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Investing Through Climate Risk in Emerging Markets Debt

Investors are facing the reality and urgency of climate change and its associated risks.

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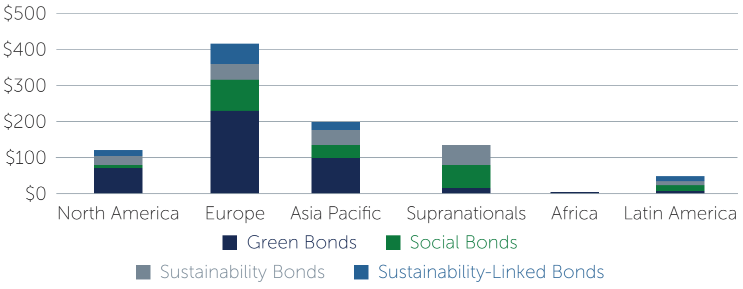
Climate change will likely play an increasingly prominent role in investment processes for years to come. How is the growing attention on carbon emissions, in particular, impacting emerging markets?

Kawtar: Given the focus on achieving 'net zero' by 2050, carbon has become a big part of the climate change conversation. Emerging markets have come under scrutiny as many are still reliant on carbon-intensive industries. Along those lines, one big question we're facing is how to assess the countries that are currently industrializing using coal or other less energy efficient techniques. For instance, questions such as whether a country is doing enough to reduce its carbon intensity, or whether it is building its resilience to major climate change disasters, are important considerations. In our view, a country shouldn't be penalized for its exposure to climate risks. Rather, we have the responsibility as investors to help ensure these countries have the policies, strategies and financing in place to improve their resilience.

What is the appetite for ESG bonds, and do you think they will continue on their current growth trajectory?

Ashwinder: 2021 was a watershed year for supply, with $904 billion of new issuance taking the stock of ESG-labeled issuance to $3 trillion last year[1]. This year, Climate Bonds Initiative estimates the supply of ESG-labeled debt will exceed $1.3 trillion, as more debt is issued to finance the climate transition. However, issuers are facing greater scrutiny. We expect more disclosure and regulation around the use of proceeds to address green-washing concerns. There is also likely to be more detailed analysis of greenhouse gas emissions reduction as well as issuers' sustainability-linked targets. Increased supply of ESG-labeled debt has also fueled investor appetite for dedicated ESG funds. In Europe, close to 65% of new bond inflows went into ESG-labeled funds last year, while in EM, this was close to 25%. The laggard was North America at 4%.[1]

2021 ESG Bond Issuance by Geography (USD billion)



Source: Climate Bonds Initiative, Unicredit.

Kawtar: Sovereign issuers have also been increasingly active when it comes to green and ESG-related bonds. As part of our sovereign engagement efforts, we're also thinking about innovative products like resilience bonds. A resilience bond from a country in the Caribbean, for instance, may have an insurance option embedded in it that could provide some liquidity relief—and potentially help the country avoid a default—while it's dealing with economic, social, political or humanitarian emergencies in the aftermath of a hurricane.

What is the impact of increasing climate change-related regulation on financial institutions?

Ashwinder: Banks have a key role in financing the climate transition. In this sector, the regulatory component started with coal—many banks and asset managers no longer want to finance coal mines or thermal-powered power plants. This has forced greater regulatory scrutiny on the other legacy exposures that sit on bank balance sheets. In 2021, the ECB conducted stress tests that suggested roughly half of bank balance sheets are exposed to climate-related physical or transition risks. The Basel Committee and Financial Stability Board have also argued that climate change is a risk to financial stability itself. Banks need to improve their physical and transition risk-related disclosures and should incorporate climate stress testing scenarios. Ultimately, the banking sector's ability to make these changes to their business models will have an impact on their valuations.

What are the knowns and unknowns with regard to sovereign debt, and what aren't investors talking about today?

Kawtar: There are many questions that need to be figured out, such as the question of data. If we can't get a good handle on how much a certain sector pollutes, how can we accurately calculate a country's overall carbon footprint? There is also the question of carbon leakage. When large multinational corporates in developed markets ship the most polluting parts of their value chain to developing countries, who should account for the carbon emissions—the producing country or the consuming country? With regard to EM, transitional dynamics represent another big question. Many developing countries have high population growth rates, high poverty, and high inequalities. This means they can't afford not to grow, or to grow less. So, how do they transition to a more energy-efficient and greener economy? For many of them, it's simply not possible to leapfrog from a polluting development path to a greener development path.

While EM countries and companies are making notable strides in confronting climate change, progress will inevitably come at different paces and with differing levels of success. Against this backdrop, active managers that integrate ESG into their investment process, and engage directly with companies and sovereigns, look best-positioned to navigate the risks and capitalize on the opportunities that arise.

Listen to the podcast conversation

[1] Source: Climate Bonds Initiative, Unicredit.

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