T. Rowe Price

Water risks will shake up countries and companies

More and more companies are realizing that water scarcity and the deterioration of oceanic habitats pose significant risks to their businesses. To mitigate these, companies cannot rely solely on governments; they must act themselves. "Water-related risks pose a growing challenge, especially in emerging markets. Through engagement and funding we aim to help companies address these issues and make a lasting and meaningful impact," asserts Tongai Kunorubwe, head of ESG fixed income, and Matt Lawton, manager of the Global Impact Credit Strategy at T. Rowe Price.

The Earth is called the Blue Planet for good reason: 75% of the globe is covered in water. However, only 3% of our planet's water is fresh water, and only 1% is suitable for human and industrial consumption. This makes water one of the most valuable natural resources and essential for human life: we cannot survive without it for more than three days. It is also a crucial commodity for major industries that play a significant role in everyday life, like the food and energy sector.

In most regions, water scarcity has long been a problem for humankind. Despite all technological progress, many people still struggle to get access to clean drinking water. The problem is worsening: water use has been increasing at more than double the rate of population growth, according to the United Nations.

> Water stress – the degree of availability of freshwater – will be one of the top challenges for humanity in the next decade and one of the important risks to global GDP growth.
>
> – Tongai Kunorubwe
> – Head of ESG fixed income

Tongai Kunorubwe explains: "The growing global population is expected to reach around 10 billion by 2050, which implies even greater food and energy demand. Food and energy are heavy water users. The World Resources Institute, for instance, estimates that around 30% of the world's GDP will be exposed to high water stress by 2050."

A quest for clean water and healthy oceans

Water scarcity is one part of the water crisis. The deterioration and pollution of our oceans and rivers are another. Both are recognized by the UN as major challenges. Two of the seventeen Sustainable Development Goals of the UN are water-related: SDG 6 (clean water) and SDG 14 (life below water).

The stakes are high. Two-thirds of the global economy is moderately or highly dependent on ocean resources. Sectors such as fisheries, tourism, renewable energy, and maritime transport are highly dependent on the health of our oceans. Rivers are an important freshwater source for water companies and agricultural irrigation.

Healthy oceans are also crucial in mitigating climate change, another major risk for emerging markets. Oceans absorb about 90% of the warming generated from climate change. "We believe that the interconnections between climate change and water risks are becoming apparent: climate risk is water risk, and it is therefore important that we engage with companies on this topic," argues Matt Lawton, manager of the Global Impact Credit Strategy.

The scarcity of freshwater is a potential problem for many more sectors that use water in their production processes. People and industries will compete for access to dwindling water supplies, forcing companies to invest in new equipment and switch to less water-consuming production methods.

Kunorubwe explains: "An industrial user like a pulp mill or a power station, consuming huge quantities of water while the population is having its water use rationed, creates a potentially very challenging dynamic between population, industry, and political parties who will have to enact and enforce water use regulations. For instance, in Latin America, select countries have imposed a maximum volume of water extraction to which industry players must comply."

Companies will want to mitigate water risks for the sake of their business model, but will also experience increasing public pressure to assist governments in big clean-up or infrastructural water projects. For this, they need expertise and funding.

A thriving blue bond market can deliver the much-needed funding

Companies will need capital to fund the necessary investments. This is a major challenge. The vibrant green bond market focuses primarily on climate issues and very little on water-related matters. Blue bonds, a new subsection of green bonds specifically targeting water projects, could be a solution. They create a focus that can galvanize investors and companies and thereby bridge the funding gap. Lawton remarks: "In any case, with green bonds, the funding gap hasn't been solved. We think that blue bonds offer a more appropriate and dedicated instrument for funding blue projects."

Lawton is convinced that blue bonds can mimic the success of green bonds. The blue bond market, however, is still relatively small.

While the blue bond market holds significant promise, it also faces challenges. One of the primary challenges is the lack of standardization and clear definitions for what constitutes a blue bond. This can create confusion, hinder the market's growth, and discourage companies from issuing a blue bond.

> To help this market flourish, T. Rowe Price and the International Finance Corporation (part of the World Bank Group) are partnering to grow the blue bond market to address the planetary and societal risks posed by the current underfunding of the blue economy.
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> – Matt Lawton
> – Portfolio manager of the Global Impact Credit Strategy

A path to stricter definitions and company guidance

According to Lawton, stricter definitions of the criteria for blue bonds will make the instrument more appealing to investors and increase the likelihood of securing funding for blue projects. "As investors, we will of course share our standards for blue bonds, but in order to create a thriving blue bond market, we need more uniformity in this market segment," states Lawton.

Progress is being made in this area. Several organizations, including the International Capital Market Association (ICMA), have developed guidelines for blue bonds. These guidelines help ensure that blue bonds meet high standards for transparency, accountability, and environmental impact. Additionally, they provide companies with an effective framework for issuing a blue bond, including clarity on eligible projects and possible key performance indicators.

Many companies also need some guidance in finding solutions for the water issues they face. It is therefore crucial to help companies better understand their water-related risks. "Most of our water engagements take the form of constructive dialogue, where we provide our view on best practices in water management. We believe a company-specific approach results in the highest impact because it aligns with our core investment approach: active management rooted in fundamental investment analysis", notes Kunorubwe.

Another challenge is the fact that issuing blue bonds entails marginally higher costs. This is due to the additional requirements for monitoring and reporting on the use of proceeds and their environmental impact. However, as the market matures and more issuers enter the space, these costs are expected to decrease even further, according to Lawton. In addition, impact investors might be willing to offer more favourable funding terms.

Lawton identifies three benefits of blue bonds:

1. Access to a larger and more diverse investor base, providing a deeper pool of funding.

2. Reputational benefits for the issuer through the credibility and ambition of the blue bond.

3. Internal benefits for companies, such as better embedding sustainability and water considerations into corporate culture and business decisions. Blue bonds can enable companies to better identify and manage risks regarding how water affects their enterprise from both an operational and financial perspective.

A closer look at water-related risks

So far, companies have taken a reactive rather than proactive approach to water issues. This will change as more extreme weather events and regulatory scrutiny bring water-related risks into the spotlight. Another engagement discussion point is that mitigating water risks is often linked to direct business operations. However, for many industries, water risks lie upstream in the supply chain or downstream when their product is used. Kunorubwe emphasizes: "It is important to recognize that water dependencies and impacts can occur anywhere in the value chain."

Water risks are location-specific and influenced by local climate, rainfall, and water supplies, making geographic assessment crucial. Additionally, complex socioeconomic factors like population growth, economic expansion, inadequate water governance, and insufficient infrastructure investment drive water insecurity. "Reputational risks for corporations are highest at the intersection of these socioeconomic risk factors and local basin risk," states Kunorubwe.

Kunorubwe adds that ideally there should be targets specific to high-water stress areas. "In the medium term, as with climate, we expect companies to adopt science-based target approaches for water. However, due to the localization aspect, companies should set individual freshwater targets for each priority basin. Some companies could be perceived to bluewash their water ambitions by not incorporating the localized nature of water risk or not considering where in the value chain the risk lies."

A constructive dialogue with companies

The complexity of water-related issues and the novelty of blue bonds will make it necessary for companies to seek support. T. Rowe Price is doing that on the ground in different regions and sectors, with local visits and expertise. In Latin America, for instance, agriculture is the most exposed to water risks since it represents almost 70% share of water usage. The energy sector is also a heavy user of water: the energy generation matrix is almost 50% hydro. Even thermal plants are very water intensive since they use water for cooling to be able to operate.

Lawton notes: "We have spoken with companies across many sectors to understand how they're attempting to mitigate water-related risk. How they're changing their practices and operations to reduce water use, and whether they're able to switch water sources for a particular asset. But also, actions that can lower freshwater use, like desalination equipment or upgrading cooling systems. And a big part of our discussions with issuers focuses on the oversight of these issues. So, who's responsible for assessing and managing these water-related risks at a company."

By addressing water issues proactively, companies can help ensure a sustainable future for both the environment and their business. Blue bonds can be a solid funding instrument for the necessary investments. They provide companies with a unique opportunity to enhance their reputation, access a broader investor base, and potentially secure favourable financing terms. Kunorubwe: "We expect the blue bond market to grow rapidly, given the need for investment in blue sustainable development. Ultimately this will lead to tangible results in tackling our world's water crises."

T. Rowe Price and the International Finance Corporation are not affiliated companies.

Risks: Blue bonds carry investment risks, which include credit risk and interest rate risk. There is no assurance that a favorable outcome will be achieved.

Important information