TECH mahindra

Whitepaper

Sustainable Finance - Funding the Transition to Net-Zero

Abstract

With the 2030 agenda for sustainable development goals and the Paris Agreement for climate change, businesses have an imperative to adopt green and sustainable practices, commonly known as environmental, social, and governance (ESG). Banks have a responsibility and an opportunity to facilitate transition of the economy to one that is low carbon intensive, while building upon their own sustainability-linked policies and practices.

The amount of investment to enable this transformation is enormous and financial institutions play a pivotal role through their expertise and funding, thereby incentivizing private and institutional investment in sustainability.

ESG is still evolving, with various countries and financial bodies / regulators framing their own standards and taxonomies. However, banks cannot afford to sit back and wait! Most commonly, for banks that are heavily invested in 'brown' portfolios, rethinking their strategy to balance their exposure to 'green' or environment friendly portfolios, is a journey that needs to begin right away.

In this whitepaper, we will delve into the imperatives for banks and corporates to net zero objectives and how banks can facilitate this transition through 'sustainable debt', particularly loans in the form of green loans and sustainability linked loans. Tech Mahindra's expertise in this area through proprietary intellectual properties (IPs), services, and key original equipment manufacturer (OEM) partnerships, will enable banks to strategize and operationalize sustainability-linked financing.

Key Takeaways

- The Drivers for Net-Zero Compliance
- Imperatives for Financial Institutions
- Green Finance and Sustainable Finance
- Market Size for Green and Sustainable Finance
- Banks 'Leading The Way' In Sustainable Finance
- Tech Mahindra's POV for Banks on Green and Sustainable Finance
- Tech Mahindra's ESG and Sustainable Finance Solutions
- Tech Mahindra - Trusted Partner to Banks for ESG and Sustainable Finance

The drivers for Net-Zero Compliance

Organizations across the globe are coming under increased pressure and scrutiny to comply with Environment, Social and Governance related regulations. In line with the Paris Agreement of 2015 to curtail templates to below 2° C, various countries have outlined their intended emission reduction actions, through their respective national determined contributions (NDCs). Each signatory country's goal translates into policies, laws, regulations, and government spending towards reduction of carbon emissions.

Climate risk, which can be broadly classified under physical and transition risk can lead to economic losses for businesses. Physical climate risks attribute to increased occurrences of floods, heatwaves, landslides, and storms. Transition risks refers to risks arising from the process of adjustment towards a low-carbon economy. These include carbon taxation, water or land use restrictions and changing market dynamics due to consumer preferences towards environment-conscious brands / business. Interestingly, this also opens a variety of opportunities for organizations that intend to combat climate risk, in the form of newer markets, wider pools of investments and innovative products and technologies.

All organizations, especially ones that are carbon-emission intensive are required to baseline their emissions and arrive at a strategy and execution plan to net zero within the stipulated timeframe as set out by respective Governments.

Climate risk and the erstwhile corporate social responsibility (CSR) have combined forces to form ESG - which stands for environment, social and governance. ESG is becoming a gold standard in evaluating a company's corporate and social values towards their customers, employees, and stakeholders. By demonstrating commitment to ESG, Corporates have an opportunity to broaden their customer base, enhance reputation and future-proof their businesses.

In 2022, the EU published the new Corporate Sustainability Reporting Directive (CSRD) mandating all listed EU companies as well as large non-listed companies within a certain threshold to publicly disclose information on risks, impacts and opportunities related to environment, social and governance aspects. The directive comes into effect for financial years starting on or after January 1st, 2024.

Imperatives for Financial Institutions

Financial institutions, have an important role to play in transitioning a country's real economy to net zero, through supporting their clients in the development of credible transition plans to committed emission reduction.

The severity of climate change related risks is jeopardizing businesses and thereby threatening the stability of the financial system. Most Central Banks have mandated incorporating climate risk as an additional measure of risk in their investing and/or financing actions and decision making.

The European Banking Authority (EBA) has mandated ESG disclosures as part of Pillar 3 for banks to disclose climate related risks, mitigating actions, along with exposure to green assets and approach to integrating sustainability as part of risk management. Suggesting a phased approach to the disclosures, the disclosures come into effect starting 2023.

The UN-convened Net-Zero Banking Alliance (NZBA) is a group of banks that have committed to reducing emissions from their lending and investing portfolio to align with net zero emissions by 2050 or sooner. With over 122 members from 41 countries and representing 40% of global banking assets, the alliance supports the implementation of emission reduction operations and de-carbonization of their portfolios. In its first progress report published in November 2022, over 50% of the members have already set their intermediate de-carbonization targets.

Banks must act NOW!

Green Finance and Sustainable Finance

Green Finance refers to companies raising debt for greening their business, viz, formulating green and sustainable strategies and developing projects that contribute to positive environmental benefits. However, sustainable finance can be applied to a larger context and can be used for funding environment, social or governance related development commitments.

According to Forrester, green finance includes green bonds, green loans, venture capital, and private equity (PE) funding for green tech, green IPO, and green acquisitions. Over the past several years, green bonds have gained momentum as a debt instrument over green loans, for green financing. Forrester[1] analysis estimates green finance to have exceeded US$720 billion. According to the Climate Bonds Initiative, green bonds hit $522.7 billion in 2021; and this accounts for more than half of all green finance. Forrester estimates that green loans exceeded $135 billion. Data from Venture Scanner indicates that VC funding, PE funding, green tech acquisitions and green tech IPOs made up the remaining US$63.2 billion.

Green loans (GL) are any type of loan instrument used to finance or re-finance projects, assets, and activities with environmental benefits. The fundamental determinant of Green Loans is the utilization of the loan proceeds for green projects. Corporates are expected to report on a regular basis to enable lenders to ascertain that the claims are authentic.

Sustainability linked loans (SLL) are loan instruments which incentivize the borrowers to meet /achieve predetermined sustainability performance objectives. As SLLs are geared towards broader ESG objectives, the fundamental determinant is to improve the borrower's sustainability profile by aligning terms to pre-determined sustainability performance targets (SPTs).

Corporates that are along the path of ESG linked development, conduct due diligence to baseline their current ESG position, perform scenario analysis in accordance to their ESG vision, to arrive at short term and long term ESG goals. ESG issues that are materially significant to their industry, geography and corporate strategy are shortlisted. The materiality assessments lead to identifying the key KPIs and corresponding sustainability performance targets (SPTs) for the KPIs.

Corporates availing green or sustainability linked finance can perform the ESG assessment in-house or through external accredited firms via second party opinions (SPOs).

Tech Mahindra's POV for Banks on Green and Sustainable Finance

Green and sustainable finance presents a significant opportunity for banks to re-align their business model as per changing consumer expectations, business, economic conditions, and mandated ESG aligned laws and regulations. By playing the role of a transformation enabler, banks can incentivize businesses and consumers to change behavior - aligning to ESG. The Loan Syndications and Trading Association (LSTA) is a leading advocate of the syndicated loan market in the U.S. with representatives from leading financial institutions active in the global syndicated loan markets. LSTA has published the Green Loan Principles (GLP)[2] and Sustainability-Linked Loan Principles (SLLP)[3] to facilitate and support environmentally and socially sustainable economic activity and growth.

Sustainable Finance Origination

In preparation for providing borrowers with sustainability linked financing, banks will have to ensure that the following pre-requisites are in place:

GL/SLL policy framework

The framework will be based on the banks' strategic objectives to de-carbonize their loan portfolios and transition to net zero portfolio over a stipulated period.

Eligibility guide

Banks must develop the relevant templates to capture information from the borrower for adequate due-diligence to ascertain its eligibility for a green loan / sustainable loan classification.

Validation of materiality issues and KPI / SPTs

According to the Guidance on Sustainability Linked Loan Principles, the materiality assessment should map to the industry of the borrower, and the KPIs should identify the ESG issue along with the scope for improvement of the identified issue. The KPIs and SPTs should be clearly defined in the loan contract along with the mechanisms to measure its improvements, until the end of term of the contract.

Depicted in Figure 1.0 is Tech Mahindra's point of view (POV) on the sustainable finance value chain

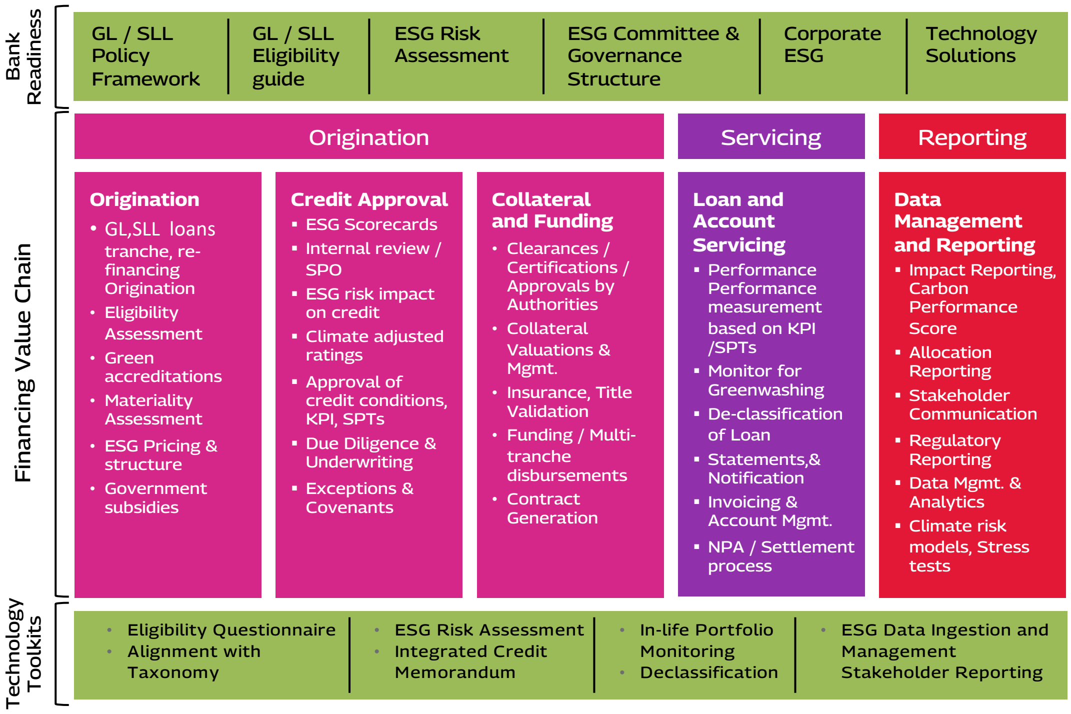

Figure 1.0: Tech Mahindra POV on Sustainable Finance

ESG Risk Assessment

Alongside traditional credit risk assessment, ESG risk assessment is taking prominence in corporate financing. Physical risks of climate change can lead to increased loan default rates for banks, resulting in increased credit risk. Similarly, banks holding collateral assets of carbon intensive industries could face risk of devaluation due to transition risk. The European Banking Authority (EBA) has published binding standards on Pillar 3 disclosures on ESG risks, to address shortcomings of institutions' current ESG disclosures. The Task Force on Climate related disclosures (TCFD) provides recommendations on information that companies should disclose to support investors, lenders, and insurance underwriters in appropriately assessing and pricing climate related risks.

Loan Servicing and Monitoring

There have been accusations on certain banks recently with regards to 'Greenwashing' for allegedly providing misleading environment representations. This is hugely detrimental for financial institutions, as it erodes established reputation and public trust. Banks must therefore conduct thorough due diligence during loan origination and ensure periodic monitoring throughout the term of the loan contract to avoid such circumstances.

GL/ SLL loans are normally priced at lower interest rates, and it is imperative for borrowers to demonstrate that the funds are being deployed for green activities / projects as stipulated in the loan contract. Banks have the option to reverse the agreed interest rates, also known as de-classification, if the borrower has not met with the stated performance targets.

Reporting

Reporting is a core component as stipulated in the Green Loan Principles (GLP) and Sustainability Linked Loan Principles (SLLP). For green loans, borrowers should provide up-to-date information on the 'Use of proceeds' to be renewed annually until fully drawn. For sustainability-linked loans, borrowers should provide the lenders with up-to-date information that will enable the lender to monitor the performance of the SPTs with relevance to the borrowers' business.

There are various global standards for reporting such as GRI, SASB, TCFD, and IR currently. However, these are constantly evolving with greater push for standardization and simplification.

Tech Mahindra's ESG Solutions for Banks

Tech Mahindra's ESG offerings for banks broadly encompass solutions in areas of:

Sustainable Finance Solutions

Tech Mahindra can assist banks in areas related to GL/ SLL policy framework development and formulation. Through proprietary frameworks and partner-led solutions for sustainable loan eligibility assessments, Tech Mahindra can enable banks to originate sustainability-linked loans, complementing the banks existing lending systems. Tech Mahindra's solution can integrate with borrower's systems through APIs to provide timely reports to lenders on management of funds disbursed and impact reporting on financing.

Corporate ESG

Tech Mahindra can assist banks with ESG baselining, materiality assessments, net zero modelling and science-based target (SBTi) setting, to enable banks achieve their net zero commitments and improve their ESG ratings. Eco-efficiency solutions of Tech Mahindra include energy management, water and waste management and renewable asset management, leveraging next-gen technologies such as internet of things (IoT), artificial intelligence (AI), and blockchain.

ESG Risk Assessment

Banks should consider materially important environment risks at both the customer and portfolio levels. Financial institutions may be exposed to social and governance risks through their own operations or services as well. Tech Mahindra has partnered with 3rd party ESG risk assessment solutions as well as developed proprietary tools to translate physical and transition climate risks into financial stability risks. Additionally, partner-led solutions for ESG risk scorecard and ESG integrated enterprise risk management solutions will enable banks to keep pace with regulatory compliance requirements and mandated disclosures.

ESG Reporting and Analytics

Tech Mahindra's reporting solution iSustain can assist Corporates to measure, monitor, improve emissions and provide ESG reporting & disclosures as per industry frameworks and standards such as GRI, SASB, TCFD, SDGs and IR. Tech Mahindra has partnered with numerous ESG reporting platforms as well as specialized climate risk and analytics solutions to provide comprehensive ESG reporting and analytics as prescribed by the global reporting standards.

Depicted in Figure 2.0 is a summary of Tech Mahindra's ESG solutions for banks.

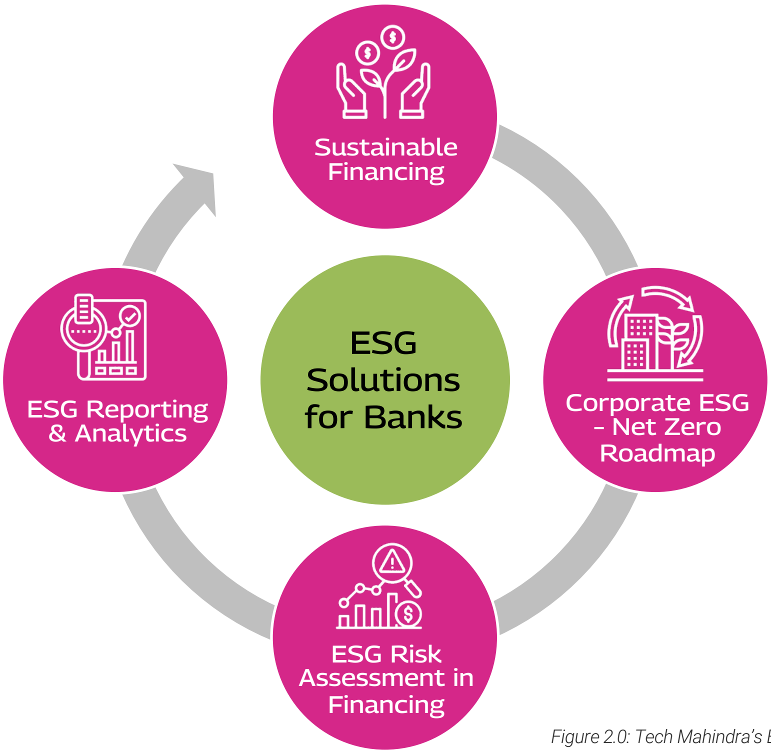

Figure 2.0: Tech Mahindra's ESG Solutions for Banks

Tech Mahindra – Trusted Partner to Banks for ESG and Sustainable Finance

Tech Mahindra is ranked #1 in India and #72 globally in the list of 'World's 100 Most Sustainable Corporations' by Corporate Knights. Tech Mahindra has taken ambitious emission targets, approved by the science-based targets initiative (SBTi) to reduce its absolute scope 1 and scope 2 greenhouse gas (GHGs) emissions. Leveraging this experience, Tech Mahindra is helping its partners and customers in the areas of energy savings, digitization / automation of operations and creating collaborative work environments addressing the need for sustainable practices.

Tech Mahindra can help banks implement corporate ESG policies to develop and operationalize ESG for its operations as well as enable banks to de-carbonize their lending portfolio and improve their green asset ratio through Tech Mahindra's solutions in sustainable finance.

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About the Author

Jayashree Thandu,

Principal Consultant and Prcatice Head, Lending

Jayashree Thandu is Principal Consultant at Tech Mahindra and leads the lending practice. Jayashree brings her lending knowledge to bear to design compelling solutions for lending organizations globally, leveraging Tech Mahindra's state-of-the-art lending projects and partnerships with innovative software product vendors. Jayashree has over two decades of experience and has worked in solution sales, consulting and strategy, and operations in IT product and services organizations. Jayashree has been associated with banking for most part of her career, notably in lending solutions and products for the past 10 years.

Jayashree.Thandu@techmahindra.com