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The Luxembourg Bankers' Association
Luxemburger Bankenvereinigung

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Sustainable Lending from the banks' perspective

Sustainable lending context

> Scaling up the transition is a challenging task. Banks, as one of the main financiers of European economic activities, are thus expected to play a pivotal role in the achievement of EU political objectives and thereby embed sustainability considerations in all their products and services, including lending.

The EU is playing a leading role in driving the sustainability agenda through 3 major pillars:

Harmonisation

Harmonised definitions of what can be qualified as sustainable, green or significantly harmful

Standardisation

Higher degree of standardisation in practices not only at EU level but worldwide

Transparency

Increased transparency of quality, comparable and reliable data

EU Sustainable Finance Action Plan – State of play

EU TAXONOMY

The development of a clear and consistent classification system of sustainable activities

Taxonomy Regulation adopted in June 2020

The first Climate Delegated Act adopted on 4 June 2021 and applicable since 1 January 2022

The Article 8 Delegated Act adopted on 6 July 2021 and applicable since 1 January 2022

The Complementary Delegated Act presented in February 2022 and could apply from 1 January 2023

DISCLOSURES

A comprehensive disclosure framework for financial and non-financial companies in the EU

Sustainable Finance Disclosure Regulation (SFDR), applicable since March 2021

Corporate Sustainability Reporting Directive (CSRD) proposed by the EC in April 2021

MiFID II sustainability preferences adopted by the EC in April 2021 and will apply from 2 August 2022

Corporate Sustainable Due Diligence Directive (CSDD) proposed on 23 February 2022

TOOLS

A set of clear standards and labels for sustainable financial instruments

EU Climate Benchmarks Regulation, applicable since April 2020

Legislative proposal for a European Green Bond Standard proposed by the EC in July 2021

EU Ecolabel for Retail Financial Products – pending proposal

EU ESG obligations relevant for lending financial institutions

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		WHAT ?	WHO ?	WHEN ?
A	Taxonomy Regulation disclosures	Report Taxonomy-eligible then aligned economic activities and assets Art. 8 TR Delegated Act	NFRD corporates (financial and non-financial undertakings)	1 January 2022
B	Non-Financial / Sustainability (NFRD - CSRD)	Corporates' sustainability and diversity information EU sustainability reporting standards	Public-interest companies (more than 500 employees) - scope to be extended with CSRD in 2026	2024 (CSRD)
C	EBA prudential disclosures (CRR/IFR) CSSF circular 21/773	ESG risks and risk mitigating actions ITS Pillar 3 disclosures on ESG risks	Large listed banks (CRR) and investment firms (IFR) Less Significant Institutions (LSIs)	June 2022 July 2021
D	Corporate Sustainable Due Diligence (CSDD)	Corporate due diligence duty & Duty of care obligation for directors	Large limited liability companies with substantial economic strength (500 -> 250 employees)	2025/2026 (tbc)

NFRD: Non-Financial Reporting Directive; CRR: Capital Requirements Regulation; CSRD: Corporate Sustainability Reporting Directive; IFR: Investment Firms Regulation;

Overview of sustainable lending drivers

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Regulatory and market expectations continue to rise

- Regulatory expectations (disclosures, risk, Green Asset Ratio)
- Increased scrutiny from investors'
- Growing demand from customers for green/ESG products
- Climate and ESG risks are expected to be integrated in credit risk assessment
- Management/mitigation of ESG risk exposure

Sustainability is set as strategic objective and targets

- Alignment with banks' own values and commitments (UN NZBA, SDGs, Carbon emissions reduction targets)
- Disclosure of sustainability financing targets
- Climate change and ESG are increasingly overseen by Board of Directors
- Remunerations are progressively linked to sustainability measures/criteria
- Climate and ESG components are being integrated as part of financial statements and management report
- Provide green and sustainable products is now a strategic focus for most banks

The EC final study states that 69% of respondents integrate ESG factors within their lending policies.

** European Commission's final study on the development of tools and mechanisms for the integration of ESG factors into the EU prudential framework and into banks' business strategies and investment policies*

Products landscape offered by banks

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Sustainable lending products seem to follow the same growth trajectory as the other sustainable investment products, driven by new regulations and public incentives and commitments that put ESG considerations at the heart of product innovation and banks' financing decisions.

Green/social loans

Any type of loan instrument made available exclusively to finance or re-finance, in whole or in part, new and/or existing eligibile green/social projects (LMA)

Green mortgages

Loans offered to houseowners at possible preferred terms and conditions to improve the energy efficiency of a building or to acquire highly energy efficient property

Sustainability-Linked Loans

Any type of loan instruments and/or contingent facilities which incentivise the borrower's achievement of ambitious, predetermined sustainability performance objectives (LMA)

Green securitisation

Asset-backed security with proceeds raised to finance loans for green infrstructure (CBI)

Sustainable lending frameworks

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As for sustainable investing, *sustainable lending* means that Environmental, Social and Governance (ESG) factors are considered as part of the credit process and decisions.

The EBA guidelines on loan origination and monitoring provide further guidance on what institutions should develop as part of their credit risks policies and procedures when originating sustainable credit facilities.

Framework

Provide a list of the projects and activities, as well as the criteria, that the bank considers eligible for sustainable lending or a reference to relevant existing standards that define what type of lending is considered to be environmentally sustainable.

Process

Specify the process by which the institutions evaluating that the proceeds of the environmentally sustainable credit facilities they have originated are used for environmentally sustainable activities.

Targets

Set up qualitative/quantitative targets to support the development and the integrity of bank's environmentally sustainable lending activity, and to assess the extent to which this development is in line with or is contributing to their overall climate-related and environmentally sustainable objectives.

Sustainable lending frameworks

According to the EBA guidelines, in cases of lending to corporates, the process should include:

- Collect information about the climate-related and environmental or otherwise sustainable business objectives of the borrowers
- Assess the conformity of the borrowers' funding projects with the qualifying environmentally sustainable projects or activities and related criteria
- Ensure that the borrowers have the willingness and capacity to appropriately monitor and report the allocation of the proceeds towards the environmentally sustainable projects or activities
- Monitor, on a regular basis, that the proceeds are allocated properly (which may consist of requesting that borrowers provide updated information on the use of the proceeds until the relevant credit facility is repaid)

Credit policy

Instructions documented specify the specific requirements and considerations of ESG risk and opportunities in the daily credit assessment process

ESG assessment

In-depth analysis is performed taking into account sustainability commitment and performance of the counterparty to measure its exposure to ESG risks and its alignment to the banks' own ambitions and principles

Dialogue with clients

Dialogue is key to support customers in their own journey of transforming their to a more sustainable business model and set clear expectations and standards

Other relevant frameworks & guidance

Green and Social Loans Principles

Issued by the Loan Market Association

Dated February 2021 (Green loans) and April 2021 (Social loans)

4 core components:
1. Use of proceeds
2. Process for Project Evaluation and Selection
3. Management of Proceeds
4. Reporting

Sustainability-Linked Loans Principles

Issued by the Loan Market Association

Dated March 2022

5 core components:
1. Selection of KPIs
2. Calibration of SPTs
3. Loan Characteristics
4. Reporting
5. Verification

Application of EU Taxonomy to bank lending

Joint report by UNEP FI and EBF

Published in February 2022

EU Taxonomy application to lending:
- Disclosures requirements
- Adapting internal frameworks
- Engagement with clients

Practical implications for banks (1/5)

What's in it for the banking industry?

- Reputational enhancement i.e. greenwashing / branding differentiation
- Holistic assessment of clients' overall performance (financial and non-financial)
- Enhanced dialogue/engagement with clients to support their efforts towards more sustainable business models
- New business opportunities (sustainable lending could form up to 30% of banks' total loan portfolio)
- Improved corporate data quality and completeness
- Alignment with banks' sustainability targets
- Reduced exposures to stranded assets / risk mitigation

Practical implications for banks (2/5)

Key challenges of sustainable lending (1/2)

- Data remains one of the main issue: qualitative rather than quantitative (hence difficult to harness); not centralised neither at European or national level, complexity of collecting data from clients; timing mismatch between corporate data availability and banks' ability to apply and disclose against sustainability criteria;
- Information on companies' plan to reduce emission and other relevant ESG issues on the long term are needed to embed forward-looking components in the assessment of ESG risk (i.e. transition risk)
- Interpretation issues; need for a common understanding/language across banks and customers
- Despite emergence of some methodologies in the area of climate risk, assessing the future ESG risk profile of the counterparties remains a complex issue
- General use financing to companies (loans to companies that are not affected to a specific activity or project) and smaller transactions or SME lending are more complex to assess (Vs project-based transactions)
- Lack of sustainable projects to be financed

Practical implications for banks (3/5)

Key challenges of sustainable lending (2/2)

- Possible divergence between EU/global sustainability targets and the economic reality where for instance energy performance of buildings does not play a primary role in the credit-decision process compared to other factors.
- Banks can not substitute the role of technical or scientific experts; it remains difficult for smaller actors to gain the skills or specialization to apply the guidelines/requirements; upskilling resources with ESG expertise is costly
- Existing tools are developed at global/international level and are sometimes not adapted to local context or specific situation as we might face in Luxembourg or with SMEs clients
- Operational challenges - increased documentation, monitoring/tracking and time necessary to complete it, monitoring of the attainment of sustainability targets and progress against transition plans

Practical implications for banks (4/5)

Observed practices in the banking industry - *illustrative*

Selection of clients/investments/exposures - *negative or positive 'asset screening'*

- When performing a positive screening, strategic objectives could take the form of commitments to report on the alignment of lending and/or investment portfolios with the EU Taxonomy, as well as targeting a specific Green Asset Ratio or contributing to achieve a minimum proportion of green assets/counterparties in the loan books on the basis of criteria such as CO_2 emissions or biodiversity conservation.
- <u>Observed practice in Luxembourg</u> – One subsidiary of a large banking group has started to implement an ESG action plan. This has translated into the decision to limit, reduce or, when possible, completely remove carbon-intensive exposures from its lending activities and thus mitigate the risks related to stranded assets help on loan books in the long run.

Tailored training / upskilling staff

- Ensuring that all relevant stakeholders have an adequate understanding of ESG factors is complicated by the intrinsic cross-functional and multi-disciplinary nature of those factors.
- <u>Observed practice in Luxembourg</u> – The local subsidiary of a Significant Institution has developed an internal ESG training whose content is tailored to the audience according to different modules: (1) General training on ESG has been provided to the whole staff; (2) One module has been developed for relationship managers, especially on green mortgages; and, (3) One module has been developed for risk managers.

Practical implications for banks (5/5)

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Observed practices in the banking industry - *illustrative*

ESG factors affecting credit risk

- In their credit risk management process, institutions are expected to consider climate-related and environmental risks at all stages of the credit-granting process and to monitor the related risks in their portfolios.
- Observed practice in Luxembourg – One large bank has undertaken a comprehensive country-specific transition risk heatmapping exercise to gain insights into how Luxembourg climate-sensitive sectors and counterparties the bank would finance may be impacted during a low-carbon transition. The country-specific heatmap evaluate transition risks for sectors and provide for information supporting the bank's lending and financing decisions.

ESG scoring

- Banks are building new ESG data capacities through either in-house model, external data providers or a combination of both to create ESG scoring models and link credit policies and products to ESG criteria.
- Observed practice in Luxembourg – A bank has defined an ESG questionnaire to gather information that would complement the assessment of the credit capacity within the credit application on a case-by-case basis, especially when data from external data providers is missing. The approximatively 30-point questionnaire is used to determine an ESG score that would be integrated in the assessment of the counterparty risk (e.g. in terms of probability of default).

How about Luxembourg action plan?

LSFI - PACTA exercise

The Luxembourg Sustainable Finance Initiative (LSFI) in collaboration with 2 Degrees Investing Initiative (2DII) has undertaken the first countrywide climate scenario analysis of Luxembourg financial institutions to assess the alignment of their loan books and investment portfolios with the Paris Agreement objectives.

ABBL dedicated taskforce

A dedicated Task force was launched end of 2021 to identify key challenges for the Luxembourg Banking sector in the field of mortgage loans to collect and access energy performance certificates and related information when financing the building, acquisition or renovation of building.

Collaboration/cooperation

Along with the cooperation with the LSFI, the ABBL, ALFI and ACA have started to joint efforts in the field of Sustainable finance while other initiatives are expected to be launched in upcoming weeks/months to foster collaboration between the financial industry, academics and the business community.

What's next?

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- Diversification of KPIs considered for sustainability-linked loans
- Impact of CSRD/adoption of ESRS, and higher maturity level with regards to ESG data collection
- Need for maintaining the integrity and credibility of the sustainable lending products (i.e. creation of label or European standards as for the EU green bonds)
- Further requirement for sustainability reporting and independent verification of sustainability performance
- New European and national initiatives to improve availability and accessibility of data (e.g. ESAP)
- Increased collaboration between Fintechs/Greentechs and financial institutions for digitalising the sustainable finance processes and operations
- Launch of a Climate Measurement and Reporting working group to coordinate efforts on this issue under the LSFI lead
- Possible collaboration between banks using their own internal database and public authorities to setup national ESG data registers