Summary of the side event

"Environmental Social and Governance (ESG) Debt Instruments to Finance Sustainable Investments"
(March 9, 2022)

I. Inauguration

The objective of this event was to analyze, from the perspectives of the public and private sectors, the role that thematic or ESG bonds can play in financing sustainable development and strengthening corporate governance structures through better risk management.

The document *"Corporate governance in Latin America and the Caribbean: using ESG debt instruments to finance sustainable investment projects,"* which has a focus on the development of the corporate market for international sustainability-linked bonds and the role of corporate governance in companies' reporting based on ESG criteria, was launched during the event.

ECLAC, together with the different United Nations agencies, seeks to promote the 2030 agenda and the SDGs, with a view to creating a sustainable development model in line with a new development paradigm that incorporates the three pillars of sustainability: social, environmental, and economic, with transparency and accountability by all actors.

The incorporation of ESG criteria in financing not only focus on the return on investment, but also, and from the point of view of governments, the correct use of public money. The use of ESG debt instruments represents an innovation that introduces new possibilities to align the work of all economic and corporate activities with those of the government.

In her welcoming remarks, the representative of GIZ–Mexico, Marita Broemmelmeier, emphasized that in these challenging and uncertain times, a sustainable and inclusive recovery from the ongoing COVID-19, economic and climate crises is required, with viable and lasting solutions that demand financing. The development of innovative financial instruments that can provide certainty, clarity, and transparency to market investors, and reduce the risk of bad practices, requires cooperation between the public, private, and financial sectors. Applying international recommendations and standards to identify, measure and mitigate the impacts of climate change risks on the operations of financial and non-financial companies, open the way to sustainable innovations. *"Sustainability-linked bonds give very good results, the most essential thing is to recognize that there is a climate urgency that requires a firm alliance and action between governments, the private sector and the financial sector."*

II. Presentation of the document

The presentation of the document highlighted the following elements:

1) In the path towards more sustainable development models, the countries of the region are exposed to transition risks, which become more complex once the productive structures are expanded and demand more financing, especially in the context of the commitments to reduce

climate risks (Paris agreement 2015 and COP 26) and fulfil the Sustainable Development Goals (SDGs) and the agenda 2030.

2) LAC sustainability-linked bond (SLB) issuances in international markets grew exponentially over the past year. The SLBs, unlike green, social, and sustainable bonds, are linked to sustainability targets defined by the issuer. The issuer's performance is then monitored through key performance indicators (KPI), to see whether the chosen target has been reached. These bonds help the issuer to be on a sustainable trajectory in accordance with its sustainability framework.

3) In 2021, LAC international ESG bond issuances grew even a little more than the world average and the SLBs became the most used ESG debt instrument in the region. Brazil, Mexico, and Chile accounted for 95% of total LAC international SLB issuances. Most issuances came from the transportation sector (including auto parts and truck equipment), forestry and paper, and food and beverage.

4) From a corporate governance and risk-management perspectives, the document analyzes the impact of SLB issuances on business strategies, including how to measure and deal with the impact of corporate activities on climate-risk and sustainability.

5) A sample of six companies that have issued SLBs in international markets were selected. They came from the top three SLB issuers in the region: Brazil (60%), Mexico (28%) and Chile (8%), and from the top three sectors: Transportation (26%), Forestry and Paper (23%) and Food and Beverage (22%).

6) The analysis highlights the absence of a clear agreed framework for reporting, measuring, and comparing the climate impact of corporate activity, as well as of benchmarks. For example, the comparison of some of the KPIs is not quantifiable, comparable, or externally verifiable. The historical data of the companies is often not reflected in these KPIs. While companies may choose the same KPIs as their peers in a given industry, their metrics vary widely. Due to this lack of harmonized metrics, companies may adjust their KPIs to the scope of their operations or business models, reducing comparability. More significantly, for many of the chosen KPIs, no international target has yet been set.

7) It is important to accelerate ESG criteria standardization at the sectoral and company levels so that these SLB issuances and sustainability targets can be comparable among industry peers. It is also important to create a taxonomy for sustainable activities to find a common language that allows for transparency in the disclosure of ESG information, to increase trust in these types of financial instruments on the part of markets and investors.

III. Panel discussion

In the panel discussion, the panelists – Mr. Mario Marcel, Minister of Finance of Chile, and Ms. Denise Pavarina, Vice President of the Task Force on Climate-related Financial Disclosures (TCFD) – were asked two questions, one of a general nature and a particular question for each of them.

First question: From a public-private perspective, what would be some advantages and disadvantages of the issuance of this type of instruments, in particular sustainability-linked bonds and sustainability bonds based on the SDGs?

For Denise Pavarina, the **advantages** are clearly cost reduction for bond issuers when compared to traditional costs, and company brand recognition. They are based on the fact that once the company establishes its objectives and values, they will move in that direction. Which means long-term planning that can be arranged with a very long-term company fundraiser. Given the objective to achieve a low-carbon economy, it would be a very positive alternative not only for climate change, but also for the fulfillment of the SDGs. The **disadvantages** are on the market side, rather than on the companies' side, because there is still a lot of work to be done. You can follow the goals that were set and corroborate at the same time whether the company has actually achieved the goals as it said it would. At the same time there are the companies that are going to certify the process. This means more work for the market.

For Mario Marcel there are two levels of **advantages**, the development of the ESG concept and its incorporation into the issuance of financial instruments is a great step forward with respect to previous experiences of corporate responsibility, because they allow to quantify more directly the ESG commitments of the companies and on the other hand give them a concrete economic value. These standards help to move the mainstream of how corporations work.

At the government level, they are both potential suppliers and buyers of ESG instruments. Suppliers as debt issuers and buyers in the investment in international reserves made by central banks or sovereign wealth funds held by countries. In that sense, society's demand for a greener economy is obviously valid not only for those who eventually buy the bonds that governments issue, but also for the investments that governments and central banks make.

Finally, the interface between these two dimensions is how far it is possible to reproduce in the ESG field the same logic of *market making* that governments often employ regarding the development of financial markets. That is, it is possible for governments to generate control *benchmarks* with which to compare certain *pricing* of private instruments or not. For the public sector it involves a greater challenge because in the case of conventional bonds it is true that it is simply the issuer's status in terms of its financial soundness, but in this case, we are talking about the issuance of bonds that are associated with ESG standards that involve more complex qualitative elements. The State would have a greater incentive to assume commitments and transparency in reporting on these commitments, to the extent that we believe that, in this second dimension, it also contributes to the development of these markets, since the issuance or acquisition of bonds by governments can meet these characteristics.

*Second question, to **Denise Pavarina**: From the perspective of corporate governance (CG), to better understand its role in the use of fixed income ESG instruments for financing, what is the importance of having an ESG corporate committee that analyzes the level of sustainability of the company and its coordination with the risk committee? and how important is the knowledge of the structure and role of the different entities that constitute it by the company?*

A: Different companies and different company sizes have different levels of maturity. If a timeline could be designed, the CG of smaller, less mature companies would have a very low level (or power) of articulation among the committees.

As we know, sustainability is about risk management, everything we talk about ESG has financial components, therefore, it should be included in the company's risk matrix. There are many components and there are also financial ones. As an example, when talking about ESG, hydronic stress is very easy to understand how it is measured, but also when a company has poor corporate governance and the company has poor results, or reputational risk, because sometimes companies don't do what they say they're going to do. In the bonds linked to sustainability, the company says that it has diversified its board and just do not know how to explain it. And people want some explanation, or they don't accept what they get and then they have some reputational problems.

Today I heard something that would really help to understand why ESG and risk committees should be very articulate. If they are separate, the tendency is to eliminate the messenger and the messenger is the ESG, because it brings the news to the risk committee to include in the risk matrix. In the governance model there is no ESG committee. ESG factors are integrated in all segments of the company, and everything would be reflected in the risk matrix because the values have been established, the company has already integrated it into corporate governance. Currently, it is still utopian to think about the existence of ESG committees, but in some years, these will be integrated. Some consider that in ESG committees it is very important to have someone who I monitored from the risk committee and also the other way around, this would make an important transfer of knowledge.

*Second question to **Mario Marcel**: Chile has been the most active country in the issuance of thematic bonds, ranking 15th in the world, first with the green and social bonds of 2019 and more recently with the bonds linked to sustainability. This raises two important issues: one, the development of a framework to establish how much to spend and know in more detail the projects related to themes linked to the national climate agenda such as energy efficiency or plans for the decarbonization of the economy and more recently, for example, the national green hydrogen plan and the valuation of these assets in the market and the determination of prices. This financial strategy currently represents more than US$ 26 million and about 25% of the total debt. What does this represent in terms of funding costs for the State?*

A: I believe that the case in which we have been able to measure more directly the financial benefit of all these issuances is that of sustainability-linked bonds, where we have a difference of 10 basis points. It has been more difficult to measure in the case of green bonds, because also the particular moment when the issuance takes place can make an important difference and in 2019, we had a lot of global and local volatility, so it has been a little more difficult to measure it, but in the case of sustainability-linked bonds we have two very consecutive issuances that make measuring that difference possible.

Along with that, I would like to highlight, apart from what can be very important projects, how governments or states can advance in terms of the measurements of a more global nature of indicators, which can be used to generate more specific indicators for projects and issuances.

In the case of Chile, the Central Bank in particular wrote a study and initiated an agenda in other areas that are particularly valuable for this. First, a study on issuances was updated, that is, the measurement of issuances by sectors using national supply chains, with which it is possible to measure the complete issuance of the entire production chain to the final product, which then allows aligning the incentives of the different actors that are in that chain.

The second thing is that we joined the natural capital committee created by the Ministry of the Environment to generate measurements, quantifications of natural capital using all the methodological advances that we have had in recent years that are very significant. I believe that in the coming years we will have a quantitative basis that will make it much easier to measure more limited actions but that have quality statistical support, in this case, by the Central Bank as well as by the statistical authority.

A question from the audience: Do you think that the financial system will change with the necessary urgency given the social environmental challenges of the continent? What has been achieved so far gives rise to optimism or pessimism?

Answer from Denise Pavarina: If there is any area that can bring together the entire economy is the financial system because it is there that information is disseminated and it makes companies look for information from the supply chain which will cause a great movement in the economy. For example, the Central Bank of Brazil, just launched a sustainability agenda, which is not only about climate change but about ESG criteria based on the pillars of the TCFD, and makes it mandatory, for financial institutions, to provide information based on the pillars of the TCFD. We know we're losing information, we don't have the standardized information, but this is a starting point. There are factors that must be taken into consideration, such as weather patterns for the "S" and "G", for which you can have many more standardized KPIs.

Answer from Mario Marcel: Chile's financial regulator, has also issued a number of rules on the matter. The financial regulator and the Central Bank are both members of the Financial Stability Board (FSB), where multi-national projects are being disseminated and developed. At the same time, new players are emerging in the financial sector and competition is very intense, with things clearly moving in the same direction. Moreover, in the current conjuncture, in which financing costs are rising, due to the beginnings of monetary normalization in many countries, particularly in developed economies, one of the opportunities that countries that issue debt have to moderate this escalation of costs is precisely to issue bonds with these ESG characteristics. So, several conditions are given for this process, which already had an important trend, to accelerate in the coming years.

Comment from Mario Cimoli. <u>Standardization</u> seems to me a fundamental issue, there is however a worrying price problem with recent events. At a certain moment, Europe's substitution process and an important impact on the companies' productive processes to replace CO_2, implied a situation and a context of issuances of a certain type. After a year we have a completely different event, which is the war in Ukraine, which generates an external shock that continues to rise and alter world energy prices in an important way, with a barrel of oil and gas reaching worrying price levels with substitution or non-substitution process. *In a context like the current one, how do you* *promote standardization and bond comparison?* Because it does not only affect a company or a sector. If you think of the productive sectors as a single production function, issuing a single bond, of a single type is enough. But if you think of an economy where there is not only a production function, but where there are many sectors and each of them with different contexts due to their particularity and different production processes, with the impact of the oil price shock, mechanisms that hinder standardization are generated, so how can standardization in the evaluation of sectoral yields be sustained?

Another issue that has not yet been discussed and that is important for the issuance of bonds is that of a regional agreement on regional sovereign biodiversity bonds. This would allow the State not only to build capital but to have a process that guarantees the evolution of a deeper degree of diversification in biodiversity. Sovereign bonds that when placed on the market allow two things: financing and, on the other hand, conserving the heritage of biodiversity.

Denise Pavarina: At the TCFD there has been a lot of discussion about the first topic, on how to deal with the differences in sectors and countries. All the analyses are done cross-sectionally, so you can't compare one industry to another, you can't compare oil to another industry, you don't go anywhere with that approach. If you talk about climate, especially climate change, it doesn't affect people equally. Despite investors' aversion, the TCFD recommends looking at it differently in different regions. For example, in South America there is a certain energy matrix and in Europe there is another, and so on. Also, the KPIs must be by industry and region, it cannot be assumed that these are for everyone.

Mario Marcel: About the first topic, when there are events of this nature, of course they will generate a mess in prices. Where there are more developed markets, one can see from the yield curve where an event of this nature is hitting. Here we don't have markets that are so developed as to be able to build the equivalent of this with respect to bonds with and without ESG targets. Today, the aim is to better align economic objectives with environmental ones. Price movements are pointing more or less in the same direction, which should be reaffirmed on the subject of risk. Fuel prices, in particular fossil fuels, are especially sensitive to episodes of instability and therefore it is true that progress in terms of diversification of the energy matrix towards renewable energies generates less dependence on fossil fuels and also allows to reduce the impact of this type of situation that we have had other times.

Regarding the second point, one of the challenges in the case of natural capital and any type of instrument linked to the protection of diversity is that it requires a considerably greater quantitative methodological effort. The Central Bank was thinking about how to structure a strategy to advance in the measurement of natural capital. It can be taken as a starting point, a geographical area and can be done differently for certain components of natural capital. It is important to consider different experiences, since there is a risk of protecting one dimension of natural capital and unprotecting another, as we know systems are interrelated.

IV. Conclusions of the event.

1) ESG factors are management and risk reduction criteria.

2) ESG factors impact monetary performance, which is critical for the company, thus ESG materiality is important for mainstreaming. It is in the interest of companies to avoid greenwashing.
3) The financial system has advanced a lot in terms of ESG considerations and will continue to advance further since it is in its interest, but advocating for public policies and a culture change towards sustainability is also necessary.
4) The green and sustainable assets that the market requires must continue to be created, and that is not only a function of the financial system but also of companies and governments.
5) Generating good ESG indicators and developing taxonomies are important challenges. Taxonomies can help generating indicators by economic activity, but they need to be flexible to renew its parameters whenever necessary, because ecosystem dynamics (social, corporate, and financial dynamics) can lead to a situation in which an indicator, after a few years, no longer represents what it used to represent.