Sustainability-linked loans for Small and Medium-sized Enterprises

Operational guidelines for commercial banks in Southeast Asia

USAID Green Invest Asia
July 2019

Statement from Association of Development Finance Institutions in Asia

Environmental governance is one of the pillars of the Association of Development Finance Institutions in Asia and the Pacific's (ADFIAP) sustainable development agenda. We strive to support our members integrate environmental, social and governance (ESG) standards into their operational processes and procedures. Technical guidelines and tools like the one you are about to read are crucial to build our members' expertise and to facilitate their work in a rapidly developing field.

These guidelines help our sector focus on small and medium-sized enterprises and land-use companies, which are both underrepresented in sustainable banking. Emerging financing instruments like sustainability-linked loans and green bonds, offer an opportunity for our members to guide clients in their journey toward green growth. USAID Green Invest Asia's sustainability-linked loan guidelines for small and medium-sized enterprises outline a pragmatic, efficient approach for innovative sustainable finance that we are proud to promote to our members.

With guidance comes experience, and with experiences come case studies and proof of concept, and with proof of concept comes more widespread adoption. We laud USAID Green Invest Asia for putting out tangible products that help transform our development finance commitments to action.

Octavio Peralta,
Secretary-General
August 2019

USAID Green Invest Asia

USAID Green Invest Asia, (www.greeninvestasia.com) is a facility of the United States Agency for International Development (USAID) that catalyzes private investment in agribusiness and forestry companies committed to sustainable land use practices in Southeast Asia. It links investors with environmentally and socially responsible deals, while helping businesses scale and become investment-ready with environmental and business consulting services. Sustainable land use management promoted by the facility will contribute to reducing commodity-driven deforestation and land degradation, while helping corporations and investors achieve sustainability goals.

ABOUT THIS REPORT

This report was written by Mekong Strategic Partners (www.mekongstrategic.com), as part of the USAID Green Invest Asia team, with David Parisse.

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Pact
1828 L St, NW, Ste 300
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Acronyms

CDD	Customer Due Diligence
E&S	Environmental and social (factors)
ESG	Environmental, social and governance (factors)
FO	Front office
GHG	Greenhouse gas (emissions)
KPI	Key performance indicators
KYC	Know Your Client
LAP	Loan Approval Process
RAROC	Risk-adjusted return on capital
SME	Small and medium-sized enterprise
SLLs	Sustainability-linked loans
USAID	United States Agency for International Development

INTRODUCTION

Sustainable finance and environmental and social governance (ESG) span multiple topics and financial instruments ranging from green bonds to company valuation and gender lens investing. These guidelines focus on one emerging instrument[1] attracting strong market interest: sustainability-linked loans (SLLs). SLLs are a financial product that ties the cost of financing to performance against defined sustainability criteria. Sustainability-linked loans represent an emerging opportunity for banks and companies to finance and foster sustainable production while growing profitable businesses.

These guidelines assist banks to develop SLLs for small and medium-sized enterprises (SME) in Southeast Asia with flexible terms and low-transaction costs. The goal is for banks to pilot and progressively mainstream SLLs into their portfolios. The guidelines are applicable to all sectors, but emphasis is given to land use sectors where SLLs have the potential for great positive impact.

There are many incentives for banks to incorporate SLLs and environmental and social (E&S) sustainability factors into their lending processes. Some of these incentives are linked to results achievable in the short term, others are linked to a longer-term strategy.

Short-term incentives

Risk management

- Integration of borrower's ESG performance into credit analysis improves the average portfolio credit worthiness
- Reduce stakeholders' legal and reputational risks

Marketing and sales

- Support the bank's reputation as market leader in the field and as a responsible lender
- Capacity to communicate green performance may attract new clientele
- Gain a deeper understanding of the underlying business, leading to opportunities for cross-selling

Medium and long-term incentives

Lower cost of funds

- A pool of sustainability-linked loans may be (re)financed through green bonds and other sustainable finance sources with lower costs and other advantages
- Possibility to refinance the SME loans through securitization to mitigate balance sheet issues or to achieve greater capital leverage

Macro factors

- Potential regulatory advantages in the future, following the trend observed in the European Union and other jurisdictions
- Increased capacities for banks to support their corporate and SME clients
- Tap an emerging and growing market. DBS has estimated the additional finance needed between 2016 and 2030 is $220 billion for sustainable agriculture, forestry and land management in Southeast Asia.[2]

1 These guidelines are not intended to be used as a general framework for environmental social and governance (ESG) standards.
2 UNEP and DBS Bank, "Green Finance Opportunities in ASEAN", November 2017

HOW TO USE THESE GUIDELINES

The guidelines are intended for bank managers, ESG department and risk department staff and other investors in SMEs in Southeast Asia.

The guidelines outline a pragmatic approach to pilot SLLs for SMEs in commercial banks in Southeast Asia and offer guidance on how to develop the required processes, tools and internal capacities.

The methodology has three underlying objectives:

1. Be simple to implement, understandable and adds value for the bank's relationship managers.
2. Add value to the bank's core business by enhancing the set of information used for decision making and it increases return on equity generated from its SME lending portfolios, through decreased nonperforming loans.
3. Create a positive difference for the bank's SME[3] clients, because the return on investment of providing the lender with more information (than usually shared with other lenders) is greater. The lender may offer discounted loan interest rates when the SME reaches ESG milestones.

- Section 1 defines SLLs and describes the key features for SMEs. The difference between SLLs and other green loans is highlighted. Some examples of existing SLLs in Southeast Asia are provided.
- Section 2 describes how to integrate SLL methodology into the bank's existing loan process chain, including client ESG assessments and ratings.
- Section 3 gives an overview of what is required for an ESG assessment of new clients and provides guidance on the types of indicators used in assessments.
- Section 4 outlines when to review the purpose of a loan in relation to ESG factors and how to assess a loan's environmental performance.
- Section 5 describes how to design and implement a pricing system for SLLs that builds on banks' existing pricing systems.

For each section, examples and templates are provided to guide implementation.

The SLL methodology is designed to be incorporated into commercial banks' existing loan processes, allowing for the constraints and challenges faced by banks in Southeast Asia.

3 SMEs are defined differently by country and oftentimes by banks within a country. In these guidelines and in line with recognized benchmarks, SMEs are defined as companies with 10 to 300 employees and annual sales between USD 100,000 and USD 15 million.

1. WHAT IS A SUSTAINABILITY-LINKED LOAN?

Financial products benchmarked to ESG criteria include green loans, sustainability loans, ESG loans and ESG-improvement loans. There are however, key differences between these concepts.

An SLL matches the interest rate applied on the debt instrument to borrowers' sustainability performance and rating. If the borrowing company meets or outperforms its sustainability targets, the interest rate will be discounted; if the company underperforms, it pays a premium. SLLs offer an incentive for companies to reduce their borrowing costs by leveraging their sustainability progress and enables lenders to reduce their E&S-induced risks.

SLLs have the following characteristics:

- The loan applies an interest rate that varies according to the borrower's ESG performance. When the borrower's ESG performance improves, the interest rate goes down (borrower reward) and vice versa.
- For loans with **unknown use of proceeds,** the loan links the interest rate to the borrower's ESG performance.
- For loans with **known use of proceeds,** the loan links the interest rate to the ESG performance of both borrower and loan combined.
- The loan incorporates a borrower's ESG performance verification into lender requirements.
- An independent auditor who reports to the lender (for corporates portfolios) typically verifies the underlying ESG performance, relying on clear benchmarks and reporting standards of ESG indicators.

Loan arrangements may be applied to syndicated and bilateral loans, revolving credit facilities with generic use of proceeds, and asset-based lending with known use of proceeds.

In 2019, the Loan Market Association (LMA) and the Asia Pacific Loan Market Association outlined four principles of SLLs.[4] The SLL Principles are voluntary and can be applied by market participants on a deal-by-deal basis, depending on a transaction's underlying characteristics.

"Sustainability linked loans are any types of loan instruments and/or contingent facilities (such as bonding lines, guarantee lines or letters of credit) which incentivize the borrower's achievement of ambitious, predetermined sustainability performance objectives. The borrower's sustainability performance is measured against sustainability performance targets (SPTs), which include key performance indicators, external ratings and/or equivalent metrics that track improvements in the borrower's sustainability profile." (2019, LMA)

According to the SLL Principles, the four defining features of SLLs are:

1. Relationship to borrower's overall corporate social responsibility strategy.
2. Target setting – measuring the sustainability of the borrower.
3. Reporting requirements.
4. Review.

4 https://www.lma.eu.com/application/files/8015/5307/4231/LMA_Sustainability_Linked_Loan_Principles.pdf

Are sustainability-linked loans the same as green loans?

The major difference is the use of proceeds. To be labelled a "green" loan, proceeds must finance a predetermined list of activities with environmental benefits as listed in the LMA green loan principles. An SLL, on the other hand, may include all activities that enable a measurable improvement of the borrower's ESG performance.The bank and borrower decide, together, what the ESG component will include (either specific ESG milestones or overall company ESG performances).

Green loans follow principles set by the Loan Market Association and have the following key features:[5]

1. The use of proceeds ("all designated green projects should provide clear environmental benefits").
2. Process for project evaluation and selection.
3. Management of proceeds ("proceeds of a green loan should be credited to a dedicated account or otherwise tracked by the borrower in an appropriate manner").
4. Reporting.

A green loan may follow the form of an SLL (i.e. with predetermined E&S KPIs, targets and milestones) and an SLL may fit the requirements of a green loan, but not all green loans are SLLs and not all SLLs are green loans.

The advantage of SLLs over green loans is that they allow for a wider range of loan purposes. Green loan proceeds are predetermined by the Loan Market Association (LMA), while SLLS can cover any activities if ESG targets or milestones are included in the loan terms and conditions.

Growth of SLLs

The SLL segment has developed rapidly in Europe and more recently in the United States. According to ING in 2018, the green/ESG loan market is set to grow more quickly than the green bonds' market in the United States in the next five years.[6,7]

Following the global trend of integrating ESG factors in the loan cycle, commercial banks and their subsidiaries in Southeast Asia have begun piloting SLLs to large companies in the agricultural sector since 2014. Two flagship transactions were successfully finalized with Olam[8] (syndicated loan) in 2018 and ING-Wilmar in 2017.[9]

Under an ESG-linked revolving credit facilities arrangement, Olam is borrowing $500 million in a club loan (15 participating banks[10]) that links the interest rate to sustainability targets. Olam committed to meet ESG targets yearly, as assessed by Sustainalytics (an ESG research and ratings company).

Wilmar converted a portion of its existing committed revolving credit facility of $150 million (bilateral agreement with ING) into a sustainability performance-linked loan. This collaboration was the first of its kind in the palm oil industry. Wilmar committed to improve its ESG performance with progress to be measured by Sustainalytics.

5 https://www.lma.eu.com/application/files/9115/4452/5458/741_LM_Green_Loan_Principles_Booklet_V8.pdf
6 https://www.ingwb.com/media/2266556/ing-sustainability-study-2018.pdf
7 https://www.environmental-finance.com/content/analysis/the-green-and-sustainability-loan-market-ready-for-take-off.html
8 https://www.olamgroup.com/news/all-news/press-release/olam-international-secures-asias-first-sustainability-linked-club-loan-facility-us500-0-million.html
9 https://www.wilmar-international.com/sustainability/wp-content/uploads/2017/11/Joint-Press-Release-Wilmar-and-ING-collaborate-on-sustainable-loan-in-Asia.pdf
10 ANZ (Australia and NZ Banking Group), Bank of Tokyo-Mitsubishi, BNP Paribas, Commerzbank, Commonwealth Bank of Australia, DBS Bank, Hongkong & Shanghai Banking Corp, Singapore Branch, ING, Mizuho, National Australia Bank, Natixis, Rabobank, Standard Chartered & UniCredit as Mandated Lead Arrangers.

SLLs are now expanding in Southeast Asia, primarily offered by regional and international banks. Banks as well as corporates have realized the potential of this product and new large-size loans are reported every year. Corporates in the agriculture and food sector have been the recipients of such loans in Southeast Asia. The potentially large environmental impacts on land use, as well as the social impacts on communities and smallholders involved in these supply chains, require banks to be even more prudent in their lending. SLLs provide a tool to structure this E&S monitoring and include incentives for the parties to honor their commitments.

Features of sustainability-linked loans for SMEs

The success of corporate SLLs relies on an independent, internationally recognized third-party auditor that verifies ESG performance, with duty of care toward the lenders. The ESG information available to the auditor is largely derived from information corporates share online, interviews conducted directly with ESG departments of the companies and field audits. Using a third-party monitoring approach is crucial when the borrower is a large corporation with obligations of public ESG disclosures.

SMEs are a major contributor to E&S degradation and negative impacts. While each SME's impact by itself is relatively small, SMEs represent between 95-98 percent of all companies in Southeast Asia and their aggregated impact is sizeable. SMEs in the land use sector exhibit a wide range of potential impacts which complicates monitoring and assessment efforts. SLLs offer great opportunities for SME lending because they integrate incentives for lenders and borrowers to improve their sustainability performance without requiring an external framework.

Implementing a similar SLL approach for SMEs is challenging as loan amounts are usually much lower, with insufficient profit margin to cover the costs of third-party verification and monitoring. Thus, an SLL methodology for SMEs must rely on indicators and milestones that can be collected and monitored by the bank and borrower themselves. SLLs equip both banks and SMEs with guiding indicators to monitor progress while reinforcing their commercial relationship.

The methodology for sustainability-linked loans for SMEs is based on the following pillars:

- Marginal additional costs of implementation.
- Use of primary data available to the SME and bank.
- Reliance on data directly verifiable by both parties.
- Support the lender/borrower partnership between the bank and SME.

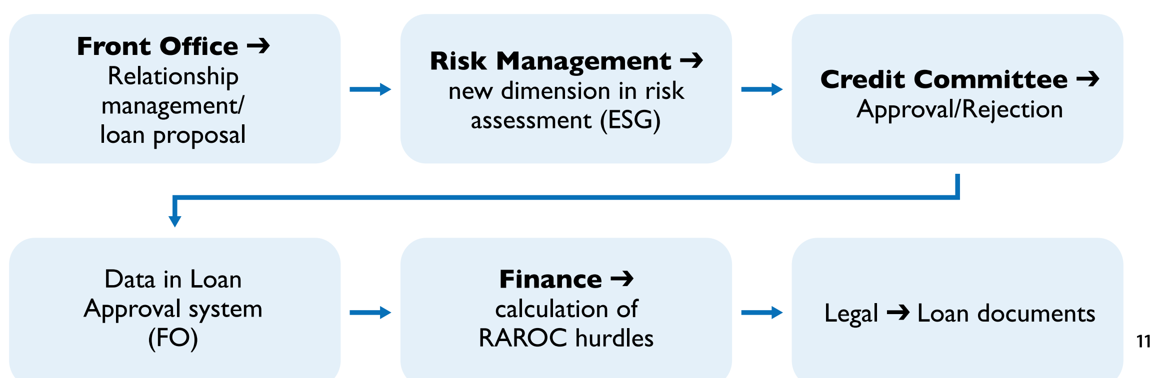
2. INTEGRATING SLLS INTO BANK PROCESSES

SLLs are a new products for most banks and as for all new products, successful adoption is dependent on how the new product affects and integrates with existing internal processes. This section describes how to integrate SLLs, ESG client assessments and ratings into all operational divisions of a bank.

Wider implementation of an SLL program affects all core business processes. It is recommended to pilot test the business model on a few selected SMEs and different types of loans. The program can be expanded when the bank has built a database of relevant indicators and collected sufficient data to develop in-house benchmarking. These guidelines present two different integration approaches: one tailored for a pilot phase and another for long term integration.

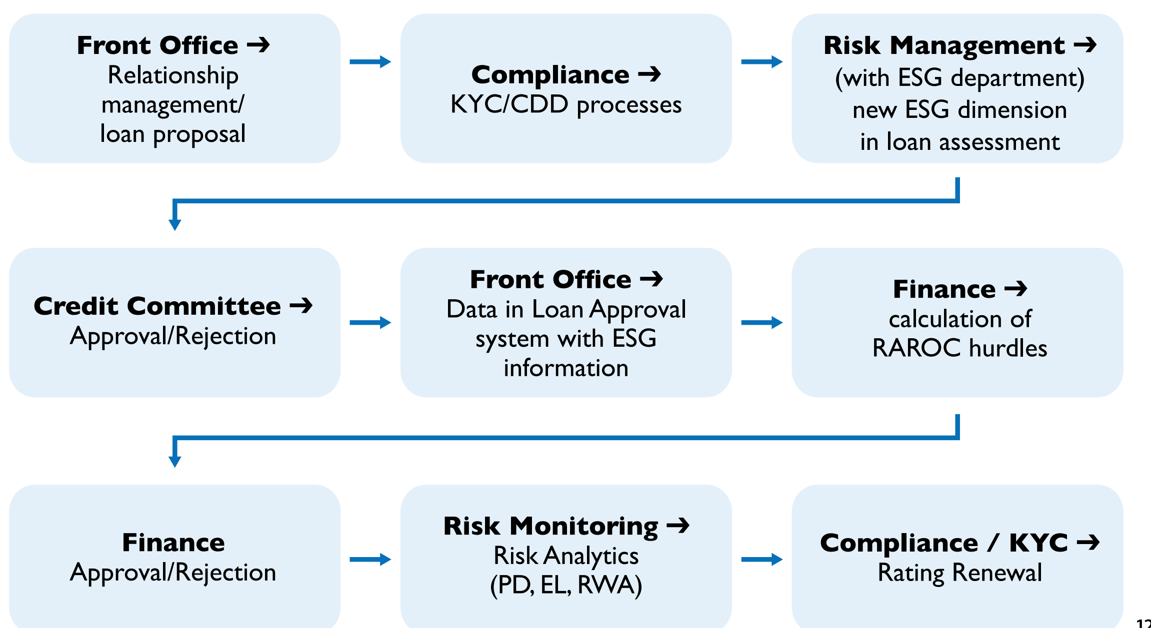
Process chain for piloting SLLs

This approach considers the implementation of only a limited number of pilot loans, without the need for information technology (IT) updates following typical processes at the bank.



[11]

Process chain for SLLs at portfolio level



[12]

11 RAROC: risk-adjusted return on capital
12 CDD: Customer due diligence; PD: Probability of Default of the borrower; EL: Expected Loss linked to the loan; RWA: Risk weighted assets

Integrating client ESG assessment and rating

The methodology relies on two existing processes used by commercial banks for client assessment: 1. Know Your Client (KYC) procedures, also called Customer Due Diligence (CDD), and 2. Loan Approval Process (LAP). It proposes that assessment of client ESG factors be performed as part of the KYC procedure, and assessment of the loan ESG factors be performed as part of the LAP.

The SLL assessment process is part of the Loan Approval Process and will usually input a large amount of financial and credit risk-related information into the system before the loan is reviewed by the Credit Approval Committee. The ESG data collected represent extra-financial information for the credit committee to review together with credit and risk information.

When a new client requests to become a borrower, the regular KYC process should include ESG-related questions. Data will be recorded automatically, in line with mandatory compliance processes.

The questions will generate an automatic rating, to be verified and approved by the ESG department - if it exists - or by the compliance department. Having an ESG department approving the process is important as it moves this responsibility away from the compliance department, which may not have the expertise to assess ESG issues. In this respect, the compliance department will simply be "lending" the existing IT processes to the ESG department, which will be able to access and assess data in the IT system.

The process may be repeated annually or less frequently, depending on the bank's existing loan review policies. Usually there is an update of the process in cases of "enhanced due diligence," where there is a higher risk linked to AML or CTF[13] issues. In this case, the KYC procedure may be performed annually.

With regular due diligence, the bank may process the KYC/CDD every three years. When the ESG rating is lower than a given threshold (becoming an "ESG laggard"), the ESG client assessment should be renewed every year. In this case, only information related to ESG should be requested from the client again.

13 Anti-Money Laundering and Counter-Terrorism Financing

Six steps to assess and integrate client ESG factors into bank processes

3. DESIGNING A CLIENT ESG PERFORMANCE ASSESSMENT

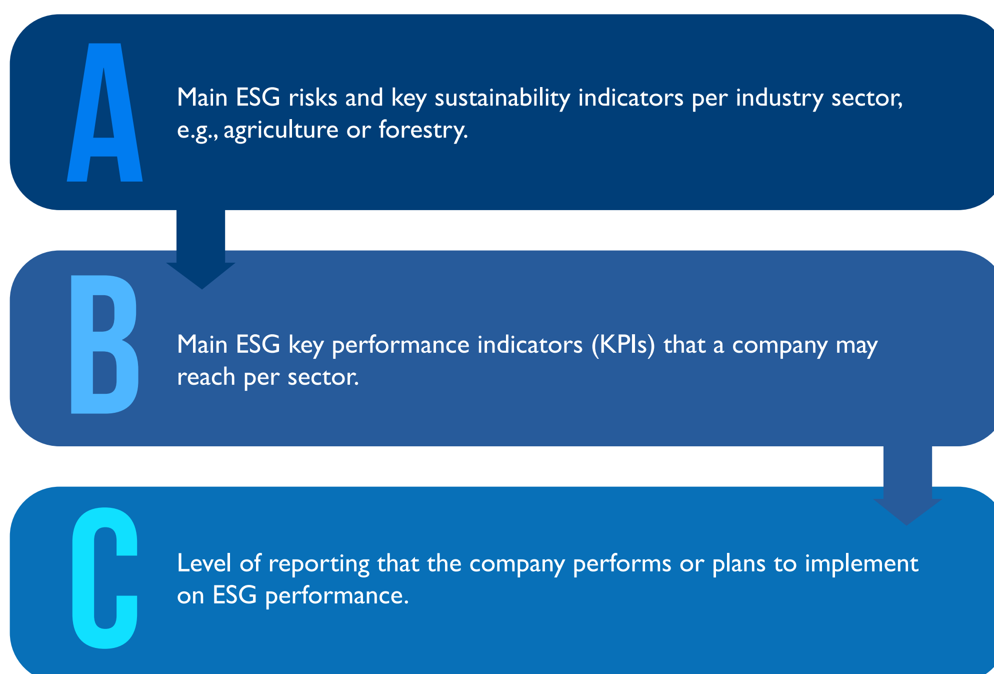
This section describes the proposed three components of an ESG assessment for new clients and provides guidance on the types of indicators to be included.

The assessment of ESG performance relies on collecting relevant data and can be performed in two ways:
(i) Collecting data from external ESG data providers. However, ESG data providers usually focus on publicly listed companies with published ESG information. There may be little to no data for SMEs in emerging markets.
(ii) Generating ESG data based on the bank's ESG internal questionnaire.

The ESG internal questionnaire aims to strike a balance between ease of implementation, data quality and scope. The questions should be:

- User-friendly: The ESG assessment should be easy to use for bank relationship managers without requiring high-level technical detail from the client. The questionnaire's complexity may vary according to the level of bank "readiness" and the client's ability to answer.
- Relevant: Questions should address the client's key ESG challenges.
- Transparent: The client should be open to discuss issues and provide available data, where possible.
- Adjustable: Questions can be fine-tuned, over time, following field testing by the bank.

The assessment is composed of three sets of indicators.



The following sample scorecard shows three sets of indicators (with their weighting) that calculate the ESG score of an SME client. The drivers represent key E&S dimensions. Banks may design a scorecard to fit their internal policies and vision by adding new drivers. Each driver will be weighted based on the domestic context and risk frequency.

14 Detailed explanations and examples of ESG questionnaires for land-use companies are provided in the publication *Environmental and social (E&S) assessment for land-use lending*, USAID Green Invest Asia, 2019.

ESG Risks			
Drivers	Evidence Available	Weight	Score [0-10] Yes = 10
Indirect deforestation or protected sites (supply chain/negative news)	YES/NO	30%	10
Compliance with regulatory requirements (no fines)	YES/NO	20%	10
Land title management (no legal disputes)	YES/NO	30%	0
Indirect illegal practices working conditions (supply chain/negative news)	YES/NO	30%	10
ESG risk subrating			7

ESG KPIs			
Drivers	Evidence Available	Weight	Score [0-10] Yes = 10
Water management - ESG standard certification (website)	YES/NO	30%	0
Labor rights - ILO conventions compliance (policy in the website)	YES/NO	20%	0
Fertilizers - Low intensity of use (balance sheet or P&L)	YES/NO	20%	10
Waste management (balance sheet or P&L)	YES/NO	20%	10
Good governance (website)	YES/NO	10%	10
ESG KPI subrating			5

ESG Reporting			
Drivers	Evidence Available	Weight	Score [0-10] Yes = 10
ESG KPIs publicly available (website)	YES/NO	30%	10
ESG policies and yearly results publicly available (website)	YES/NO	30%	0
ESG results audited yearly by independent 3rd party (website)	YES/NO	40%	10
ESG reporting subrating			7

Example of SME scorecard results
The resulting SME scorecard analyzes the three components.

The following sources for ESG reporting are valid for SMEs across all sectors:

ESG Client assessment - Rating construction					Client ESG Score	Mapping	Client ESG Rating
• ESG results, in relation to stated objectives, if publicly available (e.g., web site);							Normal
ESG Risks	→ Questionnaire	→ ESG risk subscore	→ 7	→ 40%		[7 - 10] - Laggard	
• ESG key performance indicators (KPIs) if publicly available (e.g., web site);							
ESG KPIs	→ Questionnaire	→ ESG KPI subscore	→ 5	→ 40%	= 6.2	[2 - 6.9] - Normal	
• ESG results audited by independent third party.							
ESG Reporting	→ Questionnaire	→ ESG reporting subscore	→ 7	→ 20%		[0 - 1.99] - Sustainable	

A higher weight is applied to audited reporting. Auditing by an independent third party is a strong verification of the SME's performance and indicates application of best practices.

Banks may also consider additional sources to allow a deeper understanding of the environmental and financial performance of the company:

- *Cost savings and productivity gains*. An agribusiness can save costs and increase efficiency through reducing and managing its resource use. Typically, areas where cost savings are identified include:
  - Use of raw materials and supplies;
  - Waste intensity reduction;
  - Water and energy intensity reduction;
  - Transport and travel reduction;
  - Resources used in packaging.
- *By reducing environmental impacts* (e.g., waste to landfill), agribusiness may significantly reduce taxes or levies, or avoid the cost of compliance, depending on the country's legislation. Responsible resource management reduces exposure to liabilities and insurance costs, if the company is insured against the risk of causing environmental damage.
- *Improved sales*. SMEs can benefit from improved reputation among existing and potential customers by reporting on relevant environmental standard certifications. Customer confidence can increase companies' market access and ability to apply premium prices. An SME that reports in such detail should be rewarded, as it allows better understanding of the business's success drivers and environmental performance.

Banks' carbon footprint

Reducing GHG emissions and managing the overall carbon footprint is an important aspect of SLLs for banks. The banking sector is vulnerable to transition risks through its financial exposure to borrowers. These risks qualify as transition risks if companies (investees) are affected by biophysical (for instance through deforestation), legal, market or regulatory risks linked to their E&S impacts. These risks become material for a financial institution when they affect the costs, revenues or other financials of the borrowing company. Increased attention from regulators to banks' financed emissions is likely to lead to directives monitoring and potentially regulating financed emissions of banks in the medium term. Preparing for such future regulations is an important step for banks' risk departments.

Ranking client ESG performance

This section describes the final assessment step – ranking the client ESG performance based on answers to the three indicators of risk management, performance and reporting presented above.

To facilitate the implementation of ESG questionnaires, simple "Yes/No" answers are proposed to help the bank officer verify the requested evidence. In the sample SME questionnaire on the following page, the calculation steps are summarized as follows:

- A "Yes" answer on the risk questions indicates lack of evidence for compliance. The answer scores 10 points (the higher the number of points, the lower the rating).[15]
- A "Yes" answer on the KPIs and the reporting questions indicates some certification and compliance. The answer scores zero points (the lower the score, the better the rating).
- All three areas receive a score between zero (good) and 10 (bad). The three scores are weighted to generate an overall score, also between zero and 10.
- In a range from zero (good) to 10 (bad), the company scores 7 for risks; 5 for KPIs and 7 for reporting with a weighted overall score of 6.2.[16]

15 Where there is no information, the question is answered "No".
16 Weighting calculation in this example: 7*40% + 5*40% + 7*20% = 6.2

ESG Risks			
Drivers	Evidence Available	Weight	Score [0-10] Yes = 10
Direct / Indirect deforestation or protected sites (negatives news)	YES/NO	30%	10
Compliance with regulatory requirements (no fines)	YES/NO	20%	10
Land title management (no legal disputes)	YES/NO	30%	0
Working conditions (negative news/illegal pratices)	YES/NO	20%	10
ESG risk subrating			7

ESG KPIs			
Drivers	Evidence Available	Weight	Score [0-10] Yes = 0
Water management - ESG standard certification (website)	YES/NO	30%	0
Laor rights - ILO conventions compliance (policy in the website)	YES/NO	20%	0
Fertilizers - Low intensity of use (balance sheet or P&L)	YES/NO	20%	10
Waste management (balance sheet or P&L)	YES/NO	20%	10
Good governance (website)	YES/NO	10%	10
ESG KPI subrating			5

ESG Reporting			
Drivers	Evidence Available	Weight	Score [0-10] Yes = 10
ESG KPIs publicly available (website)	YES/NO	30%	10
ESG policies and yearly results publicly available (website)	YES/NO	30%	0
ESG results audited yearly by independent 3rd party (website)	YES/NO	40%	10
ESG reporting subrating			7

Analysis of results

In this example, the SME is a risky company from an ESG perspective:

- There are doubts over its supply chain business partners, who may be involved in illegal deforestation or working practices.
- It has received a fine from the government due to waste mismanagement.

On the other hand:

- The company is certified on water management, an encouraging sign of its low environmental impact.
- The company reports complying with International Labour Organization conventions, going beyond regulations.
- The company also reports yearly ESG results on its website.

The final score ranks the client as either sustainable, normal, below average (laggard) or unacceptable.

Mapping of ESG Score to Rating										
Client ESG Rating										
0	1	2	3	4	5	6	7	8	9.5	10
S		N					L			U

The client ESG score is scored as follows:

[0 – 1.99]	–	Sustainable client
[2 – 6.99]	–	Normal client
[7 – 9.50]	–	Below average / laggard client
[9.51 – 10]	–	Unacceptable client

A simple ranking system can lead to an over-simplification of information. However, it is recommended to allow automatization of results and avoid incurring high costs for banks with a large SME portfolio.

A small percentage of clients may be directly or indirectly[17] responsible for illegal logging and deforestation, or directly imposing working conditions that are breaking the local laws and regulations.

These SMEs will be flagged as "unacceptable"[18] (scoring between 9.5 to 10) until they improve their performance.

17 Through their suppliers down the supply chain.
18 For instance, if the company or its suppliers are under criminal investigations for illegal logging/deforestation activities or if they have been denounced by prominent national and/or international 'watchdogs' or if the bank determines that illegal deforestation activities have occurred based on satellite images analysis.

4. ANALYZING AND RATING THE PURPOSE OF A LOAN

In addition to analyzing and rating the client's ESG factors, it may be necessary to review the use of the loan proceeds, particularly when the loan relates to asset development. This section describes how to analyze and categorize a loan's proceeds in relation to its ESG impact for the purpose of an SLL.

When is it necessary to rate loan proceeds?
In the framework of an SLL, only loans related to asset development require rating, in addition to the client ESG assessment. A new asset has the potential to achieve positive or negative environmental and social impacts that are independent from the client ESG profile.

Examples of loan purposes that may trigger a change in SLL ratings:

- Acquisition or development of a new commodity plantation;
- Acquisition of livestock;
- Significant change/upgrade to water distribution systems;
- Significant change/upgrade to a core production process (e.g., water irrigation in a rice plantation);
- Acquisition of energy-efficient equipment;
- Acquisition of equipment that allows more efficient use of fertilizers;
- Any other purpose that may materially affect the ESG performance of the SME (e.g., leasing of equipment that materially changes the operations).

When the loan is not asset-based or does not impact a core process that would affect the environmental and social performance of the company, the loan ESG rating is automatically defaulted to the client ESG rating. If the client rating was negative or unsustainable, the loan will not be extended, or extended only with a change in general business practices.

Example 1
Borrower: Palm oil company in Indonesia. The company has a pending lawsuit related to allegations of illegal deforestation. The company has also received complaints from local communities for mismanagement of waste disposal leading to river pollution.
Loan: Revolving credit facility with generic purpose (working capital management)
Analysis: In this case, the loan is used for normal day-to-day operations of the business, without leading to a meaningful change to operations, with potential negative impacts. The environmental or social implications of the use of loan proceeds do not affect the ESG rating. The rating remains based solely on the client ESG rating and is likely to be negative.

Example 2
Borrower: Soy farm in Vietnam. No information related to E&S violations is provided but there is some information indicating significant positive E&S impacts produced by the company.
Loan: Capital expenditure is linked to an upgrade of the farm's water distribution system and the acquisition of equipment to improve the efficiency of spraying fertilizers.
Analysis: The environmental or social implications of the use of the loan proceeds are significant in this case, as the loan is used to reduce the size of the company's water and fertilizer footprint. As wastewater and fertilizer use are two key environmental impacts generated by company operations, the loan can be disbursed, conditional on demonstrated improved environmental performance.

19 For efficiency reasons, the KYC/CDD process is always the first process to be performed. If there are any compliance issues, the SME will be ineligible for loans and no further assessment process is necessary.

Example 3

Borrower: SME rice producer in Vietnam. The company is looking to sustainably certify 50 percent of its plantations by 2021 and reach complete certification by 2023. The company wants to set annual targets and publish its environmental and social achievements on its web site.

Loan: Revolving credit facility with generic purpose (working capital management)

Analysis: Environmental or social implications of the use of loan proceeds are small, as the loan is used for the business's day-to-day operations. However, by becoming a sustainable producer, company performance will have positive environmental and social impacts. In this case, the revolving credit facility loan has the potential to be linked to the company's environmental achievements.

Categorizing loans

It is advisable to let the bank set its own thresholds for an objective assessment of what is considered a significant change or upgrade. However, depending on the size of the company, a loan that alters a core business process or production of assets by 20 to 30 percent is considered significant in changing the overall performance of a company.

The loan will be categorized as:

- A loan where the proceeds are used to improve or acquire processes and/or assets that may have positive (or negative) environmental impacts.

or

- A loan where proceeds are used for purely financial management (e.g., working capital or credit card overdrafts) and has no consequence on processes and assets of the company, with no environmental impacts.

Several types of loans may be included in the first category.

Loans for renewable energy assets

Where the proceeds are used to purchase a renewable energy asset, the loan is automatically considered a "sustainable loan", triggering a rating upgrade and subsequent interest rate discount (more information is provided in the following section on pricing). For example, SMEs may invest in the production of energy (wind, solar, landfill gas, biomass) to take advantage of tax incentives.

Loans for project finance or project finance supply

SMEs do not usually have the required equity to borrow in a large project finance transaction supported by commercial banks, but they may be suppliers to projects being built by a Special Purpose Vehicle. An SME can then be assessed by the types of projects it is supplying, as part of the client ESG assessment. For example, the SME should only supply to projects compliant with International Finance Corporation performance standards.

Loans for acquisition of sustainable assets

When a commercial bank extends loans to medium-sized companies where the use of proceeds is known, such loans may be labeled as secured loans, as they have a tangible collateral. For medium-sized companies, secured loans are usually for mortgages (factory, commercial property or land purchases), equipment purchase or vehicles needed for the business to operate.

Secured loans that purchase "sustainable assets" may be eligible for a rating upgrade. The following list of equipment, vehicles or processes may be defined as sustainable assets:

- Reducing fertilizer use through innovative equipment;
- Increasing availability of clean water through treatment or to establish more efficient water processes;
- Increasing energy efficiency (equipment);
- Reducing waste through reuse or recycling;
- Using low-carbon company transport with significant improvement in fuel efficiency or zero-emission vehicles;
- Positive environmental impact through certified commercial real estate;
- Establishing a circular business model (to be demonstrated by the company).

All the above loans will need to demonstrate performance in terms of emission reductions and savings produced for the company (e.g., electricity bills).

Assessing the environmental performance of loans

This section provides guidance on how to measure the environmental impact of loan proceeds.

Loans to purchase assets that significantly reduce greenhouse gas (GHG) emissions, increase resource efficiency or reduce the company's waste will be eligible for a rating upgrade. The change in environmental impact can be measured relative to the existing performance of the company, taken as the benchmark.[20]

Example 1: Expected impact of energy-efficient equipment purchase

An SME requests a loan for the acquisition of energy-efficient equipment. When entering into the loan agreement, the company will be asked in the contract (representation and warranties section) to track and report two pieces of information to the bank:

- Yearly electricity costs. These are likely to be reported already as it is a basic accounting control.
- GHG emissions from the process where the equipment is used. This information is more complex to track and report. Loan documents will include benchmark indicators and data to be measured. The GHG emission reduction will be calculated in proportion to equipment use.

Example 2: Expected impact of new fertilizer equipment

An SME requests a loan for the acquisition of equipment that enables more efficient fertilizer distribution. The reporting requirements will be:

Business as usual	Metrics	→	New equipment	→	Change %
Fertilizer usage (tons/year/ha)	6.5 tons/year/ha		4.6 tons/year/ha		-29%
Yearly fertilizer costs ($)	2,378,700		1,233,364		-49%

Identifying performance indicators (KPIs)

The type of assets to be purchased will determine the performance indicators set. For example, if a poultry farming business indicates that water usage, antibiotics and manure waste management are the top three priorities, the bank can agree to loans that address those priorities and set relevant performance indicators.

20 The loan performance may be compared against other data rather than previous performance of the company. For example, national statistics can be used (e.g., average fertilizer use per crop, average energy efficiency, etc.), if available.

Indicators should be quantitative and compared against a verifiable and credible benchmark. Upon verification, the results are included in the ESG score and will affect the ESG rating.

Examples of indicator frameworks for land use

The Sustainability Accounting Standards Board has developed a list of key metrics and monitoring topics relevant to land use for financial institutions. The main categories are GHG emissions, energy and fleet fuel management, water withdrawal, land use and ecological impacts, food safety and health concerns. Other sources of indicators and metrics for agriculture and land use are the Task Force on Climate-related Financial Disclosures metrics framework and the Greenhouse Gas Protocol Agriculture Guidance.[21]

Three possible outcomes for the ESG assessment of a loan are:

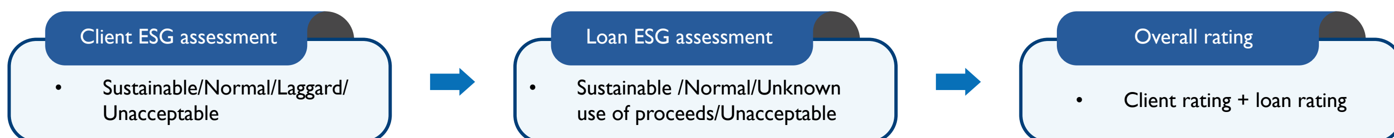
"Sustainable" Loan	Loan with asset-based purpose The company reports the environmental performance of the asset financed yearly, Or There is a positive change between the performance at the benchmark and the performance with the asset operational.
"Normal" Loan	This loan has an asset-based purpose but: Does not report annual environmental performance of the asset, Or The asset performance is neutral when compared to the benchmark.
Unacceptable	The loan is not asset-based (unknown use of proceeds), Or the loan purpose is known and breaches the ESG policy of the bank, Or the asset performance is negative when compared to the benchmark.

Applying a combined loan/client ESG rating

This section describes how to combine the client's ESG rating with a loan ESG rating to obtain an overall SLL rating. The methodology uses four possible grades, which can be applied to both the loan and the client assessments, resulting in 16 possible outcomes for the loan/client rating. This grading allows fast implementation and is understandable by the bank's front office and risk departments.

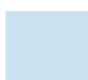
21 Source: https://materiality.sasb.org/; https://www.tcfdhub.org/Downloads/pdfs/E11%20-%20Agriculture%20-%20metrics.pdf; https://ghgprotocol.org/agriculture-guidance

Rating process summary



Client \ Loan	Sustainable	Normal	N/A (unknown use of proceeds)	Unacceptable
Sustainable				
Normal				
Laggard				
Unacceptable				

A pricing reward may be assigned, with different levels of reward depending on the combination of grades. For example, a sustainable client and sustainable loan would trigger a larger interest rate decrease than the combination of sustainable client and N/A loan.



No pricing changes are triggered due to insufficient ESG reasons.

A pricing increase may be assigned due to poor ESG performance.

A more granular approach can be implemented by the bank once field-tested, in conjunction with evolving regulations.

Key clauses in an SLL loan agreement

When incorporating ESG performance into an existing loan agreement, it is recommended to change the agreement as little as possible. A key point to include is how the bank reserves the right to vary the interest rate applied to the loan based on documentation and verification of ESG performance. The agreement should be amended to include clauses that cover potential disagreement on ESG milestones and measurements, including:

- Audit process to be performed by a third party with duty of care towards lenders;
- Quantitative targets of ESG performance to be achieved;
- Frequency of verification and timing of reporting;
- Acceptable form(s) of evidence that can trigger an interest rate adjustment.

Another important point to include is that the bank reserves the right to require an audit of SME operations, specifically, ESG indicators. Whether or not the bank exercises this right, this clause increases the likelihood of accurate SME reporting and deters "green-washing" – the practice of reporting fake or exaggerated ESG performance to achieve a lower cost of debt.

5. IMPLEMENTING A LOAN-PRICING SYSTEM

This section describes how to design a pricing system for SLLs and implement price adjustments during the loan tenure.

The methodology is based on the client's ESG baseline assessment and a variable interest rate calculated on the ESG performance of the loan, measured annually. The combined client/loan ESG rating is linked to the overall credit risk rating of the loan, which in turn is linked to the loan pricing system. Improved ESG performance reduces the bank's risks and is rewarded by a discount in interest rate over time.

In summary, SLL pricing is defined by the following steps:

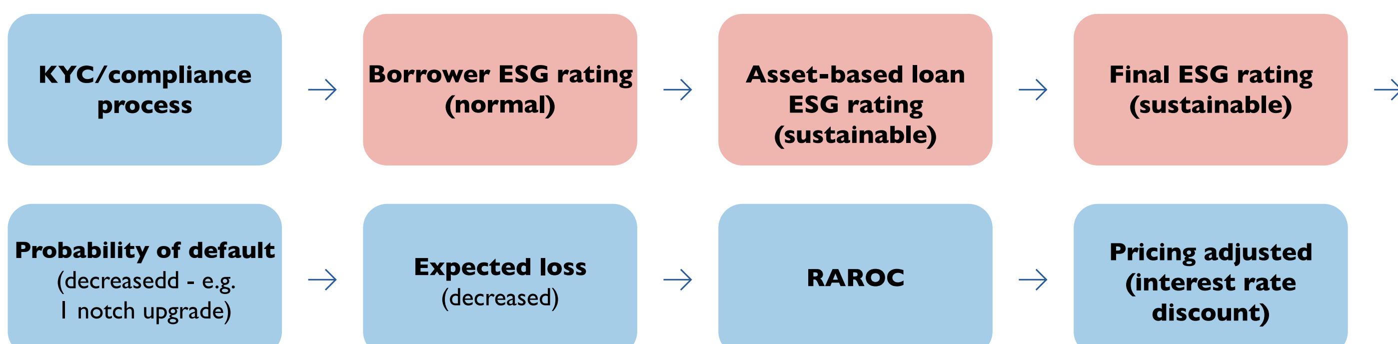
- The bank assigns an ESG rating to the loan;
- The bank links the interest rate of the loan to the usual parameters of risk and to the borrower's ESG performance;
- The bank links the interest rate of the loan to the loan ESG performance (ESG milestones reached by the borrower through its use of the loan proceeds);
- The bank defines precise interest rate triggers as a function of the borrower ESG rating.

Adopting an entirely new pricing system is complex for banks, as it imposes significant financial investments in IT and potential operational risk during the transition period. However, using the following methodology, the bank process chain between borrower, loan credit rating and interest rates will remain unchanged, with little impact on operations. The approach relies on an initial calibration of the pricing system that will only slightly affect the risk-adjusted return on capital and – at the same time – still deliver accurate and market-based pricing, including the new ESG information available (borrower's and loans' ESG ratings).

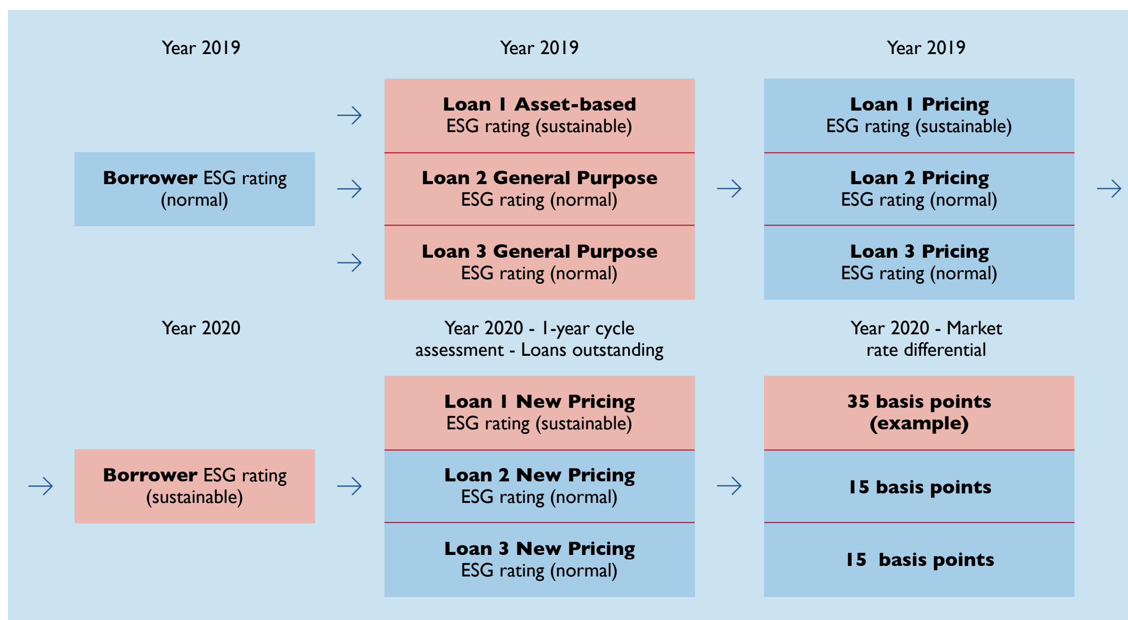
Process for interest rate adjustment

The following example depicts the most common situation where a client (borrower) has a "normal" ESG rating and a loan rated "sustainable." This information will contribute to the estimated expected loss of the loan, and therefore affects the risk-adjusted return on capital (RAROC) calculation, ultimately affecting the interest rate pricing applied to the loan.

The pink boxes indicate a new process for the bank, integrated into existing processes (blue boxes).

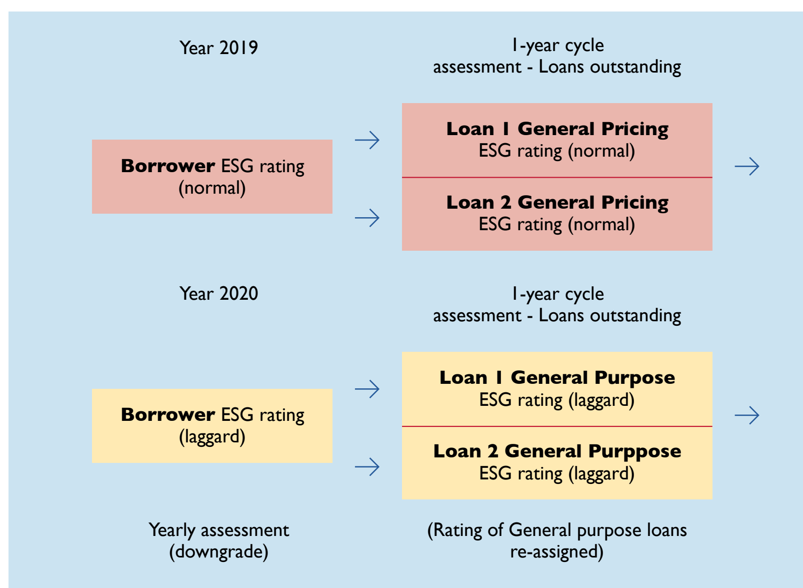


The example below shows a company with two general purpose loans and one asset-based loan over a two-year loan period. The asset-based loan has the potential to improve the company's environmental performance, thereby upgrading the company's ESG rating from normal to sustainable in the following year. This reduces the price of all outstanding loans.



The same process applies in reverse if the ESG rating of the new asset-based loan triggers a downgrade or if the client ESG performance worsens. In the example below, the borrower's ESG rating is downgraded from normal to laggard after the mandatory annual KYC assessment is completed. The process may trigger a pricing increase as a consequence.

In this case, both the borrower's ESG rating and all general-purpose loans' ESG ratings are downgraded. Although the company's loans are unchanged in terms of financial structure and purpose, their credit ratings may be also downgraded.



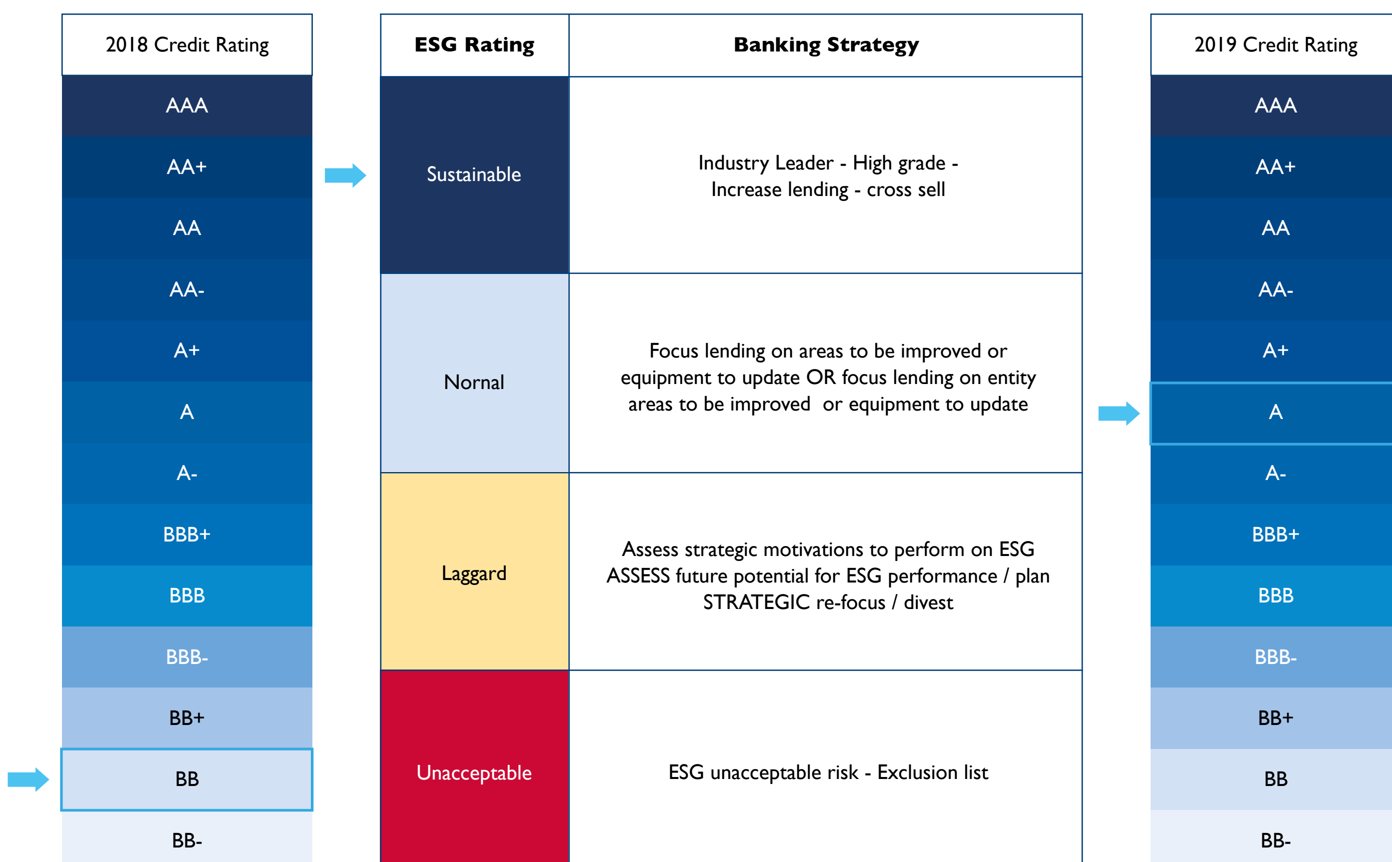
Process for price adjustment using credit risk ratings

A change in the loan may affect RAROC and risk-weighted assets calculations leading to the pricing to be adjusted. This methodology proposes, instead, that the combined ESG rating associated with the loan rating slightly affects the borrower's Probability of Default. This will, in turn, affect the Expected Loss linked to the loan. The Expected Loss is derived as the product between the Probability of Default of the borrower, the Exposure at the moment of Default and the Loss, given that a Default occurs.

The following example demonstrates how a change in credit risk rating can affect interest rate pricing.

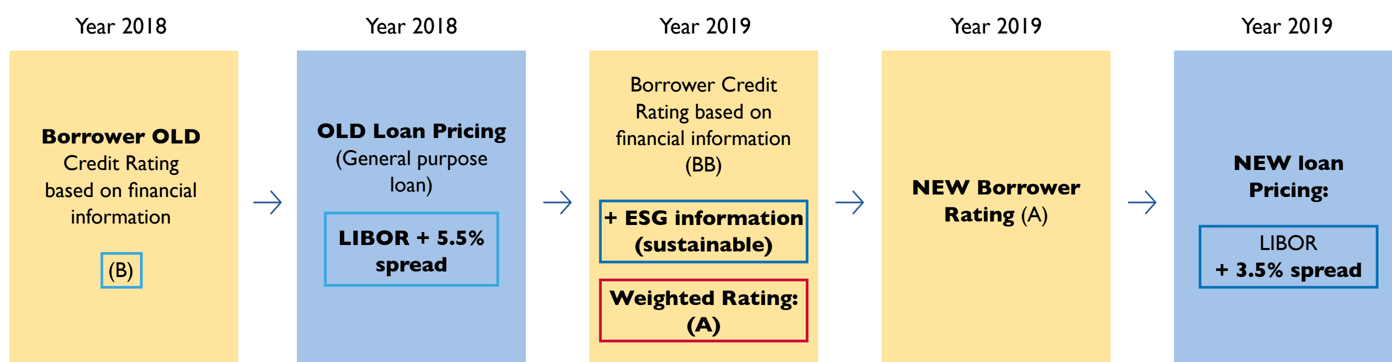
The SME has a credit rating of "BB," based on its 2018 standalone financial information in the bank system. In 2019, as part of the KYC renewal, the SME is given an ESG rating of "sustainable." The new ESG assessment gives a new credit rating of "A" to the SME, as a weighted average of the credit and ESG ratings, assuming the credit rating remains "BB" in 2019. The weighted average can be calculated in several ways, the simplest being the assignment of a percentage of the overall rating to the ESG rating, for example, the bank decides the ESG rating will weight 30 percent of the overall rating.[22]

As the company has only one general purpose loan in place, the weighting assigns a new credit rating of "A" to this loan. The loan interest rate of an "A" credit rating is expected to be lower than the interest rate previously assigned when the company was rated "BB."



22 Some credit rating agencies (e.g. Moody's Corporation and Standard & Poor's) are considering weights in the range of 10 to 30 percent for the ESG component. In the initial phase, it is advised to let the bank weight ratings according to its business model.

The following graph summarizes how changing the internal credit risk rating will potentially affect the interest rate, across a two-year rating cycle.

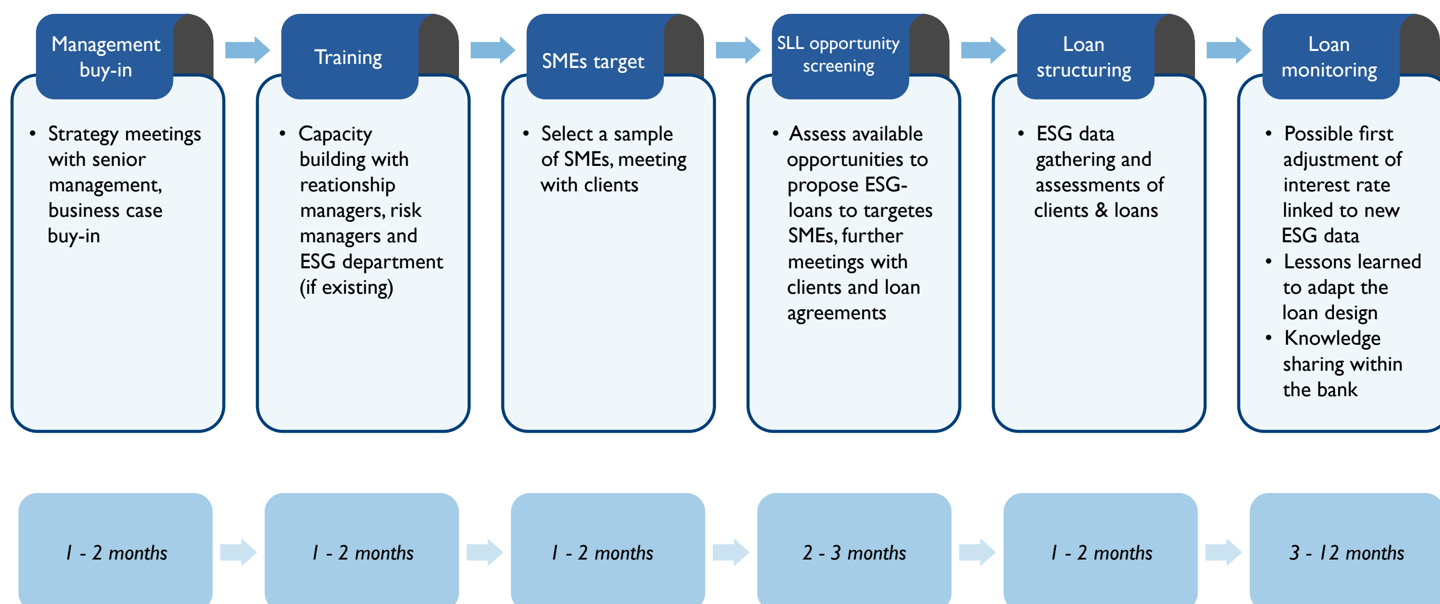


CONCLUSION

SLLs are a flexible product enabling banks to develop their internal ESG capacity and grow a portfolio of ESG-compliant loans. The approach proposed in the guidelines focuses on low-transaction costs, alignment with existing lending processes and progressive integration into bank systems.

Estimated timeline for SLL piloting

Realistic implementation planning must consider legal and operational constraints such as available human resources, capacity-building needs, interest rate premium/discount integration into contracts, regular risk evaluation and development of a pipeline of companies willing to pilot this new loan product.



USAID Green Invest Asia has developed a training curriculum and a set of case studies available to banks in Southeast Asia, and offers capacity building support for SLL piloting, available upon request. For more information, please contact info@greeninvestasia.com.