Navigating the Future: Climate Change to Redefine Lending

The global financial landscape is transforming, driven by the urgent need to combat climate change and adopt sustainable practices. As the world faces the environmental challenges of our time, the role of green deposits and investments has never been more critical. It is increasingly evident that the finance sector can no longer rely solely on technological innovation for growth; it must also become a key player in addressing pressing global sustainability concerns. In this article, we will delve into how green deposits and investments are reshaping finance and explore key strategies for integrating environmental, social, and governance (ESG) factors into lending platforms.

Green Deposits and Investments

Green deposits and investments have emerged as crucial components within the financial sector, marking a revolution. This shift signifies a broader recognition that the financial sector plays a critical role in addressing contemporary global issues, particularly climate change.

In India, as per the RBI framework, green deposits closely resemble standard fixed deposits, with interest accruing over time. However, the unique feature of these deposits lies in their allocation: the funds generated from green deposits are earmarked for environmentally beneficial activities.

This initiative has empowered banks and select non-bank financial institutions to strengthen their fundraising abilities, simultaneously facilitating businesses to access green loans more easily.

The Paradigm Shift Towards Green Deposits and Investments

In fact, in many parts of the world Green Deposits are taking center stage in policy formation for financial and non-financial corporations. For instance, to promote environmentally responsible investments, Singapore has established a range of initiatives and platforms like the Singapore Green Plan 2030 and the Green Finance Action Plan. These frameworks are designed to galvanize collaborative efforts from both the public and private sectors, with the shared goal of realizing a sustainable and climate-resilient Singapore.

Similarly, in line with the UAE's goal to attain climate neutrality by 2050 and the United Nations Sustainable Development Goals, the UBF (UAE Banks Federation) praised the active involvement of banks in combating climate change via their green finance commitments and climate-oriented initiatives.

This change in perspective about environmental awareness acknowledges that the finance sector can indeed become a significant part of the solution. Incorporating green deposits and investments into the financial ecosystem recognizes that the sector cannot operate in isolation from the world's most pressing challenges, such as climate change, environmental degradation, and social inequalities.

By embracing green finance, the sector aligns itself with the urgent need for a more sustainable future.

Integrating 'Green' Factors into Lending Platforms

Green finance is still in its early stages of development. Nevertheless, banks that proactively choose to support sustainable initiatives will have the advantage of staying ahead of regulatory changes, tapping into substantial growth potential within a growing market, and building greater public confidence.

Many financial institutions might be currently ill-prepared to fully harness the benefits of green banking due to their risk assessment methodologies and credit teams not yet being aligned with these opportunities. However, forward-looking banks are taking action by incorporating ESG (Environmental, Social, and Governance) data into their credit risk models and providing additional training to their lending staff.

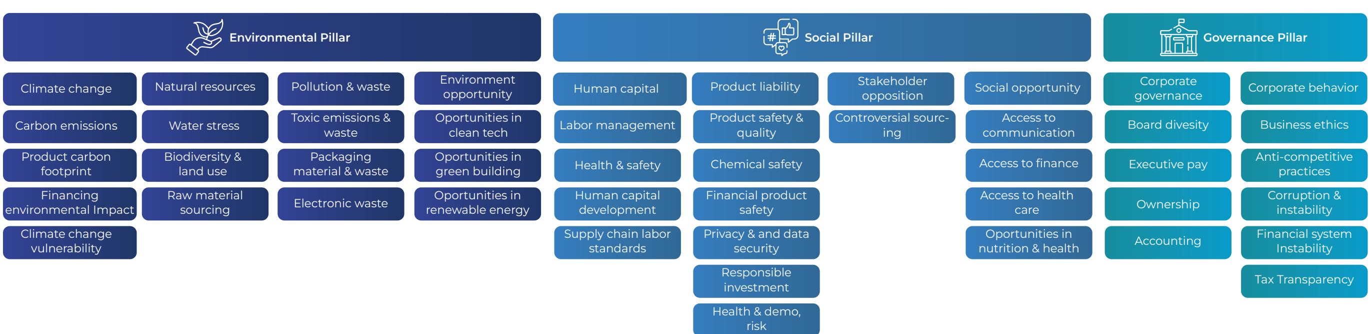
To effectively integrate 'green' factors into lending platforms, three critical approaches emerge:

ESG Scoring Criteria: Assessing Sustainability Practices

Private debt investors are progressively integrating ESG (Environmental, Social, and Governance) considerations into their investment procedures. A study by PRI[6] revealed that the primary methods for including ESG factors involve initial screening based on exclusion policies and the acquisition of ESG data for guiding investment evaluations and analyses. Additionally, ESG committees are becoming more prevalent and play a pivotal role in the pre-investment evaluation and the discussion of significant

ESG risks. For instance, launched in March 2021, Egypt's FRA established the RCSF to support Non-Banking Financial Institutions (NBFIs) in Egypt, the Middle East, and Africa. Its goals include promoting sustainable finance practices, ESG awareness, and facilitating private capital for Sustainable Development Goals.

The PRI survey outcomes also indicate that, for direct lending transactions, 94% of General Partners employ a well-defined ESG due diligence process for borrowers. This level of integration of ESG scoring criteria into lending platforms represents a significant departure from traditional risk assessment methods. It is a recognition that financial health alone is no longer a sufficient metric for evaluating borrowers. Instead, it offers a more holistic view of a company's risk profile. This shift in mindset is not just about making 'green' investments; it is about making informed investments. ESG scoring criteria empower lenders to assess sustainability practices, which, in turn, provides insights into a borrower's long-term viability.



'Figure 1' Non-exhaustive list of ESG Assessment Criteria for Corporates

Climate Risk Assessment Criteria: Evaluating Borrower Resilience

Incorporating climate risk models into lending processes is essential. It allows lenders to gauge a borrower's ability to repay loans in a rapidly changing climate landscape. This is not only applicable to corporate borrowers but also extends to retail borrowers. Understanding the impact of climate risk on borrowers' financial stability is important, as it can affect their borrowing lifecycle significantly.

Many countries globally and within the MENA region are identifying this need early on and taking active steps towards change. For instance, in 2018, Iraq received $17 million from the Global Environment Facility, $10 million from the Adaptation Fund, $6.5 million from UNDP, and $4.6 million from the Green Climate Fund for readiness activities. It is essential to optimize climate finance for projects that integrate climate action with social development and resilience goals.

In fact, we can say that now incorporating climate risk assessment criteria into lending processes is not a luxury but a necessity. Climate change poses significant threats to businesses, regardless of their size or sector. Climate change impacts individuals' financial stability, affecting their ability to repay loans, manage their financial well-being, and secure their futures. Therefore, integrating climate risk assessment criteria into lending platforms is a responsible and forward-thinking approach that promotes financial resilience for all.

Steps Banks Could Take at Each Stage

	Strategy and Products	Prospecting and Origination	Underwriting and Approval	Collateral Management and Hedging	Monitoring and Portfolio Management	Default Management	Reporting and Disclosure
Overview	• Determine business strategy • Develop products and programs • Define risk appetite and limits	• Define target clients and perform due diligence • Prepare credit applications	• Perform credit review • Assign risk rating • Prepare and approve credit proposals	• Optimize use of collateral across the portfolio • Perform risk transfer and hedging (e.g., securitization markets)	• Monitor client and portfolio performance • Estimate parameters (PD/LGD) and capital/reserves • Perform stress testing	• Manage defaults and problem assets • Identify losses and recommended charge-offs • Manage recoveries	• Report credit risk processes and outcomes to various stakeholders (e.g., business, risk, regulators)
Climate Considerations	• Establish green-lending products and portfolio targets	• Target climate-friendly sectors and institutions	• Consider ESG/climate factors for underwriting and rating	• Work with third parties to enable transfer of climate risks	• Assess impact of climate on PD for stress management	• Assess impact of climate on loss realization	• TCFD • Anticipate regulatory requirements (e.g., stress testing)

Source: Deloitte & Touche LLP

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'Figure 2' Infusing climate risk considerations throughout the credit risk lifecycle

Finance Emission Impact Model: Gauging Environmental Footprint

The finance emission impact model estimates the emissions associated with financed activities, providing a comprehensive view of the environmental impact of a loan portfolio. This model can help quantify the carbon footprint associated with lending operations, allowing financial institutions to identify areas for improvement.

This not only minimizes the environmental impact but also reduces potential risks tied to climate change. Ultimately reaffirming the sector's commitment to sustainability, demonstrating that profits need not come at the expense of the planet.

In fact, lenders can incorporate quantitative methodologies to assess the carbon footprint of their loan portfolio. Although it will differ for different loan products, one simple methodology to assess corporate loans environmental impact can be as follows,

- Financed emissions of business loans = Emissions of the borrower * Attribution factor
- Where, Attribution factor = Loans provided by bank / Borrower's total assets
- Emissions of the borrower (simple approach) = Borrower's revenue * (Industry emissions / Industry output)
- Financed emissions of business loans = (Loan provided by the bank / Borrower's total assets) * Industry emissions * (Borrower's revenue / Industry output (revenue))

This type of model can prove to be a profound statement of accountability and responsibility in an age where environmental consciousness is becoming a necessity.

Global Variations in ESG Integration

While some economies have made remarkable progress in making ESG factors mandatory criteria for businesses, it is essential to recognize the complexities faced by developing economies. Green taxonomy, which defines environmentally sustainable economic activities, is not a one-size-fits-all solution.

Developing economies often have unique challenges and priorities. They may need to balance environmental concerns with immediate economic growth imperatives. It is not a question of whether they should adopt ESG criteria but rather how they can do so in a way that suits their specific circumstances. As developed nations lead the way in setting standards, it is an opportunity for them to assist developing economies in their journey towards sustainability. Collaboration and knowledge sharing can help bridge the gap between regulations and practical implementation.

Green Taxonomy: The Global Perspective

Green taxonomy refers to a classification system that defines environmentally sustainable economic activities. It is integral to the incorporation of ESG criteria into lending platforms globally. In developed countries, central platforms like the MAS Greenprint registry, the World Bank database, and the EU taxonomy play key roles in setting standards for ESG scoring and green initiatives.

In developing countries, however, the responsibility to fast-track environmental awareness in the finance sector is a pertinent question. Lenders in these nations can take a proactive stance in promoting sustainability, helping to bridge the gap between regulations and practices.

India's BRSR Framework

India's Business Responsible and Sustainable Reporting (BRSR) framework is a significant step towards sustainability. It mandates the disclosure of ESG performance by the top 1000 listed companies, demonstrating their commitment to responsible business practices. The BRSR framework showcases India's commitment to aligning businesses with sustainability. Such frameworks serve as essential building blocks for a more responsible and sustainable financial sector.

The Role of Financial Technology (FinTech) Players

FinTech companies play a pivotal role in accelerating the integration of ESG assessment into lending platforms and processes. Here is how they can contribute.

Financial technology companies have a crucial role in not only digitizing finance but also making it more responsible and sustainable. Their innovations can expedite the transition to an ESG-focused financial sector, thus contributing to a greener and more equitable future.

ESG Data Collection and Integration

FinTech platforms can streamline the collection and integration of qualitative and quantitative ESG data points reported by corporates. This increases transparency and allows for more informed lending decisions.

FinTech's ability to efficiently gather and process ESG data can empower lenders to make better-informed decisions, further strengthening the shift toward sustainable lending.

Analysis & Decision Making with Risk Strategies and Recommended Actions

Advanced analytics and machine learning algorithms can be used by FinTech platforms to analyze ESG data, assess risk, and facilitate data-driven lending decisions. Integrating ESG criteria into risk assessment models promotes responsible lending practices.

This approach not only safeguards financial institutions from potential losses but also fosters a culture of responsible lending that supports sustainable development.

Sustainable Performance Monitoring and Reporting

FinTech platforms can provide ongoing monitoring and reporting of borrowers' and lenders' sustainable performance. This involves tracking ESG metrics over time and recommending actions aligned with predefined risk strategies.

Continuous monitoring of sustainability indicators ensures that borrowers remain committed to their ESG goals, contributing to long-term environmental and social progress.

Conclusion

The finance sector stands at a critical juncture, where addressing climate change and sustainability is not a choice but a necessity. Green deposits, green investments, and ESG-focused lending practices are reshaping the financial landscape. The integration of ESG scoring criteria, climate risk assessment criteria, and finance emission impact models is vital for building a sustainable financial future. While some economies are leading the way in embracing green taxonomy and ESG factors, others must navigate their unique paths. As we journey forward, collaboration between financial institutions, regulators, and FinTech players is imperative to ensure a more responsible and sustainable financial future for all. The finance sector has the power to shape a sustainable future – a future that benefits both, the industry, and the planet. It is not just about growing wealth; it's about securing a future where profits coexist harmoniously with the planet and its people.

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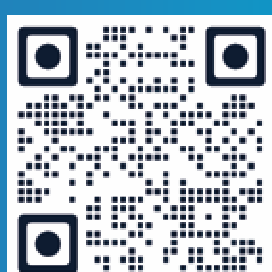

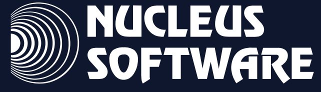

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