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LEGAL ALERT

THE CRITICAL ROLE OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) IN LENDING ACTIVITIES BY BANKS AND OTHER FINANCIAL INSTITUTIONS

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Legal Alert

THE CRITICAL ROLE OF ESG LENDING

Background

The practice of responsible investing is not a new concept. It can be traced back to the early 1960s where investors became conscious of the social responsibility of their investments and business activities. The investors wanted to ensure that their investments were directed towards socially conscious industries.

More recently, the United Nations through a joint initiative sought to incorporate principles of responsible investment into mainstream investment decision-making and ownership practices through Environmental, Social and Governance ("ESG"). ESG therefore refers to Environmental, Social and Governance factors against which socially conscious investors use to assess the behaviour of entities, that they are considering for investment. They are the set standards for a company's operations that aim to foster greater environmental consciousness, social responsibility and accountability. Indeed, many banks and other financial institutions use these standards to evaluate the riskiness of potential investments. Banks that adopt these best practices will be well-positioned to make sound investment decisions and foster sustainability, because they play a key role in the global economy and by integrating ESG into their business operations, they can help create a more sustainable future.

The COVID-19 pandemic, the global financial, environmental, and social issues, the switch to renewable energy, and the resurgence of interest in human rights have all exacerbated the need for and drive toward ESG integration and Corporate Social Responsibility ("CSR") by financial institutions. All these factors have forced financial institutions to examine their responsibilities and role in the society.

With the global crisis on the effects of climate change, financial institutions are recognizing that they play a critical role in financing the transition to a low carbon economy and are now shifting from the sole traditional goal of profit making. Banks and other financial institutions and are now more attentive to environmental concerns, social issues and good governance practices, that impact to the society at large, to ensure that they operate in an ethical and responsible manner. Indeed, banks that score well on ESG measures are often seen as being better managed and more likely to generate long-term shareholder value. Similarly, investors are making investment decisions based on purpose and sustainability. They are therefore more interested in financial institutions that not only have rosy financial statements, but also integrate social, environmental and economic concerns into their business model. ESG is therefore becoming increasingly important for banks, other financial institutions and their customers/investors for various reasons related to profitability, risk and values.

Now more than ever, financial institutions such as banks are increasingly considering ways to mitigate negative environmental and social impact, with the aim of addressing the emerging needs of the society.

Further, these institutions are experiencing internal and external pressures to be vigilant about ESG concerns. Banks are now required to build sustainable lending frameworks, to address issues such as environmental externalities, employee welfare, social diversity and the establishment of sustainable economies that are beneficial to the global citizenship.

Institutions that are unable to integrate ESG into their business models, will face increased pressure to be more responsible and accountable. The challenges they are likely to face include higher credit risks, unfavourable lending terms and weaker profitability, as ESG risks will become concentrated in their loan books.

In this alert we shall explore the sustainable loan market with particular focus on ESG lending and the interplay of ESG performance on borrowers. We shall also explore emerging trends in ESG lending landscape.

ESG Lending

Banks are the primary source of debt financing for companies and individuals around the world. As such, their lending activities are greatly linked to the impact that businesses have on ESG issues and have thus facilitated the growth in ESG lending.

ESG lending generally involves various facilities and instruments that financial institutions offer, to facilitate and support environmentally sustainable economic activities. These facilities are now offered in form of ESG loans, which are broadly categorized into two: ESG-linked loans and green loans.

Sustainable lending therefore indicates a company's dedication to environmental, social and governance issues, from both the lender's and the borrower's perspectives, thereby earning them green credentials from a growing pool of investors, who support sustainable practices.

ESG-Linked Loans

ESG-linked loans are general purpose facilities whose pricing terms are tied to the ESG adherence and performance of the borrowing entity or individual. These facilities are also referred to as sustainability-linked loans. This type of lending is more attractive to the borrower because the use of the loan proceeds is less restrictive and the interest rate is dependent on adherence to ESG practices, contained within the borrowing agreement.

ESG-linked loans are often issued in the form of revolving credit lines and are pegged explicitly on Key Performance Indicators ("KPIs") incorporating sustainability goals. These KPIs are structured either as an ESG score assigned to the borrower by external rating agencies or specific measures such as Greenhouse Gas ("GHG") emissions or employee health and safety performance.

The ESG score assigned often informs the interest rate charged on the facility by a lender. For instance, the interest rate can decrease when the ESG rating of a borrower is higher.

That notwithstanding, there is flexibility with sustainability-linked loans in that the proceeds can be used for non-green purposes, thereby broadening the scope for borrowers and lenders concerned with sustainability issues. This means that the loan proceeds can be employed for regular operations, instead of only funding projects that potentially benefit the environment.

Globally, the ESG-linked loan market has grown rapidly since 2017, when Royal Philips NV announced the first revolving credit facility linked to sustainable lending which was the first syndicated loan of this kind. Phillips entered into the agreement with a consortium of 16 banks for a new EUR 1 billion revolving credit facility, with an interest rate dependent on the company's year-on-year sustainability performance.

Closer home, we have seen the growing partnership by financial institutions to provide sustainability-linked financing to both green and non-green projects and businesses.

Green Loans/Green Bonds

Green loans or green bonds are facilities whose proceeds are earmarked to exclusively finance or re-finance, in whole or in part, environmental and climate-friendly projects such as renewable energy, biodiversity conservation, sustainable water, wastewater management and carbon capture.

Unlike ESG-linked loans, green loans fund specific projects with explicit sustainable features.

At the core of this are the Green Loan Principles which provide a list of green project categories, that shed light on the eligible green projects. These Principles must therefore be adhered to during the advancement of green loans.

They include –

(a) the use of the proceeds of a project;

(b) the process for project evaluation and selection to be developed by borrowers and lenders;

(c) management of the proceeds of a green loan i.e., to ensure transparency and promote integrity of a project; and

(d) reporting by making readily available up-to-date information on the use of proceeds, of a green project.

In Kenya, green loans are viewed as an instrument of raising funds for activities that promote environmental protection in energy, agriculture, waste management, water, transport and urban planning.

There is in place the Green Bond Program, which is coordinated by the Kenya Bankers Association, Nairobi Securities Exchange and Climate Bonds Initiative in conjunction with the Sustainable Finance Initiative.

A classic example of a financial institution offering green loans in Kenya is KCB Group. The institution was accredited in 2020 by the United Nations Green Climate Fund for on-lending investments and projects with a positive impact on the environment.

It is reported that this year, the lender is set to extend Kenya Shillings Five Billion (KShs.5,000,000,000) loan facility to an infrastructural sector firm, which shall be the first company to receive the green loan. Several other financial institutions in the country have dedicated departments that focus on sustainable lending and compliance with ESG reporting.

Other Instruments

Green Equity

Green equity is characterized as a direct investment, semi-direct investment and indirect investment in the shares of an entity to promote environmentally sustainable and climate-compatible projects. The capital raised from the said investment is used to pursue this cause, with the aim of complying with the mandates under the Paris Agreement of 2015.

Sustainability-Linked Schuldschein

A Schuldschein is a form of private debt placement comprising typically unsecured medium to long-term debt obligation. It has been used for decades in Germany and Austria. It comprises of both the elements of loans and bonds and can be offered in a range of maturities, interest rates, currencies, and lending amounts. However, unlike a traditional bond, a Schuldschein is not registered as a security and does not require a formal rating from a credit ratings agency. It can, however, be marketed and traded among investors.

It is now emerging that sustainability-linked Schuldschein can be offered as a sustainable finance facility, within the confines of green financing as they are credible and impactful. This is because sustainability-linked debt encourages issuers to measurably change their business models, in favour of sustainability, regardless of where they currently fall, with regard of their environmental effect.

Green Sukuk

Sukuk are Shariah compliant securities backed by a specific pool of assets. Green Sukuk are Shariah compliant investments in renewable energy and other environmental assets. They therefore address Shariah concern for protecting the environment. The proceeds of the Green Sukuk are used to finance climate change mitigation, climate change adaptation and environmental projects.

Regulatory Framework Bolstering ESG Lending in Kenya

(I) Central Bank of Kenya Guidance on Climate-Related Risk Management

This Guidance was issued in October 2021 pursuant to Section 33(4) of the Banking Act Cap 488 Laws of Kenya, which empowers the Central Bank of Kenya to provide guidance to institutions with the aim of maintaining a stable and efficient banking and financial system. The main aim of the Guidance is to provide institutions with a roadmap to integrate climate-related risks, in their decision-making frameworks.

The rationale behind emphasizing on integrating climate-related risks is that climate-related financial risks, significantly increase the banking sector credit risk as a result of factors such as: severe floods, drought, landslides and wildfires that have the effect of destroying a borrower's assets or impairing supply chains.

The Guidance provides guidelines to the banking industry stakeholders on how: to embed considerations of the financial risks from climate change in their governance structures; to incorporate the financial risks from climate change into their existing financial risk management practice; and to develop an approach relating to disclosure on the financial risks from climate change. Additionally, the responsibility of formulating and implementing these climate-related financial risk management strategies for an institution, is placed on the board of directors and the senior management of the institution.

Finally, the Guidance sheds light on the formulation of an effective climate governance structure to enable financial institutions to not only properly assess climate-related risks and opportunities, but to also enable them set the relevant goals and targets.

(II) The Code of Corporate Governance Practices for Issuers of Securities to the Public, 2015

This Code was issued pursuant to Section 11(3) of the Capital Markets Act, Cap 485A Laws of Kenya. Its main aim is providing a roadmap with respect to the principles and specific recommendations on structures and processes which companies should adopt in integrating good corporate governance in their business dealings and culture.

In particular, the Code obliges boards of directors to ensure that they have formal strategies in place to promote sustainability and that particular attention is paid to the ESG aspects of the business.

This is done through the "Apply or Explain" approach, where boards of directors are required to fully disclose any non-compliance with the Code to the relevant stakeholders, with a firm commitment to move towards full compliance. The Code therefore, advocates for the adoption of standards that go beyond the minimum prescribed by legislation, for instance taking into account the welfare of the stakeholders.

(III) Nairobi Securities Exchange ESG Disclosures ("NSEEDs")

In November 2021, the Nairobi Securities Exchange alongside the Global Reporting Initiative released the Nairobi Securities Exchange ESG Disclosures. The motivation behind issuing the guidelines is that ESG reporting provides a framework through which investors, owners of capital and the public at large, can have a more comprehensive view of the company's activities and performance, beyond its financial numbers.

The guidelines aim to improve and standardize ESG information reported by listed companies and provide a granular, as well as tactical approach to ESG reporting, that meets international standards such as the United Nations ESG reporting requirements.

The NSEEDs also provide guidelines on how to meet corporate governance reporting requirements contained in the CMA's Code of Corporate Governance Practices, for Issuers of Securities to the Public, with the aim of capturing significant opportunities for stakeholders while managing critical business risks.

The NSEEDs provide key emphasis on the expectations for lenders to ensure business continuity, regulatory compliance, responsible application of credit products and the protection of human rights which should be continuously communicated through financial statements, environmental and social monitoring reports and sustainability reports.

In conclusion, consistent application of the guidelines will help improve the capital markets in Kenya, by providing information that investors are now demanding to facilitate decision making and capital allocation, which is the key objective of capital markets.

Emerging Trends

1. Financial Technology

Financial technology such as blockchain and distributed ledgers are emerging in the sustainable finance ecosystem. They are aiding in overcoming market impediments that would ordinarily hamper sustainable financial instruments and investment vehicles. Additionally, they are assisting in reducing transaction costs significantly, a key benefit any borrower.

The World Bank has pointed out three key ways that digital innovation can promote sustainable finance practices. They include: the provision of transparency and robust rule implementation though smart contracts; collaborative governance systems that ensure effective monitoring, reporting and verification standards; and leveraging the use of data flows.

2. Sustainable Finance to the Unbanked

Microfinance Institutions ("MFIs") play a key role in society by providing access to financial services to the unbanked section of the population. MFIs are equipped with the rural infrastructure to bring fundamental transformation at the social and environmental level. With respect to governance, MFIs in Kenya are adequately regulated and have in place strong corporate governance structures which ensure that they are properly structured to provide responsible and sustainable finance.

In this regard, MFIs are proving to be a financial institution of choice for large part of the demographic and with their widespread reach, they are at the epicentre of contributing to the ESG framework in Kenya.

Conclusion

ESG issues are key considerations for banks and other financial institutions, just like any other businesses. More and more, customers, investors and other stakeholders are looking for banks that take ESG seriously. This is not a trend – it is here to stay and banks that do not pay attention to ESG, will find themselves at a disadvantage in the years to come, if they do not develop comprehensive ESG policies. They must make sure that they have committed teams who are understand ESG policies and know how to implement them. In some countries, stock exchanges now require listed companies to disclose their ESG policies and performance metrics. Banks and other financial institutions must communicate these policies to their stakeholders and most importantly, live up to their commitments, without focusing only on profits.

Financial institutions have a responsibility to uphold ESG practices. This is not only sound business practice, it is the right thing to do. By implementing ESG policies, financial institutions create a positive impact in the world, while protecting their bottom line. With time, all serious banks will have to disclose their own ESG practices in a transparent way, to build trust with stakeholders and confirm that they genuinely include the implementation of ESG policies, in their business strategies. Indeed, banks and financial institutions that adopt effective ESG policies can attract more customers, improve their reputation and generate higher profits. They will be well-positioned to make sound investment decisions and foster sustainability. In today's world, there is simply no excuse for financial institutions not to be responsible and ethical in implementing their ESG policies.

There is no doubt that financial institutions are witnessing the rapid growth and emphasis on sustainable finance. As shareholders become increasingly focused on responsible investing, it is likely that disclosures around ESG performance will continue to increase. With the significant growth being currently experienced in ESG lending and reporting activities, we are keen to monitor the emerging trends relating to ESG-related facilities and the exploration of credit markets, by financial institutions.

In the wake of change in attitudes with respect to how financial institutions operate, it is important to understand the concept of ESG, as it continues to take a critical role in corporate reporting. As such, financial institutions are using ESG more frequently to create shared value, rather than merely complying with recognised standards or principles, that they are required to accept. Financial institutions must lend responsibly and be accountable as global citizens, if they want to remain relevant.

We foresee both legislative and stakeholder intervention, through rules and regulations based on international best practice, rather than market discretion in Kenya. It will be interesting to see the interplay of cross-boundary facilities and syndicated loan options, that shall be available to borrowers in the Kenyan market.

Disclaimer

This alert is for informational purposes only and should not be taken or be construed as a legal opinion. If you have any queries or need any clarifications as to how any aspect of the amendments might affect you, please do not hesitate to contact Pamella Ager - Managing Partner, (pamella@oraro.co.ke) and Anna Kandu, Associate (anna@oraro.co.ke), or your usual contact at our firm.

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