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How Sustainable Finance is Shaping Change in Banking

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Introduction

As sustainability gains importance for all sectors of society, the world of finance is no exception. Sustainable finance – the practice of taking environmental, social and governance (ESG) considerations into account when making investment decisions – has transformed from a niche market into a leading global practice in little over a decade. The growth has been staggering: even with market disruptions due to the COVID-19 pandemic, the issuance of sustainable debt alone reached $732 billion in 2020 – a 23% increase compared to the year before.[i ii]

Fueled by these growing market demands, stakeholder expectations and regulatory trends, leading banks and issuers are embracing sustainable finance practices. ESG considerations are increasingly applied to banks' portfolio decisions, product development, pricing and underwriting, as well as risk management to protect against ESG-related risks. To support these activities, many banks such as Barclays and Standard Chartered are developing sustainable finance frameworks to guide decision-making and provide credibility on ESG-related investments. This ebook explores the rationale behind banks' embrace of sustainable finance portfolios, tracks recent trends in sustainable financial instruments, and examines how banks are improving their sustainable finance strategies through the development of bespoke frameworks.

Sustainable Finance Key Concepts

Green and social loans are any loan instrument used exclusively to fund new or existing projects with environmental or social benefit. Market participants are encouraged to align their loan agreements with the Green Loan Principles and Social Loan Principles developed by the Loan Market Association, Asia Pacific Loan Market Association and Loan Syndications & Trading Association. This framework of market standards and guidelines was established to preserve the integrity of the green and social loan markets.

Green, social and sustainability bonds are use of proceed bonds in which the funds are allocated to finance or re-finance new and/or existing projects with an environmental and/or social benefit. To improve transparency and insights on the impacts of these projects, issuers are encouraged to develop a bond framework that aligns to the principles set out by the International Capital Markets Association.

Sustainability-linked instruments, such as bonds and loans, tie the terms of the finance agreement to the issuer's or borrower's achievement of predetermined sustainability targets. In the case of sustainability-linked loans, the interest rate of the loan may increase if the borrower fails to meet the target, and vice versa. In a sustainability-linked bond agreement, the bond's coupon rate will increase, or the issuer may pay a penalty when the bond matures if it fails to achieve the sustainability or ESG objectives. In both instances, the proceeds can be used for general corporate purposes.

Why Banks are Embracing Sustainable Finance

The shift to incorporate ESG metrics into banks' capital allocation and stewardship criteria is driven by more than just altruistic goals and regulatory trends; there are substantial financial and non-financial benefits in doing so.

Broadening Market Demand

As private sector actors seek to mitigate climate change and improve their sustainability performance, there is an increased demand for financing for ESG-focused projects and sustainable economic activities. Issuers and institutional investors have responded by offering a range of innovative financial instruments to keep up with market demand, including instruments that expand access to borrowers in industries not traditionally considered "green." Sustainability-linked debt, for instance, is sector agnostic and has experienced a meteoric rise since 2017, with companies ranging from AccorHotels to Sydney Airport entering into sustainability-linked loans.

International Calls for Action

International organizations have been placing pressure on banks and other financial institutions to redirect capital toward sustainable economic activities. International agreements such as the Paris Climate Agreement, the European Union (EU)'s Green Deal, and the UN's 2030 Agenda with its 17 Sustainable Development Goals (SDGs) have prompted banks and institutional investors to finance projects and corporations seeking to tackle pressing social and environmental issues. Goldman Sachs and Bank of America alone have pledged to spend trillions on sustainable finance to support these international commitments. In 2019, the UN established the Principles for Responsible Banking, which requires signatory banks' strategies and practices to align with the SDGs and the Paris Climate Agreement. Uptake has been noteworthy: over 40% of the global banking sector have become signatories in less than two years since establishment of the principles.[iii]

A Supportive Regulatory Environment

International and domestic calls for action have also led many countries to introduce legislation defining and fostering the continued growth of sustainable finance. Countries from all regions of the globe have introduced frameworks to redirect capital to sustainable economic activities, some of which include comprehensive classification schemes to provide clarity and certainty on the environmental sustainability of investments such as the EU's Taxonomy for Sustainable Activities and China's updated Green Bond Endorsed Project Catalogue 2021.

EMEA

An early adopter of sustainable finance, Europe benefits from comprehensive measures to promote market discipline and foster the practice's growth. The EU recently passed legislation on introducing the EU Taxonomy, a classification framework for determining what economic activities qualify as environmentally sustainable, and the Sustainable Finance Disclosure Regulation (SFDR), a directive requiring standardized ESG-related disclosures of financial market participants. As part of the European Green Deal Investment Plan, the EU has also committed to mobilize at least €1 trillion of sustainable investments to fund the green transition over the next decade.[iv] Outside of the EU, other EMEA countries are following suit, with the Russian Central Bank introducing recommendations in 2020 for incorporating sustainable investment principles into the selection and management of investment projects and introducing emission standards for the usage of green and social bonds' funds.[v]

Americas

With the recent change in administration, the United States is seeking to align to international regulatory trends regarding sustainable finance. Introduced in 2021, the proposed ESG Disclosure Simplification Act of 2021 would require publicly traded companies to disclose ESG information in their Securities and Exchange Commission (SEC) filings. Standardizing corporate ESG disclosures under this proposed legislation would support sustainable finance by providing banks with additional information on potential borrowers' sustainability performance.

APAC

Across the Asia-Pacific region, there is an increasingly supportive policy environment for sustainable finance, including recent legislation in Singapore, Japan and Hong Kong.[vi] One of the most prominent examples is the Green Credit Guidelines developed by the People's Bank of China and the China Banking Regulatory Commission, which encourages banks to lend more to sustainable companies and establishes a reporting system for green credit.

Decreased Exposure to Sustainability-Related Risks

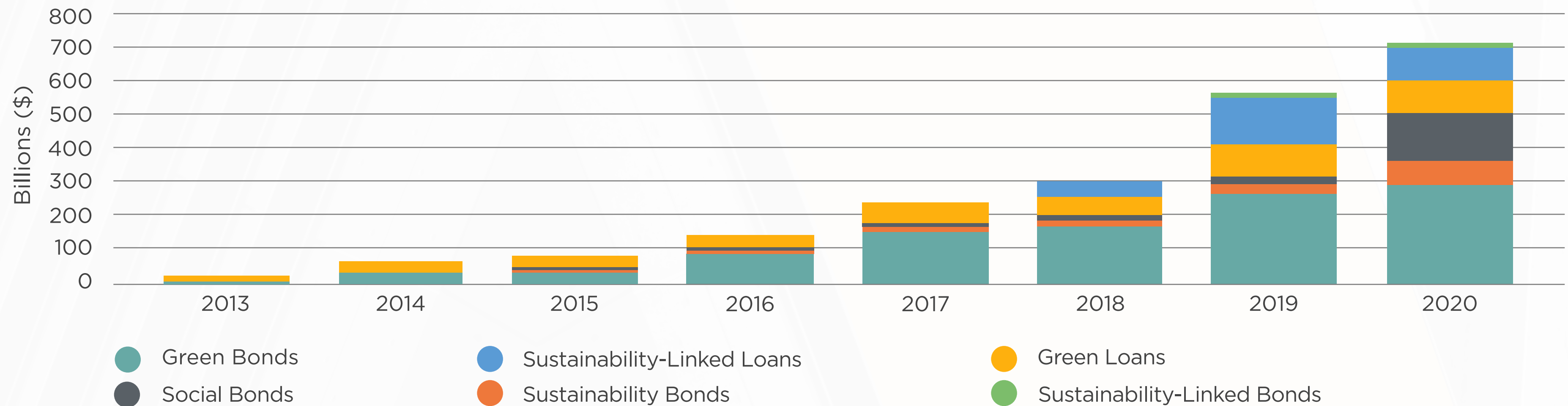
Integrating ESG considerations into capital allocation is also quickly becoming a key aspect of many banks' risk management frameworks. ESG-related risks such as an asset's exposure to rising sea levels, inflated senior management compensation, or possible human rights violations across a product's supply chain can carry significant financial and reputational risks for banks. Among EU banks alone, climate change-related risks are anticipated to put up to 15% of banks' balance sheets at risk, including from financial impacts from stranded assets and increased risks of major crop failures.[vii] Given that many sustainable financial products consider ESG issues, sustainable finance can help mitigate against a bank's exposure to ESG-related risks and even influence profitability. The adoption of green financing policies in China, for example, was found to have a positive impact on the banks' non-performing loan ratios.[viii]

Increased Reputational Benefits

As stakeholders use an organization's sustainability commitment as a new lens to compare organizations, banks can benefit from reputation gains and brand differentiation by expanding their sustainable finance portfolios.[ix] A comprehensive sustainable finance strategy can demonstrate a bank's commitment to sustainability, promote the credibility of the institution, and reduce reputational risks of "greenwashing" financial instruments. In comparison, banks with weak sustainable finance frameworks and targets may face public criticism. Deutsche Bank brought forward its sustainable finance goal of facilitating more than $244 billion in sustainable financing and investments by two years in response to public pressure and to position the bank as a sustainability leader.[x]

How Sustainable Finance Instruments are Evolving

Sustainable finance continues to expand into new areas and redefine equity and debt capital markets. While the issuance of green loans, sustainability-linked loans and labeled bonds continue to grow, new financial instruments such as green deposits and sustainability-linked bonds are expected to rise in prominence.



Source: Bullard, N. (2021). 'The Sustainable Debt Market is All Grown up,' Bloomberg, accessed (13.05.21). For informational purposes only.

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Expansion of Sustainability-Linked Debt

2020 marked a new high for sustainable debt issuance with around $730 billion in transactions.[xi] Sustainability-linked loans (SLLs) – loans that tie loan terms to the borrower's sustainability performance – continue to grow in popularity and constitute the largest proportion of sustainability-linked debt. Recent updates to the Sustainability Linked Loan Principles have increased the credibility of this financial instrument and promoted market discipline on the issuance of SLLs.

2020 was also a breakout year for sustainability-linked bonds (SLBs), with around $11 billion in transactions.[xii] Similar to SLLs, SLBs tie the coupon to the issuer's sustainability performance and allow proceeds to be used for general corporate purpose, offering flexibility for issuers. As a result, SLBs provide opportunities for companies across all industries or those with insufficient assets to qualify as green to access the sustainable finance market and a more diverse pool of investors.

Continued Growth of Labeled Bonds

Since their introduction in 2007, green bonds have continued to be a popular financial instrument, with global cumulative issuance surpassing the $1 trillion mark in 2020.[xiii] As a testament to the continuing rapid market growth, issuance is expected to reach €2 trillion in the next three years.[xiv] Taking a closer look at 2020, issuances of other labeled bonds such as social bonds, sustainability bonds, blue bonds, gender bonds and most recently – COVID-19 bonds – also gained momentum. Fueled by the need for funds to support pandemic healthcare and relief efforts, social bonds had a banner year in 2020, seeing a 700% increase in issuance year-over-year, totaling $130 billion.[xv] In comparison, adoption of transition bonds has been slow since their introduction in 2019; however, with the London Stock Exchange establishing a transition bond segment and several significant transactions completed in 2021, market signals are indicating that transition bonds may play a more prominent role in the future, particularly for heavy industries.[xvi] Seaspan, a global marine logistic company, completed an upsized $750 million offering of transition bonds in 2021, indicating the choice of transition bonds to raise funds as a key in driving the improvement of its fleet's environmental performance and decarbonization in the shipping industry.[xvii]

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Breakout Innovations in Sustainable Finance

To meet the growing demand for sustainable finance, banks and other issuers are innovating with new sustainable financial instruments.

- **Green deposits** offer opportunities to invest short-term liquidity into environmentally sustainable projects, with companies required to meet certain eligibility criteria to qualify for green deposits. Banks like the MUFG Union Bank, the SMBC or the Citizens Financial Group have included this new sustainable finance instrument into their portfolios. To support implementation, many banks have developed green deposit frameworks to ensure that capital goes toward financing qualifying initiatives.

- **Sustainable deposits** are used to fund small and medium-sized enterprises in developing countries, take on microfinancing and provide resources for sustainable projects. The world's first sustainable deposit was launched in 2019 by Standard Chartered to finance the Sustainable Development Goals in Africa, Asia and the Middle East using their Green and Sustainable Product Framework.

- **Green trade loans** finance the purchases of goods and materials to support sustainable initiatives, including the transition toward renewable energy or sustainable food production. As part of its Sustainable Finance Framework, Barclays is offering its British clients access to green trade loans for short-term borrowing needs of between 30 and 364 days.

- **Green guarantees and letters of credit** finance projects or products with a clear positive impact on the environment and the transition to a low-carbon economy. Siemens Gamesa Renewable Energy, a leading provider of wind power solutions, was the first recipient of Societe Generale's certified green trade finance transaction of €230 million.[xviii]

- **Sustainable supply chain financing** is a partnership between a corporation and its suppliers, with suppliers able to access financing options based on their ESG profile. By providing access to better loan terms compared to less sustainable vendors, banks and their corporate clients can incentivize suppliers to improve their sustainability performance. ING Bank recently developed a sustainable supply chain financing solution to respond to its corporate clients' calls for solutions to strengthen their sustainable supply chain management and finance vendors.

Market Maturity Across the Globe

Despite economic disruptions caused by the COVID-19 pandemic, sustainable finance continued to grow during 2020, with a 29% global growth rate from 2019 to 2020.[xix] During this period, Sustainalytics witnessed a significant uptake in all markets for corporations seeking sustainable finance solutions. The Asia-Pacific and the Americas regions recorded the largest market growth due to legislation change, business demands, and an increased focus on sustainable finance by investors. Despite this growth, EMEA continues to lead in the adoption of sustainable finance practices, regulation, and frameworks.

EMEA

Supported by the EU's regulatory measures, the relative maturity of the market, and now the bloc's first (and world's largest) green bond issuance, Europe remains the leader in sustainable finance, accounting for almost half of all ESG assets under management. In 2020, issuance of green loans and labeled bonds grew from €245 billion in 2019 to €389 billion, an increase of almost 59% compared to 2019.[xx] Among labeled bonds, issuance of social bonds rose significantly linked to COVID-related support throughout Europe.

Americas

While sustainable finance markets in the Americas still lack strong regulatory drivers, market demand in the U.S. has increased dramatically. The U.S. had the strongest uptake of sustainable finance in 2020 and may dominate in total ESG assets under management starting as early as 2022. In both Canada and the United States, green bonds constitute the majority of sustainable financial instruments issued, although sustainability-linked debt is also gaining traction.[xxii]

APAC

While previously lagging in comparison to other regional markets, Asian markets' uptake of sustainable finance in 2020 is quickly closing the gap. As Asian central banks and regulators commit to more sustainable finance policies and ESG disclosures, some experts anticipate the next large wave of growth in sustainable finance coming from Asia.[xxiii] [xxiv] New disclosure policies are also expected to bring more market discipline, with Hong Kong recently announcing that disclosures related to ESG will be mandatory by 2025 for all financial organizations and relevant fields, including underwriters and asset managers.

How Banks are Structuring Sustainable Finance Strategies

With sustainable finance gaining momentum across the financial industry, banks are developing frameworks and strategies to embed ESG considerations into their lending and investment decisions and help transition toward greener portfolios. Many banks utilize well-known ESG investing strategies such as negative screening and thematic investing when making lending and investment decisions.

Environmental and Social Due Diligence

Environmental and social due diligence practices vary across banks and transactions. Until 2019, there were no globally recognized environmental and social due diligence standards for general corporate lending or underwriting transactions. The publication of the OECD Due Diligence for Responsible Corporate Lending and Securities Underwriting and the establishment of the Principles for Responsible Banking in 2019 provided banks with due diligence frameworks and ESG risk management for both project finance and corporate lending transactions.

Most major banks screen their lending portfolios against specific ESG risks as per the OECD Due Diligence guidance, and many embrace negative or positive screening for potential corporate lending transactions or project finance transactions.[xxv] Screening strategies filter potential transactions using predetermined ESG criteria to rule companies in or out of contention for financing. Negative screening and norm-based screening involve the exclusion or avoidance of transactions not aligned with environmental, social and ethical standards. Exclusion criteria often include issues like weapon manufacturing, tobacco sales or production of fossil fuels. While negative and norm-based screening are the most popular techniques used for ESG asset management, these practices have been losing traction since 2015.[xxvi]

Positive screening, on the other hand, selects corporate borrowers that score highly on ESG factors relative to their peers. This can include best-in-class screening, or the inclusion of investments in companies and sectors with higher ESG scores as compared to their peers or companies that are actively improving their ESG performance. This screening method does not necessarily exclude ESG laggards but rather focuses on those performing best with regards to ESG in relation to comparable companies or industries. In comparison to corporate lending transactions, the intensity of screening is often higher for project finance transactions given due diligence requirements under the Equator Principles.

Integration and Thematic Investment Strategies

Integration strategies systematically include ESG issues in financing decisions to better manage risks and improve returns. Compared to screening, certain sectors or companies are not excluded from lending or investment decisions at the outset. Instead, additions to the bank's sustainable finance portfolio are selected using both financial and ESG factors, such as calculating the ESG risks of a portfolio addition or valuing the impact of increasingly stringent environmental regulations on revenue. ESG factors to be included in integration strategies should only be those material ESG issues that can significantly affect corporate and investment performance. To assess whether an ESG issue is material or not, banks collect information from a variety of sources, including company filings, media reports, and third-party ESG research providers.

Thematic investment strategies prioritize companies or projects which support the achievement of a social or environmental outcome, such as addressing climate change, promoting gender equality, or the achievement of an SDG. The Bank of America Environmental Business Initiative, for example, will deploy and mobilize $1 trillion by 2030 to accelerate the transition to a low-carbon, sustainable economy. The focus of the initiative is on projects particularly targeting the achievement of the United Nation's SDGs. Impact investing also falls under the category of thematic investment strategies.

ESG Engagement Strategies

In contrast to screening and integration strategies, ESG engagement strategies take a more active role in managing ESG impacts. It includes discussing ESG issues with corporate borrowers to improve their performance. ESG engagement strategies are still a growing trend but often a requirement to industry initiatives on sustainable banking practices. In April 2021, a group of banks representing almost a quarter of global banking assets helped establish the Net-Zero Banking Alliance, which requires signatories to align their portfolios with net-zero emissions by 2050. Signatories to the Net-Zero Banking Alliance are strongly encouraged to engage with corporate borrowers in reducing their carbon emissions and developing innovative climate solutions in their portfolio.

Advancement of Sustainable Finance Frameworks

To systematically apply sustainable financing strategies, banks are creating frameworks to outline the methodology and processes they use to embed ESG criteria into their lending and investment decisions. When developing sustainable finance frameworks, banks often align with well-established international standards such as the UN-backed Principles for Responsible Banking, the Equator Principles, the Green, Social & Sustainability Bond Principles, and Partnership for Carbon Accounting Financials, as well as seeking the support of third-party ESG advisors on the classification requirements of sustainable finance instruments.

Although a relatively new phenomenon, there are key similarities across banks' sustainable finance frameworks, as detailed below.

Sustainable Finance Goals and Other ESG-related Targets

The first section of a sustainable finance framework details the bank's overall commitment to sustainability, including any relevant ESG-related goals and sustainable finance targets. Any underpinning ESG financing strategies utilized by the bank and key material ESG factors for the bank are also often listed.

Classification of Eligible Financing Activities

Eligibility for an investment's inclusion in a sustainable finance portfolio is defined through predetermined criteria. The framework's evaluation and selection criteria should be transparent and understandable to all relevant stakeholders. Deutsche Bank and Barclays utilize decision trees to simplify the classification process, while other banks such as Standard Chartered use classification tables to guide the inclusion and exclusion of transactions. Furthermore, some banks also base eligibility and exclusion criteria on an upstream classification of transactions (i.e., use of proceeds, company profile, the financial product itself).

Most banks draw on international principles to guide the issuance of sustainable financial instruments, such as the Green Bond Principles, Social Bond Principles, Sustainability Bond Guidelines, the Green Loan Principles, and Sustainability Linked Loan Principles. To verify alignment of the framework with applicable market standards, banks may seek a second-party opinion when formulating eligibility criteria. **Sumitomo Mitsui Banking Corporation**, for example, entered an agreement with Sustainalytics to formulate green deposit eligibility guidelines. These guidelines are used to direct the deposits placed by customers toward financing the environmental sector, with Sustainalytics evaluating the operational status on an annual basis.

Alignment with International Goals

The bank's contribution to international targets such as the SDGs should be articulated within the framework and integrated within the eligibility criteria. For instance, a threshold for carbon emissions in line with the Paris Agreement could be included in the eligibility criteria. If desired, eligible financing themes can also be aligned with relevant international targets.[xxvii] Barclays' Sustainable Finance Framework, for example, maps out all its eligible sustainable finance activities by SDGs and Standard Chartered broadly aligns eligibility criteria with the EU Taxonomy.

Due Diligence Processes

Frameworks detail the due diligence required before an investment decision is undertaken. Verification of corporations' ESG-related information is often undertaken through second-party opinion providers or through direct collaboration with third-party providers. As sustainable finance instruments evolve, so is the discussion regarding "greenwashing" and the need for robust verification processes. To protect the credibility of sustainable financial products, many banks utilize third-party verification for the development and issuance of sustainable financial instruments. Third-party reviews are necessary for the issuance of certain products such as SLLs, which require corporate borrowers to secure third-party verification of their performance against the SLL's Sustainability Performance Targets (SPTs). Other market standards, such as the updated Green Bond Principles, recommend that bond issuers appoint a third party to assess and verify the alignment of the management of proceeds with the Green Bond Principles.

Review Guidelines

To establish credibility and to support external validity, many sustainable finance frameworks are reviewed by an independent third party. Banks can also choose to commit to regular framework reviews to keep pace with changing regulative environments and market developments. Standard Chartered, for instance, has committed to reviewing its framework on an annual basis.

Looking ahead as banks pivot their finance toward more sustainable investments, issuers also need to manage the transition from "brown" assets to more sustainable portfolios. With many of these brown assets still generating profits, banks need to balance their duty to finance the transition to sustainability against their fiduciary duties to shareholders. Experience, insight and data are needed to help map potential consequences and ensure a successful portfolio transition.

Third-Party Support in Developing Sustainable Finance Frameworks

Sustainable finance frameworks are a powerful tool to help banks achieve their sustainable finance goals. With a multitude of emerging regulations, standards, and best practices, many banks rely on third-party support in developing their frameworks. Some of the benefits of consulting third parties include:

- **Enhance credibility:** Third parties can verify the impact of the eligibility criteria, examine ESG risk management approaches and reduce potential reputational risk concerns.
- **Draw from industry expertise**: Leading banks like Standard Chartered collaborate with external parties to jointly develop robust state-of-the-market frameworks.
- **Ensure alignment with market expectations:** Third-party providers can verify adherence to international sustainable finance standards and ensure that financial instruments are aligned to market expectations.

Into the Future: Sustainable Finance as the 21st Century Approach to Banking

Two decades ago, sustainable finance was a niche concept for most of the finance world. Fast forward to 2021 and the practice is on the agenda of almost every major bank. Leading banks are recalibrating their finance strategies and setting course for a greener portfolio through the adoption of sustainable finance frameworks and other ESG financing strategies. Growing market demand, accelerating regulatory pressures, and the groundswell of public expectations for financial market participants to support sustainable development are likely to facilitate further growth of the sustainable finance market over the coming years.

Resources for Companies

- **UN Principles for Responsible Banking:** The Principles for Responsible Banking provides an international framework for a sustainable banking system, with resources and tools on impact analyses, target setting and best practices for banking practitioners on sustainable finance.
- **Equator Principles:** The Equator Principles are a risk management framework for financial institutions in determining, assessing and managing environmental and social risk in projects and is primarily intended to provide a minimum standard for due diligence and monitoring to support responsible risk decision-making.
- **International Capital Markets Association (ICMA) Finance Resource Centre:** A non-profit membership association serving firms active in the international debt capital markets. ICMA developed the leading global frameworks for the issuance of sustainable bonds – the Green Bond Principles, the Social Bond Principles, the Sustainability Bond Guidelines and the Sustainability-Linked Bond Principles.
- **Climate Bonds Initiative**: A non-profit organization working to mobilize the bond market for climate change solutions. It developed the Climate Bonds Standard and Certification Scheme for bonds as a tool for investors and governments to easily identify and prioritize investments that contribute to addressing climate change.
- **Partnership for Carbon Accounting Financials (PCAF):** A global partnership of banks and financial institutions, PCAF provides resources for financial institutions to assess and disclose the greenhouse gas emissions associated with their loans and investments
- **Sustainable Banking and Finance Network (SBFN):** As a voluntary community of financial sector regulatory agencies and banking associations from emerging markets, SBFN is committed to advancing sustainable finance in line with international good practice such as guidance on improved ESG risk management.

Sustainalytics' Sustainable Financing Solutions for Banks

Sustainalytics offers several solutions for banks to support their sustainable financing activities, including supporting the development of sustainable finance frameworks.

- **Second-party Opinions and Annual Reviews:** Sustainalytics provides second-party opinion services to assure that frameworks are aligned to accepted market principles. Our Annual Review service further ensures that the projects financed and the reporting are aligned with the intended use of proceeds and commitments set out in the framework. The services cover various categories including sustainability-linked bonds and loans, sustainable finance frameworks or sustainable deposit frameworks.
- **ESG Ratings:** Banks and lenders can use Sustainalytics' ESG Risk Ratings as a part of their sustainable finance strategies and for the issuance of sustainable financial instruments such as sustainability-linked loans.
- **Sustainable Finance Insights:** Sustainalytics supports banks in advancing their sustainable finance strategies by providing valuable insights and expertise into activities that can be considered impactful and material.

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[xxvii] The International Capital Market Association has developed a mapping tool to guide high-level alignment of green, social and sustainability bonds to the SDGs.

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