Resetting the ESG Investment Paradigm to Support Emerging Markets & Developing Economies (EMDEs)

ESG investment paradigm impact on emerging market capital flows

The report focuses on the importance of ESG to investment policy and questions the extent to which an increased influence of ESG considerations could divert capital away from EMDEs. The study details several aspects of the current ESG investment paradigm that could impact how capital flows to EMDEs over the next five years. The report refers to these as the determinants of capital flows to EMDEs.

Data

Determinant: The availability of extensive and comparable ESG data for EMDEs will have a significant bearing on investment flows.

Impact: ESG data gaps and inappropriate screening methods are set to increasingly divert capital from EMDEs.

Regulations

Determinant: Regulators in developed markets are ramping up ESG disclosure regulation.

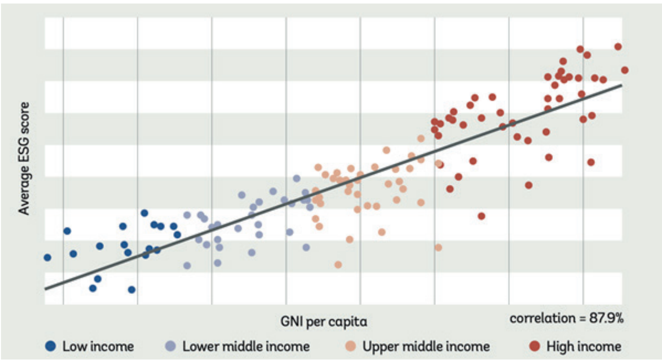
Impact: Increases the compliance costs and risks associated with investing in EMDEs.

Identifying the ESG investment challenge

ESG investing is being driven by a diverse set of stakeholders including governments, regulatory bodies, multilateral development banks, financial institutions and a raft of international non-governmental organisations. Given the lack of coordination between these stakeholders, the regulatory and data frameworks that underpin the current ESG investment paradigm are fragmented and challenging to navigate.

Under-representation of ESG investment in EMDEs: ESG mainstreaming will exacerbate the under-representation of EMDEs in global capital markets. The report assesses the role of (i) an ingrained income bias, whereby wealthier countries have higher ESG scores (see graph on right), (ii) extensive ESG data gaps in EMDEs, and (iii) a myopic focus on metrics on which many EMDEs score poorly (for example, territorial GHG emissions, which do not account for emissions embodied in imported products).

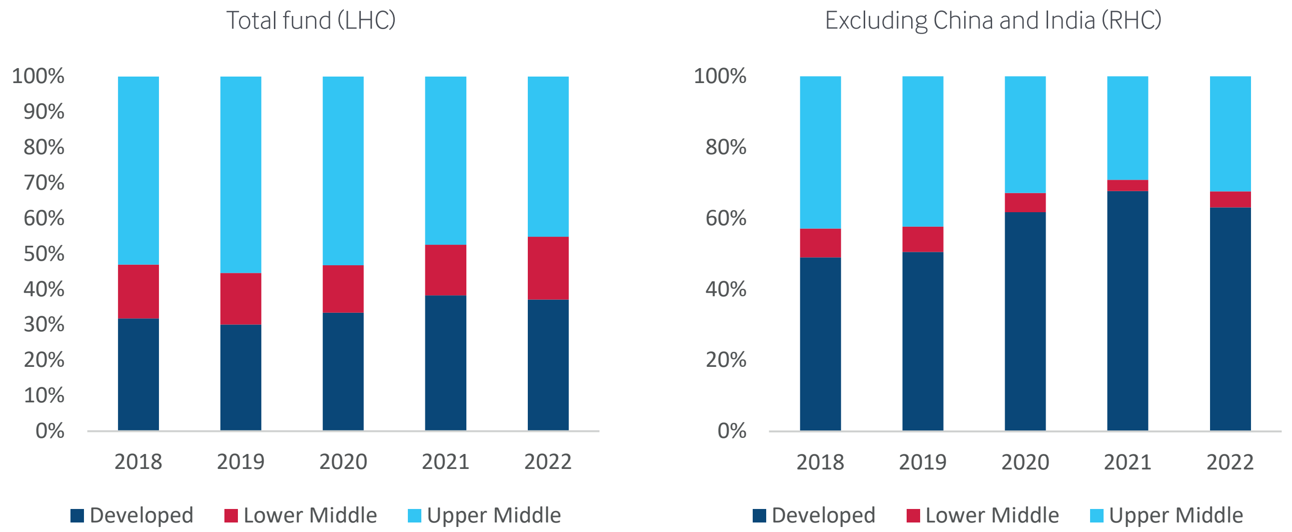
Sovereign ESG scores and per capita Gross National Income (GNI)



Note: Sovereign ESG scores for each country are an average of seven ratings providers.
Source: World Bank, JP Morgan

Pressure mounts on assets with weak ESG scores: The report finds some indicative evidence that ESG mainstreaming can reduce flows to EMDEs as growing pressures mount on asset managers to exclude assets with weak ESG scores. In 2018, the MSCI EM ESG Leaders fund allocated 68% of capital to countries classed by the OECD as EMDEs, a share that declined to 63% in 2022. Excluding China and India, the decline was starker still, falling from 33% in 2018 to 22% four years later.

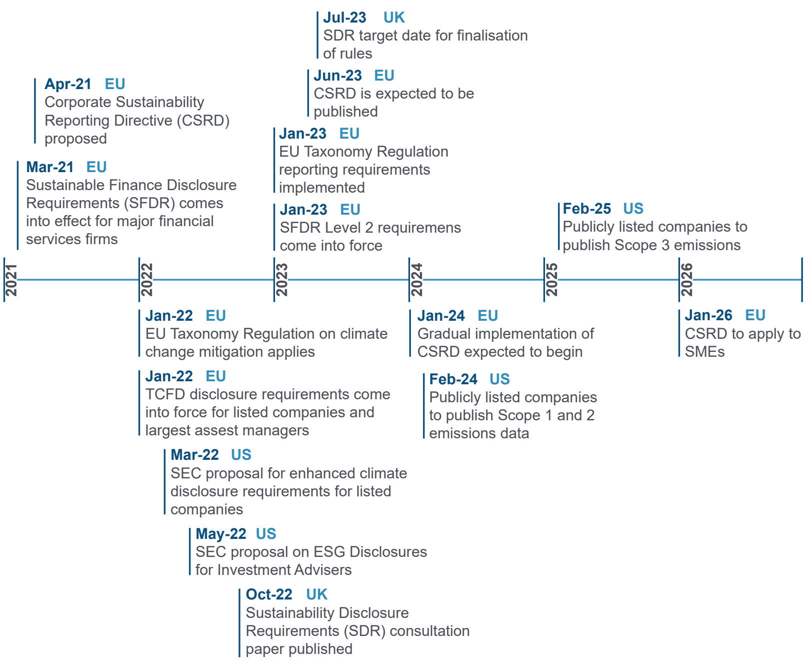
MSCI EM ESG Leaders equity fund - % Allocation by country category



Source: MSCI, Bloomberg, Fitch Solutions

New ESG regulations to impact global capital flows: The risk of capital diversion away from EMDEs will grow due to the planned introduction of more stringent ESG regulations over the next 3-5 years. In particular, proposed regulations in the EU and the US are set to make it more difficult for firms to invest in those EMDEs with weak ESG scores or poor disclosure records. These regulations include the EU's Sustainable Finance Disclosure Regulation (SFDR) and the US SEC's Climate Disclosure Bill, which are discussed in the report.

Timeline: landmark ESG regulations in the EU, the US and the UK



Mitigating capital diversion from EMDEs through changes to the ESG investment paradigm

In some cases, EMDEs are pioneering their own pathways to navigate ESG mainstreaming. Solutions described in the report have been chosen on the basis that we believe they could be scaled and possibly replicated to address the ESG determinants of capital diversion from EMDEs.

- **Adapting market disclosures and frameworks:** The localisation of frameworks allows local contexts to be applied, as illustrated by the ASEAN Taxonomy for Sustainable Finance, which has a multi-tiered approach to classifying sustainability activities, and makes greater allowance for the specific economic development of the 10 ASEAN members.

ASEAN Taxonomy – Traffic light classification of activities

Green
- Clearly contributes to or enables climate change mitigation

Amber
- Contributing to decarbonisation, but mitigation of collateral harm to environment is required

Red
- Does not contribute to or enable climate change mitigation

Source: ASEAN Sustainable Finance Taxonomy

Working with local development banks on bond issuance: BOAD, the regional development bank of the member states of the West African Economic and Monetary Union (WAEMU), paved the way for inaugural green and sustainability bonds in Benin and Togo. Similarly, the Inter-American Development Bank (IADB) worked closely with Uruguay's Ministry of Economy and Finance to construct a Sustainability-Linked Bond Framework, which creates incentives for Uruguay to perform strongly on important environmental performance metrics, such as reducing aggregate gross GHG emissions and maintaining native forest areas.

Encouraging local companies to improve ESG disclosure: The Stock Exchange of Thailand (SET) has showed that incentives can be used to increase ESG disclosure. Before ESG reporting was made mandatory for listed companies in 2021, SET launched the SETTHSI, a sustainability-themed index, which was used by institutional investors to guide investment decisions.

More can and should be done to mitigate the risks of capital diversion and ensure that EMDE perspectives shape the global ESG debate.

Solution Category	Recommendation
Market Regulations	• **Regional EMDE political and trade blocs** should create localised frameworks with a tailored taxonomy that can apply to a group of countries that represent a large enough share of the global economy for global regulators and investors to take notice. • **Regulators** in EMDEs need to make their voice heard in ongoing international consultations on reforms to ESG regulations. • **EMDE stock exchanges** should encourage firms to improve data disclosure by highlighting the potential investment that such disclosure can attract.
Data & Screening Frameworks	• **Investors** and **data providers** should assess company and country performance in terms of their momentum and transition rather than using current and backward-looking data • **DFIs** and multilateral organisations should provide technical assistance and expertise in the construction of GSSS bond frameworks
Unlocking Investment Opportunities	• **Private equity** funds should use public equity markets, particularly markets based in developed economies to raise new capital that could be directed to a portfolio of ESG-focused investments in EMDEs.