3 OPPORTUNITIES FOR LENDERS TO PROFIT WITH SUSTAINABILITY

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EXECUTIVE SUMMARY

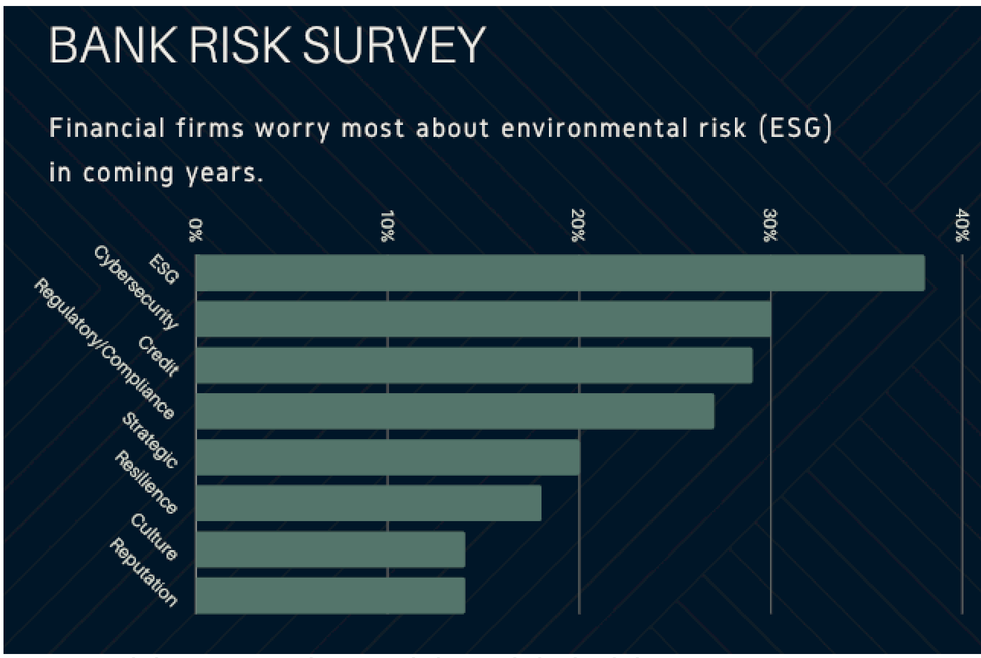
Sustainability and ESG strategies are key differentiators used by companies to increase profits and reduce risk.

But there's a problem for lenders...

"FOR FINANCIAL FIRMS, IT'S HARDER TO ADAPT TO CHANGES IN THE ESG ENVIRONMENT BECAUSE IT'S NOT ONLY ABOUT THEIR OWN CARBON FOOTPRINT.. THEY ALSO HAVE TO LOOK AT THEIR CLIENTS' FOOTPRINT" - J.H. Caldwell, Global Head of Financial Services Risk Advisory, Deloitte

Because of this, many of the world's largest financial institutions, such as BlackRock, Goldman Sachs, and J.P. Morgan Chase have made commitments to institute sustainability monitoring and carbon disclosures across their client base and portfolio companies. Unfortunately, lenders who do not strategically implement sustainability processes now will likely have higher risk portfolios, reduced profitability, and increased regulatory scrutiny as sustainability becomes mainstream.

The importance of climate risk and social-responsibility has grown so much that in a 2020 survey of financial executives, Environmental, Social, and Governance (ESG) risk was ranked the #1 risk for lenders. In the survey, 47% of respondents indicated it is an "extremely" or "very-high" priority for their institutions to improve their ability to manage ESG, including climate risk.



"Top Risks For Banks" Deloitte Global Risk Management Survey

MATERIALITY

Before we outline the opportunities for financial firms, it is important to note that addressing all ESG concerns at once is impossible, even for the most forward-looking companies. The key to success is materiality, that is, the understanding of which ESG risks are relevant to a company's sector and overall operating context. For this document, we will focus on opportunities in 'Sustainability', as it relates to the 'E' or 'Environmental' portion of ESG, which is widely applicable across industries, and consistently affects the bottom line.

3 OPPORTUNITIES FOR LENDERS TO EMBRACE SUSTAINABILITY

Use these opportunities to win new business from the competition, reduce risk in your portfolio, and increase your profitability in 2021.

1. VOLUNTARY SUSTAINABILITY REPORTING

One surefire way to combat ESG risk is sustainability 'benchmarking', or reporting to a widely-approved sustainability framework. The UN Principles for Responsible Banking (PRB), the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD), and the UN Sustainable Development Goals (SDGs) are all respected frameworks to choose from for financial firms. Early adopters who implement voluntary sustainability reporting processes, and push their clients to do the same, can gain a powerful competitive advantage in the marketplace and a valuable framework for building and enforcing ESG policies.

United Nations Principles for Responsible Banking

The UN Principles for Responsible Banking (PRB) were developed by 28 leading banks across 5 continents. The purpose of the principles is to align financial firms with society's goals as expressed in the UN SDGs and the Paris Climate Agreement. The SDGs and Paris Agreement aim to keep the global temperature increase well below 2°C from preindustrial temperatures, an important threshold and tipping point for earth's climate. The principles set the global benchmark for what it means to be a responsible lender, and provide actionable guidance for how to achieve this.

The PRB principles drive ambition and challenge banks to continuously increase their contribution towards a sustainable future. Jean-Laurent Bonnafe, CEO of BNP Paribas summarized the PRB as such:

> **"FINANCE IN ITS VERY NATURE IS FORWARD LOOKING, AND WE MUST MAKE SURE THAT IT WORKS NOT ONLY FOR PROFIT BUT ALSO FOR THE FUTURE OF THE PEOPLE AND THE PLANET. THE FRAMEWORK SET OUT IN THE PRINCIPLES FOR RESPONSIBLE BANKING WILL ENABLE US TO MOVE COLLECTIVELY IN THAT DIRECTION"**

The PRB focus on 6 principles to place efforts where financial firms have the most significant sustainability impact:

Principle 1 - Alignment: Strategic alignment means creating consistency between the bank's value creation model and the SDGs and Paris Agreement.

Principle 2 - Impact: The goal of principle #2 is to increase the lender's positive impacts while reducing the negative impacts on, and managing the risks to, people and environment resulting from the lender's activities, products and services.

Principle 3 - Clients & Customers: Principle #3 seeks to work responsibly with the bank's clients to encourage sustainable practices and enable economic activities that create shared prosperity for current and future generations.

Principle 4 - Stakeholders: Principle #4 seeks to proactively and responsibly consult, engage and partner with relevant stakeholders to achieve society's goals.

Principle 5 - Governance & Target Setting: The goal of principle #5 is to implement the lender's commitment to the Principles through effective governance and a culture of responsible banking, demonstrating ambition and accountability by setting public targets relating to each lender's most significant impacts

Principle 6 - Transparency & Accountability: Principle #6 commits to periodically review the bank's individual and collective implementation of the principles and be transparent about and accountable for each bank's positive and negative impacts and contribution to society's goals.

As a lender looking to establish a sustainability strategy, alignment with the PRB is an effective way to ensure your firm is an industry-leading firm. For more details, please refer to the Principles of Responsible Banking here.

Task Force on Climate-Related Financial Disclosures (TCFD)

The TCFD was organized by the international Financial Stability Board (FSB), and in 2017 released a list of recommendations for companies to promote advancements in the availability and quality of climate-related disclosure. The TCFD disclosure recommendations are structured around four thematic areas that represent core elements of how organizations operate: governance, strategy, risk management, and metrics and targets.

Governance: Disclose the organization's governance around climate-related risks and opportunities.

- Recommendation: Describe the organization's governance around climate-related risks and opportunities.
- Recommendation: Describe management's role in assessing and managing climate-related risks and opportunities.

Strategy: Disclose the actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning where such information is material.

- Recommendation: Describe the climate-related risks and opportunities the organization has identified over the short, medium, and long term.
- Recommendation: Describe the impact of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning.
- Recommendation: Describe the resilience of the organization's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario.

Risk Management: Disclose how the organization identifies, assesses, and manages climate-related risks.

- Recommendation: Describe the organization’s processes for identifying and assessing climate-related risks.
- Recommendation: Describe the organization’s processes for managing climate-related risks.
- Recommendation: Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organization’s overall risk management.

Metrics & Targets: Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.

- Recommendation: Disclose the metrics used by the organization to assess climate-related risks and opportunities in line with its strategy and risk management process.
- Recommendation: Disclose Scope 1, Scope 2 and, if appropriate, Scope 3 greenhouse gas (GHG) emissions and the related risks.
- Recommendation: Describe the targets used by the organization to manage climate-related risks and opportunities and performance against targets.

TCFD has increased in prominence as many of the worlds premier financial institutions now produce reporting in line with the TCFD recommendations. BlackRock, the world's largest asset manager, declared in 2020 that it is pushing 100% of its investments to report using TCFD. The asset manager stresses that companies need to improve disclosures of emissions, and will actively divest from companies it classifies as 'carbon intensive'.

Lenders who encourage clients to report the TCFD disclosures will not only have access to additional investment information, but will unlock shareholder value as companies find “operational efficiencies” that will lower costs by decreasing energy use, deploying new technologies and reducing waste. Review the TCFD disclosures here for more detail on the integration of TCFD into your client's and your organization's reporting.

How can I Implement sustainability reporting to lower my portfolio's ESG risk?
ESG monitoring providers, such as FreeWorld, can assist with implementing sustainability reporting across your organization's full portfolio of clients and investments.

United Nations (UN) Sustainable Development Goals (SDGs)

A framework which considers all portions of sustainability is summarized by the United Nations Sustainable Development Goals. The universally-approved policy framework includes a wide variety of issues facing humanity (equality, climate, poverty, disease, etc.) and makes it easy to set sustainability goals aligned with broader humanity's goals.

The following SDGs relate directly to reduced carbon footprint and environmental impact, however, the results of an effective sustainability plan affect all of the 17 SDGs:

- SDG #6: Clean Water & Sanitation
- SDG #7: Affordable & Clean Energy
- SDG #11: Sustainable Cities & Communities
- SDG #12: Responsible Consumption & Production
- SDG #13: Climate Action
- SDG #14: Life Below Water
- SDG #15: Life On Land

Using the SDGs to guide sustainable investment decisions ensures that lenders and banks are aligned with the universally-approved sustainability strategy adopted by the United Nations. Alignment with the SDGs gives greater authority to the sustainability reporting, and is increasingly becoming a prerequisite for many bank's sustainable investment decisions.

United Nations Sustainable Development Goals (SDGs)

2. SUSTAINABLE FINANCE

"THERE IS A PRESSING NEED FOR A NEW INCENTIVE SYSTEM IN FINANCE THAT USES FISCAL MEASURES TO REWARD COMPANIES STRIVING FOR SUSTAINABILITY OUTCOMES"

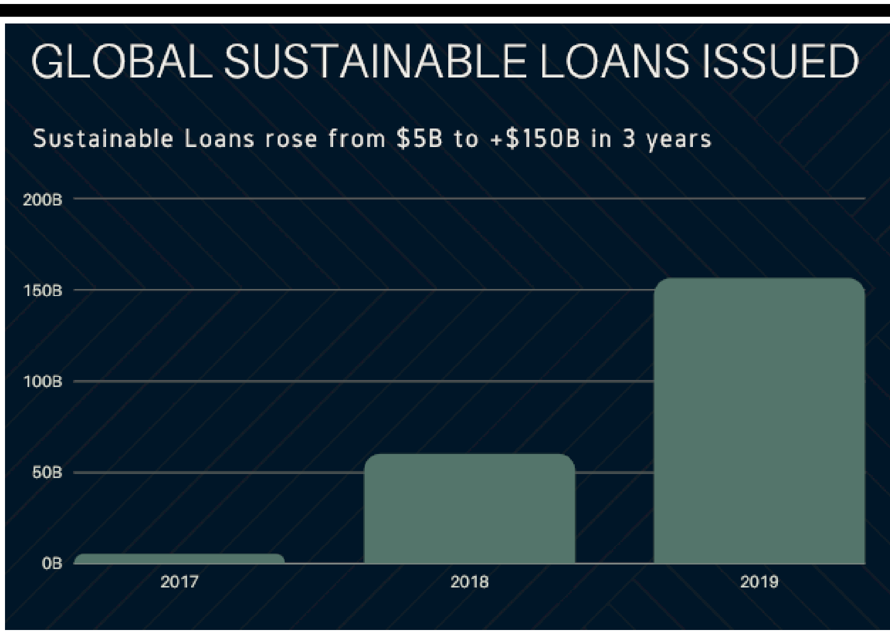
- Global Investors Sustainable Development Alliance (GISD)

The rise of Sustainable Finance (or ESG-Linked Finance, Climate Finance) over the past 3 years is staggering, and represents an opportunity for lenders and banks to harness the power of sustainability to drive positive change and profits.

Sustainable Finance can be categorized into multiple products, from Green Financing, to 'Sustainability-Linked Loans' and Bonds. The distinction between 'green' and 'sustainable' financing is made in the 'use of proceeds'. Green Loans and Bonds must be used for approved 'Green' projects such as renewable energy installations and energy efficient buildings. Sustainability-Linked Loans and Bonds are advantageous in their ability to be used for general corporate purposes, much like a traditional business loan or bond. The lack of 'use of proceeds' restrictions allow Sustainability-Linked Loans and Bonds to be widely applicable and empower companies across many industries.

What are Sustainable Loans?

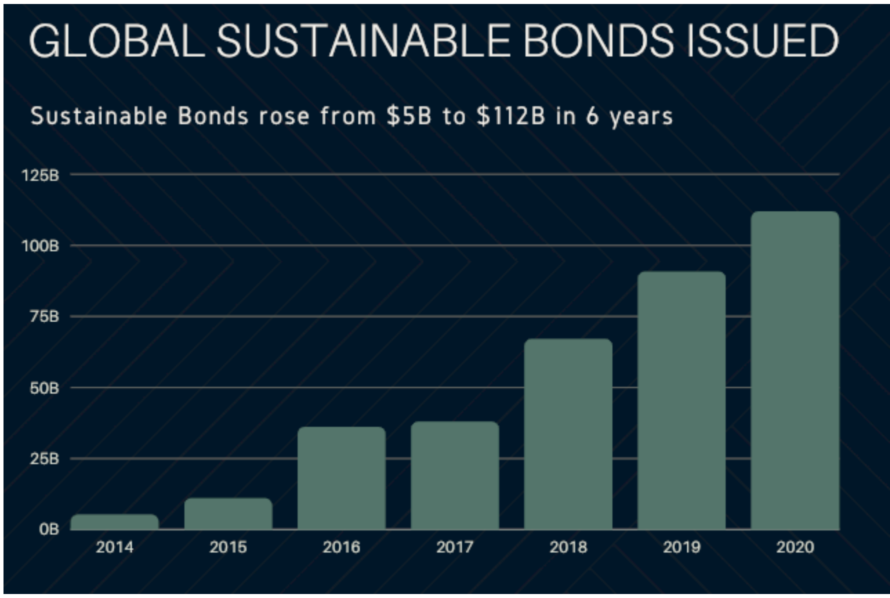
Sustainability-Linked Loans (SLLs) are similar to other loans, with the difference being the interest paid by the borrower. The interest rate is linked to agreed upon sustainability metrics, for example, carbon emissions, energy usage (kWh), or a more generic ESG target. Borrowers who achieve their sustainability targets benefit from favorable interest rates, while a failure to do so will lead to higher rates. **SLLs provide an incentive to align both financial and sustainable objectives**. As seen in the graph, SLLs have exploded as a mechanism for lenders to drive sustainability, **<u>increasing 3,000% from $4B to $135B since 2017</u>.**



"Sustainable Loan Issuances" Financial Times

What are Sustainable Bonds?

Sustainability-Linked Bonds (SLBs) operate similar to SLLs in that the bond pricing is tied to sustainability targets approved by the Issuer and Guarantor. Sustainability-Linked Bonds usually have a coupon 'step-up' clause, meaning the coupon rate increases if the Issuer does not achieve their sustainability targets within the agreed upon time frame.



"Sustainable Bond Issuances" Bloomberg

SLLs and SLBs allow both businesses and lenders to achieve sustainability targets, shrink operating costs, create shareholder value, and boost customer/investor engagement.

Examples of Sustainable Finance

Each month, more businesses use Sustainable Finance products to boost growth, achieve sustainability goals, and reduce financing costs. Recently, large corporations have leveraged Sustainable Finance to separate their brands from the competition.

- In February 2021, clothing retailer H&M issued a $600M sustainability-linked bond, which **drew in an astounding $4.6B in orders, making the bond offering 7.6x over subscribed**. The coupon rate of the bond is tied to H&M reducing their greenhouse gas (GHG) emissions by 20% and increasing their use of recycled material by 30% by 2025. H&M's CFO stated "Sustainability is an integral part of our operations. This type of bond creates a clear and transparent commitment and incentive for the company."
- In February 2021, AB InBev, the maker of beer brands Budweiser and Stella Artois, signed a $10.1B Sustainability-Linked Loan, the largest in the SLL market's short history. The interest rate of the loan is tied to AB InBev reducing their GHG emissions by 25% and consuming 100% renewable energy by 2025.
- In November 2019, fashion designer, Prada, signed a €50M SLL based on its use of recycled goods and energy efficient buildings.

Sustainable Finance is not limited to large corporations. The examples stated above indicate market acceptance of SLLs and SLBs, but there is now massive opportunity to issue Sustainable Financing to SMBs and middle-market companies.

How can my firm implement Sustainable Finance?

Lender-sourced financing: Lenders can easily partner with a third-party 'sustainability coordinator', such as FreeWorld, to issue Sustainable Finance. Lenders market SLLs and SLBs to their clients as an advantageous form of financing, then recruit the sustainability coordinator to verify each borrower's sustainability framework and issue a 'Second-Party Opinion' indicating whether the terms of the financing are certified against SLL and SLB industry guidelines, the Sustainability-Linked Loan Principles (SLLP) and Sustainability-Linked Bond Principles (SLBP). The sustainability coordinator performs sustainability monitoring over the life of the loan or bond, and reports to the Lender of any changes in the interest or coupon rate depending on the sustainability performance of the Borrower. This model of financing allows lenders to enter the Sustainable Finance market and leverage the expertise of the sustainability coordinator to verify each financing prior to issuance.

Sustainable Finance Marketplace: Lenders who wish to boost market share and issue loans immediately can join a Sustainable Finance marketplace such as the FreeWorld Finance Marketplace. In the marketplace, the Lender can choose from a pipeline of sustainable-certified businesses seeking financing. Each Borrower's sustainability framework is verified by the sustainability coordinator and the Lender is provided access to all Borrower information needed to make a credit decision and offer financing terms. If the financing offer is accepted, the sustainability coordinator assists the Lender with incorporating necessary verbiage in the underwriting documents to execute the sustainability-linked financing. By joining a Sustainable Finance marketplace, lenders and banks can easily reach new companies seeking Sustainable Finance and responsibly grow their lending business in 2021.

Sustainable Finance is best used as a tool to drive real results in sustainability, reduce 'greenwashing', and drastically improve the 98% of companies which fail to reach their sustainable goals. Lenders who adopt Sustainable Finance now will have a considerable advantage as the industry continues to grow.

3. COMMUNICATE SUSTAINABILITY COMMITMENTS

Increasingly, banks are communicating major long-term sustainability commitments, which provide an opportunity to link products and services to corporate responsibility. However, as sustainability commitments grow, the need for transparency about these initiatives will increase.

As of March 2021, the United States' 'Big 6' banks, J.P. Morgan Chase, Wells Fargo, Goldman Sachs, Morgan Stanley, Bank of America, and Citigroup, have all published 'net-zero' commitments. These net-zero commitments align the banks with the goals of the Paris Agreement, pledging that all the banks' operations, including projects and companies they finance, will achieve net-zero carbon emissions by 2050.

While these ambitious commitments create industry momentum and demonstrate both business and ESG value, transparency about the methodology and criteria for calculating sustainable impact will help banks add credibility to these initiatives. These examples are just a sample of the hundreds of financial institutions, large and small, making commitments towards sustainability around the world. Lenders, banks, and credit unions of all sizes should consider publicly committing to sustainability to drive value to many aspects of their business.

CONCLUSION

As sustainability continues to grow in importance in the financial industry, Lenders who do not incorporate sustainable processes and products will likely lose market share and profitability.

With proper preparation, lenders and banks of all sizes can transform into firms which are admired by customers, competitors, and investors alike. Lenders who embrace this important paradigm shift will capitalize on additional growth provided by sustainability reporting, sustainable finance products, and sustainability commitments. If you are interested in incorporating these opportunities into your business, FreeWorld can help with all aspects of your sustainable lending business.

By signing up for Freeworld Finance, your business will get assistance with sustainability reporting for your company and your clients, sustainability-linked bonds, sustainability-linked loans, and more to shrink your carbon footprint and increase your company bank account in 2021.

We look forward to helping your business succeed!

Sign Up Now

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