Chapter 6.

Key drivers of sustainable environmental lending

Following the discussion on the barriers to environmental lending, this chapter sets out a framework for understanding how International Finance Institutions and donors might best approach the design and delivery of programmes for environmental lending, including both the design of credit lines and technical assistance for their implementation.

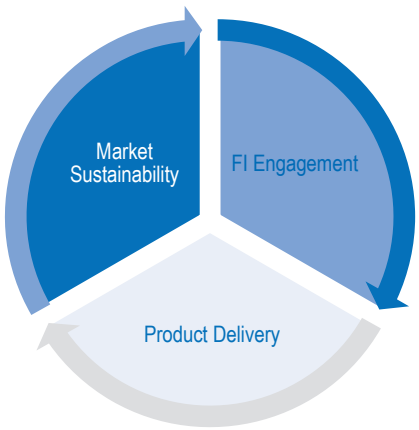
Key drivers for scaling up environmental lending

The ultimate goal of International Finance Institution (IFI) environmental lending products is to create a demand-driven self-sustaining market through local (commercially operated) financial institutions (FIs). Such markets may serve a steady financing demand from private and public sector entities, including households. The earlier analysis of the IFI portfolio identified a number of barriers to achieving such level of financing. On the basis of this analysis, we identify areas where donor and IFI support may be important to ensure the scale up of environmental lending. These areas, or key drivers, can be grouped around 3 key factors:

- *FI engagement:* the ability to persuade FIs to adopt environmental lending practices;
- *Product delivery:* the capacity to design and disburse credit lines in an effective manner;
- *Market sustainability:* the extent to which policy/market drivers support ongoing lending.

Each of these drivers, with their specific motivations, are discussed in more detail further below.

Figure 6.1. **Key drivers to develop and scale up environmental lending**



FI Engagement
- Access to finance
- Concessionality
- Technical advisory
- Market positioning
- Business development
- Minimal resource demand

Product Delivery
- Resources and staffing
- Skills and capacity building
- Product design and promotion
- Effective pipeline development
- Adoption of tools and methods
- Robust appraisal and reporting

Market Sustainability
- Strong investment climate
- Environmental policy support
- Access to finance
- Effective donor support

FI Engagement

The first set of key success factors relate to the capacity of IFIs to engage with and persuade local FIs to accept funding for and develop environmental lending products. Environmental finance remains a product that needs to be sold to FIs, rather than one for which there is a strong natural demand. There are a number of challenges and barriers in this regard. Local FIs are often unfamiliar with the definitions, eligibility and reporting frameworks used by the IFIs for environmental credit lines. Environmental lending may be perceived as more complex to appraise, more difficult to promote to customers, and more onerous in terms of reporting.

We recognise the following potential motivations for local FIs to engage with IFI environmental credit lines:

- ***Building profitable market share:*** A small number of FIs may consider that environmental lending provides a significant growth opportunity. Against a backdrop of rising energy prices, tighter environmental legislation and more robust efficiency standards, FIs may identify environmental lending as a potentially profitable market. By early positioning, they hope to achieve first mover advantage and take a dominant share. The promotion by IFIs of environmental finance draws heavily upon this narrative, even if in early testing and adoption phases, the product is likely to require net investment by the FI.
- ***Addressing liquidity issues*:** Many of the EU's Eastern Partnership (EaP) countries have been experiencing tight credit conditions since 2008 associated with the problems in global financial markets. For a small number of FIs, the provision of funds for environmental purposes has become an attractive route to addressing liquidity requirements, particularly where these funds address existing customer segments, and where the IFI has already lent on more mainstream products (e.g. small and medium sized enterprises (SME) and is now seeking to push additionality. The local FI pipeline may already contain eligible projects that would have otherwise been financed through more mainstream products (SME, residential loans), and the additional costs of origination are therefore not significant. It should be noted that this represents a small percentage, as most FIs tend to have a wider relationship with IFIs, and an environmental lending product does not normally represent the first lending relationship between the institutions.
- ***Credit line concessionality and tenor*:** Generally, IFIs are committed to not distorting commercial lending markets unless there is a clear market failure and associated development benefit. The cost of IFI funds is often not the lowest available to commercial banks, although tenor is often longer than that available elsewhere. IFI credit lines are also perceived to have more robust conditionality and reporting criteria. However, interest rates offered on IFI environmental credit lines may be more concessional than for other products (such as SME credit lines), making them more attractive for local FIs. This reflects the potential development impact, and the public good associated with addressing environmental externalities. Lower rates may be achieved through the blending with donor grant finance, or by IFI board approval based on the expected demonstration effect. FIs may accept an environmental lending component alongside a more mainstream credit product in order to improve the terms on which it is offered.

- ***The provision of grant-based technical assistance*:** IFI credit lines are often accompanied by substantial technical assistance. This support can range from pipeline development, staff training, project preparation, project appraisal, technical implementation and monitoring and verification. Such activities are often grant-supported, and provided to FIs and their clients free, or on heavily subsidised terms. This can be a powerful driver of FI participation (as well as for customer take up), both from a capacity building perspective, as well as by reducing the resource burden of product development and compliance.
- ***Environmental positioning:*** Some FIs have developed social and environmental policies, and seek to position themselves as proactive in addressing climate change, or resource issues. This may be particularly true for those with significant international representation amongst their shareholder base. Engaging on dedicated environmental lending products can demonstrate a level of commitment to the banks ethical or environmental involvement. Such activities can form the basis of corporate social responsibility (CSR) reporting and be used for media and marketing purposes. In addition, IFI clients may be required to adopt or meet higher environmental or social performance standards than would be expected under national laws. International Finance Corporation (IFC) cascades its performance standards to its clients. Of the eight standards, two relate directly to environmental performance (see Table 6.1).
- ***Establishing credibility:*** The prospect of partnership with an IFI can be attractive for the management team of a local FI. Such a partnership can build market credibility and positioning. In transition economies, there is a perception that IFI due diligence procedures are robust and a willingness to partner provide an indicator of corporate health. Partner banks may promote the IFI partnership prominently on their website and other corporate communication materials.

Table 6.1. **IFC Performance standards**

Performance Standard	Objectives
PERFORMANCE STANDARD (PS) 1: **Assessment and management of environmental and social risks and impacts**	▪ Identify project environmental and social risks and impacts ▪ Adopt mitigation hierarchy ▪ Anticipate, avoid ▪ Minimize ▪ Compensate or offset ▪ Improve performance through an Environmental and Social Management System (ESMS) ▪ Engagement with Affected Communities, other stakeholders ▪ Throughout project cycle, include communications, grievance mechanisms
PERFORMANCE STANDARD (PS) 3: **Resource efficiency and pollution prevention**	▪ Avoid, minimize, and reduce project related pollution ▪ More sustainable use of resources, including energy and water ▪ Reduced project related greenhouse gas (GHG) emissions

Source: IFC (2012).

Product delivery

The second set of key drivers relates to the ability of local FIs to successfully design a product that will allow them to disburse IFI credit lines. Where the credit line disbursement proves problematic or overly resource intensive, it is unlikely that there will be a product continuation. Barriers include a limited project pipeline, lack of customer awareness, inadequate staffing and skills, inadequate incentives, and a lack of commitment from senior management. We identify the following key success factors in effective design and disbursement:

- ***Product design and promotion:*** Local FIs need to design products that are financially attractive and with a strong narrative. The financing model should be based on the local context and the marketing needs of the bank's clients. The product should be focused initially on core business segments before moving on to new markets. It is important that any IFI concessionality is passed through to end borrowers. FIs should also recognise that their customer base may not be primarily motivated by environmental concerns, and that environmental benefits (such as greenhouse gas (GHG) emission mitigation), may be secondary to the financial benefits associated with increased productivity or reduced energy bills.
- ***Integration with institutional strategies:*** Environmental lending works most effectively where it maps onto existing operational structures and processes. Sustainable energy products need to be properly integrated into the banks' institutional procedures, but nonetheless separated from the core business activities. Local financial institutions might consider deploying a matrix structure (with dual reporting lines) where an energy efficiency product is managed separately, but as a subset of SME or residential lending. However, this is particularly challenging, with local FIs often not seeing the benefits of such a complex management structure.
- ***Resources and staffing:*** While it is important that environmental lending should map as much as possible onto existing FI structures and processes, a lack of investment in staffing may indicate a low level of commitment to the project. Ideally, environmental lending products are supported not only by a dedicated product manager or team at headquarters (depending on the size of the credit line and the complexity of the product), but also by responsible/informed lending officers in regional branches. However, this may only be commercially viable where demand is sufficiently high, and where the value of transactions is sufficiently large. There should be a recognition that such products require a level of upfront investment in staff and procedures, even if they take advantage of existing resources.
- ***Skills and capacity building:*** Environmental lending products are potentially more complex in their appraisal and reporting. Staff will often require training to recognise potential customer opportunities, communicate benefits to customers, ensure that loan applications meet eligibility criteria, and to report on key indicators. Support is often provided by donor-funded technical assistance grant facilities that allow FIs to mitigate technical risks through the use of external consultants or by the creation of in-house specialist teams (e.g. EBRD – Ukreximbank). Over time, these skills can be mainstreamed into the organisation.
- ***Internal messaging and incentives:*** Clear internal messaging from senior management about the importance of the environmental lending product is required. The alignment of staff incentives is also important. Without these, there

may be a perception that the product is a "one off" and its promotion by loan officers will remain of secondary importance to other products perceived as more strategically important or lucrative.

- ***Effective pipeline development:*** A strong project pipeline is important to the success of a dedicated credit line. At the SME and household level, a significant proportion of the existing customer base may be eligible for targeted environmental products without significant additional support – staff simply need to be able to recognise eligible activities. For more complex corporate lending projects, local FIs may choose to co-develop eligible and bankable projects with their client base, potentially with the support of IFI-funded external consultants.
- ***Adoption of tools and methods:*** Products that measure energy savings or GHG emission mitigation benefits will require some level of technical calculation derived from equipment performance and standards. Such calculations are ordinarily performed by qualified engineers. FIs may adopt specific tools (e.g. energy saving calculators, CO_2 calculators) to support their staff in the appraisal of projects. IFIs and their consultants may develop standard web-based tools to allow bank staff to assess and appraise economic and environmental aspects of their portfolio for reporting purposes.
- ***Robust appraisal and reporting:*** Environmental credit lines carry with them enhanced reporting and verification requirements associated with the externality being addressed. This requires more robust *ex-ante* technical appraisal processes (*i.e*. to assess whether a project might be expected to deliver adequate energy and other resource savings) and *ex-post* verification (to measure these savings and to report on the associated environmental benefits – e.g. CO_2 abatement). Such activities can be resource intensive, particularly for smaller clients and loan values, and often require significant IFI/donor support to deliver.

Market sustainability

The third set of key success factors relate to the market and policy environment in which the environmental lending product is to be developed. While IFIs may successfully engage with a local FI and assist in the successful disbursement of the credit line, without a supportive market environment, FIs are unlikely to commit to supporting ongoing lending operations without continuing IFI support. This can be particularly true where the IFI has provided significant support in terms of concessionality and/or technical assistance to support disbursement. Without the demonstration effect of a local FI building a sustainable lending product, other local financial institutions are less likely to enter the market.

A number of market and policy barriers have been identified earlier in the report. These include poor private sector investment climate, lack of supportive and consistent policy frameworks for environmental investment, and limited access to finance beyond IFI sources. Some of the key factors that can help reduce the above barriers include:

- ***Strong investment climate:*** Sustainable environmental lending requires a supportive investment climate (strong investor protection, governance, competition policy and regulation). While common to other sectors, such factors nonetheless are a pre-requisite for investment in relevant sectors such as renewables, waste and energy efficiency. Private sector investors are unlikely to invest in environmental outcomes where there is a level of political and regulatory risk.

- ***Environmental policy support:*** Customers must be sufficiently mandated or incentivised to engage with environmental lending products. A supportive policy environment may include legislation mandating environmental standards (e.g. buildings efficiency standards, industrial equipment, Best Available Techniques (BAT), incentives promoting certain types of renewable energy sources (obligations or feed-in tariffs), or the removal of market distorting subsidies (e.g. fossil fuel support) that reduce incentives for investment in clean alternatives or their efficient use. Goals may be supported by the use of trading systems and/or taxation (e.g. emissions trading), and incentives (e.g. tax rebates, accelerated depreciation). Policy goals need to be both coherent (linking permitting and licensing to economic instruments) and long term (e.g. targets and pathways).
- ***Access to finance:*** A sustainable environmental lending market is only possible if FI access to finance can be sustained without ongoing concessional support. This requires developed domestic debt markets, and accessible rates and tenor of loans for potential customer segments. It also depends on the extent to which specific stakeholder groups (corporates, SMEs, households) can access domestic finance to achieve environmental objectives, either through mainstream lending (e.g. SME loans) or using specific lending products (e.g. energy efficiency loans), potentially supported by risk mitigation instruments or other donor funds.
- ***Network support:*** Banks operating in a network of other financial institutions supporting similar products (such as through the Sustainable Energy Finance Facilities model used by EBRD), can benefit from shared insights, pooled technical resources and other network benefits. Challenges remain, however, in relation to capacity transfer due to issues of competition and intellectual property rights protection.
- ***Phased product development:*** FIs need first to leverage on their core operations to deliver value added sustainable energy financing and advisory to their existing clients; and second to acquire appropriate marketing and management capacities before they diversify activities and divert scarce resources into new business areas (e.g. for an SME bank moving into residential energy efficiency sector, etc.).
- ***Effective donor support:*** Given limited capital, local FIs are most likely to pursue market segments where the resource requirements and complexity are low, product returns high and the market large. This represents a potential opportunity cost for developing environmental lending products (for example, the commercial market for such products remains limited in OECD countries). A key challenge is the resource demand associated with pipeline development and the preparation of bankable projects. Donors have therefore sought to address this through the provision of extensive technical assistance support (often free and outsourced). While underpinning FI engagement and credit line disbursement, the over-provision of technical support and concessional funds may both intensify FI perceptions of product complexity and slow the transfer of skills and capacity to the local market. Both of these can undermine longer term market development. The result is that FIs may choose to pursue such products with the same levels of concessional finance and technical assistance. Likewise, IFIs may become accustomed to providing follow-on credit lines to existing borrowers in order to meet internal lending targets. Going forward, IFIs may have to broaden their role towards de-risking the flow of third party public and private finance, rather than to meeting their own lending targets (BMZ, 2014).

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