Mobilising the resources needed to finance the green transition in Latin America and the Caribbean

Key highlights

- Financing the green transition will require mobilising massive amounts of financial resources from a wide array of public and private stakeholders. While the green agenda demands vast resources, the cost of inaction can be high.

- The region will need to promote sustainable fiscal tools such as environmental taxes, emissions trading systems, and a gradual phase-out of fossil-fuel subsidies, all under a tight fiscal space. Environment-related tax revenues amounted to only 1% of GDP in 2021 on average in LAC (2% of GDP for the OECD average). The role of national and sub-national development banks is also key, including for leveraging private-sector resources.

- Innovative debt tools such as green, social, sustainable and sustainability-linked (GSSS) bonds can play a key role in financing the green transition. From 2014 to 2022, the region's GSSS market reached USD 100 billion. Sustainable finance frameworks in the region should increase harmonisation of GSSS regulatory tools, including principles, standards, and taxonomies, and consolidate reliable monitoring and verification systems to maintain market transparency and avoid greenwashing/SDG-washing.

What's the issue?

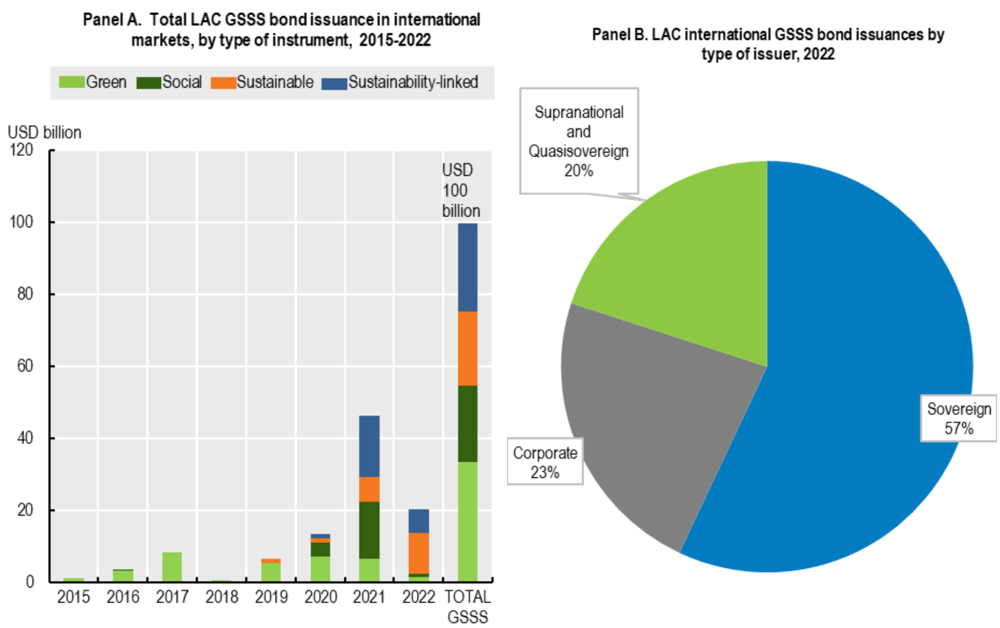
Financing the green transition will require mobilising massive amounts of financial resources from a wide array of public and private stakeholders. While advancing the green agenda will require vast financing, the cost of inaction is also significant, due to the increased impact of climate events, the loss of fossil-fuel revenues as these become less in demand worldwide, or the risk of stranded assets.

The region faces a tight fiscal space and will need to strengthen ways in which to generate additional revenue. Following the pandemic, public debt stood at 70.6% of GDP in 2021, up from a level of 67.9% in 2019. Tax revenue reached an average of 21.7% of GDP in 2021, compared with an OECD average of 34.1% (ECLAC, 2023; OECD et al., 2023). In this context, it will be important to explore ways in which to raise additional resources while protecting the environment: environmentally-related taxes, emissions trading systems, and the gradual reduction of fossil-fuel subsidies are key areas. On average, environment-related tax revenue in LAC amounted to only 1% of GDP in 2020, just half of the estimated OECD average of 2% of GDP (OECD et al., 2022).

Promoting and scaling up innovative financial instruments to mitigate climate change and achieve sustainable development will be fundamental. The development and strengthening of green, social, sustainable and sustainability-linked (GSSS) bonds[1] helps to consolidate a capital markets-based approach to green finance, thus facilitating increased private sector financing. Scaling up other mechanisms (e.g. debt-for-nature swaps, catastrophe bonds and natural disaster clauses in bond issuances) is also key to addressing important challenges such as fiscal volatility, stabilising budgets, and the need to build up large budget reserves (OECD et al., 2022).

The region's GSSS bond issuances in international markets have grown substantially since 2015. The GSSS market reached an accumulated USD 100 billion from 2014 to 2022, of which green bond issuance accounted for USD 33.4 billion alone, followed by sustainability-linked bonds by an amount of USD 24.4 billion (Figure 1, Panel A). In 2021, corporates led total GSSS bond volumes with a share of 54% of the total LAC GSSS bond issuance, while sovereigns represented 37%, quasi-sovereigns 12% and supranational issuers 5%. The role of sovereigns in total LAC GSSS bond issuances has been growing in recent years, particularly in 2022, when they represented 57% of total LAC international GSSS bond issuances (Figure 1, Panel B). Internationally, the GSSS bond market constitutes only a fraction of the global bond market so far. Representing only 1% of total assets outstanding and around 2% of new issuances, there is broad potential to continue expanding this market (OECD, 2022).

Figure 1. International issuance of LAC GSSS bonds by type of instrument and issuers



Note: Sov = sovereign. Corp = corporate. Ssov = sub-sovereign (states, cities and provinces). Supr = supranational. Qsov = quasi-sovereign. Quasi-sovereign issuers are defined as companies with full or partial government ownership or control, and supranational issuers as entities formed by two or more central governments to promote economic development for member countries.
Source: (OECD et al., 2022 ; ECLAC, 2023[1]).

[1] Green, social and sustainability bonds are fixed income instruments whose proceeds are exclusively applied to finance or refinance, entirely or partially, environmental or social projects or a combination of both. Sustainability-linked bonds (SLBs), on the other hand, are target linked, and proceeds are used for general purposes. With SLBs, issuers choose the associated targets they want to achieve through the issuance of the bond, and these are later tracked through the assessment of key performance indicators (KPI) (OECD et al., 2022; Núñez, G., H. Velloso and F. Da Silva, 2022). Hence, the regulatory frameworks for GSS bonds differ from that of SLBs.

Financial strategies will have to enhance private and public sector resource mobilisation, in part by engaging key actors including subnational, national and international development finance institutions. Enhancing green fiscal frameworks (e.g. through green fiscal rules) will be crucial as will expanding sustainable finance frameworks to ensure that public and private investments effectively reach environmentally sustainable projects. Since the private sector will account for most of the investment needed to undertake the green transition, the public sector will have to create the necessary incentives to redirect these investments toward sustainable projects (OECD et al., 2022). To facilitate this, it will be necessary to improve and expand sustainable finance frameworks to ensure that the right regulatory tools are in place (e.g. GSSS principles, standards, and taxonomies). Putting in place mechanisms to avoid greenwashing/SDG-washing will be critically important (OECD et al., 2022).

National and sub-national development banks (NDBs and SDBs) can have a significant impact in mobilising resources to drive and support the green agenda. They can provide technical and direct financial support for the design of climate and financial strategies, and they can help in mobilising and leveraging private flows towards low-carbon and climate-resilient pathways, specifically through de-risking and credit enhancement. NDBs and SDBs can also be critical in developing innovative financial solutions for micro, small and medium enterprises and for infrastructure projects, with terms tailored to the financial profile for low-carbon investments (OECD et al.,2022).

Examples of sustainable finance frameworks in LAC countries

Several LAC governments and financial institutions are developing GSSS standards and taxonomies to classify their own issuances using the International Capital Markets Association (ICMA) principles[2] as a general framework.

GSSS standards

Chile is a good example in the region of how standards have been gradually developed for all types of GSSS bond issuances. In 2019, Chile's Ministry of Finance published the "Sovereign Green Bond Framework" in collaboration with the Ministry of Environment. This framework sets forth standards and obligations for the Chilean government as a green bond issuer following the four main components of the ICMA's Principles. In 2020, the Ministry of Finance published its first "Sustainable Bond Framework" setting standards for the issuance of not only green bonds, but also social and sustainable bonds. In 2022, the Ministry of Finance also developed a Sustainability-Linked Bond Framework (SLB Framework) prior to issuing its first sovereign sustainability-linked bond in March 2022 (OECD et al., 2022).

[2] International Capital Markets Association (ICMA) principles is an overarching international framework. Every year they publish procedural guidelines defined as "collection of voluntary frameworks with the stated mission and vision of promoting the role that global debt capital markets can play in financing progress towards environmental and social sustainability" (ICMA, 2023).

Taxonomies

Green and sustainable taxonomies have been developed in the region. They have been implemented in Mexico and Colombia, while they are under development in countries such as Brazil, Chile, Dominican Republic, and Peru and in sub-regions such as Central America. In April 2022, the Colombian government published the region's first green taxonomy. This taxonomy seeks to facilitate the identification of projects with environmental objectives, develop capital markets, and promote the effective mobilisation of private and public resources. In June 2023, the UN system in LAC launched the first "Common Framework of Sustainable Finance Taxonomies" through the Working Group on Taxonomies of Sustainable Finance in Latin America and the Caribbean [3]. This regional framework is intended as a voluntary guidance document for actors in the region that are in the process of developing or that intend to develop taxonomies. The framework also provides guidance for interoperability of taxonomies within LAC and globally (UNEP, 2023). Harmonising the methodologies behind the different taxonomies will increase trust among investors and reduce transaction costs.

Further co-operation is needed so that GSSS standards and taxonomies are harmonised at both regional and international levels with other initiatives such as those of the EU and the ASEAN. This is essential to boost the transparency and reliability of the GSSS bond market in the region and to develop stronger joint monitoring and verification systems.

LAC sovereign GSSS bond issuance

Since 2019, a growing trend of sustainable issuances by national governments has been observed in the region. Regarding issuances in international markets, in 2019, Chile issued the region's first green sovereign bond in international markets. From then until 2022, seven countries - Chile, Ecuador, Guatemala, Mexico, Peru, Bahamas and Uruguay - in order of appearance in international markets, issued green (or blue), social, sustainability and sustainability-linked bonds. Regarding issuances in the domestic market, in 2021, Colombia became the first emerging economy to issue a sovereign green bond in local currency (TES Verdes). This bond amounted to around USD 350 million, distributed across 27 projects and 6 categories, including water management, sustainable transport, protection of diversity, the transition to non-conventional and renewable energies, waste and circular economy, and sustainable agricultural production (OECD et al., 2022; ECLAC, 2023).

The issuance of sovereign sustainability-linked bonds (SLBs) has gained traction in the region as an instrument that can help governments tackle economic, social, and environmental challenges in a holistic way. In 2022, Chile issued the world's first SLBfor USD 2 billion, with two performance indicators geared toward reducing emissions and increasing Chile's use of renewable energy. In November 2022, Uruguay also issued its first Bond Indexed to Climate Change Indicators (BIICC). The Framework was jointly developed by five ministries, with technical assistance from the Inter-American Development Bank (IDB) and the United Nations Development Programme (UNDP). The bond represents a pioneering effort in that it links its interest rate to the country's progress in two environmental dimensions: the reduction of GHG emissions and the conservation of the area of native forests (OECD et al., 2022).

[3] The Working Group on Sustainable Finance Taxonomies in Latin America and the Caribbean is formed by the United Nations Environment Programme (UNEP), the World Bank Group, the United Nations Development Programme (UNDP), the Economic Commission for Latin America and the Caribbean (ECLAC), the Inter-American Development Bank (IDB), the Development Bank of Latin America (CAF) and the Food and Agriculture Organization of the United Nations (FAO).

Suggested policy actions

Better align environmentally related taxes and subsidies with the cost of pollution. This includes rationalising and phasing out unjustified fossil fuel subsidies (particularly to the most affluent population), increasing revenues from environmental taxes, and working further in the consolidation of carbon pricing instruments.

Implement fiscal frameworks that protect green investments, through instruments (e.g. fiscal rules) that include a green golden rule to protect green investments from economic and political cycles. It is essential to implement mechanisms such as green budgeting and lower social discount rates to evaluate projects with higher environmental benefits.

Increase support to National Development Banks (NDBs) and Subnational Development Banks (SDBs) to facilitate the mobilisation of public and private resources for sustainable projects. Generate incentives for NDBs to reduce risk and improve lending for sustainable projects, and support SDBs to develop subnational financial markets (e.g. for intermediate cities).

Advance the blended finance agenda. This requires continued collaboration between international and domestic development banks, as well as with policy makers and the private sector.

Support the improvement and expansion of sustainable finance frameworks. It is important to promote the harmonisation of GSSS standards and taxonomies across the region. Likewise, sustainable finance frameworks should be extended to the non-bank sector (e.g. pensions, capital markets and asset management sectors) to boost competitiveness and investment opportunities.

Main references and further reading

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