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# How Sustainable Lending Is Financing A Greener Future

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The sustainable financing market has grown substantially in recent years, as businesses respond to concerns about climate change and, in many cases, pivot toward a more sustainable development path.

Governments and regulators around the world are increasingly focused on issues relating to sustainability. The Paris agreement,[1] signed in 2016, represents the first-ever worldwide accord on a pragmatic path to tackle climate change.

In the wake of these developments, climate financing has emerged as one of the leading opportunities for the increased involvement of credit market participants. The success and resilience of the green bond market over the last decade has encouraged borrowers and lenders to tap the sustainable lending market as a source of financing.

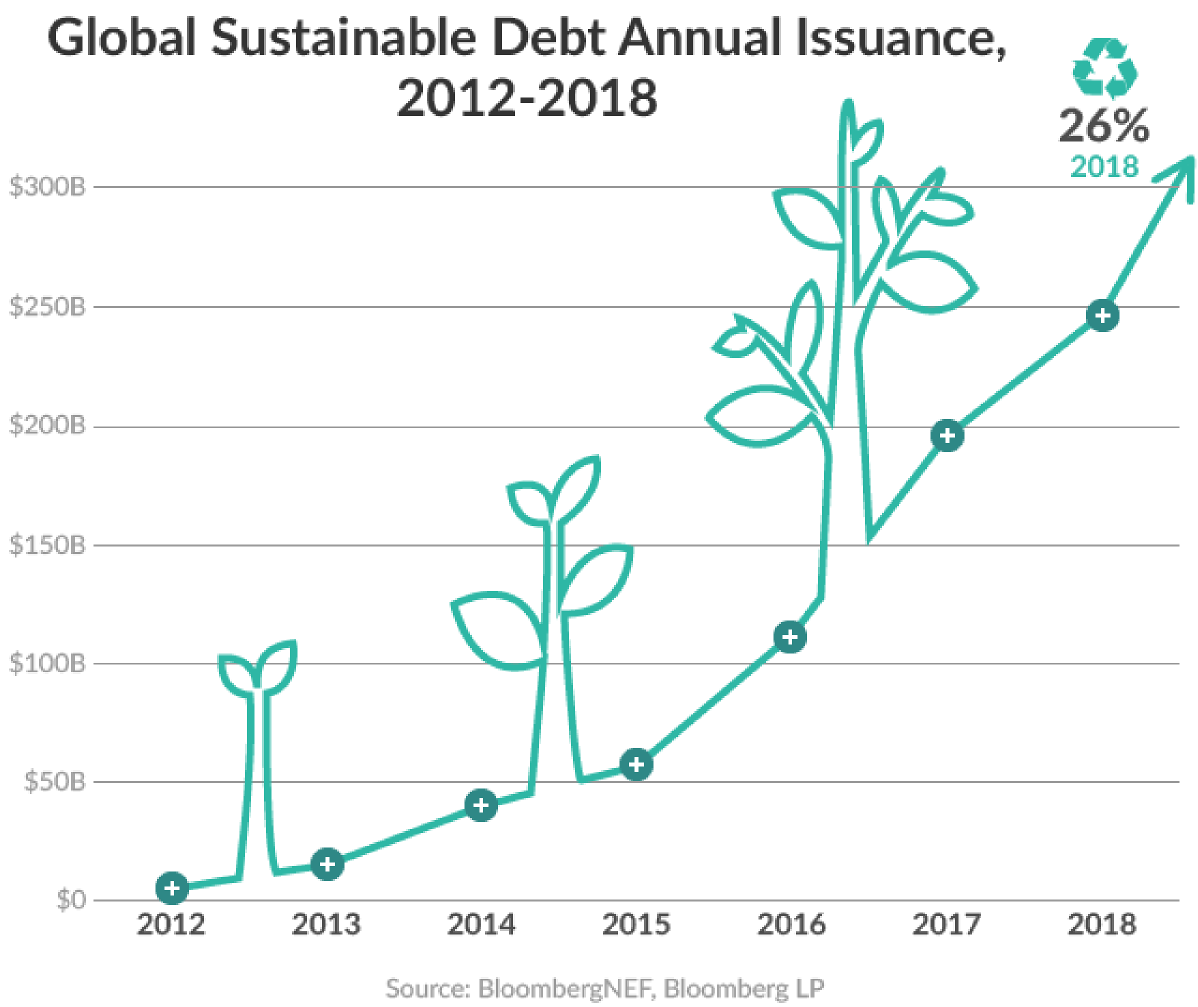
This has coincided with a rising environmental consciousness among investors, shareholders and regulators, all of whom are placing increasing pressure on borrowers and lenders to pay attention to environmental and sustainability risk factors in their businesses and to demonstrate their serious commitment to improve the status quo. For example, as of August, more than 40 financial institutions have announced divestment and exclusion policies in relation to financing new coal plants and mines.

This article highlights the key sustainable finance developments across Asia, Europe and North America over the past two years, discusses the two most recent milestone developments in the sustainable loan market, provides insight into key features of sustainable loan documentation, and highlights some of the key challenges that face this market.

**Key Developments**

The growing inclination to alleviate the negative effects of climate change has propelled a series of collaborations among various stakeholders, and culminated in a number of positive developments over the course of the last two years.

Select examples from various regions are summarized below.




***Europe***

In June, the European Commission-appointed Technical Expert Group on Sustainable Finance published a far-reaching set of recommendations for taxonomy of sustainability economic activities. The EU taxonomy is a list of economic activities with performance criteria for their contribution to six environmental objectives — namely:

- Climate change mitigation;
- Climate change adaptation;
- Sustainable use and protection of water and marine resources;
- Transition to a circular economy, waste prevention and recycling;
- Pollution prevention and control; and
- Protection of healthy ecosystems.

The establishment of this classification system marks a significant step towards a more orderly and standardized transition to a low-carbon and climate-resilient economy. It bridges the gap between commitments to the Paris agreement and actual investment practice, helps reduce costs for market players in analyzing the sustainability of an investment, and eliminates the reputational risk which may arise when market participants have to define sustainability for themselves.

In the coming months, we expect more institutional investors (particularly in Europe) to align their sustainability frameworks with the EU taxonomy. The next key step will be to work across other large financial markets to harmonize the different approaches.

***North America***

In June, the New York State Assembly passed the most aggressive clean-energy target in the United States, requiring New York to generate 100% of its electricity from zero-emissions sources by 2040.

***Asia***

In October, Japan held its first global summit to encourage corporate disclosures on climate change, and to explore and advance emerging best practices in climate-related financial disclosure. Japan has established itself at the forefront of advancing the Task Force on Climate-Related Financial Disclosures, or TCFD, agenda, with a total of 194 Japanese companies now supporting TCFD, and with the recent establishment of the Japan TCFD Consortium.

Alongside the summit, the Japan TCFD Consortium announced the release of the Guidance for Utilizing Climate-Related Information to Promote Green Investment, which provides commentaries on perspectives needed by investors and other stakeholders when understanding the information disclosed based on TCFD recommendations. To further support environmental innovation, the Japanese government also intends to make amendments to its state insurance scheme to help Japanese companies fund new overseas sustainable investment projects.

In 2017, eight central banks and supervisors (including the Monetary Authority of Singapore) collectively committed to establish a Network of Central Banks and Supervisors for Greening the Financial System. As of October, the network has grown to 46, including representation from other Asian countries such as China, Japan, Malaysia and Thailand.

The purpose of the network is to share best practices, contribute to the development of climate and environment-related risk management in the financial sector, and mobilize mainstream finance to support the transition toward a sustainable economy. The network has since issued its first report, in relation to a comprehensive portfolio-management survey among its members focusing on how they integrate sustainability factors.

***Global***

In October, on the margins of the International Monetary Fund/World Bank annual meetings in Washington, D.C., the European Union, together with relevant authorities from Argentina, Canada, Chile, China, India, Kenya and Morocco, launched the International Platform on Sustainable Finance. The purpose of the IPSF is to scale up the mobilization of private capital towards environmentally sustainable investments and to strengthen international cooperation.

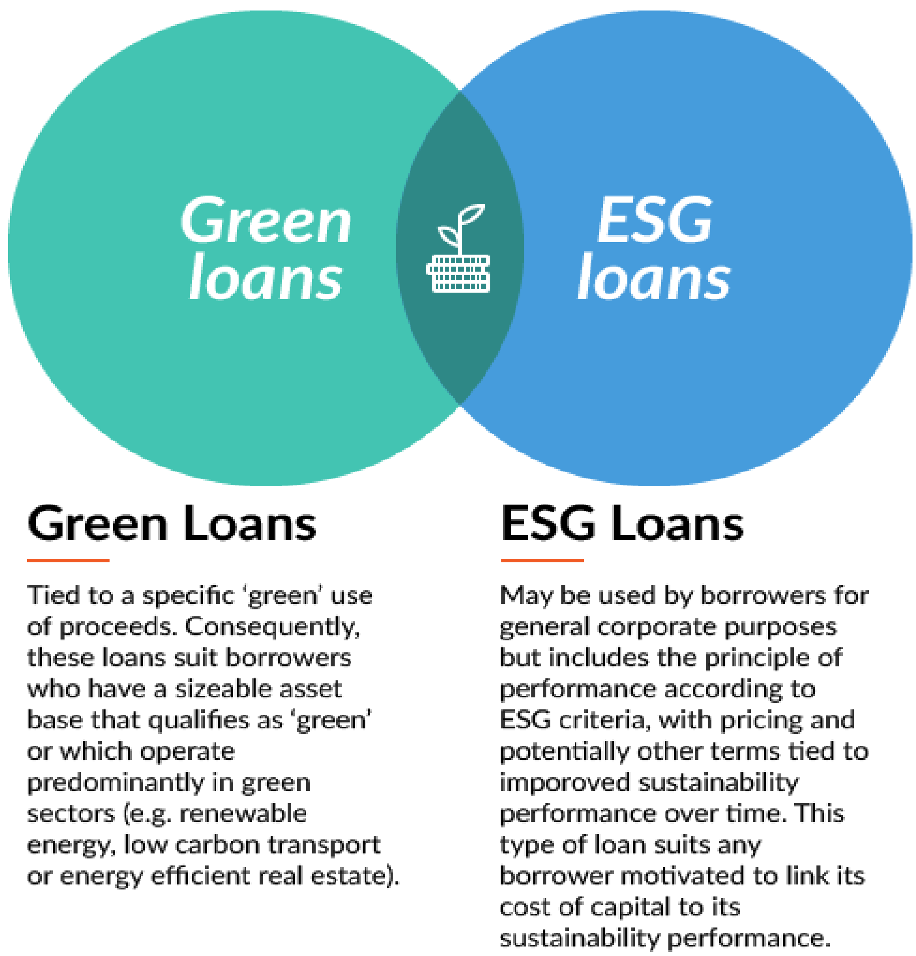
In late 2018, 28 leading banks from around the globe came together to establish the Principles for Responsible Banking under the United Nations Environment Programme Finance Initiative. Under the auspices of this initiative, they have all committed to transforming the banking industry so it plays a leading role in achieving society's goals.

The highly anticipated Principles for Responsible Banking were launched on Sept. 22 and 23, during the annual United Nations General Assembly in New York. The six Principles for Responsible Banking are:

- Alignment;
- Impact and target setting;
- Clients and customers;
- Stakeholders;
- Governance and culture; and
- Transparency and accountability.

**Green Loans and ESG Loans — Are They the Same?**

Following on the heels of the green bond market, the sustainable products currently available in the loan markets are mainly green loans and environmental, social and governance-linked, or ESG, loans. While the two products are fundamentally different, the terminologies are often conflated.



**The Green Loan Principles and Proposed Implementation**

In March 2018, the Loan Market Association, together with the Asia-Pacific Loan Market Association and the Loan Syndications and Trading Association, launched the Green Loan Principles with the support of the International Capital Market Association. These principles aim to create a high-level framework of market standards and guidelines to promote greater consistency across the wholesale green loan market. The four key components of the framework focus on:

- The use of proceeds;
- The process for project evaluation and selection;
- The management of proceeds; and
- Ongoing reporting.

***Use of Proceeds***

The purpose clause in the loan agreement must set out clearly how the proposed loan proceeds are to be utilized for green activities and projects. While the scope of this requirement is an evolving construct, the Green Loan Principles refer to a number of common examples. These include renewable energy (electricity generation from non-fossil fuel sources and investment in renewable energy technologies), green buildings (development of green buildings with accredited green standards) and energy efficiency (investment in technology, products or systems demonstrating a clear, measurable improvement in energy efficiency).

To mitigate the risk of "greenwashing," various international banks and financial institutions have developed, or are in the process of developing, green finance frameworks that set out clear criteria for the green transactions they wish to support.[2]

In connection with a borrower's commitment to use the loan proceeds for a green activity or project, the borrower may be required to deliver an action plan (in form and substance satisfactory to the finance parties) that sets out the precise application of loan proceeds. Such an action plan may form a part of (1) the information package required to be delivered as a condition precedent to signing or utilization, and (2) the ongoing suite of compliance undertakings under the loan agreement.

Some lenders may also seek the inclusion of a mandatory prepayment requirement if the loan proceeds are applied in a manner which is inconsistent with the approved purpose, although this is often resisted by borrowers.

***Process for Evaluation and Selection***

The lenders or the sustainability consultant (usually known as a "second party opinion provider") advising the lenders will typically analyze (1) the borrower's environmental sustainability objectives, and (2) whether the borrower has a robust process to ensure that the proceeds of the loan are applied in accordance with the requirements of the loan agreement, and is capable of identifying and managing potential environmental risks associated with the proposed green project. An evaluation report is likely to be required by the lenders as a part of their initial assessment of the proposed transaction.

***Management of Proceeds***

Borrowers may be required to open a dedicated account for disbursement of loan proceeds and to track the allocation of these proceeds to the green purpose of the loan facility. Account structures of this kind, and the related financial discipline, will be very familiar to lenders and borrowers engaged in project finance.

However, this may not be required if the borrower's business is entirely green in nature (such as renewable energy or green real estate), or if the second party opinion provider is satisfied with the commitment and capability of the borrower to track the allocation and application of green loan proceeds.

***Ongoing Reporting and Compliance***

The loan agreement will typically include enhanced information undertakings relating to the environmental aspects of the borrower's business and the allocation of loan proceeds. Borrowers may deliver this information through their websites, annual reports or sustainability reports published internally or by third-party consultants on a periodic basis.

There may also be a requirement for ongoing certification of a business or an asset by an independent third party, for example, in accordance with rating systems for the design, development, operation and maintenance of green buildings developed in various jurisdictions.

**The Sustainability Linked Loan Principles and Proposed Implementation**

In March of this year, the Loan Market Association, the Asia-Pacific Loan Market Association and the Loan Syndications and Trading Association launched the Sustainability Linked Loan Principles. These are intended to promote development of a versatile sustainable finance product while preserving the integrity of ESG loans.

The core components of this framework are (1) the borrower's overall ESG strategy, (2) measuring and supporting the sustainability of the borrower's business through target setting and (3) ongoing reporting and independent review.

***Relationship to Borrower's Overall ESG Strategy and Measuring Sustainability of the Borrower's Business***

Prior to commencement of documentation, borrowers and lenders must agree on sustainability performance targets, or SPTs (e.g., through external ratings and/or equivalent metrics), to measure improvements in the borrower's sustainability profile.

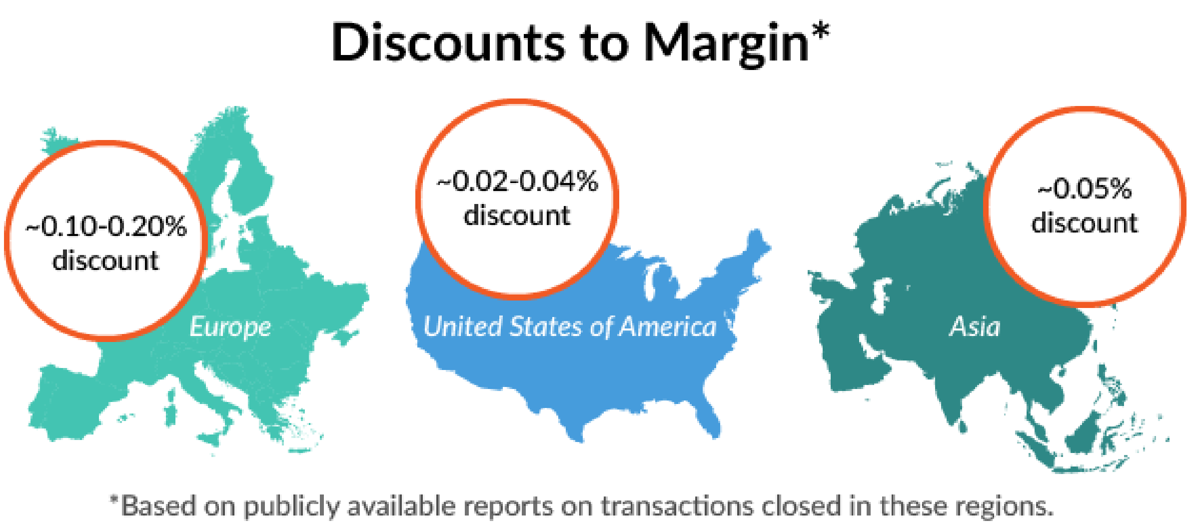
The range of SPTs span diverse categories, such as energy efficiency (e.g., through the reduction of greenhouse gas emissions or selection of cleaner sources of electricity), conservation of biodiversity (e.g., taking positive action to protect biodiversity and ecosystems), social investment programs (e.g., increasing charitable contributions and pro bono work) and improving the workforce environment (e.g., enhancing gender diversity, equality and employee satisfaction).

***Pricing Adjustment***

ESG loans typically include performance elements which reduce the margin on the loan if the borrower satisfies or is on track to satisfying its SPTs. More recently, to enhance the incentive for borrowers to meet their SPTs, lenders have introduced penalty elements which increase the margin when the borrower does not meet its SPTs.

While this has motivated borrowers further to achieve compliance with SPTs, it creates an interesting dynamic in which lenders achieve better returns from borrowers which are not meeting their SPTs. In light of this, certain alternative structures are being developed.

These include requiring borrowers to make additional payments into separate secured bank accounts when they do not meet their SPTs, and restricting borrowers from withdrawing these sums unless they can demonstrate that the proceeds will be invested in improving their sustainability profiles. The proposition that ESG loans provide borrowers with potentially lower pricing is supported by some publicly available market information, as illustrated by the infographic below.




***Reporting and Independent Review***

Compliance with SPTs is usually conducted by third party agencies, such as Sustainalytics and Viego Eiris, which assess the borrower's performance by reference to specified objective criteria relevant to the SPTs under review (and agreed in the loan agreement at the outset of the transaction).

As with green loan agreements, lenders will likely require the inclusion of information undertakings which oblige borrowers to provide periodic updates to the finance parties on completion of milestones and compliance with agreed SPTs.

**Challenges for the Sustainable Finance Market**

While there are good reasons for both lenders and borrowers to consider sustainable loans, a number of key issues will remain relevant as the market develops.

***Financial Incentives and Capital Relief***

Unlike ESG loans, the pricing of green loans is not directly linked to the green performance of the borrower, so improved performance does not lead directly to lower pricing. Borrowers may therefore perceive that there is no clear-cut financial incentive to raise green loans.

However, there is some evidence that higher demand for green loans has a beneficial effect on pricing from the borrower's perspective, and this is likely to be better understood as the green loan market develops and meaningful statistics become more widely available. For example, analysis conducted by Natixis[3] suggests that green bond issuers have experienced indirect economic benefits as they have been able to better withstand difficult market conditions due to the profile and investment priorities of green bond investors.

Conversely, from financial institutions' perspective, in certain markets where pricing is already highly competitive, and in the absence of regulatory support for capital relief, the scope for offering lower interest rates on green loans or ESG loans may be more limited. Most central banks currently oppose calls for them to support sustainable finance by reducing capital requirements for such lending, on the basis that, without clear evidence that sustainable finance carries lower risks, such a policy "could compromise the key objective of maintaining capital buffers."[4]

Regulators are also concerned that the desire for more favorable capital treatment could lead to greenwashing of loans. In this respect, the publication of the Green Loan Principles and the Sustainability Linked Loan Principles are important milestones in the development of a common framework for structuring and assessing green and ESG loans. As market practice develops and monitoring and reporting methodologies become more consistent and understood, central banks may be more willing to offer incentives.

***Onerous Documentation, Monitoring and Reporting Requirements***

There is a perception among some borrowers that green loans or ESG loans involve more onerous business controls and disclosure obligations, and require specialist internal teams to drive and monitor compliance. However, it is worth bearing in mind that:

- Several international banks have already mandated the inclusion of environmental and social undertakings as a matter of policy in all loan transactions, so green loans and ESG loans merely add a further layer that would, in any event, be consistent with borrowers' existing or aspirational internal policies;

- An increasing number of international banks, ratings agencies and other transnational bodies are making efforts to formulate and standardize sustainable finance frameworks to mitigate these perceived burdens;

- Second opinion providers have grown more accessible, and are able to assist lenders and borrowers to evaluate borrowers' integration of social, environmental and governance factors into their strategy, operations and management — with a focus on promoting economic performance, responsible investment and sustainable value creation; and

- Regulators are beginning to encourage sustainable financing, for example, by making grants available to fund the cost of second opinion providers or green certification for green and sustainable bonds.[5] It is hoped that these incentives will be extended to the loan market in due course.

**Conclusion**

The Green Loan Principles and the Sustainability Linked Loan Principles provide loan market participants and regulators in the European, Asian and North American markets with an important framework to guide expectations, standardize market practice and enhance the consistency and integrity of the asset class.

Alongside other industry and regulatory initiatives which are gaining momentum, borrowers and lenders have a unique business opportunity to improve the sustainability of their businesses and drive positive outcomes. As such, we anticipate substantial and continued evolution in the sustainable finance market in the next few years, particularly in the global loan markets.

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[1] The Paris agreement is an agreement within the United Nations Framework Convention on Climate Change, dealing with greenhouse-gas-emissions mitigation, adaptation and finance, effective in 2016. The central aim of the Paris agreement is to strengthen the global response to the threat of climate change by keeping a global temperature rise this century below 2 degrees Celsius above preindustrial levels. http://www.worldbank.org/en/results/2016/10/07/bangladesh-ensuring-a-reliable-and-quality-energy-supply.

[2] Barclays, Credit Agricole CB, HSBC, ING and Macquarie are some examples of the financial institutions which have published such frameworks.

[3] https://www.epfsf.org/images/stories/PDF/2017/Beyond%20Green%20Bonds%20-%20Sustainable%20Finance%20Comes%20Of%20Age,%2026%20April%202017.pdf.

[4] De Nederlandsche Bank, Dutch central bank.

[5] MAS Sustainable Bond Grant Scheme.