An Update on the Evolving Developments in Sustainable Banking

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Sustainability has hit center stage across all economic sectors, including in commodities. Shareholders and clients are responding to sustainability challenges, and the banking sector has been listening. Banks are making environmental, social and governance (ESG) issues much more of a priority and are diversifying their offerings to include socially responsible investment products. This is a big change from a few years ago when sustainability was more of a fringe issue in banking.

In traditional banking, lending decisions were based on a basic risk and return analysis. Banks analyzed cash flow and probability of default and then weighed factors that related to internal risk diversification and capital adequacy. Two things seem to have changed to push banking to respond to sustainability challenges.

First, the general political atmosphere, especially in Europe, has swung in favor of considering environmental issues. Second, again in Europe and now starting to arrive in the U.S., is a keen awareness that both clients and shareholders are increasingly prioritizing sustainability challenges in terms of how this impacts their global brand. To the extent that companies want to be perceived as moving toward sustainability targets, they have worked with banks to develop new capital markets products that emphasize ESG objectives.

Let's explore a few developments a little more deeply.

Coal. European banks have effectively stopped lending to the coal industry. Used extensively to generate electricity, coal is viewed negatively from a public relations perspective. European banks simply have backed away from the sector almost completely. Of course, banks were pushed, as there is national legislation in European countries that forced the banks to move in that direction.

Even in the U.S., where the politics of the coal remain divisive, coal usage has declined mostly due to the very low price of natural gas, a relatively clean competitor in the arena of electricity generation. It is worth noting that certain industrial companies have made it clear they will pay a premium for inputs, such as aluminum, that are processed with electricity from cleaner energy sources. Such considerations have become an important brand issue for companies such as BMW and Airbus, as seen at the huge BMW factory in South Carolina or the Airbus facility in Alabama. U.S. banks have not been blind to this change in sentiment.

Capital Market Products. European banks have started to experiment with back-up credit lending facilities that have a small portion of the interest rate tied to ESG objectives and audited by an external

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party. That is, if a company can achieve specified ESG objectives, with clear metrics that are externally verified, it can shave a few basis points off their credit costs.

Many banks have started to create sustainability teams associated with their ESG lending and capital market products. Typically, sustainability teams are small in size (3 or fewer people). This means it is important for team members to be able to leverage relationships across the organization in order to coordinate sustainability initiatives. It also means in order to have an impact on sustainability, ownership of the sustainability agenda must cut across the entire organization.

Standards. As banks become more focused on how sustainable lending impacts their own brand and investor relations, they have had to confront the ambiguity of the metrics available. No common metrics exist to measure sustainability practices. Definitions of sustainability vary greatly across industries. This uncertainty and ambiguity has created confusion in aligning best practices across the globe.

The default for banks has been to rely on emerging reporting standards. For companies that are being considered for loans and capital market products by an ESG banking team, the first litmus test is whether the companies are reporting ESG metrics at all. To measure and disclose shows transparency and awareness of environmental impacts. The next question is what standards and metrics they report. There are a number of sustainability reporting standards, and they each assess sustainability a bit differently. They all factor in the 17 SDGs (sustainable development goals) which are targets set by the United Nations to achieve a sustainable future. On net, the evolution in sustainability banking has been to consider the targets for the 17 SDGs in their lending plans and capital market activities.

Emerging Trends in Sustainability Finance. Here is our perspective on the five key trends in ESG and how the next legs of the sustainability movement in finance is progressing.

- **Supply chain accountability.** The demand for green products is rising. That means companies are being pressured to disclose what is in their products so they can relay this to consumers.

- **Plastic pollution.** More than 60 countries have introduced measures to limit single-use plastic waste through bans or levies.

- **Energy efficient transportation.** The electric vehicle (EV) market appears poised for expansion. By 2021, virtually every major automobile manufacturer will be offering innovative and competitive EV vehicles from the low-end to the high-end and everything in between. Younger generations have embraced sustainability and the percent of EV sales is likely to have a sharp rise in the decade of the 2020s. Moreover, transportation efficiency is likely to increase dramatically over the next decade. Autonomous vehicles offer the possibility of large savings in fuel efficiency – long haul trucking is one example. We also note that the Sustainability Accounting Standards Board (SASB) has provided some guidance and focus.

- **Data transparency.** We have already discussed the growing importance of ESG reporting in regard to banking. The same trend is equally important to the funds management industry as they develop ESG indexes and Exchange-Traded Funds (ETFs) based on these indexes. Already, there has been a backlash against some fund managers who launched ESG products in name but failed to follow through on their own enforceability standards.

- **Water challenges.** Water scarcity will be one of the most significant problems of the 21st century. Nearly half the world's population—3.3 billion people—already lacks access to clean water or soon will. As water scarcity becomes more dire, the sustainability dialogue could shift to local, community-based solutions in developing regions.

Bottom line. Sustainability financing is moving from an innovative backwater to a front and center priority. ESG awareness has arrived in the C-suite of banking.

Author Biography

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Prior to her role as senior carbon market developer in North America for World Fuel Services, Ms. Tina Reine held senior level positions in carbon markets at J.P. Morgan in New York City, Cantor Fitzgerald in London, and at NextEra Energy where she received the Innovation Award for creating a new financial product. She has an M.B.A. from Columbia Business School.

Ms. Reine previously contributed to the Summer 2019 issue of the *GCARD*, providing a book review of *Economics Gone Astray*.