Sri Lankan Sustainable Banking Initiative

Consultant Training

Colombo, November 21 & 22, 2019

Sri Lanka Banks' Association
Sustainable Banking Initiative

Designed by Melissa Makwarimba &
presented by Kiran Dhanapala

khoKhela. CONSULT

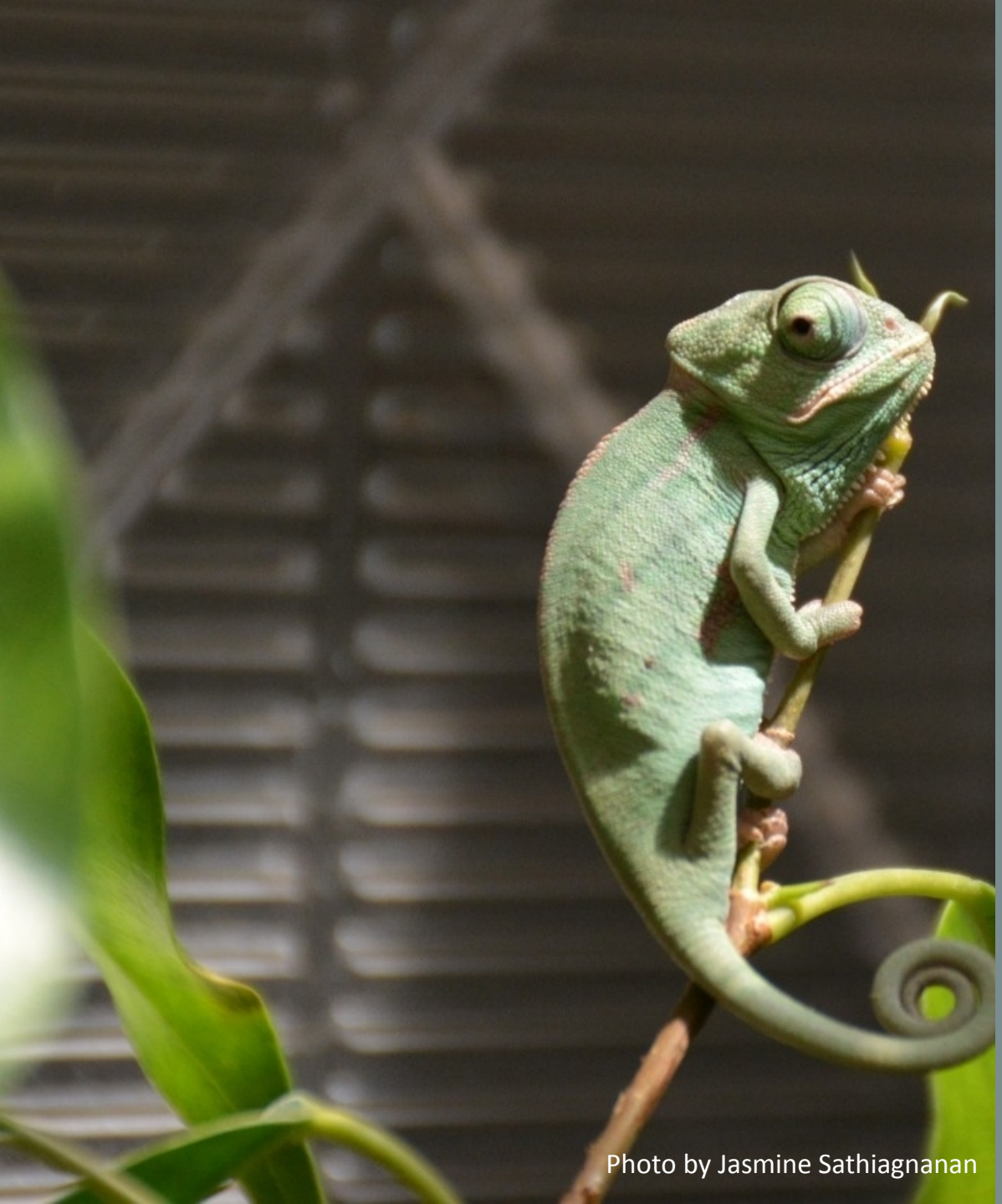


Photo by Jasmine Sathiagnanan

Good Morning and Welcome!

SESSION 1

INTRODUCTION & BACKGROUND TO SUSTAINABLE FINANCE

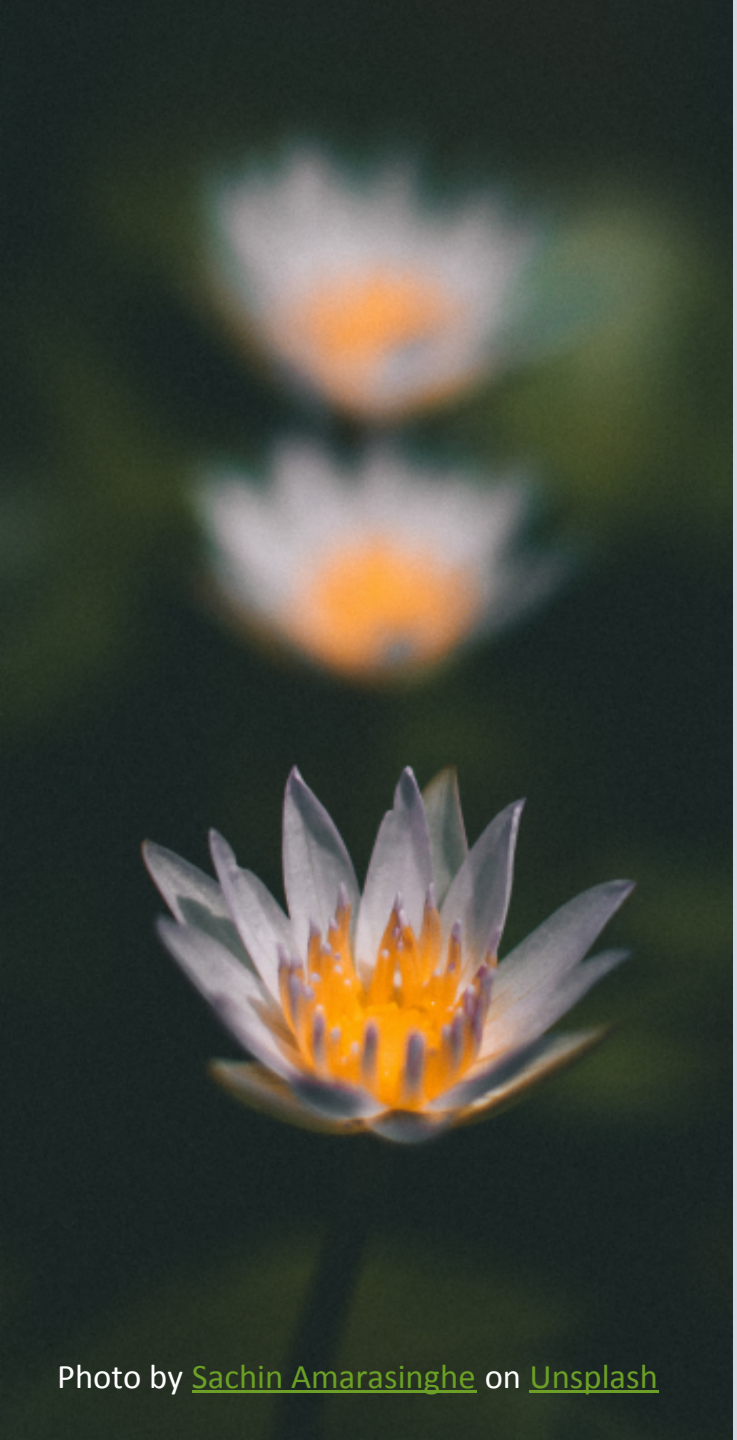


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Why are we here?

We understand the urgency for more sustainable economic growth and development agenda. We are familiar with the international commitment to and ambition of Agenda 2030 and the SDGs and the Paris Agreement on Climate Change

BUT……

Why does the finance sector need to be concerned about sustainable economic growth?

What role does it have to play?

Value Erosion

- The negative impact of one business has the potential to impact the value of another e.g. water pollution upstream increases clean water costs downstream to another

Financial Instability

- Resulting social and environmental stresses present a systemic risk to financial markets e.g. climate change, water scarcity (quality & quantity), social unrest

Finance has reason to pause and think and there is growing awareness, particularly among institutional investors, insurance and central banks

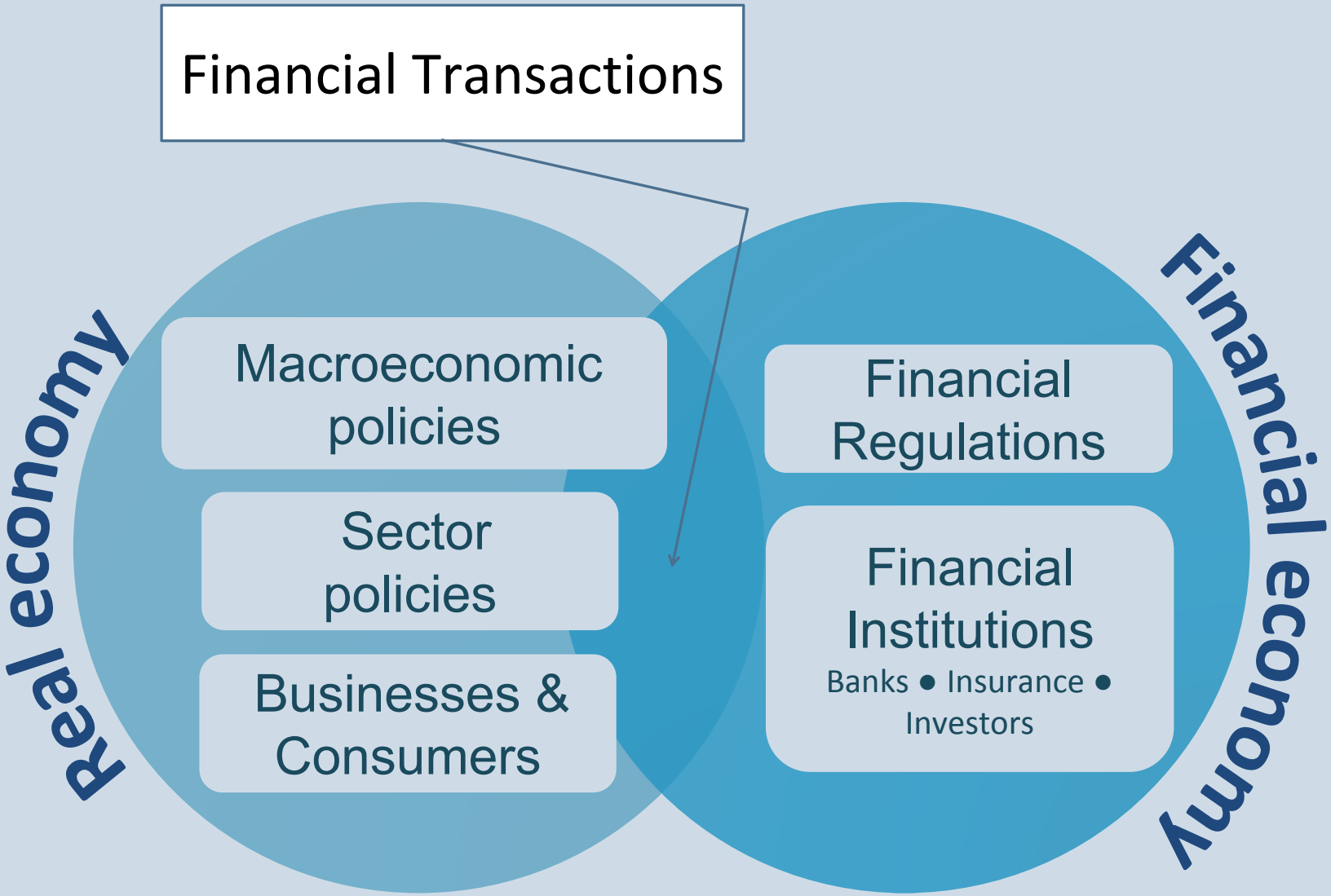


When we finance businesses that degrade the natural environment and undermine human rights ……

…….the impact of those businesses is felt in other parts of the financial market.

Our misallocation of financial capital erodes value creation in other parts of the economy.

The effect of the misallocation is often separated far in time and place from the original financing decision.


Financial Transactions
Real economy
Macroeconomic policies
Sector policies
Businesses & Consumers
Financial economy
Financial Regulations
Financial Institutions
Banks ● Insurance ● Investors

Banks are the intermediary between those with shortages and those with surpluses of capital. The decision making of a bank, along with other actors in the financial sector, will determine whether we achieve more sustainable economic growth

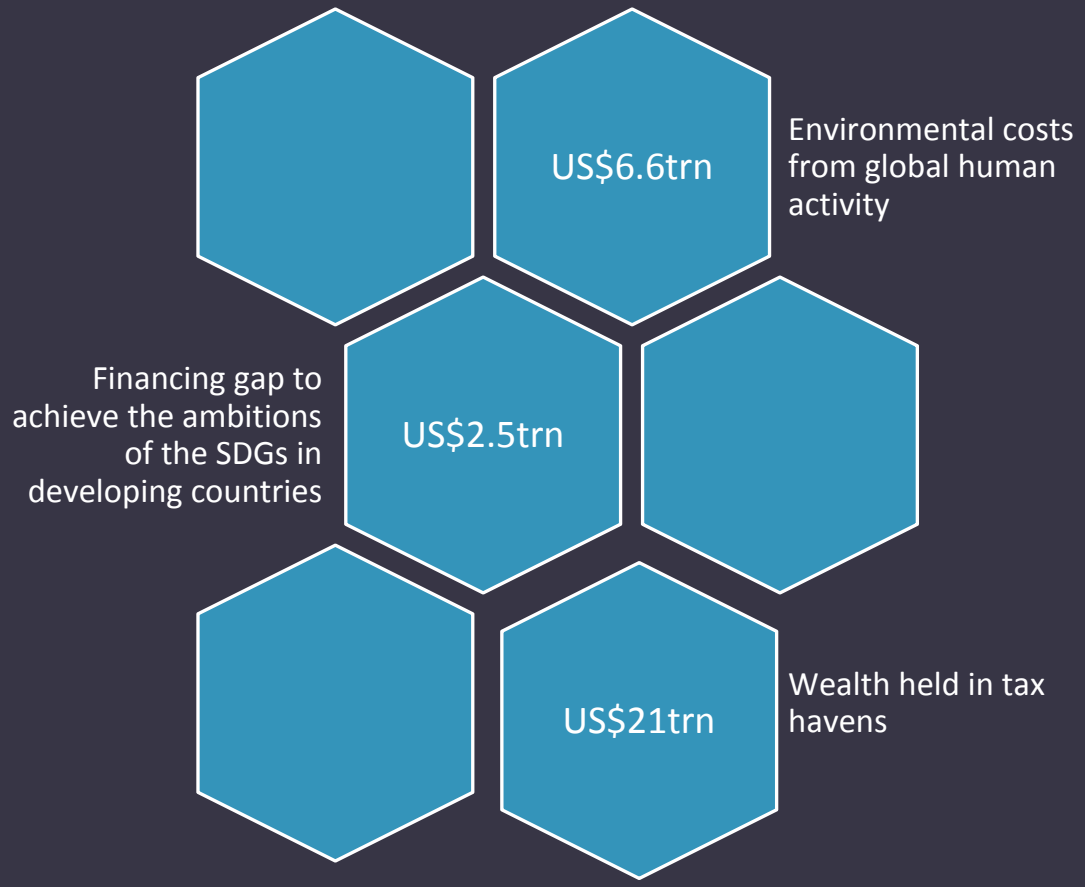
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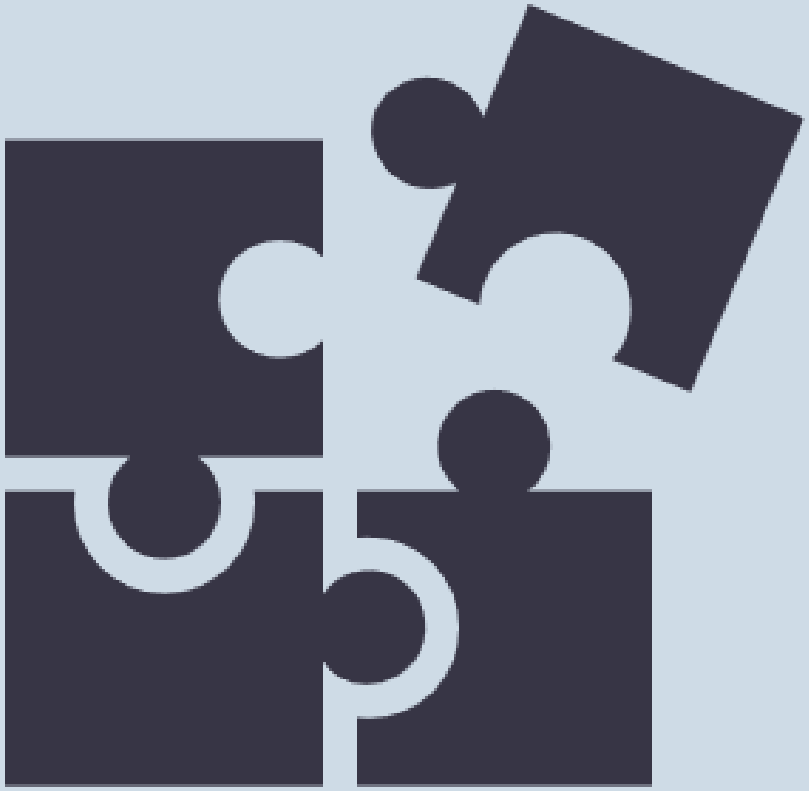
Banks need to be motivated to understand that they have the responsibility to, and can, direct capital away from economic activities that are harmful to the environment and society and towards critical priorities

As a knowledge broker between the world of sustainability and finance

THESE ARE THE MESSAGES THAT YOU NEED TO CONVEY AND ASSIST FINANCIAL INSTITUTIONS TO ACT ON

Possibility that misallocation of finance has left us with a considerable financing gap to achieve sustainable economic growth





US$23 trillion
Climate investment opportunity

Sell the idea of opportunity as well as responsible financing

Selling a new financing paradigm

1. Considerate

- Is aware of how financing decisions can result in costly impacts to society and the environment

2. Incentivises desired behaviours

- Rewards sustainable financing and business practices

3. Inter-generational equity

- Ensures future generations don't carry the cost of poor decision making now

4. Longer term horizons

- Allocates capital with a long-term, forward looking orientation

5. Inclusive

- Contributes to empowering those who have been economically disenfranchised

6. Purposeful

- Is deliberate about placing capital that delivers positive impact to the environment and society

HOW HAS THE FINANCE SECTOR RESPONDED?



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Changing demands on the finance sector

Pre-1980s

- Focus was on the environmental impact of large infrastructure projects funded by the World Bank Group.
- Triggered early guidelines to analyse environmental impacts in projects emanate from them (1987)
- Taking us to Equator Principles for Banks (2003)

Today

- Focus is on ALL financial institutions and variety of issues such as complicity with human rights abuses, fuelling climate change, laundering proceeds from illicit gains (e.g. illegal logging) to unfair retail practices
- Plethora of initiatives across the finance sector – investment, private equity, insurance, regulators
- Latest – **UNEP Principles for Responsible Banking (2018)**

In practice what is happening



1. Integration of E&S impact considerations into credit decision making processes.

Generally compliance driven, limited opportunity seeking and innovation to drive more positive impact business activity



2. Mobilisation of financial resources for values driven financing – for “greener” “socially impactful” businesses.

Typically focussed on niche markets. Market leaders moving this type of finance into the mainstream.

And where does it need to go



With Agenda 2030 and Paris agreement there is increasing pressure for business models that recognise sustainable development challenges as core business drivers and are conceived to address/deliver impact.



Sustainable finance, in turn, is about changing core decision making practices (from policy, strategy, financing) of a bank to allocate capital to more sustainable business practices

01

Financing new growth industries and technologies

02

Developing new financial products and services and new markets

1. Facilitation of responsible growth through business development that is informed by sustainability challenges

Financing new growth industries and opportunities



Renewable energy (solar & wind), waste to energy, energy & water efficient technologies, cleaner production



New technologies for climate change adaptation and resource scarcity e.g. climate resilient crops and seeds, cultivation (e.g. hydroponics) and irrigation technologies, organic/bio dynamic agriculture



New smart materials



Up and down the value chain

New financial products and services and new markets

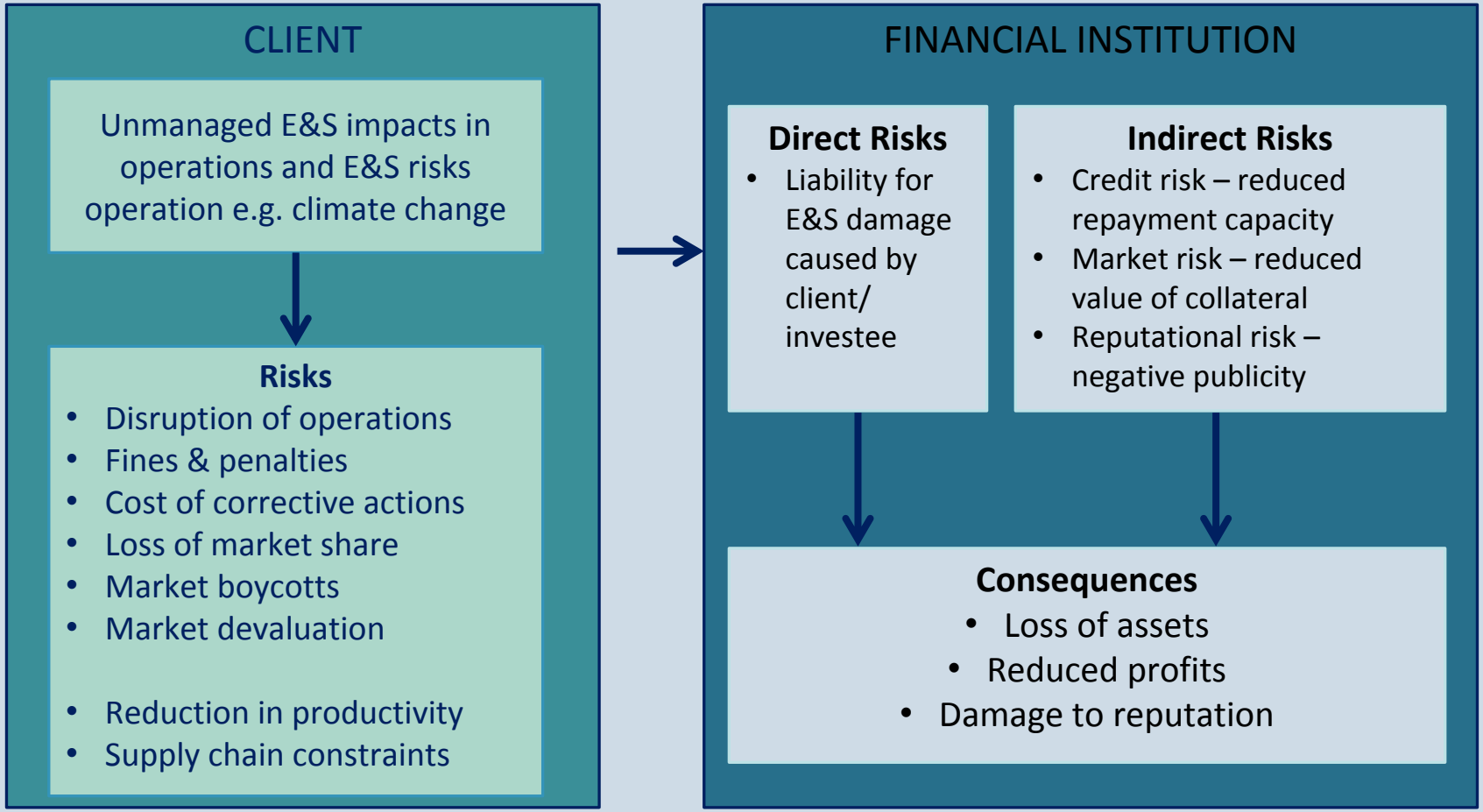
Themed fixed income	Green, blue, social, sustainability, SDG, bonds & funds
Themed loans	Themed green & sustainability loans in corporate finance and themed retail (e.g. mortgages, leases) and savings products; linked to use of proceeds
Positive incentive loans	Relatively new – loans that are not linked to a dedicated use of proceeds but are linked to a company improving its management of social and environmental impact
Financial Inclusion	Servicing the underserved & unbanked: middle market between SMEs and large business; microfinance, mobile banking, financial literacy
Impact investing	Impact investments: investment that maximize environmental & social benefits with financial returns



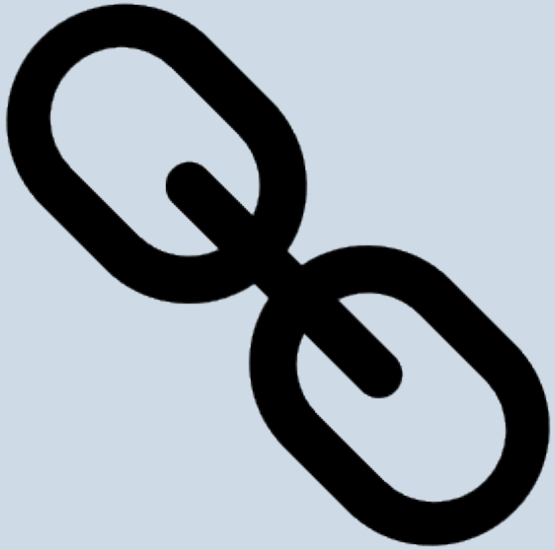
Image - Pixabay

2. Integrating E&S impacts into credit decision making

From Client E&S Impact to Risk to Bank



Financing business models that are conceptualised through the lens of sustainability challenges with the intent to maximise positive impact and manage adverse impacts.



Ultimately need to bring the two together

FOR FURTHER READING GO TO UNEPFI POSITIVE IMPACT INITIATIVE

THE SLBA SUSTAINABLE BANKING INITIATIVE (SBI)

PHOTO BY ADITYA SIVA ON UNSPLASH

Background



Set up under Sri Lanka Banks' Association

Formulated **Sustainable Banking Principles**; signed by 18 banks, November 4th 2015

The Principles – basis for "levelling the playing field"

Platform for knowledge sharing/cooperation with respect to the banking sectors role in facilitating more sustainable economic growth and development

Capacity building programme – e-learning platform

From Principles to positive outcome



Role of SLBA SBI

SHORT TERM

Capacity Building Programme

- SBI Platform
- Principles & Guidance Notes
- Case Studies
- E-learning programme
- Face to face workshops

MID TO LONG TERM

Facilitates dialogue, collaboration to create enabling environment

Engages with policy makers, regulators

Knowledge dissemination

Event coordination – Green finance conferences

R&D – Green bonds

Awards programmes

COFFEE!!!

30 mins max!!!!

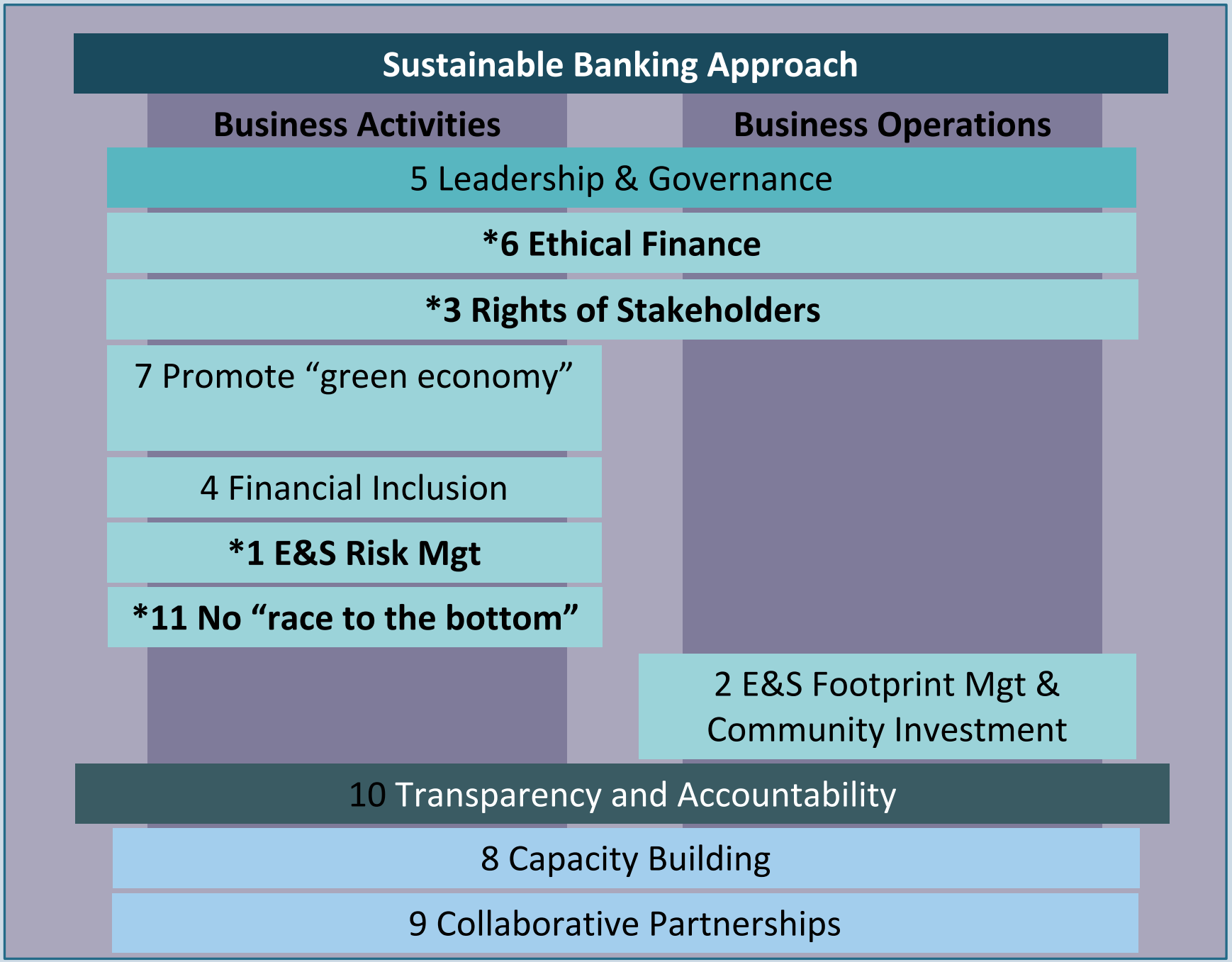
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SESSION 2

THE PRINCIPLES


Sustainable Banking Approach
Business Activities
Business Operations
5 Leadership & Governance
*6 Ethical Finance
*3 Rights of Stakeholders
7 Promote “green economy”
4 Financial Inclusion
*1 E&S Risk Mgt
*11 No “race to the bottom”
2 E&S Footprint Mgt & Community Investment
10 Transparency and Accountability
8 Capacity Building
9 Collaborative Partnerships

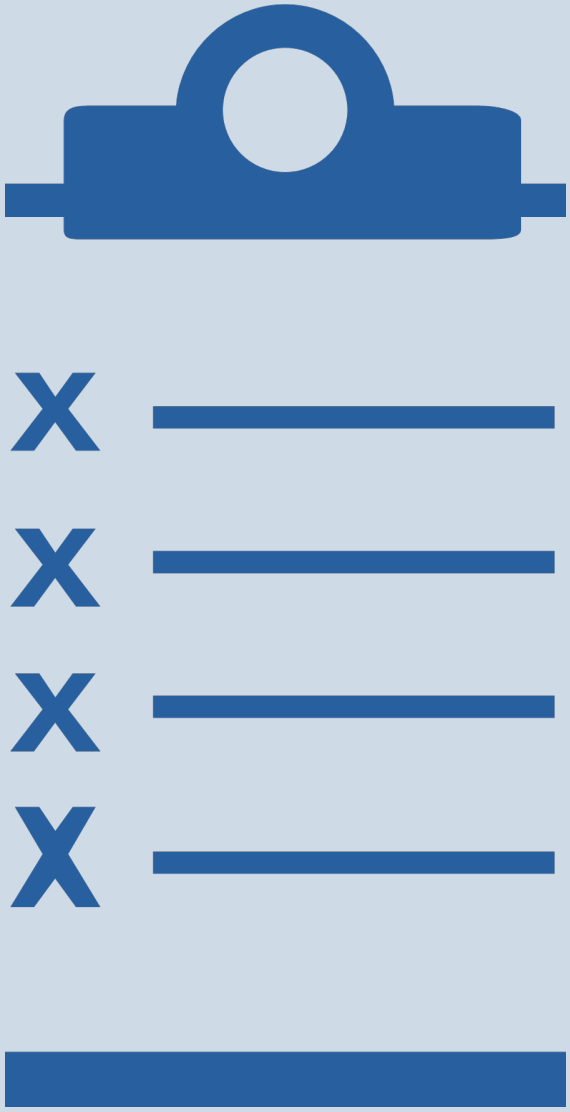


Principle 5 – E&S Governance

"We will implement robust and transparent E&S governance practices in our respective institutions and assess the E&S governance practices of our clients"

Govern the bank to deliver banking products and services that achieve business growth but not at the expense of human development and the natural environment.





Principle 6 – Ethical Finance

"We will not finance certain "excluded" activities, we will not tolerate unethical or criminal behaviour"

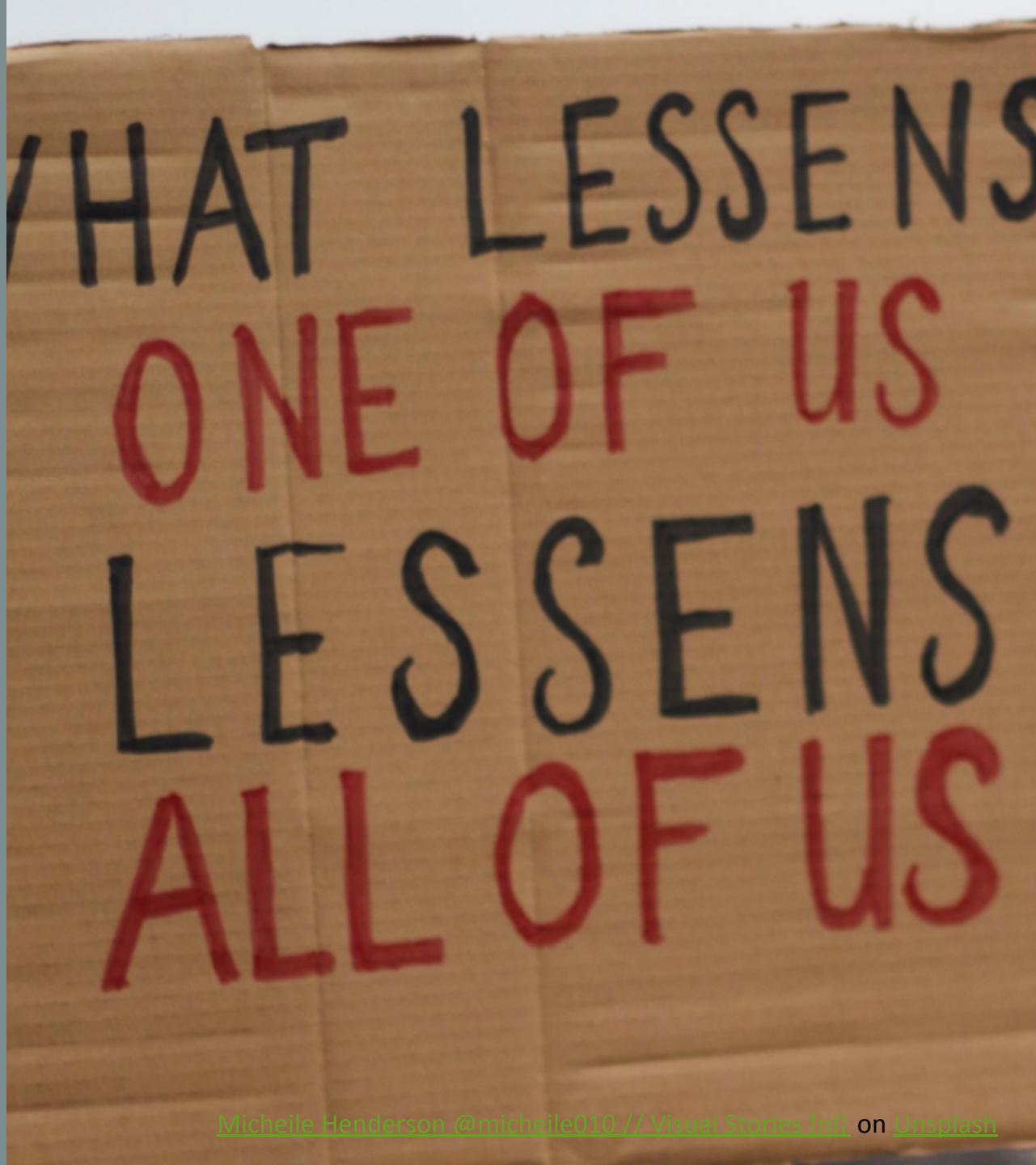
Don’t finance anything unethical (negative/ exclusionary screening).

Photo by Markus Spiske on Unsplash

Principle 3 – Rights of Respective Stakeholders

"We will respect relevant human rights principles in our Business Operations and Business Activities"

Make sure human rights are respected by the bank (employees, service providers & customers) and its clients. Zero tolerance for complicity in human rights infringements.



Micheile Henderson @micheile010 // Visual Stories [nl] on Unsplash

What we need to achieve #5, #6 & #3 and lay the foundation for the other principles.

Enlightened leadership	Bank policy & strategy talks to sustainable banking responsibilities. Application of an **exclusion list**.
Oversight capacity	Direction from the very top and integration of responsibilities into oversight functions
Ethical conduct*	Promotion of values - honesty, integrity, fairness Zero tolerance to corrupt practices and criminal behaviour. Consumer protection & product/service responsibility
Performance Management systems	Incentivise desired behaviours.
Risk Management*	E&S risk analysis in financing decision making processes
Inclusive approach*	Product and services Rights of stakeholders, engagement, grievance mechanisms
Transparency and accountability*	

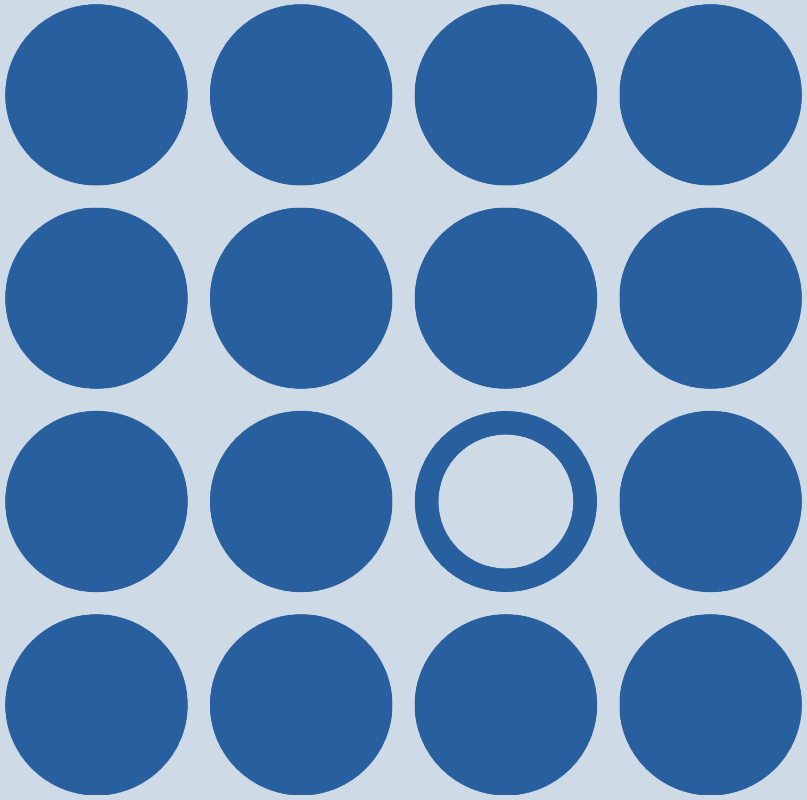


Principle 7 – Promote "green economy"

"We will promote projects and other activities that contribute to a greener cleaner economy in Sri Lanka"

Develop business lines / products that contribute to a cleaner economy in Sri Lanka.

Photo by Guillherme Schneider on Unsplash



Principle 4 – Financial Inclusion

"We will promote financial inclusion, seeking to provide financial services to individuals and communities that traditionally have had limited or no access to the formal financial sector"

Offer responsible products and services to those that so far have been left out, protecting consumers and promoting financial literacy.



Photo by Fabian Blank on Unsplash



Principle 1 – E&S Risk Management

"We will integrate environmental and social considerations into decision-making processes relating to our Business Activities to avoid, minimise or offset negative impacts"

Ensure that business activities financed by the Bank manage their environmental and social impacts responsibly. Explicitly include environmental, social and governance considerations into credit analysis.

Photo by Niko Lienata on Unsplash

Principle 11 – No "race to the bottom"

"We will not compete with other banks on E&S issues, i.e. undermine our competitor on E&S requirements towards the credit taker"

Commit to fair play and please don’t undermine your competitor on E&S requirements towards the credit taker.



Principle 2 – E&S Footprint

"We will avoid, minimise or offset the negative impacts of our Business Operations on the environmental and local communities in which we operate and, where possible, promote positive impacts"

Ensure your own operations are ok.

Photo by Alfonso Navarro on Unsplash

Principle 10 – Transparency & Accountability

“We will promote transparency and accountability, regularly review and report on our progress in meeting these Principles at individual and sector level”

Regularly review and report on your progress in meeting these Principles.

Photo by bruno-van-der-kraan on Unsplash

Principle 8 – Capacity Building

"We will develop individual institutional and sector capacity necessary to identify, assess and manage the environmental and social risks and opportunities associated with our Business Activities and Business Operations"

Ensure your staff are sufficiently trained and provide sufficient resources for them to execute these Principles.

Principle 9 – Collaborative Partnerships

"We will not collaborate across the sector and leverage international partnerships to accelerate our collective progress and move the sector as one, ensuring our approach is consistent with international standards and Sri Lankan development needs"

Work together with your colleagues from other banks, actors in the finance sector and other sectors to drive improved standards and build a financial system that responds to our sustainability challenges.

Photo by Alex Azabache on Unsplash

TIME OUT

60 mins max!!!!

Photo by Pez González on Unsplash

SESSION 3

ESRA – PRINCIPLE #1 IN MORE DETAIL



WARM UP



TEXTILE COMPANY

Fast growth

Brand customers

Term loan of LKR 100m to install new production line

Borders a stream

Client indicated that subject to stringent effluent discharge standards



METALS FASTNERS INC

Fast growth

Quality product

Term loan of LKR 300m to relocate and expand production capacity

State of the art facility with pollution control

12 – 18 month build time

TEXTILE COMPANY
DIG a bit deeper….. IF YOU don't……THIS MAY COMES TO PASS……

1. No documentation or further investigation was undertaken to verify that the company was complying. No check was made of what capacity the effluent treatment plant could handle.
2. Shortly after the disbursement dead fish found in wetland. Community suspected effluent discharges.
3. The community launched a public protest when the company ignored their concerns, which triggered an investigation.
4. It was established that the quality of the effluent discharges fluctuated as plant couldn't treat large volumes adequately. It also emerged that the company had not obtained environmental clearance for the factory expansion from the CEA.
5. The company was ordered to immediately stop expansion and to relocate.
6. Some of the company's customers ended their contracts.
7. The impact of the relocation and lost revenue strained the company's cash flow and their ability to meet loan repayments.
8. The Bank decided to stop any further loan disbursements.

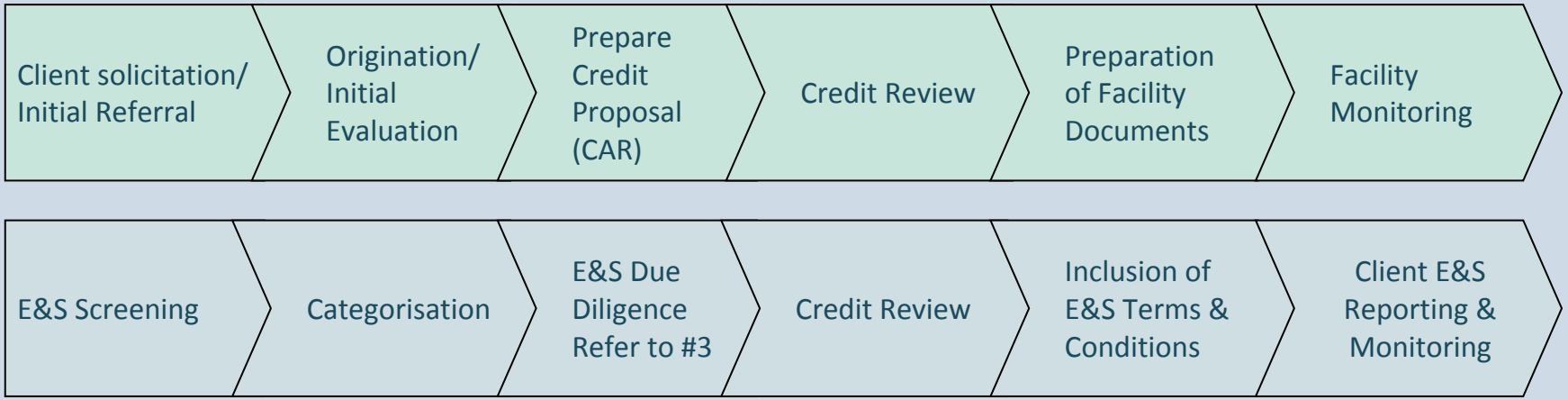
Photo by Matt Seymour on Unsplash

METAL FASTNERS INC – A Lot can happen in a year and a half!

1. Two months before the facility was due to commence operations the community neighbouring the existing operation raised a complaint against the company.
2. The community was concerned with a deterioration in the water quality in their dug wells.
3. An investigation found that effluent discharges from the metal plating company were responsible for the ground water contamination.
4. It was further established that rinsing water and spent water from the acid/alkali baths had been discharged directly onto the ground instead by a new employee of the gully bowsers. The company accepted responsibility.
5. The company had to close operations, clean-up the contamination, fund the construction of a new piped water supply and bowser in water supplies.
6. The company incurred heavy costs from the clean-up, project delays (the new facility completion was set back by 6 months and lost revenue from 8 months on non-production.

Photo by Trevor Gerzen on Unsplash

Generic ESRA Process



Threshold (total project value)	E&S management minimum requirements
<3 Mio. US$	Screening against exclusion list, E&S categorisation, standard E&S legal building blocks
Higher than 3 Mio. US$ total project value and tenure > 1yr	Robust E&S Management System (ESMS) based on good international practices (DEG ESMS KPIs)
> 20 Mio. US$ total project value	External E&S due diligence category A or (B and not requiring an EIA according to local law), ideally compliance with international standards (IFC, ADB, Equator Principles, or similar)

#1 – Scope

PROJECT RELATED FINANCE

INDICATED IN THE PRINCIPLES – BUT FOCUS IS ON PROJECT FINANCE WHICH IS A SMALL FRACTION OF ALL FINANCING

Adopt an E&S risk assessment process that is independent of a specific transaction and linked to internal credit rating processes.

The E&S risk analysis focuses on establishing how well a client understands their E&S impacts, controls and manages them.

Use a tool like the client commitment, capacity and track record assessment used by the CDC Group for the initial assessment.

For annually updating of data captured use a performance monitoring questionnaire which focuses on establishing whether there have been any material changes to the client operation and/or incidents to report.

#2 – Scope

NON- PROJECT RELATED FINANCE

GENERAL PURPOSE CORPORATE FACILITIES

REVOLVING WORKING CAPITAL

SME

GOOD PRACTICE COVERS NON-PROJECT RELATED FINANCING

Case Example

Commercial Bank – 2000 clients

Bank gathers basic information about client operations and how they manage their E&S impacts at point of onboarding a client; or one by one as the ESMS is implemented.

Information is captured for corporate and investment banking clients who

(1) comply with any exclusion list the bank may apply

(2) need E&S licenses/approvals for their operations and

(3) have credit limit greater than US$500,000

Information captured goes through a verification process that can include… …news on the internet …checks with stakeholders …government websites …visits, in some cases.

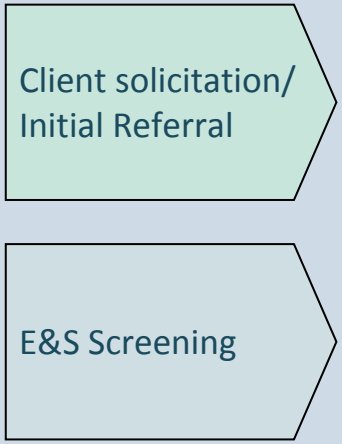
Data is sent to credit committee where credit rating is given that includes E&S rating.

Ideally there should be **two** ratings. One that reflects the inherent E&S risk of the operations the client runs and a second that indicates how well they manage their E&S impacts.

Data updated annually as part of credit rating procedure.

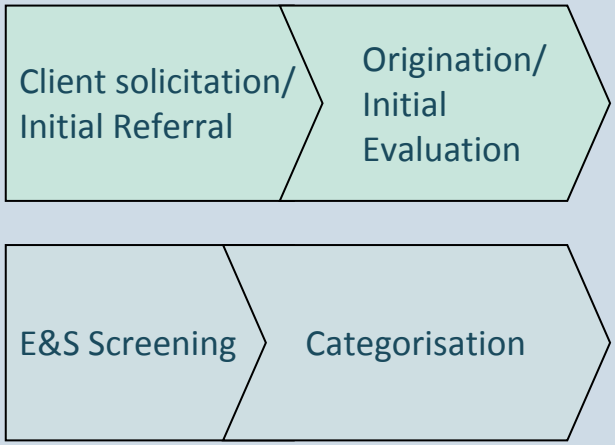


Screening - Exclusion List



- All facilities enter this step
- Completed by individual initiating the relationship for new facility applications
- Not applied retrospectively, but need to find a pragmatic way of bringing in existing facilities at point of review, renegotiation

E&S Risk Categorisation



- All facilities proceed to this step
- A process that categorizes the proposed projects/client operations. It flags inherent E&S risk of project/operations. Indicates extent of oversight required. How deep do we go?
- Projects are classified as Category A (High), B (medium) or C (low), depending on the type, location (nearness to ecologically vulnerable areas), sensitivity and scale of the project
- Completed by individual responsible for relationship or credit officer

E&S Risk Category Definitions



A/High

- Transactions/projects with potential significant **adverse** social or environmental impacts which are **diverse, irreversible or unprecedented**

B/Medium risk

- Transactions/projects with potential **limited** adverse social or environmental impacts that are few in number, **generally site specific, largely reversible** and **readily addressed** through mitigation measures

C/Low risk

- Transactions/projects with minimal or no adverse social or environmental impacts

MINI QUIZ

Revolving working capital facility to retail petroleum operator. Multiple sites primarily in densely populated area

Corporate finance to agro-industrial concern (planation and processing plants)

Project finance high rise apartment complex

Leasing finance to health service provider to purchase cars

Leasing finance to a safari jeep operator

Mini hydro-power plant near a protected area

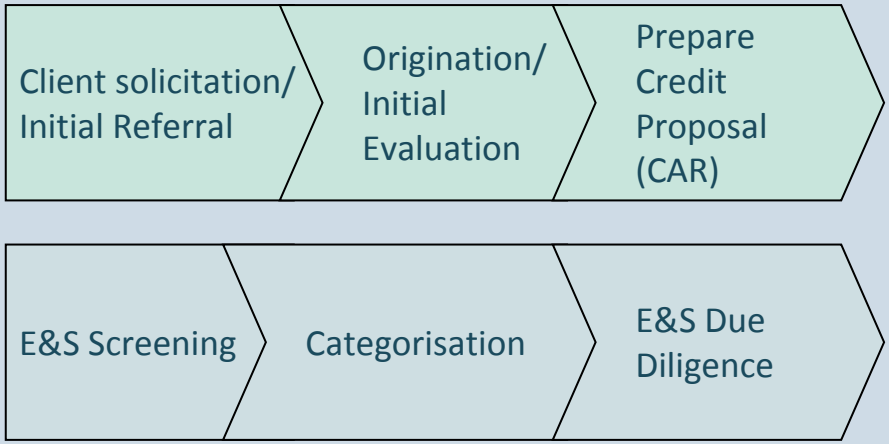
Leasing finance to furniture and wood products manufacturer

Corporate facility to finance new production line at textile manufacturer – where finishing of fabrics involved

Corporate facility to holding companies with subsidiaries in apparel manufacture and leather tanning

Trade finance to wholesalers of truck spare parts

E&S Due Diligence/Risk Analysis



- Not all facilities proceed to this step – Category C (low) no further detailed E&S analysis required. Legal compliance check.
- Completed by individual responsible for credit analysis
- Supporting tools, guidelines and reporting template

E&S due diligence/risk analysis

To assess possible E&S impacts that the project/company activities might generate

To establish Client's commitment, capacity & track record

To establish company's E&S performance against appropriate standards

- Minimum compliance for all – national law
- For higher risk – IFC Performance Standards are good reference material

Make recommendation

- Strategy: Avoid, minimise, mitigate and compensate
- Increase positive impact
- Identify actions to close gaps – Action Plan

For smaller tickets focus should be on adding value to client to achieve more positive impact/ sector rather than individual transaction approach

- Small scale farmers – how to handle pesticides safely;
- Traders/store owners – how to store chemicals safely



Key Considerations

The E&S risk exposure of your client's existing business operations /project referenced to the industry sector's material E&S issues

- All aspects of the client business that you could be exposed to
- Locations where your client operates
- The position of your client in the supply chain
- Scale of controversial activities
- Past Performance – track record
- The responsiveness & capacity of your client in addressing E&S



Reference Material

Client EIAs, Audits, Licences, Permits

National Laws

International conventions

National programmes, initiatives, research papers

IFC Performance Standards

WBG EHS Guidelines

EBRD Sector Guidelines

ADB Guidelines

Internet, Google Earth

Media reports



EIA, Audit

Environmental Impact Assessment (EIA, ESIA, SEIA)

- Assessment of a new project development's environmental and social impact and recommendations
- National Regulatory requirement
- IFC Performance Standards – Gold Standard

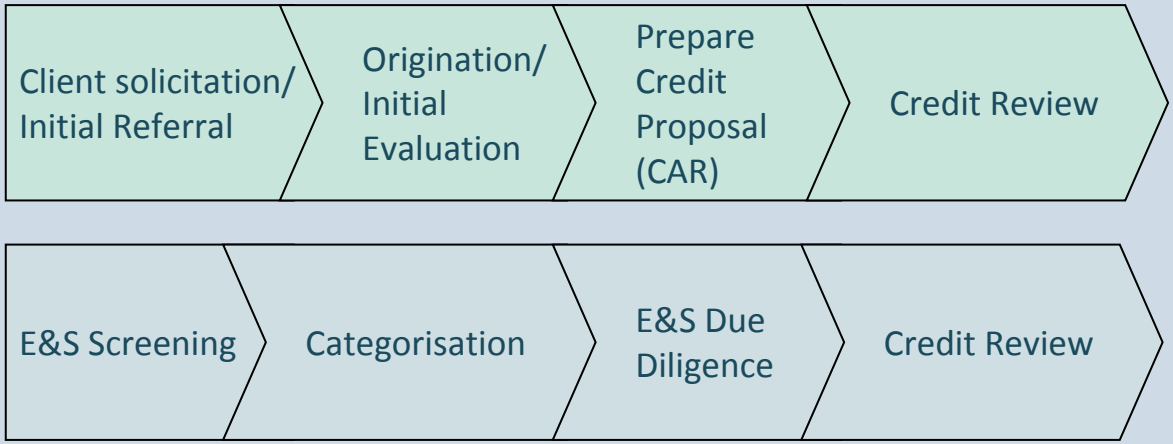
Environmental Audit

- Performance review of an existing operation's management and control of their E&S impact
- Clients with active environmental and social management systems (e.g. ISO 14001, OSHAS 18001) in place usually have regular audits undertaken

Undertaken at the Client's expense

A Bank may commission an independent review of EIA

Credit Review



- Credit memos submitted to designated authorities for review including summary of the findings and recommendations of the E&S risk analysis.
- Designated authorities review and make recommendations on way forward

Managing Unjustified Risks

Environmental and Social Action Plan – for capturing specific actions required

Terms in financing agreements – basic E&S clause on compliance with national environmental, OHS and labour laws and provisions for specific requirements.

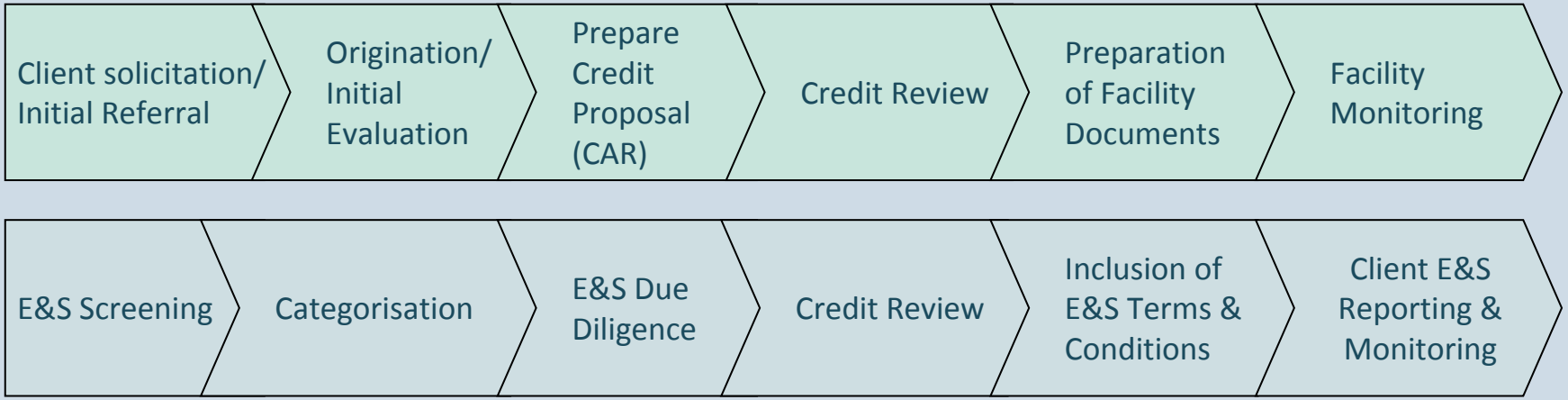
Monitoring requirements

Client reporting requirements

- Annual E&S performance report
- Incident/accident reports
- Any material change in business activity

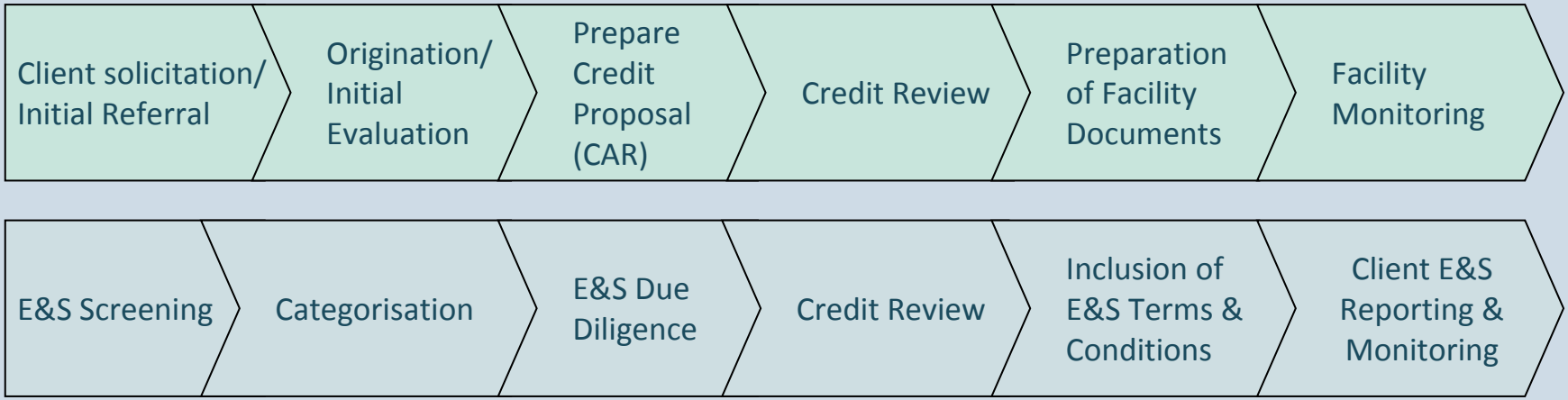
All requirements must be clearly laid out in the financing agreements

Managing Compliance



- Monitoring – specifically following up on any specific requirements, appended action plans, and reporting requests
- Client reporting – client may be required to submit performance reports; updated information for capture on credit files.
- Monitoring and client reporting should be commensurate with E&S risk of client
- Who should undertake post-disbursement follow ups, data collection?

1. An ESMS policy with clear compliance standards & guidance to business lines and decision makers on key topics



Role of Support Functions

1. Core banking systems/loan origination system
2. Internal Audit
3. Training & development

Portfolio Level

1. Tracking the tobacco, hard liquor, casino thresholds
2. Portfolio monitoring and integrated reporting
3. Clear picture of your performance with respect to
   a. Protection & creation of value
   b. Facilitation of more sustainable economic growth

IMPLEMENTATION

Department responsible for ownership of the E&S risk management policy and procedures

Relationship managers and credit analysts will do much of the heavy lifting

Support from E&S specialist – individual or team

Credit administration

Internal audit

Policy level input

Policy/position statements on higher E&S risk sectors and or contemporary E&S issues e.g. forestry, climate change, human rights

Organisational aspects

Hard Controls

- Sound organizational structure.
- Clearly defined roles and responsibilities of business units and staff and integrated into relevant bank policies.
- Policy framework and operational processes.

Soft Controls

- Create an enabling environment for sound E&S practices via incentives, facilitation, rewards and staff training
- Re-orientating attitudes, values,
- Access to relevant information, resources

Common organizational dilemmas on implementation

- Which board committees are responsible for oversight of E&S risk?
- Do you assign E&S risk strategy & control to a single unit or to separate functions?
- Who has ownership of design and maintenance of E&S risk policy?
- Allocation of operational responsibility?
- Are there any points that require an internal check e.g. categorization?

TIME TO REFRESH & TAKE STOCK

30 mins max!!!!

Photo by Loverna Journey on Unsplash

Challenges

1. Managing additional work-load

Simply not possible to look at every deal in detail. Hence risk categorisation by inherent E&S risk and also type, amount and tenor of financing

Different process approaches – one for project related transactions and one for client analysis

Integration into existing business processes – requires **ownership** from the top

2. Knowledge of credit teams – new territory

Procedures, data collection forms, report templates

Information databases – e.g. legal registers

Training

3. Client resistance/managing the client relationship

Approach with client will be guided by leverage Bank has over the client.

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Thank You

Sri Lanka Banks' Association
Sustainable Banking Initiative

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