The future of lending is environmentally sustainable

Lending turns over a new leaf
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There is no doubt that the environmental, social and governance (ESG) agenda is now at the top of boards’ action lists.

Pressure from stakeholders including investors, customers, employees, and partners is encouraging corporates to not just accelerate their progress towards ESG-related goals, but to provide transparent and genuine evidence that action has been taken. While the social and governance elements of ESG are primarily to do with making internal or external changes to treat people more fairly, improve living conditions or increase transparency, the environmental strand is fundamentally about helping society and businesses alike transition to a low-carbon economy that mitigates accelerating global climate change.

According to data from Refinitiv, the Sustainability linked lending market experienced huge growth in 2021 and looks set to continue in 2022. A record-breaking US$1.6tn in global ESG financing was completed in 2021, a 116% increase compared to the 2020 total. In the first six weeks of 2022, more than US$40bn of ESG loan volume has been announced, up 56.25% from the US$25.6bn raised at the same time in 2021.

"...the environmental strand is fundamentally about helping society and businesses alike to transition to a low-carbon economy that mitigates accelerating global climate change."
ESG lending: sustained growth

ESG financing is fast growing and ESG issues are now centre-stage

1Q22 Global ESG financings at US$133.5bn

- Green and ESG Financing at a record US$133.8bn in Q1 of 2022.
- Over US$40bn of ESG loan volume has been announced globally six weeks into 2022, up 56.25% from the US$25.6bn raised at the same time last year.
- Over 23% of global ESG loan volume to date represents lending to telecom borrowers, followed by financial services names at 12%.

1Q22 ESG and green loan volume at US$40.4bn

- A record setting US$1.6trn in global ESG financing was completed in 2021, a 116% increase compared to 2020 total.
- Over US$682bn in global ESG loan volume was completed in 2021 to set a new record.
- 2021 deal counts were three times year-ago totals.

Source: Data compiled by Refinitiv LPC, an LSEG business

- Green and ESG financing issues are now centre-stage.
- Green opportunity
- What's the difference?
- How is success measured?
- Seeking best practice

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Green, social, sustainable: what’s the difference?

Before examining the unique terms and conditions that green loans should include, it’s worth exploring the differences between green, social and sustainability linked loans.

In general, **green loans** are those where 100% of the proceeds are used to finance green projects, which aim to make a substantial contribution to an environmental objective. These could include renewable energy, energy efficiency, clean transportation, pollution prevention, and sustainable water and waste management.

Similarly, **social loans** aim to facilitate and support economic activity which mitigates social issues and challenges, and/or achieves positive social outcomes in areas such as healthcare, education, and affordable housing.

It’s also important to note that green, social and sustainable loans are usually offered with lower rates of interest to the borrower as the ‘return’ for the ESG-focused investor who has provided the capital through a direct investment, their pension or otherwise is gained not only in monetary terms but also in the environmental and social value created from the allocation of their capital. This makes ESG investing not only purposeful and impactful but affordable as well.

An original borrower may take out a Social or Green loan and act as lender to one or more borrowers, for example governments, development finance institutions, or municipalities.

A recent example of a Green loan would be that of Dogger Bank offshore wind farm with a GBP 6 billion in funding for the first two phases from 29 banks and 3 export credit agencies to generate 5% of UK’s demand by 2026 on completion. The 3rd phase is estimated to cost an additional GBP 3 billion.1

A **sustainability-linked loan (SLL)** incentivizes the borrower’s achievement of ambitious, predetermined sustainability performance objectives related to ESG factors. The important aspect of an SLL is that the target should be ambitious, material, and relevant to the borrower’s core sustainability and business strategy. Unlike Green and Social loans, the use of loan funds is not a determining factor for SLLs.


How is success measured?

Green and Social projects are evaluated and selected for funding, the use and management of funds for a specific cause is clearly defined and monitored throughout the life of the loan. The environmental or social benefits will be assessed, measured, and reported by the borrower or one of their stakeholders.

For SLL’s, the borrower’s performance related to Sustainability is measured periodically (usually on an annual basis) throughout the Loan’s life using sustainability performance targets (SPTs), as set based on key performance indicators (KPIs) or based on a broader improvement in their ESG rating delivered by external agencies. For example, Ford’s KPIs are to become carbon neutral by 2050, eliminate single use plastics from their operations by 2030, and use 100% renewable energy for all manufacturing plants globally by 2035.

Once the borrower achieves the stated SPT’s there might be a margin incentive applied on Interest, Fee, or commission. Margin ratchets can be one-way or two-way.

With one-way pricing, the margin decreases if the borrower satisfies the pre-set criteria. With two-way pricing the margin decreases when the borrower satisfies the criteria and/or increases if the borrower falls short of the set targets or fails to provide the requisite information. Two-way pricing is the more commonly used model.

SMBC Closes $915MM in Green Financing to finance the construction of a flood diversion channel and associated infrastructure that will help prevent future flooding events from impacting the Fargo-Moorhead area in North Dakota and Minnesota.

China Development Bank (CDB) offered financing to the construction of Karot hydropower station in Pakistan, which is also the first large-scale hydropower project backed by the BRI. When completed, the power plant will generate 3.2 billion kWh of electricity and reduce 3.5 million tons of carbon emissions annually.

What is the bank’s role in green, social or sustainability linked lending?

ESG, Green and social funding presents a huge opportunity for banks to respond with relevant financial instruments that can help fund ‘green’ and ‘social’ projects and promote improvements in a borrower’s ESG-related parameters. Examples include building sustainable housing, providing alternative energy sources, providing clean water supplies, funding environmentally friendly steel production using green energy instead of coal-powered blast furnaces, ferrous metal instead of mining iron ore, improving working conditions at the workplace and so on.

In some ways, green and sustainability linked lending will create the next seismic change in the way that banks provide finance to their client base. Banks will now have to adjust their policies, train staff on new processes, plan product offerings to embed new risks and pricing structures, be compliant with the evolving applicable regulations ‘region and industry wise’ and follow the new reporting and disclosures requirements.

Simply put this means a change in all the aspects of the bank’s end-to-end lending process, starting from origination to servicing of the credit line till maturity, whilst also creating an opportunity for banks to put green objectives at the heart of their own ESG strategies.

Banks can play a key role by setting up a panel of industry experts comprising of ESG experts and auditors, who can guide borrowers to adopt the right KPIs and SPTs. They could work with borrowers to identify the most relevant ESG factors for their businesses and their respective supply chains and help incorporate them in credit agreements.

Building on this, banks can act as the custodians of data relating to green loans. They can help to accurately measure avoided and offset carbon emissions therefore reduce greenwashing with tight monitoring and timely corrective actions. This will promote greater trust through verified impactful green and ESG outcomes.

Of course, it means that banks will need to make policy changes to assess and embed the physical and transition risks introduced by this shift, as well as be able to consider ESG-related risks in pricing and risk management. Banks may also need to adjust their customer profile to balance the proportion of green loans in their portfolio to match their own sustainability strategies.

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1. SMBC
2. CDB
### Selected global sustainability regulatory initiatives expected by 2025

<table>
<thead>
<tr>
<th>Region</th>
<th>Regulatory Initiative</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>E.M.E.A</strong></td>
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<tr>
<td>E.U.</td>
<td>EC: Sustainable Finance Disclosure Regulation (SFDR)</td>
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<tr>
<td></td>
<td>EC: EU Taxonomy article 8 discloses delegated act</td>
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<tr>
<td></td>
<td>EC: Corporate sustainability reporting directive (CSRD)*</td>
</tr>
<tr>
<td>U.K.</td>
<td>FCA: Sustainability disclosure requirements (SDR) &amp; investment labels*</td>
</tr>
<tr>
<td></td>
<td>FCA: Diversity &amp; inclusion on company boards &amp; executive committees*</td>
</tr>
<tr>
<td></td>
<td>FCA: Climate-related disclosure requirements*</td>
</tr>
<tr>
<td><strong>U.S.</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>SEC: Climate disclosure for public companies**</td>
</tr>
<tr>
<td></td>
<td>FIO: Climate-related financial risks &amp; insurers**</td>
</tr>
<tr>
<td>Canada</td>
<td>CSA: ESG-related investment disclosure for funds**</td>
</tr>
<tr>
<td></td>
<td>CSA: Climate-related disclosure for listed issuers*</td>
</tr>
<tr>
<td>Chile</td>
<td>CMF: Sustainability and corporate governance requirements in annual reports</td>
</tr>
<tr>
<td>Brazil</td>
<td>BCB: Management and disclosure of social, environmental and climate risks</td>
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<tr>
<td><strong>A.P.A.C.</strong></td>
<td></td>
</tr>
<tr>
<td>Australia</td>
<td>APRA: Prudential practice guidance on climate change financial risks</td>
</tr>
<tr>
<td>China</td>
<td>CSRC: ESG-related amendments to the disclosure rules applicable to listed companies</td>
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<tr>
<td>Japan</td>
<td>FSA: Revisions of corporate governance code</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>SFC/HKMA: Green &amp; sustainable finance strategy (climate-related disclosures)*</td>
</tr>
<tr>
<td>New Zealand</td>
<td>XRB: Mandatory TCFD reporting*</td>
</tr>
<tr>
<td>Singapore</td>
<td>MAS: Environmental risk management for asset managers, banks, insurers</td>
</tr>
<tr>
<td>South Korea</td>
<td>FSC: Mandatory ESG report disclosure*</td>
</tr>
</tbody>
</table>

**Notes:**
- **Proposed or in consultation**
- **Planned**

### Reporting entity
- Issuer
- Product
- Financial
- Product
- Key origin
- Capital allocation

### Objective
- Materiality
- Stringency
- Uniformity in reporting

### Financial materiality
- Yes
- No

### Guidance
- Mandatory
- Only qualitative
- Highly prescriptive template

### Objective
- Double materiality
- Unclear/evolving
- Comply or explain

Source: MSCI *2022 ESG Trends to Watch* - December 2021
Selected global sustainability regulatory initiatives expected by 2025

To prepare for this new paradigm, banks can seek advice on best practices from several credible sources, including the Loan Market Association (LMA) which has, together with the Loan Syndications and Trading Association (LSTA) and the Asia Pacific Loan Market Association (APLMA), published the Green Loan Principles, Social Loan Principles and Sustainability Linked Loan Principles (SLLPs) along with respective Guidance for each.

The SLLPs were developed by a working party consisting of representatives from leading financial institutions active in the sustainable lending market, with the support of the International Capital Market Association (ICMA).

For guidance on which KPIs corporates will need to disclose as part of their reporting, banks can consult with the Sustainability Accounting Standards Board (SASB), the Climate Disclosure Standard board (CDSB) and the Global Reporting Initiative (GRI) which provide ESG-related frameworks.

We expect that the evolving Green/ESG lending will be heavily regulated, with strict disclosure and reporting norms, and that numerous region-specific best practice guidelines will be published to ensure the integrity and compliance of lender and borrower goals.

With the inclusion of ESG-related margins, the already complicated pricing structure for loans and spreads will only become more complex to maintain and to account for. This is especially so following the recent move away from LIBOR to Risk Free Rates which has already added complexity and added operational oversight to the lending business. As the market saw with LIBOR, the impact of ESG-related lending spans the entire corporate finance lifecycle, from origination and credit decision to fulfilment, servicing, and regulatory reporting.
One of the key challenges for banks to undertake comprehensive ESG analysis is the availability of “good” data. This, coupled with a current perceived lack of third-party data providers, and ongoing regulation changes will continue to add complexity to the banks’ lending process.

Banks will be supported in their endeavours to provide green, social or sustainability loans by suppliers of their core banking systems, including Finastra. Our aim is to facilitate compliance of emerging regulations and disclosure guidelines by enhancing our systems, introducing services to smooth workflows, and enabling integration with software vendors and fintechs across the value chain for various ESG-related processes.

This means the time is right for banks to prepare as much as possible, whether that means rebalancing lending portfolios, working on likely future scenarios, crafting the right conversations with corporations concerning their future ESG-led borrowing requirements, and staying abreast of fast-moving regulations. Now is the time to ensure that ESG is discussed at all levels and across all functions within the bank.

Simon Thorogood
Senior Director - Product Management, Corporate & Syndicated Lending, Finastra

Finastra has been on a journey to create environmental and social value for all its stakeholders through its Corporate Social Responsibility (CSR) agenda since its inception in 2017. With the launch of the Finastra Reach Beyond corporate strategy in 2021, Finastra transitioned to a more holistic ESG, Purpose and Impact program, where the executive leadership team have declared ambitious ESG goals, such as being a net-zero company with gender parity across the business by 2030. Finastra is also committed to adhering to the Ten Principles of the UN Global Compact and measuring our ESG progress in line with the World Economic Forum and International Business Council’s (WEF-IBC) Stakeholder Capitalism Framework.

As a global business, we very much see ESG as an opportunity for Finastra and our customers, particularly in the area of lending. In the absence of a carbon tax from national governments, more affordable green, social and sustainable linked loans funded by the ever-growing capital allocation into ESG investments can provide the financial incentives for corporates to make greener and more sustainable choices for both their own operations and their supply chains. We see the finance cost savings from emerging ESG loan products only offsetting the ‘green premium’ associated with the cost of consuming costlier greener products and services but importantly, enable the financial services sector to help in the essential transition to a net-zero global economy, in line with the goals of the UN Sustainable Development Goals (SDGs) and the Net-Zero Banking Alliance.

With Finastra’s position as the leading corporate lending software provider, we are committed to supporting the lending community as Green/ESG considerations gain significant market momentum. Look for our upcoming paper with more details on solution components and find out more about our Finastra-wide ESG journey here.

Jay Mukhey
Senior Director, ESG, Purpose & Impact
Finastra unlocks innovation across the world of financial services, through our trusted software and open platform.
About the authors

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Simon is responsible for leading the strategic functional direction of Loan IQ and its partner products within Lending, with a focus on global client needs outside of the Americas. Working with the Sales, Solution Consultants and Product Managers, Simon is accountable for defining the strategic roadmap to ensure Loan IQ remains the leading global lending solution, meeting the needs of our corporate and syndicated lending clients.  
Simon has spent over 30 years in the lending industry at banks such as Credit Suisse, RBS/Natwest and HSBC, covering many roles within operations as well as technology, strategic change and programme management before joining Finastra in 2021.

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Adwait Nene  
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Adwait is responsible for solution design across key product initiatives such as ESG Lending, Alternative Reference Rates, and Sovereign Lending. He is leading the detailed analysis to define the functional requirements for ESG financing and the solution design based on active client consultations. Adwait holds a degree in Engineering and a postgraduate Diploma in Management from the Indian Institute of Management, Lucknow.  
He has worked in the banking industry in the areas of project finance and corporate banking for over a decade, and subsequently in the fintech industry for over two decades across functions such as pre-sales consulting, business development and product management. He joined Finastra in 2016.
About Finastra

Finastra is a global provider of financial software applications and marketplaces, and launched the leading open platform for innovation, FusionFabric.cloud, in 2017. It serves institutions of all sizes, providing award-winning solutions and services across Lending, Payments, Treasury & Capital Markets and Universal Banking (digital, retail and commercial banking) for banks to support direct banking relationships and grow through indirect channels, such as embedded finance and Banking as a Service. Its pioneering approach and commitment to open finance and collaboration is why it is trusted by ~8,600 institutions, including 90 of the world’s top 100 banks. For more information, finastra.com

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