ESG’s undeniable influence on investment in Latin America

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Introduction

In Latin America, concern for environmental and social issues is high and made more urgent in the Coronavirus era. Scarcely a day passes without newly issued statistics, a newly created ESG (Environmental, Social and Governance) index, investor groups weighing in, or a domestic or international political initiative in the area.

ESG is a complex topic, raising a broad range of issues. In Latin America, a number of these issues are centered on ESG investment. With the region demonstrating the strongest demand for ESG investment globally and an influx of public and private investment to aid in rebuilding economies after the COVID-19 pandemic, raising capital in the form of ESG bonds, green loans, and other similar instruments, is not only compelling to investors, but essential for the development of the region.

What is ESG?

ESG is the consideration of environmental, social and governance factors as a way of looking at the long-term sustainability of an entity, alongside backward looking and more short-term financial metrics. How ESG considerations impact an entity or investment opportunity depends on many investor-, entity-, industry-, country- and region-specific factors:

Environmental: How is an entity performing as a steward of the natural environment, including with respect to energy consumption, water management, pollution, and other material issues? Issues include climate change, protection of natural resources, development of renewable and/or low carbon energy, pollution, including carbon mitigation, control and waste management.

Social: How is an entity managing relationships with its employees, suppliers, customers and the communities in which it operates, as well as pressing socioeconomic disasters, such as the current COVID-19 pandemic? Issues include education, which encompasses human capital development within an entity, product quality, social opportunities, and access to healthcare and retirement benefits

Governance: How is an entity handling important structural, policy and behavioral matters, such as executive pay, board composition, ethics, transparency and shareholder rights? Issues include diversity, pay, ownership and control, and corporate behavior.

Forces Driving ESG Evolution

The environmental leg of ESG investing is one of the driving forces of ESG evolution in Latin America. Motivated by a push towards low carbon energy to address the looming threat of a climate crisis, both internal and external forces have played an integral role in its development. The signing of the Paris Agreement by 23 countries, coupled with the September 2019 public pledge by a coalition comprised of a number of the region's jurisdictions to generate 70% of their electricity needs from renewables by 2030, has resulted in a wide range of opportunities for investors looking to expand their ESG portfolios.

Another driving force is the social leg of ESG investing, which includes addressing the vast gaps in healthcare that have been further exposed by the COVID-19 pandemic. The urgent need to make investments in the development of better health infrastructure and significantly improve access to healthcare is expected to be another source of ESG investment. As new investment vehicles are created to address these issues, such as the COVID-19 bond, this social need will inevitably continue to influence ESG investment.

Basics of ESG Investment

There is a range of ESG investment products, including bonds and loans. ESG bonds are securities issued to address specific Environmental, Social, and Governance matters. The most common ESG bond is a green bond issued by a public or private entity (including a sovereign) in which the issuer agrees to use the proceeds raised for dedicated 'green' purposes, typically environmentally friendly projects. A total of 1,802 green bonds were issued globally in 2019, up by 13% as compared to the previous year (according to the Climate Bonds Initiative's 'Green bonds Global State of the Market 2019'), and that growth has continued in 2020.

In the lending space, ESG-linked loans, also referred to as sustainability-linked loans, are any type of loan instrument and/or contingent facility, that incentivizes the borrower to meet predetermined sustainability targets. A green loan, in its strictest sense, is a type of ESG loan that has stringent requirements for the use of its proceeds, requiring that said proceeds be used exclusively to finance or refinance green projects, such as those tied to increased energy efficiency, avoided and/or mitigated carbon emissions, reduced water consumption or other assets that have a positive externality for the environment. Unlike with a green loan, proceeds from ESG-linked loans do not need to be allocated to a specific ESG project, rather proceeds from ESG-linked loans can be used for general corporate purposes.

Where is Latin America in the evolution of ESG?

Key ESG Players

ESG key players include a wide variety of entities, such as institutional investors, NGOs, ISS/Glass Lewis, and ESG standard setting bodies.

The International Capital Markets Association (ICMA) has launched the Green Bond Principles, the Social Bond Principles, the Sustainability Bond Guidelines, and as recently as June 2020, the Sustainability-Linked Bond Principles (collectively, 'the Principles'). Serving as the Secretariat, the ICMA provides guidance for the governance of the Principles, which have become the leading framework globally for the issuance of ESG bonds. Taking the lead role in disseminating this information to catalyze a pipeline of investments, the investor-focused, not-for-profit, Climate Bonds Initiative focuses on developing a liquid green bond market in order to facilitate the transition to a low carbon economy.

Similarly, in the loan market, the Loan Syndication & Trading Association, the Loan Market Association, and the Asia Pacific Loan Market Association, collectively issued the two highest profile loan guidance documents (and their recently published accompanying guidelines): the Green Loan Principles (GLPs) and the Sustainability Linked Loan Principles (SLLPs). The GLPs and SLLPs each provide four core components, all of which must be satisfied for a loan to be deemed a green loan or an ESG-linked loan. With the sustainability finance market currently remaining largely unregulated, these guidance documents are emerging as the de facto market standard.

One development in the region is the implementation of disclosure standards and indices spearheaded by local regulators and stock exchanges. For example, this past year, Mexico launched the S&P/BMV Total Mexico ESG Index, which uses a rules-based selection criterion based on relevant ESG principles. However, ESG reporting is still voluntary. In Argentina, the Buenos Aires Stock Exchange (BYMA) does not require a public company to submit or publish a sustainability report. Instead, in line with international practices, the BYMA has implemented various initiatives to promote good corporate governance and sustainability practices, such as a Sustainability Index with the IDB that serves to highlight leading ESG companies to investors. Brazil is requiring listed issuers to disclose socio-environmental information in their annual reports. The stated purpose is to encourage issuers to make consistent disclosures on social and environmental issues, and provide the market with comparative information, thereby dependably apprising investors of Brazil's pertinent ESG information.

Many other countries in the region are developing sustainability standards and are looking to enhance the investment products in the space to further aid in economic development.

Overall, Latin America is actively creating many opportunities for ESG investment and we expect that governments and private sector actors will continue to promote ESG investment in the region.

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