LLOYDS BANK
SUSTAINALYTICS

Sustainability Bonds for Commercial Banks

Introduction: A pivotal year for sustainability bonds

2014 saw a substantial increase in the sustainability fixed income market with green bond issues reportedly increasing to over US $36billion[1] – more than a threefold increase on the value issued in 2013, with some forecasting issuance to reach US $100billion in 2015 and up to US $300billion in 2018.[2]

Despite this growth, commercial banks (i.e., non SSA FIs) have been somewhat under-represented with only Lloyds Bank, TD Bank, NAB and Muenchener Hyp issuing sustainability bonds in the EUR/GBP market. Looking forward, we expect this to change, driven by two macro trends, namely banks sustainability strategies becoming an increasingly core part of their post-crisis corporate identity and increasing investor momentum around sustainability in general and 'green' bonds in particular.

Over the past year Lloyds Bank and Sustainalytics have worked on a range of sustainability bond transactions totalling €2.5 billion, equivalent in the last year, in particular Lloyds Bank's self-led £250 million sustainability bond launched in July 2014 – implying growth in this sub asset class.

Section 1: Why do Commercial Banks issue sustainability bonds?

Sustainability is becoming core to banks' strategies

Sustainability has become a core part of banks' strategies for a number of reasons. One is defining their post financial crisis identity and re-building reputations, another is the increased focus on longer term risks posed by issues such as climate change.

Sustainability strategies tend to be unique to each institution, but there is increasing buy-in to the benefits of a proactive sustainability strategy. Much analysis has been produced to link sustainability strategies with cost of capital. A recent study by Clark et al. reviewed 190 academic studies on this topic concluding that:[3]

- 90% of studies on cost of capital show that sound sustainability practices reduce cost of capital
- 88% of studies show sustainability practices improve operational performance (cashflows)
- 80% of studies show stock performance is influenced by strong sustainability practices

Sustainability strategies often connect central departments that sometimes struggle to drive the CSR agenda on their own. A bond issue could bring colleagues together from across the business to achieve a common sustainability goal. This helps to integrate a sustainability strategy with the business and the dialogue often leads to follow on opportunities. Externally, the bond roadshow creates a unique opportunity to have a direct and focused dialogue with investors who are increasingly focused on sustainability in the context of overall risk reduction of an issuer which may ultimately result in a positive pricing differential.

Investor momentum

Sustainability bond issuances generally form part of a wider sustainability strategy and are rarely a stand-alone funding decision. Issuers should not expect a single bond issue to reduce their cost of capital but a sustainability bond can be an important catalyst. Investors have different requirements and strategies, with momentum building in three general areas:

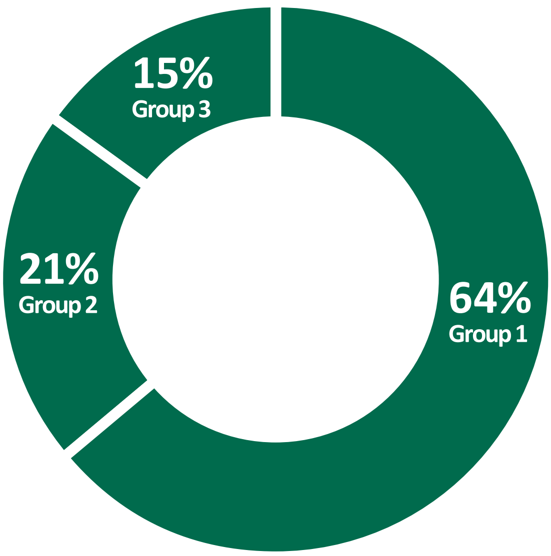
1. **Socially Responsible Investment ("SRI") / Ethical funds;**
2. **ESG Integration** – mainstream investors are increasingly integrating environmental, social and governance (ESG) risks into their decision making; and
3. **Thematic funds** that focus on green assets

Currently the greatest momentum is among mainstream investors, who increasingly see sustainability risks as a key measure of non-financial risk (measured by ESG performance) and are integrating such risks into pricing and asset allocation decisions. Investors with US $45 trillion in assets under managements have signed the Principles of Responsible Investment (PRI), agreeing to integrate ESG into their decision making.[4] A report from the US SIF Foundation suggests that assets managed with some element of sustainability considerations now account for US $6.57 trillion, or almost one-in-six dollars invested. The report also cited that firms considering sustainability risks in their investment decisions had risen three-fold since 2012.

In addition to the above, there is significant investor momentum in the green bond space, with 25 high profile names such as BlackRock, Allianz, PIMCO and RBC GAM all signing the INCR "Statement of Investor Expectations for the Green Bond Market".[5] Indeed, Zurich Insurance, a major investor in green bonds, has expressed its support in the development of market standards and procedures to ensure the integrity of green bonds.[6]

FI issuers should expect a significant level of investor diversification from a sustainability bond issue. In the case of Lloyd's recent sustainability bond, the chart below show the split between investors with varying degrees of sustainability focus:

Lloyds £250m ESG Bond



Group 1
64.2% dedicated Green or SRI funds/investors who have a strong commitment to ESG

Group 2
20.8% PRI signatories who are not Tier 1, or who have evidenced that they are moving towards ESG Integration

Group 3
15.0% Other

Post issuance, the Lloyds Bank ESG bond has traded above par in good volume on the secondary market in line with the outstanding senior funding curve, indicating a continued interest from a wider pool of investors. Other notable sustainability bonds issued in 2014 from investment grade issuers such as Iberdrola, Unilever and EDF have traded in line with their senior funding curve.

Section 2: What assets should banks consider?

Assets already in banks' portfolios

Banks have a number of sustainability-related assets (with both positive environmental and/or social impacts) on their existing (and future) lending books – across personal, small business, large corporate and project loans. In many cases, these assets stem from explicit sustainability lending products that aim to finance positive environmental and social activities. Examples include loans to improve the energy efficiency of homes or business operations, affordable mortgages to low-income segments, micro financing for small enterprises, and finance for renewable energy projects. Furthermore, there are additional business lines and lending products that may not be labelled as sustainability lending products, but may contain underlying assets with positive sustainability impacts. For example, a vehicle leasing product may not be labelled as a sustainability product, but may contain sustainability assets such as low-carbon or electric vehicles. Furthermore, project financing of railways, mass transit, or water management systems can have inherent green characteristics, and similarly, construction finance of schools and hospitals may have social benefits.

Link between asset and impact

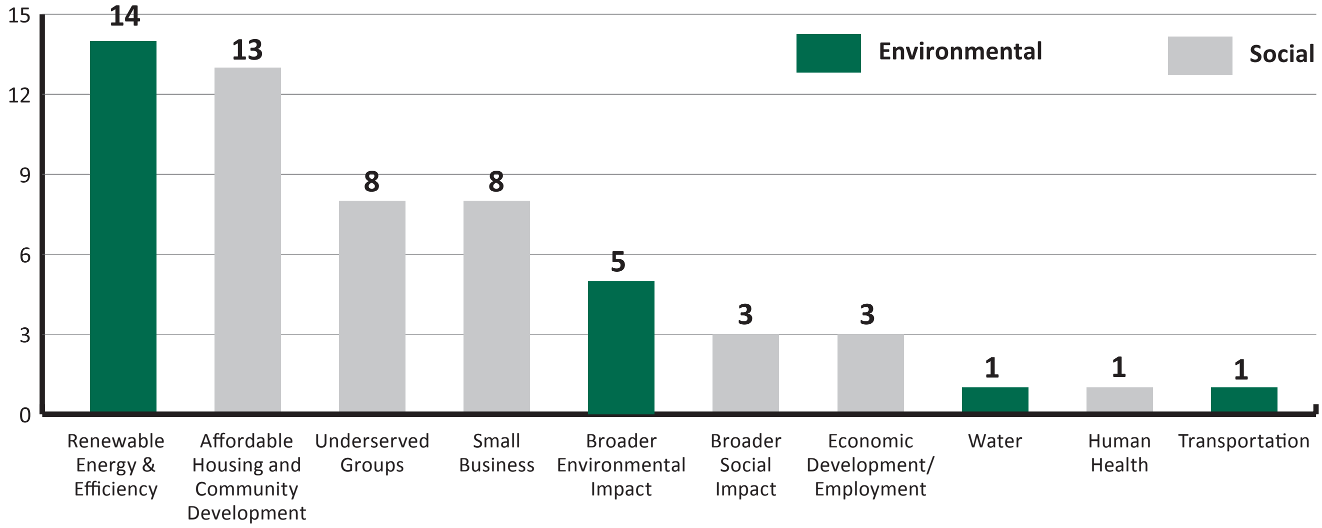
The assets to be considered for a sustainability bond portfolio should demonstrate a strong link to a positive social or environmental impact. Once the social or environmental impact objective is defined, assets with a link to such outcomes can be identified within a portfolio. In project financing, the link between the asset and its impact tends to be direct, and identifying assets with a positive social or environmental impact may be less challenging – e.g. attributing climate change mitigation impact to a renewable energy project is fairly straight forward, whereas the link may be less evident in other cases. For example, a corporate loan to an energy company could be applied to either its fossil fuel or renewable energy activities, and therefore, a positive environmental outcome cannot be assumed. An innovative corporate lending solution linked to a positive environmental outcome was provided by Lloyds Bank to Sainsbury's in the form of a 'green loan' to finance energy efficiency initiatives. However, in many cases, the link between assets financed and impact achieved is not entirely clear. As such, a natural first step in identifying eligible assets for a sustainability bond portfolio is to look at specific sustainability lending products within a bank's product offerings.

Sustainability Lending Activities

To better understand the green and social lending products and initiatives currently in the market, Sustainalytics recently reviewed the activities of a sample of global banks. Although the sample reviewed is not intended to be representative of the entire banking industry, the findings do provide meaningful insights into some of the sustainability lending activities offered by these banks. These activities range from broad initiatives and commitments to more specific products. Note that this review did not look at underlying assets, but rather at broader lending activities in place to promote sustainability.

Out of the 40 sustainability lending activities across the 13 banks reviewed by Sustainalytics, 13 could be classified as having potentially positive green or environmental impact, 21 as having social impact, and six as both. By far the most prevalent green lending activity among these banks related to renewable energy and energy efficiency. On the social side, lending related to affordable housing and community development was most common, followed by lending to underserved communities and small businesses. The graph below outlines the impact types identified in the review and their frequencies. It should be noted that many of the 40 lending activities were classified under more than one impact category.

Sustainability lending activities per impact type



Lending Initiatives and Products

As mentioned previously, the sustainability lending activities in this sample range from large-scale initiatives to promote sustainability lending to specific products. Some of the broader initiatives in particular, suggest that certain banks may be accumulating substantial portfolios of sustainability assets, including:

- Wells Fargo’s US $30 billion commitment to loans and investments to support a ‘greener’ economy
- Westpac’s commitment of US $6 billion for lending and investment to the clean tech and environmental services sector by 2017
- Morgan Stanley’s US $1 billion initiative to spur affordable housing
- Bank of America’s 10-year community development lending and investment initiative of US$1.5 trillion plus US $70 billion in financing commitments to businesses that address climate change
- Citigroup’s plans to lend, invest and facilitate deals worth $100bn in Cleantech by 2025 to support the fight against climate change and protect the environment
- In the area of small business lending, Lloyds Bank has committed to growing net lending to SMEs by £1 billion as part of its Helping Britain Prosper Plan

With respect to specific sustainability products, the below table highlights a selection of different product types and corresponding examples from the sample of 13 banks reviewed.

Green Lending Products	Examples
Renewable energy	Westpac's 'Solar Shed' product offers farmers affordable access to solar energy
Transportation	Vancity offers clean air vehicle loans with preferential rates
Renewable energy & efficiency	GreenLoans, a 100% subsidiary of ABN AMRO, offers loans to customers seeking to make sustainable improvements to their homes such as solar panels, solar boilers, heat pumps and floor, wall and roof insulation
Renewable energy	In 2011, Bank of America Merrill Lynch stated that it structured and financed the largest distributed rooftop solar generation project in the world, between ProLogis and investor NRG Energy, a US $2.6 billion transaction
Eco mortgages	Bank of Montreal offers the BMO Eco Smart Mortgage for homes that meet certain energy-efficiency criteria

Social Lending Products	
Affordable housing	In 2012, Citi lent and invested more than US $5.3 billion in 255 transactions with communities in the U.S. through the bank's Home Affordable Modification Program
Affordable Housing	Wells Fargo's NeighborhoodLIFT and CityLIFT programs offer downpayment assistance for qualified buyers
Small business	Westpac's microfinance partnership with Many Rivers Microfinance (MRM) is designed to assist indigenous and non-indigenous entrepreneurs to develop sustainable businesses
Underserved groups	RBC provides several services to assist Aboriginal Peoples in achieving home ownership

Constructing a portfolio

Investor momentum for sustainability bonds points to a substantial and continuing increase in market depth, which could result in a future pricing advantage for sustainability bond issuance. Given the current lack of pricing advantage, issuers have latitude to choose environmental or social themed assets. Going forward, there is significant momentum behind green bonds that could lead to investors differentiating between environmental and social themed assets.

Section 3: How to implement a sustainability bond?

Industry Standards

Though there are no statutory standards for sustainability bonds, an increasing number of investors are looking for standards to ensure that bonds deliver on their sustainability commitments. The Green Bond Principles (GBPs) outline four broad principles that are commonly applied as best practice across sustainability bonds.[7] The GBPs cover four key areas, namely:

- Use of proceeds
- Process for Project Evaluation and Selection
- Management of Proceeds
- Reporting

With the GBPs in mind, issuers have a reasonable amount of flexibility to decide how best to structure and implement their bond. This process is slightly more time consuming than a typical unsecured bond but significantly less time-consuming than a typical secured bond issue. A group of 22 investors have taken this a step further issuing a statement of expectations.[8]

Implementation

1

Internal preparation

Issuers should identify an initial list of potential uses of proceeds in collaboration with internal lending and sustainability colleagues.

2

Appoint a third-party sustainability expert

A sustainability expert (e.g. Sustainalytics) can formally document the eligibility criteria for the bond and provide an independent evaluation. To develop a sustainability bond, issuers should carefully consider the eligibility criteria that assets must meet to qualify for inclusion. Investors look for detailed, credible and transparent eligibility criteria for the use of bond proceeds as well as an indication of what positive impacts the bond is likely to achieve. Furthermore, eligibility criteria should align with the broader corporate sustainability goals, which in many cases encompass both environmental and social objectives.

3

Work with existing internal processes to ensure the proceeds can be tracked and reported

For a sustainability bond to deliver on its promises of positive impact, it is necessary that there be effective systems and processes in place for the allocation and management of proceeds. An independent assessment and opinion of issuer processes can increase investor confidence that a bond will be managed efficiently and that intended outcomes will be achieved. Issuers should be transparent about how asset eligibility will be determined, proceeds allocated, and outcomes reported to investors. In many cases, issuers can leverage existing monitoring and governance mechanisms within the firm to support their sustainability bond implementation and meet disclosure and reporting commitments.

4

Investor reporting

It has become increasingly important to investors that issuers report, preferably on an annual basis, on the allocation of proceeds of a sustainability bond. Ideally investors want to trace their funds to specific projects/assets and want to see external auditor assurance that their investments have indeed been allocated to positive impact projects in accordance with the issuer's commitments. To this extent, issuers are expected to provide allocation reports showing total funds raised, funds allocated by projects and unallocated balance. Investors are also increasingly expecting issuers to measure, where possible, the positive sustainability impacts achieved by bond proceeds. It is important to note that in many cases existing reporting processes can be leveraged and that only certain metrics that are of particular importance to investors need to be externally audited.

The process can generally be completed in weeks rather than months. Based on the combined experience of Lloyds Bank and Sustainalytics across a range of transactions, the following are key factors affecting ease of implementation:

- Level of senior buy-in
- Degree of alignment with existing sustainability strategies
- Finding assets that are not being used for another purpose
- Number of departments involved – it is often easier to use assets from within one area of the business rather than multiple areas, particularly when it comes to reporting
- Green vs. other sustainability-themed assets. Investors are focused across the ESG spectrum but there is more momentum behind green bond assets

Independent evaluation

As the sustainability bond market grows, issuers are increasingly seeking independent evaluation to strengthen transparency and signal to investors that the bond meets certain expectations. These expectations broadly relate to the anticipated positive environmental and/or social impact of the bond as well as the transparency and process around allocating proceeds. Furthermore, beyond evaluating sustainability bond frameworks, independent verifiers such as Sustainalytics in many cases support issuers in actually developing the frameworks themselves, including the definition of sustainability criteria for selecting eligible assets, analysis of the corporate strategy for issuing a sustainability bond, identification of the monitoring and governance mechanisms that underpin the allocation of proceeds, as well as advice on reporting on bond allocations.

An independent review provides investors with a clear understanding of the positive objectives and expected outcomes of a sustainability bond, helping to inform investment decisions. The benefit to issuers of conducting an independent review is not limited to identifying potential gaps in the approach, but also ensures that the sustainability bond has credibility and is in line with investor expectations. Furthermore, some issuers find that the guidance and advice provided through an independent review can facilitate and speed up the process of issuing a sustainability bond.

Looking Forward

After a successful year in the sustainability bond market, which saw landmark transactions from a wide range of issuers, 2015 is likely to see progression of this sub asset class into a core product for both issuers and investors alike. As banks look to embed their sustainability strategies as a critical component of their corporate culture, investors will be keen to see the development of standards of disclosure and reporting to support a growing number of dedicated sustainability related funds. As the number of investors grow it is not unreasonable to expect a small pricing benefit to emerge which would likely create a step change in issuer side momentum and underpin the business case to incur the costs associated higher standards of disclosure and reporting.

References

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[3] Gordon L. Clark, Andreas Feiner and Michael Viehs, "From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance", Oxford University Smith School of Enterprise and Environment, 20 Oct 2014

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[6] Aaron Pickering, Ceres, "Investors Encourage Further Transparency, Standardization to Spur Green Bond Market Growth", 10 Feb 2015, further information at www.ceres.org/clean-trillion

[7] International Capital Markets Association website: http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/green-bonds/

[8] INCR, "A Statement of Investor Expectations for the Green Bond Market"

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