Swiss Sustainable Finance

Zürcher Hochschule für Angewandte Wissenschaften

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Kantonalbanken
Banques Cantonales
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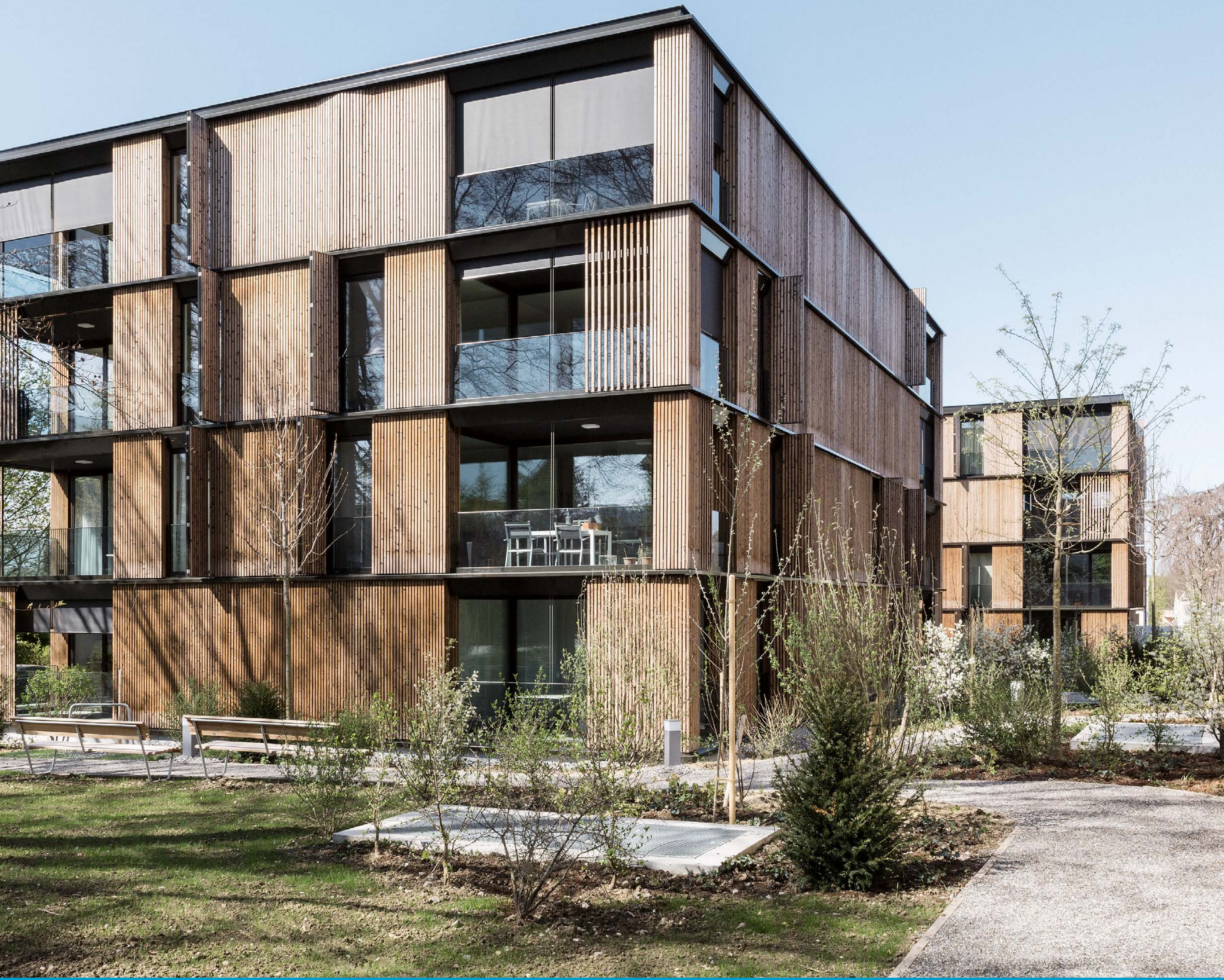
Sustainability in lending

Executive Summary



Executive Summary

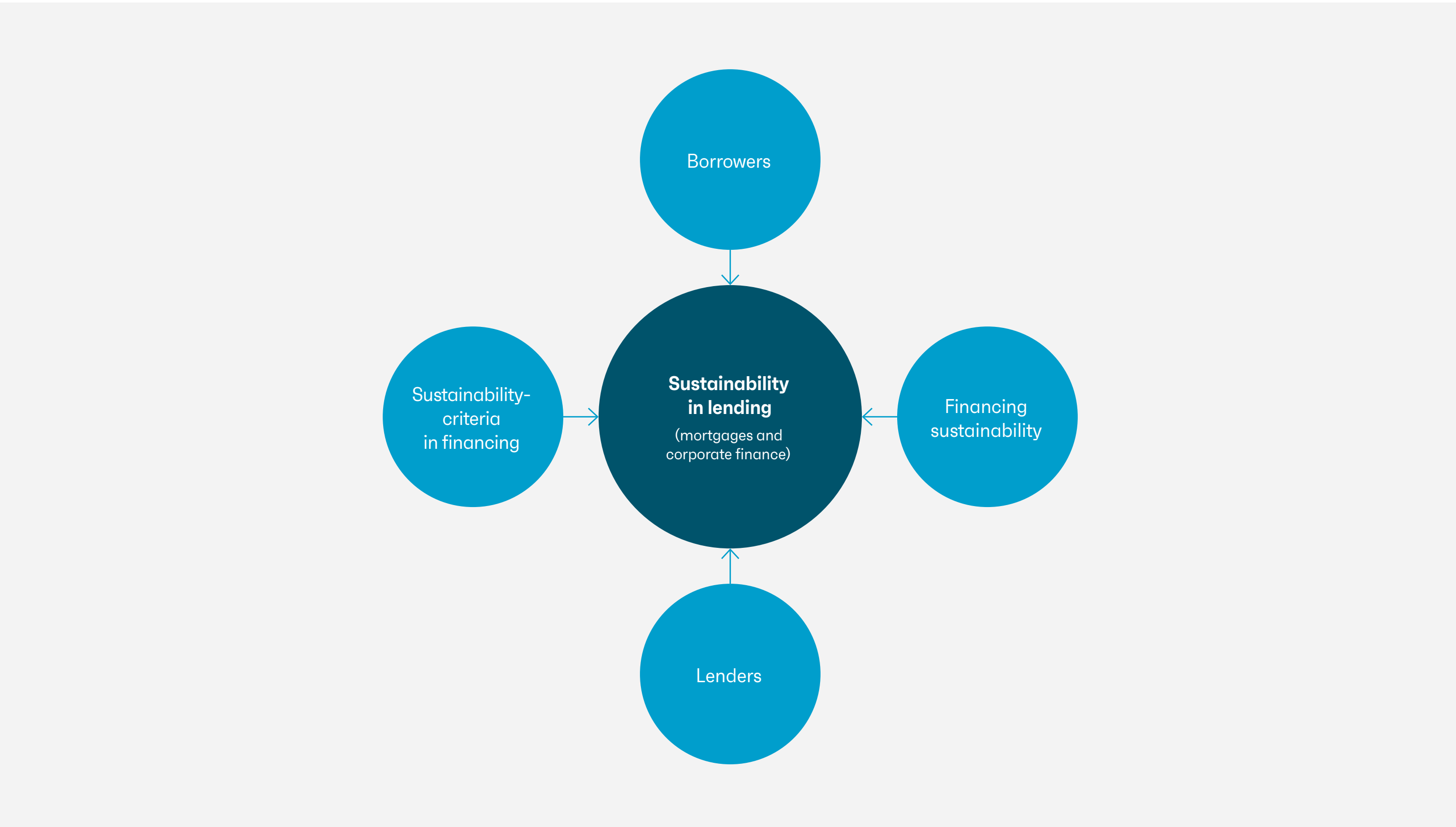
Introduction

It is estimated that Switzerland needs to invest some 13 billion Swiss francs every year up to 2050 to finance the country's transition to a more sustainable economy. As providers of corporate credit and mortgages, banks have a key role to play here: unlike big corporations, SMEs and private individuals in particular cannot access the capital market to raise finance. The financing side is therefore just as important as the investment side for supporting the shift towards a more sustainable economy.

Various approaches already exist for embedding sustainability firmly on the financing side. The associated challenges are complex, however, and range from lending practices to risk assessment, as well as the diverse demands of the real economy, the financial system and politics.

This publication provides a platform for discussing this complexity. It helps to refine and disseminate existing approaches for embedding sustainability in lending. The study offers a comprehensive overview of theory, practice and future action areas. The focus here is on the two most important sub-areas of financing: corporate lending (Chapter 2) and mortgages (Chapter 3). In addition, specific approaches for financing transformation initiatives that go beyond the traditional credit business are discussed (Chapter 4).

As a basis for the discussion of the individual sub-areas of the credit business, the various perspectives on sustainable lending are discussed as a key focus. One the one hand, it must be remembered that within the topic of sustainability it is not simply a matter of taking into consideration sustainability criteria in financing, but also of providing capital for the sustainability transformation or sustainability solutions required to meet the 17 UN Sustainable Development Goals (UN SDGs), in other words the financing of sustainability. On the other hand, both sides of a credit transaction – lenders and borrowers – must be given due consideration.

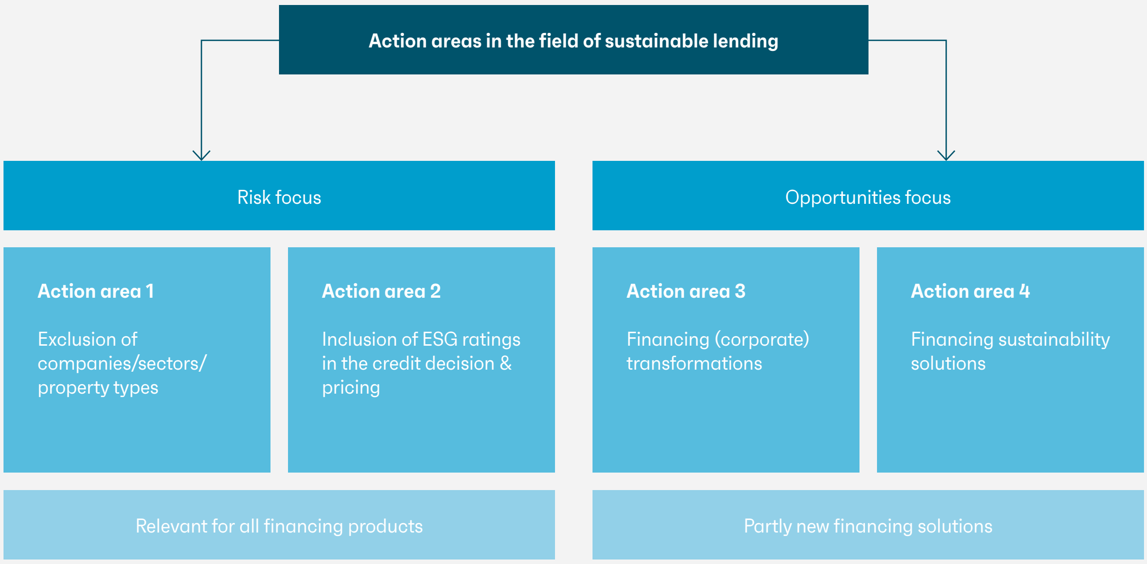


Relevant perspectives in the area of sustainable lending

Different strategic approaches regarding sustainability can be identified both for the lender and borrower position. Based on the established high-level approaches applied for sustainable investment (*Exclusion, ESG Integration, Active Ownership and Impact*) the approaches for sustainable lending can be classed into four action areas:

- Action area 1: Exclusion of specific borrowers, sectors or property types
- Action area 2: Inclusion of ESG ratings in the credit decision and in pricing
- Action area 3: Financing of (company) transformations
- Action area 4: Financing of sustainability solutions

Here, action areas 1 and 2 have a stronger *risk focus* and are therefore relevant for all forms of financing and lenders, and thus for the traditional lending business as well. Action areas 3 and 4 have a stronger *opportunities focus* and potentially offer a greater contribution to sustainability. However, they frequently – though not inevitably – carry a higher financial risk, which is why it is often impossible to finance innovative sustainability solutions with traditional forms of credit. Adapted lending facilities, such as mezzanine financing, would be a suitable option here.



Action areas in sustainable lending

Corporate lending and sustainability

Corporate lending is a potentially important lever for sustainability transformation. According to current studies, the bulk of the necessary investments in a greener economy will presumably have to be financed through corporate lending without collateral. In addition to the inclusion of these transformation aspects, due consideration of sustainability criteria in lending practices also means the existing, financially focused risk view will be extended to include new dimensions: specifically, the question of how ESG factors influence credit risks.

Accordingly, all four action areas are relevant for the area of corporate lending. A recent survey of cantonal banks shows that the majority of activities are currently concentrated in action area 1 (*Exclusion*). In this action area there is growing public pressure for the exclusion criteria to be tightened. For lenders, it is not merely the ethical considerations that matter, but also the financial risks and weighing up the various stakeholder interests.

There is still very little activity to be seen in action area 2, *Inclusion of ESG Ratings*. Although many banks expect sustainability ratings to be integrated into the lending process in the mid-term, the relevant ratings – or a framework for their evaluation or systematic application – are still in the development stage. Furthermore, current data sources are inadequate. However, it is interesting to see that the corporate lending sector is also increasingly copying solutions from the bond market, which is more developed. In action area 2, therefore, some instruments are also used that not only offer more attractive interest rates for better sustainability ratings, but also reward any improvement in the sustainability rating over time with interest rate reductions (or alternatively penalise the lender if there is no improvement). The first such sustainability-linked loans have been taken up by various companies in recent years.

By comparison, action areas 3 and 4 can therefore be classed as more challenging – and also show less activity. Although *company transformations* and the development of *sustainability solutions* can sometimes help reduce financial risk in the long term, at the same time they can increase the short-term risk over the course of the transformation. Since the focus of the credit assessment is generally on the next five to seven years, there is an area of conflict here that is not easy to resolve. Approaches to the problem include the provision of specific financing instruments which in turn are geared towards developments currently seen in the bond market. Examples include green loans, social loans or the sustainability-linked loans mentioned previously. Green loans and social loans designate funds specifically for environmental or social projects, but no such restriction exists for sustainability linked loans. Even so, these financing instruments do not resolve the timing conflict described above. Similar to action area 4, which presents the same challenges, additional financing solutions are required that are suited to the increased risks, such as mezzanine instruments or finance innovations.

Further challenges include data availability (such as sustainability data and ratings in the SME domain) and building up the required expertise within banks. The multidimensional nature of sustainability as a topic, as well as the various areas of conflict, also mean there is a significant need for training at individual institutions, which also leads to higher costs.

Sustainable mortgages

Sustainability in the area of mortgage lending is currently focused mainly on the environmental dimension, and only to a very limited extent on the social dimension. In Switzerland, buildings account for around a quarter of CO_2 emissions and some 40% of energy consumption, with roughly two thirds of all buildings still heated by fossil fuels or electricity. To achieve the targets set by the Federal Council, over a million properties urgently need an energy upgrade. At present, only around one percent of existing building stocks are being modernised. Since mortgages also represent one of the biggest assets carried on banks' balance sheets, there is enormous potential here for lenders to act as a catalyst for sustainability transformation.

On the one hand, green buildings[1] offer a number of advantages. On average, they have lower operating costs and higher rental and selling prices. In addition, "green" mortgages have lower default rates. On the other hand, they are not always profitable, as they tend to be associated with higher initial investment costs and their certification requires extra effort for the owner, both in terms of time and cost.

Banks can link the conditions for mortgages (interest-rate reductions) with the sustainability of real estate (often energy certificates) in order to manage the risks of the loan portfolio and avoid adverse selection (action area 2). Here the boundary between action area 3 is fluid. For borrowers, more attractive mortgage interest rates can also influence the cost-benefit analysis for green buildings. Discounts are often offered for new buildings, however. As these already meet high standards, the *transformational effect* of these products tends to be limited at present. By contrast, the transformation of buildings in existing housing stock can be encouraged by promoting certification and energy-saving advice. Furthermore, lower interest rates also provide an incentive for the renovation and energy upgrading of existing properties.

In the mortgages sector, action areas 1 and 4 are currently less in the focus of discussion. In action area 1, refusal to finance non-sustainable buildings could be a consideration. Given the extremely negative consequences this would have for existing business, however, this is hardly realistic without some sort of regulatory support. Action area 4 includes the financing of innovative sustainability approaches that potentially carry more risk. In general, such solutions belong more to the area of technological development, however, and therefore concern corporate lending far more than the mortgage business.

Many banks already offer sustainable mortgages. Apart from the aspect of the credit risk profile, other factors such as marketing considerations and the avoidance of adverse selection are likely to play a role. Challenges still exist above all in the areas of measuring sustainability (one-sided focus on energy certificates), product design (lack of differentiation), data availability, and collaboration between the various actors and processes (sustainability aspects in the financing and valuation stages).

1 According to the World Green Building Council, buildings whose design, construction and operation prevent or reduce the negative effects on the climate and the natural environment are classified as green.

Specific financing of sustainability solutions

So far it has been shown that although action areas 1 and 2 are not always developed to the same degree throughout the lending business, potential approaches and strategic directions do exist. Compared with action areas 1 and 2, areas 3 and 4 present a greater challenge. The main problem especially is the trickier *risk assessment* (due to the lack of data), the *small transaction amounts* (in the SME domain), the *higher risk* due to *long terms to maturity, lack of collateral* and *secondary markets* and, in the start-up domain, *uncertainty about profitability*. In addition, it is often difficult to quantify a project's contribution towards meeting sustainability goals, as this requires specific know-how.

Although part of action areas 3 and 4 can be addressed through the private equity market or through direct investments, this does not work so well in the SME domain. One approach therefore lies in *financing innovations*. There are already various international initiatives (UN working group or Switzerland's "SDG Impact Finance Initiative (SIFI)") whose aim is to promote financial innovation. The most important strategic approaches include:

— *Specialised intermediaries:* Especially in action area 4, specialised intermediaries (such as asset managers) could fill the gap between investors and companies. They have the necessary specialist expertise to analyse financing objects and the contacts needed to structure the finance.
— *Collaboration with the public sector (blended finance):* The state assumes certain risks, provides additional guarantees, insurances or subsidies, or contributes its know-how. In Switzerland this already occurs via technology funds, among other things. These products reduce risks for private lenders in action areas 3 and 4, and also help place the focus on the attainment of non-financial goals.
— *Structuring of finance:* Breaking up the classical structures of equity financing and debt financing makes it possible to adjust the risk profile to the requirements of both investors and companies. These mezzanine instruments are particularly suitable if they combine risk-appropriate compensation for lenders with liquidity protection for the company (e.g. participatory loans with a low fixed interest rate but a profit-sharing option).
— *Technological solutions:* Modern financial technologies (FinTech) can open up new markets (e.g. crowd-lending platforms) that improve efficiency or reduce transaction costs (such as decentralisation of the loan issue process through distributed ledger technology).

Conclusion

Overall, it is clear that sustainability approaches are already being applied on the financing side, and are being continuously developed. Given the escalating demand for financing to support the transformation to a more sustainable society and economy, these trends should continue to grow. At the same time, when considering the current challenges it is clear that the potential cannot yet be fully exploited due to various barriers. These include the lack of standards and inadequate data, but also regulatory hurdles, poor coordination between market players, and challenges in the areas of risk and maturity structure. Fully exploiting the potential in this area requires cooperation between the financial sector, the real economy and policymakers.

	Corporate lending		Mortgage lending	
	Approaches	**Importance**	**Approaches**	**Importance**
Action area 1 Exclusion of specific borrowers, sectors or property types	Exclusion of individual companies or entire sectors, such as producers of tobacco products or military weapons.	In Switzerland, banks are mainly active in this area at present. Exclusion is intended to prevent both credit losses and damage to reputation. As with mortgages, different stakeholder interests are at odds here.	Exclusion of certain types of property, such as those heated by fossil fuels.	Risks from mortgages that arise due to non-compliant environmental standards of the buildings serving as collateral can be reduced. Challenges exist in the differing interests of the stakeholders.
Action area 2 Inclusion of ESG ratings in the credit decision & in pricing	Inclusion of own or third-party sustainability ratings in the assessment and structuring of the loan (credit decision and interest rate).	Very few banks in Switzerland are active in this area. Only occasionally are ESG ratings systematically included in the credit assessment process. Some initial loans have already been issued where sustainability goals have been agreed (sustainability-linked loans).	Mainly discount models for buildings that meet certain sustainability standards (sustainability rating).	The approach is already being implemented by many banks, especially for new buildings. There is potential in applying the approach to refurbishments and increased interest rate differentiation.
Action area 3 Financing of (company) transformations	Financing the adaptation and ongoing development of companies to reflect a change in general conditions, such as those caused by climate change. Possible instruments include green loans and social loans (used specifically to fund environmental or social projects).	There is still very little action from banks in this area. To date, lending has mostly been to multinationals whose size allows them to take out a high enough loan amount to justify the additional effort for banks. As this action area becomes more important, it is expected that more and more smaller loans will be granted.	Assumption of costs for certification or energy-saving advice to promote the transformation. In addition, products intended to target the financing of renovation and energy upgrade work on existing buildings, combined with a more attractive interest rate (cf. action area 2).	This measure is appearing in the market and can be effective when combined with other measures. Additional advisory services can increase the understanding of property owners that sustainable buildings also pay off economically. At the same time, more attractive financing conditions can incentivise a transformation. The regulator could be supportive here by allowing higher loan-to-value ratios.
Action area 4 Financing of sustainability solutions	Specific financing solutions with a high degree of specialisation (complex risk assessment) or lenders with a higher risk tolerance.	In their current set-up, banks can only offer solutions for this action area under restricted terms. Regulatory reasons often prevent them from issuing the necessary loans. Alternative and innovative financing instruments are needed.	Specific financing instruments, such as subsidies via innovation funds or combined with zero-interest products.	In general, such solutions are more likely to be found in the area of technology development and thus concern corporate credit rather than the mortgage sector.

Action areas in the corporate lending and mortgage sector

Editorial

Zürcher Hochschule
für Angewandte Wissenschaften

Editor: Swiss Sustainable Finance
The mission of Swiss Sustainable Finance (SSF) is to strengthen Switzerland's position as a leading voice and actor in sustainable finance, thereby contributing to a sustainable and prosperous economy. The association, founded in 2014, has representative offices in Zurich, Geneva and Lugano. Currently, SSF unites over 200 members and network partners from financial service providers, investors, universities and business schools, public-sector entities and other interested organisations. Through research, capacity-building and the development of practical tools and supportive frameworks, SSF fosters the integration of sustainability factors into all financial services. An overview of SSF's current members and partners can be found on its website: sustainablefinance.ch

Editor: Association of Swiss Cantonal Banks
The group of Cantonal Banks comprises 24 institutions with branches in 26 cantons. They are thus present throughout Switzerland and take on a leading role with approximately 19,000 employees and a network of approximately 640 branches. Their market share in the domestic business is around 30 percent. In 1907, the Cantonal Banks jointly established the Association of Swiss Cantonal Banks (ASCB). The association represents the joint interests of its members towards third parties. It helps to strengthen the position of the Cantonal Banks in society, economy, and politics and encourages the cooperation among its individual members.

Research partner: Zurich University of Applied Sciences
The Zurich University of Applied Sciences (ZHAW) is one of the leading universities for applied sciences in Switzerland. By combining research, teaching and practice, it makes an active contribution to solving societal challenges. As part of the Institute of Financial Management, the Corporate Performance & Sustainable Financing unit focuses on sustainable financing in its teaching, research and continuing education programs. In addition to its own continuing education products and in-house training courses at banks, the focus is particularly on application-oriented research and innovation projects.

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