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The rise of sustainable finance

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Introduction

The world's largest investors, central banks, financial market regulators and sovereign wealth funds are increasingly focusing their attention on sustainable finance, with a marked shift in the pattern of capital flows into this area. This has deep implications across the NSW Government public sector for the issuance of debt, investing the state's financial assets, and economic activity.

How can we maximise the opportunity this presents (while minimising the risk) and where are the opportunities that could drive long-term growth across NSW? TCorp has identified and is monitoring 3 key areas: the availability and cost of funding, the link between sustainable investment and economic performance and investment returns. In this briefing note, we explore recent trends in each area, discuss significant developments and their impacts.

This matters because it could affect:

- The cost of the debt that TCorp raises to fund the critical activities of the NSW Government family
- The performance of the NSW economy itself and the resilience of the state's finances
- The ability of TCorp's investment clients to continue to meet their investment objectives.

The availability and cost of funding

Potentially, debt used to fund sustainable investments will have access to a larger pool of funding at cheaper cost while investments that do not will be penalised.

This is already a significant market; $3tn of sustainable debt was issued in financial markets last year – attracting less than 10% of funds available from fund managers looking to invest in this area – while total sovereign sustainable issuance was around US$41bn, having doubled during 2020.

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Sustainable investments can also mean cheaper funding for governments – bonds issued to fund environmentally beneficial projects have recorded lower yields. Investors are calling this phenomenon a "greenium" and a key indicator of this is the green 2030 German bond trading at a discount of 6bps – or more than 15% lower – than the conventional 2030 bund (a sovereign debt instrument issued by the German government).

On the flip side, investors are increasingly singling out issuance which may exacerbate environmental problems, leading to more expensive debt. The move to net zero portfolios is a case in point where a growing base of asset managers with around US$43tn, or close to half of the world's assets under management, have flagged their commitment to this target.

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Fossil fuel exposure is another consideration. Studies find that there are major negative effects on the value of an issuer's bonds when the economy relies heavily on fossil fuels. This "climate spread" can be as large as 15-20%[1] and equates to a significantly higher cost of funding.

[1] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3376218

Sustainability considerations are also impacting government reputations, which is critical for maintaining long-term access to funding markets with investors thinking more about sustainable *issuers* rather than sustainable *issuance*. They are concerned not only whether a green bond itself is sustainable, but the overall economic makeup and carbon emissions of the issuer.

For example, Australia rates poorly on metrics proposed by the European Union, namely carbon emissions per capita. Investors, who will likely need to make this disclosure as part of reporting on the carbon intensity of their portfolios, could regard Australian bonds as less attractive.

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Investment managers are attracted to sustainable issuers who can achieve greater diversification of funding. In 2020, the Climate Bond Initiative published a survey suggesting that sovereign participation in sustainable issuance broadened and diversified the investor base. Italy's inaugural green bond issue, in early 2021, is a relevant example here, with the issue 10 times oversubscribed.

To meet investors' expectations, governments will need to be proactive on ESG programmes and disclosures and demonstrate credibility in setting and fulfilling sustainable goals. Corporate disclosure on climate risk has been a significant area for investor engagement and activism, and with investors expecting action from all organisations, governments can expect to be next in line for attention.

As TCorp borrows money on behalf of our clients across the NSW Government family to fund their critical activities, it will be important to identify how these trends may shift the funding markets and ensure that NSW doesn't pay more than is necessary for the debt that we issue.

The link between sustainable investment and economic performance

Encouraging sustainable investment may result in stronger employment and economic growth, a diversified economic base, and ultimately enhance the government's fiscal position. Late movers may miss out on these benefits.

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Sustainable finance can fund policy reform and economic development strategies that support job creation and mitigate costs to economic performance. This outlook is aligned to investigations already undertaken by the NSW Government, including the NSW Treasury 2040 Economic Blueprint (2019), with its focus on sustainable environment and resource management, and the Productivity Commission White Paper (2021).

The potential impacts for jobs, economic diversification and competitiveness are significant:

- The renewable energy industry could create 20,000 jobs from 2020-2025, on estimates from the University of Technology Sydney's Institute for Sustainable Futures[2]. More broadly, job creation opportunities go hand-in-hand with robust net zero commitments. Australia could

[2] https://www.uts.edu.au/research-and-teaching/our-research/institute-sustainable-futures/our-research/energy-futures/renewable-energy-employment-australia

stand to gain 250,000 new jobs by 2070, as compared to 880,000 jobs lost, according to Deloitte[3], with policies geared to the achievement of net zero by 2050.

- The forecast employment growth in renewable energy would make the size of the sector's workforce comparable to that of the coal industry in Australia, pointing to a real potential avenue for diversification. Such investment will not only lead to industrial diversification, but also geographical diversification, with many regional and rural areas standing to benefit.
- The overall benefits of a comprehensive diversification plan are expected to be substantial, for example PWC predicts that a revamped, sustainability-focused approach to the built environment, transportation and housing will deliver $1,860bn in direct benefits in Australia over the next 20 years.

As investors increasingly seek opportunities in sustainable finance and allocate more capital to those sectors, economic activity will follow. Given the strong relationships that TCorp has established with the investment community, one of the challenges will be to explain how NSW is taking advantage of these opportunities and reassure them that the NSW economy and finances will be resilient to these shifts.

Investment returns

"Assets considered to be inconsistent with sustainability principles may stagnate, or even become 'stranded' (where the economic life of an asset is curtailed due to technological, regulatory or consumer shifts)"

As interest grows in sustainable investments, it could push up the price of assets that meet the required criteria.

The increased focus can directly affect investment returns in 2 ways:

- Those assets that are consistent with sustainability criteria can outperform, as their price is bid up by a growing pool of investors competing for the same assets.
- Assets considered to be inconsistent with sustainability principles may stagnate, or even become "stranded" (where the economic life of an asset is curtailed due to technological, regulatory or consumer shifts).

Prudent investors also look at a diverse range of considerations which can alter investment returns based on whether companies are taking sustainability seriously:

- Do insurance policies take into account the prospect of more frequent and more extreme weather events? And if private insurers stop offering insurance, how will governments respond?
- Do banks consider the implications of changing climate conditions when they issue mortgages on properties that may be affected by extreme weather events?

Certainly, this has also become a growing focus for financial market regulators. This way of thinking also explains why investors are increasingly focusing on sustainable issuers, rather than just sustainable issuance, when they decide how to allocate their funds.

As the custodian of the NSW Government family's financial assets it will be critical to monitor how these structural changes may affect the risk and return characteristics of different assets so that our clients continue to meet their investment objectives.

[3] https://www2.deloitte.com/au/en/pages/economics/articles/new-choice-climate-growth.html

Conclusion

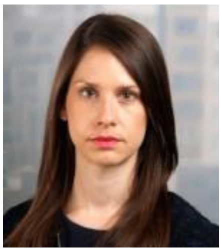
The focus of the global investment community on sustainable finance has reached the point where it is becoming an important driver of capital flows. TCorp has responded, adjusting how it operates by, for example, leading the way on Green and Sustainability Bond issuance in Australia and incorporating ESG considerations into the core of its investment principles.

The implications of this growing trend, however, are not limited to TCorp. Rather, it could affect all parts of society – households, businesses and governments. This shift poses risks to some activities, but also creates opportunities in other areas. Institutions that are nimble and respond to how the landscape is changing are likely to prosper well into the future.

Authors

Brian Redican

Chief Economist



Rebecca Hiscock-Croft

Senior Economist

Level 7, Deutsche Bank Place
126 Phillip Street
Sydney NSW 2000, Australia

T +61 2 9325 9325
W www.tcorp.nsw.gov.au

ABN 99 095 235 825

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