Can Singapore banks deliver the green promise?

While lender intermediation to facilitate a greener transition is promising, a careful assessment of the associated risks is also crucial, by XIE TAOJUN and AMMU GEORGE.

IN MAY, OCBC joined DBS and UOB in setting targets to reduce financed emissions in six emissions-intensive sectors. Decarbonising the loan portfolio has been very popular lately, with large banks doubling down on sustainability-linked loan (SLL) frameworks. While bank intermediation to facilitate a greener transition is promising, a careful assessment of the associated risks is also crucial.

Singapore has positioned itself as a regional hub for green finance. The national mandate has raised the prominence of sustainable loans, with a larger proportion being SLLs than traditional green loans.

In contrast to green loans, which exclusively finance environmental or climate-related projects, SLLs allow borrowers not in typical green industries to access sustainable financing. A portion of the interest rate on SLLs depends on the borrower's ability to achieve sustainability performance targets (SPTs). These targets typically relate to environmental, social, or governance (ESG) metrics, such as greenhouse gas emissions reductions or renewable energy adoption.

There have been catalysts that have nudged the SLL expansion in Singapore. The Monetary Authority of Singapore (MAS) has rigorously increased its advocacy towards sustainable financing and advisory services to develop SLL frameworks under the Loan Grant Scheme. Subsidy coverage increases for SLLs targeting SMIs or individuals. The SLL purview now includes transitioning financing under the net zero (FINZ) action plan.

Another major driver has been the interest from banks in joining the net-zero banking alliance (NZBA). DBS, UOB and OCBC have recently assumed membership in this United Nations-convened banking consortium committed to aligning lending activity toward attaining net-zero emissions by 2050. This has motivated the banks to enhance their SLL portfolios.

Sustainability reports indicate that the large banks in Singapore have surpassed their initial targets in sustainability loans. An important question arises on the precise motive for banks to signal as champions of environmental sustainability.

As financial intermediaries, banks survive on the interest earnings from lending. Although sustainability mandates on loans provide reputational benefits, there is no direct interest rate on SLLs. Banks are motivated to achieve the SLM's goals to build the green reputation and attract business and consumers who face a penalty of a carbon tax in case of non-adherence.

Banks foresee energy transition as a significant "industry" in the near future, requiring robust investment in renewables. A recent study by Asia Competitiveness Institute found that, under certain assumptions, the spurt in SLL demand would more than compensate for the lower interest rates, translating to a higher profit margin for banks when economies make a green transition.

The growing demand for SLLs, however, could culminate in an overall increase in credit and amplify banking sector risks. Such an outcome may not be desirable for central banks, especially in times of financial instability or high inflation.

An ideal scenario would entail a smoother transition to a greener economy with fewer external loan increases that could exacerbate financial sector uncertainty.

The greenwashing threat

Another concern about SLL pertains to the definition of sustainability targets, which critics argue is somewhat too abstract. While many companies have set net-zero targets, these targets may not be sufficient to qualify for SLL. According to The Net Zero Tracker, a global initiative that evaluates net-zero targets, some sustainability targets may not be grounded in the latest research.

Furthermore, studies have indicated that borrowers' ESG scores can deteriorate after the issuance of sustainable loans, particularly when there is a lack of clear disclosure regarding the ESG-contingent contractual details. This raises concerns about the potential for "greenwashing," wherein investments and business practices appear to be greener in name than in reality.

This collaboration falls under the International Platform on Sustainable Finance (IPSF) to enable deeper bilateral cooperation in cross-border green and transition finance and to create regional standards. One of the workstreams of this partnership emphasises collaboration to achieve interoperability between the Singapore and China taxonomies.

Committed to targets

Industry experts claim that SLLs in Singapore are progressively incorporating more advanced and science-based targets, such as a reduction in GHG emissions in the mid-term, as well as commitments to net-zero targets in the long-term. For example, the targets in OCBC's recent 1.5 degC loan demonstrate adherence to scientific "reference pathways" by autonomous global organisations.

Borrowers are also increasingly committed to targets endorsed by the Science-Based Targets initiative (SBT). Some banks require borrowers to obtain a Second Party Opinion (SPO) to evaluate the materiality, relevance, and ambition of the sustainability targets chosen.

Currently, the terms of SLL issuance in Singapore are still confidential. The claim that SLL targets are becoming more scientific can be validated only with transparency from both borrowers and lenders of SLL.

This would help explain whether borrowing costs are linked to scientific sustainability targets and whether borrowers showcase the required sustainability performance.

Undoubtedly, SLLs are intuitive tools to nudge corporates towards greener production, as banks are usually their main source of funding. But as society becomes more aware of the importance of a green transition, there will come a time when the banks and regulators will have to carefully assess the costs and benefits of such preferential interest rates, as well as the resulting expanded loan provisions. Corporates, riding the wave of green transition, should also take into account that borrowing costs might yet rise again.

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