



WHITE PAPER

# EMBRACING ESG

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The true meaning for lenders

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## What does ESG mean to your lending business?

Three letters. Four words. A whole range of implications for financial markets. In the lending industry, as in most other sectors, environmental, social and governance (ESG) is a hot topic and an increasingly burning priority. But how you view that priority can vary from business to business.

As the world makes faltering attempts to protect the natural environment, drive social equality and ensure corporate responsibility, ESG principles have emerged, fundamentally, to help individuals and companies do the right thing.

However, with human nature as it is, we need laws to make principles stick. So, it's only been a matter of time before regulations enter the frame to turn ESG intentions into a hard and fast set of rules.

For lenders, regulatory requirements for ESG are already taking shape, if not effect, around the world. Driven by regulatory bodies like the European Banking Authority (EBA), new guidelines highlight the importance of including ESG factors in your internal risk strategy and policies, as well as in the calculation of customers' creditworthiness.

## The compliance challenge

Currently, lending regulation is putting most emphasis on the environmental side of ESG and is essentially asking firms to show they are greening their portfolio and lending to more sustainable businesses.

Over the next decade, regulators' requirements will change what it takes to be a creditworthy customer. Some of today's strongest orgs are sure to lose their AAA rating and preferential rates if they don't change their business model and move away from selling – or even heavily using – fossil fuels. And with loan time horizons typically stretching to 10 years and beyond, the time to start factoring ESG into credit assessments is now.

For consistency with the European Green Deal and the Paris Agreement, the EBA has recently published its final draft of the “implementing technical standards” (ITS) for Pillar 3 ESG disclosures. The final draft ITS addresses comparable disclosures to show how climate change may aggravate other risks within an institution's balance sheet. It also shows how institutions are mitigating these risks – and improving their ratios, such as the Green Asset Ratio (GAR) – on exposures financing taxonomy-aligned activities.

In essence, this gives financial and lending institutions a blueprint for embedding ESG considerations into their risk management practices, their overall business model and, notably, their governance – the G in ESG. It hence goes a step further than the EBA's Loan Origination and Monitoring Guidelines, which simply set out how banks should capture ESG information.

In the U.K., plans are also afoot to make every corporation calculate a baseline carbon footprint and show the steps it is taking and the progress it is making to become carbon neutral by 2050.

In short, there will soon be hard targets to hit and another raft of detailed data to report. Understandably, then, lenders are now turning their attention to the most immediate challenge – compliance with short-term regulatory requirements and how to achieve it as efficiently as possible.

But ESG principles deserve more than a short-term, tactical solution. The priority for lenders should be to drive new, more responsible ways of thinking and acting deep into the lending process.



## Why ESG is about more than reporting data

It will be a mistake for lenders to think of ESG as just another regulatory calculation to make and reporting duty to fulfill. That's exactly what many firms did with Basel II, which like ESG transformed the way we look at credit.

Before Basel II, a huge variety of loans attracted the same capital charge and the calculations were relatively simple. Suddenly, banks had to start classifying their deals at a much more granular level, which drove them to view Basel II as mainly a calculation project.

Only after building the right algorithms did many banks realize that they didn't have all the numbers they needed to make their capital calculations. They then invested heavily in systems that would add in the vital data before it reached the calculation engine. But this process could take days or even weeks – and with regulators now wanting the data on a daily basis, all that investment quickly became redundant.

What the banks should have done, and only a handful did, was transform their lending process to onboard all the right credit data from the outset – while they were assessing and making their deals, not after the fact.

The same needs to happen with ESG. It shouldn't be seen simply as a calculation project, a risk model project or even a data project. It's about embracing the sentiments of ESG and building the framework, processes and controls you need to make the right lending decisions every time, based on all the right ESG data.

## The process challenge

The key to embracing, not just reporting on, ESG is to embed its principles into your credit policy and, in turn, your lending process. Throughout the lending life cycle, every deal – and how you price, score and service it – must take ESG into account, reflect your risk appetite and help you meet your internal, as well as regulatory, targets for ESG.

How green do you need your portfolio to be and by when? What ESG criteria are you going to base your credit assessments on, above and beyond the usual financials? Will a deal help you achieve net-zero carbon emissions by your target date? These are the kind of questions you should address from the start of the lending life cycle: big questions that only a well-defined credit policy can answer – and a well-designed lending process will make sure you ask.

However, a major part of the process challenge for lenders will, of course, be to pull in the necessary ESG data. Although many banks have already developed an ESG rating methodology for large public companies, there's not much data available to date on the unlisted private companies that make up a large percentage of many loan portfolios.

That leaves lenders with a lot of responsibility for intelligence gathering. While some forward-thinking banks have their own sustainability analysts to research customers and their commitment to ESG, others are charging their loan officers and relationship managers with the task. Without the specialist knowledge or experience required, lenders may struggle to educate their customers on the implications of ESG for creditworthiness, prices and renewals. They could also slow down the lending process with potentially weeks of manual work.

Therefore, as well building ESG into your lending process as a whole, you need to keep that process as automated as possible. And that's where technology comes in.





## How technology can make ESG work for your business

Problems with data, reporting, risk models and risk ratings are all making it hard for lenders to get to grips with ESG. Technology can not only solve these challenges but also glue their management together into one cohesive, efficient process.

It's no coincidence that, alongside advice on ESG, EBA's 2020 guidelines on loan origination and monitoring emphasized the importance of a solid credit life cycle management process, supported by modern IT infrastructure. With a single end-to-end solution for lending, you can define your ESG processes and bring them to life across the loan origination, credit assessment and ongoing monitoring stages of the lending life cycle, while quickly identifying and integrating appropriate data to support human analysis.

A traffic-light system could show if deals are conforming or not to your policies, or a change in workflow might alert you to, or escalate, issues with a borrower from the start. With dynamic dashboard analytics, you could also monitor covenants according to customers' ESG profiles – and, at the portfolio level, see how close you are to meeting or exceeding your own targets.

## Sustainable profits

Ultimately, despite the complexities involved, technology allows you to integrate ESG into the lending process without compromising efficiency. At the same time, the most advanced systems can actively help you balance compliance with profitability and consider the potential impact of deals on margins as well as sustainability.

Built-in capabilities for early warning, what-if projection and optimization allow you to test current lending strategies and policies against your latest view of the markets and all the risk factors affecting your portfolio. As a result, you can identify problem exposures and sectors in time to take corrective action, project concentration risk and then optimize your portfolio for profitability, all in just minutes.

## Build a flexible framework for sustainable finance

However ESG rules and regulations develop, the journey toward sustainable finance is only just beginning. Lenders must therefore take a long-term view and look beyond compliance obligations to find the true meaning of ESG for their business.

The right technology will help you create a framework for managing ESG that embraces its principles, puts them at the heart of all your lending decisions and makes them as integral to your loan process as the assessment of financials and KYC checks. It will also give you the flexibility to evolve your approach as regulatory requirements shift or grow.

Whatever your environmental, social and governance objectives, you can realize them loan by loan and meet profitability targets, too. But you need to make your lending process sustainable first. Speak to FIS® and find out how we can help.

## About FIS

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