a company pledging to reduce its carbon emissions by a certain percentage can qualify for an SLB. If it fails to reduce its emissions according to the terms of the bond, then it must pay investors more money.
  - **Sustainability-linked loans (SLLs)** - are similar to sustainability-linked bonds (SLBs) in that they are behaviour-based. Yet, because they qualify as loans rather than bonds, SLLs operate within the private sector and cannot be publicly traded. SLLs motivate businesses to hit sustainability targets based on incentives, such as positively fluctuating interest rates influenced by sustainability performance. Maintaining sustainability targets and keeping interest rates down ensures a company's capital significantly increases and provides a steady cash flow for investors.
- Lastly, LexisNexis mentions a variety of sustainability linked derivatives. These feature the addition of an ESG pricing component into otherwise conventional hedging instruments. If the relevant party meets the ESG target (which is measured using key performance indicators or KPIs), then the cashflows of the derivative will be adjusted such that the party pays less if meeting the agreed ESG target and/or more if failing to meet the agreed ESG target.

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MARKET SIZE AND OUTLOOK

- In its in its Green Bond Report (Dec-22), Swedish financial services group Skandinaviska Enskilda Banken AB (SEB) said the total transaction volume of the sustainable debt market was estimated at US$1.55 trillion in 2022, down from US$1.69 trillion in 2021.
- SEB lists a series of headwinds that impacted the sustainable debt market in 2022. The interest rate hikes across the world, along with the war in Ukraine and the ensuing energy crises worsened the macroeconomic situation further by making everyone painfully aware of paramount importance of energy supply.
- The paradigm shift in monetary policy, energy shortages and geopolitical tensions led to a significant slowdown in the global bond market which declined by an estimated -22% in 2022.
- White & Case (Dec-22) provides the following comparison of sustainable bond and loan issuance in the last five years:

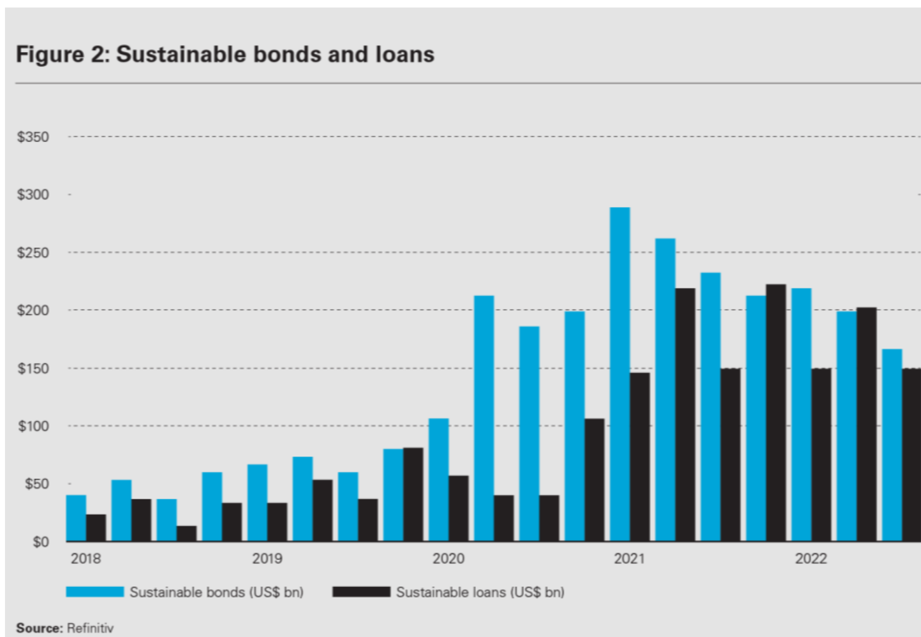
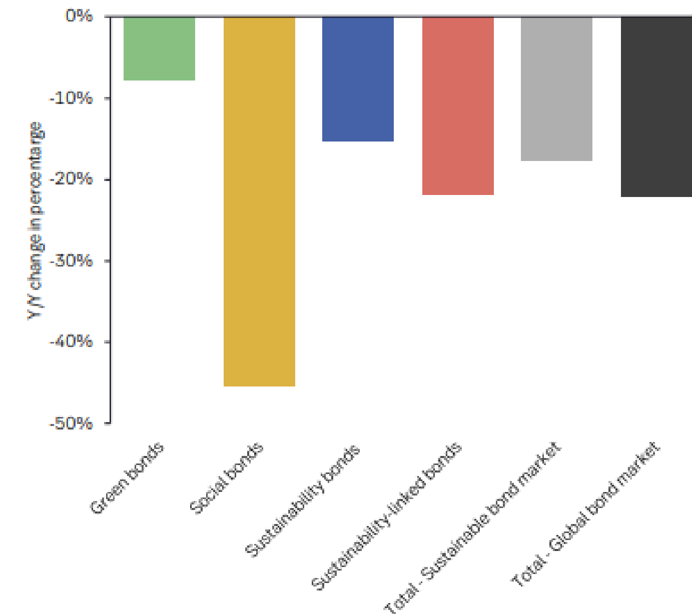


Figure 2: Sustainable bonds and loans

Source: Refinitiv

- Against this background, SEB (Dec-22) estimates sustainable bonds outperformed the general market as the volume of new issuances fell by only -18% in 2022 vs. -22% for the global bond market. Green bonds were least affected by the slowdown in sustainable borrowing and social bonds most.

Figure 9 Estimated Y/Y change in sustainable bond market and the general bond market



Source: Bloomberg New Energy Finance 30 November 2022, SEB estimate

Source: SEB (Dec-22)

- In 2023, SEB expected sustainable bonds and loans to return to growth and continue to take an increasing market share of the general debt market. If the general global debt market stabilises, SEB forecasts the global volume of sustainable bonds and loans will grow to US$1.76 trillion in 2023 (see chart below).

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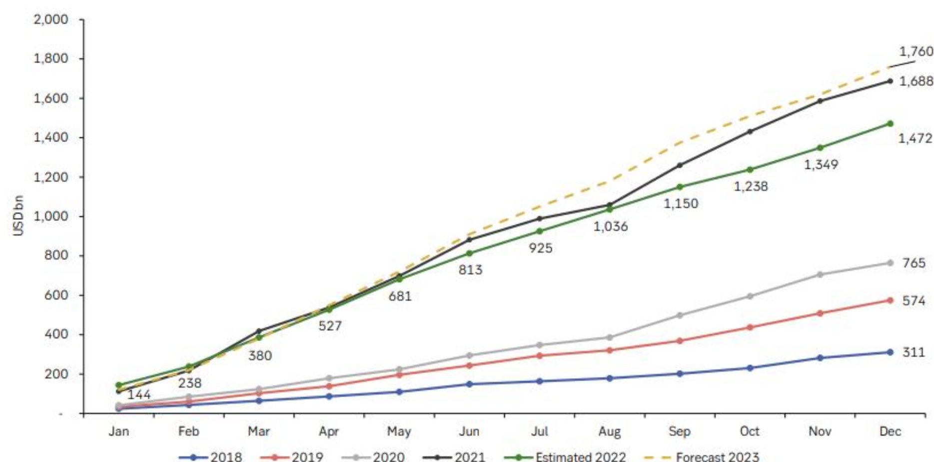
Figure 8 Cumulative annual sustainable debt transactions



Source: Bloomberg New Energy Finance 30 November, SEB estimate

Source: SEB (Dec-22)

- SEB said at the time growth in 2023 would be driven by a stronger sustainable bond market as investments ramp up and uncertainties about interest rates, energy prices and other economic downside risks subside. This will help clear the backlog of sustainable bond financing that have been put on hold during 2022. At the same time, increased regulatory and investor scrutiny means that issuers of sustainable bonds will have to put more effort into showing ambition and impact."

Green bonds 'on track' for record year after busiest May ever

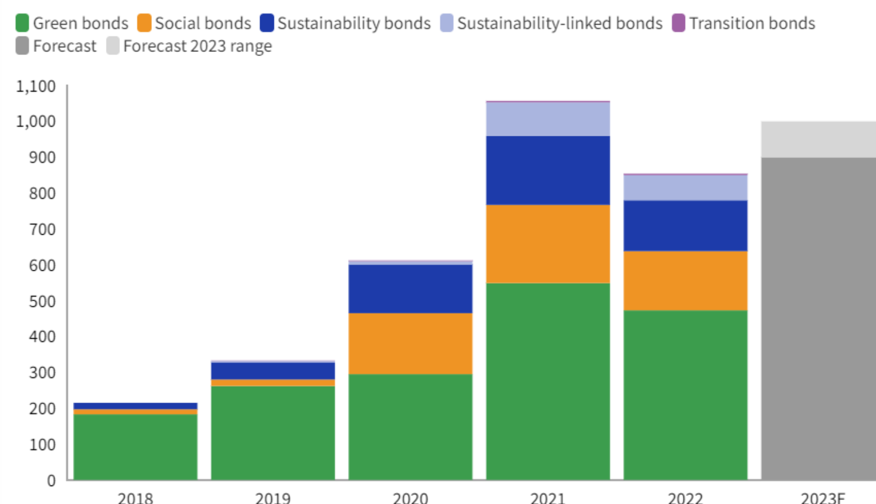
- Bloomberg (Jun-23) said new sales of green bonds totalled US$62.3bn in May 2023, making it the most active May since the inception of the green debt market in 2007. That is slightly higher than the US$60.3bn raised in May 2022 and the highest monthly total since October 2021.

BONDS DRIVE WIDER GROWTH OF THE MARKET

- S&P Global (Mar-23) estimates modest growth of +2.5% in the green, social, sustainable, and sustainability-linked bond (GSSSB) market for 2023, reaching US$900bn-$1 trillion, nearing the record US$1.06 trillion in 2021 (vs. SEB's calculation of US$1.69 trillion in 2021 for total transaction volume of the sustainable debt market). This follows a 2022 in which contractionary monetary policy and macroeconomic uncertainty pulled down global bond issuance by -22%.
- The composition of the green, social, sustainable, and sustainability-linked bond (GSSSB) in 2022 was: **green bonds** continued to account for over half of issuance (55%); while **social** (19%), **sustainability** (17%) and **sustainability-linked bonds (SLBs)** (8%) each comprised a marginally smaller proportion of the market compared to 2021.
- S&P expects **green** bonds will continue to dominate. However, it expects to see **sustainability bonds** become more prevalent. Meanwhile, **sustainability-linked bonds (SLBs)** are at an inflection point. Scepticism and questions around the credibility of the asset class's ability to achieve meaningful sustainability targets are increasing, weighing on the minds of investors and issuers.
- **Green** bond issuance decreased less than any other bond type in 2022, demonstrating resilience to challenging market conditions. **Social bond** issuance in 2022 was largely dominated by international public finance entities. These bonds were the only type for which issuance declined below 2020 levels in 2022.

Global GSSSB issuance forecast to reach $900 billion to $1 trillion in 2023

Annual GSSSB issuance by instrument type (US$B)



Excludes structured finance issuance.
F = S&P Global Ratings forecast; GSSSB = green, social, sustainability and sustainability-linked bonds.
Sources: Environmental Finance Bond Database; S&P Global Ratings.

Source: S&P Global (Mar-23)

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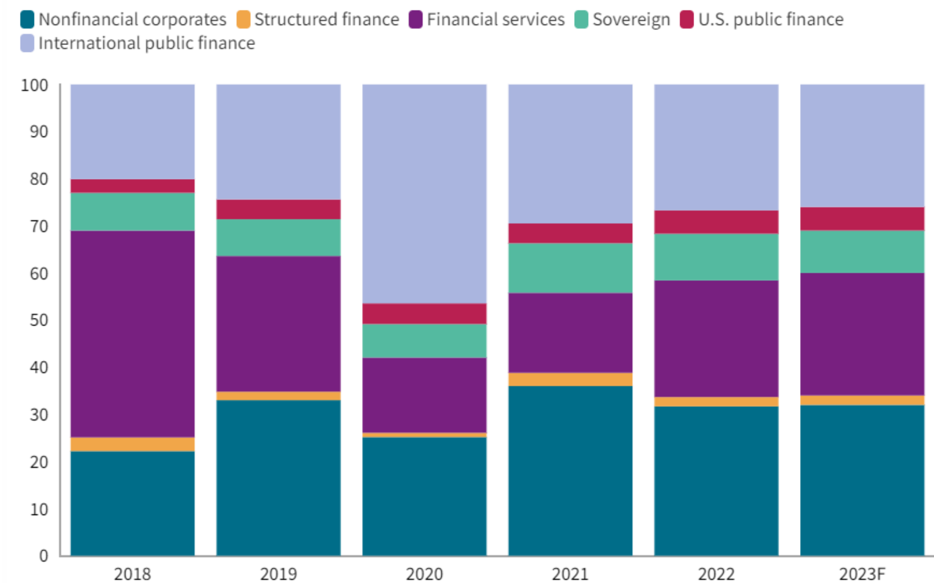
Green bonds will continue to set the pace

- S&P (Mar-23) anticipates that in 2023, **green bonds** will continue to drive the green, social, sustainable, and sustainability-linked bond (GSSSB) market. Issuers across sectors are likely to look to finance projects that allow them to align themselves with nationally determined contributions and individual net-zero commitments.
- As for **social bonds**, issuance growth will be the slowest among the GSSSB types in 2023. Tremendous growth in 2020 and 2021 was driven by local and national governments, as well as supranational entities. All looked to the capital markets to finance pandemic relief programmes. However, issuance contracted by -24% in 2022, largely because the need for pandemic relief financing tailed off. In 2023, S&P sees two trends that could drive growth in **social and sustainability bond** issuance.
  - The first is affordable housing, with more interest from public finance entities seeking social bonds to fund affordable housing projects as interest rates rise and housing stocks struggle to keep pace with demand.
  - Similarly, access to affordable finance has become increasingly difficult for many in the current economic environment. Financial institutions, including banks and non-bank lenders, are therefore exploring ways to secure financing that can support lending to underserved segments of the population through social bonds.
  - As issuers explore using GSSSB to finance these social projects, they may increasingly look to combine them with green financing. S&P considers this synergy to be a second possible growth driver because it could lead to increased issuance of sustainability bonds in 2023. For instance, issuers in the public housing sector may look to develop green social housing options. Banks, in addition, could look to combine access to affordable finance with existing green lending initiatives. Further, public finance and supranational entities may look to the sustainability bond market to finance more environmentally friendly social infrastructure such as schools, municipal buildings, hospitals, roads, and energy.

GREEN, SOCIAL, SUSTAINABLE, AND SUSTAINABILITY-LINKED BOND (GSSSB) GROWTH BY SECTOR

- S&P (Mar-23) said that in 2022, most sectors contracted. Non-financial corporate issuance led the decline, down -28% year-on-year. However, issuance in the financial services sector increased by +14%.
- In 2023, S&P (Mar-23) anticipates a return to growth in all sectors. It forecasts each sector will grow at least in line with, and in many cases exceed, the expected respective growth in overall bond issuance. S&P said financial services look poised to grow the most in 2023, increasing their share again this year. Non-financial corporate issuers, meanwhile, should continue to be the leading contributor to GSSSB issuance.



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Taking a look at each in turn:

- **Non-financial corporates.** S&P (Mar-23) anticipates a return to growth for the non-financial corporate sector in 2023 partly because of the growing maturity of issuers' sustainability funding strategies. However, there are likely to be continued challenging market conditions generally. For example, GSSSB issuance levels may remain tempered by the trade-off between the speed to market offered by standard bonds and the additional resources and time required to bring a sustainable bond to market. Non-financial corporate issuers saw the largest contraction in GSSSB issuance in 2022, down -28% compared to 2021. Another constraining factor in 2022 was limited expansion toward smaller issuers. Such issuers may face challenges to provide historical sustainability indicators and confidently track them going forward. In 2023, the non-financial corporate category should see more diversification in terms of sector, geography, and size of issuers.
- **US public finance.** For 2023, the share of GSSSB issuance as a proportion of overall US public finance issuance will likely reach a range of 13%-15%. Challenges, however, are likely to endure. The US municipal market's smaller and more fragmented nature makes it difficult to measure any pricing advantage for GSSSB issuance. At the same time, S&P expects that GSSSB issuance may be tempered by some issuers and investors preference not to offer or invest in bonds falling under the label of GSSSB. This could hinder growth. Finally, while progress toward disclosure of best practices or post-issuance regulatory guidance may help bring clarity to the market and solidify demand from certain investors, there are drawbacks. Stricter rules in these areas could sideline some potential GSSSB issuers if they would be burdened with additional financing costs or disclosure expectations.
- **International public finance.** Supranational agencies and multilateral lending institutions (MLIs) comprise the bulk of GSSSB issuance in the international public finance sector, along with government-related entities. After record issuance in 2020 and 2021, led by social and sustainability bonds, issuance contracted by -26% in 2022. Health problems and economic fallout associated with COVID-19 drove issuance in 2020 and 2021. The need for financing pandemic relief receded in 2022. S&P expects national government related entities such as the French social security fund Caisse d'Amortissement de la Dette Social (CADES) to modestly increase labelled issuance.
- **Structured finance.** S&P does not expect structured finance issuance to materially increase in 2023. However, issuance in the GSSSB segment should be relatively stronger than the -7% decline it forecasts for total structured finance issuance in 2023. GSSSB issued by structured finance issuers contracted by -39% in 2022 from a year earlier. S&P thinks the electrification of light vehicle fleets will likely fuel growth for green collateral that can be securitised. Solar equipment and energy efficient commercial and residential properties should also see from growth in collateral that can be securitised. However, while progress has been made, challenges that are slowing issuance of sustainable securitisations continue. These challenges include a lack of sustainable collateral originations and the absence of standardised ESG data, disclosures, and definitions.
- **Sovereigns.** A continued policy focus on climate resilience in 2023 will likely support modest growth in sovereign GSSSB issuance compared with 2022, particularly for EU states. This is largely in line with preliminary expectation for gross sovereign long-term commercial borrowing this year. Sovereigns issued -28% less GSSSB in 2022 compared with 2021. This was largely in line with an overall reduction of -18% in sovereign borrowing. The EU accounted for nearly 50% of sovereign GSSSB issuance in 2022. Outside the EU, the UK (10%), Chile (9%) and Canada (5%) were the largest sovereign issuers of debt labelled either green or social in 2022.
- **Financial services.** The financial services sector will continue to expand GSSSB issuance in 2023. Banks, insurers, and other financial institutions are still increasing transparency around their sustainability strategies. Many are working toward implementing net-zero ambitions and Paris-aligned targets. In 2022, financial services issuers were the only issuer type to have increased bond issuance volumes year-on-year in 2022. Their total issuance value reached nearly US$215bn in 2022, a +14% increase. S&P expects that use-of-proceeds bonds will continue to be the most prevalent form of GSSSB from financial services issuers. This is because increasingly demanding regulatory environments should allow banks to quickly identify sustainable assets in their portfolios that can be financed using such bonds.

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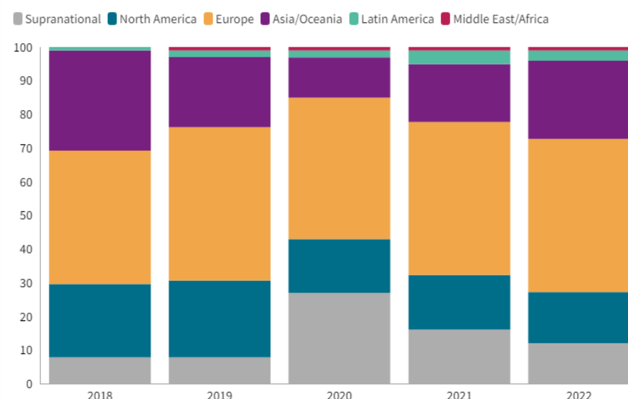
DRIVERS AND TRENDS

KEY DRIVERS BY REGION

- S&P (Mar-23) expects Europe, the Middle East and Africa (EMEA) to retain the leading share of issuance across regions. However, Asia-Pacific and Latin America look likely to continue increasing their share of global issuance as they have done in recent years.



Source: S&P Global (Mar-23)

- **Asia-Pacific.** S&P (Mar-23) anticipates that green, social, sustainable, and sustainability-linked bond (GSSSB) in Asia-Pacific (APAC) will grow +20% in 2023, outpacing other regions. In 2022, the market for GSSSB in APAC maintained momentum, with issuance up by +10%. In addition, its share of the global GSSSB market increased to 23%, up from 17% in 2021. The region proved more resilient to global macroeconomic uncertainties than others.
- In terms of GSSSB growth in 2023, APAC starts from a lower existing base. However, there is also growing awareness of calls for sustainable economic development across the region, especially regarding decarbonisation. China, South Korea, and Japan will drive the region's issuance, in S&P's view. Some other countries are starting to catch up. The continued development of local regulations will also instil discipline and credibility into the GSSSB market. This could potentially lead to additional issuance in some places.
  - Citing S&P, ESG Business (Jun-23) said China, South Korea, and Japan, will remain the dominant GSSSB issuers in APAC due to the size of their economies and established issuer and investor bases. These countries have accounted for 70% to 80% of the region's issuance for the past five years. Other markets, including Australia, India, Indonesia, and Malaysia, are slowly catching up with North Asia's GSSSB issuance volumes. India's government plans to add 450 GW in capacity for renewable electricity generation by 2030, which is expected to drive GSSSB issuance in the country. Australia's government has made a stronger commitment to reducing carbon emissions, and funding needs for clean energy projects are growing, which could lead to more green bond issuances. **Green** bonds will continue to dominate GSSSB issuance in APAC, accounting for nearly half of the overall volume, with climate mitigation investments, such as renewable energy, green buildings, and energy efficiency, accounting for two-thirds of volumes. **Sustainability-linked bonds (SLBs)** could be a source of growth in the region. However, they will face challenges in 2023, as investors increasingly question issues surrounding the ambitiousness of targets to effectively address sustainability issues (refer to 'Investor scepticism around sustainability-linked bonds (SLBs)' under 'Challenges' below).
- **Europe, the Middle East and Africa.** Europe is expected to retain its leading share of issuance in 2023. In addition, there is likely to be a strong pipeline of issuance coming from the Middle East in 2023. GSSSB issuance from EMEA continued to lead the way among global regions in 2022. However, some ground was lost as issuance in the Middle East and Africa slowed significantly. **Green** bonds in the use-of-proceeds category will continue to lead issuance in EMEA in 2023, driven by the focus on credible net-zero plans by issuers, the European Central Bank's intent to green its bond-buying programme, and the implementation of the EU Taxonomy and EU green bond standards.
  - The National News (Feb-23) adds the market for **green and sustainable bonds and sukuk** in GCC economies set a record in 2022 amid increased participation from banks and government-related entities, according to data from Bloomberg's Capital Markets League Tables. Total GCC **green and sustainable bond and sukuk issuances** reached US$8.5bn from 15 deals in 2022, compared with US$605m from six deals in 2021. Saudi Arabia was the leading issuer within the region, accounting for more than half of the total volume, with the UAE accounting for the remaining issue volume.

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- **North America.** A return to GSSSB issuance growth is expected in North America, as economies in the region begin to recover in the second half of 2023. Non-financial corporate issuance in particular may rebound, and issuance volumes will likely increase to new highs as entities look to take advantage of tax credits offered by the Inflation Reduction Act. Issuance of GSSSB in North America contracted by -22% in 2022. This was because of rising interest rates and investor scepticism toward the effectiveness of sustainability-linked bonds (SLBs). US municipal issuers have demonstrated resilience in the face of wider bond market headwinds, and S&P expects this trend to continue in 2023. There is sizeable demand for GSSSB bonds in municipal markets. Canada issued its inaugural sovereign green bond in early 2022. Meanwhile, some high-emitting corporates in the country are in the process of developing transition bond frameworks. This could increase non-financial corporate GSSSB issuance in the region.
- **Latin America.** S&P anticipates that 2023 will see a return to growth for GSSSB in Latin America. At least one-third of all bonds issued in the region are likely to be labelled as GSSSB. Latin American GSSSB issuance contracted -48% in 2022 year-on-year. While this contraction was more pronounced than in other regions, the asset class held up well relative to the -60% contraction experienced in total bond issuance in the region. Financial institutions, meanwhile, should gradually increase participation in the GSSSB market. A number of large banks in the region are likely to set interim greenhouse gas emissions reduction targets and decarbonisation agendas for their lending and investment portfolios before the end of 2023.

POLICY, REGULATION AND TRANSPARENCY INITIATIVES SHOULD DRIVE GSSSB ISSUANCE OVER TIME

- S&P (Mar-23) says the impact on investor demand and issuer appetite for green, social, sustainable, and sustainability-linked bond (GSSSB) from sustainability-related policies, regulations and transparency initiatives will be mixed in 2023. Development and implementation in these areas is likely to gather pace globally over the next few years.
- The Inflation Reduction Act, which passed in the US in August 2022 is already driving issuance. However, EU initiatives such as the EU Taxonomy and the EU Green Bond Standard are unlikely to significantly influence issuance levels in 2023. This is because S&P thinks most issuers are likely to continue to follow the International Capital Market Association (ICMA) principles.
- Over the next five years, regulatory initiatives could be a key driver of whether the GSSSB market grows. National directives on electric vehicles or national building standards, for example, could provide direction or signals for further sustainable finance flows. The content of initiatives could inform corporate and government decisions on financing research and development, infrastructure projects, and plants and equipment.
- The US Inflation Reduction Act, for instance, could further boost GSSSB issuance in the US by incentivising certain corporate behaviour. It can do so through mechanisms, such as tax credits, that encourage investment in green projects, particularly in the energy sector.
- Transparency initiatives, such as the EU Taxonomy, will drive issuers to take stock of the impact of their activities on the environment and related risks. Understanding and reporting on issuers' environmental profiles may help reduce the burden of pulling together this information for GSSSB issuances, which in turn could facilitate future issuance.
- Reporting requirements for investors, such as the EU's Sustainable Finance Disclosure Regulation (SFDR), are also spurring demand for credible sustainable bonds and investments. The effects of this regulation could be felt beyond the EU. Issuers looking to broaden their investor base may voluntarily adopt these reporting standards and practices. Doing so would make it easier for Europeans to invest in their sustainable bonds.

CORPORATE BONDS FOR ENERGY SECURITY

- As the energy transition gains traction, BNP Paribas (Feb-23) says there are many opportunities for companies to use green, social and sustainable (GSS) bonds to help raise the capital needed, particularly in carbon-intensive sectors.
- The energy, building and transport sectors are large use-of-proceeds bond issuers. For example, Dutch-German grid operator Tennet launched a €3bn green bond in October 2022 for its onshore grid to increase the transmission of renewable energy.
- As part of efforts to decarbonise its corporate bond portfolio, the European Central Bank has said it would give **green bonds** preferential treatment in its primary market. If other central banks were to take a similar stance, this could encourage companies to issue more green bonds.
- Moody’s said that the energy crisis has increased the prospect of greater long-term sustainable debt issuance to finance Europe’s energy transition as the region seeks to move away from reliance on Russian fossil fuels. To accelerate such a shift, significant amounts will need to be invested in infrastructure.

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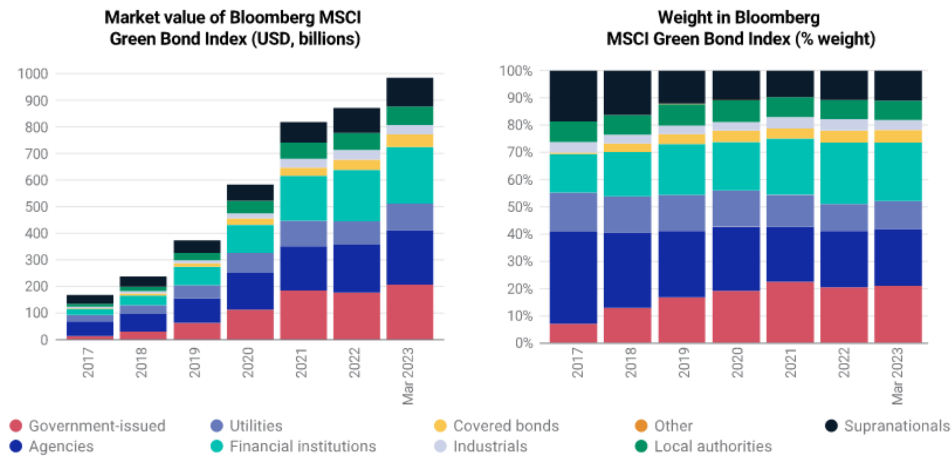
GOVERNMENT ISSUES

- According to MSCI (Apr-23), with the expansion of the global **green**-bond market, there has been a notable rise in the share of green bonds issued by governments. Bonds issued directly by government departments have risen from approximately 7% of the US$167bn total market value on 31 December 2017, to over 20% of the US$986bn market on 31 March 2023.

The growing share of government-issued green bonds

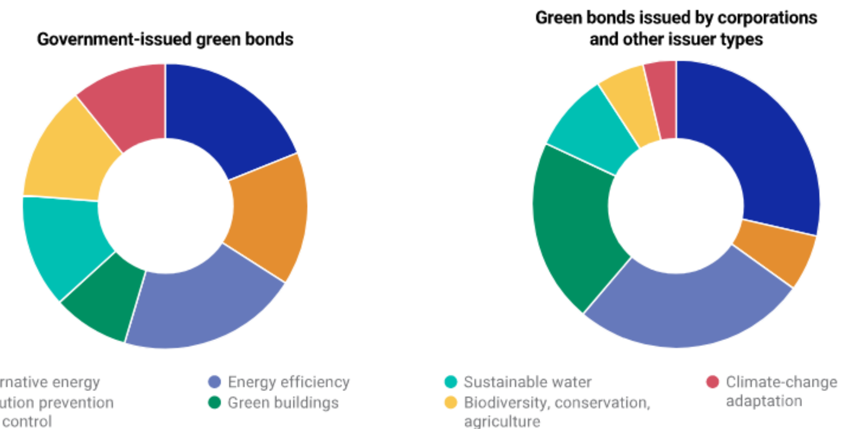


Dates represent Dec. 31 of each stated year, except for 2023, where the data is as of March 31. "Government-issued" bonds refer to all sovereign issuance, as either local-currency sovereign bonds or hard-currency sovereign bonds. Source: Bloomberg MSCI Green Bond Index, MSCI ESG Research, MSCI's

Source: MSCI (Apr-23)

- Governments have become noteworthy green-bond issuers, in part because of the state's unique role in spearheading climate-transition projects (e.g. large-scale national infrastructure).

Government-issued green bonds finance a broad mix of projects



Source: MSCI (Apr-23)

GREEN, SOCIAL, SUSTAINABLE, AND SUSTAINABILITY-LINKED BOND (GSSSB) MAY CONTRIBUTE TO FINANCING ADAPTATION AND RESILIENCE

- S&P (Mar-23) believes COP27 in November 2022 emphasised the need for more investment in adaptation and resilience to the physical risks of climate change. The GSSSB market could contribute to answering that call from the UN Climate Change Conference.
- The focus on adaptation and resilience is likely to increase, and interest should trickle down from the public sector to the private sector. This interest could be a source of growth for the GSSSB asset class in 2023 and beyond.
- However, the adaptation finance market faces several challenges, including long time horizons for realising benefits. In fact, actual investment in adaptation finance has lagged the needs identified by the UN. It represents less than 8% of global climate finance, according to the Intergovernmental Panel on Climate Change, and less than 4% of climate-related GSSSB issuance. Further challenges include identifying benefits and cash flows, and the potential for mismatch between those financing projects and those who benefit from them.

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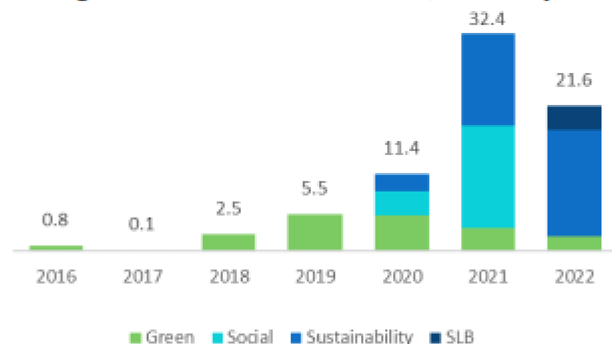
- S&P expects the public sector to remain the leader in financing adaptation and resilience. That said, there are signs that adaptation and resilience are increasingly on the radar of the private sector. Multilateral lending institutions will continue to explore and scale up the use of blended finance. Such finance uses funds for public development to mobilise additional commercial capital, primarily from private sources, to help achieve sustainability goals. The institutions may bolster risk-sharing facilities, particularly in low- and middle-income countries that could attract further private capital via GSSSB issuance. Blended finance may make institutions looking to invest private capital more confident about deploying it in developing countries.
- S&P goes on to say some corporate sectors, such as the building sector, could begin to embed adaptation and resilience into their issuance more clearly. Doing so could help support projects that boost the resilience of their assets. For example, there are instances of corporates looking to raise funding to invest in building materials or manage supply chain risk in areas where they have faced significant costs from climate impacts such as flooding and heat stress. In addition, there are examples of private equity firms and large institutional investors entering the fray.

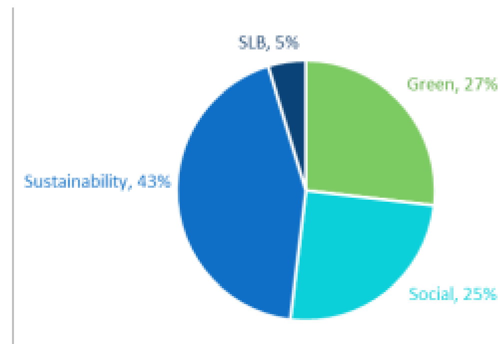
EMERGING MARKETS

- According to the World Bank (Dec-22), Since 2016, 19 emerging market (EM) sovereigns have issued GSS bonds for a total of US$74bn, representing 2% of total GSS bonds issued globally. In 2022, EM sovereign issuances declined by -33% to US$21.6bn compared to 2021.



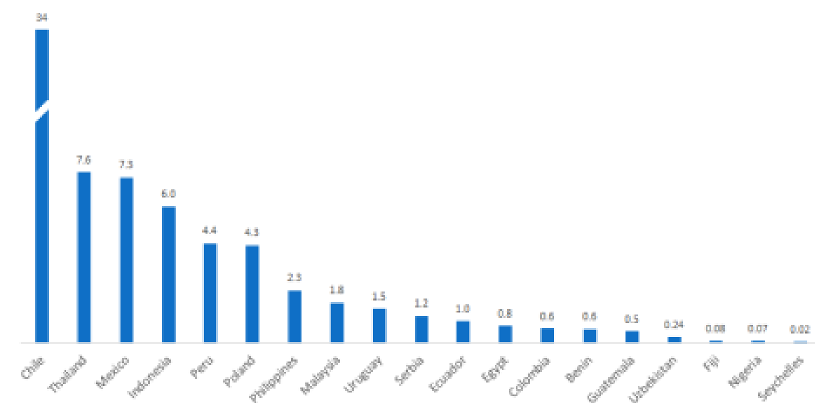
Source: World Bank (Dec-22)

- Unlike advanced market sovereigns, which still demonstrate a strong preference for green bonds (representing 94% of their total amount issued), EM sovereigns are issuing **more sustainability bonds** (43% of their total amount issued). Sustainability bond portfolios include projects with positive environmental and social returns. In 2022, Chile and Uruguay issued the first sovereign sustainability-linked bonds.



Source: World Bank (Dec-22)

- The World Bank says that among the EMs, Chile remains the largest issuer with US$34bn issued, followed by Thailand with US$7.6bn, and Mexico with US$7.3bn, as of December 2022.



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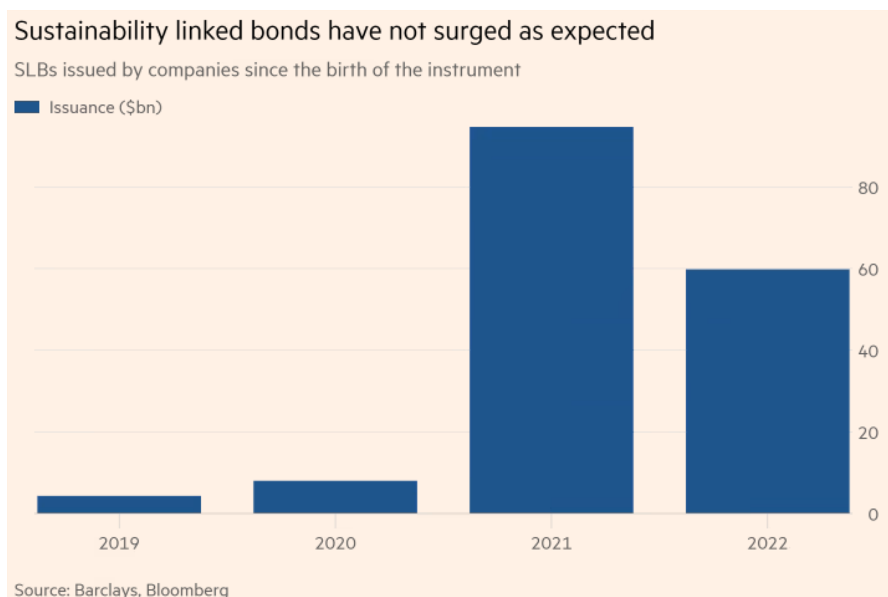
CHALLENGES

INVESTOR SCEPTICISM AROUND SUSTAINABILITY-LINKED BONDS (SLBS)

- The FT (Feb-23) reported the market for sustainability linked bonds (SLBs) is flagging, as investors worry that the debt does not impose sufficiently stringent penalties on companies for missing their climate targets.
- The FT says that, in practice, the "step-up" in coupon payments embedded in the bonds' terms have been too small to provide much incentive to issuers to clean up their act. Meanwhile, some environmentally conscious investors simply do not want to hold debt issued by companies at risk of reneging on their green promises.



Source: FT (Feb-23)

- A symptom of market dysfunction for some is that SLBs have not so far benefited from the elusive "greenium" - a lower borrowing cost that companies hope to achieve when they issue bonds with a sustainability label.
- Esma, the financial sector regulator for the EU, warned that SLBs could be considered a "free lunch" for issuers, for example because of the widespread use of call options, which means issuers could recall a bond before a step-up takes place, as well as low step-up rates.
- More step-ups could turn out to be a good thing if they give investors' confidence the market is capable of making issuers pay for climate failure. A recent Morgan Stanley report recommended issuers start setting goals that are trickier to meet, "otherwise the bond's impact is de minimis."

Sustainability-linked bonds (SLBs) reach an inflection point

- S&P (Mar-23) says that, to get back to growth in 2023 and beyond, issuers of SLBs will have to find ways to address concerns flagged by market participants about the credibility of SLBs, namely surrounding issuer ambitions and incentives to achieve sustainability targets.
- SLBs offer more flexibility than other types of green, social, sustainable, and sustainability-linked bond (GSSSB). This flexibility has led to the bond type being widely used by issuers which may have business models that are not suited to use-of-proceeds bonds. Companies in the consumer discretionary and healthcare sectors, and in hard-to-abate sectors such as industrials or materials, are among those that would find issuing green or social investments difficult.
- SLBs allow access to sustainable financing for those in this situation still wishing to participate in GSSSB markets. During the last two years, the market for such bonds has grown dramatically – issuance volume has grown seven-fold since 2020, reaching a total of US$70bn. SLBs accounted for 9% of GSSSB global issuance during their 2021 peak.
- Returning to growth is now the challenge for issuers. In 2022, SLB issuance levels dropped significantly, by -25%, compared with 2021. This was in large part due to difficult market conditions for non-financial corporates. They have represented about 90% of SLB issuers in recent years. However, increasing scrutiny from stakeholders such as investors and policymakers on the credibility of the asset class – that is, whether SLBs help companies achieve meaningful sustainability targets also contributed to the decline.

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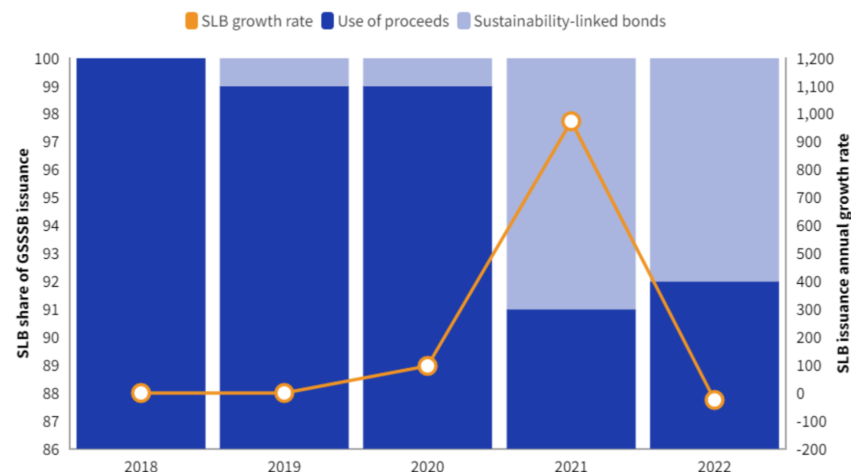

Source: S&P (Mar-23)

IMPACT WASHING

- The Harvard Business School (Aug-22) says that, while sustainable debt investing has clear social and environmental benefits, its growth has led to the rise of a phenomenon known as "impact washing."
- Impact washing is the practice of embellishing or overstating a particular investment's positive impact. Without laws and proper regulation for sustainable investments, some bond issuers or fund managers exploit this trend by declaring assets, stocks, or bonds as green without backing up claims or guaranteeing results.
- Impact washing is not always done with malicious intent. When a company fails to measure its sustainability impact accurately, it can unknowingly mislead investors regarding its environmental or social impacts.
- Greenwashing is when a company claims business practices or products are sustainable when they are not. This is often done to garner positive attention and attract socially and environmentally conscious customers.
- Impact washing is similar to greenwashing but specific to the investment world. It is done to draw socially and environmentally minded people to specific investment decisions. Impact washing can be harder to identify than greenwashing, so it continues to be a real problem in the investment space.
- Some firms take advantage of this lack of legal governance to exploit the growing trend, labelling stocks, bonds, or other assets as sustainable or green without ensuring they'll be used for such purposes.

LACK OF ESG INFORMATION IN DEVELOPING COUNTRIES

- According to the World Economic Forum (May-22), the absence of Environmental, Social and Governance (ESG) information in most developing countries could hide potential opportunities, and add to the income bias in investment decisions.
- About 90% of a country's sovereign ESG score is explained by its level of development, and failure to account for this bias in investment decisions could potentially divert flows to higher income countries (HICs) at the expense of poorer countries. The drive for sustainability could give a new impetus to the long-overdue reform of credit and risk ratings, as well as the fight against impact-washing in HICs, that unduly distracts investors from emerging markets. The use of innovative financial and de-risking instruments, such as results-based rewarding mechanisms or blended finance, should be further explored.

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