Financing for sustainability: Inside Asia Pacific's rapid market growth

This is the first in a series of articles exploring the findings from ***Financing for sustainability: Asia Pacific's evolving ESG market***, an Economist Impact report sponsored by Westpac. The report draws on a survey on the state of sustainable finance in the region gleaned from issuers in the US, Europe and Asia Pacific, and investors in Australia, Hong Kong, Japan, New Zealand and Singapore. It aims to understand today's sustainable finance market drivers and the potential for future growth, and provides comparisons to inaugural research conducted in 2019. This article provides deeper context to the survey results, with additional insights from major market participants.

Asia Pacific's sustainable finance market has grown rapidly over the past two years. This growth has been fuelled by rising recognition of the urgency to mitigate climate risks and the need to meet the United Nations 2030 Sustainable Development Goals. As the market matures, new products and increasing demand are helping companies and investors make the challenging transition to net zero and fulfil their ESG obligations.

In 2019, research conducted by Economist Impact revealed a nascent but fast-growing sustainable finance market in Asia Pacific. Investor demand was outstripping issuances and supply was a challenge, but companies were starting to recognise the need to change and exploring how sustainable finance could improve their ESG reputations, obligations and financial positions. The market was at a potential tipping point, with sustainable finance beginning to move from being a niche market to a mainstream consideration.

A turbulent two years have resulted in big changes. In 2022, *Financing for sustainability: Asia Pacific's evolving ESG market* reveals growth in the size, breadth and sophistication of sustainable finance regionally, driven primarily by recognition among businesses of the immediate need to focus on climate risk mitigation.

From an issuer perspective, an increasing number of companies are using sustainable finance to fund their transitions and secure future business models. They are also using a wider range of products, like sustainability-linked loans, green deposits and sustainability-linked derivatives.

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This in turn has provided investors—who are also aiming to limit portfolio risk—with a greater supply of potential opportunities. The rapid market growth is being fuelled by the urgent need to transition to net zero, adapt to market changes and secure their business future, among issuers and investors alike.

"We invest globally and understand how the circumstances around us will impact the integrity of our investments," explains Mark Konyn, group chief investment officer at AIA, an insurance and finance company. "Whatever methodology you use to forecast forward, it's pretty clear that the way the world operates today needs to take account of changing societal priorities."

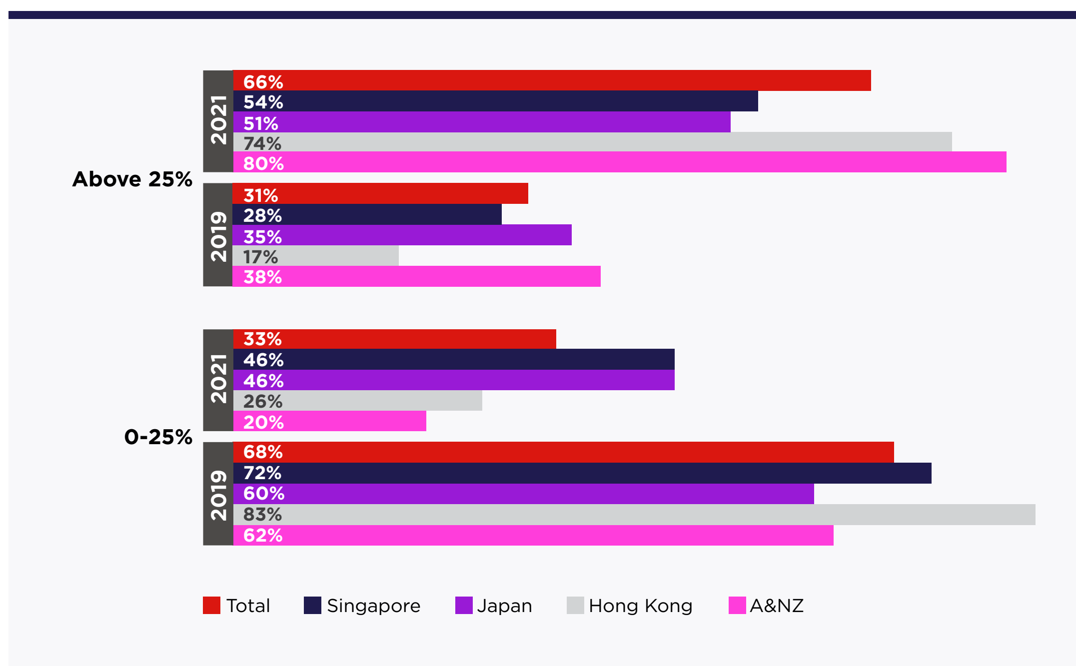
A growth trajectory

The growth in Asia Pacific's sustainable finance market is reflected in both investments and issuance.

In 2019, 31% of investor respondents had more than 25% of their assets under management (AUM) in sustainable investments; that share has more than doubled to 66% of investors today. Supply has also grown substantially. Just 18% of companies surveyed in 2019 had issued or utilised sustainable financing compared with 56% in 2021.

Although supply has increased, demand from investors still outstrips the supply of sustainable finance issuances, and this market growth looks set to continue. One in three (35%) respondents say they plan to issue or use sustainable finance for the first time in the coming year and almost half of investors (47%) expect to have over 50% of their AUM allocated to sustainable finance by 2025.

According to Rob Kenna, general manager of financial markets at TCorp, the New South Wales (NSW) government funding



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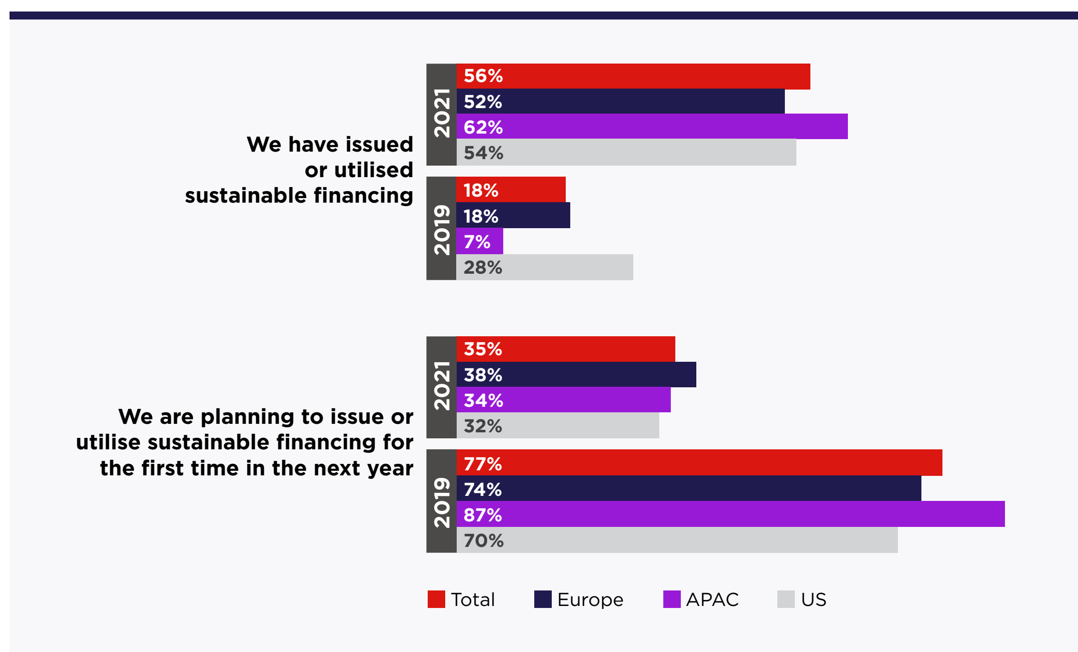
Issuers: Sustainable finance activities



corporation, growth in sustainable financing in Australia started slowly, but has gathered rapid pace as organisations have begun to fully appreciate the enormous social and economic costs of climate change and explore ways to make their businesses more resilient.

"Climate change has real human social impacts, but it also has financial consequences. From my mind, you can't disentangle these things," says Mr Kenna. "But sometimes just that little forward step is what's needed to get the ball rolling."

Risk drives change

This growing appreciation of the costs of climate change is reflected in the survey results, with climate risk mitigation now one of the primary factors driving sustainable finance growth. The drivers of investment and issuance in 2019 were more external pressures, whereas protecting investments or a business from the potential impacts of ESG and climate risks—including the potential risk of sustainable litigation—is now seen as a key part of fiduciary duty.

Indeed, 25% of companies say the primary reason they now use sustainable financing is to meet the company's sustainability objectives, followed by financial benefits (22%) and diversification of their investor base (18%). Almost two thirds (65%) agree their company's corporate sustainability strategy has a significant impact on its financing decisions, while 85% agree their sustainable financings have helped their organisation reduce its climate risk exposure.

For investors, improved management of ESG risk is now the main driver of sustainable finance investments, whereas diversification was the primary motivation in 2019.

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Drivers of sustainable investments and financing

2021 | 2019

	INVESTORS			ISSUERS		
	Driver	2021	2019	Driver	2021	2019
SUSTAINABILITY/ IMPACT OUTCOMES	Investing for sustainability or impact outcomes	23%	22%	Source capital for a sustainability-related project	9%	11%
				Meet the company's sustainability objectives	25%	25%
				Increase awareness of the organisation's sustainability practices	18%	23%
FINANCIAL GAINS	Enhanced financial returns	17%	19%	Achieve financial benefits	22%	19%
DIVERSIFICATION	Diversification of investments	16%	27%	Diversify our investor base	18%	16%
STAKEHOLDER PRESSURE	Member or customer pressure	1%	11%	Shareholder or customer pressure	9%	7%
RISK AND GOVERNANCE	Improved management of ESG risk	24%	16%			
	Reporting / regulatory drivers	2%	6%			

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Mr Kenna says perceptions remain important, but the tangible work to mitigate climate and ESG risk is now of far greater benefit to companies in Asia Pacific. "You can see that businesses are appreciating climate risk. Corporate boards are heavily involved in ESG, you've got people starting to use sustainable finance as a way of managing the climate risks that they're acknowledging," he says.

"Risk management underlines everything. Our ESG journey began with risk mitigation, understanding the threats to business models and making sure we're not exposed to stranded assets and other issues," adds Mr Konyn, noting that AIA's approach has also matured as it has recognised the growing financial opportunities. "We're now thinking about how we use ESG criteria to our advantage and generate better returns over the long term for our stakeholders. It's not just about risk mitigation but growing a holistic approach."

For investors and issuers alike, the financial benefits from improved returns and better execution also help make risk mitigation attractive. "The assets are valued by investors. And there's less of those bonds available, so they're scarcer," says Mr Kenna. "And so, in ordinary conditions, you do perhaps get a better price outcome, and you tend to get better execution in difficult markets."

Transition challenges

Challenges remain though. One of the key considerations for investors looking for long-term sustainable investment opportunities and issuers in high-emissions industries is the transition from a high carbon-emitting—or brown—business model to one that is carbon neutral or green.

There is intense debate around the way investors engage with such companies, but there is a need to drive change. In fact, 85% of investor respondents say their organisation would consider investing in a company that is clearly transitioning from brown to green. How this happens, however, is not always straightforward.

> **85% of investors agree or strongly agree that their organisation would consider investing in a company that is clearly transitioning from brown to green**

Mr Konyn says AIA believes in engagement, rather than straight divestment, and works hard to help companies they believe have a strong business model to adapt. He says the direct costs and unintended consequences of transition need to be considered, and that investment decisions in green alternatives that are presently available can be highly uncertain.

"I don't think anyone has a complete picture or an answer to some of the challenges. The cost of transition is going to be high and who bears the cost is not fully known," he says.

Using AIA's approach to energy as an example, he says the financial risks associated with coal and the prospect of stranded assets saw AIA divest all its coal investments. Yet alternative energy businesses have high investment entry levels, have not always provided the return on capital required from a fiduciary perspective, and can be fraught with government involvement that distorts a market and makes it harder for the private sector to participate.

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AIA are therefore investing in alternatives, but also working to help existing non-coal energy assets transition their business models. The aim is to invest in a way that will enable AIA to maintain its returns over the next decade, and also meet its commitment to being net zero by 2050.

"Where we see companies making a genuine and authentic effort to understand their role in the transition, to move towards a set of strategies that promote the transition, and who are willing to use Science Based Targets (SBTi) as a means for measurement, disclosure and for monitoring progress, then we will deploy. That's the approach that we are taking and how we're viewing the transition for our portfolios," says Mr Konyn.

Mr Kenna agrees and says it's important to manage change to reduce the social and economic costs of transitioning and not "let perfect be the enemy of the good".

"We haven't reached a point where the average person can survive without those brown things. And there have been examples where the capital has rushed away, and it has some unintended and un-forecast consequences," he says. "To achieve good progress, you need to be able to move forward. And sometimes, that's not just throwing out everything straight away."

Read the full report and details of research methodology on Westpac IQ.

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