EXECUTIVE SUMMARY

About the report

The mainstreaming of environmental, social, and governance (ESG) considerations is increasingly shaping the flow of capital to and among emerging markets and developing economies (EMDEs). This study assesses the nature and extent of this influence and documents how EMDEs are responding to shape the ESG paradigm to their specific objectives and market context. We also develop a set of recommendations to ensure any risks of capital diversion are mitigated, and to ensure that EMDE perspectives are well-represented in the global ESG debate.

The research combines a secondary evidence review with original data analysis and expert interviews with market participants. The purpose of this consultation was to hear practitioners' views on the impact of current ESG mainstreaming on capital allocation in EMDEs and to identify how EMDE policymakers, regulators, issuers, investors and intermediaries are responding. Representation across EMDEs in terms of geography and market development was central to the study, including interviews with experts experienced in markets such as Brazil, India, Kenya, Morocco, Pakistan, South Africa, Thailand and Uruguay.

Capital diversion from EMDEs

The report finds indicative evidence that ESG mainstreaming can reduce flows to EMDEs as growing pressures mount on asset managers to exclude assets with weak ESG scores. For example, in 2018 the MSCI EM ESG Leaders Index had a 68.2% weighting to countries classed by the OECD as EMDEs, a share that had declined to 62.9% by 2022. Excluding China and India, which together account for more than a third of all market capitalisation in the index, this share declined further from 33.2% in 2018 to 21.7% in 2022.

Critically, EMDEs' collective weight has fallen more significantly in ESG-focused indices than in mainstream benchmarks, suggesting that underperformance of EMDEs more generally was not the only driver of their declining share in ESG-focused indices. For example, EMDEs' weight in the MSCI Emerging Markets ESG Leaders Index was proportionately 5% greater than in the non-ESG MSCI Emerging Markets index in 2018, but was 2% smaller in 2022.

Capital diversion from EMDEs appears to have been less of an issue for the ESG-labelled bond market than for equity markets. While initially slow to adopt this financing tool, EMDEs have rapidly increased issuance in recent years, led by China. Total EMDE green, social and sustainability bond issuance is estimated at almost USD200bn in 2021, about four times the 2018 level. But EMDEs are still under-represented in the sustainable bonds market. EMDEs in 2020 accounted for a lower share of global sustainable debt issuance (20.1%) than they accounted for total bond issuance (30%), global equity market capitalisation (23.1%) or global GDP (42%).

Interviews with market participants confirmed the view that deficiencies in ESG data and scoring may exacerbate inefficiencies in capital allocation and reduce flows to the markets most in need of investment. Where company-level ESG data is missing, investors will often use proxies to fill the gaps in their analysis. For example, sovereign ESG data is frequently used to plug data gaps for entities. However, country-level ESG scores are highly correlated to per capita income. Consequently, an ingrained income bias, whereby rich countries generally have higher ESG scores, could contribute to an under-representation of EMDEs in global capital markets.

ESG determinants of capital flows to EMDEs

- Looking ahead, a combination of two aspects of the current ESG investment paradigm will impact how capital flows to EMDEs over the next five years.
  - A lack of comprehensive and comparable ESG data for EMDEs will have a significant bearing on investment flows as ESG data gaps and screening methods will exacerbate capital diversion from EMDEs.
  - Regulators are ramping up ESG disclosure requirements, exacerbating capital diversion by increasing compliance costs and risks associated with investing in EMDEs.
- The problems with ESG data for EMDEs can be broadly categorised into two: data gaps and data bias. A shortage of data makes it harder for potential investors to determine ESG compliance for themselves or to prove to regulators how ownership of an asset could impact the investor's ESG

profile. Standard ESG screening and regulatory frameworks were largely created in developed market contexts and are not necessarily appropriate for directing investment in EMDEs. For example, ESG metrics have tended to be backward looking and typically do not capture a company's ESG journey or relative performance. Therefore, when investors use ESG scores to screen assets suitable for investments, EMDEs may suffer as they can be perceived as higher risk and so less attractive from a risk-adjusted returns perspective.

- The risk of capital diversion away from EMDEs will also grow due to the planned introduction of more stringent ESG regulations. Proposed regulations in the EU, the UK and the US have two broad aims: (i) to prevent greenwashing and (ii) to expand the scale and scope of ESG disclosure. To support the first of these, new naming conventions are planned to be implemented, which will require asset managers to state more precisely the investment objective of their funds. Regulation will also seek to expand the amount of ESG-related data that listed firms and asset managers are required to publish. One of the consequences of these proposed regulations would be an increased cost of compliance, with firms and investors operating in the EU, the US and the UK having a greater burden of proof to satisfy their respective regulators that they are compliant with ESG disclosure requirements. All else equal, these costs will disproportionately affect smaller cap companies and companies in more data-scarce environments, both of which are more likely to apply in EMDEs.

Solutions – mitigating capital diversion from EMDEs

- EMDEs are pioneering their own pathways. The report outlines ways in which ongoing and future capital diversion from EMDEs is being mitigated. These solutions are drawn from EMDE case studies and are grouped into three categories:
    - Reforming market disclosures and frameworks
    - New data collection methods and sources
    - Innovative ESG investment products
- Expanding and improving the quality of ESG reporting across EMDEs will help to reduce capital diversion caused by ESG mainstreaming. More widespread and comparable ESG data for EMDE entities would reduce the perceived risks of investing in EMDE assets and prevent some of these assets from being filtered out of investment screening processes due to data gaps. The report highlights a number of important initiatives to support these aims.
    - Adoption of the international framework created by the Task Force on Climate-Related Disclosures (TCFD) is encouraging the expansion of relevant data.
    - The ASEAN Taxonomy for Sustainable Finance highlights the effectiveness of a regional taxonomy to adapt international frameworks to local EMDE contexts, making greater allowance for the specific economic and ESG characteristics of the 10 ASEAN members.
    - The EU-China Common Taxonomy demonstrates how regulators can help investors navigate different regional or country-specific taxonomies.
- Removing some of the bias against EMDEs caused by current ESG data frameworks will require new types of data, not just more data from existing sources. ESG reporting requirements can thus only address part of the data problem. Data lags, a lack of forward-looking data and the shortage of transitional data reporting also represent very real challenges, especially in EMDEs. New techniques for gathering ESG data can help to mitigate the problems around data verification. The report outlines a number of solutions that are trying to improve the availability of ESG data for EMDE firms.
    - The IFC's esgNLP product illustrates that a natural language processing (NLP) tool can analyse vast amounts of unstructured data and text to produce ESG scores for companies.
    - The Transition Pathway Initiative shows how more forward-looking ESG company data can be provided, which would help to highlight those EMDE firms that are rapidly improving on weak legacy performance.
    - The World Wide Fund for Nature's geospatial project examines an innovative new way of reducing gaps in EMDE environmental data, which is a particularly important area for investors.
- Product innovation in the ESG investment space could also help to reduce capital diversion from EMDEs if it helps create a larger menu of ESG-aligned investable opportunities for global asset managers. These types of solutions are already being implemented and could be scaled further to more significantly impact capital flows. The report highlights several examples.
    - The Inter-American Development Bank and Uruguay's Ministry of Economy and Finance constructed a Sustainability-Linked Bond Framework, which creates incentives for Uruguay to perform strongly on environmental

performance metrics, such as reducing aggregate gross GHG emissions and maintaining native forest areas.

- The Thomas Lloyd Energy Impact (TLEI) Trust shows how private equity investors with an ESG impact mandate can raise funds on public equity markets.

- The Amundi Planet Emerging Green One (EGO) Fund is an example of how an equity listing can better connect institutional investors with green bonds in EMDEs. Not only are fixed income investment opportunities surfaced on a public equity market, but the IFC de-risks the fund to make it more attractive to investors.

Recommendations

More can and should be done to mitigate the risks of capital diversion and ensure that EMDE perspectives shape the global ESG debate. The report breaks out its recommendations into three categories.

- As flagship proposals in the US, the EU and the International Sustainability Standards Board (ISSB) are undergoing review, feedback and even pushback, there is an important window of opportunity for adapting international ESG regulations to local EMDE contexts and frameworks.

- EMDEs should contribute to ongoing consultations around any reforms to ESG regulations.

- Regional political and trade blocs should consider creating localised frameworks with tailored taxonomies that support the specific economic development of that region.

- Multilateral organisations and development finance institutions (DFIs) should provide capacity building support to the creation of localised frameworks and improvements in relation to data disclosure.

- These recommendations are mainly aimed at investors and data providers.

  - Country and company performance should be assessed in terms of momentum and transition rather than the use of current and backward-looking data alone.

  - The use of alternative data solutions – including AI and NLP technologies and geospatial data – would allow more unstructured data from company reports and more timely and independent data on environmental factors to be integrated within screening valuation models. However, technical challenges in EMDE contexts are identified in this report.

- These recommendations focus on bond issuance and utilising public equity markets.

  - Theme-specific GSS+ bonds can be an effective tool for governments and companies in EMDEs as they look to raise capital to finance specific green, social and sustainable projects.

  - DFIs and multilateral organisations should provide technical assistance and expertise in constructing GSS+ bond frameworks.

  - Private equity funds should use public equity markets to raise capital that will be directed to a portfolio of ESG-focused investments in EMDEs.