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Status and Challenges of Sustainable Finance in Korea: Environment and Finance

ESG Policies and Sustainability Efforts in Korea

The mounting sustainability crisis, encompassing climate change, ecosystem degradation, extreme inequality, and social polarization, has prompted a heightened focus on environmental, social, and governance (ESG) concerns. In order to address the aforementioned sustainability crises, it is imperative that financial markets assume a more pivotal role. In response to these challenges, Korea has acknowledged the significance of ESG and has implemented a range of policies that reflect this.

In December 2021, the Ministry of Trade, Industry and Energy released the K-ESG Guidelines, which provide guidance on the introduction and establishment of ESG management in domestic companies. The guidelines are designed to assist companies in evaluating their ESG performance by providing transparent and comprehensive criteria, including environmental indicators such as environmental mark certification, compliance with environmental laws and regulations, greenhouse gas emissions, waste and pollutant generation, recycling rate, and so forth. Furthermore, on December 7, 2022, the Ministry of Trade, Industry and Energy released the K-ESG Guidelines for Supply Chain Due Diligence in response to the development of supply chain due diligence laws in major countries and the expansion of global ESG initiatives. In 2023, the Ministry of Trade, Industry and Energy provided K-ESG Guidelines for four domestic industrial sectors (steel, automobile, petrochemical, and semiconductor) that met global standards in the context of advanced ESG disclosure standards and assessments, as well as the emergence of industry-specific ESG indicators.

In December 2021, the Ministry of Environment (MOE) announced the Korean Green Classification System (K-Taxonomy) in accordance with the Environmental Technology and Environmental Industry Support Act. The K-Taxonomy provides principles and standards for economic activities that contribute to environmental goals such as greenhouse gas reduction and climate change adaptation. It is organized into two categories: the “green sector” and the “transition sector.” The Green Sector encompasses 64 economic activities that are essential for achieving carbon neutrality and environmental improvement, including renewable energy. The Transition Sector includes five economic activities that are working towards becoming carbon neutral, such as liquefied natural gas (LNG) power generation. In December 2022, the MOE announced the revised K-Taxonomy, which includes the nuclear economic activity sector, in line with the European Union (EU) Taxonomy enacted in July of the same year. In 2024, the K-Taxonomy will undergo a partial revision with the objective of targeting four environmental goals (water, circular economy, pollution prevention, and biodiversity). Concurrently, the K-Taxonomy will be gradually expanded to include not only green bonds but also credit, stocks, and funds. Furthermore, a green classification system for credit products will be prepared in consultation with the Financial Services Commission and the Financial Supervisory Service.

These endeavors are designed to elevate the national discourse on ESG-related matters and to prompt companies to prioritize these concerns. This represents a transformation in the investor mindset, moving beyond a narrow focus on financial returns. Investors are recognizing that a company’s environmental awareness and robust governance are essential for ensuring its long-term viability.

Key ESG Regulators and ESG Disclosures

The primary regulatory bodies over ESG matters include the Financial Services

Commission, the Financial Supervisory Service, the Korea Exchange, and the MOE. The Financial Services Commission is responsible for regulating the financial industry and financial policies related to ESG finance and disclosure. In contrast, the Korea Exchange places a strong emphasis on corporate responsibility for ESG issues, establishing regulations and disclosure standards for listed companies. In particular, on January 18, 2021, the Financial Services Commission and the Korea Exchange released ESG disclosure guidelines.

The guidelines encourage companies to make voluntary ESG disclosures until 2025, after which mandatory disclosures will be phased in for companies listed on the Korea Composite Stock Price Index (KOSPI) Market with total assets of more than KRW2 trillion.[1] Furthermore, all companies listed on the KOSPI will be required to make disclosures starting in 2030. To establish an ESG supervisory system, the Financial Supervisory Service is implementing measures such as reviewing domestic disclosure standards, setting ESG bond evaluation standards, preparing disclosure proposals for evaluation reports, strengthening screening of investment strategies such as ESG fund portfolio composition, and conducting post-inspection. Additionally, the Service is planning to establish supervisory standards for the sale of ESG financial products and establish a financial product disclosure system.

The MOE is implementing system improvements, including the transition from a linear to a circular economy, with the goal of achieving carbon neutrality by 2050. On March 24, 2021, the MOE amended the Environmental Technology and Environmental Industry Support Act to enhance environmental disclosure by companies. Previously, only certain companies were required to disclose information; however, with this amendment, the obligation to disclose has been extended to listed companies with total assets exceeding KRW2 trillion. This reflects a growing trend of strengthening disclosure obligations related to environmental impact management.

The authors' research, which utilized ESG disclosure data for domestic companies from 2011 to 2020, demonstrated that the presence of foreign investors and national pension funds as major shareholders was associated with a statistically significant increase in general ESG disclosure rates.[2] Nevertheless, there is no statistically significant effect on the rate of ESG disclosure based on materiality. This can be interpreted as the absence of a unified disclosure standard for ESG, which allows companies to focus their voluntary disclosures to large institutional investors such as foreign investors and national pension funds on general ESG information rather than material ESG information. Consequently, investors are increasingly demanding clear standards and regulations for ESG disclosure, and various domestic and international organizations are working to respond. This is part of a global trend towards sustainable management and socially responsible business practices.

On June 26, 2023, the International Sustainability Standards Board (ISSB) released its inaugural set of standards on sustainability disclosures. These standards, collectively titled International Financial Reporting Standards (IFRS) S1 'General Requirements for Disclosures of Sustainability-related Financial Information' and IFRS S2 'Climate-related Disclosures', represent a significant advancement in the field of sustainability reporting. In Korea, on April 30, 2024, the Korea Sustainability Standards Board (KSSB) released a draft of domestic sustainability disclosure standards that are intended to be interoperable with ISSB disclosure standards and those in the EU and United States (US). The disclosure draft comprises mandatory disclosure standards for companies, general disclosures for sustainability-related financial information (No. 1), climate-related disclosures (No. 2), and optional additional disclosures that consider policy objectives among sustainability-related issues (No. 101).

The Current State of the ESG Ratings Market

The current state of the ESG assessment market is a complex landscape, comprising a number of challenges. The most significant challenge is the lack of uniformity in ESG assessments, which is crucial for attaining environmental and social objectives and reinforcing investor confidence. The opacity of ESG ratings is also evident in the 2022 report from the Korea Institute of Corporate Governance and Sustainability, which demonstrated a decline in the ESG ratings of Korean companies. Specifically, the number of A+-rated companies decreased, while the number of D-rated companies increased year-on-year. It is imperative that policy efforts be undertaken to enhance the transparency and credibility of domestic ESG raters. This is necessary to ensure that Korean companies are not penalized by ESG ratings, given that they have fewer opportunities to receive feedback from raters and the methodology is not disclosed. It is similarly important to facilitate communication between companies and rating agencies.

Moreover, a report by the Korea Institute for International Economic Policy (KIEP) indicates that Korean companies' ESG scores in the Governance category are below the global average.[3] This indicates that Korean companies must enhance their comprehension of ESG matters and integrate them into their business strategies. Moreover, it is crucial to prioritize the enhancement of corporate governance. To bridge the gap between theory and practice, companies should adopt a transparent approach to disclosing ESG information and provide active feedback on their performance.

The market for ESG ratings presents a challenge for investors and stakeholders due to the diversity of methodologies and metrics employed by different rating agencies. Consequently, companies frequently encounter difficulties in comprehending their ratings and in identifying avenues for enhancing their ESG measurement. In response to these challenges, the Financial Services Commission established the ESG Rating Agency Guidelines in May 2023. In order to overcome the challenges currently facing the ESG rating market, it is necessary to make efforts to establish and maintain transparent corporate governance, improve ESG disclosure, and develop standardized ESG rating systems.

Sustainable Capital Markets: K-Taxonomy and Green Bonds

The sustainable finance market in Korea is demonstrating remarkable growth across all sectors. In particular, investments in ESG factors are expanding rapidly, especially among institutional investors. Their investment balances have increased significantly, from KRW26 trillion in 2017 to

KRW212 trillion in 2021. The National Pension Service, a major investor, has contributed to this growth. On the other hand, the issuance amount of social bonds increased to KRW86 trillion in 2021, accounting for 71.1% of the total. This indicates that the domestic ESG bond market is relatively lacking in the diversity of eco-friendly social projects. Consequently, it is imperative to address this imbalance and ensure the establishment of a more balanced and diverse portfolio of ESG projects.

In general, sustainable financial instruments are employed to invest in environmental protection and social issues. Domestic green bond issuers are required to adhere to specific issuance procedures and guidelines, including external review, in order to prevent the possibility of "greenwashing." As the domestic and international green bond markets have grown rapidly in recent years, measures to prevent greenwashing and improve the quality of external review reports are needed to enhance the credibility of green bonds. In this regard, K-Taxonomy can play an important role. Those industries that have been recognized for their green economic activities will be able to secure more funding, while institutions issuing green bonds will be able to gain investor confidence through K-Taxonomy. Furthermore, the December 2022 revision of the Green Bond Guidelines included the introduction of a process to determine eligibility for K-Taxonomy, the implementation of a registration system for external rating agencies, and the establishment of a green bond follow-up (monitoring) system.

The author's research indicates that data from the domestic green bond issuance market from 2018 to 2022 was analyzed. This analysis revealed that the amount of environmental information included in the external assurance report affects the interest rate of green bonds.[4] In practice, the verification standards of green bond external verifiers vary considerably and lack objectivity and consistency. Consequently, the provision of a certain level of information (exceeding 22-23 pages of the report) by the external verification process has the effect of lowering the interest rate of green bonds. This implies that companies may be able to reduce the cost of financing green projects if the external reviewer's report provides sufficient information to investors. These findings demonstrate the pivotal role of sustainable capital markets, K-Taxonomy, and green bonds in fostering sustainable finance and investment in Korea.

Future Challenges

As has been demonstrated, the prospective ESG challenges are numerous and necessitate a comprehensive approach for their resolution. This includes the continued development of infrastructure related to ESG, improved disclosure, improved methodologies, and enhanced impact assessment. It is similarly vital to sustain investor interest and confidence in ESG investing, as well as companies' dedication to objective and reliable ESG information disclosure.

Moreover, international initiatives such as RE100 (100% Renewable Energy) and ESG standards may not be fully compatible with the energy-intensive, manufacturing-driven economies of certain countries. For instance, in a country like Korea, which is heavily reliant on fossil fuel-powered electricity generation, it is challenging to construct new manufacturing facilities without significant technological advancement. Consequently, it is imperative to develop evaluation and disclosure standards that are tailored to the local context, rather than adopting directly European and US-led ESG standards.

In conclusion, the aforementioned challenges must be addressed in a systematic and logical manner, taking into account the unique circumstances and requirements of each country and industry. It is therefore to be expected that ESG investments will grow, and that sustainable growth and development will be achieved.

Notes

1 The Financial Services Commission has announced that it will postpone the mandatory disclosure of ESG information from 2025 to 2026.

2 Hyun et al. (2023), "Exploring the Impact of Information Environment on ESG Disclosure Behavior: Evidence from National Pensions and Foreign Investors," 2023 Korean Accounting Association Summer International Conference.

3 Korea Institute for International Economic Policy (2022), "The reality and implications of ESG performance assessment in major countries," *World Economy Today*.

4 Hyun et al. (2023), "Price Implications of Greenwashing: Evidence from Korean Green Bond Markets," Working Paper.

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