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# Sustainable Finance Outlook 2024

Broadening of Issues, Local Priorities, Policy Momentum Shifts to Dominate the Coming Year

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# Sustainable Finance Outlook 2024

## Broadening of Issues, Local Priorities, Policy Momentum Shifts to Dominate the Coming Year

### Key Themes for Sustainable Finance in 2024

Sustainable Finance Market Is Broadening with Product and Framework Innovation

Localisation Trend Reflects Local, Regional Environmental, Social Priorities

Developed and Emerging Markets Consider Mandatory ISSB Adoption

Social, Nature Co-Benefits Gain Momentum

SLL Credibility Issues to the Forefront

The five themes we identify for the year ahead are not an exhaustive list, but, rather a selection of what we expect will be most pertinent for stakeholders – from investors and corporates to policymakers – within sustainable finance.

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Fixed-income investors are becoming more discerning in their approach to sustainable finance investing. Sustainable Fitch believes this will be apparent through two main trends in the coming year.

Firstly, there will be a greater appetite to consider a broader range of issues, technologies and more specialised frameworks in labelled bonds. There is also likely to be more thought given to a wider range of co-benefits between climate change mitigation, such as food security or health outcomes, which we see becoming more important to asset owners.

Secondly, the robustness and credibility of targets in loans with ESG covenants as well as the extent of their alignment with a company's business activities will become a crucial aspect for investors and lenders in sustainability loans.

## Striking a Balance between Localisation and Standardisation

Sustainable Fitch expects to see a greater emphasis on addressing local sustainability priorities in taxonomies, as well as a desire by investors and attempts by standard-setters to harmonise sustainability-related disclosures.

We acknowledge that these may at first instance seem conflicting, for example, the rising demand for local or regional priorities in taxonomies or sustainability guidelines, against the robust demand for standardisation and a universal disclosure framework for sustainability-related disclosures.

We do not view these as mutually exclusive however. An International Sustainability Standards Board (ISSB) baseline disclosure standard can enhance information usability and comparability, while taxonomies of sustainable or transition activities may be more detailed and tailored to specific jurisdictions and their needs. We see both these trends advancing in 2024.

## Holistic Approach on Targets and Metrics for ESG Loans

The robustness and credibility of KPIs and sustainability performance targets (SPTs) in loans with ESG ratchets and covenants, as well as the extent of their alignment with a company's business activities will become a crucial determinant for sustainability-linked loans (SLLs) as market participants become more circumspect about allocations in a segment still in flux.

## Political, Macro Factors Remain Pertinent for Climate Policies and Issuance in 2024

The broader backdrop of suspended uncertainty, due to numerous elections in major markets and shifting economic conditions, will underpin market dynamics. We explore the related key implications of such a backdrop for the sustainable finance market in the final section of this report.

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## Theme 1: Sustainable Finance Market Is Broadening with Product and Framework Innovation

We expect the sustainable finance fixed-income market to broaden in 2024, amid continued innovation in labelled debt products, frameworks, and the growing scope of sectors being financed.

While it may add some complexity to the market, especially to an external audience not used to sustainable finance aspects, the broadening of the market will also provide diversity and nuance to investors.

One of the main goals of broadening the scope of sustainable finance is to help channel more financing towards emerging markets, a trend that started gaining momentum this year. These markets are characterised by the large presence of hard-to-abate sectors, high dependence on fossil fuels, and they therefore require at times a different set of instruments.

### Growing Scope of Sectors Accessing Sustainable Finance

Sustainable Fitch expects the activities and sectors financed by sustainable debt instruments to broaden in 2024 and beyond, which will support innovation in ESG debt labels and frameworks. Currently, use of proceed (UoP) bonds mostly finance a small amount of activities: renewable energy, energy efficiency, clean transport and green building (green bonds); and affordable housing, socioeconomic advancement and affordable basic infrastructure (social bonds).

We expect a growing number of activities to be financed via labelled debt in 2024 and beyond. This will be partly driven by investors' shift from divestment towards transition strategies for hard-to-abate sectors, a trend that emerged in 2023 and which we expect to be more prominent in 2024.

Labelled bond issuances from most hard-to-abate sectors has been low. But the development of sectoral decarbonisation pathways providing more clarity on transition-eligible projects, coupled with the renewed interest from investors to invest in and help transition hard-to-abate sectors may encourage issuances from these sectors.

This could be the case for green hydrogen projects and green shipping fuel projects, among others. Agrifood-related issuances, linked to regenerative agriculture and food security projects for example, are likely to grow as the sector is asked to accelerate decarbonisation efforts, which have been slow.

On the social front, we expect issuances related to health and healthcare projects to gain momentum in 2024 and beyond (see Theme 4 – Social, Nature Co-Benefits Gain Momentum), which usually fall under 'Access to essential services' UoP category of social bonds.

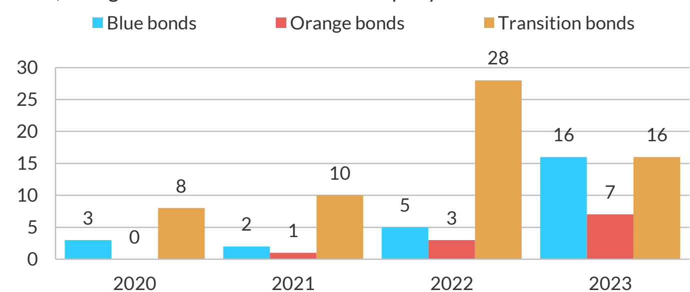
Sustainable finance investors are also venturing into the new frontier of nature and biodiversity, via a range of instruments. Labelled bonds including biodiversity conservation among their UoPs represent a modest but growing segment of the labelled debt market. Carbon credits linked to nature-based solutions (NBS) and biocredits provide further avenues for market participants to channel financing to biodiversity.

### New ESG Debt Labels and Frameworks Continue to Surface

The likely growth in issuance of new debt labels and the launch of new, more sophisticated sustainable finance frameworks are further signs of the broadening of the sustainable fixed-income market. We expect this to be a key trend of 2024, as the market 'comes of age', its practitioners become more experienced, and more investors look at sustainability through fixed-income instruments. Investors are also ready to venture to more novel sectors and structures. The broadening of sectors accessing sustainable finance will encourage innovation towards new products and frameworks.

**Issuance of New Labels to Grow**

Blue, orange and transition bonds issued per year




Source: Sustainable Fitch, Environmental Finance

### Investors to Explore More Types of Labelled Bonds

With the growing focus on natural capital themes, we expect more types of labelled bonds, such as blue bonds, those connected with financing sustainability in oceans, to garner interest from investors next year. The ICMA, in partnership with the International Finance Corporation, the UN Global Compact and the UN Environment Programme Finance Initiative, released more guidance on blue-themed bonds in September.

The new global guidance, which contains eligibility criteria and suggested key performance indicators (KPIs), is likely to encourage the issuance of more of these bonds. This will build on the issuances we have seen this year from the likes of Indonesia and Gabon. Given Asia's heavy dependence on coastal and marine resources, we may see more countries in the region issue guidelines and issue inaugural blue bonds. For example, the Philippines' Securities and Exchange Commission published guidelines for blue bond issuances in September, which will pave the way for future issuances.

As investor focus also shifts to issues other than environmental ones, we may see also growth in issuances of orange bonds. Orange bonds typically tackle social issues and are named in reference to the colour of UN Sustainable Development Goal 5 on Gender Equality.

Considerable progress was made this year across several Asian countries to better define what transition encompasses and to set qualifying criteria for an activity to be considered transition. This momentum will carry on into 2024, especially as frameworks are made more comprehensive and more guidance emerges. Transition bonds, hitherto lacking much momentum and investor response, may see some rising interest, although we reiterate that KPI-linked instruments have been a more desirable framework for transitions activities, notwithstanding challenges related to KPIs.

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Japan, a pioneer of transition finance, plans to issue its inaugural sovereign climate transition bonds from February 2024. The indications are that the issuance will be in Japanese yen with a two-year tenor, but there are plans to issue longer tenors in future. Japan issued its transition framework in October 2023, which includes in accepted UoPs various technologies such as CCS, ammonia blends and sustainable aviation. The issuance by Japan and specifically the extent of non-local investors buy-in will act as a litmus test on transition bonds for other governments with economies heavily reliant on fossil fuels, corporates and investors.

Within slightly more established bonds, including SLBs, which were first issued in 2019, there are also increasing new nuances considered for their structures to encourage more investors into the market.

For example, the Anthropocene Fixed Income Institute has proposed using 'contingent resilience-linked' bonds, which are similar to SLBs with a step-down structure, but where a credit enhancement provided by a development finance institution helps to keep the initial coupon of the bond fixed to the market rate for an equivalent vanilla bond by the same issuer. If the entity defaults, but has met its sustainability performance targets (SPTs), then what is lost equivalent to the credit guarantee will be repaid by the DFI. The aim of the initiative is to create a fixed income instrument to mobilise private capital for emerging markets sustainability and resilience initiatives in particular, with DFI credit enhancements acting as a multiplier for private capital.

### New Frameworks Arise, Leading to Increased Scrutiny

More sophisticated frameworks have been launched in recent months and we expect this trend to accelerate in 2024, as experienced issuers aim to customise instruments. However, those specific frameworks will remain the exception rather the norm for now, as they require certain experience with the market and heavy engagement with investors to communicate their benefits.

For example, a few issuers have chosen a 'dual-purpose' sustainable finance framework in 2023, combining UoP and sustainability-linked bond (SLB) frameworks into a unique document covering a larger share of their debt capital needs. Some financial institutions are looking at issuing UoP bonds to finance SLLs and launched dedicated sustainable finance frameworks in 2023.

Innovative frameworks are likely to continue emerging in 2024. We could see interest from pure players to avoid identifying UoPs when all their activities focus exclusively on the green economy, in particular renewables. In that case, we would expect impact reporting for the entire business to become critical to investors to assess the benefits and impact of the investments.

These new frameworks are likely to be favoured by returning large issuers with a record in the market, as the requirements are probably too demanding for first-time or small to medium-sized issuers.

### Benefits of Instruments and Issuers Diversity for Investors

While newcomers to the sustainable fixed-income market may face a steepening learning curve as the market broadens and matures, we find in our interactions with investors that they value the growing diversity in issuers and instruments, as it allows for more choice, and differentiated investment approaches.

### Related Research

Biodiversity in ESG: State of the Sustainable Finance Market (October 2023)

Sustainable Fitch: Bonds Use of Proceeds Could Focus More on New Projects, Best Practices (August 2023)

Transition Finance Gap Remains Amid Uncertainties (July 2023)

## Theme 2: Localisation Trend Reflects Local, Regional Environmental, Social Priorities

Sustainable Fitch anticipates a growing trend in 2024 with strategies and approaches to sustainable finance being increasingly tailored for each region's needs. This is related to the first trend, specifically on attempts to widen the market for transition activities. This shift in the second theme is happening alongside a global recognition of the importance of aligned sustainability and climate-related disclosure requirements, which serve as a fundamental common baseline to ensure transparency across jurisdictions (see Theme 3: Jurisdictions Consider Mandatory ISSB Adoption).

At the core of this localisation trend is a variation in ESG priorities and net zero pathways in different jurisdictions. While the EU has blazed a trail in terms of regulations and an expansive taxonomy that focuses on climate mitigation and green technologies, Latin America is increasingly emphasising climate adaptation and just transitions, while transition finance is emerging as an area of particular interest in Asia-Pacific.

### Asia Develops Guidance on Transition Finance

The theme of transition finance expanded this year, particularly in Asia due to its economic reliance on carbon-intensive sectors. With no universal definition or guidance, Asian countries are innovating their own guidelines and frameworks to facilitate their own efforts. Sustainable Fitch predicts more efforts to define 'transition' moving in 2024, including clearer guidance on transition activities and viable pathways.

Though some consolidation of high-level standards in transition approaches has emerged in Asia-Pacific, we believe that more detailed consolidation will likely take several years to materialise as governments and industries would need to agree upon several elements, such as the treatment of certain industries, and targets and metrics for each sector.

Japan led the way in Asia by creating low-carbon transition frameworks in line with local priorities. In 2021, it established a comprehensive transition finance framework, offering sector-specific guidance for corporates to balance net-zero ambitions with competitiveness. Similar developments are seen in neighbouring countries, including China, which is developing a transition taxonomy for steel, coal power, building materials, and agriculture.

The ASEAN Taxonomy for Sustainable Finance introduced a traffic-light system to categorise activities based on their environmental alignment, a system also being adopted by Singapore and considered by Australia. Following these developments, the EU proposed measures to strengthen its sustainable finance framework, underscoring the growing importance of transition finance.

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### Latin America Innovates in Sustainable Finance with Emphasis on Social Issues

Latin America is creating a unique sustainable finance universe that reflects its distinct social and environmental needs. We anticipate this trend to continue in 2024.

The region has shown differentiation in the development of its sustainable taxonomies. Colombia's taxonomy includes land use, an aspect not covered by the EU taxonomy, while Mexico's taxonomy introduces a pillar dedicated to gender equality, reflecting its emphasis on social issues. Countries like Chile and Brazil are making substantial progress in developing national taxonomies that encompass hard-to-abate sectors, and Brazil will also include social objectives.

At the regional level, initiatives like the Latin America and Caribbean Working Group on Sustainable Finance Taxonomy are laying the groundwork for transition finance and phasing out financing for carbon-intensive sectors. These efforts, focusing on climate mitigation and adaptation strategies, are set to expand to further environmental objectives, including biodiversity protection. This focus on biodiversity is particularly relevant given Latin America's rich natural resources and biodiversity.

Latin American sovereigns are driving financial innovation with unique approaches to SLBs. Uruguay's SLB, for example, is the world's first with a step-down coupon mechanism. It has also proposed an SLB loan with the World Bank, which includes a similar step-down coupon mechanism tied to ambitious methane emission reduction targets in the livestock sector.

Chile and Brazil have incorporated social goals into their SLBs. Chile has issued multiple SLBs, including the first sovereign local-currency SLB and another with a KPI linked to gender equality targets in corporate boards. This innovative social KPI aligns with the regional trend emphasising social objectives. Brazil, as the region's largest economy and a crucial player in biodiversity, has also entered the labelled bond markets with a sovereign framework that focuses heavily on climate adaptation, land use and biodiversity. A distinctive feature of the Brazilian framework is the explicit inclusion of a category to counter social and racial discrimination, underscoring the region's emphasis on social issues in its sustainable finance innovations.

### Growing Risk of Regulatory Arbitrage

With the proliferation of sustainable finance and transition frameworks, we expect some investors or corporates to take advantage of regulatory arbitrage, where certain parties may align with the least stringent frameworks where possible. While this may not necessarily be categorised as a greenwashing risk, it does highlight that more focus on equivalence between existing standards and frameworks is necessary to minimise exploitation of such loopholes. This is especially so as regulatory fatigue among investors and corporates intensifies, and many reporting and disclosure rules operate on a 'comply-or-explain' basis, rather than mandatory one.

### Comparison of Treatment of Natural Gas Across Regions

| | ASEAN Taxonomy | Japan Guidelines | EU Taxonomy | Chile Taxonomy |
|---|---|---|---|---|
| Environmental objective alignment | Climate Change Mitigation | - | Climate Change Mitigation | Climate Change Mitigation |
| Have technical screening criteria been set? | Yes | No | Yes | No |
| Has a sector roadmap been laid out? | No | Yes | No | No |
| Is a traffic-light system used for activity categorisation? | Yes | No | Proposed | No |

Note: Chile's taxonomy is under development.
Source: Sustainable Fitch Regulations and Reporting Standards Tracker Tool

Although southeast Asia, Thailand and Japan have their own taxonomies and transition approaches, the treatment of the natural gas sector between countries still differs quite noticeably. Differences even exist between southeast Asia's and Thailand's taxonomies. While both categorise activities using a traffic-light system, the ASEAN taxonomy includes a further nuance based on a two-tiered framework to account for economic disparities.

### Related Research

Brazil's Sovereign Framework Set to Increase Investors' Confidence (October 2023)

Sustainable Fitch: Local Considerations Increasingly Shape ESG Regulatory Approaches (May 2023)

Revised ASEAN Taxonomy Paves Way for More Transition Financing (April 2023)

Japan Promotes Transition Financing as Global Market Seeks Further Clarity on Label (November 2022)

## Theme 3: Developed and Emerging Markets Consider Mandatory ISSB Adoption

The evolution towards localisation occurs in tandem with the widespread recognition of the need for harmonised sustainability and climate-related disclosures. Several jurisdictions have already indicated that they are exploring mandating adoption of the IFRS sustainability-related disclosure frameworks.

The ISSB launched the two standards IFRS S1 and IFRS S2 (S1 and S2)) in June 2023 with wide endorsement from regulators, supervisors, and investors and corporates. The standards are designed to offer investors information about sustainability-related risks and opportunities, specifically a view of the impact of sustainability-related issues on an entity's cashflows, access to capital and cost of financing. IFRS S1 looks at general sustainability while S2 takes a climate-specific disclosures approach.

The ISSB standards are voluntary but their objective is to establish a global baseline for reporting. Local regulators can decide the extent to which they mandate sustainability-related disclosures

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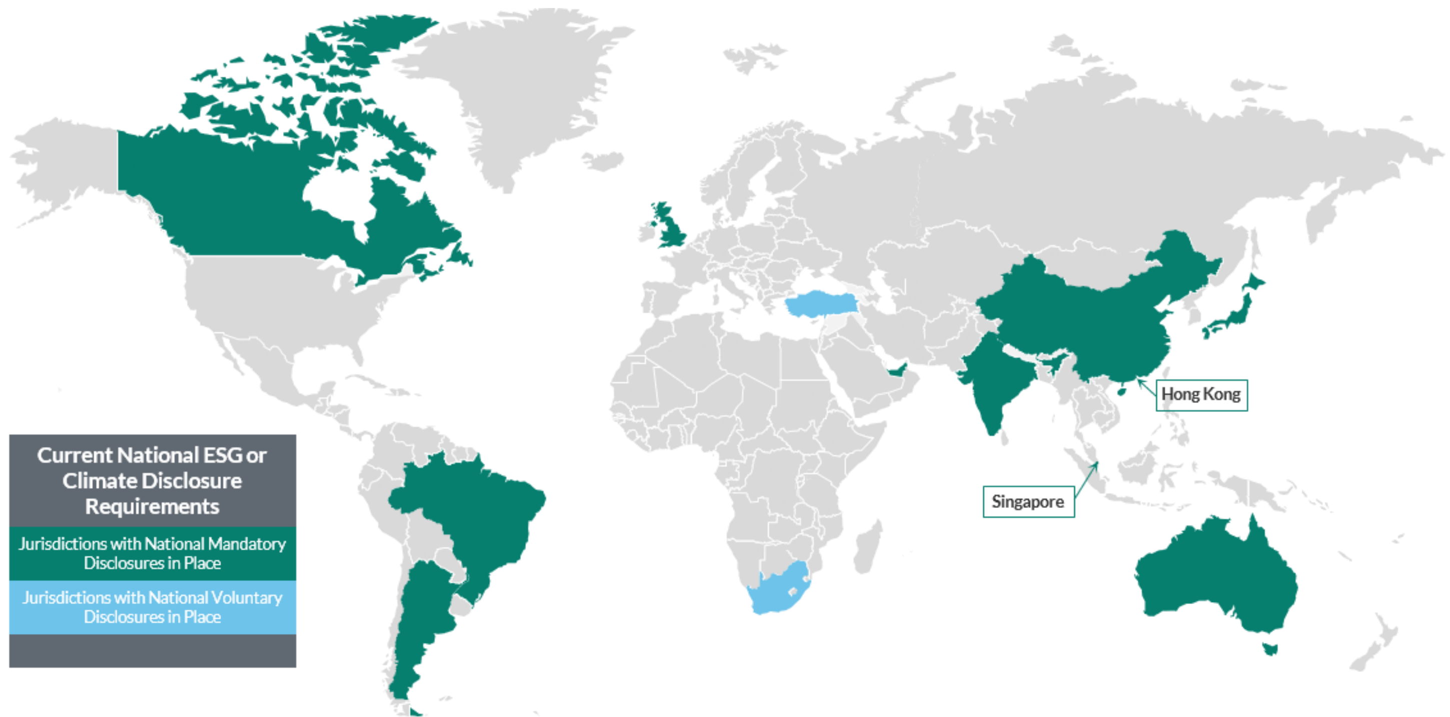
**Jurisdictions Considering Integrating ISSB Standards**




Note: The map is based on official announcement by local authorities considering integrating ISSB standards as of 23 November 2024.
Source: Sustainable Fitch

based on the ISSB standards and choose to mandate other metrics over and above IFRS S1 and S2.

According to Sustainable Fitch's *ESG Regulations Tracker*, which monitors the nearly 100 sustainability-related disclosure regulations or mandates around the world, almost 70% are mandatory disclosures, with the rest a combination of comply-or-explain, voluntary or guidelines.

The UK is a leading case study of mandatory climate-related disclosures for listed companies based on the TCFD mandated by the Financial Conduct Authority, which is intending to update the

For Canada, ISSB implementation is being moved forward by the Canadian Sustainability Standards Board, which will release recommendations to the relevant authorities. There is no established timeline on this.

Brazil has said it will adopt the ISSB standards on a voluntary basis in 2024 and make them mandatory in 2026.

In addition, in 2H24 the International Public Sector Accounting Standards Board, the standard setter for public-sector accounting, will launch its draft climate-related disclosures standard, which is closely modelled on IFRS S2.

## Biodiversity Is One of the Issues Being Considered by ISSB

Furthermore, the ISSB launched a consultation on what issues to tackle next for its upcoming two-year plan. The board will announce

rule to include the ISSB standards. The UK government also intends to publish mandatory corporate sustainability disclosure standards for UK companies based on the ISSB by July 2024.

Australia, Canada and Japan are considering incorporating ISSB into their reporting rules, as are several key emerging markets, such as Brazil and Nigeria.

The Australian Accounting Standards Board has released for consultation two exposure drafts on climate and sustainability-related financial disclosures based on IFRS S1 and S2. The consultation closes on 1 March 2024.

the workplan, which will be heavily informed by the consultation, by mid-2024.

In a statement summarising the feedback it had received, the ISSB said most respondents consider the highest priority item for the board to be supporting the implementation of S1 and S2. Many respondents also suggested that the ISSB consider inter-operability of ISSB standards with other prominent sustainability standards, a double-materiality approach, and connectivity of ISSB with the IASB.

One area that could emerge to be of interest is a deeper dive into nature and biodiversity, which has risen up investors' agendas with the launch of the TNFD in September 2023, which provided a comprehensive framework to capture nature-related disclosures. The ISSB included a proposed research and standard-setting project on Biodiversity, Ecosystems and Ecosystem Services in its consultation. The other two issues on which it sought market opinions were human capital and human rights.

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Based on the summary of responses to the proposed research projects, many respondents suggested a holistic approach, while most respondents also provided feedback on priority of sub-topics, if that were to be the approach. For biodiversity, land use and water ranked as top priorities. On human capital and human rights, some respondents said the topics should be considered under a single, overarching research project on social issues and sustainability-related disclosures.[1]

### Related Research

ESG Regulations and Reporting Standards Tracker – September 2023 Update (September 2023)

ISSB Is Major Boost for Market Transparency on Sustainability (June 2023)

## Theme 4: Social, Nature Co-Benefits Gain Momentum

Specific social themes are likely to gain more attention from market participants in 2024, particularly those where impacts feature linkages with established environmental and nature topics, with food security and public health likely to head sustainability-focused investors' concerns.

We anticipate that the challenging geopolitical backdrop and the cumulative socio-economic impact of extreme weather events will serve to refocus attention on social issues.

Already, weather patterns driven by the El Nino phenomenon have resulted in extreme heat and water shortages in some emerging markets (Malaysia) and disruptive flooding in others (Kenya and the Horn of Africa). These are damaging agricultural yields, placing upward pressure on food prices that will continue well into 2024, exacerbating cost-of-living issues and undermining progress of poverty reduction.

### Revival After a Weak Period for Social Issues

The focus on social issues had waned in recent quarters. They were high on the ESG agenda during the coronavirus pandemic, and this contributed to a rise in social bond issuance in 2020 and 2021. The murder of George Floyd in the US drew attention to systemic inequalities facing minority groups, triggering a wave or corporate diversity, equity and inclusion initiatives, and an upsurge in demand for financing for such programmes.

However, the impetus behind both these drivers weakened in 2023. The shelving of the EU's proposed social taxonomy in mid-2022 over political tensions about what to include, and the backlash against ESG in the US, further hampered the relative development of social topics within sustainable finance.

Social issues are often values-based and lack universally agreed measurement methodologies. This contrasts with environmental topics where classification systems and reporting standards have advanced in recent years and are usually science-based, which aids building of consensus around priority goals and assessment approaches. This leaves social issues out of sync with other ESG areas where taxonomies and target-setting have progressed.

### Nature Focus Elevates Social Co-Benefits

We expect that recent developments in the field of nature finance to elevate certain social issues by providing more formalised frameworks with which to set goals, and to classify and assess impacts. As nature becomes a core theme in sustainable finance, it is mainstreaming approaches that integrate environmental with certain social considerations into a more holistic understanding of sustainability.

Preservation of natural resources that provide ecosystem services is a key aim for many entities issuing nature-related labelled debt, with ecosystem services by definition encompassing goods and services that provide benefits to people (such as water supplies for irrigation). Financing of projects providing NBS similarly brings together both environmental and social benefits, e.g. sustainable forest management that generates incomes for local communities.

These linkages are increasingly recognised in formal targets and frameworks referenced by market participants. Several of the targets agreed at the UN biodiversity summit in 2022 (COP 15) focus on protecting natural resources to ensure the sustainable flow of benefits to people, as well managing those resources equitably (e.g. ensuring that benefits arising from genetic resources are shared).

The ICMA's recent guidance on blue bonds builds on both its Green Bond Principles and Social Bond Principles, noting that the transition to a sustainable ocean economy can only be achieved with equitable access to resources and benefit sharing. The TNFD guidance accompanying its reporting framework also references social benefits and includes specific guidance on engagement with indigenous communities.

Ultimately, these developments may drive transaction activity financing of projects and activities where there are more explicit nature and social co-benefits, with global conditions in particular pushing attention towards food security and public health.

### Food Security Rises Up the Agenda

Sustainable Fitch expects to see more focus on food security as a sustainability theme in the context of 2023's record high temperatures, the influence on seasonal weather patterns on food production, and greater attention to humanitarian concerns due to conflict and displacement of peoples.

ICMA includes 'food security and sustainable food systems' as a project category under its social bond principles (SBP), identifying activities that both improve access to nutritious food and support the agricultural sector. Within the SBP categories, food security has the most overlap with green activities due to the inherent relationship between food production and nature.

Many of climate change's physical effects have a significant impact on agricultural productivity: precipitation changes, soil quality, pests and disease, extreme weather events, and rising land and

[1] ISSB Consultation on Agenda Priorities, Feedback summary – Proposed projects in sustainability-related risks and opportunities, Agenda reference: 2D, November 2023, https://www.ifrs.org/content/dam/ifrs/meetings/2023/november/issb/ap2d-feedback-summary-proposed-projects-on-sustainability-related-risks-and-opportunities.pdf

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ocean temperatures. In ICMA's Harmonised Framework for Impact Reporting, several impact metrics under green categories are outcomes that would directly contribute to improved food security.

### Food Security-Related Eligible Green Projects

| Activity | Category | Sample Impact Metric |
|---|---|---|
| R&D for drought resilience | Climate change adaptation | Increase in land area using drought resistant crops |
| Flood management agricultural practices | Climate change adaptation | Reduced/avoided loss of crops |
| Food loss and waste management | Pollution prevention and control | Amount of prevented or minimised food waste |
| Improved operational resource efficiency | Management of living natural resources and land use | Water savings from improved irrigation |
| Mitigation of environmental impacts from livestock | Management of living natural resources and land use | Increase in feedstock supply chain certification coverage |

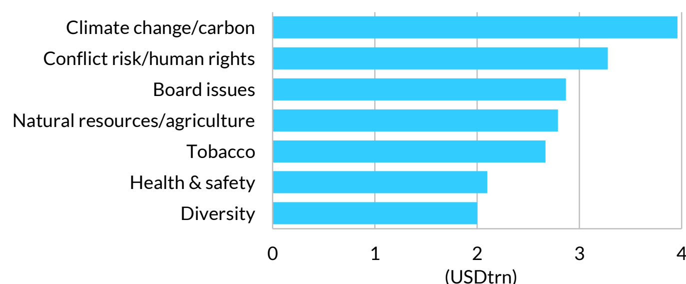
Source: Sustainable Fitch, ICMA

Nearly all sustainable bonds with food security UoPs are issued under sustainability (88%) or social (11.8%) labels, with fewer than 1% using a green label, according to Environmental Finance. The concentration of food security financing under these labels may obscure significant green co-benefits that would otherwise attract investors whose sustainability priorities are mainly environmental.

In a 2022 survey by the US Sustainable Investment Forum of around 500 US asset owners with USD6.6 trillion in funds under management subject to ESG incorporation, climate change and sustainable natural resources and agriculture were the most important green topics.

### Sustainability Criteria for US Asset Owners, 2022

Factors considered in asset-weighted terms




Source: Sustainable Fitch, US SIF

These preferences indicate that there is potentially more demand for food security themed investments than there is supply in the sustainable bond market at present, given our previous findings on the small share of bonds – only about 1% of our rated instruments – with food security as a UoPs or KPI.

We have seen several first-time issuers in the ESG-labelled bond market include food security within their frameworks in 2023. The OPEC Fund for International Development raised USD1 billion in a January sustainability bond offering, prioritizing activities that contribute to multiple SDGs, such as sustainable agriculture (No Poverty and Zero Hunger). Cyprus's debut EUR1 billion sustainability bond in April included a food security UoP with special consideration to farmers in disadvantaged areas.

In its inaugural sustainable finance framework, the government of Brazil lists food security-related impact metrics under both green and social categories. Its Treasury has said that 10%-17% of the sustainable bond programme will be allocated to food security and sustainable food systems. It has raised USD2 billion in a seven-year bond issued in November to strong investor interest.

### Human Health in a Changing Climate

The first-ever Health Day at COP 28 marks a shift in the role of health within climate change policy and planning.

The Health and Climate Network, founded in 2021 by a global group of research institutions and public health advocates, describes climate change as a "threat multiplier due to its influence on the social and environmental determinants of health".[2] Many health conditions and infectious diseases are exacerbated by a warmer climate and destruction of natural capital.

Deforestation, changes to ecosystems, and urbanization contribute to increased risk of many vector-borne diseases, such as malaria and Dengue fever. These and other infectious diseases, traditionally common in tropical regions, may spread to new parts of the world as temperatures rise. Epidemiological research has linked the 2015-2016 Zika virus outbreak in Brazil to record warm temperatures and drought, and there were cases of local Zika transmission in the warmest region of the US. The Wellcome Trust, a healthcare research charity, estimates that by 2080 an additional billion people would be at risk of climate-sensitive infectious diseases carried by mosquitoes as warmer temperatures encourage migration of the insects to previously colder, inhospitable climates.

Analysis by The Lancet indicates that the number of hours a day in which humans are subject to higher heat-related health stress has risen steadily since 1991-2000. Among the 10 largest countries by population, there are an average 4.5 additional hours a day during which moderate heat stress during light outdoor physical activity is a risk. In Indonesia and Bangladesh, there are nearly eight more hours of heat stress risk a day than the baseline.

[2] "Sustainable and Climate Resilient Health Systems," Health and Climate Network, August 2021.

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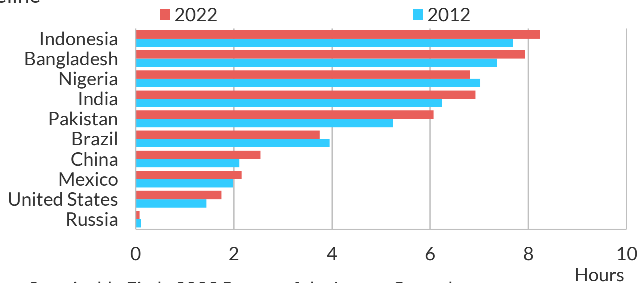
### Heat Stress Risk Has Risen in Largest Countries

Additional hours per day of heat stress risk compared to 1991-2000 baseline

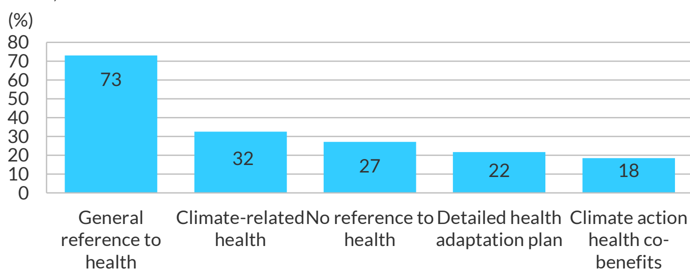



Source: Sustainable Fitch, 2023 Report of the Lancet Countdown

There has been a notable increase in the number of nationally determined contributions (NDCs) that include references to health, rising from 73% in 2020 to more than 90% in 2022[3]. Most of the health proposals included in NDCs are unfunded, leaving a significant financing gap for climate-related health adaptation and healthcare system resilience. Varied estimates indicate that less than 5% of multilateral climate finance is earmarked for public health or healthcare.

### Health in Nationally Determined Contributions

2020, 185 total NDCs




Source: Sustainable Fitch, Jankin Mikhaylov, Slava, 2020

Some of this financing gap will need to be filled by private capital. Following COP 28 we expect to see more sustainable debt activity by sovereigns and supranationals incorporating climate change and health. Private sector groups like the Sustainable Markets Initiative Health Systems Task Force could influence the scope of activities companies consider within their own sustainable finance frameworks; members Merck & Co and Sanofi SA have previously issued labelled bonds.

Healthcare falls under "access to essential services" in the SBP, but climate-related health activities can also be considered green. Health-related impact metrics under ICMA's "climate change adaptation" green category include improvements in workforce absenteeism due to climate-related health impacts and number of people affected by floods and other climate hazards, in addition to metrics related to improving climate resilience of buildings such as hospitals or clinics.

### Related Research

Brazil's Sovereign Framework Set to Increase Investors' Confidence (October 2023)

ESG Ratings Insights: Bond Use of Proceeds (August 2023)

South Korea's Green Financing Incentives Aim to Match Strong Social Bond Growth (June 2023)

Mexico's Taxonomy Lays Foundation to Address Key Social Factors (May 2023)

## Theme 5: SLL Credibility Issues to the Forefront

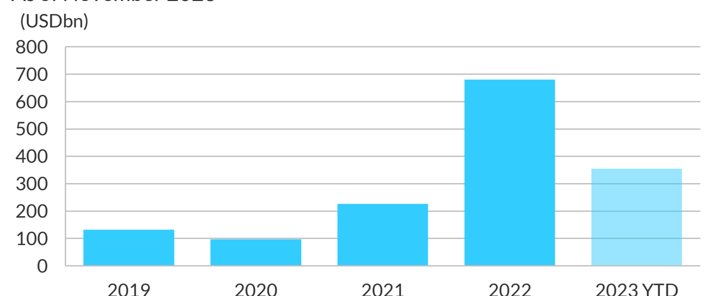
The robustness and credibility of KPIs and sustainability performance targets (SPT)s in loans with ESG ratchets and covenants, as well as the extent of their alignment with a company's business activities will become a crucial determinant for investors in the SLL space. This is a trend widely observed in the public debt market that we expect will become a defining feature of the SLL market in 2024.

Similar to SLBs in public capital markets, market participants have become circumspect over the credibility of SLLs. Asset owners are more likely to scrutinise how the investment decisions can deliver real impact on the environment and society, as well as protect them from reputational risks associated with weak sustainability frameworks or poorly designed sustainability-linked instruments.

Coupled with higher rates and macro uncertainty that deter borrowing especially from highly leveraged companies, the buoyancy of 2021 and 2022 of issuing SLLs in the broadly syndicated, leveraged loans market was replaced with a notable paring back of KPI-linked loans issuance in 2023. Fatigue among borrowers with the reporting requirements and time and cost to structure a loan with ESG covenants and ratchets may have also been a contributing factor to the decline. The size in US dollars of SLLs structured as of November 2023 was nearly 50% lower than 2022, according to Environmental Finance.

### Sharp Decline of SLL in 2023

As of November 2023




Source: Sustainable Fitch, EF Data.

Lack of robust KPI selection of SLLs is a central concern. KPIs need to be relevant, core and material to the borrower's overall business, measurable and able to be benchmarked. However, some market

[3] Jankin Mikhaylov, Slava, 2020, *Replication Data for: Engagement with health n national climate change commitments under the Paris Agreement*. https://doi.org/10.7910/DVN/SSZB5I, Harvard Dataverse, V2

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participants expect half of the SLLs to fail to set robust KPIs, according to research by Financial Conduct Authority in June 2023[4]. The SPTs are poorly designed with lower ambition, which are not able to drive meaningful changes in corporate behaviours.

Research from Covenant Review, a Fitch Solutions company, highlighted investors' negative perceptions over 'sustainability washing', overcomplexity of ESG-related provisions within loan agreements, that have led to rejection or removal of the ESG ratchet in loan deals in the European leveraged loan market.

The Sustainability-linked Loan Principles (SLLP), jointly published by the Asia Pacific Loan Market Association, the Loan Market Association and the Loan Syndications and Trading Association in February 2023, stresses the need for clearer standards and market guidance as the sustainability-linked market expands.

The new SLLPs set stricter criteria for SPTs, and require the KPIs to be material to a borrower's sustainability strategy and business operations. But wide adoption of the SLLP is uncertain due to its voluntary nature.

External reporting, monitoring and assurance on KPI targets, selection and level of SPT ambition can ultimately become a standard requirement from investors, as they seek confidence and protection against greenwashing risks. We expect that to be the direction of travel for 2024, though we are also aware that reporting fatigue may creep in. Borrowers, lenders and investors may remain wary of reinstating ESG ratchets in absence of significant improvements in sustainability performance of companies.

Managers' ESG integration or impact assessment credentials and processes can thus become a more important differentiator. Research based on Sustainable Fitch's ESG Scores for Leveraged Finance found that EMEA CLO managers outperform US peers in terms of environmental and social scores. The ESG scores are disclosure agnostic and rely on an independent asset-by-asset view of the impact that a business has on both environmental and social factors. CLOs with the highest ESG Scores are most exposed to healthcare providers, telecommunications and business services. CLOs with lower ESG Scores are most exposed to utilities, industrial and manufacturing, and broadcasting and media.

SUF ESG Scores provide transparency for CLO managers, investors and private debt investors to assess the ESG profiles and impact of privately held borrowers in EMEA and North America.

## Rise in Private Credit ESG Impact Strategies, but Will Face Same KPI Credibility Challenges

We discussed the growing role of ESG in private markets in our ESG Market Trends 2023 and we reiterate the rise of ESG integration and impact considerations as a trend to watch in the market for 2024. However, Sustainable Fitch refines the view by adding the caveat that the credibility, transparency and materiality of KPIs in SLLs will be an important objective in private debt, just as discussed above for leveraged loans.

Impact investing in private credit is in its very early stages, despite the rapid growth of the private credit market – AUM grew from about USD280 billion in 2007 to USD1.5 trillion by 2022, according to data by Preqin. A survey of pension funds by consultancy Apex found that only 9% of pension funds have made allocations to ESG private debt funds greater than 5% of their total portfolio [5]. However, we observe a (nascent) maturity trajectory of ESG factors in private credit portfolios similar to what we observed in the recent past in the public markets – and that is, moving from predominantly exclusionary policies to integration and then to grow towards impact investing as metrics and standards begin.

Impact-oriented strategies can be particularly relevant for private credit (more so even for private equity which we discussed last year, though we leave this out of this report's scope ) who can steward, influence and insist on robust sustainability outcomes tied to borrowing given the very small number of lenders, often bilateral, involved in structuring the loan. With sizeable amounts of capital under management and clear direction from asset owners/investors to consider environmental and social impacts, private credit, particularly direct lending, will play a bigger role in bridging the financing gap for sustainable investments.

Sustainability-linked issuances, have grown in popularity among private credit funds. The flexible nature of SLLs makes the instrument an attractive option to finance transition activities of hard-to-abate sectors. Some private credit funds have structured SLLs to finance borrowers across a range of risk and return profiles.

Ares Management, one of the largest direct lenders, structured the first sustainability-liked debt facility of GBP1 billion to RSK, a UK-based engineering and environmental consultancy, in 2021. The KPIs were linked to carbon intensity reduction, and continual improvement to health and safety management and ethics. Ares has since expanded the scale of sustainability – linked direct lending practices to more sectors, such as data solutions centre, day care provider, and waste management. Blackstone secured an AUD1.45 billion SLL in Australia's industrial sector in October 2023. PAG, a Hong Kong-based alternative investment manager, also established a sustainability-linked subscription line credit facility for an undisclosed amount in October 2023.

However, lack of borrower disclosure on ESG information and historical performance challenges private credit investors/LPs to assess the sustainability performance and impact on credit risks particularly of small and mid-cap borrowers. Investors need better disclosure to understand materiality of ESG issues in private credit investments. A survey from PRI in 2023 among private credit practitioners shows that 42% of LPs require GPs to provide annual ESG related disclosures and 31% request information on a more frequent basis.[6]

[4] FCA outlines concerns about sustainability-linked loans market, 29 June 2023 -- https://www.fca.org.uk/news/news-stories/fca-outlines-concerns-about-sustainability-linked-loans-market

[5] Apex Group report reveals pension fund attitudes to ESG in private markets, 23 October 2023 -- https://www.apexgroup.com/insights/apex-group-report-reveals-pension-fund-attitudes-to-esg-in-private-markets/

[6] New PRI report outlines progress on responsible investment practices in private debt and direct lending, 14 September 2023 -- https://www.unpri.org/news-and-press/new-pri-report-outlines-progress-on-responsible-investment-practices-in-private-debt-and-direct-lending/11784.article

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## Related Research

Sustainable Fitch: European CLOs Have Higher ESG Scores than North America CLOs (November 2023)

Sustainable Fitch: Issuer Profile, Targets and Reporting Drive SLB Ratings (November 2023)

## Political and Macroeconomic Volatility to Test Sustainable Finance for Another Year

In 2024, with elections in multiple countries, sustainable finance will have to operate within a broader environment of political and macroeconomic uncertainty. Our ESG Market Trends 2023 report highlighted that macro and geopolitical challenges could slow but not deter sustainable investing. We expect these dynamics to remain relevant for stakeholders in sustainable finance over 2024.

While different markets and jurisdictions will face different outcomes, we believe investors will need to keep these increasing uncertainties and possible shifts of the political environment and climate policies near front-of-mind.

Specifically, political change can affect the direction of environmental and specifically climate-related policies, the pace of enacting, amending or proposing new climate-related regulations, and policy shifts can be most material for investors and corporates. High interest rates may mean another year of subdued issuance of labelled debt.

### Elections in Key Jurisdictions Affecting Climate Policies

Major economies, such as India, the EU, the US, the UK, Indonesia, and South Africa, are electing new parliaments or presidents. Significant shifts to climate policy direction (strengthening and weakening) could result from elections in some jurisdictions, creating uncertainty in the markets.

The Global Stocktake of governments' climate actions, conducted in the runup to COP 28, warned that progress towards climate targets remains inadequate. In 2023, record extreme temperatures, destructive wildfires and floods sharpen focus on the need for climate change mitigation.

At the same, we have observed palpable tensions among policy-makers around cost of transition, impacts on certain industries or groups at a time of cost-of-living pressures on households. Within the context of the just transition, prospective job losses associated with the energy transition is likely to became increasingly unpalatable politically as elections progress throughout the upcoming year. How policy makers faced with electoral tests respond to these tensions will be a big issue in 2024.

While the EU has positioned itself as a leader in transitioning its economy under the flagship EU Green Deal, very tense negotiations and near misses in major environment-related legislative proposals over 2023, such as the fight in the EU Parliament over the EU's Nature Restoration Law or a motion, ultimately defeated, to repeal the European Sustainability Reporting Standards, revealed a fragile consensus on the green agenda. With elections for MEPs due in June 2024, we would expect some stalling on proposals, while the make-up of the new parliament can prove decisive on the pace with which ambitions of the EU Green Deal proceed in coming years.

In the US, the upcoming presidential election is set to elevate existing discord across the country, especially if issues like the economy and foreign policy likely take centre stage in campaigning. However, climate-related topics, including the adoption of low-carbon technologies across the US, are still like to surface as points of debate. Although sweeping policy changes are unlikely until the next administration comes into office in 2025, we believe early campaign rhetoric can serve as an important indicator of the direction of future US climate policy.

In some jurisdictions, elections might divert attention away from climate change towards other pressing social or economic issues. Especially in countries struggling with a challenging economic environment, high interest rates, inflation and housing issues, politicians can be tempted to frame climate policies as expensive, burdensome or unnecessary. This could lead to delay of implementation of existing climate policies or pledges or to abandonment of climate pledges and targets.

### 2024 Elections in Key Jurisdictions

| Jurisdiction | Type of election | Expected date |
|---|---|---|
| Brazil | Nationwide local | October |
| EU | Legislative | June |
| India | Legislative | April |
| Indonesia | Presidential | February |
| Mexico | Presidential | June |
| Russia | Presidential | March |
| South Africa | Legislative | May |
| South Korea | Legislative | April |
| Turkiye | Nationwide local | March |
| UK | Legislative | By January 2025 |
| US | Presidential | November |

Source: Fitch Ratings, BMI

### Macroeconomic Environment Poses a Challenge

Volatile and uncertain economic conditions are also positioned to meaningfully influence progress on climate change through 2024. Although some jurisdictions may face greater degrees of economic headwinds due to region-specific factors, we view this trend as largely agnostic to geographical borders.

While inflation has eased, most economic forecasts appear to anticipate moderately high levels persisting into at least 1H24 for major economies.

High interest rates are a key, though not the only factor, affecting the willingness of issuers to launch new labelled debt instruments. This may be especially true for corporates and financial institutions, which took a backseat on issuance in 2023 relative to sovereigns.

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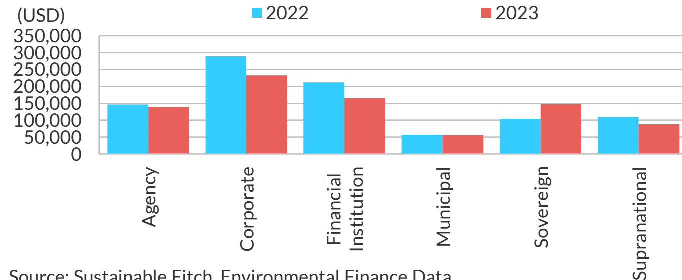
### Value of Issued Bonds Decreased Among Most Issuer Types

USD value of issued labelled bonds, 2022 and 2023 YTD




Source: Sustainable Fitch, Environmental Finance Data

For the year ahead, it could remain the case that sovereigns drive some of the growth in labelled bonds with issuance from corporates and financial institutions remaining restrained. We view strong interest from sovereign issuances as a signal towards the growing imperative to address climate change (including both mitigation and adaptation). This is especially true for emerging markets, where both physical climate risks and transition risks are poised to become increasingly financial material.

However, fiscal tightening and heavy debt burdens can also realistically curb some of the momentum behind sovereign-labelled bond issuance in 2024. If calls for higher degrees of blended finance also bear fruit, then supranational and agencies can also come to the market for higher levels of labelled bonds.

### Trade Friction Adds Costs to Low-Carbon Transition

The impacts of the provisions of the US Inflation Reduction Act, favouring domestic supply chains for the clean energy transition, the EU's carbon border adjustment mechanism imposing a green tariff on the EU's borders for certain goods, the EU's Net Zero Industry Act (NZIA), which offers heavy state-support for green tech development in an effort to counter the outflow of investments towards the US under the IRA set a precedent and incentive for other major jurisdictions to set up similar policies to protect national industries and seek to recalibrate supply chains. The EU's NZIA has a target of 40% of the EU's clean or green technologies to be produced within the bloc by 2030. In addition, the European Commission launched a probe into state subsidies of Chinese BEVs in October 2023, which could see imposition of levies on imports if substantiated.

A rise in trade friction manifested by a higher prevalence of protectionist policies can increase the cost of the energy transition. Technological innovation and knowledge transfer, necessary to decarbonise key industries, such as freight transport, energy, cement and steel production, will slow in a protectionist environment. This will also delay the lowering of cost of currently economically unviable decarbonisation solutions.

Corporates will face growing challenges in regard to access to markets and essential materials, such as critical minerals. Cost of doing business, especially in sectors with complex, international supply chains will increase in a more protectionist world.

While this may be a more structural shift whose effects unfold over time, it will be a feature of 2024, especially given the heavy election calendar that may see politicians lean into these more prominently.

### Related Research

ESG Market Trends 2023 (December 2022)

EU Net Zero Industry Act Boosts Support For Clean Tech (March 2023)

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