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UNLEASHING Sustainable Finance in Southeast Asia

Abstract

Climate change mitigation and adaptation efforts are urgently needed across Southeast Asia. The region has some of the most greenhouse gas (GHG)-intensive economies in the world. At the same time, climate change is significantly impacting and altering the operating environment for firms, investors, and communities. Economies in Southeast Asia are among the most exposed in the world. Climate-change-related disasters cause significant economic and social losses, and pose severe risks to Southeast Asia's long-term economic development agendas. To achieve low-carbon and climate-resilient economies, the ASEAN-5 economies—Indonesia, Malaysia, Philippines, Thailand, and Vietnam—must undergo a costly but necessary economic transformation toward low-carbon and climate-resilient economies.

The financial sector can play a critical role supporting countries in their journey toward greater resilience and sustainability, but it must adapt to do so effectively. This economic transformation will entail large scale investments, which in turn, will require massive funding. Public sector financing alone is not sufficient and needs to be complemented with private financing. Well-developed financial markets can catalyze large amounts of funds for climate change mitigation and adaption efforts. But for that to occur, sustainability considerations must become mainstream, entering the core of the decision-making processes of financial institutions. Developing financial systems for these goals entails addressing two interrelated challenges: (i) management of climate risks to the financial sector itself; and (ii) capital mobilization for sustainable investments. This report focuses on the latter.

This report shows that while sustainable finance has experienced widespread expansion, sustainable financial markets remain small and unable to meet the funding needs of ASEAN-5 economies for their various sustainability objectives. Sustainable debt and equity markets have shown impressive growth over the last five years across the ASEAN-5. For example, the total amount of sustainable debt raised annually increased from US$0.25 billion in 2016 to US$6.75 billion in 2021, bringing the total amount of outstanding sustainable debt to about US$24 billion. Yet, ASEAN-5 economies are still at the stage of trying to deepen sustainable financing from "millions to billions," far from the much-needed escalation from "billions to trillions." Furthermore, the research shows that sustainable debt and equity markets remain a small fraction of conventional markets, suggesting the potential for further growth of sustainable finance is largely untapped.

The outreach of sustainable financial markets is extremely limited, with a sizeable gap in sustainable financing, especially for small and medium enterprises (SMEs). Only 83 non-financial firms in the ASEAN-5 have tapped sustainable equity and debt markets since 2017. Sustainable debt markets have financed mostly listed firms with an investment grade, whereas private equity markets have funded small corporations with projects in climate and/or clean technologies. Novel survey results in this report indicate a limited range of other sustainable financial products in the offerings of financial institutions in the ASEAN-5. Insurance is notably absent.

A marked gap in climate-related information hampers investments in sustainability and is further exacerbated by limited capabilities across a wide range of stakeholders in sustainable finance. About 88 percent of the surveyed financial institutions in the ASEAN-5 cited the limited availability and complexity of climate-related information as core challenges for sustainable investing—from the high costs of gathering and processing climate-related information, if at all available, to the complexity of sustainability metrics and the lack of reporting standards. The lack of well-established standards and the information gap is particularly challenging in an environment with limited capabilities. Survey findings indicate that limited capabilities, particularly shortage of expertise in the financial sector, hinder the development of sustainable finance. The results also suggest a lack of green projects, which arguably stems from a lack of capabilities needed to generate a pipeline of sustainability projects, such as the lack of technical expertise in the private sector.

Financial performance is a key driver of sustainable investments for financial institutions, often prioritized over sustainability considerations. Even in the absence of information gaps, assessing the financial benefits of sustainable investments is particularly challenging in the context of climate change, as many benefits of mitigation and adaptation efforts are realized, for example, as avoided damages rather than direct revenue streams. Difficulties in accessing and analyzing climate-related information exacerbate this challenge. To the extent that financial concerns and interrelated, complex challenges hinder sustainable financing, thus motivation for change can come via "incentives from the top." The research in this report highlights that swift and strong actions by the top echelon of financial institutions and governments can play a critical role in driving investments toward sustainability.

To unleash sustainable finance in Southeast Asia, policy makers must *REACT* to mobilize private capital towards sustainability. This report highlights the importance of developing the financial architecture for sustainability in financial markets. While the ASEAN-5 economies have made significant headway in this regard, enabling policy frameworks are often at an early stage of implementation. ASEAN-5 economies have a lengthy road to travel before sustainability is fully integrated into investment decisions. This report proposes a new framework for policy action, the five REACT policy priorities, with policy implementation as an important cross-cutting theme:

(i) ***R****eadiness:* Policy makers should mitigate investment challenges for creditors and investors, especially those associated with the high riskiness (whether real or perceived) of investments in sustainability. Policies should aim to de-risk sustainable investments, support better risk diversification across investors, and foster pricing efficiency in financial markets. Policy makers can also be instrumental in addressing the lack of sustainable assets for investments.

(ii) ***E****nabling environment:* Policy makers should foster a supportive enabling environment to broaden financial market development, focusing on improving local financial market infrastructures for deeper and more accessible financial systems.

(iii) ***A****nalytics:* Closing data gaps and enhancing information systems should be a policy priority. High-quality, granular, and timely data must be collected and accessible to a broad set of stakeholders. An important next step for most of the ASEAN-5 is to push forward with an effective implementation of taxonomies and disclosure standards, with the ultimate goal of wider implementation across the private sector at large.

(iv) ***C****apabilities:* Building capabilities and enhancing sustainable finance literacy can accelerate the mainstreaming of sustainability in finance. These efforts should go beyond financial institutions themselves and encompass policy makers and the private sector at large.

(v) ***T****ransition:* To ensure a 'just transition,' policy makers should pay close attention to firms that may be negatively impacted by the transition toward greater sustainability as well as those that face greater risks of exclusion from current sustainable financial markets. These firms may *de facto* be excluded from critical financing sources, which in turn could lead to economic inefficiencies.

Fostering sustainable financial market development will require a deliberate and holistic approach to catalyze private investments. Although not directly addressed in this report, policy makers should also recognize that adjustments to supervisory practices and frameworks to mitigate the potential impact of climate-related risks on financial stability can provide further incentives for financial institutions to reallocate their portfolios toward more sustainable investments. In addition, policy makers need to consider the broader and complex policy landscape for the development of more sustainable and resilient economies. Of particular importance is the agenda supporting firms in building climate change resilience and becoming more sustainable.