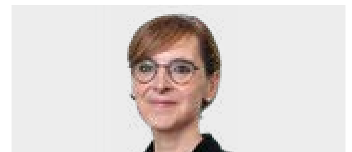
AXA Investment Managers

December 2022

Rising social risks in emerging markets should be a catalyst for action for responsible investors



Virginie Derue,
Head of ESG Research, AXA IM Core

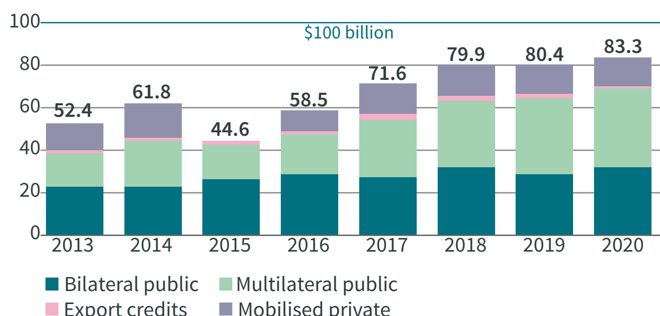
- **Emerging markets are the most at risk from the effects of climate change and the immediate effects of war in Ukraine. This is leading to potentially damaging social impacts, including food insecurity and rising inequality**
- **Major gaps remain in the finance available for developing countries. COP27 saw an agreement to create a "loss and damage" fund but details are still lacking, while a now-obsolete annual financing target of $100bn still needs to be updated. Rising interest rates are also making it more difficult to raise funds**
- **This is a challenging investment environment but responsible investors can facilitate financing through engagement and advocacy. Blended finance should be an important avenue, while enhancing sovereigns' capacity to issue green, social and sustainability bonds may be another effective course of action**
- **We believe targeted input from investors can help address social factors and help to foster a more sustainable environment, extending to human rights and nature preservation. We think this could bring social benefits and open up investment opportunities**

Thirteen years ago, at a United Nations Climate Summit in Copenhagen, Denmark, rich countries committed to channel $100bn per year to developing countries by 2020, to help them adapt to climate change and mitigate the negative consequences of global warming. That commitment was not met.

According to the latest figures from the Organisation for Economic Co-operation and Development (OECD) only $83.3bn of climate finance ended up making it to developing countries in 2020.[1] As shown in the graph below, most of that came from bilateral public financing or through multilateral developments banks (MDBs) – supranational institutions set up by sovereigns that can raise financing through private markets.

Climate finance for developing countries

Climate finance provided and mobilised by developed countries, in $ billions



Note: The gap in the private finance series in 2015 is due to the implementation of enhanced measurelent methodologies. As a result, private flows for 2015-18 cannot be directly compared with private flows for 2013-14.
Source: OECD (2022), Aggregate Trends of Climate Finance and Mobilised by Developed Countries in 2013-2020

The role of private finance remained comparatively small and even fell between 2018 and 2020. The concern is that it comes at a time when the medium-term prospects for the overall financing gap to developing countries has deteriorated. Developed countries' fiscal room for manoeuvre has diminished after COVID-19-related spending, while the economic effects of the war in Ukraine and rising interest rates are further compromising fund raising opportunities for developing countries.

In truth, even successfully meeting that $100bn commitment would have fallen short of the coming estimated needs. In a recent paper, authors including climate economist Nicolas Stern suggested that if emerging markets are to finance the scale of long-term investment programmes necessary to meet climate and development goals, at least $1trn a year in additional private capital would be required by 2030 from different parts of the financial system, domestic and international.[2]

The intervention of private finance is getting more urgent as the world seeks to address the exacerbated social risks developing countries are facing, driven by extreme weather and the global consequences of war.

We must not be naïve, of course. The equation is more complex than simply ramping up any kind of investment flows. If poorer countries face a cost of capital close to the 10%-20% annual returns sought by venture capital, there will not be much investment in clean energy, better healthcare or more education.

In our view, the priority should be to increase the volume of lending from MDBs which, even if not subsidised, remains considerably cheaper, provides risk insurance and may offer an entry point for private investors. More positively on that front, a report from an independent panel of experts to assess MDB capital adequacy concluded that, if implemented, reforms would support a major increase in collective MDB lending, likely reaching hundreds of billions of dollars over time.[3]

MDBs alone don't have enough capacity to deliver on the United Nations' 2030 Agenda for sustainable development though. As echoed at COP27, what is needed is a transformation of the financial system and of its structures and processes, engaging governments, central banks, commercial banks, institutional investors and other financial actors.

Blended finance remains, in that context, one valid approach in a toolkit of cooperation mechanisms, that combines official development assistance with other public or private resources in a partnership promoting sustainable development. The idea is that official assistance can be used to remove barriers to public or private investments in developing countries. These barriers might include poorly functioning local financial markets, a general lack of understanding around the nature and risks in emerging markets or the existence of political and financial uncertainty.

Blended finance may use a variety of financial instruments, depending on the nature of the underlying projects, on the maturity of the company and the market where the investment is taking place. In general, technical assistance and grants would play an important role in the early stages, where high transaction costs and high risk are involved. Risk-absorbing instruments are most likely to be used in the facilitating stages, where returns are uncertain and unproven.

Equity investments tend to be more important in later stages so that they may serve to consolidate projects and attract additional capital. In practice, these models still need to be improved, to gain scale and ensure that they extend to the least developed countries and to social sectors such as water and sanitation, education and health.

The OECD is working on the topic in its Blended Finance Principles Guidance.[4]

[1] Climate Finance and the USD 100 Billion Goal, OECD, September 2022
[2] Finance for climate action: Scaling up investment for climate and development, Independent High-Level Expert Group on Climate Finance, November 2022. The figure excludes China
[3] Boosting MDBs' investing capacity: An Independent Review of Multilateral Development Banks' Capital Adequacy Frameworks, G20 Expert Panel, 2022
[4] Blended Finance Principles Guidance, OECD, September 2020

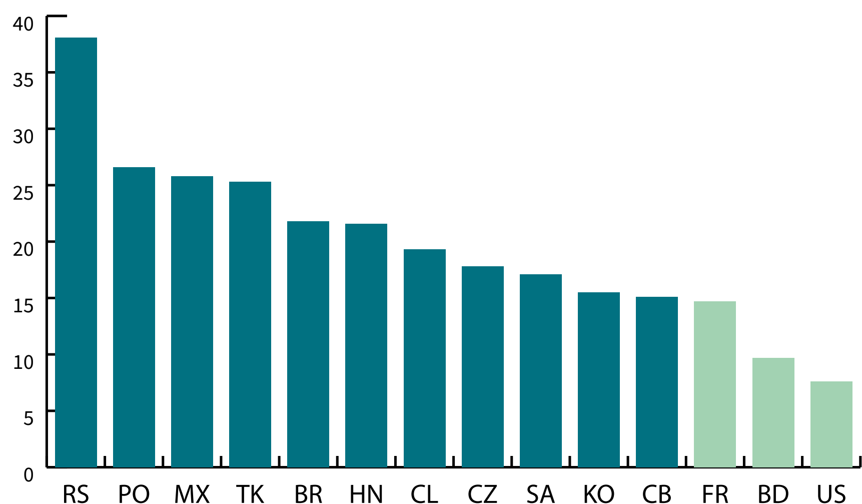
Social concerns on the rise

The primary cause for concern right now is food insecurity, driven by the Ukraine conflict which has altered global patterns of production and trade, ultimately pushing inflation higher. In recent years Russia and Ukraine have accounted for about one quarter of global wheat exports,[5] meaning that sanctions and closures of Ukrainian ports on the Black Sea have led to significant supply disruptions, in turn leading to a sharp increase in prices. A 29 September report from the World Bank estimated that average wheat and maize prices were respectively 33% and 30% higher than in January 2021.[6]

Food price inflation has been made worse by additional supply disruptions in fertilisers, a segment where Russia and Belarus remain leading exporters. At the same time, a sharp increase in natural gas prices saw many fertiliser makers find it unprofitable to keep production lines open. Developing countries are the most vulnerable to food inflation given the higher share of food prices in their consumer price index (CPI) basket of goods, as shown in the chart below.

Recent extreme weather has added to food insecurity. Heat waves, as an example, have left the Horn of Africa experiencing its worst drought in more than 40 years and more widely, a global humanitarian crisis is emerging, with more than 222 million people likely to need urgent assistance in 2023 as reported by the Food and Agricultural Organization of the United Nations (FAO) and the World Food Programme (WFP).[7]

Food and non-alcoholic-bev weights in CPI (%)



(RS: Russia; PO: Poland; MX: Mexico; TK: Turkey; BR: Brazil; HN: Hungary; CL: Chile; CZ: Czech Republic; SA: South Africa; KO: Korea; CB: Colombia; FR: France; BD: Germany; US)

Source: Refinitiv Datastream and AXA IM Research 22

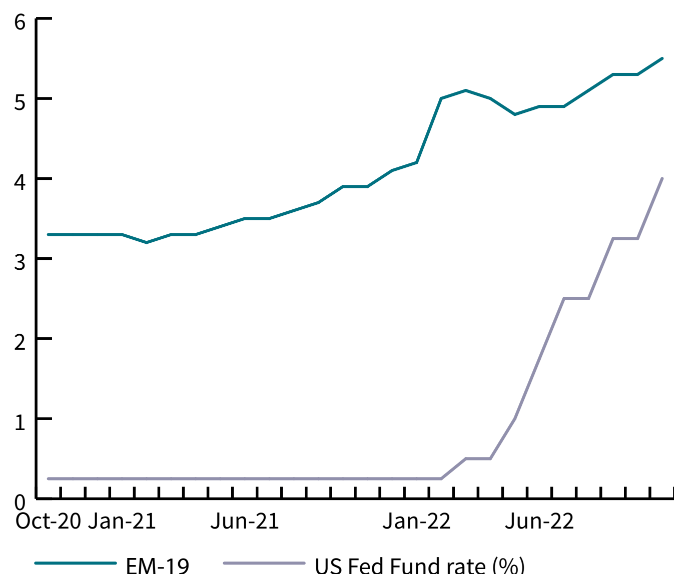
[5] Commodity prices surge due to the war in Ukraine, World Bank, May 2022
[6] Food Security Update, World Bank, September 2022
[7] Hunger Hotspots FAO WFP early warnings on acute food insecurity, World Food Programme, September 2022

> **“Finance is both a contributor to the divergence we are seeing between developed and developing countries and a key to overcoming it.”**
> António Guterres, UN Secretary-General

Geopolitics and the intensification of climate change are fuelling rising inequalities – between countries and within countries – and hitting the poorest the most. In 2021, the average income of people in the bottom 40% of the global income distribution was 6.7% lower than pre-pandemic levels, while those of people in the top 40% were down by only 2.8%.[8]

This increasing divergence between developing and developed economies has been exacerbated by the latter being able to borrow record amounts at historically low interest rates to support their economies though the pandemic and invest in recovery. Developing countries, by contrast, have been much more constrained, with limited room for monetary accommodation and a reduced fiscal response. The graph below illustrates the significant discrepancy during the pandemic between emerging market policy rates (excluding the outlier Turkey) and developed market rates, using the US as a proxy.

EM policy rates vs Fed Fund rates (%)



Source: AXA IM, December 2022

And as we move into a new environment of rising interest rates and strengthening of the US dollar, these are bound to trigger more austerity measures in developing countries, reducing health and education budgets as well as other investments that could contribute to the UN Sustainable Development Goals (SDGs),[9] undermining not only these nations’ recovery but also their medium and long-term economic prospects.

Private capital flows are returning to pre-pandemic levels in middle-income and upper middle-income countries, but lower-middle-income countries are not catching up, highlighting the structural lack of access to capital in developing countries.[10] Action is therefore urgent. In his foreword to the Financing for Sustainable Development Report 2022, UN Secretary-General António Guterres wrote: “Finance is both a contributor to the divergence we are seeing between developed and developing countries and a key to overcoming it”.

As echoed at COP27, bridging the financing gap requires a transformation of the financial system, including increased international support, strengthened involvement of multilateral banks and public-private partnerships through credit enhancement mechanisms and guarantees that can facilitate private sector financing. In this environment, investors with a focus on environmental, social and governance (ESG) factors can have a significant role to play.

As a growing share of world wealth is managed in a way which integrates ESG considerations – more than 20% of assets under management, according to one recent study[11] – then if developing/emerging nations score structurally poorly on ESG indicators, this could become a crucial impediment to the channelling of private sector money to these countries.

[8] Inequality and Shared Prosperity, The World Bank, April 2022
[9] The UN SDGs are a set of 17 targets adopted by all member states in 2015 with the intention of guiding and influencing the global policy environment to 2030.
[10] Bridging the great finance divide between developed and developing countries, Aspenia Online, October 2022
[11] ESG-focused institutional investment seen soaring 84% to US$33.9 trillion in 2026, making up 21.5% of assets under management, PwC, October 2022

Addressing challenges for ESG investors

We think investors need to keep two important issues in mind when considering how they can use ESG-aligned investments to play a role in bridging the financing gap for developing countries. First, they may face cases of weak governance at sovereign or corporate level; second, they may face poor data disclosure and lack of harmonisation.

These are genuine obstacles for investment but they should not be seen as an excuse for inaction. We think that by establishing clear red lines, it is possible for responsible investors to find potential powerful opportunities to address those clear investment needs and tap into the real opportunities stemming from the inherent demographic trends and investment needs in those geographies.

Tackling weak governance

The quality of leadership and of the institutions and processes by which countries and businesses are managed remains a major point of concern, and qualitative analysis remains unavoidable to properly assess the issues at stake and select viable investment opportunities.

For sovereigns, this means complementing the use of public data on corruption and rule of law by defining potential qualitative red lines when countries are viewed as having strategic deficiencies in the field of money laundering or the financing of terrorism. Political stability and regulatory quality will, of course, be key criteria to integrate as we forge our view.

Where corruption remains a primary source of concern and an impediment to investments, it is still possible to drive change, in our view. A particular concern is public procurement where each year, trillions of dollars are wasted due to corruption and inefficiencies. According to the World Bank, low-income countries spend on average about 13% of GDP on goods and services procurement, only marginally less than their middle and high-income peers.[12]

However, there are large discrepancies within that 13%. Certain emerging market contracts - worth billions of dollars - in oil, gas, mining and agriculture, lack transparent procurement, independent complaint procedures and external auditing. These are all factors, that if in place, could drive higher competition and reduce the potential for kickbacks and other corruption.

Pursuing reforms in that direction takes time, requires political will, technical skills and a sustained effort, meaning any investor's individual action will not be enough to drive positive change. We believe that by joining collective initiatives and working on advocacy, progress can be made. As an example, the Advisory Council for the International Capital Market Association's Green Bonds Principles has been working on this topic in 2022, focusing on areas such as capacity building in emerging markets, impact reporting, and standards and taxonomies.

For corporates, the integration of governance has pre-dated ESG approaches as a key criterion of fundamental analysis. The quality of governance remains uneven across emerging markets and still requires close attention from investors.

The strength of the governance structures, the level of independence of the board and the extent of its oversight remain priorities where investors should seek continuous improvement. Asia and Latin America, although less advanced than developed markets, have made progress on that front and seem eager to share good practice as they seek to attract and retain investors.

Tackling poor disclosure

Poor data disclosure has been another hurdle undermining the investment case for responsible investors in emerging markets. Again, encouraging good practice can be a lever to facilitate investments and here investors have a substantial role to play. We think it is important to encourage companies to disclose key data, especially in the social sphere which has been less of a focus than governance, and which lacks the clarity of a widely accepted single metric as climate has in CO_2 emissions. Social brings a multitude of aspects to consider, not always entirely quantifiable or measurable, and demands careful management.

[12] How large is public procurement?, World Bank Blogs, February 2020

The bigger picture

Ripple effects from the economic and inflationary environment have put social matters centre stage. This is the case worldwide, but particularly in emerging markets. Employment in key developing economies has yet to return to pre-pandemic levels, with the regions most affected being Latin America, the Caribbean and Southeast Asia.[13]

In this environment, if responsible investors are to drive capital flows towards the regions most impacted by climate woes and by the economic fallout from high energy prices, then we believe there is real value in putting pressure on investee companies around important issues. These should include worker rights, living wages and health and safety as the first priorities, followed by diversity and supply chain practices.

This is particularly topical in a context of higher vulnerability of employment in those regions, driven by more widespread temporary employment which remains a buffer in times of economic uncertainty. The more precarious nature of the job, then the more social risks are in play, whether through lack of rights and benefits, lower pay or absence of social security. Investors' scrutiny becomes even more important where operations are reliant on 'informal' work conditions.

We believe specific attention should be paid to human rights. In a 2022 World Benchmarking Alliance study of 129 companies across three sectors (agrifood, information technology manufacturing and auto manufacturing) 82% of alleged human rights issues occurred in non-OECD nations.[14] The most frequently reported allegations globally were forced labour (26%), discrimination (15%) health and safety (14%), excessive working hours (10%) and child labour (9%).

While forced labour exploitation is often related to domestic work, the private sector is not spared, with services, construction, manufacturing and agriculture bearing the highest risks from that perspective.[15] They are therefore key sectors for investor engagement and scrutiny. And attention would logically then extend to European companies and those from other developed nations that are customers (and which can therefore conduct their own engagement to require good practice around social factors).

On that front, proposed new European legislation around due diligence would bring regulatory pressure to bear – and should push investors to anticipate the likely demands. The directive, still at the stage of a legislative proposal, envisages requiring large European companies to identify potential adverse human rights risks including in their supply chain, to prevent or mitigate potential impacts, to establish complaint mechanisms and to monitor the effectiveness of due diligence policies. Legal remedies and sanctions form part of the current proposals.[16]

Geographical differentiation matters, and investors must adapt to local realities and local needs. According to one 2018 study, there were 400 companies generating revenues of $1bn or more in Africa, but half of these were in South Africa,[17] while in sub-Saharan Africa more broadly, there were an estimated 44 million medium, small and micro businesses.[18] As such we believe investors should consider engagement at the sovereign level to be a priority. By contrast, in Asia or in Latin America, where corporates have been raising funds in capital markets for longer, engagement can be targeted at executive teams to accelerate the understanding and integration of ESG issues and to foster improvements.

82%
of alleged human rights issues occurred in non-OECD nations

[13] World Employment and Social Outlook: Trends 2022, International Labour Organization, January 2022
[14] 2022 Corporate Human Rights Benchmark, World Benchmarking Alliance, November 2022
[15] 50 million people worldwide in modern slavery, International Labour Organization, September 2022
[16] Proposal for a Directive on corporate sustainability due diligence and annex, European Commission, February 2022
[17] Africa's overlooked business revolution, McKinsey & Co,, November 2018
[18] MSME Finance Gap: Assessment of the Shortfalls and Opportunities in Financing Micro, Small and Medium Enterprises in Emerging Markets, World Bank and International Finance Corp, 2017

A lever for change: Green, social and sustainable bonds

Another potential area of effective action for responsible investors would be to enhance the capacity of developing countries to put in place green, social and sustainable bond (GSSB) frameworks. Sovereign issuers have the power to scale up GSSB capacity more than any other issuer. There remains a relatively low take-up of GSSB issuance in developing economies with very few in Africa.[19]

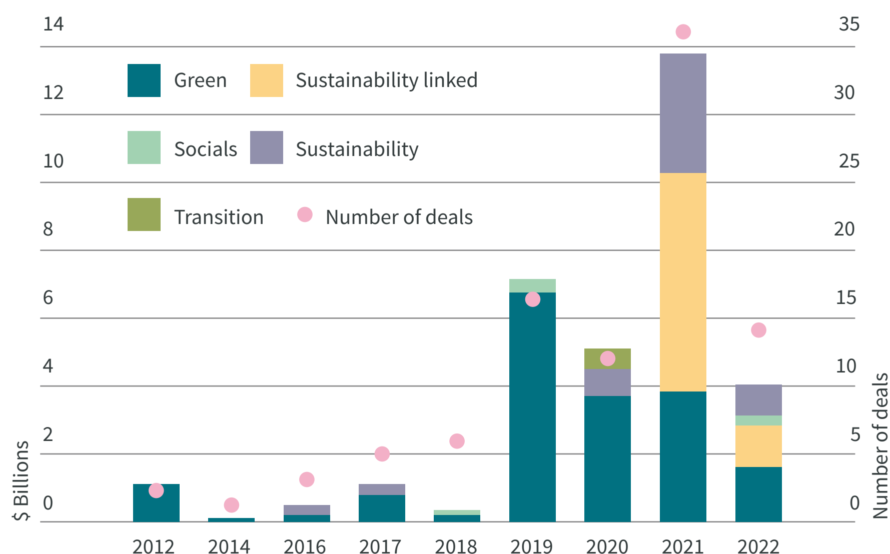
The preparation for a sovereign to issue a GSSB is more complex than for private sector issuers. It typically is part of wider fiscal budgeting, beyond standard criteria for GSSBs and tends to take more time. In that context, joining collective engagement and advocacy initiatives is key for investors to effectively create an environment in which issuance can take place.

GSSBs tend towards longer duration, relatively speaking, and therefore attract, in particular, insurance companies and pension funds seeking to match long-dated liability cash flows. In our view, they allow investors to seek financial returns while financing projects that can potentially contribute to climate adaptation, green energy, or demonstrate social benefits.

The social element here could be pursued more aggressively – while green issuance has stepped up significantly including from developing countries, so far the social component has remained under represented. The chart below highlights that dynamic in GSSB issuance in the Middle East and Africa (MEA).

Investors considering developing market GSSBs do face impediments and there is a clear need for coordinated policy action, both between investors and at the regulatory level. But we think lessons can be drawn from the experience in developed markets where standards have evolved which aim to ensure financed projects meet strict eligibility rules and are subject to oversight.[20] Issuers might encourage investor confidence by ensuring proceeds are segregated in ring-fenced accounts, while additional mechanisms could be structured in the bond documentation to ensure potential recourse/ callability should issues arise, whether around the use of proceeds or related to local political developments.

Cumulative MEA volumes were $33.2bn at the end of Q3 2022



Source: Climate Bonds Initiative, Sustainable Debt Market, Summary Q3 2022

[19] Sovereign Green, Social, and Sustainability Bond Survey, Climate Bonds Initiative, January 2021. Since this report was published Benin has become the latest new African GSSB issuer
[20] GSSBs: Our framework for assessment, AXA IM, September 2022

Natural Capital

At the intersection of social factors and climate lie biodiversity and nature – crucial areas where we think investors can generate a positive impact in developing countries. The oceans, forests, agricultural land and climate, as well as the plants and animals they support, form the natural capital on which all countries rely, but this is often amplified in emerging markets.[21] The topic is known to be especially acute in the Asia Pacific region where 63% of GDP is estimated to be dependent on the region's rapidly depleting natural environment.[22]

Hopefully, at a global level, this month's COP15 on biodiversity in Montreal will pave the way for concrete action and milestones – mooted pledges include a commitment to protect at least 30% of the planet's land and oceans by 2030. However, private sector action is still lagging, including in economic sectors where the health of the value chain is closely tied to that of nature.

As few global companies are committed to fighting deforestation or biodiversity loss, responsible investors have an important role to play to encourage the development of sustainable economies that protect financial returns. We think it is important to put pressure on executive teams to take action – with clear intermediate targets and milestones – and to act through their supply chains. Advancements in knowledge and data around biodiversity, and the development of tools to assess the negative impact that companies have on biodiversity, can now be effective drivers of focused engagement, tackling biodiversity degradation and associated social issues.

We think companies with the highest biodiversity footprint should be targeted first, with the aim to ensure that effective mitigation actions are taken. Although the challenge is massive, it also represents a significant business opportunity, with one estimate that 'nature-positive' solutions might create up to $10trn in annual new business value.[23]

Such opportunities could be found in the field of precision-agriculture technologies for instance – aimed at improving crop yields, in the diversification of the product mix or in boosting agroforestry and peatland restoration.

[21] Global Futures: Modelling the global economic impacts of environmental change to support policy-making, WWF, February 2020
[22] New Nature Economy: Asia's Next Wave, World Economic Forum, AlphaBeta, September 2021
[23] New Nature Economy Report II: The Future of Nature and Business, World Economic Forum, July 2020

Monetising natural capital potential

There is an inherent financial value in the forests and other carbon sinks that act to remove CO2 from the atmosphere – and which are often abundant in the developing world.

These so-called 'nature-based solutions' have historically been a controversial part of the climate debate. One argument has been that the benefits may mostly fall into the hands of the private sector, while national governments have shown concern that carbon credits generated and exported as part of a voluntary carbon market (VCM), without their knowledge, could ultimately undermine their ability to achieve their nationally determined contributions (known as NDCs). Things have changed though, and governments have come round to the idea that Voluntary Carbon Markets may be a powerful tool to help them achieve or even enhance their NDC ambition.

One of the major outcomes of COP26 in Glasgow was to blur the frontier between VCMs and the calculation of NDCs – allowing more flexibility for countries and tying up some loose ends from the Paris Agreement in 2015.[24] This is encouraging, but we would remain cautious about the prospects for rapid progress in the monetisation of natural capital.

First, it is inherently heterogenous (even within a country, local specificities can have material effects on outcomes); second, the technical hurdles associated with the measurement and verification of related carbon credits remain problematic; and third, there is a sizeable time lag between action and carbon sequestration impact.

Beyond those factors, political will and stability, but also how projects are structured and governed, remain important factors that impact both the mobilisation of supply and investors' appetite. In that context, acting on scalability and hence on accelerated monetisation of natural capital would seem to go beyond the role of responsible investors.

We still have a role to play though, pushing for the kind of high-integrity solutions that are key to increasing investor confidence and boosting capital flows to developing countries. Those solutions must include ensuring benefits are shared with local communities, widely accepted by responsible investors as a key safeguard and echoing the objectives of the International Finance Corporation's Social and Environmental Performance Standards.[25]

Beyond safeguards, it also enables the creation of positive social impacts, such as in the field of sanitation for instance, or in gender equality and education – for example, solutions that save women and children from having to walk miles to fetch timber for cooking.

An obligation and an opportunity

Fundamentally, there has been a steady acknowledgement that given the industrialisation of developed countries has been largely responsible for climate change, then they have a duty to support developing countries in their industrial and social ambitions as they battle the consequences of that. The decision to create a "loss and damage" fund at last month's COP27 meeting in Egypt reflected that reality, as will plans to update that now-obsolete $100bn-a-year target for financing.

It is now more urgent than ever that efforts are accelerated as the war in Ukraine, its ripple effects on the global economy and high inflation have affected developing countries the most. Increasing financial transfers to the affected regions is crucial, but to do that it will first be essential to build the structures and the confidence that can make it possible. Responsible investors have an important role to play in this decisive collective action that will ensure capital flows where it is most needed.

[24] The COP26 conference saw a finalisation of the Paris Rulebook's decisions relating to Article 6 – which provides a framework for international cooperation on emissions reductions and contributes to the development of both international emissions trading schemes and voluntary carbon credits, thereby accelerating the fight against climate change. It had until then been mostly inoperative in the absence of specific guidelines for implementation.
[25] Performance Standards, International Finance Corporation, January 2012

Investment Managers

This document is for informational purposes only and does not constitute investment research or financial analysis relating to transactions in financial instruments as per MIF Directive (2014/65/EU), nor does it constitute on the part of AXA Investment Managers or its affiliated companies an offer to buy or sell any investments, products or services, and should not be considered as solicitation or investment, legal or tax advice, a recommendation for an investment strategy or a personalized recommendation to buy or sell securities.

Due to its simplification, this document is partial and opinions, estimates and forecasts herein are subjective and subject to change without notice. There is no guarantee forecasts made will come to pass. Data, figures, declarations, analysis, predictions and other information in this document is provided based on our state of knowledge at the time of creation of this document. Whilst every care is taken, no representation or warranty (including liability towards third parties), express or implied, is made as to the accuracy, reliability or completeness of the information contained herein. Reliance upon information in this material is at the sole discretion of the recipient. This material does not contain sufficient information to support an investment decision.

Issued in the UK by AXA Investment Managers UK Limited, which is authorised and regulated by the Financial Conduct Authority in the UK. Registered in England and Wales, No: 01431068. Registered Office: 22 Bishopsgate, London, EC2N 4BQ.

In other jurisdictions, this document is issued by AXA Investment Managers SA's affiliates in those countries.

Design & Production: Internal Design Agency (IDA) | 18-UK-011060 - 12/2022 | Photo Credit: Getty Images