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ESG: On government agendas

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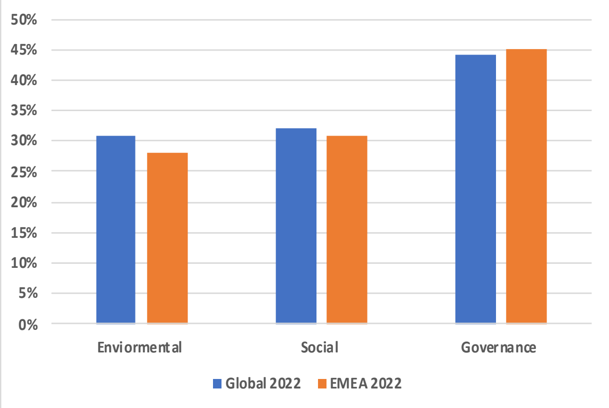
- **The adoption of Environmental, Social and Corporate Governance (ESG) in the MENA region is nascent, but its mainstreaming will increase virtually exponentially over the next decade.**
- **Key drivers stem from sovereign wealth funds' (SWFs) growing ESG investments, as well as the launch of indices by regional security exchanges.**
- **With sustainable reporting and disclosure becoming mandatory for listed companies in the UAE, they are expected to lead the region in terms of adoption rates. This will likely reverberate to non-listed private companies, incentivising them to improve their reporting standards.**

ESG in MENA: Gathering pace

The emergence of ESG practices has accelerated internationally over the past few years with impact-driven investments and the reallocation of capital towards ESG-themed solutions becoming increasingly popular. The MENA region is only starting to adopt the concept, but growth in this field is likely to accelerate as regulatory frameworks are introduced.

- This year witnessed a global boom in ESG standards, providing a growing focus for financial bodies.[2]
  - The International Financial Reporting Standards Foundation began developing a single set of international sustainability standards in February; these are expected to be fully established by September this year.
- The increasing emphasis on ESG is also reflected in the MENA region. The pandemic has intensified the importance of overall attention social welfare and has also increased awareness of environmental and governance issues. This has reinforced the importance of adopting ESG practices.
  - According to HSBC's Sustainable Financing and Investing Survey, around 93% of capital market issuers and around 65% of investors in the region are aware of the importance of incorporating ESG practices.
  - While the investor figure is low relative to other regions, it is set to grow, especially given governmental efforts towards ESG standardisation.
- Going forward, MENA could well lead global ESG integration given that it complements Islamic finance practices. This is because capital raising strategies and investment approaches under Sharia law are governed by principles that value the development of a sustainable and fair society.
  - As Islamic investors continue to pursue sustainable risk-adjusted investment returns, we expect ESG factors to feature increasingly within their decision making, helping to align their financial objectives with social and environmental goals.
- This growth is underscored by the increasing role of regional SWFs. Indeed, SWFs are starting to integrate ESG policies and to ramp up investments in the green sector.

Figure 1 - Projected ESG Impact Globally vs. EMEA[1]



  - In 2018, four SWFs[3] in the GCC were among the founding members of the 'One Planet Sovereign Wealth Funds' working group. This is an international coalition of SWFs established with the aim of accelerating financial opportunities related to climate change with regard to the management of long-term assets.
    - The UAE's Mubadala Investment Company recently joined the working group in November 2020.
- The role of SWFs emphasises how the GCC is becoming increasingly committed to integrating ESG practices for investment decisions and their overall management portfolio. This is key for encouraging regional private investors to make value-driven investments.
  - Today, around 65% of the region's SWFs are implementing ESG in their fixed income portfolios.
  - Green bonds are at the forefront of satisfying growing demands for ESG considerations. Around 50% of SWFs and around 30% of central banks in the MENA region have invested in green bonds.
- Since the launch of the region's first green bond by the Moroccan Agency for Sustainable Energy in 2016, interest in green issuance has grown exponentially.
  - Last year, as the region accelerated diversification and took advantage of the strong global appetite for sustainable investment, Egypt, Qatar, Saudi Arabia and the UAE all issued green and sustainability-driven bonds.

ESG regulations gaining momentum

The acceleration of ESG practices in the MENA region is best seen through the launch of sustainability disclosure reports and indices by the region's capital markets.

- ESG is becoming an international investment requirement and a crucial step towards long-term sustainable development. In the MENA region, regulatory authorities are establishing standards and frameworks to ensure mandatory sustainability reporting. Companies are therefore faced with growing pressure to provide detailed non-financial and ESG-related disclosures. This will be key to shaping ESG trends in the region.

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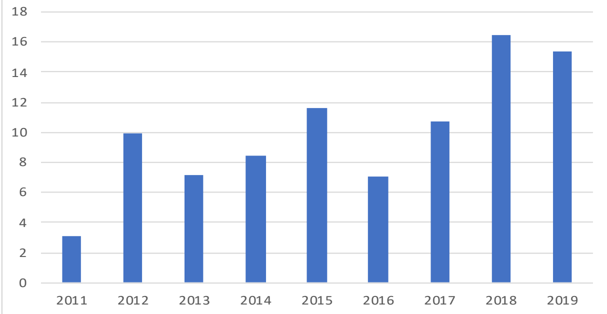
[1] Arabia Monitor; CFA Institute. EMEA stands for Europe, the Middle East and Africa.
[2] At the World Economic Forum in January, a coalition of multinational corporations and business leaders signed the "Stakeholder Capitalism Metrics". These constitute a new set of ESG standards which measure companies' non-financial long-term value creation.
[3] SWF members are Abu Dhabi Investment Authority, Kuwait Investment Authority, Qatar Investment Authority, and Saudi Arabia's Public Investment Fund.

- The Hawkamah Institute for Corporate Governance and S&P Dow Jones Indices developed in tandem the first ESG Pan-Arab Index. This measures the performance of the region's 50 companies with the highest scores in ESG factors.
  - The index constituents are selected from the top 150 listed companies on the national exchanges of several countries in the region, including Egypt, Jordan, Lebanon, Morocco and Tunisia, as well as all the GCC countries.
  - Screened annually, the index serves as an important benchmarking tool for investors who want to overlap their passive investment strategies with ESG standards.
- Today, the UAE is leading the region's ESG adoption.
  - In a major step, the Abu Dhabi Securities Exchange (ADX) and the Dubai Financial Market (DFX) issued a set of ESG guidelines. They stipulate that private sector and listed securities must adhere to ESG principles in reporting, business activity and decision making.
  - The guidance provides ADX-listed companies with 31 ESG indicators that must be reported. This is based on the recommendations of the Sustainable Stock Exchanges Initiative and the World Federation of Exchanges.
  - More recently, in February, the Abu Dhabi Investment Office (ADIO) launched an ESG policy that aims to encourage partner companies and public-private partnership transactions to adopt ESG principles.
- These regulations, coupled with national initiatives like the UAE's 'Year of Tolerance', are expected to encourage organisations to disclose ESG reporting and promote social responsibility within their wider business operations.
- We can already see that efforts in the UAE are reaping rewards.
  - According to KPMG's Survey of Sustainability Reporting 2020, sustainable reporting increased to 51% last year, up from 47% in 2017.
  - With ESG reporting becoming mandatory for listed companies in the UAE, we expect to see greater commitment and proactivity with regard to ESG practices being employed across the wider private sector.
- The importance of investing in ESG is also beginning to have traction in Saudi Arabia.
  - Saudi Arabia's Future Investment Initiative (FII) and the Tadawul (the Saudi Stock Exchange) signed an MoU to advance ESG awareness in the kingdom in January 2021.
    - The agreement aims to promote ESG thought leadership, as well as events that bring together relevant stakeholders to advance the impact of ESG in Saudi Arabia.
  - The Tadawul is set to launch an ESG Index with the MSCI this year to encourage businesses to embrace ESG practices.
    - The index will include over 70 Saudi-listed companies and will be based on MSCI standards.
    - A set of ESG guidelines will be released for all listed Saudi securities. Issuing the ESG index is expected to deepen the Tadawul's capital market further, and to increase its attractiveness.

Table 1 - ESG Integration in MENA[4]

DRIVERS	BARRIERS
Investor demand (incl. international investors)	Lack of standardisation of ESG
Sustainable stock market regulations	Lack of understanding of ESG
Client demand & asset flow	Lack of regulation/incentives
Growing green investment portfolio	Cost of ESG

Figure 2 - Green Investment in MENA (USD, B)[5]



- Egypt is also committed to embracing ESG practices and is already working on meeting the UN's Sustainable Development Goals (SDGs).
  - Recently, the Ministry of Investment and International Cooperation partnered with the UNDP to implement global principles of impact measurement and to introduce practical tools to local experts to support their ESG impact management.
  - In March, Egypt's Financial Regulatory Authority launched a Regional Center for Sustainable Finance.
    - As the MENA region's first sustainable finance centre, its focus is on strengthening Egyptian presence on the global green economy map.
  - This move is crucial for promoting an ESG culture domestically, especially as Egypt is rapidly expanding its green portfolio (which is now worth over USD 1.9B in government debt?).
- The unfolding paradigm shift in sustainable finance and ESG practices by stock market regulators in some countries should encourage others in the region to join, particularly given the growing willingness of governments to promote their national sustainability agendas.
- However, more is needed to unlock the full potential of sustainable finance and to overcome the lack of demand for ESG among private investors.
  - The progress in terms of corporate governance regulations and disclosure requirements throughout the MENA region is yet to be translated into substantial improvements vis-à-vis ESG reporting by individual companies.
  - ESG reporting is still at an embryonic stage. This is mainly due to a lack of standardisation, as well as a lack of understanding of ESG. Nevertheless, this is expected to change as regional governments and domestic companies increase their exposure to international investors who demand the integration of ESG considerations as part of their investment decision-making processes.

[4] Arabia Monitor; CFA Institute.

[5] Arabia Monitor; Statista.

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