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ESG snapshot: Sustainable Finance

Sustainable Finance and Responsible Investment

In a world that faces growing challenges from climate change and social inequality, sustainable finance is growing in importance. Sustainable finance gives market participants a choice to act in a responsible way and to support positive change in day-to-day business. This document is intended to provide an overview of the key terminology, regulatory framework and trends relevant to this area.

What is sustainable finance?

Alongside increased regulation, the concept of sustainable economic activity is a key post-crisis development in the banking sector and the promotion of so-called "sustainable" forms of finance is now viewed as not only central to maintaining the integrity of the financial system but also as fundamental to achieving international policy objectives, such as the 2015 Paris Agreement on climate change (Paris Agreement) and the UN's Sustainable Development Goals (UNSDGs). While no conclusive definitions have been established, methods of sustainable debt financing may be divided into the following overlapping categories:

Environmental, social and governance (ESG) lending

Conventional lending which incorporates environmental, social and governance criteria underpinned by bespoke reporting and monitoring obligations. Arguably most commercial financial institutions' green products sit within the ESG framework. The LMA's Green Loan Principles seek to develop a market-standard approach to this form of debt.

Ethical lending

Conventional lending subject to screening for ethically unsound purposes (e.g. tobacco, alcohol, arms). While a commercial lender funding an ESG loan would typically avoid "unethical" sectors, there is greater scope within the ESG loan market to finance environmental efficiencies or other social or governance-based improvements within those sectors than in traditional ethical lending.

Impact lending

The allocation of new capital with a direct and verifiable social or environmental impact. In the current market, impact lending tends to be the domain of microfinance organisations, philanthropic funds and development institutions or otherwise forms the focus of corporate social responsibility policies of larger commercial banks. Commentators have underlined the importance of impact lending in meeting both the UNSDGs and the targets set by the Paris Agreement.

What are ESG factors?

ESG issues can cover:

Environmental

- Greenhouse gas (GHG) emissions
- Biodiversity loss
- Pollution and contamination
- Carbon regulation exposure
- Renewable energy

Social

- Labour practices
- Community displacement
- Human rights
- Health and safety
- Financial inclusion

Governance

- Corruption and bribery
- Reputation
- Management effectiveness
- Board diversity

Why is ESG relevant to banks?

This is a rapidly growing sector, with international policy initiatives giving rise to changing attitudes in the investment and lending community. Clients are increasingly concerned with climate change and resource scarcity and are looking for ways to invest in clean, sustainable initiatives and banks will be at the forefront of the promotion of industry standards in this area (such as the Green Loan Principles), and the support of UNSDGs. Crucially, the negative impact of climate change can be substantially mitigated by banks actively pursuing the opportunities presented by the move to a low carbon economy.

Are there any regulatory frameworks?

While there is no binding regulatory framework or incentive programme for sustainable finance, economic activity that could be classed as sustainable would likely be underpinned by reference to one or more of the following documents, which encompass not only financial sustainability but wider social and inclusivity goals:

- The Paris Agreement
- UNSDGs
- EU Action Plan for Financing Sustainable Growth
- Financial Stability Board's Task Force on Climate-related Financial Disclosure
- LMA Green Loan Principles
- ICMA Green Bond Principles
- ICMA Social Bond Principles
- ICMA Sustainability Bond Principles
- EU Directive on disclosure of non-financial and diversity information
- Equator Principles
- UK Government's Clean Growth Strategy
- Government Green Finance Taskforce recommendations

Is there a consensus on what constitutes sustainable finance?

One of the challenges in dealing with the topic is the variety of definitions being used in the market as to what constitutes sustainable finance. There is at present no unified framework for classifying green products and services. In contrast with traditional sector investment, it is challenging to shape, define and communicate a coherent investment strategy in sustainable finance. The European Commission has established a technical expert group on sustainable finance (TEG), which will operate until mid/end 2019 and is working on a unified classification system for environmentally sustainable economic activities. The EU has indicated that in the next phase of its work the TEG will seek to classify socially sustainable economic activities.

How is sustainable finance an opportunity for the banking sector?

The green economy is a global market opportunity. It is widely acknowledged that resource efficient companies produce higher returns and that companies which proactively manage ESG issues are better placed than their competitors to generate long-term tangible and intangible results. Sustainable finance offers sector access to new markets and provides a valuable opportunity for banks and their advisers to engage with clients. From an environmental perspective, the negative impact of climate related risks on existing lending can be mitigated by the opportunities presented by the decarbonisation of the economy. For example, the Global Commission on the Economy and Climate estimates that USD 90tn worth of sustainable infrastructure will be required by 2030, with 60% of these investments required in energy and transport to meet international climate targets.

Why is sustainable lending on the rise?

Drivers for the recent uptick in sustainable lending include:

- Clients (particularly wealthy clients and their future successors) are becoming more concerned with wider social issues and are seeking to invest in ways that will have a positive impact on the world
- Institutional investors are looking to integrate sustainability factors into their investments
- Evidence demonstrates low default rates among environmentally responsible businesses
- Cost efficiencies to be gained through reduced carbon technologies
- Central bank policy leaning towards the establishment of a carbon stress test

What are lenders doing?

- Barclays was the first UK bank to launch a green finance product framework, which aims to give all commercial borrowers access to financing with green principles at the core
- HSBC raised EUR 5bn in green bonds in 2015 and has since committed up to USD 100bn to sustainable investment
- RBS has seen a significant decline in exposure to oil and gas projects and an increase in green project lending
- Lloyds has launched a discounted lending programme for customers seeking to invest in 'green' upgrades under its GBP 2bn Clean Growth Finance Initiative

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