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Sustainable Finance: Driving Transformation

Sustainable Finance
and Responsible Investment

Introduction

In November 2018, a number of senior figures from across the financial services landscape gathered for a round table at CMS' London office to discuss the sustainable finance and environmental, social and corporate governance (ESG) themes developing in the banking industry. This report summarises the highlights of lively discussions that sought to address some key questions, including:

— Should banks and other debt providers be prioritising sustainable finance and ESG lending?
— Is there a market for sustainable/ESG debt and what are the risks?
— Is it just a question of window-dressing or greenwashing?

Sustainability is a priority focus area for governments across the globe and there is no question that 'sustainable finance' and 'ESG' linked performance are popular buzzwords in business today. Accordingly, sustainable finance is rapidly becoming a regulatory imperative – companies are not only increasingly talking about how to address issues of sustainability but are also starting to put it into practice.

Through the introduction of debt financing products, such as green home mortgages and ESG-linked revolving credit facilities, banks and other financial institutions have started a process of transformation, acting as catalysts of change offering their customers the opportunity to transform their businesses to a sustainable and environmentally friendly business model. In an industry still very much in its infancy, it remains to be seen whether the move to sustainability is one that will ultimately be adopted by their customers across the board and bring about transformation, as well as create new business for debt providers.

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Is sustainable finance/ESG generating new business for lenders?

There has been a realisation among lenders that there is a client interest in sustainable finance products, which will only grow as the regulatory environment changes and technology advances. There are also interesting discussions to be had between lenders and clients on how clients can access and benefit from sustainable finance products.

For example, house builders and homeowners securing more affordable loans through the development and purchase of greener homes or commodity companies securing discounts on loans for using sustainably sourced products and then, possibly even ploughing those savings into their corporate social responsibility initiatives.

Currently, ESG products often require a degree of initiative on the part of a lender's customer and not every business sees the need for it yet. As such, a lender may struggle to ramp up the issue of ESG-linked revolving credit facilities or other ESG products because there needs to be time to work with customers to explain what these products are and how they work.

There are a number of ways that lenders can drive the development of sustainable finance within their organisations. This could include: setting up a green council with committed employees working as "green champions" within an organisation; establishing a green framework setting out a lender's sustainable finance model; and creating innovative sustainable finance products that not only work for clients but also help encourage top-down support from "C-suite" executives.

As the regulatory environment monitoring sustainability in business and finance continues to change, this will only further propel development in this area.

> Sometimes, all it takes to gain momentum is for a handful of successful sustainable finance deals to take place to encourage others to follow suit.
>
> *Participant*

How to convince companies that sustainable finance and ESG agendas are important

Most lenders with experience in the sector would agree that having wide-ranging, intelligent conversations with clients on sustainable finance can lead to the creation of innovative solutions. Green finance is not only appropriate for sustainable assets or projects but can also be linked to a wide array of other business work streams, such as sustainable sourcing of materials.

These conversations can, however, be difficult to start when dealing with companies with no corporate social responsibility (CSR) agendas, and/or financial management which is not interested in opening the discussion (often on the assumption that there is no economic benefit).

However, companies will find themselves coming under increasing pressure to demonstrate sustainability within their business from both regulators, legislation and, perhaps even more pertinently, from shareholders with their own ESG agendas. Institutional investors and large private equity players seem to be particularly advanced in this respect, incorporating ESG themes into their agendas. The growing influence and spending power of millennials who favour ethical business practices is also pushing institutional investors to acknowledge that demand for investment in companies with high ESG-targets is growing. With recent changes to the UK corporate governance code, it seems clear that sustainability is now a tangibly important consideration for business.

As lenders gain more experience and knowledge in initiating and monitoring sustainable finance, it is likely to gain more prominence in the corporate world. Anecdotally, experience indicates that finance directors become more open to the idea of sustainable initiatives where an evidence base is built up, demonstrating how these initiatives can make a difference to a business's operational performance and drive earnings growth. In addition, using third party capital to help fund an ESG agenda could also be highly attractive to businesses facing numerous demands for capital expenditure within the organisation.

For many investors and lenders with strong ESG-linked agendas, a company (potential borrower) that has made a clear commitment to sustainability and has articulated its ESG agenda, receives an immediate tick in the box when it comes to deciding whether to invest in that business. The awareness of this may lead companies to wake up to the potential of sustainable finance to assist with achieving this the wider ESG performance of their business.

It may also be important, particularly in a nascent part of the finance industry, for lenders to consider adopting an inclusive approach to working with companies on sustainable initiatives. Lenders need to decide whether it is better to blacklist a company deemed to have an unsustainable business model, or work with companies to help them go greener. For example, an oil company operating rigs in the developing world may not be deemed to be "green" but what if the provision of a "green loan" helps that company to stop the environmentally unfriendly process of flaring gas on those rigs? There is clearly more than one shade of "green" to consider in the world of sustainable finance.

» The importance that investors today place on companies with a strong ESG-linked agenda, should alone help companies wake up to the potential of sustainable finance.

Participant

What are the risks for companies pursuing ESG and sustainable agendas?

A potential issue for companies (and their potential debt funders) exploring the introduction of sustainable initiatives and finance, is finding the right advice. This does not just relate to securing independent guidance on what is the right sustainable initiative or debt financing product and which standards to apply, it also involves an analysis and mitigation of risks and whether such risks are insurable.

For example, a company may wish to install solar panels to lower its energy usage but it will also need assurances that it will be protected if the solar panels were to fail and cause a loss to the business. Lenders and companies may need to partner with organisations that can provide independent, agnostic advice about what is possible and which, if any, risks are insurable and worth taking.

Sustainable finance can be complex, particularly when linked to new and evolving technologies. Looking at the example of electricity storage, it is clear that whilst batteries are being deployed alongside regular renewable energy technologies (such as solar), on an increasing basis there are still a number of key risks. What is the residual value of the batteries? How viable are the revenue streams from the batteries? Is it risky to invest now when the technology is evolving so quickly? These risks are why, for now, battery storage is still mostly attracting private equity capital investment rather than debt finance.

Nevertheless, there is already a growing body of evidence that sustainable investments can generate reliable income streams and returns that benefit investors, banks and commercial entities. The fact that private equity groups are increasingly investing in this space also clearly demonstrates there are returns to be made.

» A well-thought out ESG agenda is not only about making a company more sustainable, it is also about making it more efficient and profitable while effectively managing risk.

Is there a tendency for greenwashing?

Greenwashing is the practice of making unsubstantiated or misleading claims about the environmental benefits of a product, service, technology or company practice. Greenwashing can make a company appear to be more environmentally friendly than it really is.

This is a particular risk for debt funders and investors in the world of sustainable finance where the offer of "cheap" money and discounts for "green" initiatives can be alluring to companies. Businesses cannot simply expect a cheap deal from a lender without having a meaningful discussion about what they are doing to drive their sustainability agenda and what impact this has on the business. Similarly, some banks try to ensure they have their own sustainable lending frameworks to avoid any reputational damage associated with perceived "greenwashing".

However, guarding against greenwashing does not need to be restrictive for lenders or their customers. There is a growing view that commercially sound sustainable finance products are often highly innovative as they have built-in drivers and levers that encourage companies or individuals to seriously address sustainability issues, while also driving a return for the relevant lender. For example, a lender using government data on the energy performance of houses and cross-matching its mortgage loan book can discover whether there is any positive correlation between energy efficiency and the performance of a mortgage over its lifetime. This could help reduce the risk of its mortgage loan book and potentially lead to the issuance of more "green" mortgages, green development loans and green bonds and the diversion of more capital to such loans.

However, lenders do need to be wary of simply trying to retroactively cherry-pick some of the loans in the existing loan book and re-badging them as "green". For sustainable finance to truly gain ground, it needs to increase the proportion of capital committed to sustainable business and genuinely create innovative solutions, otherwise it will continue to attract criticism for "greenwashing". A recognition of this has led to certain lenders establishing their own sustainability criteria for application over and above external benchmarks such as the Loan Market Association's (LMA) "Green Loan Principles" referred to on the next page.

> Greater regulation of, and government involvement in, the promotion of sustainable technologies and products in time will lessen the risk of "greenwashing" practices, as well as potentially make green investments more attractive, depending on what policy framework is established.

There also needs to be a realisation that sustainable finance and ESG initiatives are not only about "green" environmental concerns. Many companies and investors today prefer to adopt a much broader view when assessing the sustainability of a business model. This could include everything from considering how companies are managed, to how they treat staff and gender and ethnic diversity.

Should definitions of sustainability be harmonised and global ESG certifications created to assist in the growth of sustainable financings?

There are already a number of guidelines and frameworks that have been established by various bodies in an attempt to harmonise definitions of sustainable ESG led finance and investments. It is important at a time when investors, lenders and companies are increasingly seeking standardised methods to verify ESG data to monitor the compliance of their assets and investments.

However, as with any nascent industry where harmonisation and certification is clearly needed, it is also necessary to strike the right balance in order to avoid stifling a burgeoning new market and the increase in capital invested in sustainable business.

One of the best-known frameworks for debt finance is the LMA's "Green Loan Principles". This aims to create a high-level framework of market standards and guidelines that provide a consistent methodology for use across the green loan market, but which also allows individual loan products to retain their flexibility while preserving the integrity of a developing green loan market.

There is also the "Climate Bonds Initiative" which is an international investor-focused, not-for-profit group that is working on the mobilisation of the USD100 trillion bond market for climate change solutions.
It has its own certification programme that verifies bonds, linked to assets such as solar, wind energy and low carbon building, which conform to its standards and has taken hold in the Asian finance markets in particular. Currently, the Climate Bonds Initiative is considered to be the most demanding, notwithstanding that the eligibility of certain projects e.g. coal fired power plants within its regime is deemed as highly questionable by certain sectors of the ESG industry.

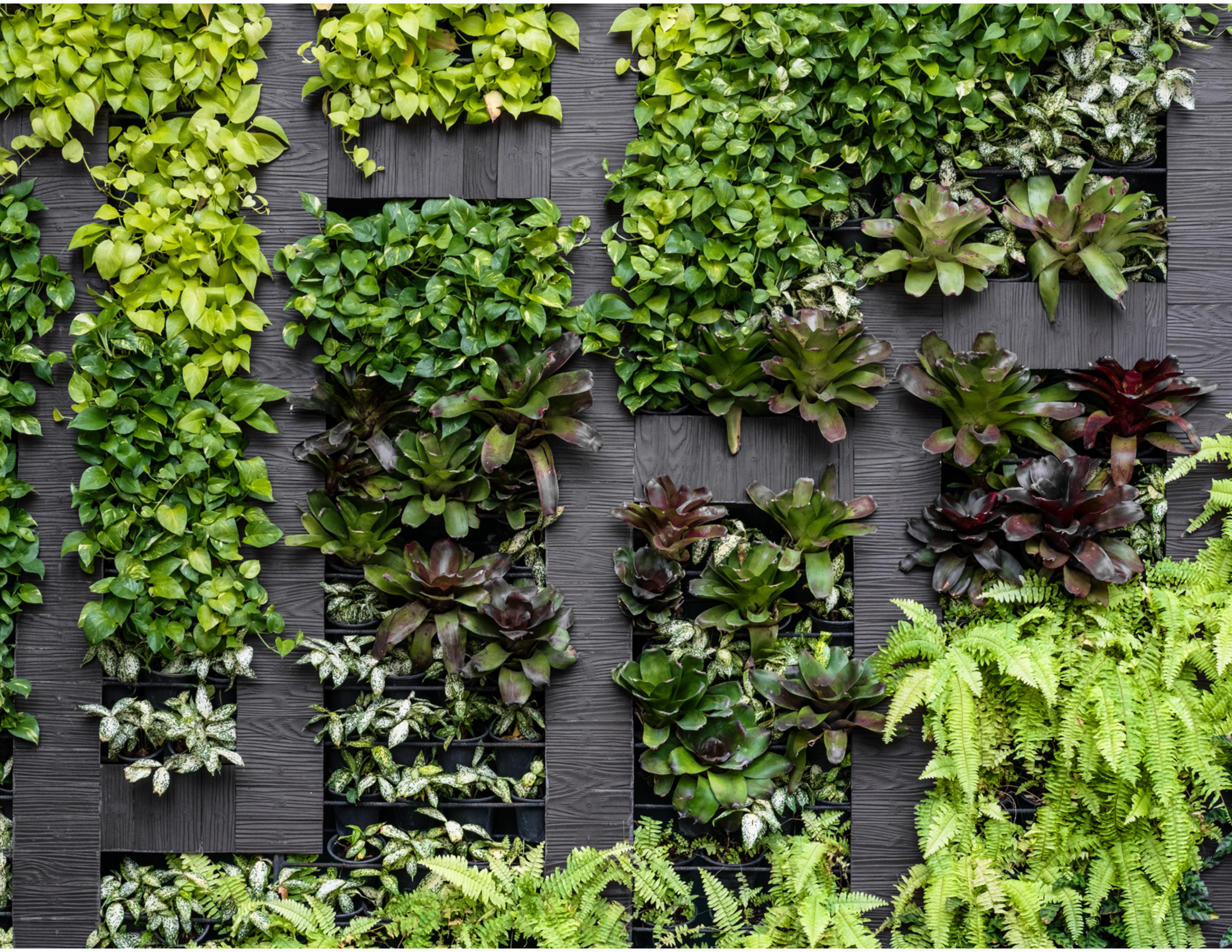
The European Union is separately also seeking to introduce its own taxonomy, or unified classification system, on what can be considered an environmentally sustainable economic activity. The EU believes this is a first and essential step in the efforts to facilitate the channelling of investments into sustainable activities with a view to complying with EU's commitments under the Parts Climate Change Act.

> While it is helpful to have these classifications, if they are too restrictive it could dissuade investors from pursuing sustainable investments.

Much of the demand for classification has been driven by institutional investors seeking evermore data on the companies they invest in. This includes not only large pension funds and asset managers–many of which have been assessing the ESG performance of companies held in their equity portfolios for some time now–but increasingly fixed income investors too.

> The market could potentially end up with different league tables and benchmarks.

Participant



There is growing acceptance among many investors that there could be varying types of “light green” to “dark green” sustainable investments to consider in the future. In China, banks are already issuing green bonds against brown coal refinancing, which may not appear to be “green”, but is deemed sustainable by investors/lenders as it helps to improve social conditions by generating employment.

Ultimately, it may not be possible to have a one-size-fits-all classification and certification system. The market could potentially end up with different league tables and benchmarks linked to specific key performance indicators or other parameters.

As more companies, lenders, institutions and government bodies worldwide pursue sustainable investments, there will be increasing amounts of data and evidence that can be cross-shared and used to inform the harmonisation and certification process.

Do we need new business models for companies taking on the sustainable/ESG mantle, thereby making sustainable finance easier?

It is universally agreed that there is no need to reinvent the wheel for the world of sustainable finance and ESG. Promoting sustainable investment is possible without having to invent new lending or business models, or take on new financial risks.

Many lending products exist in the banking market that could be appropriate for sustainable lending. A host of banks and lending bodies are already working hard to properly analyse and adapt these products for ESG-linked investments. While it may be complex at first, as more work is done and as more commercially sound ESG-linked loans and bonds are successfully issued, the market will grow in scale and prominence.

Britain's Green Investment Bank (now the Green Investment Group), was one of the first institutions to package up renewable assets with a highly attractive return. Investors did not buy into these projects simply because they were altruistically motivated by backing "renewable" assets but because it was a sound investment. This is a crucial factor in understanding how to propel further sustainable investments.

Similarly, the early growth of the offshore wind market in the UK may have been helped by government subsidies but it did not need the creation of a new project finance model. It simply needed a "first mover" to take the risk and then others followed. Today, the offshore wind market is attracting so much capital that it is largely considered to be a "commoditised sector", even though it is still a relatively high-risk investment.

Banks and other organisations operating in the sustainable lending space say that the nascent industry will not be driven by inventing "new" business models but through creating momentum with existing products. As demand for these evolved and adapted projects grows, the questions being asked by lenders will soon shift from "should we do this?" to "why aren't we doing this already?"

» For businesses too, sustainability does not have to mean the establishment of a whole new business model. In fact, a successful sustainable ESG agenda will likely be interwoven into the overall group strategy.

There is probably no better example of this than Unilever, the consumer giant which makes everything from Persil to Dove Soap and Magnum ice cream. The dual-listed Anglo-Dutch group decided some time ago that driving sustainability in its business was not a luxury but an essential survival tool. Unilever's customers are insistently demanding more sustainable products and so the consumer conglomerate giant decided to really promote sustainability throughout its entire business. This clearly differentiated its products and corporate strategy from its competitors while pushing exponential profit growth in recent years.

Do we need greater regulation and monitoring of sustainable investments to stimulate sustainable financings?

Greater government intervention in and regulation of sustainable investments and lending will likely shape how the industry develops and the speed at which it does so in the coming years. For example, if the government were to impose a tax on carbon emissions, it could have a significant effect on that market and industry and the financial markets would have to respond quickly. This can be seen from the experience of a decade ago where the institutions and banks that ploughed money into solar and wind initially did so because the government awarded subsidies and not because they necessarily thought it was a great idea to back renewable energy. However, regulation can sometimes perversely negatively impact how a market develops.

It is true that in some key areas of sustainability, no significant progress may be made until there is some form of government intervention or regulation e.g. plastics. However, it is important to realise that regulation can sometimes act as a cap to free market innovation and the development of creative solutions. For example, in unguarded moments, most house builders would no doubt confess to only building to regulation without further thought. It has been observed that this is gradually leading to issues around the overheating of properties.

Industry and the finance sector also face a challenge in understanding and predicting where the regulation pendulum will fall.

By illustration, key government (sustainable) strategy is presently aimed at driving behavioural change of homeowners and small and medium sized businesses. The much hyped introduction of energy performance certificates for private homes giving rise to no premium associated with owning a top rated sustainable home. As has long been the case, the paramount consideration remains "location location location", so these certificates have not driven any meaningful differentiation. However, this could change overnight if the government otherwise encouraged, through subsidies or taxes, the development of truly sustainable homes.

This also highlights another theme that may require further focus – the monitoring of an investment during its lifetime. This is increasingly seen as vital by investors and lenders. For example, Britain's construction community has blazed a trail producing a host of buildings with the environmental BREEAM "excellent" rating, however, evidence is beginning to show that those buildings do not necessarily retain that standard of excellence throughout the property's lifetime. This could be for a number of reasons such as, the landlord passing on responsibility for maintaining energy efficiency to a potentially ill-equipped key tenant or the expense and operational complexity of maintaining a top rated environmentally sound building.

The questions of (a) how to ensure high standards are maintained throughout the lifetime of an asset and (b) independent verification mechanisms also need to be addressed. This could also be partly addressed through regulation. In the meanwhile, it's likely that the industry and lenders will move ahead of government led thinking using independent data-led monitoring and ESG-linked loans to help transform an emerging sector in finance and bring its key themes into the mainstream.

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