

Environmental, Social and Governance Practices for Value Creation in the Commonwealth



The Commonwealth

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This Paper was prepared by Economic and Sustainable Development Directorate. This research, analysis and conclusions expressed are the responsibility of the authors.

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Acronyms and Abbreviations

CHOGM	Commonwealth Heads of Government Meeting
COVID-19	SARS-CoV-2 virus
ESG	Environmental, Social and Governance
EU	European Union
IFI	International Finance Institutions
IMF	International Monetary Fund
LDCs	least developed countries
SBP	Social Bond Principles
SDG	Sustainable Development Goals
SIDS	small island developing states
UN PRI	United Nations Principles for Responsible Investment

Foreword

The need for longer-term investment in resilient infrastructure, in social protection systems, in digitisation and leveraging new technologies for development, has never been greater.

The UN Conference on Trade and Development (UNCTAD 2022) estimates an annual investment gap of US\$4 trillion to finance the Sustainable Development Goals (SDGs) in developing countries. Greater public and private collaboration and investment can help to fill this gap for Commonwealth countries, but efficient and sustainable financial management practices are essential if we are to deliver value-for-money socio-economic and development outcomes.

Environmental, Social and Governance (ESG) principles offer a strong framework to guide investment decisions for public and private spending. In fact, sustainable development cannot be achieved without the concerted action to promote environmental outcomes, social protection, sustainable livelihoods, and essential education and health services that ESG principles enable.

Greater international collaboration, capacity building and policy alignment is vital to ensure positive ESG

outcomes from ongoing developments in many Commonwealth countries on carbon disclosure regulation, sustainable finance taxonomies and ESG bonds.

The Commonwealth Secretariat continues to provide evidence-based research and analysis, as well as knowledge sharing and technical assistance, to member countries through our Economy and Sustainable Development Directorate.

Our work to help unlock ESG outcomes will continue to expand, while our expertise across the interconnected areas of debt management, public governance and economic policy will offer principled and practical support to Commonwealth member countries.

Together we will continue to deliver on the mandates of our Heads of Government and outcomes of Commonwealth ministerial meetings to create a more prosperous, resilient and sustainable future for the whole Commonwealth Family.

The Rt Honourable Patricia Scotland KC
Secretary-General of the Commonwealth

Executive Summary

Developing countries are being confronted with unprecedented economic, environmental and social challenges. The COVID-19 pandemic demonstrated global disruption on a scale never seen before and has reversed progress being made toward meeting the Sustainable Development Goals (SDGs) to 2030. As countries recover from the pandemic, the compounding challenges of global inflation, debt, climate change and socio-political scenarios have resulted in uncertainties, particularly for small island developing states (SIDS) and least developed countries (LDCs). As countries explore new investment strategies to accelerate economic development, build resilience and balance competing environmental, economic and social pressures, the concept of Environmental, Social and Governance (ESG) as a framework for sustainable growth has gained new relevance.

The concept of ESG is used to effectively assess longer-term environmental, social and governance risks and opportunities for firms. It has gained traction in recent years with the public sector and with international finance institutions. ESG investments globally are expected to reach US\$33.9 trillion by 2026 (PwC 2022). ESG investment increased even during the COVID-19 pandemic and continues to be one of the fastest growing areas of private finance. Studies have shown that the integration of ESG creates more positive investment outcomes, especially in the longer term, and enables more sustainable business practices by firms.

As a major institutional investor, the public sector can gain from ESG frameworks and concepts to facilitate more effective investment and development outcomes. Greater emphasis on ESG can provide a range of benefits, ensuring closer alignment with the financing criteria of international financial institutions (IFIs) and synergising with SDG targets related to the environment, climate and social development, including gender parity. Creating an enabling policy environment for growing sustainable investing markets also presents an opportunity for greater tax outcomes while minimising negative externalities. The fast-growing ESG bond market has potential, as bonds are a key financing mechanism that cuts across corporates,

governments, municipalities and development banks at a scale and liquidity necessary for investors. Since 2020, social bonds as well as sustainability bonds have received a lot of attention. They were used by the governments to finance healthcare issues relating to COVID-19. Therefore, there is scope for enhancing existing bonds further, as they can enhance opportunities to meet the relevant development needs.

Three key challenges remain to ensure effective ESG sector outcomes and growth. First, the most common criticism of ESG is that it provides opportunities for companies to engage in 'greenwashing' – inflating their sustainability credentials while continuing business-as-usual. Second, the application of ESG lacks a clear or standardised definition or assessment methodology. This results in high uncertainty around scoring and impact. Finally, although ESG has been growing in all regions, the maturity of regulatory and policy frameworks is highly unequal. Often the areas that would benefit the most from green investment are not able to access it. Therefore, it is essential to improve sustainable investment policy frameworks, develop capacities and invest resources to build enabling regulatory environments for ESG.

At the Commonwealth Heads of Government Meeting (CHOGM) in 2022, Heads '*acknowledged that high quality investment and infrastructure, both digital and physical, and notably clean, green infrastructure investment, is a cornerstone of sustainable economic growth*'. This paper focuses on the potential benefits of ESG toward enabling sustainable economic growth in the Commonwealth. This includes possible technical assistance, capacity building and policy development on ESG for public debt management and improved public sector sustainability, including collaboration with International Financial Institutions (IFI) financing standards. Further, a Commonwealth ESG working group is proposed for developing ESG principles relevant for member countries. In particular, common approaches to sustainable finance taxonomies and carbon disclosure regulation would be beneficial.

The Commonwealth is uniquely positioned for working together with member countries and international partners, involving co-ordination and advocacy toward developing ESG strategies to enable value creation and ensure sustainable development. Reorienting ESG principles and

developing responsible mechanisms and strategies to capitalise investments offers opportunities for public, private and third sector organisations to work in partnership towards sustainable and resilient development outcomes, while also protecting our planet.

An Introduction to Environmental, Social and Governance (ESG) Practices

The principle of responsible investing for social benefit has always existed in some form. The practice of Environmental, Social and Governance (ESG) began in the 1950s and has gained momentum in recent years. One estimate suggests that ESG-related assets under management (AuM) are expected to increase 84 per cent by 2026 to a global value of US\$33.9 trillion (PwC 2022). Further, ESG assets are expected to constitute 21.5 per cent of total global AuM for a projected compound annual growth rate (CAGR) of 12.9 per cent.

ESG is a concept used to assess the viability of proposed investments and projects based on their expected environmental and social impact and governance practices. The ultimate goal of ESG is to identify profitable investments that can enhance sustainable economic growth, together with improving citizen well-being and environmental protection. This includes issues of how investors respond to climate change, water management, supply chains, workers' rights and corporate social responsibility. This paper presents a scoping of ESG concepts and opportunities for value creation for Commonwealth member countries, together with protecting the welfare of our people and our planet. This paper also takes cognisance of challenges posed by ESG and the overlap between private and public sector priorities.

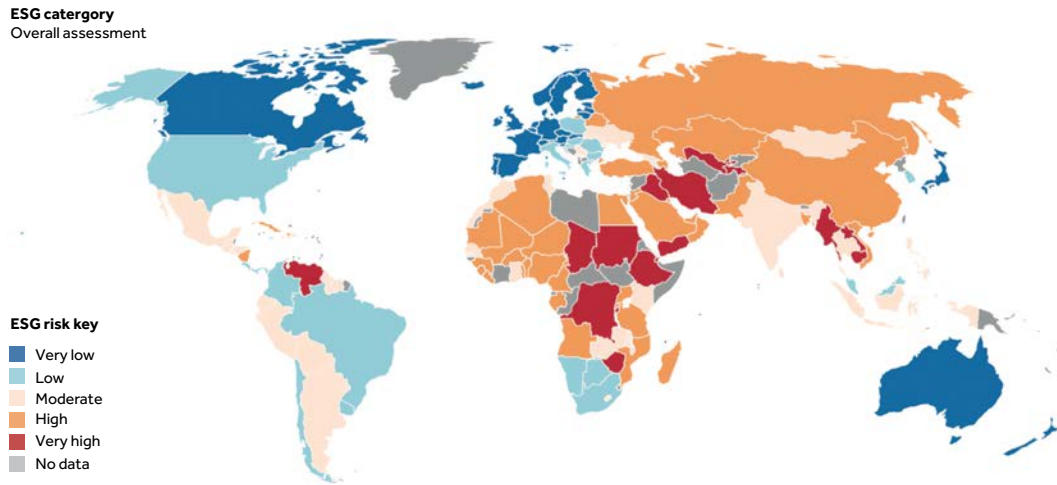
ESG was initially developed to provide a framework for 'socially responsible investing' and to effectively assess longer-term environmental, social and governance risks to firms. The origin of the concept of ESG can be traced back to the 1950s, when workers' unions began investing pension capital in affordable housing and health facilities. The formation of the United National Global Compact in 2000 represented a major milestone for ESG and called on companies *'to align strategies and operations with universal principals on human rights, labour, environment, and anti-corruption, and take actions to advance those goals'*. In 2004, then UN Secretary General, Kofi Annan, invited the chief

executive officers (CEOs) from 55 leading financial institutions to participate in a joint initiative with the UN Global Compact. Together they produced a report entitled *Who Cares Wins*, which provided recommendations to public, private and civil society stakeholders on incorporating ESG to promote better investment markets and more sustainable societies (United Nations 2004). At the same time, the UN Environment Programme (UNEP) Finance Initiative produced a legal framework for the integration of ESG into institutional investment with a focus on financial valuations (UNEP/Fi 2005).

These two reports formed the basis for the launch of the UN-supported Principles for Responsible Investment (PRI) at the New York Stock Exchange in 2006 and the launch of the Sustainable Stock Exchange Initiative (SSEI) the following year (Forbes 2018). PRI is now a global initiative with over 4,900 members representing more than US\$121.3 trillion in total assets under management (PRI 2022). PRI's role is to advance the integration of ESG into analysis and decision-making. The SSEI, supported by the Geneva-based UNCTAD, has grown over the years – with many exchanges now mandating ESG disclosure for listed companies or providing guidance on how to report on ESG issues. These initiatives have brought together leading institutional investors to commit to more sustainable investing practices and ESG is now widespread in the private finance sector. ESG assessments and scoring methods are typically used to screen and compare stock/share options and firms based on their sustainability, governance practices and operations. In 2020, more than US\$35 trillion in assets were under management following some sort of ESG screening process, with capital transfer to ESG growing even during the COVID-19 pandemic (GSIA 2020).

In terms of environmental and climate risks, it is estimated the cost to suppliers due to supply chain disruptions will come to US\$1.26 trillion by 2026, with the associated price increases expected to cost private businesses US\$120

Figure 1. ESG investment risk by country.

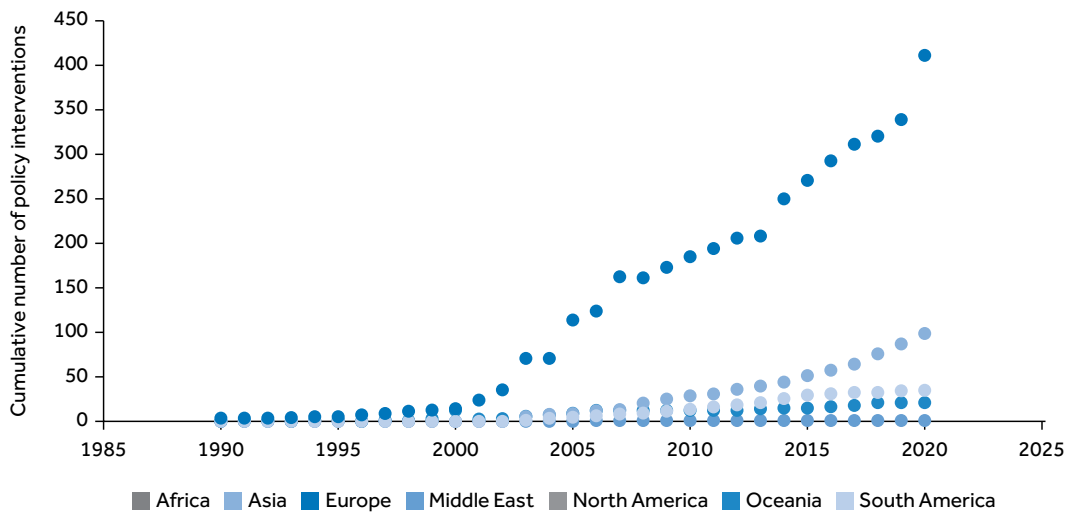


Source: Economist Intelligence Unit (2022).

billion (CDP 2020). Similarly, firms that fail to manage their risks and that experience high-to-severe ESG incidents are expected to lose 6 per cent of their market capitalisation on average (Morrow et al. 2017). At a global scale, the need for investment in clean energy, climate adaptation and public services continues to grow. Additional investments of US\$4.3 trillion per year among developing countries are needed by 2030 to meet the Sustainable Development Goals (SDGs) (UNCTAD 2022).

National and subnational governments, as major investors, can integrate ESG frameworks and concepts to enable more effective public investment decisions, more sustainable procurement and better public-private partnerships (PPPs). Many IFIs have also developed similar frameworks to assess lending proposals and project feasibility. Ensuring capacity within governments to both meet these international standards, and to promote a more sustainable environment for foreign direct investment (FDI) and domestic investments, is critical.

Figure 2. Cumulative sustainable investing policy interventions by region, 1985-2025.



Source: PRI (2021).

Table 1. Typical broad ESG assessment criteria.

Environmental	Social	Governance
Greenhouse gas (GHG) emissions	Supply chain ethics	Company leadership and pay structures
Carbon intensity	Diversity and inclusion	Shareholder accountability
Water and energy consumption	Employment turnover, development and protection	Transparency and anti-corruption
Relationship with regulatory bodies	Consumer protections	Fiscal policies and taxation
Waste generation and management	Community engagement and outcomes	Regulatory principles and accounting practices

In 2018, the World Bank produced its 'Environmental and Social Framework', which aims to enhance commitments to sustainable practices and support borrowers' risk management. It comprises ten 'Environmental and Social Standards' (ESSs): (1) assessment and management of environmental and social risks and impacts; (2) labour and working conditions; (3) resource efficiency and pollution prevention and management; (4) community health and safety; (5) land acquisition, restrictions on land use and involuntary resettlement; (6) biodiversity conservation and sustainable management of living natural resources; (7) indigenous peoples/sub-Saharan African historically underserved traditional local communities; (8) cultural heritage; (9) financial intermediaries; and (10) stakeholder engagement and information disclosure.

To date, ESG funds and investments are largely focused in the Europe and North America regions, which have a more developed regulatory

infrastructure (especially in the European Union [EU]), and more mainstreamed private sector ESG risk management (see [Figures 1 and 2](#)). Although ESG has been growing in all regions, the maturity of regulatory and policy frameworks is highly unequal. Within the top 50 largest economies, 48 have at least one or more policies to help investors consider sustainability risks and outcomes (see [Figure 2](#)). However, many more countries, particularly those in sub-Saharan Africa and least developed countries (LDCs), have yet to introduce sufficient policies to encourage sustainable investment.

For the private sector, typical inputs and indicators are shown in [Table 1](#). However, the range of assessment and reporting methodologies used by firms to evaluate ESG credentials is yet to gain uniform consensus.

1. How Does ESG Influence Financial Performance and Investment Returns?

Proponents often suggest that ESG can provide better outcomes for both shareholders and the environment compared to traditional investing. The benefits of ESG can be assessed according to three key criteria:

- (1) Whether the integration of ESG practices within firms results in more productive business outcomes?
- (2) Whether investors and funds who choose firms with more positive ESG scores produce better returns than conventional portfolios?
- (3) Whether ESG practices effectively protect the welfare of people and the climate alongside enabling sustainable economic growth?

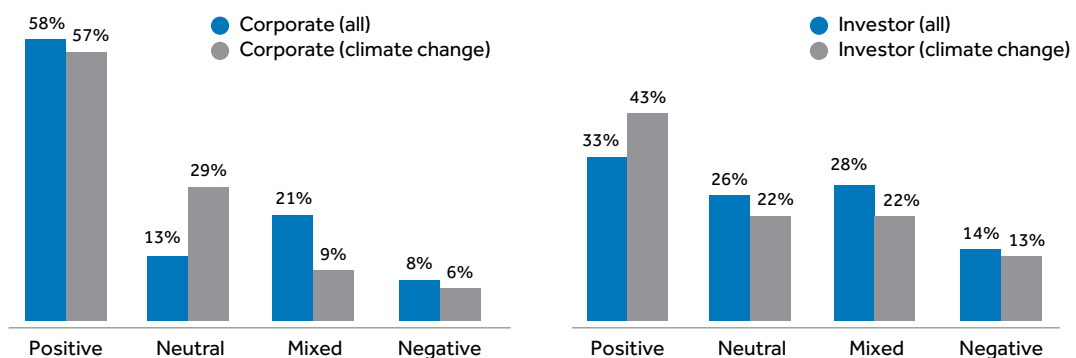
A review of more than 1,000 ESG research papers published between 2015 and 2020 found a positive relationship between ESG and financial performance for 58 per cent of 'corporate studies', a neutral or mixed result for 34 per cent of studies, and a negative relationship for 8 per cent of studies (Whelan et al. 2021). Therefore, findings suggest that incorporation of ESG practices leads overall to positive corporate financial performance, while also addressing climate change challenges (Figure 1.1).

For firms, ESG creates value in five ways (Henisz et al. 2019). These are: (1) sustainable economic growth, (2) reduced regulatory and legal intervention risk, (3) increased productivity and information advantage, (4) cost reductions and investment, and (5) asset optimisation. The integration of sustainability strategies also often drives better financial performance through a renewed focus on stakeholder relations, risk management, innovation capacity and operational efficiency. However, just reporting ESG disclosures alone did not improve performance. In each case, a full corporate sustainability and ESG investment strategy followed by implementation and monitoring is required.

When comparing investment fund performance, ESG profits were often not distinguishable from conventional investing portfolios. That said, a key benefit from the investor studies showed that ESG funds provided:

- (1) more downside protection and resilience during social or economic crisis; and
- (2) more significant returns when positions were taken over longer time horizons.

Figure 1.1. Comparison of all versus ESG corporate and investor financial performance outcomes.



Source: Whelan et al. (2021).

Dedicated ESG mutual funds provided better returns following the financial crisis and during COVID-19. In 2020, 24 out of 26 sample ESG indices outperformed their conventional counterparts (Hale 2020), and analysis of more than 3,000 funds showed that sustainable equity funds outperformed by a median 3.9 per cent (Morgan Stanley Institute for Sustainable Investing 2021). More recently in the second quarter of 2022, in a context of global economic recession, the conflict in Ukraine, and inflationary pressures, the decline in asset value within ESG funds was less pronounced than within the broader market (Morningstar 2022). As countries look for strategies to encourage

sustained economic recovery post-COVID-19, the resilience and stability of ESG investment presents an important mechanism to ensure effective allocation of public and private funds, greater economic stability, and more reliable tax revenues.

This also has special relevance for public sector planning, which often operates on longer time scales and prefers safer investments to manage costs. Mainstreaming ESG screening for public projects provides an opportunity to enhance investment returns, meet national climate targets, and ensure provision of sufficient environmental, social and governance safeguards.

2. Barriers to Effective ESG Outcomes

The rapid rise of ESG investing, increasing public sector and regulatory engagement, and the ongoing climate crisis, has necessitated further scrutiny on the effectiveness and feasibility of ESG. Some of the main criticisms of ESG are as follows.

Across the private and public sectors, the application of ESG lacks a clear, standardised definition, and exhibits high variance in assessment methodologies and reporting. This creates inconsistencies in ESG scores, dependent on the assessor's chosen indicators and weightings, making comparisons difficult. While traditional stock and company credit ratings show a 99 per cent correlation across independent rating agencies, ESG assessment providers only result in 54 per cent correlation. This divergence becomes even larger when disaggregating for the more qualitative social and governance scores (Berg et al. 2022).

Perhaps the most common criticism of ESG is that it provides opportunities for companies to engage in 'greenwashing', especially in cases where ESG scores are self-reported. In many cases, sustainability and social/environmental outcomes remain as a minor motivation among private sector firms, and especially in cases where these may conflict with profit incentives and fiduciary duties to maximise financial returns.

Similarly, the nascent ESG policy environment, especially in countries with less developed financial markets, often fails to create positive incentives, availability and trust in ESG products. Often the countries that would most benefit from the social and environmental co-benefits promised by ESG have very high investment risk. If sustainable investing is to be a means to facilitate sustainable development, then ESG in these more unstable markets must be carefully developed in collaboration with policy-makers and wider stakeholders. Even in more mature markets,

many green products such as green bonds often lack clearly defined contractual obligations for what is considered 'green investment', with no legal recourse or default payout to bondholders if issuers fail to invest in ESG projects and firms (Baker McKenzie 2019).

Finally, incorporating the wide range of Environmental, Social and Governance indicators into a single index masks the inherent social and environmental trade-offs faced by companies. It also reduces the overall weighting of each individual factor – for example, a firm with poor environmental outcomes can mitigate this with token social and governance interventions and still be considered a sustainable investment. For this reason, many firms that wouldn't be considered traditionally sustainable can score highly (for example, arms manufacturers).

Additionally, there are widespread issues with the accessibility, quality and consistency of sustainability data for ESG frameworks (BNP Paribas 2021). Considering the complexity of ESG assessments, a framework that enables disaggregated transparent reporting for each of Environmental, Social and Governance criteria is needed. The *Economist* (2022) suggests an overhaul to only consider greenhouse gas (GHG) emissions as the primary investment criteria due to the scale and immediacy of climate change.

Despite many private sector advocates, ESG cannot replace practical and ambitious public policy to reduce emissions. The reliance on free markets alone to correct history's largest market failure is not a feasible strategy for sustainable development. Instead, the private sector must work in close collaboration with national and subnational governments to promote achievement of Net Zero targets and the Sustainable Development Goals (SDGs) by 2030.

Box 1. Sustainable finance taxonomies – frameworks needed to circumvent greenwashing

The lack of standard 'green' definitions and prevalence of voluntary compliance standards risks allowing corporate greenwashing. One possible solution is to implement a more concrete classification framework to help firms and investors to identify and validate which economic activities are considered sustainable. Adopting common taxonomies across regions, rather than individual countries developing and mandating different criteria, can attract investment across jurisdictions and reduce the costs of accessing cross-border capital markets (IPSF 2020). These criteria can be aligned with the SDGs and Nationally Defined Contributions (NDCs).

In recent years, some progress has been made in this regard. One of the most advanced and ambitious is the EU's *Regulation 2020/852 on the establishment of a framework to facilitate sustainable investment*. This aims to determine activities that contribute to six environmental outcomes: climate change mitigation; climate change adaptation; sustainable use and protection of water and marine resources; transition to a circular economy; pollution prevention; and the protection and restoration of biodiversity and ecosystems. Sustainable economic activities can be distinguished as 'substantial contribution economic activities', 'enabling economic activities', or 'transitional economic activities'. For each, technical screening criteria are established to identify the minimum requirements for contributions; provisions to update the criteria over time are also included (PRI 2022).

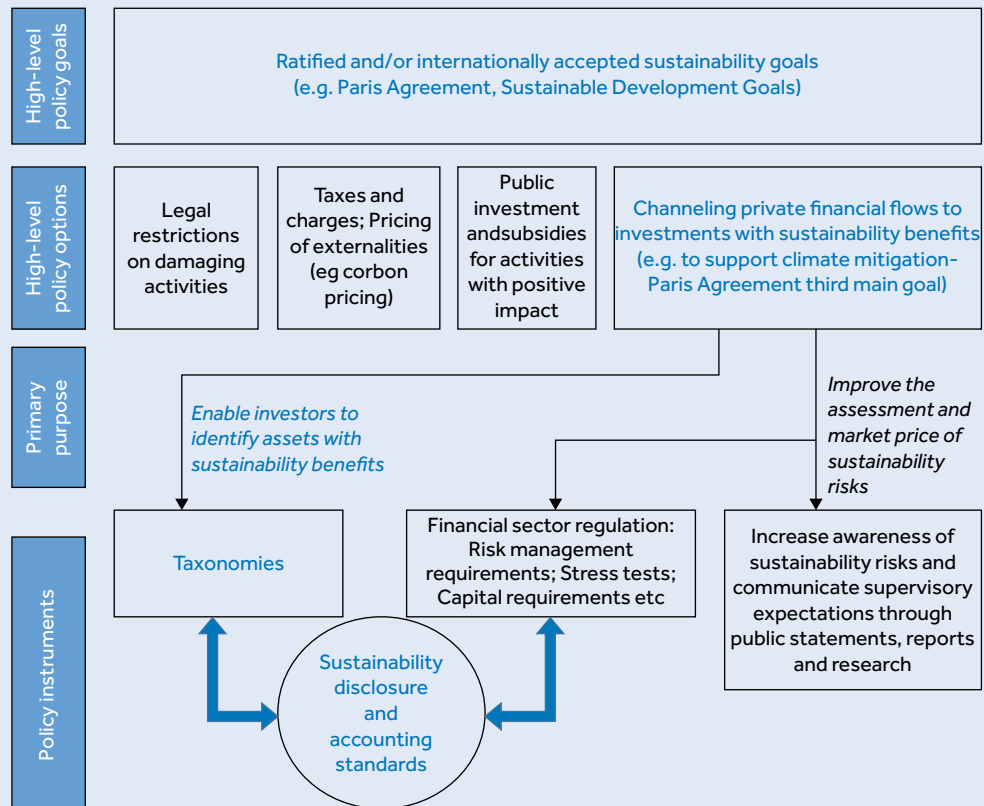
Countries can use sustainable finance taxonomy tools to achieve their high-level policy goals (see [Figure 2.1](#)), many of these are designed to be operable with the EU framework.

- The Australian Sustainable Finance Institute (ASFI) is currently working on a green taxonomy for government and industry consultation.
- Bangladesh Bank has developed a granular national taxonomy, including 8 categories and listing 55 designated green products, project and initiatives.
- Malaysia's Climate Change and Principle-based Taxonomy.
- India's Ministry of Finance is drafting an upcoming taxonomy led by the Sustainable Finance Taskforce.
- Singapore's Green Finance Industry Taskforce is developing a Singapore Taxonomy.
- South Africa published the South African Green Finance Taxonomy in March 2022, as part of its Sustainable Finance Initiative, chaired by the National Treasury.
- The UK's Green Technical Advisory Group is supporting development of a Green Taxonomy for launch in 2023 as part of the 2021 Greening Finance: A Roadmap to Sustainable Investing.

The World Bank provides guidance for countries aiming to develop a national green taxonomy [here](#).

Source: Ehlers et al. (2021).

Figure 2.1. Using sustainable finance taxonomy instruments to achieve high-level policy goals.



Source: Ehlers et al. (2021).

3. Future Trends in ESG

The application of ESG frameworks has clear benefits for financial decision-making by both public and private sector investors. ESG investing will continue to grow with increasing quantities of capital allocated based on ESG assessment criteria, especially as countries approach their Net Zero deadlines. The systemic transition towards ESG investing will provide more robust evidence to assess the effectiveness of ESG for sustainable development outcomes and positive social and environmental impact.

There remains a clear need to find consensus around the key definitions, reporting methods and scope of ESG. Greater multilateral and multisectoral co-ordination and collaboration will be needed to ensure regulatory consistency and the sharing of best practices across jurisdictions.

Where not already present, governments will need to develop policy frameworks that can

attract sustainable investors and capital, foster ESG, and prevent greenwashing, particularly in developing countries. Governments will require capacity building and training to be able to create effective regulation and create conducive investing ecosystems.

Increasingly, policy instruments are being developed to mandate firms to disclose their emissions and environmental impact. Transparent public disclosures have scope to increase consumer and stakeholder awareness of environmental and social issues and put pressure on firms to become more sustainable. For examples of recent legislation in this area, see: European Union (2019), Sustainable Finance Disclosure Regulation; and US Securities Exchange Commission (SEC 2022), The Enhancement and Standardization of Climate-Related Disclosures for Investors.

Box 2. Climate-related financial disclosure regulation – United Kingdom (2022)

In 2022, the United Kingdom became the first G20 country to mandate climate-related financial disclosures for over 1,300 UK-registered firms. Following recommendations of the Task Force on Climate-Related Financial Disclosures, an industry group established at COP21, these new requirements aim to support investors and businesses to better understand the financial impacts of climate change exposures, contribute to Net Zero commitments and allow for better pricing of climate risks.

Disclosures target companies and LLPs (limited liability partnerships) with more than 500 employees and require reporting of climate physical and transition risks and management for global operations. This includes:

- (a) a description of the governance arrangements of the company or LLP in relation to assessing and managing climate-related risks and opportunities;
- (b) a description of how the company or LLP identifies, assesses and manages climate-related risks and opportunities;
- (c) a description of how processes for identifying, assessing and managing climate-related risks are integrated into the overall risk management process in the company or LLP;
- (d) a description of (i) the principal climate-related risks and opportunities arising in connection with the operations of the company or LLP, and (ii) the time periods by reference to which those risks and opportunities are assessed;

- (e) a description of the actual and potential impacts of the principal climate-related risks and opportunities on the business model and strategy of the company or LLP;
- (f) an analysis of the resilience of the business model and strategy of the company or LLP, taking into consideration the different climate-related scenarios;
- (g) a description of the targets used by the company or LLPs to manage climate-related risks and to realise climate-related opportunities and of performance against those targets; and
- (h) the key performance indicators used to assess progress against targets used to manage climate-related risks and realise climate-related opportunities and a description of the calculations on which those key performance indicators are based.

Source: UK Department for Business, Energy & Industrial Strategy (2022).

4. ESG for Government and the Public Sector

Governments are major economic actors and institutional investors. They employ thousands of civil servants, and spend and invest vast sums of capital per year – average government expenditure was 36 per cent of gross domestic product (GDP) in Commonwealth countries in 2022 (IMF 2022). They also directly and indirectly produce high quantities of waste and carbon emissions and have the primary responsibility for managing of these issues and achieving sustainable development. The mainstreaming of ESG practices by governments presents opportunities for the implementation of environmental, social and governance best practices in fiscal decision-making and project management. Additionally, more public sector ESG will facilitate closer alignment with IFI standards and guidelines and synergise with wider policy efforts around gender equality and youth engagement.

IFI funding applications and project proposals typically require a full social, environmental and governance impact assessment and monitoring strategy. Building capacity within national and subnational governments to work within these frameworks has the potential to improve access to development finance and international climate finance. Similarly, ESG frameworks can provide new insights when evaluating the feasibility of domestic investments and public works.

The more investor-focused model of ESG can be directly applied to the activities of sovereign wealth funds and/or state-owned pension funds. Due to their public ownership, both are typically more focused on maximising long-term returns and stable investments that are conducive to ESG. Here, national development outcomes can be achieved alongside positive returns for citizens.

In many countries, government departments have already allocated emission budgets and reduction targets, including more than 130 countries that have set Net Zero targets by or before 2050 (Net Zero Tracker 2022). All Commonwealth countries have developed emission reduction targets in some form, including 40 Net Zero commitments. As public sector objectives are fundamentally linked to

improving public welfare, there is a strong argument for increased transparency and sustainability reporting by the public sector. Taxpayers and citizens have a right to be informed and understand how and where public money is spent and how public sector as well as private sector organisations (as they benefit from support from the public sector, including public finance) are tackling sustainability challenges.

However, this kind of reporting is only just beginning. A global survey of public sector organisations by the Chartered Institute of Public Finance and Accountancy (CIPFA 2021) found that fewer than half of respondent organisations produced a sustainability report and only 20 per cent agreed that sustainability reporting was supported within their overall policy mandate and, of the organisations that produced reports, only 37 per cent said they felt they had the in-house skills and capacity to deliver. While sustainability reporting by private organisations must increase to meet ambitious climate targets, greater emphasis on public sector reporting is required to ensure the same challenges can be addressed.

ESG has scope for integration within sovereign debt management and the construction of debt portfolios. ESG metrics are increasingly being considered by many stakeholders regarding public debt management. Sovereign bond investors often incorporate ESG into investment, research, valuation and asset selection. Recognising that ESG risks play a prominent role in creditworthiness, major credit rating agencies have begun to integrate ESG into their sovereign assessment methodologies. Given the growing awareness and uptake of ESG, it is important for public debt managers to consider these factors within their debt management strategies, portfolio risk management and borrowing activities.

A recent survey on approaches to ESG in public debt management, including the issuance of sovereign green bonds, suggested countries should: (1) be more proactive and transparent in providing information to investors, rating

agencies and the broader public on government initiatives and actions to promote ESG issues; (2) add ESG-related risk scenarios into debt analysis and medium- and long-term debt sustainability analyses; and (3) issue ESG-labelled bonds (OECD 2021; 2022).

The nascent, but fast-growing, ESG bond market can play an important role in developing economies, particularly with the aim of 'green and inclusive recovery' following the COVID-19 pandemic. Bonds are the main financing mechanism that cuts across a broad set of actors involved in the realisation of the SDGs, including corporates, governments, municipalities or development banks providing the breadth of actors and scale and liquidity necessary for investors. The bond market is a longer-term, lower-risk asset class that matches the profile of SDG activities and has enough scale to address the climate and SDGs financing gaps.

Fixed income is an important asset class to drive meaningful improvement in terms of the SDGs financing gap, as the global bond market is almost double the size of the equity market (PIMCO n.d.). At the same time, bond returns are relatively stable and predictable when compared to equity (Climate Bonds Initiative 2015). Debt servicing cost on these bonds may be lower compared to conventional ones, at least in the initial stages, as appetite for these instruments by institutional investors is expected to remain high, as evidenced by the oversubscription of several high-profile bonds issued by emerging economies.

The green bond market was the first ESG-relevant bond to gain traction and has remained a core part of the ecosystem, with volumes growing at an average rate of 20 per cent. However, during 2020, social bonds received a lot of attention and were used by governments to finance healthcare issues relating to COVID-19. Broadly, two factors contributed to the early lead in the issuance of green bonds: investor demand and the relative ease of impact measurement.

Issuers carried out 'greening' of their bond issue, as it added to perceived value for many investors without increasing risk. Moreover, impact measurement for green bonds was relatively straightforward and based on a quantifiable and

generally standardised set of data. This increased investor certainty about the real, verifiable environmental impact of investments. Green bond assets and projects are also easier for issuers to identify and 'ring-fence' than social bonds. Further, the green bond market is relatively much larger and more diversified than the social bond market, which has typically been exceptionally niche in terms of size and issuer diversity.

Sovereign social bonds were instead mainly issued in 2020 to finance COVID-19 response efforts, through improved health infrastructure and preventive health practices. Social bonds involve the use of bonds proceeds for new and existing projects with positive social outcomes. The Social Bond Principles (SBPs) seek to support issuers in financing socially sound and sustainable projects that achieve greater social benefits (ICMA 2021). SBP-aligned issuances should provide transparent social credentials alongside proposed investment opportunities. Much of the social bond market's issuances were by government agencies, supranational and local authorities. The main factor that has constrained social bond issuance is not the demand side, but the supply side. Corporate issuers like banks and non-financial issuers need to find assets on their balance sheets or eligible projects that meet the issuing principles, which is considerably easier for green projects than for social projects.

ESG bonds also carry risks that emerging market policymakers must monitor and address. Financial stability risk is one such risk, as the investor base for these bonds is different relative to more traditional investors, and is potentially more sensitive to global financial conditions, given the technology-heavy composition of many ESG indices. This is an important consideration in the current policy environment, with central banks in advanced economies raising interest rates and unwinding policy accommodation given during the pandemic.

Finally, the wider promotion of private sector ESG has the potential to bring a range of benefits to governments. The growth of the sustainable investing sector and firms provides positive tax outcomes, while minimising the negative externalities often associated with economic growth.

Box 3. Overview of thematic ESG-relevant bonds

1. **Green bonds:** Issued for the first time in 2007 as 'Climate Awareness Bonds' by the European Investment Bank, these bonds were soon followed by bonds issued by the World Bank and other supranational issuers. Green bonds aim to provide funding for projects intended to deliver a positive environmental impact. Examples of projects eligible for green bond issuance include renewable energy, energy efficiency, clean transportation, green buildings, wastewater management and climate change adaptation.
2. **Blue bonds:** These gained attention in October 2018, after the World Bank facilitated the launch of the world's first sovereign blue bond by Seychelles. These bonds dedicate proceeds to marine projects, such as promoting biodiversity, coastal economies and sustainable fisheries.
3. **Social bonds** are an increasingly popular fixed-income product with issuances led by multilateral development banks (MDBs), which often have access to a social bond-eligible pipeline of projects. Examples of eligible projects include food security and sustainable food systems, local economic development, affordable housing and essential services such as healthcare.
4. **Gender bonds** are relatively new and no official definition yet exists. However, they can be broadly defined as bonds that support women's empowerment and gender equality. Various international initiatives, such as the 'UN Women Empowerment Principles' and the '2X Challenge', can help identify eligible investment activities, benefits and impacts of gender bonds. Prominent examples include the Asian Development Bank's (ADB) US\$90 billion gender bond, issued in 2017, and the International Finance Corporation's (IFC) 2020 commitment to fully support Indonesia bank OCBC NISP's gender bond.
5. **COVID-19 bonds:** Lastly, the COVID-19 pandemic created demand for new types of funding instruments. COVID-19 bonds raise finance to mitigate the adverse impacts of the pandemic and drive socio-economic recovery plans.
6. **Sustainability bonds** are bonds where the proceeds exclusively finance or re-finance a combination of both environmental and social projects. They offer a wider range of potential investment opportunities and eligible project categories. Although the wide range of the SDGs provides issuers with many opportunities to help achieve the 2030 Agenda, SDG bonds are still at a nascent stage. Further growth in the SDG bond market could come from expanding eligible assets and projects categories, with clear guidance on SDG alignment.
7. **Transition bonds** are used to finance projects allocated for pre-defined climate transition-related activities.

Source: OECD (2021).

5. Scoping ESG for the Commonwealth

Commonwealth countries have been confronted with unprecedented economic, environmental and social challenges since the start of this Decade of Action to deliver the Sustainable Development Goals. The COVID-19 pandemic brought global disruption and will leave a legacy of poverty and debt that threatens the achievement of the SDGs. As countries emerge from the pandemic, the compounding challenges of increasing commodity prices, global inflationary pressures, extreme debt, geopolitical instability and conflict, and sustained supply chain disruption mean the rate of economic recovery remains uncertain, especially for low-income countries, small island developing states (SIDS) and LDCs. As a result, global growth is projected to slow from an estimated 6.1 per cent in 2021 to 3.6 per cent in 2022 and 2023 (IMF 2022). Additionally, the existential climate-related risks, particularly for our small island states, are growing rapidly. Effective long-term finance and investment is critical in bringing the global development trajectory back on track to meet our growing global challenges. Environmental, Social and Governance (ESG) provides one avenue for countries to better direct capital towards attaining SDG outcomes.

At the Commonwealth Heads of Government Meeting (CHOGM) in 2022, the mandate for the Commonwealth Secretariat to broaden and strengthen technical support for development financing was renewed. CHOGM Communique Outcome 39 presents an opportunity to scope a range of ESG-related activities and technical assistance for member states:

39. Heads recognised the crucial role of investment in transforming economies and creating inclusive economic growth and long-term prosperity. They acknowledged that high quality investment and infrastructure, both digital and physical, and notably clean, green infrastructure investment, is a cornerstone of sustainable economic growth.

The Commonwealth is home to several major international finance hubs and stock exchanges that contribute to private sector ESG, including but not limited to: London, Singapore, Toronto, Melbourne, Mumbai, Cape Town, Mauritius, The

Bahamas, Kigali, Nairobi and Lagos. There is scope to share policy experiences between regulators and between countries as they develop their own sustainable investing and policy frameworks appropriate to their country context.

Commonwealth countries would benefit from developing strategies to integrate ESG factors into sovereign debt management institutional and legal frameworks. This would span back, middle and front office activities, including funding and issuance strategies, investor relations programmes, debt management practices, and debt reporting and transparency. Implementation would provide an actionable plan to help governments link sovereign debt to impactful ESG outcomes, while simultaneously broadening and diversifying their investor base.

Wider capacity building and training on the concepts, risks and opportunities presented by ESG could also be offered at the national and subnational levels. This would support alignment with IFI standards and improve public sector sustainability and performance towards Net Zero targets.

Finally, a wider collaboration among Commonwealth countries for regular discussion and development ESG strategies would enable knowledge exchange, facilitate data sharing, and bring coherence to the multiplicity of methodologies and definitions currently in circulation. In particular, support for the development of sustainable finance taxonomies and carbon disclosure regulation would be beneficial. To avoid fragmentation of markets and regulatory approaches, international co-ordination and the adoption of global standards remain paramount.

Pending availability of quality reporting and sustainability data, further research toolkits and country trackers could be developed to benchmark, monitor and accelerate country progress on sustainable investing. As an expanding concept, ESG has the scope to support governments, businesses, communities and citizens to work collaboratively towards a more socially and environmentally responsible economy and society, together with protecting our planet.

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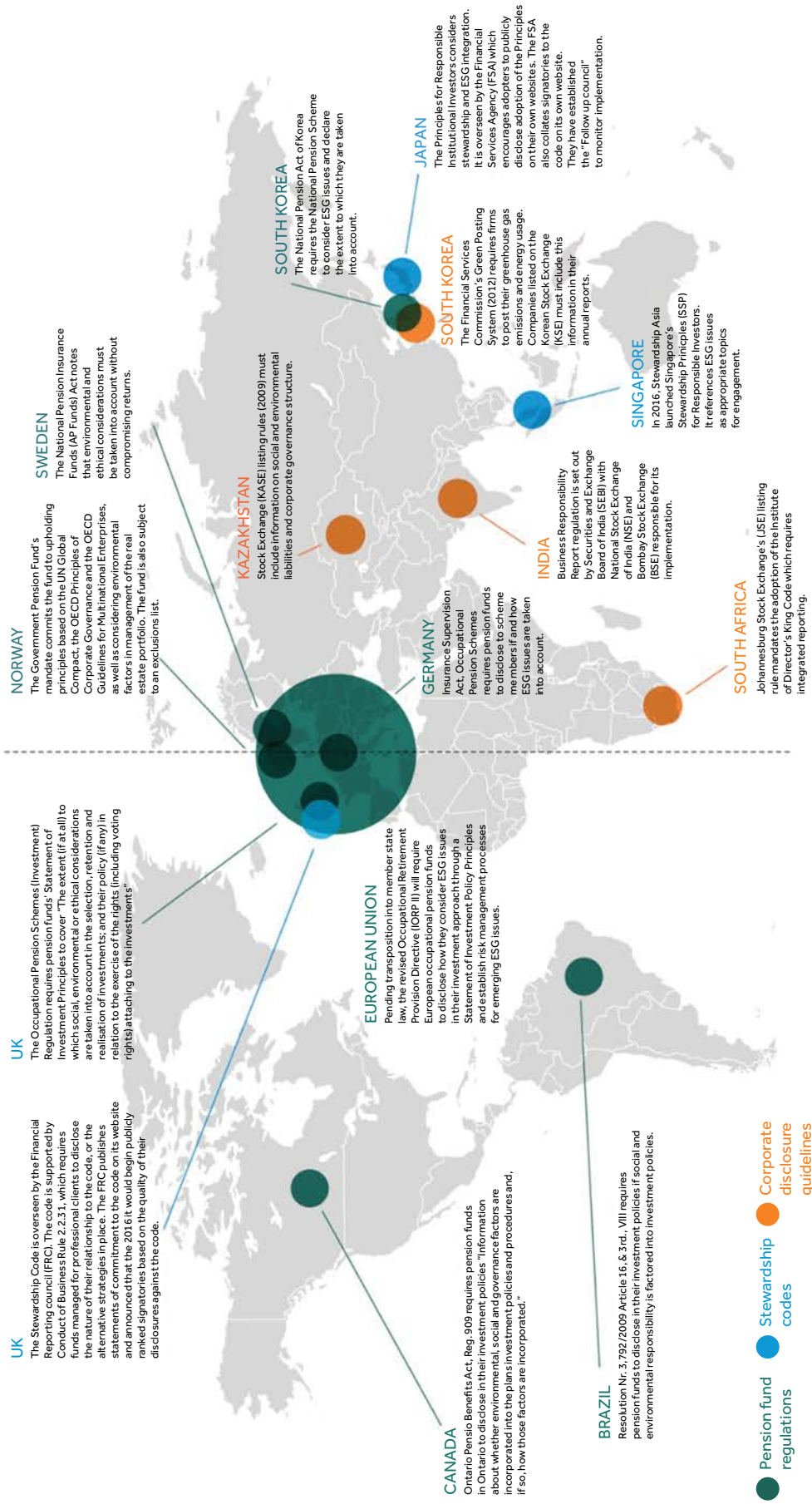
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Annex A. Supplementary Material

Annex A1 Global examples of ESG and sustainable investment legislation.

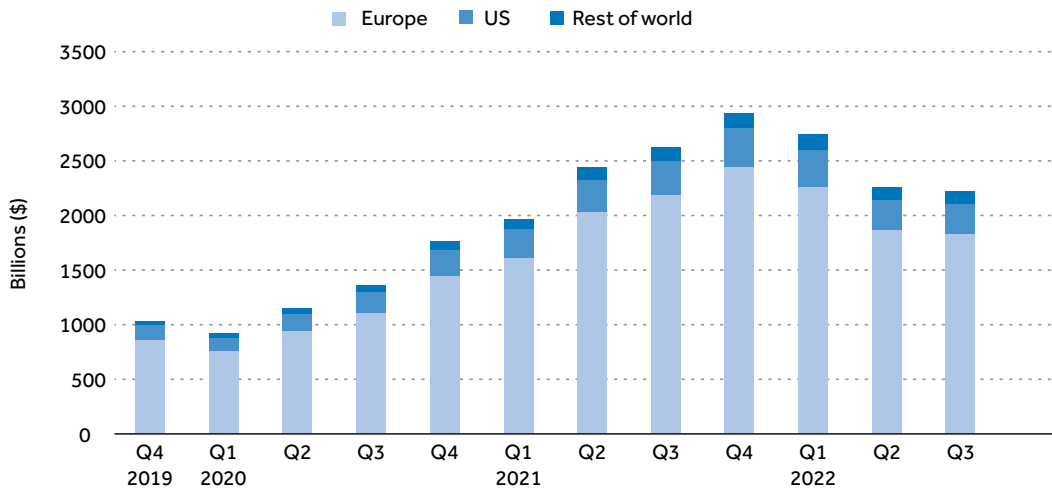


- Pension fund regulations
- Stewardship codes
- Corporate disclosure guidelines

Source: PRI (2016)

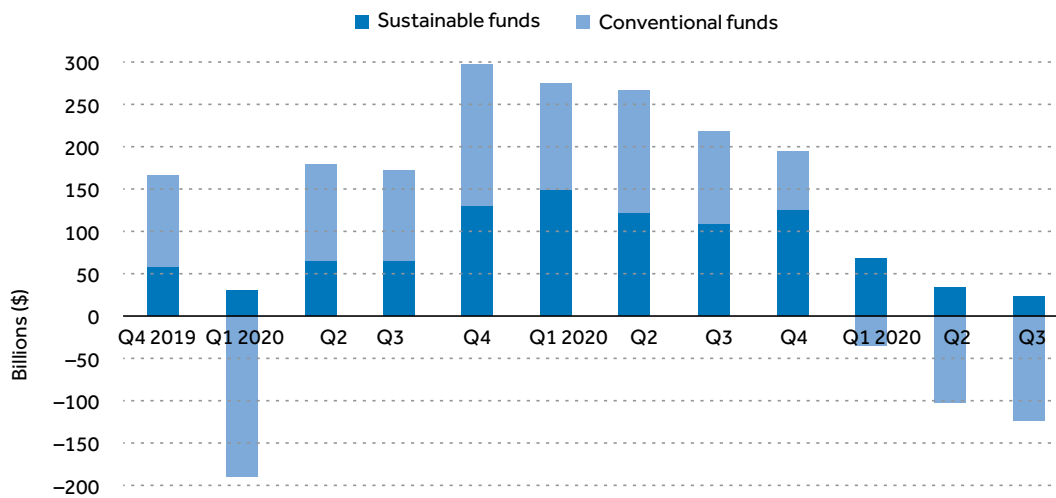
Annex A2 Selected figures and tables from the *Global Sustainable Fund Flows: Q3 2022 in Review* report tracking investment activity across 6,777 funds (Morningstar 2022).

Quarterly global sustainable fund assets under management



Source: Morningstar Direct, Manager Research. Data as of September 2022.

Sustainable fund flows compared with conventional fund flows



Source: Morningstar Direct, Manager Research. Data as of September 2022. Sustainable fund flow data for Q1 and Q2 was retreated using the new framework for ease of comparison. Under the old framework, flows in Q1 and Q2 were USD 71.7 billion and USD 30.7 billion, respectively.

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