Sustainable Finance: Managing Capital, Risk and pricing

IACPM Annual Spring Conference
May 2024

Create more value, make a measurable difference, accelerate the transition to a fair and sustainable future.

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Building a better working world

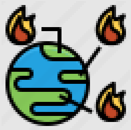
ESG Risks and opportunities for Financing

The introduction of ESG elements in different funding tools is one of the key trends in the world of finance. ESG elements impact the key drivers of finance: client onboarding, information required, risk assessment, capital consumption or pricing considerations.

The impact may be analyzed through two channels: how ESG impacts the risk assessment and how and what opportunities arise from ESG challenges.

ESG ELEMENTS

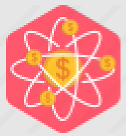
Risks



- Physical
- Transition

Impact on

- Expected loss
- Capital loss
- Pricing



Opportunities

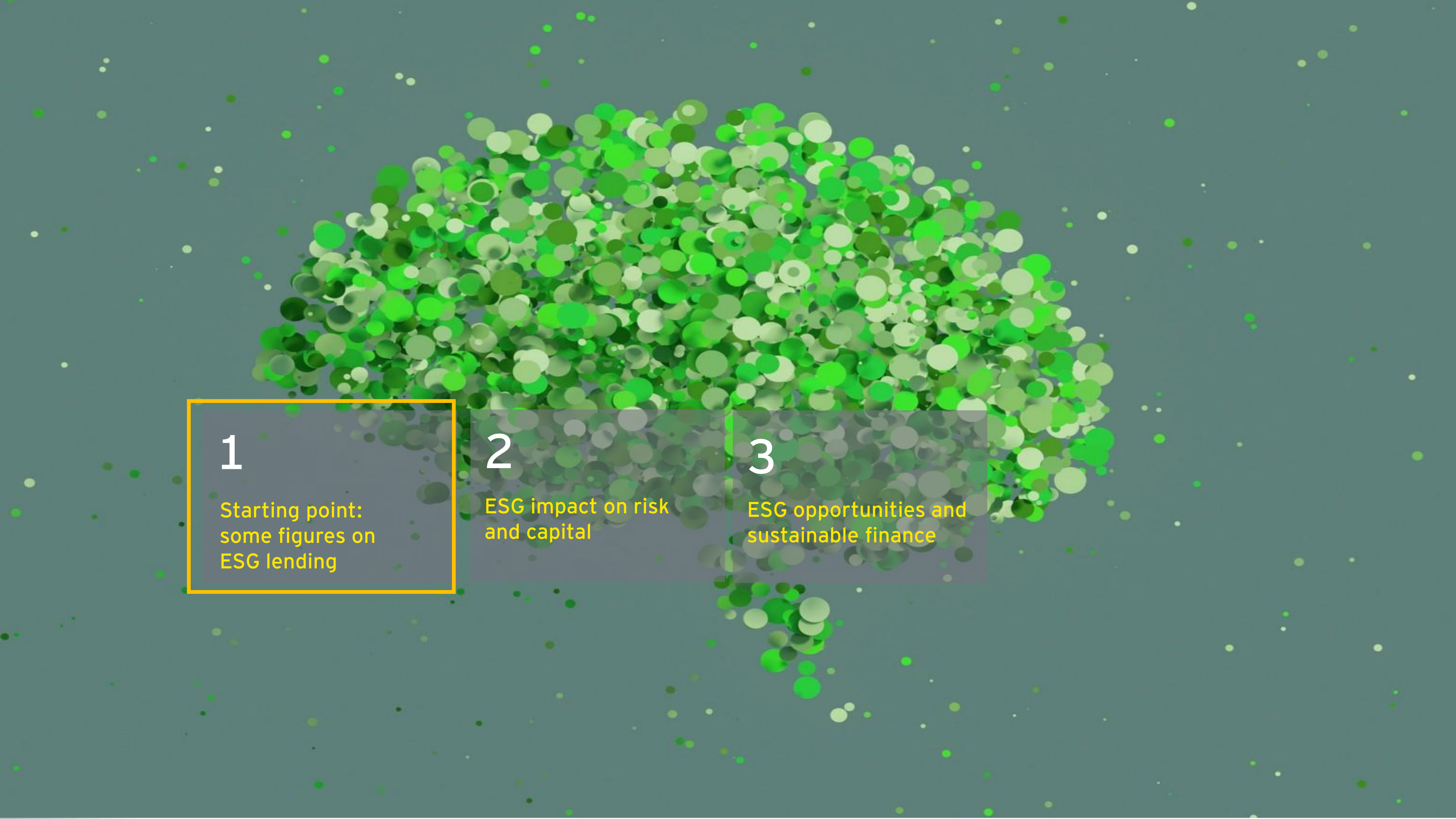
- Transition needs
- Social investments
- …

Impact on

- Sources of funding
- Pricing

KEY TOPICS

- Data
- Tools
- Engagement with clients
- Greenwashing risk
- Material topics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Starting point: some figures on ESG lending
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ESG impact on risk and capital
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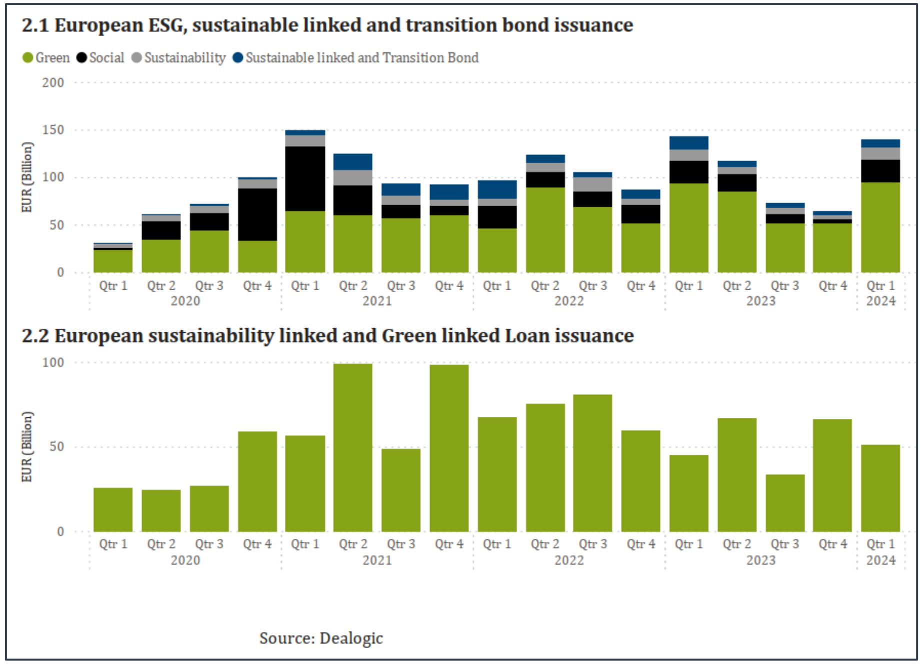
ESG opportunities and sustainable finance

Some figures on ESG lending

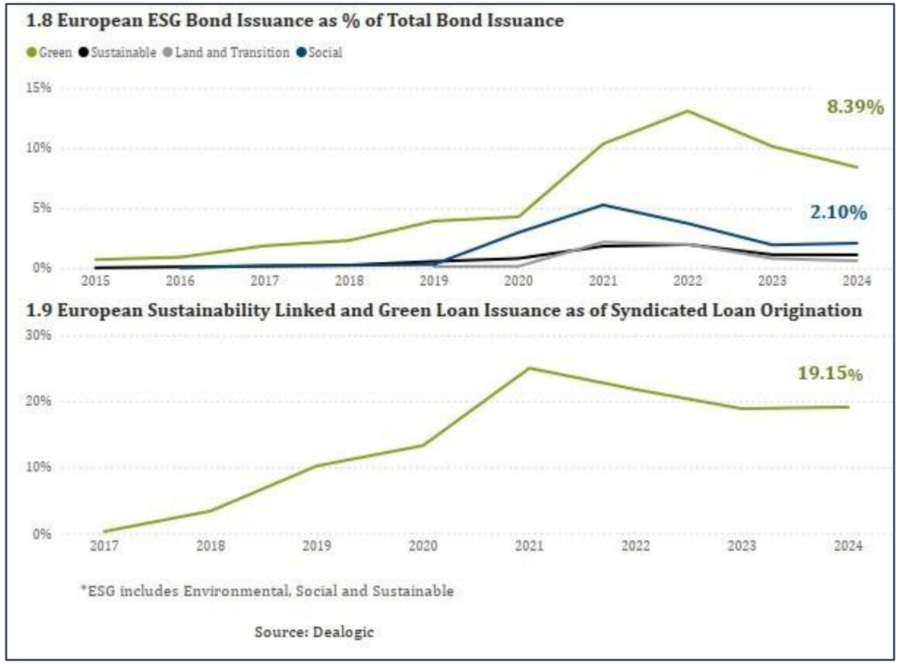
✓ ESG financing has gained a relevant weight within the broader financing activity, through many different forms…

- … ESG bonds (be them Green, Social, or Broad Sustainability) have stabilized in Europe in the environment of 10-15% of total bond issuance…
- … The European Union remains the primary issuer of this type of bonds…
- … and sustainability / green linked loans have reached a percentage of around 20% of total syndicated loans.

ESG Bond and Loan Issuance



% of total issuance / lending



Source: AFME, Q1 2024 ESG Finance Report

ESG and Banks’ balance sheets

✓ In 2024 European entities have began reporting the Green Asset Ratio which intends to measure the percentage of green assets over total assets…

✓ Still, the definition of the ratio has a number of limitations…

- … Not all sectors are eligibile for alignment…
- … Not all the assets are included in the numerator (SMEs, non EU exposures)…
- … As a result, the GAR varies a lot depending on the business model of the entities and its geographical footprint.

- … And it is key that industries that have transition challenges maintain access to financing to cover those needs.

Sample of Green Asset Ratios

Green Asset Ratio		Total (14 entities)		
		Maximum	Average	Minimum
Eligible	Aligned	7,0%	2,3%	0,5%
	Non aligned	55,8%	35,9%	20,0%
Non eligible		78,7%	61,8%	42,2%

Green Asset Ratio		Spain (9 entities)		
		Maximum	Average	Minimum
Eligible	Aligned	4,4%	2,1%	0,5%
	Non aligned	55,8%	39,9%	27,7%
Non eligible		71,8%	68,5%	42,2%

Green Asset Ratio		Europe (5 entities)		
		Maximum	Average	Minimum
Eligible	Aligned	7,0%	2,7%	0,8%
	Non aligned	44,0%	28,8%	20,0%
Non eligible		78,7%	68,5%	49,0%

Source: Own elaboration

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Key material topics for Banks

As a result of a EY study carried out on the materiality analyses reported in 2024 by companies from the banking sector, the following conclusions were drawn:

ESRS E1 Climate change	ESRS E2 Pollution	ESRS E3 Water and marine resources	ESRS E4 Biodiversity and ecosystems	ESRS E5 Circular economy	ESRS S1 Own workforce	ESRS S2 Workers in the value chain	ESRS S3 Affected communities	ESRS S4 Consumers and end-users	ESRS G1 Business conduct
25	4	1	1	0	26	25	7	44	48

ESRS E1
- Decarbonization.
- Sustainable investment and Finance.
- Fight against climate change.
- Sustainable products and services.
- …

ESRS E2
- Pollution prevention and control.

ESRS E3
- Water and hydric resources.

ESRS E4
- Biodiversity and ecosystems preservation.

ESRS S1
- Diversity, equity and inclusion.
- Talent management, development and personal training.
- …

ESRS S2
- Responsible supply chain.
- …

ESRS S3
- Actions in benefit of society.
- Investment with social impact.
- …

ESRS S4
- Experience and satisfaction of clients.
- Digitalization and innovation.
- …

ESRS G1
- Ethics and entrepreneurial conduct
- Transparency.
- Corruption and bribery.
- …

	# mentions
(dark red)	40-50
(red)	20-30
(light red)	1-10
(pale pink)	0

56% of the entities analyzed reported a **double materiality** analysis

Source: Own elaboration

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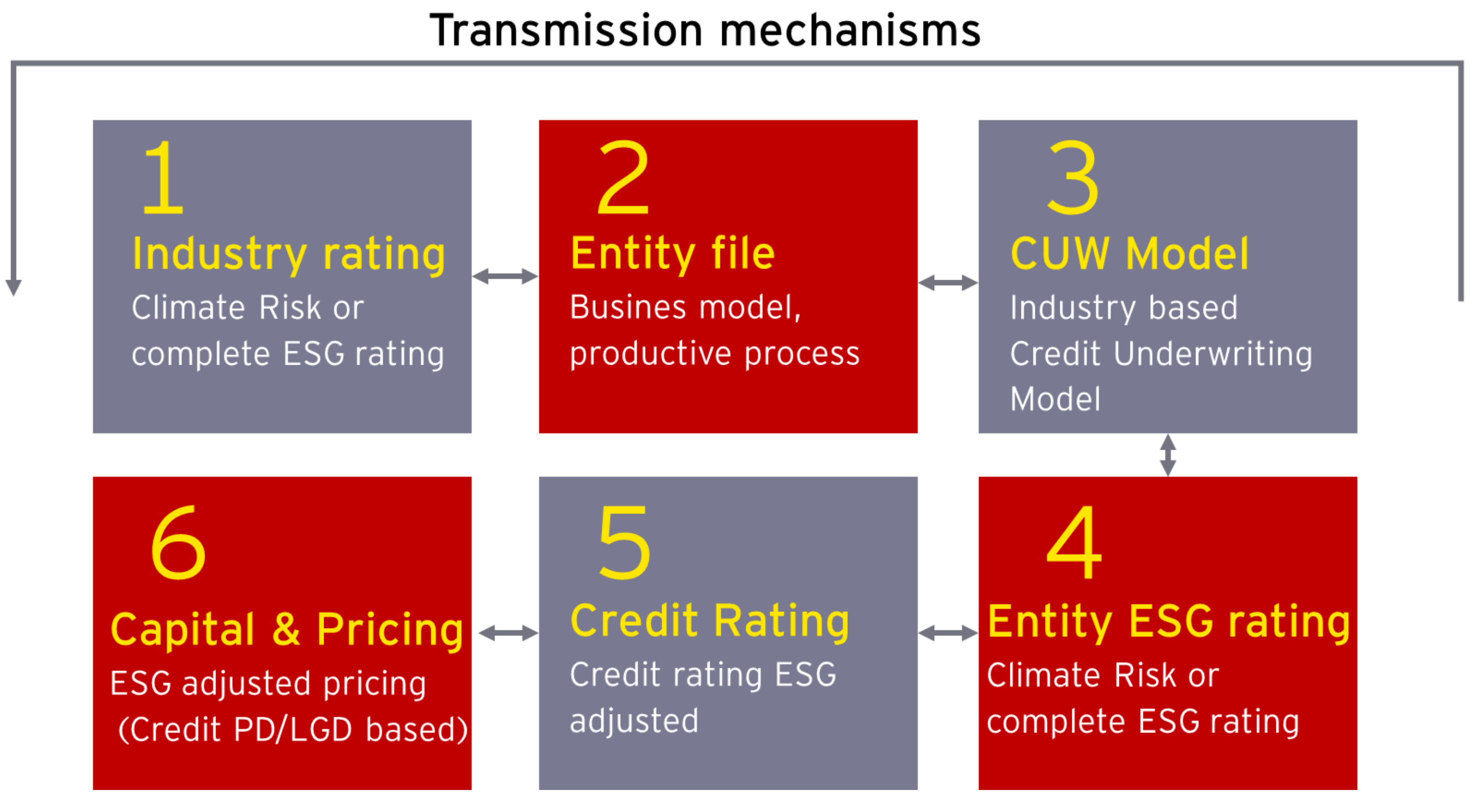
From ESG Risk to pricing

- ✓ ESG risks (physical and transition) impact Banks' through the traditional risks such as credit, market and operational…
- ✓ Banks need to internalice those elements in the assessment of the traditional risks…
- For Loan Origination and Monitoring, entities need to conduct a specific assessment of the ESG Risks of the counterparty that will differ from industry to industry…



Source: Own elaboration

Risk management

- ✓ Banks are increasingly giving more importance to ESG risks…
- ✓ According to the **IIF – EY 2024 Global Bank Risk Management Survey report**, climate risks are among the most relevant risks for the next five years both for CROs and for the Board of Directors.
- ✓ The ECB has also identified a number of best practices on ESG Risk integration.

Chart 1

Stylised visualisation of heatmap results to identify which risk drivers are material

Sector portfolio exposure to physical and transition risk drivers

(size of the bubble indicates exposure at default)

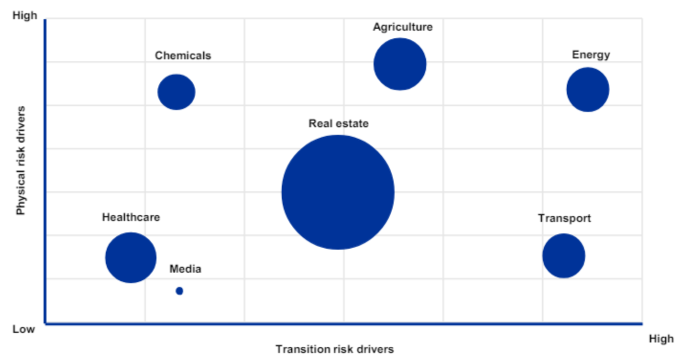


Figure 3: What emerging risks do you believe will be most important for your risk organization over the next five years?

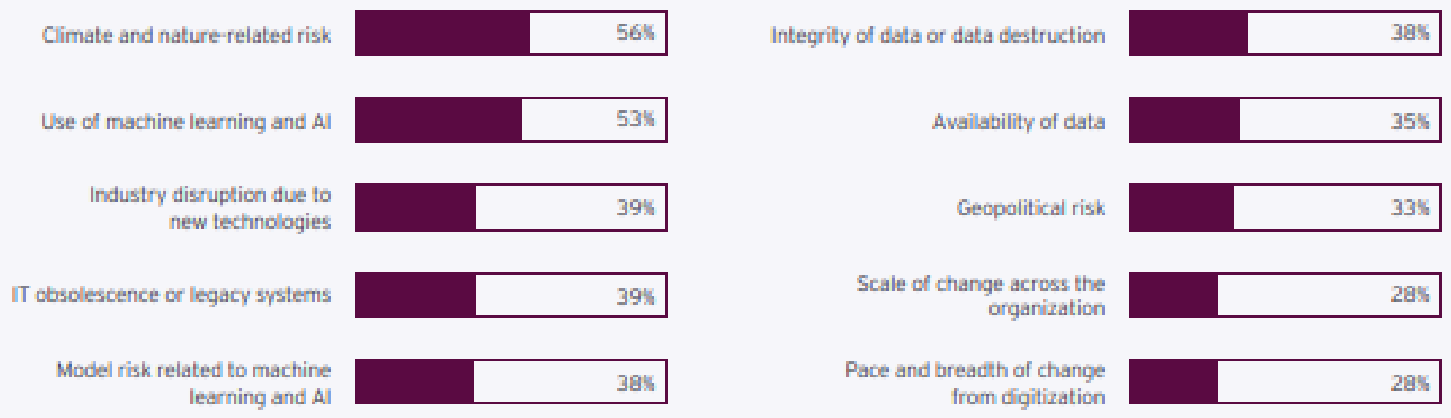
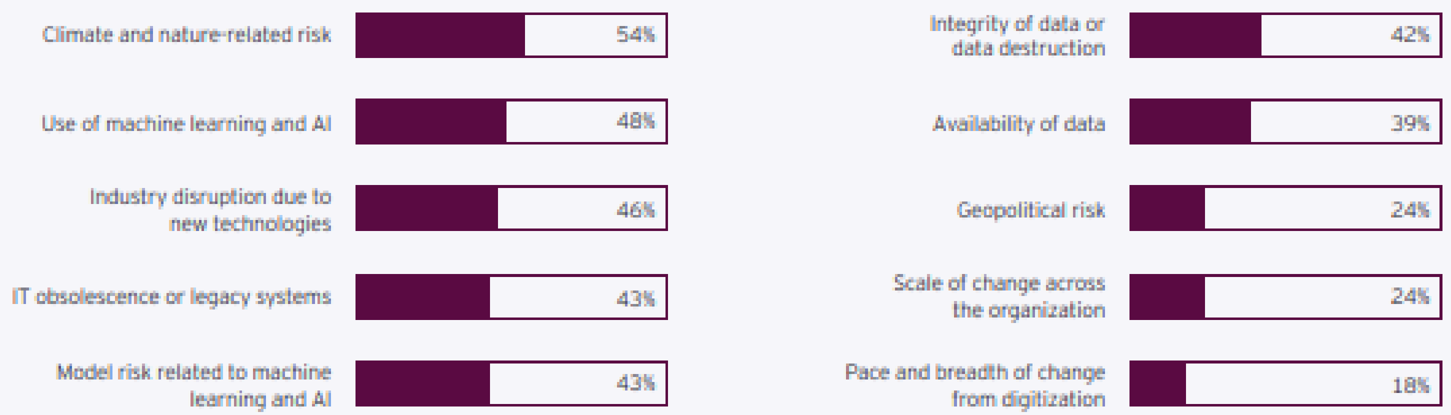


Figure 4: In your opinion, which would be the most important to the board of directors or risk committee of the board over the next five years?



From ESG Risk… to Capital Requirements

- ✓ European Regulators are analyzing how to integrate ESG Risks in capital requiremetns…
- ✓ The order of progress has been…
  - Transparency requirements: pillar 3
  - Ad-hoc requirements: pillar 2
  - General requirements: pillar 1

PRUDENTIAL REGULATION – ESG RISKS

Pillar I — In 2023 the EBA produced a report on how a possible way to modify pillar 1 requirements to incorporate ESG risks.

Pillar II — The ECB has published a guide on its expectations for entities to manage ESG risks; additionally, in 2022 it conducted a climate stress test

Pillar III — In 2022 the EBA published templates on how to report ESG risks in the pillar 3 report.

Source: Own elaboration

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Types of sustainable finance instruments

Green finance and sustainable finance are the main tools that financial entities use to support the transition to a low-carbon, sustainable economy while addressing global challenges, such as climate change and emerging environmental and sustainability risks.

Capital markets

- Sustainable investments
- Green / social bonds

Banking products

- Retail
- Mortgage
- Corporate
- Sustainability linked Loans
- Deposits

Public financing

- Public projects
- Next Gen EU

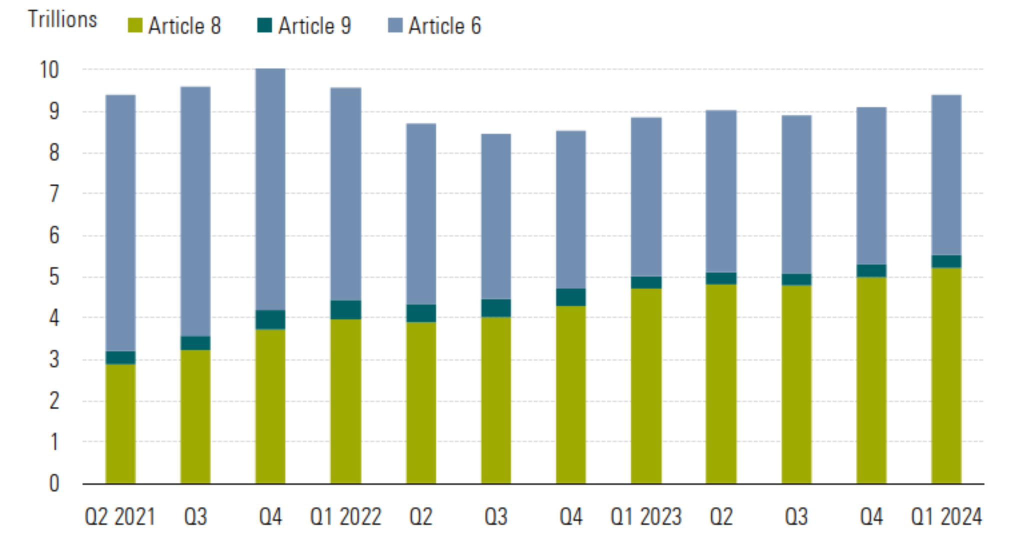
ESG investment keep gaining weight

✓ The EU has passed a regulation (SFDR) requiring to provide detailed information on the sustainability characteristics of Investment Funds. It disitnguishes three types of Funds:

- **Article 6**: Funds without a sustainability scope
- **Article 8:** Funds that promote environmental or social characteristics (light green)
- **Article 9**: Funds that have sustainable investment as their objective (dark green)

Quaterly Asset Breakdown by SFDR Classification

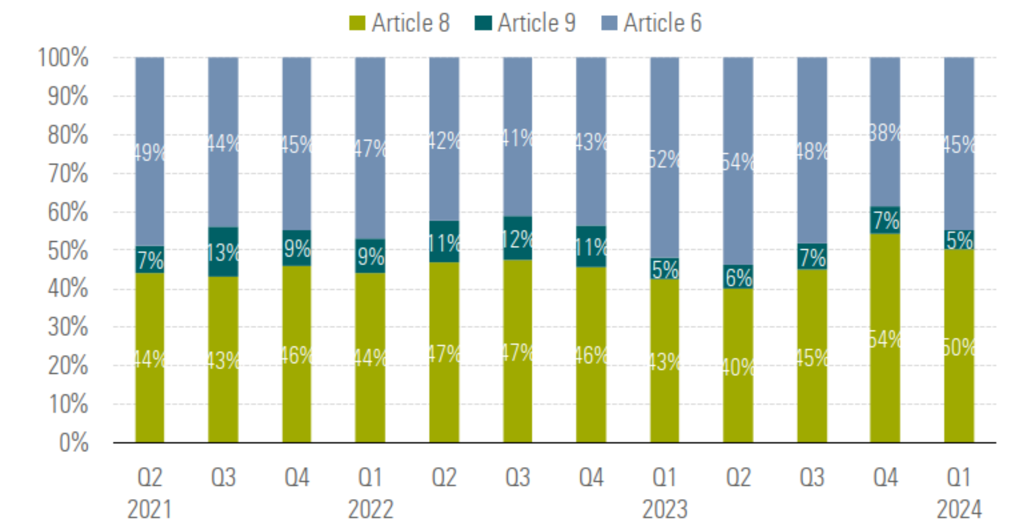
Exhibit 5 Quarterly Asset Breakdown by SFDR Classification (EUR Trillion)



Source: Morningstar Direct. Assets as of March 2024. Based on SFDR data collected from prospectuses on 98% of funds available for sale in the EU, excluding money market funds, funds of funds, and feeder funds.

Quaterly Breakdown of Fund Launches by SFDR Classification

Exhibit 8 Quarterly Breakdown of Fund Launches



Source: Morningstar Direct. Data as of March 2024. Based on SFDR data collected from prospectuses on 98% of funds available for sale in the EU, excluding money market funds, funds of funds, and feeder funds.

Source: MorningStar, SFDR Article 8 and 9 Funds, Q1 2024 in Review

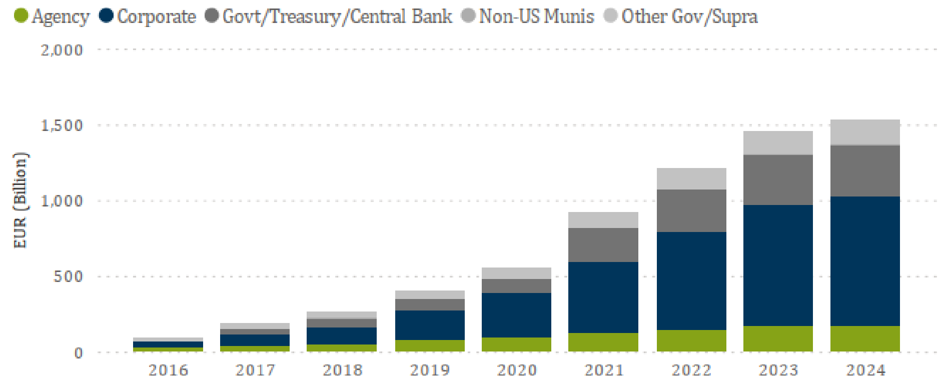
ESG Bonds have stabilized as a key funding instrument

✓ In the EU, the outstanding amount of…

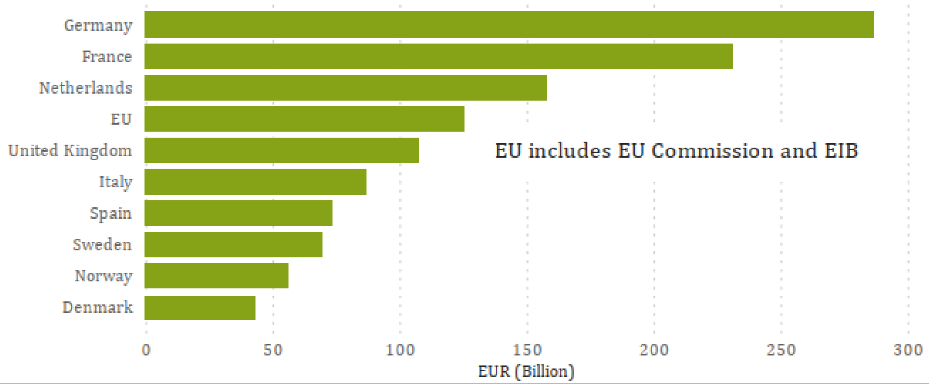
- … Green bonds is close to € 1.500 b…
- … Social bonds is close to € 400 b.

Evolution of green and social bonds in the EU

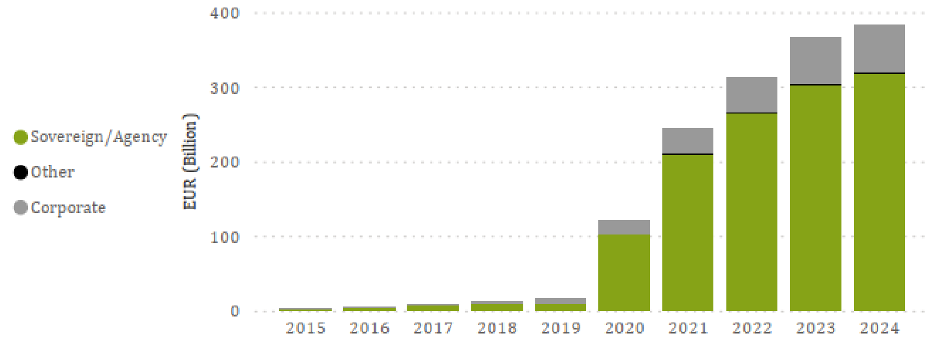
3.1 Evolution of European Green Bonds Outstanding



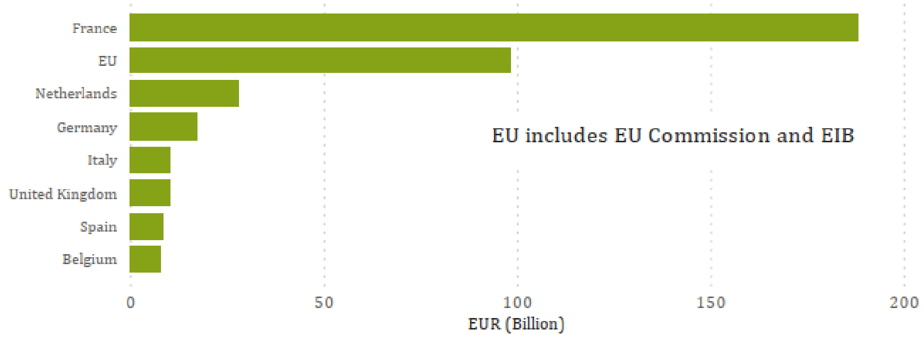
3.2 Outstanding Amount by Country (top 10)



3.9 Evolution of Outstanding



3.10 Social Bonds Outstanding by Country (top 8)

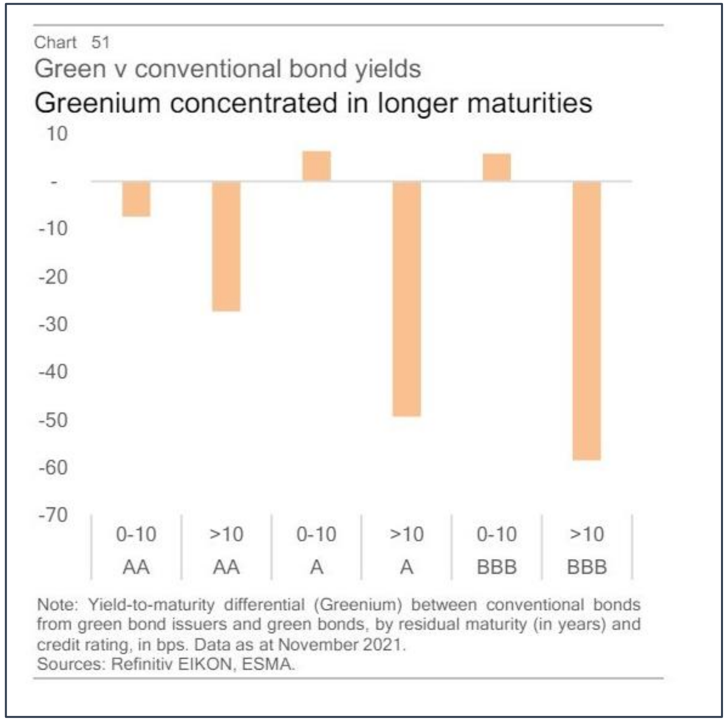


Source: AFME, Q1 2024 ESG Finance Report

ESG bonds – discussion around the "greenium"

- ✓ According to the United Nations Development Programma, the "*Greenium refers to pricing benefits for sustainable debt issuer, based on the logic that investors are willing to pay extra or accept lower yields in exchange for sustainable impact*".
- ✓ Initial estimates by ESMA found evidence of a "greenium" in the European markets,…
  - … even if recent studies are not so conclusive…

Evolution of evidence on "greenium" in the EU



Source: ESMA Report on Trends, Risks and Vulnerabilities No. 1, 2022

Key take aways:_
- ✓ No systematic existence of a Greenium for neither sustainable bond category…
- ✓ ESG bond issuers benefitted from yield discounts in the past…
- ✓ Potential implications for sustainable financing needs

Source: ESMA; Do Issuers benefit from a ESG pricing effect?; October 2023

Banks are developing a number of ESG - products

Banks are developing an increasing number of ESG linked products.

1

Mortgage: green mortgage that links mortgage rates to the green credentials of the home, or ¡, in other words – the greener the home, the lower the mortgage.

2

Cards: calculate the carbon footprint of each customer (individual or corporate) based on day-to-day expenses made with debit and credit cards.

3

Business Loans: provide financing to businesses for eco-friendly projects, such as the installation of solar panels or energy-efficient equipment.

4

Deposits: green deposit where the funds are used exclusively to finance or refinance green projects, such as renewable energy and clean transportation.

5

Project Financing: green Loans for the construction of renewable energy projects typically considered to generate +90% of revenue from renewable energy generation.

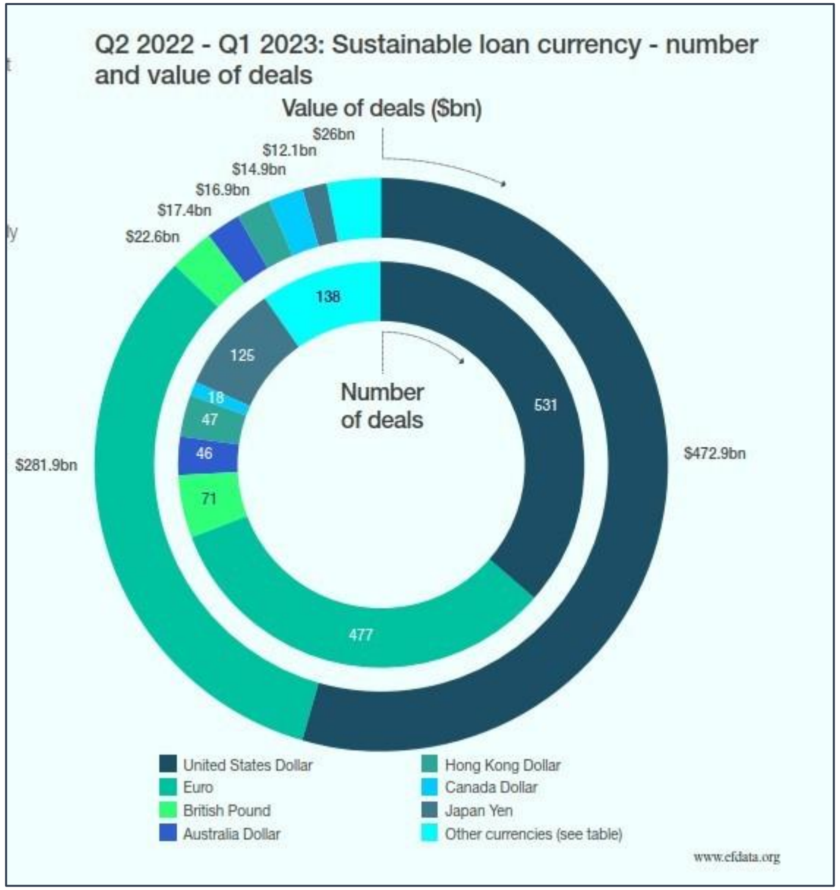
6

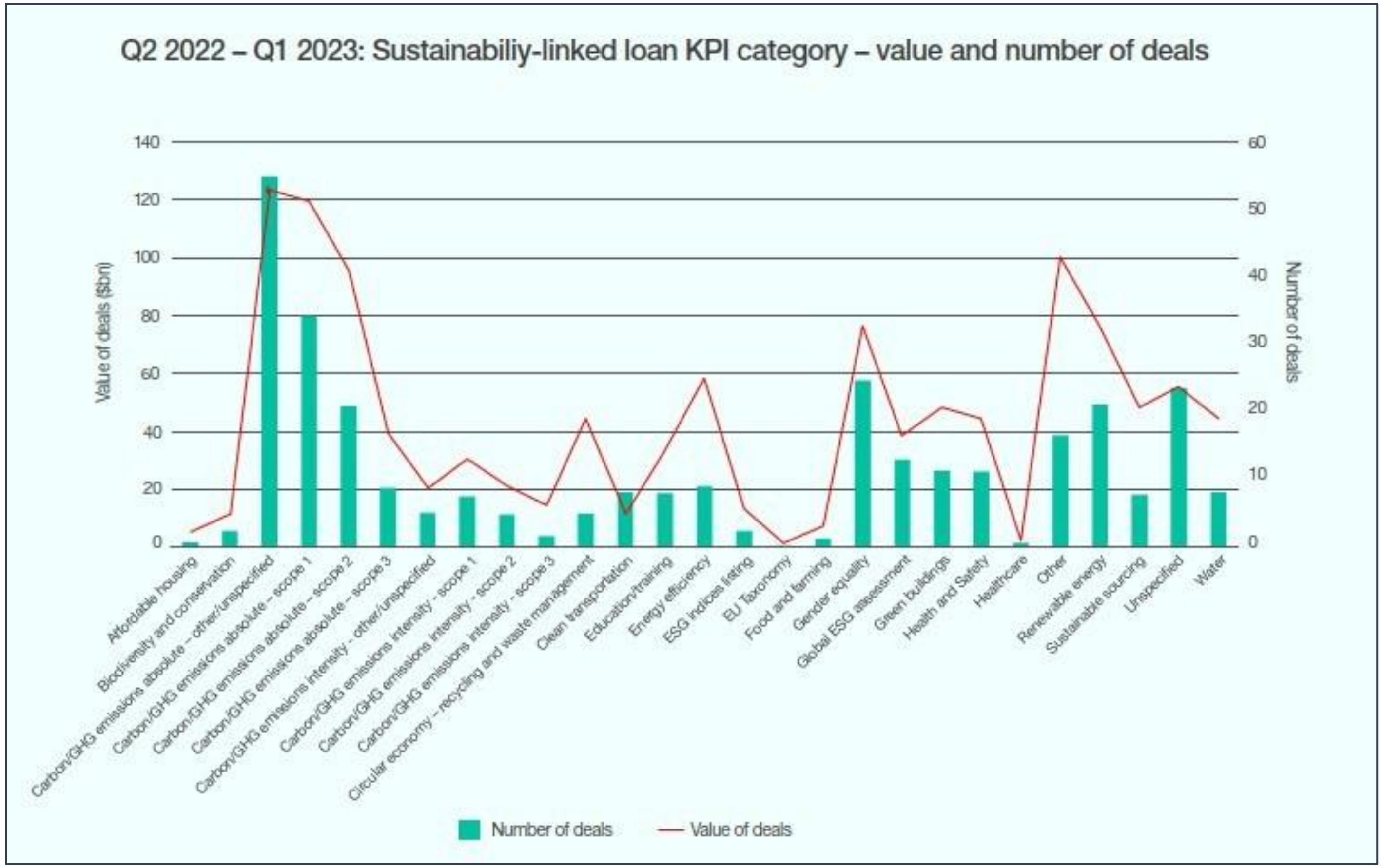
Bonds: green Bonds with capital funded by Institutional investors for projects or companies with "green" activities, typically accompanied by a green certificate confirming the activity.

Sustainability Linked Loans – volumes and typical KPIs

- ✓ **ESG-linked loans** link the pricing of a loan to the borrower’s ESG performance (such as carbon emissions reduction or gender diversity).

Figures on Sustainability Linked Loans





Source: Environmental Finance; Sustainable Loans Insight 2023

Public Funds and ESG

✓ **ESG-linked loans** link the pricing of a loan to the borrower's ESG performance (such as carbon emissions reduction or gender diversity).

Spanish Recovery Plan = 160.000 M€

1 Pandemic Irruption (COVID-19)
COVID-19 had a strong impact on the European economy (2020)

2 EU Response
To respond to this economic impact the EU creates:
Next Generation EU = **800.000 M€**

3 Spanish Recovery Plan: Phase 1
It was approved by the European Commission on July 13, 2021.
PRTR = **70.000 M€**

4 Spanish Recovery Plan: Phase 2
It was approved by the European Commission on October 2, 2023.
PRTR Addendum = **93.500 M€**

ADDITIONAL TRANSFERS = **7.700 M€**
"Reinforce Strategic Projects (PERTE)"

REPowerEU TRANSFERS = **2.600 M€**
"Energy sources diversification, renewables and savings"

LOANS = **+ 83.000 M€**

Instituto de Crédito Oficial — 40.000 M€
- Green (22.000 M€)
- Companies and Entrepreneur (8.150 M€)
- Promotion Social Housing for Rent (4.000 M€)
- Technology NG Startup Fund (4.000 M€)
- Spain Audiovisual Hub Fund (1.712 M€)

European Investment Bank (The EU bank) — 20.000 M€
- Social living place and urban regeneration
- Sustainable transport
- Industrial and development competitivenes
- Sustainable tourism
- I+D+i
- Care economy
- Water and waste management and energy transition

+ 20.000 M€
- COFIDES Inversión y desarrollo
- SEPIDES SEPI Desarrollo Empresarial
- *Other Intermediary Institutions*

Ministerial Orders
- ✓ HFP/1030/2021: Configure the Management System.
- ✓ HFP/1031/2021: Establishes Information Procedure.
- ✓ HFP/55/2023: Analyzes Risk of Conflicts of Interest.

Financial Instruments
- ✓ Financial mediation lines
- ✓ Direct loans
- ✓ Bonds acquisition
- ✓ Capital investments

Beneficiaries
- ✓ SMEs/self-employed
- ✓ Homes
- ✓ Startups
- ✓ Industry sectors

Main Requirements
- ✓ Green Tagged.
- ✓ Digital Tagged.
- ✓ Principle DNSH (Do No Significant Harm)
- ✓ No Fraud, corruption, conflicts of interest.

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Conclusions

Conclusions: Challenges for ESG lending

1. Any linkage to ESG criteria would rely on the availability of accurate, granular and consistent **data**

   …CSRD will be a key step forward in this regard…

   …but tools to make the most of those data will remain essential.

2. **ESG KPIs** will be increasingly integrated in BAU management

   Risk Appetite Framework…

   Loan Origination and Monitoring.

3. **Engagement with clients** will cover more ESG areas…

   Compliance with decarbonization plans…

   Progress in achieving their own ESG goals…

4. **Greenwashing risk** requires explicit management…

   …for conduct reasons…

   …market protection…

   …and progress towards green transitioning.

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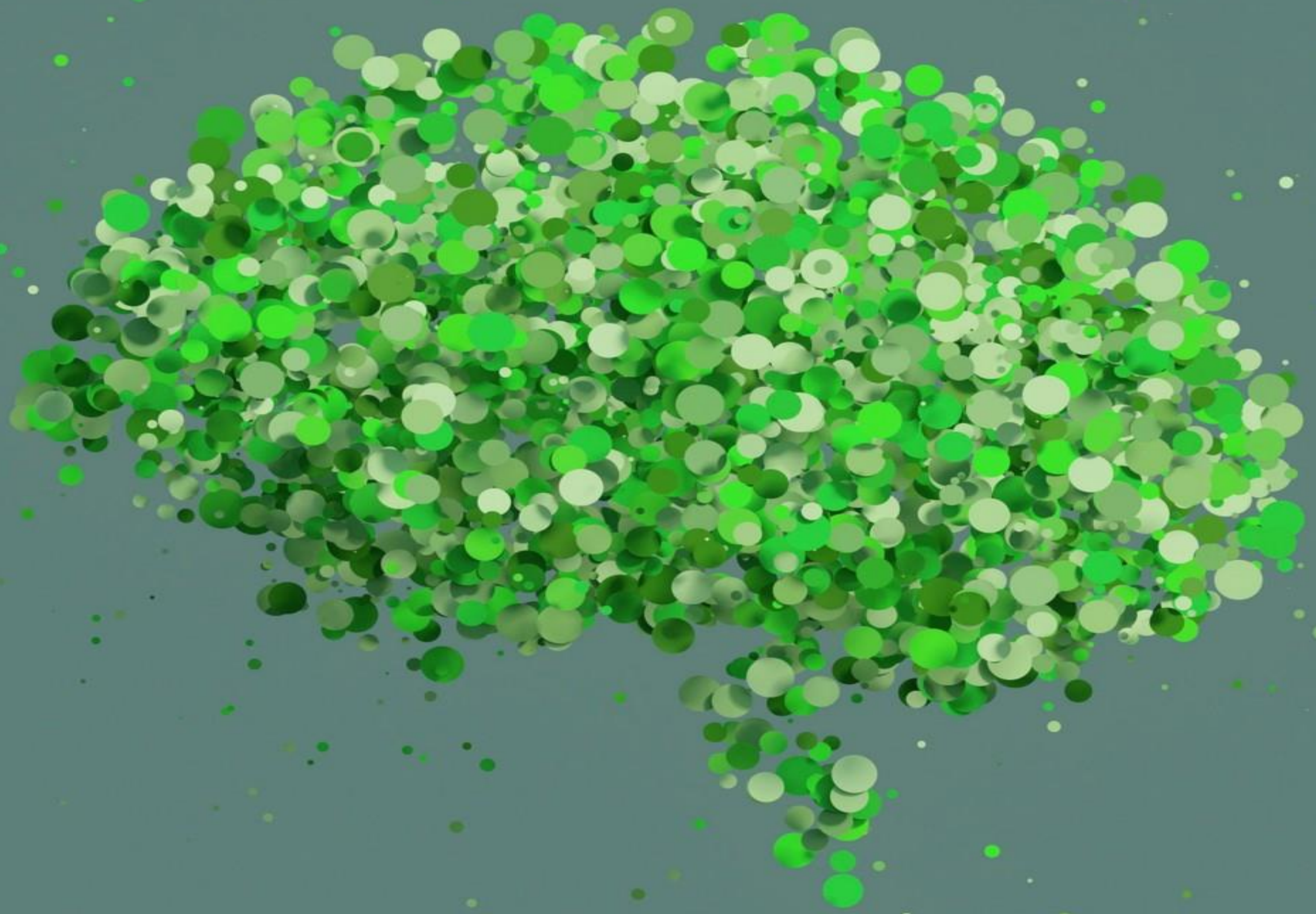
Key Take Outs

Putting a price on ESG risks, whether positive or negative is not guesswork and is likely to vary by jurisdiction, industry and the banks risk appetite and funding program. Needs to be a consideration in every bank's ESG transition plan and decarbonization commitments.

Themes addressed	Things to look out for going forward
KEY TRENDS 2024	**Impact on commercial lending portfolios** • Banks are preparing to respond to current and future regulation (strategy, systems, processes etc) • Collecting, managing and applying ESG data is done after the deal has been processed (difficult to back out) • Technology – able to access internal/external data (AI supported) through APIs, seamless assessment & escalation at the right time.
REGULATORY COMPLIANCE	**Not one size fits all** • Banks are struggling to respond to current and future regulation, including financed emissions. • EU Next Gen funds include linkages to ESG objectives and safeguards (Do No Significant Harm) including pricing benefits. • Global banks will need to create flexible and configurable assessment frameworks that solve for local requirements and align to global standards
PRICING & CAPITAL	**Hesitance to address pricing and profitability impact** Banks know it is coming but pricing new lending with consideration to ESG practices/risks very immature • Limited understanding of capital impact • Fear of getting it wrong so banks don't incorporate into pricing and deal decisions (greenwashing, applying the right "grenium" etc) • ESG transition plans and decarbonization commitments do not consider price, capital or profit impact
PORTFOLIO MANAGEMENT	**Solutions need to be flexible and scalable** • ESG is fundamentally shifting the way banks operate • Portfolio managers need to account for increased transition & physical risks and impact on cost of capital. • Banks are looking at SaaS solutions that are easy to set up, and scalable for the future



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