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Sustainable Financing: It's "Risk(y)" Business

Proposed guidelines on environmental risk management (Banks)

From a domestic, national perspective, given our island-state's natural vulnerability to environmental changes, Singapore has set ambitious environmental targets for itself and has made Singapore's response to climate change one of the country's key objectives / priorities, as exemplified by Prime Minister Lee Hsien Loong's focus on the impact of climate change at the National Day Rally 2019. Singapore has progressively taken a multi-pronged approach in seeking ways of achieving these targets, with a further view to positioning Singapore as a leading centre for green finance in Asia and globally.

In line with these goals, the Monetary Authority of Singapore ("**MAS**") has taken proactive steps to promote green financing, announcing its Green Finance Action Plan in November 2019 for Singapore to become a leading global centre for green finance. As part of its Green Finance Action Plan, MAS has recently issued a consultation paper on its proposed Guidelines on Environmental Risk Management (Banks) ("**MAS Guidelines**")[1] (similar consultation papers were also concurrently issued by MAS for asset managers and insurers). The consultation paper for banks seeks feedback from banks, merchant banks, finance companies (collectively, "**FIs**") and other interested parties on MAS's proposals to enhance FIs' environmental risk management practices and serves as a call to action for FIs to help drive the transition to an environmentally sustainable economy, by enhancing the integration of environmental risk considerations in FIs' financing and investment decisions, and promoting new opportunities for green financing. Whilst MAS recognises that various banks in Singapore are at different stages of implementation of their environmental risk management policies, the MAS Guidelines serve to encourage a consistently robust standard across all players and in all financial markets.

Homing in on risk management

Apart from setting out, among others, guidelines on governance and strategy of a bank's environmental risk management framework and policies (including the roles and responsibilities of the Board and senior management in overseeing environmental risk management and developing entrenched environmental risk management framework and policies within the bank) and disclosure of the bank's approach to managing environmental risk to its stakeholders, the MAS Guidelines focus substantially on risk identification, assessment and management at both customer and portfolio levels. In particular, the MAS Guidelines suggest that banks should "*assess each customer's environmental risk as part of its assessment process for credit facilities or capital market transactions*" and "*engage each customer that poses higher environmental risk to improve the customer's environmental risk profile and support its transition towards sustainable business practices over time*". This approach is, in spirit, not at all unlike the thrust of the sustainability-linked loan principles published by the joint working group comprising the

[1] Accessible at: https://www.mas.gov.sg/-/media/MAS/News-and-Publications/Consultation-Papers/2020/Consultation-Paper-on-Proposed-Guidelines-on-Environmental-Risk-Management-for-Banks.pdf.

At the time of writing, the MAS Guidelines are currently at consultative stage; the consultation closes at 6.30 p.m. on 7 August 2020.

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Loan Market Association, the Loan Syndications and Trading Association and the Asia Pacific Loan Market Association, where banks engage borrowers to incentivise their efforts to improve their sustainability profiles by aligning loan terms to the borrowers' achievement of ambitious predetermined sustainability performance targets ("**SPTs**").

What this means for loan documentation

MAS's stance on customers who pose higher environmental risk is clear: "*The bank may consider the use of financing conditions or covenants in loan agreements, to require a customer with higher environmental risk to take steps to manage its environmental risk within an acceptable timeframe… For a customer that does not manage its environmental risk adequately, the bank should consider a range of mitigating options such as reflecting the cost of the additional risk in the loan pricing, applying limits on the loan exposure, and re-assessing the customer relationship, including declining future transactions and exiting the relationship*." (emphasis ours).

The challenge then, lies in transposing these management tools into the credit process and, ultimately, the credit documentation for each affected borrower. How would a bank 'stress test' its borrower and incentivise the borrower to meet environmental targets, or clearly communicate to the borrower that the failure to meet environmental targets would result in actual and immediate repercussions on the borrower?

Setting appropriate SPTs – Bearing in mind negative externalities

To this end, common approaches in loan documentation would include step up / down interest rates or penalties linked to the borrower's realisation of SPTs. Not a novel concept, the use of margin ratchets is a key feature of sustainability-linked loans and, prior to that, incentive-linked loans generally. However, the key focus should be on identifying appropriate and effective SPTs which are able to incentivise a genuine transition in the borrower's business towards more sustainable practices by rewarding actual positive change. In this regard, SPTs set must be aggressive (to incite a shift away from the status quo) and specifically tailored to a particular borrower's environmental profile (to take into account the type of industry that the borrower is involved in and the sustainability practices that the borrower is already engaged in). In order to do so, the MAS Guidelines recommend that banks undertake "*enhanced due diligence*" on transactions with higher environmental risk, which may "*include site visits to the customer and separate review by in-house or external personnel with environmental risk expertise*" and look at the borrower's strategy and engage with senior management of the borrower. That said, it should also be stressed that banks should not focus on the beneficial effects of SPTs in silo as this ignores the fact that attaining certain SPTs comes with negative consequences which may in some cases offset the positive effects that realising the SPTs is meant to have. For example, in setting an SPT based on the volume of production of batteries for electric, hydrogen or other alternative fuel vehicles, banks should also bear in mind that the production of components for such batteries is often a carbon-intensive process which may not be compliant with environmental, social, and governance ("**ESG**") standards.

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Setting appropriate SPTs – Pitfalls associated with external rating agencies and internationally recognised standards

In setting SPTs, the MAS Guidelines also recommend that FIs "*develop sector-specific policies, which clearly articulate the bank's expectations towards an existing or prospective customer, and where possible, take into account internationally recognised sustainability standards and certification schemes*". Where reference is made to an external sustainability rating agency / provider, however, it should be borne in mind that borrowers will have little control over, e.g., the frequency of the rating. For example, in a loan where the margin is linked to the borrower's achievements in the Global Real Estate Sustainability Benchmark ("**GRESB**"), parties should be mindful of the fact that GRESB results are only published once a year. If, in the meantime, should parties wish to adjust the margin, e.g., to encourage the borrower to hasten its efforts to manage its environmental risk, the parties may find themselves locked into the current margin ratchet provisions if no other SPT is set. Banks might also wish to take into account the fact that ESG performance is notoriously difficult to measure, with the corollary that even ESG ratings by prominent ESG rating agencies may diverge. As standards of disclosure and data evolve to become more aligned across the globe, ESG standards will hopefully become more harmonised eventually, and divergence between ESG scores of different ESG rating agencies should narrow. In the meantime, should parties wish to reference the ESG scores of a borrower in SPTs, parties may consider using ESG ratings as a form of minimum standard that the borrower has to adhere to or, alternatively, reference multiple ESG ratings and link margin ratchets to the achievement of a minimum score by the majority (and not all) of the ESG rating agencies.

Monitoring and Reporting of SPTs

As part of the suite of best practices discussed in the MAS Guidelines, banks should "*monitor [the customer] on an ongoing basis for any adverse environment-related activity, or potential non-compliance with the bank's policies*". In this regard, MAS recommends that transactions with higher environmental risk be "*subject to the bank's enhanced due diligence, which may include site visits to the customer*". To achieve this, the relevant loan agreement should include monitoring / reporting covenants where borrowers are obliged to provide periodic updates to lenders and/or certify when a particular milestone is reached. Banks should also ensure that rights of access to view, examine and / or investigate project sites of the borrower are clearly documented in loan agreements. Where third-party consultants are involved, e.g., in the certification of the borrower's ESG ratings, the loan agreement should perhaps also incorporate representations as to the accuracy and adequacy of information provided to such external parties, notwithstanding that they are not parties to the loan agreement. Moving forward, much like how the majority of loan agreements today oblige the borrower to provide financial reports in respect of itself / its group of companies, we may perhaps see a stronger trend for ESG reporting to be included as part of the typical suite of information undertakings agreed to by borrowers in loan agreements.

Concluding thoughts

A bank's substantial environmental risks are those of its customers. Facilitating their customers' adoption of more sustainable practices not only has reputational benefits for the bank itself, but could also directly affect a bank's bottom line. Consequently, could it be timely for banks now to consider upping the ante on the repercussions which will flow from a sustainability breach, e.g., from the mere

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imposition of an interest premium, to the trigger of some form or extent of mandatory prepayment and, perhaps in the case of more severe and chronic sustainability breaches, even to the termination of the customer relationship completely?

Banks play a crucial role in the transition towards an environmentally sustainable economy and, in this context, the suite of best practices in relation to a bank's governance, risk management and disclosure outlined in the MAS Guidelines is a welcome step in the right direction.

If you would like information or assistance on the above or any other area of law, you may wish to contact the Partner at WongPartnership whom you normally work with or any of the following Partners:

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