5. Promoting responsible lending in the banking sector: The next frontier for sustainable finance

This chapter explains why strengthening ESG integration in corporate lending practices should be a key objective of sustainable finance initiatives and provides an overview of drivers for ESG in the commercial lending activities of banks. It examines the current practices of banks in integrating sustainability considerations into their corporate lending activities, the challenges they face in doing so and how policy makers can facilitate scaling up responsible lending practices.

5.1. Introduction

Sustainable finance, as a practice and policy concept, is on the rise globally. The volume of "responsible" or "sustainable" financial products and strategies has grown exponentially in the past 10 years, driven largely by increased demand from beneficiaries, as well as policy signals that the financial sector should be a driving force in achieving global sustainability agendas. To date, the focus of these initiatives has largely been on the role of institutional investors and asset owners.[1] Less attention has been paid to how banks can drive sustainability through corporate lending although this represents a significant source of global capital.

While corporate debt has always been an important source of finance for enterprises, recent years have seen unprecedented growth in the volume of debt stocks. In March 2020, the Economist reported that non-financial corporate debt had reached USD 74 trillion (Economist, 2020[1]). At the end of 2019, the global outstanding stock of non-financial corporate bonds, a sub-set of global corporate non-financial debt, reached an all-time high of USD 13.5 trillion in real terms (Celik, Demirtas and Isaksson, 2020[2]).[2] As debt has ballooned, the relative quality of new debt stocks has diminished. Research by the OECD published in early 2020 found that "compared with previous credit cycles, today's stock of outstanding corporate bonds has lower overall credit quality, higher payback requirements, longer maturities and inferior covenant protection. These are features that may amplify the negative effects that an economic downturn would have on the non-financial corporate sector and the overall economy" (Celik, Demirtas and Isaksson, 2020[2]).[3] See also (Economist, 2020[1]).

Credit from banking institutions continues to be a dominant source of finance globally. In the European Union it represents around two thirds of investment and in 2017 the banking share of total debt of non-financial corporations stood at 82% (European Banking Federation, 2017[3]). However, competition from non-bank lenders such as private capital firms and fintechs is on the rise (Deloitte, 2020[4]).[4]These platforms have the potential to harness and analyse large amounts of data, potentially accelerating and simplifying financing transactions, but also putting pressure on commercial banks to keep pace.

Growing global debt, diminishing quality, and competitive pressures can have important implications for promoting ESG in corporate finance. On the one hand, ESG integration into lending activities may contribute to higher quality debt stocks and more resilience in the financial sector. For example, early evidence from the period of the COVID-19 pandemic is showing that companies which perform better on ESG have also been slightly more financially resilient in the face of disruptions wrought by the crisis (see below). However, competition from peers and new entrants to the sector threaten to put banks that conduct thorough environmental and social due diligence at a disadvantage in attracting clients, who may be able to access financing more quickly from other sources.

Additionally, challenges with respect to in-house capacity of practitioners, quality and availability of ESG data and barriers to collaboration also hinder banks from meaningfully integrating ESG in their lending processes. While there has been significant progress in terms of practice, many banking practitioners are still in early stages of understanding and managing ESG types of risks.

As the world braces itself against the current disruptions caused by the COVID-19 crisis, policy makers should also consider how to build back more resilient systems to cope with future shocks, including those predicted to manifest from climate impacts in the near future. Global leaders have regularly underscored that private finance will be needed to achieve many global goals (United Nations, 2015[5]) (G20, 2017[6]). An estimated USD 5-7 trillion a year is needed to realise the 2030 Sustainable Development Agenda (UNEPFI, 2018[7]), and an additional USD 83 billion in energy related investments is needed per year from the period 2016-2050 to limit global warming to 1.5 degrees Celsius (IPCC, 2018[8]). However, such goals do not appear to be fully reflected in many commercial and investment banking practices. For example, research by the European Central Bank has found that corporate lending is less likely to promote lower CO_2 emissions than equity capital (Popov, 2019[9]). (See also Chapter 4).

Given the scale and significance of this part of the sector, strengthening ESG integration in corporate lending practice will be necessary to meet global sustainability goals as well as enhance resiliency in the financial sector. This chapter explores current practices of banks in integrating sustainability considerations into their corporate lending activities, the challenges they face in doing so and how policy makers can facilitate scaling up responsible lending practices.

5.2. What is driving ESG in corporate lending transactions?

As in other parts of the financial sector described in Chapter 1, consideration of ESG issues is on the rise in the context of corporate finance. Various drivers are behind this trend including demand from investors, pressure from civil society, and increasing understanding of the material impact of ESG on the financial performance of corporates.

From May to June 2020, the OECD Secretariat conducted interviews with 17 of the largest banks headquartered in OECD countries to understand current drivers, practices and challenges facing practitioners in integrating ESG consideration in lending transactions (see Annex 5 for more information). According to the banks interviewed, demand from investors, as reflected in investor position statements such as BlackRock CEO's letter to companies, was a leading driver for ESG integration in lending practices.

rA 2019 S&P survey of 194 credit risk professionals working in banks and other financial institutions found that 86% agreed that heightened investor demand is making it critical to consider ESG factors more fully in credit risk analysis (S&P Global Market Intelligence, 2019 ESG Survey[10]). The same survey found that 83% of respondents noted that ESG factors are integral to the credit risk area.

Considering the impact of environmental and social issues on creditworthiness has become commonplace in recent years driven primarily by concerns about physical and transition risks related to climate change. In seven of the last ten years, the global costs of natural disasters have exceeded the 30-year average of USD 140 billion per year. In 2017 alone natural disasters cost the US economy USD 307 billion (Reuters, 2018[11]). Such impacts can pose a risk to financial stability broadly as well as to individual banks. For example, analysis by the European Systemic Risk Board (ESRB) has found that costs associated with climate change are inevitable and that to date financial markets only price this risk in a limited way. It found that while diversified exposures should shield the banking sector from large losses, if high-emitting firms within sectors at risk of climate change are downgraded, losses for selected exposures would still be significant (ESRB, 2020[12]). On the flip side, various studies have shown that sustainable lending can decrease risks of default. For example, research has found that Chinese banks with higher ratios of green lending have lower non-performing loan (NPL) ratios (Cui, 2018[13]).

Early evidence also suggests that companies with strong ESG performance have been more resilient in withstanding shocks associated with the COVID-19 crisis. For example, in the months following the introduction of confinement measures in OECD countries, sustainable debt and green bonds have been more resilient than mainstream corporate debt. According to Bloomberg/Barclays, the US Green Bond Index has outperformed S high-grade corporate index by 261 bps (Climate-kic, 2020[14]). This trend will need to be re-evaluated at a later date to take into account time lags in arrangement, issuance, and trading in secondary markets.

Beyond the potential impact of ESG issues on creditworthiness, pressures on investors to integrate and report on ESG in their processes may be cascading down to banks in corporates. In April of 2019, the European Parliament approved Regulation 2019/2088 on Sustainability-Related Disclosures in the Financial Services Sector ("Sustainable Finance Disclosures Regulation"). The Regulation introduces transparency rules for financial institutions involved in investment management on the integration of sustainability risks and impacts in their processes and financial products, including reporting on adherence to internationally recognised standards for due diligence (Official Journal of the European Union, 2019[15]).[5] Subsequently,

investor pressure on banks as well as corporates to engage in ESG risk management and reporting is increasing. For example, in 2020 a group of 105 international investors, representing over USD 5 trillion in assets under management, called on governments to put in place regulatory measures requiring companies to conduct and report on human rights due diligence (Investor Alliance for Human Rights, 2020[16]).

Social expectations and pressure from civil society on the banking sector to consider environmental and social risks more carefully is also growing. Data from Sigwatch, an organisation which tracks NGO campaigning activity globally has found that the number of campaigns targeting the financial sector have nearly doubled over the last 8 years (Sigwatch, 2019[17]). Such campaigns can represent significant reputational and financial risk to banks. For example, as part of protests against the construction of the Dakota Access Pipeline (DAPL) in the United States, several campaigns targeting banks providing financial support to the project were launched, inviting clients of these banks to close their accounts. The Defund DAPL website reported total account closures valued at USD 4.4 billion. This figure includes 150,000 personal account closures valued at USD 86.2 million and city divestment valued at USD 4.3 billion (Fredericks, 2018[18]).

International instruments, such as the OECD Guidelines for Multinational Enterprises and UN Guiding Principles for Business and Human Rights, also recognise that enterprises, including banks, should prevent and mitigate any adverse impacts to society and the environment arising from their activities (OECD, 2011[19]). In recent years there has been a rise of submissions involving the financial sector to OECD National Contact Points, the grievance mechanism attached to the OECD Guidelines for Multinational Enterprises.[6] For the past three years (2016-2019) 15% of all new submissions target the financial sector (compared to less than 10% in 2000-2015) (See Box 5.1).

Box 5.1. Examples of submissions filed with OECD National Contact Points involving the financial sector

Australian and New Zealand Banking Group Limited (ANZ Group) financing of Phnom Penh Sugar: In 2014, NGOs Equitable Cambodia (EC) and Inclusive Development International (IDI) submitted a case on behalf of 681 families in relation to ANZ's involvement with Phnom Penh Sugar (PPS), the developer of a sugar plantation and refinery project in Cambodia. The project is alleged to have forcibly displaced the families and dispossessed them of their land and productive resources. The NCP concluded that in this case it was difficult to reconcile ANZ's decision to take on PPS as a client with its own internal policies and procedures—which appear to accord with the OECD Guidelines—as the potential risks associated with this decision would likely have been readily apparent. The NCP also recommended a series of actions to strengthen ANZ's due diligence and remediation mechanisms. In February 2020, the parties reached an agreement in which ANZ Bank agreed to compensate the impacted families by paying them the profits it earned from the loan, setting a precedent for provision of remedy in the banking sector.

ING climate risk management and disclosure: In 2017, the NGOs Oxfam Novib, Greenpeace, BankTrack and Friends of the Earth Netherlands submitted a case to the Dutch NCP concerning ING, a Dutch bank. Specifically, the submitters argued that the bank does not report the levels of greenhouse gas emissions caused by its lending activities and has not yet announced whether it intends to do so in the near future. In addition, they argued that the bank has not set a target to reduce greenhouse gas emissions in its lending. Their submission requested the NCP to examine ING's climate policy and to urge ING to align its climate and other policies with the Guidelines. In April 2019, the case was concluded and the parties reached an agreement, in which ING committed to align its portfolio with the Paris Agreement. Additionally, ING and the NGOs called directly on the Dutch government to request the International Energy Agency (IEA) to develop two 1.5 degrees scenarios, one with and without the use of Carbon Capture and Storage (CCS), that provide a 66% chance to limit global warming to below 1.5 degrees.

Credit Suisse relationship with companies involved in the North Dakota Access Pipeline: In April 2017, the Swiss NCP received a submission from the Society for Threatened Peoples (STP) concerning the business relationship of Credit Suisse with companies involved in the construction of the Dakota Access Pipeline ("DAPL") in the United States. The submitter claimed that despite international criticism about the project, Credit Suisse has increased its business relations with enterprises involved in the construction of the DAPL. On September 2019, the parties reached an agreement on several points. One outcome from the agreement includes the inclusion of Free Prior Informed Consent (FPIC) in Credit Suisse's internal sector specific policies for Oil & Gas, Mining and Forestry & Agribusiness.

Source: OECD Database of Specific Instances

Unlike institutional investors, banks in OECD countries have been under less regulatory pressure to integrate ESG into their lending processes and to date have largely used voluntary industry standards to guide their ESG strategies (see below). However, policy makers have been recognising in recent years that initiatives in the banking sector should be scaled up, and therefore regulation may become a stronger driving force in promoting ESG in this sector in the near future.

5.3. Current practices in ESG integration and due diligence in corporate lending

5.3.1. Moving beyond project finance

Consideration of ESG issues has long been common practice for banks in the context of project finance transactions, specifically those concerning large-scale infrastructure or extractive projects. Immobile assets, potentially significant environmental and social footprints, large upfront costs and long repayment terms heighten the significance of ESG risks associated with these type of projects. For example, research on the costs of company-community conflict, a major source of disruption in mining and other infrastructure projects, has found that lost productivity due to temporary shutdowns or delay would cost a **major, world-class mining project with capital expenditure of between USD 3-5 billion roughly USD 20 million per week of delayed production in Net Present Value** (NPV) (Franks, 2014[20]).

Box 5.2. Terminology: RBC, ESG, and ESR

Under the OECD Guidelines for Multinational Enterprises "responsible business conduct" (RBC) means that business should: i) make a positive contribution to economic, environmental, and social progress with a view to achieving sustainable development; and ii) should avoid and address adverse impacts through their own activities and seek to prevent or mitigate adverse impacts directly linked to their operations, products, or services by a business relationship (OECD, 2011[19]). "Environmental, social, and governance" (ESG) criteria or "Environmental and social risk" (ESR) is the term normally used by financial institutions to describe the set of criteria they use when assessing the sustainability performance of a company.

The scope of RBC and ESG/ESR criteria are highly related. Both relate to understanding and quantifying the impacts of business activities on environmental and social issues. However RBC is specific to the standards and recommendations set out in the MNE Guidelines and pertains primarily to impacts to the environment and society, independent of financial materiality. While no formal, widespread definition exists for "ESG" and there is diversity with respect to how these concepts are instrumentalised by financial institutions and intermediaries, they often pertain primarily to environmental and social risks which also pose financial risks.

In this respect some banks have adhered to and implement the Equator Principles (EPs). The EPs are an industry-developed standard for managing environmental and social risks associated with project finance transactions for commercial banks. They have been adopted by 105 financial institutions in 38 countries and include specific benchmarks and requirements with respect to the ESG performance, rooted in recommendations of the International Finance Corporation (IFC) performance standards (see Box 5.2).

Box 5.3. Overview of the Equator Principles (EP)

The Equator Principles (EP) were first introduced in 2003 and most recently updated (EP4) in 2019. The EP are a risk management framework for determining, assessing and managing environmental and social risk in projects, including in sectors such as mining, infrastructure and oil and gas, which are funded by financial institutions.

Equator Principle Financial Institutions (EPFIs) commit to implementing the EP in their internal environmental and social policies, procedures and standards for financing projects and also commit to not extend financing where a prospective client will not, or is unable to, comply with the EP.

Broadly, the EP require its members to categorise projects "based on the magnitude of potential environmental and social risks and impacts" based on the IFC's environmental and social categorisation. Based on the project's risk categorisation, EPFIs are required to conduct appropriate due diligence, and assessment documentation must include both an Environmental and Social Impact Assessment (ESIA) and an assessment of human rights and climate risks and impacts.

For certain projects EPFIs also commit to requiring clients to engage in effective stakeholder engagement, establish environmental and social management systems and grievance mechanism, and incorporate expectations into financing covenants.

EPFIs are also required to publically report annually on transactions covered by the EP framework that reach financial close.

The EP apply to transactions in all industries and sectors that meet the below thresholds:

1. **Project Finance Advisory Services** where total Project Capital Costs are USD 10 million or more.
2. **Project Finance** with total Project Costs of USD 10 million or more.
3. **Project-Related Corporate Loans** where all the following three criteria are met:
    a. The majority of the loan is related to a Project over which the client has Effective Operational Control (either direct or indirect).
    b. The total aggregate loan amount and the EPFI's individual commitment (before syndication or sell down) are each at least USD 50 million.
    c. The loan tenor is at least two years.
4. **Bridge Loans** with a tenor of less than two years that are intended to be refinanced by Project Finance or a Project-Related Corporate Loan that is anticipated to meet the relevant criteria described in 2 and 3 above.
5. **Project-Related Refinance and Project-Related Acquisition Finance**, where all of the following three criteria are met:
    a. The underlying Project was financed in accordance with the Equator Principles framework.
    b. There has been no material change in the scale or scope of the Project.
    c. Project Completion has not yet occurred at the time of the signing of the facility or loan agreement.

Source: Equator Principles (2020), https://equator-principles.com/wp-content/uploads/2020/05/The-Equator-Principles-July-2020-v2.pdf

Although the EP provide a strong framework for assessing and responding to certain ESG risks, only a small amount of global corporate lending transactions fall within their scope (see Box 5.4). Indeed many leading banks have noted that they conduct minimal project finance transactions and/or that this line of businesses is decreasing. For example, during the 2018 reporting period, the total number of transactions reported, including project finance advisory services, project related corporate loans, and project finance transactions across all EP adherents, was 1 031 by 102 financial institutions.[7] The largest number of transactions reported among the institutions which have adopted the EPs was 88 by Sumitomo Mitsui Banking Corporation, followed by 87 by MUFG Bank, and 55 by Société Générale. In terms of other leading banks, only 2 transactions were reported by Bank of America, 4 by Wells Fargo, 8 by JP Morgan, 22 by BNP Paribas and 26 by HSBC Holdings. By comparison, all banks interviewed by the OECD noted that they each carry out thousands of corporate lending transactions annually, for some institutions even tens of thousands. Several banks interviewed by OECD noted they applied the standards of the EPs beyond transactions falling within their defined threshold for application. Nonetheless the vast majority of bank's lending portfolios are currently not subject to the EPs.

Box 5.4. OECD Due Diligence for Responsible Corporate Lending and Securities Underwriting

The guidance outlines how banks can carry out a due diligence process to identify and respond to environmental and social risks and impacts associated with the activities of clients or prospective clients. The guidance is organised according to a six step framework:

1. **Embedding RBC into policies and management systems**: describe approaches to due diligence and assign roles to relevant business units.
2. **Identifying actual and potential adverse RBC impacts**: develop a *first* screen and *second* screen for enhanced identification, and develop a process for assessing a bank's involvement with an adverse impact.
3. **The cessation, prevention, and mitigation of such impacts**: for corporate lending transactions, incorporate RBC expectations in contractual documents or written agreements, engaging with clients, and well as collaborating to address systemic issues.
4. **Tracking implementation and results**: request clients to report on issues and in high risk cases, require third party review of compliance.
5. **Communicating how impacts are addressed**: publicly communicate on RBC policies and number of corporate lending transactions subjected to enhanced due diligence.
6. **Providing for or cooperating in remediation when appropriate**: seek to use leverage to encourage clients to provide for or co-operate in remediation and enable access to remediation by establishing a bank-level grievance mechanism.

The guidance was developed in close consultation with a multi-stakeholder advisory group of over 50 organisations, including leading global banks, governments and expert stakeholders. It was also approved by the 49 governments that adhere to the OECD Guidelines for Multinational Enterprises.

Source: OECD (2019), Due Diligence for Responsible Corporate Lending and Securities Underwriting, https://mneguidelines.oecd.org/due-diligence-for-responsible-corporate-lending-and-securities-underwriting.htm.

Until very recently, no broadly recognised environmental and social standards existed for general corporate lending or underwriting transactions, although they represent the vast majority of banking finance activities. This changed in 2019 with the publication of the *OECD Due Diligence for Responsible Corporate Lending and Securities Underwriting* (OECD, 2019[21]) and, separately, the UNEP FI Principles for Responsible Banking (UNEP-FI, 2019[22]) (see Box 5.5 and Box 5.6). Both standards provide frameworks for ESG risk

management for lending transactions beyond project finance. However, as they have only recently been introduced, awareness and implementation of these standards are in their initial stages and many banks have only recently began incorporating ESG considerations into general corporate lending transactions. For the most part, such processes are generally less developed and thorough than processes undertaken for project finance activity. However, they are also quickly evolving and in interviews conducted by the OECD most banks have signalled a willingness to be more ambitious with respect to ESG due diligence processes in general corporate lending transactions. Nonetheless, several challenges were identified by banks interviewed by the OECD to enhancing ESG practices in the context of these transactions, including issues around resources, constraints to collaboration and transparency, and quality of data. These are further discussed in the following section.

Box 5.5. The UNEP Finance Initiative Principles for Responsible Banking

In September 2019, the United Nations Environment Programme Finance Initiative (UNEP FI) Principles for Responsible Banking were launched with the objective of providing guidance on sustainability across all business areas of banks. These principles provide a six-point framework for sustainable banking:

1. **Alignment:** with social goals, such as with the SDGs and Paris Climate Agreement
2. **Impact and Target Setting:** publish targets related to most significant impacts
3. **Clients and Customers:** encourage sustainable practices with clients and customers
4. **Stakeholders:** engage stakeholders
5. **Governance and Culture:** implement effective governance and culture of responsible banking
6. **Transparency and Accountability:** review individual and collective implementation of the principles and be transparent and accountable for positive and negative impacts

The principles represent a multi-stakeholder partnership between UNEP FI and the banking industry to help banks implement these principles through guidance and reporting frameworks. They are open for banks to sign on. Signatory banks are required to report on their self-assessment within 18 months of becoming a signatory. Within a maximum of four years, banks are expected to have implemented their targets.

Source: UNEP FI Principles for Responsible Banking, https://www.unepfi.org/banking/bankingprinciples.

5.3.2. Current practice in lending transaction

ESG policies

In OECD interviews with banks, nearly all noted that they had an environmental and social (E&S or ESG) policy, and that most of the policies covered E&S practices in general corporate lending.[8] Generally, the banks' E&S policies outline the framework and governance of E&S risk management, including the responsibilities and mandates of various group functions. All banks interviewed also noted that their policies referenced international standards or frameworks, including one or more of the following: the UN Guiding Principles for Human Rights, OECD Guidelines for Multinational Enterprises, OECD due diligence standards, UN Global Compact, IFC Performance Standards, Equator Principles, Principles for Responsible Investment, and the Paris Agreement. Many of the banks interviewed by the OECD also noted that they are now studying their policies' alignment with the OECD guidance on *Due Diligence for Responsible Corporate Lending and Securities Underwriting*.

Research by Fitch Ratings has also found that the influence of ESG-related policies spans beyond major banks that formally adhere to them (i.e. through signing onto them or explicitly referencing them in their policies). According to the study, almost half the 182 surveyed banks' stock of lending assets and new lending flows are affected by ESG policies. (Fitch Ratings, 2020[23])

5.3.3. ESG incorporation in Risk Management

Banks have displayed diversity and variation in how they apply international standards in their E&S due diligence.

All banks interviewed by the OECD noted that they screen their lending portfolios against specific ESG risks. However, banks reported a broad range of practice with respect to the degree of ESG due diligence that is carried out. For example, most banks noted that they normally undertake several thousand corporate lending transactions per year, including revolving credit facilities and new loans. Several of the banks noted they would undertake enhanced due diligence processes for only around ten general corporate lending transactions per year, while one bank reported it undertook enhanced due diligence on 281 general corporate lending transactions in the previous year. All banks reported that enhanced ESG due diligence was more common for project finance transactions, as it was required by the Equator Principles.

A recent study by Fitch Ratings surveying 182 global banks found that 64% of them incorporated ESG into their risk management processes 'always' or 'most of the time'. (Fitch Raings, 2019[24]) The study found that banks based in Africa and Asia-Pacific were more likely to integrate ESG into risk management frameworks than European (particularly Eastern European) and North American banks. This discrepancy was particularly pronounced with respect to climate risk management, where North American banks significantly lagged behind those in Africa and Asia; 77% of African banks integrated climate-related consideration into their risk framework, compared to only 18% of North American banks. This discrepancy was partially attributed to fewer ESG-related regulatory standards in Europe and North American companies (see below).

Research by Fitch also concluded that ESG screening would in most cases lead to enhanced due diligence and further checks on clients rather than a restriction on financing. Only in limited cases where significant human rights impacts were identified or where a bank committed to stop financing of specific types of assets (i.e. new thermal coal-mines or coal-fired power station projects) was financing not extended (Fitch Ratings, 2020[23]). Similarly, in OECD interviews with banks, all noted that rescinding or suspending existing credit lines due to ESG issues was extremely uncommon.

According to interviews with OECD banks, ESG integration in annual credit reviews appeared to be the main systematic monitoring process for general corporate lending. In this respect some banks noted that they require an update on ESG issues for all clients, while other banks include such criteria only for select clients prioritised by risk if reputational issues or if allegations of adverse impacts have arisen, or on a client-sector basis. Beyond annual credit reviews, the monitoring of clients on ESG issues appeared limited when not required by specific criteria integrated in covenants, risk prioritisation by sector or geography as outlined in a bank's policy.

Most interviewed banks noted that they would like to scale up their ESG integration processes and that ESG processes related to corporate lending transactions could be further enhanced. Many also recognised that their peers felt the same way. However almost all interviewed banks noted that syndicated transactions currently posed challenges to ESG integration. Specifically, they noted that it is difficult to ensure that participating banks carry out the same level of due diligence or require the same standard of conduct from their clients, particularly when they are working with banks operating in different geographies. Information asymmetries between the lead arranger bank and participants can also pose challenges. Some banks have pointed out that integration of ESG expectations into template lending covenants, such as those developed by the Loan Markets Association (LMA), could be useful in establishing a baseline for ESG

expectations of clients and due diligence processes of lenders. LMA template covenants do not currently include any conditions related to environmental and social performance and as such it is very rare for banks to include these types conditions in lending contracts (except in the context of project finance transactions covered by the Equator Principles, see above).

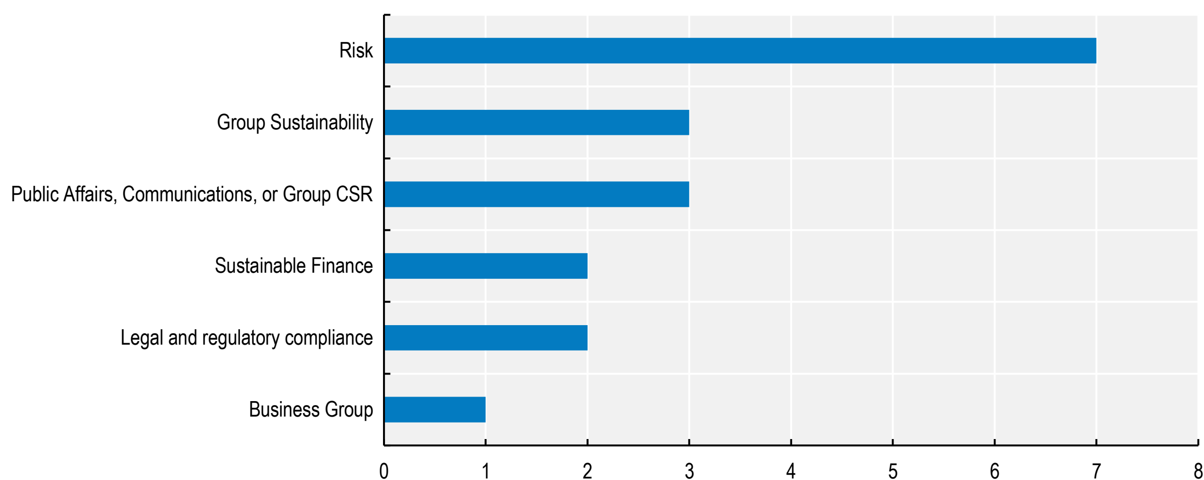
Human Resources for ESG analysis

Human resources for ESG analysis in finance department of banks is currently limited. The reported number of staff ranged from two dedicated staff to 13, with an average of 7.5. Many interviewed banks noted that capacity remained a challenge, especially when considering the volume of lending transactions handled and the complexity and variety of ESG issues that banks are exposed to. However 13 out of the 17 interviewed banks noted that their staff resources have grown over recent years. An additional three banks responded that they are or were planning to commit further resources to these issues. Many banks also noted that in addition to a dedicated ESG team they are working to mainstream ESG related functions by enhancing capacity on ESG issues amongst relationship managers, credit officers and other front office roles.

Where ESG functions sit within a bank can also vary significantly and may impact to what extent ESG issues are considered in lending decisions.

Among interviewed banks the most common location of the team responsible for undertaking ESG due diligence was in the risk function category (See Figure 1.1). This includes teams hosted in a global E&S risk management unit or linked to the credit risk function or group. While a number of banks did not formally locate their E&S risk management teams in a risk function, the large majority of the banks interviewed noted that E&S risk assessments and due diligence are formally embedded in the credit approval process for general corporate lending transactions.

Figure 5.1. Location of E&S due diligence teams of banks interviewed



In this respect, some banks noted that E&S teams provide advisory support to credit committees on an ad hoc basis and do not have decision-making power with respect to approval of a transaction, whereas others responded that the consent of E&S teams is required for transaction approval.

Most banks responded that they have formal escalation channels where a more senior ranking committee can take a decision on a transaction if there is a difference of opinion at the credit committee level. A number of financial institutions noted that it is important for deal teams to have a strong understanding of

the bank's ESG/RBC policy so that transactions that do not comply with the policy do not reach a formal credit approval process, as this would result in lost time and efforts by transaction teams.

Sustainability Reporting

Most banks interviewed noted that they produce sustainability reports and that they base their disclosures on sustainable reporting standards. These include recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), Global Reporting Initiative (GRI), Sustainability Accounting Standards Board (SASB), and Carbon Disclosure Project (CDP). However, quality ESG reporting continues to be a challenge globally, and particularly in the banking sector.

A KPMG study of sustainability reporting in the banking sector found that banking is one of the sectors least likely to set targets for material ESG issues in public disclosures. Over a quarter (27%) of banks do not set any targets at all, compared to the global average of 17%. Additionally, fewer than half of banks report in detail on the social and environmental impacts of their products and services (47%). Additionally, less than a quarter of banks (23%) currently report on the financial impacts associated with ESG risks related to their products or services (KPMG, 2016[25]). In the context of climate impacts the European Central Bank has likewise noted that insufficient granularity and breadth of corporate disclosures had resulted in the ESG ratings of banks being driven by traditional corporate social responsibility considerations, such as operational carbon emissions, rather than lending activity to carbon-intensive companies (Responsible Investor, 2020[26]).

Likewise a study of sustainably reporting across banks in 5 ASEAN countries[9] found that though there have been noticeable improvements over recent years, disclosure practices of banks are still uneven within and across ASEAN countries. In this respect only five out of 29 banks assessed disclose statistics on the implementation of their E&S policies (e.g. number of transactions assessed, or declined based on E&S considerations) (WWF, 2019[27]).

As in other parts of the financial sector, data gaps on ESG continue to be a challenge to banks in accurately measuring and tracking ESG risks. For example, a lack of historical performance data related to ESG issues makes it difficult to assess and quantify related financial risk. A study by the European Systemic Risk Board (ESRB) notes that there are considerable uncertainties around amplifying dynamics regarding physical risks associated with climate change, and their impact on financial institutions (ESRB, 2020[12]).

While the capacity to measure impact of climate, governance and some other environmental impacts is growing, understanding the financial risks associated with social issues such as human rights and labour violations is still at a very early stage, even though these issues can also have a financially material impact. In the wake of COVID-19, ESG-related conditions have reportedly become a bigger priority for banks and investors (Wall Street Journal, 2020[28]).[10]

ESG impacts associated with loans for general corporate purposes are even more difficult to assess as they have a weaker link to a specific project or activity (Network for Greening the FInancial System, 2020[29]). For example, a study by UNEP FI found that with respect to climate risks, banks lack data on the locations and production characteristics and facilities of commercial borrowers, making it difficult to assess climate risk in a general corporate lending transaction (UNEP FI, n.d.[30]). The same study found that additional in-house technical capacity to understand climate risks would be useful to help banks better identify and assess these risks in lending transactions.

A lack of adequate sustainability reporting within banks can pose risks both to investors relying on such disclosures and to the banks themselves. In recent years, activist groups have started targeting banks with insufficient sustainability disclosure. For example, shareholders of the Commonwealth Bank of Australia brought a lawsuit against the bank in 2016 alleging that it violated local company law by failing to disclose climate change risks related to a proposed investment in a controversial coal mine in its annual report (Guardian, 2017[31]). In 2017, a complaint was brought to the OECD NCP of the Netherlands alleging that

ING bank did not observe the OECD MNE Guidelines by failing to report levels of greenhouse gas emissions associated with its lending activities and to set targets for reducing such emissions in its lending (see Box 5.2).

During the development of the OECD paper *Due Diligence for Responsible Corporate Lending and Underwriting*, banks identified client confidentiality obligations as a barrier to sustainability reporting and due diligence more broadly. Many jurisdictions have legal frameworks that recognise that a bank has a legal duty to keep its clients' affairs confidential. The scope of the duty differs from one country to another[11], however where it exists, a bank's duty of client confidentiality generally covers more than just financial information (e.g. the state of the client's account) and extends to all information received in the course of the relationship. It may also require the bank to keep confidential the existence of the client relationship itself. Such confidentiality obligations can prevent sustainability reporting related to specific clients and issues, which can make disclosures less useful for investors and other stakeholders. It can also limit opportunities for collaboration and tracking on ESG performance across a bank's business units, in syndicated transactions and at an industry level.

5.3.4. "Green" and sustainable lending

Beyond integrating ESG into risk management systems, sustainable or green lending (see Box 5.7) has also been on the rise in recent years.

Box 5.6. Classifications of sustainable loans

Green loans – The funds are committed to environmental or climate projects, such as recycling of plastic.

Social loans – The funds are committed to social impact projects, such as training people with disabilities to improve employability.

Sustainability loans – The funds are committed to green and social impact projects, such as providing people with disabilities employment opportunities in a plant that recycles plastic.

Source: Sustainalytics, https://www.sustainalytics.com/sustainable-finance/2019/08/15/sustainable-finance-green-bonds-green-loans-sustainability-linked-loan/.

Global green and sustainability-linked loans have risen to over USD 99 billion starting in 2018 (Linklaters, n.d.[32]). According to the Financial Times and based on data from Refinitiv, the issuance of sustainability-linked loans increased by nearly 250%in 2019 with similar growth expected in 2020 (Financial Times, 2020[33]).

The majority of banks interviewed by the OECD highlighted the growth of sustainability-linked loans as a positive development and opportunity. However, some banks noted that whilst there has been a great deal of attention placed on green loans (as well as bonds), these products primarily focus on climate impacts and limited attention has been dedicated to other social issues such as labour rights, biodiversity, and human rights.

Others noted that classifying what may qualify as "sustainable" or "green" and ensuring that such products actually reflect strong ESG performance can be challenging. According to Reuters, "increasing issuance of sustainability-linked loans by top investment-grade companies is boosting lenders' reliance on

independent ratings agencies to score and monitor firms' environmental, social and governance (ESG) performance […]" (Reuters, 2019[34]). Reliance on ESG performance ratings can be problematic as the quality and consistency of ESG ratings services vary, and methodologies evaluating ESG performance are likely to evolve. These issues are discussed in more detail in Chapter 2 of this publication. Credit raters such as S&P and Moody's have in recent years also begun integrating ESG ratings into credit worthiness assessment, in addition to issuing separate ESG ratings. Unlike ESG performance ratings, credit ratings of companies across agencies have been found to match 99% of the time (Florian Berg, 2020[35]). However the reason for this might at least partially be due to "credit rating shopping" by companies (Florian Berg, 2020[35]). [12]

In 2019, the Loan Syndications and Trading Association, Loan Market Association and Asia Pacific Loan Market Association developed Sustainability-Linked Loan Principles to guide lending of this nature. (see Box 5.8). Such principles provide a good starting point on minimum guidelines for sustainable lending but remain relatively high level and aspirational. In May 2020 the EBA also published guidelines on Loan Origination and Monitoring which include binding requirements for environmentally sustainable lending. These guidelines call on banks to develop policies and processes defining eligibility for products and activities as well as evaluating the use of proceeds of these loans. They also call for the establishment of indicators to assess the contribution of the products or activities to environmental sustainability (European Banking Authority, 2020[36]). Additional technical guidance on benchmarking performance such as taxonomies developed by the EU and China and more concrete reporting expectations could be useful to banks seeking to enhance the use of sustainability linked loans. This is discussed further below.

Box 5.7. Sustainability-Linked Loan Principles

In March 2019, the LMA with the Loan Syndications and Trading Association and the Asia Pacific Loan Market Association, launched the Sustainability Linked Loan Principles (SLLP). In May 2020, a Guidance on Sustainability Linked Loan Principles was published.

The SLLP "aim to facilitate and support environmentally and socially sustainable economic activity and growth" and define sustainability-linked loans as "any types of loan instruments and/or contingent facilities (such as bonding lines, guarantee lines or letters of credit) which incentivise the borrower's achievement of ambitious, predetermined sustainability performance objectives."

The SLLP contain four core components which aim to guide market participants on the characteristics of a sustainability linked loan

1. **Relationship to Borrower's Overall Sustainability Strategy:** borrowers are encouraged to communicate how a sustainability linked loan aligns with the borrower's sustainability performance targets (SPT) and sustainability strategy, policy, or processes.
2. **Target Setting – Measuring the Sustainability of the Borrower:** loan terms should be linked to the borrower's sustainability performance.
3. **Reporting:** borrowers should be encouraged to publically report information on their STPs.
4. **Review:** it is recommended that a borrower seek external review of its performance against STPs, such as an auditor, environmental consultant, and/or independent rating agency.

Source: https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/LMASustainabilityLinkedLoanPrinciples-270919.pdf.

Box 5.8. Spotlight on ESG and underwriting

While this paper has primarily focused on E&S due diligence and risk management integration in corporate lending, debt and equity underwriting also represent two important pillars of bank financing and associated services and thus merit mention here.

Debt underwriting

The first green bond was issued by the World Bank in 2008, and since then more than USD 500 billion worth of bonds have been issued. Additionally, in recent years, sustainable and SDG linked bonds have been introduced by banks and other enterprises. In 2019, Enel issued the first general-purpose SDG linked bond raising USD 1.5 billion. Investor demand continues to grow for these products, as they allow for investment in activities aligned with global sustainability agendas and meet growing demands of beneficiaries.

Banks that underwrite such bonds are in a unique position to encourage clients to identify, assess and disclose important information on ESG issues, which investors are increasingly demanding. However, in the context of underwriting activities banks face the same challenges related to data as those faced in the provision of sustainability linked loans. (See above) Furthermore, “green” or “SDG” bonds are often designated as such by the issuer rather than the bank. These classifications are not currently based on agreed classifications or benchmarks, which may increase the risk of greenwashing and undermine this growing industry.

Equity underwriting: IPOs

Banks also have large potential to increase E&S risk factor integration and disclosure in IPOs. However, often prospectus material contains only highly general or superficial treatment of ESG issues.

For example, in the prospectus materials of the largest IPO of 2019, Saudi Aramco, climate change is recognised as a major risk factor, noting “[c]limate change concerns manifested in public sentiment, government policies, laws and regulations, international agreements and treaties and other actions may reduce global demand for hydrocarbons and propel a shift to lower carbon intensity fossil fuels such as gas or alternative energy sources.” It is also notes that climate change concerns “including physical impacts to infrastructure” will have a “material adverse effect” on the company. However, only three paragraphs out of the 658-page prospectus deal with this topic. Furthermore, no information is provided about the company’s GHG emissions, reduction targets or climate transition plans.

This example also reflects a general trend of prospectus materials describing ESG risks as externalities rather than issues linked to the business model or operations of a company itself. For example, OECD analysis of seven of the ten largest IPOs of 2019[1] revealed that where ESG risks were mentioned, 87% of the time they were presented as potential systemic or external issues threatening the profitably of the enterprise, rather than risks related to the actual operations or business model or culture of the enterprise itself.

Considering the growing demand for ESG disclosure and data by investors, governments, and the public, the depth of elaboration in company prospectuses on ESG risk factors may not be sufficient.

[1] Seven out of the ten largest IPOs’ prospectuses were assessed and analysed, while three IPO prospectuses were omitted due to their unavailability in English or online access. The 10 largest IPOs were determined according to data by FactSet, a data provider, and reported by CNBC, https://www.cnbc.com/2019/12/29/saudi-aramco-alibaba-among-biggest-ipos-of-2019.html.

Source: World Bank (2019), https://www.worldbank.org/en/news/immersive-story/2019/03/18/10-years-of-green-bonds-creating-the-blueprint-for-sustainability-across-capital-markets , UN Global Compact, https://www.unglobalcompact.org/news/4471-09-06-2019 , Saudi Aramco IPO Prospectus, https://www.saudiaramco.com/-/media/images/investors/saudi-aramco-prospectus-en.pdf?la=en&hash=8DE2DCD689D6E383BB8F4C393033D8964C9F5585, Uber IPO Prospectus, https://www.sec.gov/Archives/edgar/data/1543151/000119312519103850/d647752ds1.htm#toc647752_2, S&P (2019), Banks face scrutiny for underwriting Aramco IPO amid climate change concerns, https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/banks-face-scrutiny-for-underwriting-aramco-ipo-amid-climate-change-concerns-55641656.

5.4. Select policy initiatives to enhance ESG in corporate lending

The past ten years have seen a dramatic increase in ESG regulation and policy in the financial sector. The amount of policy instruments that require or encourage ESG integration across the intermediation chain in finance doubled between 2013 and 2016 and has only increased since (PRI, 2016[37]).

Although corporate lending represents a significant source of global capital, policy responses to promote sustainable finance have to date largely not focused closely on this part of the sector. As of December 2019, the Green Financial Measure Database has mapped 391 national and sub-national policy and regulatory measures in place related to sustainability in the financial sector. Of those already implemented, nearly half (47%) focus exclusively on the investment sector. Measures relating to the banking sector accounted for approximately 16% (Green Growth Knowledge Platform, 2019[38]). See Table 5.1 and Figure 5.2 for a break-down of the measures in the database for banks by geography and theme.

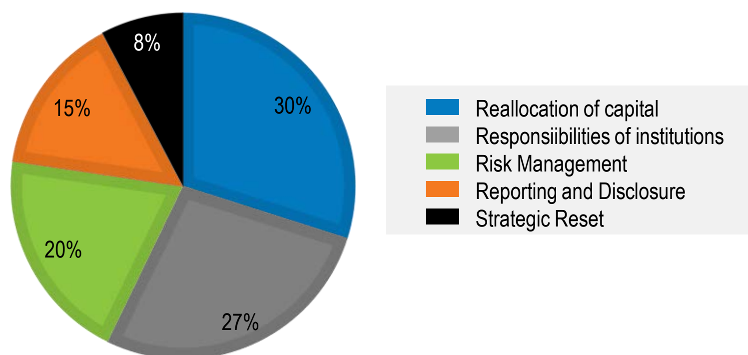
Table 5.1. Policy and regulation related to sustainability in the banking sector by geography

Geography	Number of policy and regulations related to sustainability in the banking sector
Africa	
Kenya	1
Morocco	2
Nigeria	1
South Africa	3
Asia & Middle East	
Bangladesh	5
Cambodia	1
China	8
India	1
Indonesia	7
Japan	6
Kazakhstan	2
Lebanon	3
Malaysia	2
Nepal	1
Pakistan	2
Singapore	4
Thailand	1
United Arab Emirates	2
Vietnam	2
Europe	
Austria	2
Belgium	1
Bulgaria	1
Croatia	1
Czech Republic	1
Denmark	1
EU	14
Finland	1
France	9
Germany	4
Greece	1
Hungary	2
Ireland	1

Geography	Number of policy and regulations related to sustainability in the banking sector
Italy	2
Luxembourg	1
Netherlands	5
Portugal	1
Russia	3
Spain	1
Sweden	5
United Kingdom	6
Americas	
Argentina	2
Brazil	10
Canada	6
Colombia	1
Costa Rica	1
Mexico	2
Mongolia	2
Peru	1
United States of America	8
Oceania	
Australia	9
Fiji	1
New Zealand	2

Note: The above table includes mandatory regulation as well a non-binding guidance and policy on sustainability issues related to the banking sector as collected by the Green Finance Platform. It is not an exhaustive compilation of measures. It is not limited to regulation and policy specific to lending activity.
Source: (Green Growth Knowledge Platform, 2019[38]) Accessed 15 September 2020.

Figure 5.2. Focus areas of policy and regulation related to sustainability in the banking sector



Notes: The above table includes mandatory regulation as well a non-binding guidance and policy on sustainability issues related to the banking sector as collected by the Green Finance Platform. It is not an exhaustive compilation of measures. It is not limited to regulation and policy specific to lending activity.
Reallocation of capital refers to promoting capital allocation to green sectors; Risk management refers to strengthening environmental risk management practices within institutions; Responsibility refers to clarifications of banks responsibilities regarding environmental factors in capital markets; Reporting and disclosure refers to strengthening flows of information related to environmental factors within the financial system; Reset refers to measures to align banks with environmental and sustainability objectives.
Source: (Green Growth Knowledge Platform, 2019[38]). Accessed 15 September 2020.

To date many of these interventions have been principle-based, voluntary or are in the early stages of development. Policy makers broadly agree that further action in this area is necessary.

In the context of the EU Sustainable Finance Action Plan, legislators agreed on three actions aimed at integrating ESG considerations into EU banking regulation:

- a mandate for the European Banking Authority (EBA) to assess whether a dedicated prudential treatment of exposures related to assets or activities associated substantially with sustainability objectives would be justified.
- a mandate for the European Banking Authority (EBA) to assess and possibly issue guidelines regarding the inclusion of ESG risks in the supervisory review and evaluation process;
- a requirement for large, listed institutions to disclose ESG risk (European Commission, 2020[39]).[13]

As discussed further below in 2019 the EU adopted a banking package making concrete progress on several of these elements (European Commission, 2019[40]). However, the consultation document developed for the revision of the EU Sustainable Finance Strategy notes that "[g]iven the new objectives under the European Green Deal, it can be argued that the efforts in this area need to be scaled up in order to support a faster transition to a sustainable economy and increase the resilience of physical assets to climate and environmental risks" (European Commission, 2020[39]).

Broad categories of policy responses are considered in more detail in the next section. The following analysis does not represent a comprehensive analysis of global regulatory approaches to promote sustainable lending but rather provides illustrative examples of the initiatives in select jurisdictions.

5.4.1. Macro-prudential responses

Central banks and supervisors are increasingly recognising climate impacts as a potential risk to financial stability and the economy. In this respect, the Network for Greening the Financial System (NGFS)[14] has stressed the importance for regulators of including climate related risks in prudential agendas. (NGFS, 2020[41]) (see also Chapter 2). However, in most jurisdictions such approaches are relatively nascent. A survey by the Basel Committee of its 27 member countries and observers found that the majority of these countries have not yet factored the mitigation of climate related financial risks into their prudential capital frameworks, or considered doing so, and none had short-term plans of applying Pillar 1 or Pillar 2 capital requirements to climate risks (Basel Committee on Banking Supervision, 2020[42]).

Some emerging market central banks have used prudential policies in order to encourage lending to low-carbon activities. For example, Banque du Liban differentiates reserve requirement ratios according to the amount of bank lending flowing to renewable energy and energy efficiency projects (Banque du Liban, 2010[43]) (Campiglio, 2018[44]). However, this is not yet common practice.

One challenge to integration of climate issues into capital requirements is the lack of sufficient evidence of a risk differential associated with "green" or sustainable products. Alternatively, the idea of introducing a "brown penalty", which would require enhanced capital reserves for activities that are not in line with climate objectives, has not gained political traction. While proponents believe this would help capture and account for climate risks currently not adequately priced into lending transactions, critics point out that it could penalize major economic sectors and create disincentives to greening those sectors.

Adjusting capital requirements to better capture ESG risk and drive sustainable finance can be a powerful tool for policy makers. However, further study on risk differentials associated with sustainability and climate risks will be needed before this becomes widespread practice.

5.4.2. ESG risk management frameworks for lending activity

Policy makers can promote ESG risk management at firm level by encouraging banks to enhance ESG integration in governance and risk management. In the context of the revision of its Sustainable Finance Strategy, the EU has recognised that "[i]ntegrating sustainability considerations in banks' business model requires change in culture which their governance structure need to effectively reflect and support" (European Commission, 2020[39]).

In this respect, various jurisdictions have introduced policies requiring that banks integrate sustainability issues in their corporate governance models. For example, the Reserve Bank of India has been issuing circulars and guidance on the Role of Banks in Corporate Social Responsibility, Sustainable Development and Non-Financial Reporting since 2007 (Chakrabarty, n.d.[45]). The Bank of England Prudential Regulation Authority has also released guidance asking that boards of banks understand and manage financial risks posed by climate change (Bank of England Prudential Regulation Authority, 2019[46]) and the German Federal Financial Supervisory Authorities has issued guidance on how sustainability risks should be managed through responsible corporate governance frameworks (BaFin, 2019[47]). The European Central Bank also recently published a Guide on climate-related and environmental risks noting that a bank's "management body is expected to consider climate-related and environmental risks when developing the institution's overall business strategy, business objectives and risk management framework and to exercise effective oversight of climate-related and environmental risks" (European Central Bank, n.d.[48]). In May 2020, EU Commissioner Reynders likewise announced that the European Union would consider a revision to EU regulation on director duties to incorporate sustainability considerations.

As discussed above, to date banks in OECD countries have broadly relied on industry-led guidelines to define their ESG risk management approaches and, until recently, such standards were limited to defining environmental and social due diligence for project finance transactions. Expectations from policy makers to integrate ESG considerations into lending transactions, where they exist, have largely taken the forms of voluntary guidelines rather than mandatory regulations. For example, in a survey of 27 Basel members, three fifths of respondents noted that they have not issued supervisory guidance related to governance, strategy or risk management of climate-related financial risks by banks. The remainder noted that they have or are in the process of issuing such guidance, but that guidance was not necessarily legally binding but principle-based or interpretations of existing rules (Basel Committee on Banking Supervision, 2020[42]). Under the 2019 banking package adopted by the EU the European Banking Authority has been mandated to develop two reports: one on how to incorporate environmental, social and governance (ESG) risks into the supervisory process and one on the prudential treatment of assets associated with environmental or social objectives (European Commission, 2019[40]).

Mandatory approaches calling for ESG risk management in lending transactions have been more common in developing and emerging economies (Campiglio, 2018[44]). For example, the Central Bank of Nigeria requires financial institutions to formalise their ESG policy and monitors performance of financial institutions against principles for responsible finance it has issued (Sustainable Banking Network, n.d.[49]). In Vietnam credit institutions are required to formalise their E&S risk management policies and report to the central banks (State Bank of Vietnam, 2015[50]). Banco Central do Brazil requires commercial banks to incorporate environmental and social risk factors into their governance framework and demonstrate how these risks are evaluated when calculating their capital needs (Banco Central do Brasil, 2011[51]) (Campiglio, 2018[44]).

In order to enhance practice but also to help banks overcome coordination issues in the context of syndicated transitions, regulators may consider clarifying minimum expectations for ESG risk management or due diligence in lending transactions and monitoring compliance with these expectations. Introducing common standards, drawing from existing internationally agreed benchmarks, can also provide a common reference point or baseline of expectations for financial institutions and mitigate the risk of a multiplication

of varying expectations across jurisdictions and initiatives. In this respect policy makers may wish to build on international standards already being implemented by banks. See Boxes 1.4, 1.5 and 1.6.

5.4.3. Sustainability disclosure

Sustainability reporting has been a key regulatory tool for policy makers looking to promote ESG integration as well to ensure that institutional investors, shareholders and other stakeholders have access to necessary information about corporate conduct. In this respect studies have found that mandatory sustainability reporting can have a meaningful impact on socially responsible management practices (Serafeim, 2014[52]).[15] Likewise, a lack of quality disclosures continues to be a key barrier to understanding and managing ESG risks in lending transactions and more broadly. This has been particularly underscored in the context of climate issues. For example, the ESRB has noted that improving disclosures on climate risks to address current information gaps will be a crucial step to better understanding systemic risks and performance differentials associated with climate impacts (ESRB, 2020[12]).

As discussed in other chapters of this publication, few countries have introduced mandatory sustainability reporting requirements for banks.[16] However, reporting in response to these expectations is often still not of sufficient quality. For example, study of 1 000 reports filed in response to the EU Directive found that on average less than a quarter of companies report on specific environmental risks that may affect their business model, strategy, and financials, only 14% report on human rights risks in this respect, and only 0.5% provide information on sustainability challenges supported by financial amounts (Corporate Alliance for Transparency, 2019[53]). The same study found that across sectors companies from the financial sector were least likely to disclose climate related targets (20.5%). Likewise a relatively low percentage of financial companies reported on strategies to manage risks and impacts of climate change (25.2%), and on exposure of their lending, investment and underwriting activities to sectors contributing to climate change (13.4%).

Sustainability reporting requirements which provide more specificity and require reporting on specific sustainability risks, strategies and targets, as well as performance against those targets would be useful in promoting more useful disclosures. This would also align with reporting recommendations of the TCFD, updated GRI universal reporting standards and OECD due diligence reporting standards.

There is also an emerging consensus on the need for standardised benchmarks and definitions related to ESG impacts and performance both to respond to various expectations of shareholders and stakeholders as well as to ensure that materiality and risk information that is tied to that can be better construed (see also Chapters 1 and 2). In this context international standards such as the OECD Guidelines for Multinational Enterprises could provide a useful foundation.[17] “Double materiality” reporting which would call for disclosure of ESG information that is deemed to be financially material as well as information about significant ESG performance and impacts (i.e. climate performance or linkage to human rights impacts) independent of the financial impact of those issues to the reporting entity could also be useful, especially as financial impacts of ESG are currently not well understood and can be expected to continue evolving.

The EU has already called for considering and reporting in line with a concept of double materiality in its recently agreed Sustainable Finance Disclosures Regulation (Official Journal of the European Union, 2019[15]). Additionally, the concept of double materiality reporting has received strong support in the context of the revision of the EU non-financial reporting directive from leading ESG standards bodies including SASB (SASB, 2020[54]) the UN Global Compact, the Social Value Initiative and the World Benchmarking Alliance (IMP Structured Network, 2020[55]).

Policy makers should also ensure that there is alignment between reporting obligations of corporates, banks and investors. In the context of the EU this would mean aligning expectations of the Sustainable Finance Disclosures Regulation, Non-Financial Reporting Directive and any future legislation mandating environmental and social due diligence for corporate actors. Comprehensive and quality ESG reporting by

non-financial corporates will be a prerequisite for banks and other financial institutions to use such information in risk processes, ESG financial products, and their own sustainability reporting.

Lastly, policy makers should consider whether client confidentiality obligations (discussed above) are creating barriers to meaningful disclosure and how these could be overcome. For example, by creating exemptions in existing laws or helping to make client consent processes systematic. Working with industry associations such as the Loan Markets Association to encourage inclusion of client consent to disclose the existence of the client relationship in template covenants can also be helpful to overcoming some of the associated challenges.

5.4.4. Agreeing on metrics and benchmarks

In addition to strengthening and aligning disclosure expectations, in order to help banks better identify and report on risks associated with ESG impacts, specifically with respect to climate, forward looking methodologies are needed. A core aspect of the recommendations of the TCFD relates to reporting on climate metrics and targets and taking into consideration different climate-related scenarios. (TCFD, 2017[56]). In the context of climate issues industry actors have requested policy makers to prioritise the development of common scenarios and assumptions to facilitate banks' scenario analysis and enhancement of their own stress testing frameworks (European Banking Federation, 2017[3]). Some central banks and supervisory authorities have attempted to undertake climate stress tests to assess risks on the financial system more broadly (in equity and debt portfolios).[18] Notably, DNB (Netherlands) did the first climate stress test two years ago and central banks of England, France and Japan currently have stress tests ongoing. Although central bank level stress tests have different objectives to bank level scenario analysis (respectively, measuring risks to financial stability vs demonstrating resilience to investors), they provide a useful reference.

Stronger benchmarks and taxonomies to assess ESG performance of clients and specific activities can also help facilitate green and sustainable lending and avoid some of the issues involved in reliance on ESG rating and research providers. Common taxonomies have also been identified by practitioners as essential for efficient allocation of financial resources to green products and assets (European Banking Federation, 2017[3]).

Both China and the EU have developed green taxonomies to assess the environmental performance of activities. While the EU taxonomy is voluntary and does not currently apply to lending activities it can still provide a useful framework for banks (see also Chapter 2). Over time, policy makers may also consider developing further taxonomies for other leading ESG impacts such a human rights and labour issues.[19] In order to do so, impact measurement methodologies and data collection on social risks will need to also be improved.

5.5. Conclusions

Expectations of banks to integrate ESG considerations – with an emphasis on climate issues – is growing amongst investors and society. Until recently ESG standards for general corporate lending transactions did not exist and sustainability considerations did not feature prominently in the context of these transactions. Bank themselves have signalled that they would like to scale up ESG integration in lending transactions but have noted that challenges associated with capacity, competition and co-ordination, and data continue to hamper their efforts.

Despite the significance of lending transactions in global capital flows, to date this part of the sector has been largely overlooked by sustainable finance policy initiatives that focus more prominently on the role of institutional investors. In this respect policy makers should allocate more attention to scaling up sustainability in lending transactions and may consider:

- Developing guidance for integration of sustainability considerations within the governance frameworks and introducing minimum expectations for ESG risk management or due diligence in lending transactions in line with international standards.
- Promoting sustainability reporting that encourages disclosure on sustainability (including disclosure on ESG performance and impacts in addition to the potential financial risk related to that performance and those impacts), strategies and targets, as well as performance against targets; this reporting should be streamlined across banks, corporates and investors.
- Leading development of necessary metrics and methodologies to facilitate measurement of risk associated with ESG issues (at a macro and firm level), and overtime, expanding such metrics and methodologies beyond climate environmental performance to other significant ESG issues such as human rights and labour.

Policy makers should also be mindful of new entrants to this sector and ensure that any expectations imposed on banks should likewise apply to non-bank enterprises providing lending services.

In the coming year, responding to disruptions wrought by the COVID-19 crisis will be a priority for policy makers globally. In this respect, it is important that the momentum of the sustainable finance agenda is not lost. Enhancing sustainability throughout the financial sector can strengthen resilience and better prepare economies for future shocks. But more importantly, it can contribute to channelling global capital towards activities that avoid negative impacts to society and the environment and thus potentially lessens shocks related to climate impacts or pandemics.

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Annex 5.A. Questionnaire on current practices in E&S bank policies on corporate lending

From May to June 2020, the OECD Secretariat conducted phone interviews with key E&S risk management practitioners in 17 leading banks headquartered in OECD countries. The banks were asked eight questions (see Annex Table 5.A.1), including on current practices in E&S bank policies on corporate lending, E&S risk management incorporation in credit approval and committee processes, and what challenges and opportunities practitioners currently foresee in this work. The scope of the interviews was limited to general corporate lending, also known as general corporate purpose loans. Practices in credit or equity underwriting were out of the scope of the interviews. The list of participating banks is located in Table 5.A.2.

Annex Table 5.A.1. Questionnaire on E&S integration in corporate lending in leading banks in OECD countries

1	Do you have an E&S policy, and if so, does it cover general corporate lending transactions?
2	On average, approximately how many corporate lending transactions does your bank handle annually? Approximately how many of these transactions are screened for E&S risks and how many undergo an enhanced E&S screen?
3	How large is your E&S team? Where is it located in the bank's structure? Are you planning to grow the team or resources?
4	Is an E&S risk assessment and due diligence formally embedded in the credit approval process for general corporate lending transactions?
5	To what extent does your bank consider E&S criteria or conditions in the provision of finance (e.g. client commitment to E&S industry standards and international standards, exclusionary criteria, action plans)? Does the bank engage in E&S performance monitoring of a client once a loan has been disbursed?
6	Does your institution have or participate in any grievance mechanism for issues resulting from activities of companies you provide financing to?
7	Does your policy commit to international standards or instruments? What standards or frameworks, if any, do you use for your non-financial reporting (e.g. GRI, SASB, TCFD)?
8	What are the biggest challenges and opportunities you see for integrating E&S due diligence into general corporate lending transactions?

The banks that accepted to participate in the phone interviews conducted by the OECD Secretariat feature in the top 60 largest banks headquartered in OECD countries as measured by Assets Under Management (AUM) by S&P in 2019.[20]

Annex Table 5.A.2. List of banks who participated in the phone interviews

Name	Country	Total Assets in 2019 (USD Billion)
Mitsubishi UFJ Financial Group	Japan	3 069.20
JPMorgan Chase	United States	2 622.53
BNP Paribas	France	2 336.66
Wells Fargo	United States	1 895.88
Deutsche Bank	Germany	1 543.55
Barclays	United Kingdom	1 444.39
ING Group	Netherlands	1 015.61
UBS	Switzerland	958.49
Goldman Sachs	United States	931.8
Credit Suisse	Switzerland	781.45
Standard Chartered	United Kingdom	688.76
Australia and New Zealand Banking Group	Australia	681.3
Westpac	Australia	636.69
Bank of Montreal	Canada	613.56
National Australia Bank	Australia	583.79
ABN AMRO Group	Netherlands	436.56
KBC Bank	Belgium	324.95

Notes

[1] ESG practices and policy for institutional investors was explored in OECD (2019), "Trust and financial markets", in OECD Business and Finance Outlook 2019: Strengthening Trust in Business, OECD Publishing, Paris, https://doi.org/10.1787/4d7c9b81-en, and is also discussed in further detail in this year's publication in Chapters 1, 2 and 4.

[2] This record amount is the result of an unprecedented build-up in corporate bond debt since 2008 and a further USD 2.1 trillion in borrowing by non-financial companies during 2019.

[3] According to The Economist, two-thirds of non-financial corporate bonds in America are rated “junk” or “bbb”, the category just above junk. Outside America the figure is 39%.

[4] According to the 2020 Deloitte Banking and Capital Markets Outlook report, “[d]emand for real-time liquidity and funding is expected to grow. […] There could very well be greater competition from insurance companies, private equity firms, traditional asset managers, and fintechs in the corporate lending space. Thus, the corporate bank over the next decade could look very different than the one today, as it redefines its role in the new financial ecosystem.”

[5] The Regulation also notes that when reporting on due diligence, practitioners “should consider the due diligence guidance for responsible business conduct developed by the Organisation for Economic Cooperation and Development.”

[6] National Contact Points (NCPs) are set up by governments that have adhered to the OECD Guidelines for Multinational Enterprises (the Guidelines). NCPs have two main objectives: to promote the Guidelines and handle enquiries, which means that NCPs: 1) organise and participate in events related to RBC to raise awareness of the Guidelines and respond to questions about the Guidelines; and 2) provide a grievance mechanism to resolve cases (known as "specific instances") relating to non-observance of the recommendations of the Guidelines. To date over 500 specific instances have been filed with NCPs.

[7] Figure developed based on NGO BankTrack's database collection of public reporting by Equator Principle member banks, https://docs.google.com/spreadsheets/d/1K0qTCeioe9epPjwcKnGSZ7OOwslmnuoHzWgZmiUjX3Q/edit?ts=5bc5ceea (accessed 10 June 2020).

[8] One bank noted it was currently developing such a policy.

[9] Indonesia, Malaysia, Singapore, Thailand, Vietnam.

[10] According to Citigroup, investors are asking more questions about issues such as employee benefits and mortgage relief, and COVID is affecting priorities in ESG, making temporary workers and stock buybacks the new focus for corporate governance.

[11] For example, while this duty does not exist in the United States, it is recognised in the United Kingdom and most European countries under civil law. In Switzerland and Singapore, violating obligations of client confidentiality can be a criminal offence.

[12] The authors of the study have noted that this rate can be attributed to the fact that 1) credit worthiness is clearly defined as likelihood of default while ESG performance is currently not clearly defined, 2) ESG performance ratings are often based on corporate sustainability disclosures which are not standardised, and 3) companies, rather than investors, pay for credit ratings which may result in in "rating shopping".

[13] A vast array of policy instruments exist or have been proposed to promote sustainable finance. This chapter does not treat them all in detail but provides a broad outline of recent developments with respect to prudential association, ESG integration, and reporting and measurement of ESG issues.

[14] The Central Banks and Supervisors Network for Greening the Financial System (NGFS) is a group of Central Banks and Supervisors willing, on a voluntary basis, to exchange experiences, share best practices, contribute to the development of environment and climate risk management in the financial sector, and to mobilise mainstream finance to support the transition toward a sustainable economy.

[15] A study by Professor Ioannis Ioannou of London Business School and Geoge Serafeim of Harvard Business School found that where mandatory sustainability reporting was introduced, sustainable development and employee training become a higher priority for companies and corporate governance improved. The study also found that companies implemented more ethical practices, reduced bribery and corruption and increased managerial credibility. The effects were larger for countries with stronger law enforcement and more widespread assurance of sustainability reports.

[16] For example, Austria in 2003, Malaysia in 2007, Sweden in 2009, China in 2020, Spain in 2012, Belgium in 2016 and Hungary and Singapore in 2017.

[17] 17% of financial statements filed in response to the EU NFRD in 2019 specify that they rely on the OECD Guidelines for Multinational Enterprises or OECD due diligence guidance. Furthermore, OECD due diligence standards will be incorporated in GRI universal report standards, relied on in 54% of financial statements filed. See (Corporate Alliance for Transparency, 2019[53]).

[18] A stress test is a "projection of the financial condition of a firm or economy, under a specific set of severely adverse conditions. This may be the result of several risk factors over multiple periods of time, or one risk factor that is short in duration." A sensitivity analysis is the "effect of a set of alternative assumptions regarding a future environment. A scenario used for sensitivity testing usually represents a relatively small change in these risk factors or their likelihood of occurrence."

[19] Although the current taxonomy includes minimum safeguards related to human rights and labour issues (see Box 1.1) it does not include technical guidance and benchmarks for assessing performance related to social issues.

[20] The world's 100 largest banks, S&P Global Market Intelligence. 5 April 2019, https://www.spglobal.com/marketintelligence/en/news-insights/trending/t-38wta5twjgrrqccf4_ca2.

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