Sustainable Finance- no more an option but an imperative for lenders and borrowers

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With increasing impetus globally, thrust by investors, requirements by regulators, and expectations from stakeholders sustainable finance is becoming much more mainstream. A global investor survey that PWC published in 2022 suggests that 82% of investors were exerting pressure on their portfolio companies to set and aim at sustainability objectives. Year 2022, saw a record near $500bn invested in renewable energy. Further there were over 1,000 venture equity investments into climate start ups and growing with over $40bn deployed.

Devastating effects of climate changes including increase in global temperature upto 2.2%, has led to mounting resentment in general public against polluters.

In fact as risks associated with ESG increases and as their implications on sustainability becomes critical, the companies themselves have become increasingly conscious about national and global requirements for emissions reduction targets, human rights and integritysss. They are increasingly incorporating ESG-related targets and commitments into their management processes including decision-making. The backlash of stakeholders has made it imperative for them to think about what they do and that affects sustainability ,what their targets should be and what they are trying to accomplish and how they would.

Sustainable finance is the process of taking due account of environmental, social and governance considerations when making investment decisions in the financial sector, leading to increased investments into sustainable economic activities and projects. Sustainable finance prompts integration of ESG issues into corporate activity.

Sustainable finance can take form of sustainability-linked loans or green financing. Sustainability-linked loan(SLL) are currently pre dominant. These incentivise the borrowers for achievement of predetermined sustainability performance objectives with predefined key performance indicators or metrics (which link economic outcomes to sustainable practice).Unlike green financing the proceeds need not to be used for a specific project or a green project. SLL provide concessional interest rate and/or increase in repayment period along with other relaxation in terms and conditions for borrowers to improve their overall sustainability performance.Importantly borrowers have the flexibility in deploying proceeds of loan in achieving ESG objectives.

Green financing is a form that requires borrowers to use the proceeds to fund specific projects that make a substantial contribution to environmental objectives. These projects typically are development of a renewable energy, clean transportation, environmentally sustainable agriculture, construction of green buildings and the likes, which meet prescribed standards or certifications.

Further it requires a clear process for project evaluation and selection ;for management of proceeds for ensuring utilisation in specified manner;and for reporting on qualitative and quantitative aspects. Disclosures are mainly focused on capacity of project, the level of generation or utilization,contribution to emissions reductions, environment protection and preservation,and mitigation of social impacts.

For Existing companies green loans on may provide for utilization of funds exclusively for projects or new assets necessary for transition to milestones and achievement of agreed targets. In fact green loan or bond scheme it self lays down the eligibility criteria, process and framework following which funds should be used and managed.

Sustainability finance is also imperative for lenders as companies while responding to their ESG requirements, will need funds to support.

For example, a company which aim at reduction in emissions would need finance for decommissioning of their GHG emissions intensive liabilities or in the alternative to construct a renewable energy project. Given the limitations of the capital markets, banks and financial institutions are the only available source left. Further lenders have to set and target their own commitments for sustainability objectives. They themselves have reporting obligations under applicable regulatory norms and are subject to stakeholder's scrutiny. Typically ESG policy of lenders focuses on the priority they give to ESG -objectives, targets, challenges, risks, mitigation, resilience and adaptation.These will include diversity, equity and inclusion, and good governance as well.

Earlier the focus of lenders on ESG compliance was limited to box- ticking to meet back to back conditions of the line of credit of bi/multi- lateral institutions. The terms and conditions of loans normally included a standard stipulation requiring the borrowers to comply with the related industrial, environmental and social laws. The focus has now shifted to more formalized approach, though much more needs to be done for ensuring substantive compliance.The terms and conditions now increasing stipulate key performance indicators including in regard to reduction of scope 1 and 2 emissions, treatment and disposal of waste, gender pay equality and social inclusion,and governance aspects.

There are however challenges both for lenders and borrowers in setting up meaningful and credible KPIs. For borrowers, the challenges include setting up of clear milestones relevant to business , targets and implementing those, in qualitatively as well as quantitative terms (in a manner that does not cause confusion and disputes later), reporting on their KPI frameworks .The lenders on the other hand need to ensure that agreed KPIs are aligned with their own sustainability related targets and commitments and these are capable of being appropriately monitored.

In case of failure to achieve, there should be clarity on when and how the default clause will trigger and with what consequences.

For setting targets there are no best practices evolved so far. The practice generally followed is to set targets seeing the past performance and industry trends. The SEBI's recent framework for KPIs and reporting thereon provides for key parameters in general,without being industry specific. The lender and the borrower should under the circumstances attempt to strike a balance between what is required to create a positive change while being realistic to ground realities and challenges involved in implementation and monitoring.

Failure to do so can cause commercial and legal risks to both lenders and borrowers. This also tempts them to resorting to deceptive practices like green washing or bluewashing. As per PWC's global investor survey, as referred earlier, 87% of the investors lacked trust in monitoring mechanism and disclosures made by corporates and lenders. It is expected that phased implementation of recent SEBI framework will lead to greater credibility to monitoring and reporting on sustainability. Gradually the, regulators will start cracking down on misleading ESG claims.

The corporate borrowers who don't position themselves appropriately and implement respectable ESG targets may encounter difficulties in obtaining finance or may have to obtain finance on less favourable terms. The SEBI framework provides them adequate preparation time to address challenges currently being faced and be ready as ESG KPIs becomes as important parameter as financial parameters are, in the emerging financing model.