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HOW BANKS COULD BENEFIT FROM ESG BONDS

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How banks could benefit from ESG Bonds

Since 2021, SA Banks have increased their issuance of various "use of proceeds" ESG-related bonds into the debt capital markets (DCM). These bonds include social, green, and sustainability-linked bonds, with issuance from South African (SA) banks being focused mostly on environmental aspects. The proceeds from these issuances are being used to lend to SA corporates who are facing escalating electricity prices, unreliable supply from Eskom, and a mandate from various stakeholders to be more environmentally sustainable.

It is not surprising that we see a move and demand towards specific sustainability-linked borrowing by SA corporates. The main requirements for corporates to quality for these preferred green finance facilities from the banks are to incorporate improved ESG disclosure, metrics, and green targets. Although there are some clear benefits to corporates, the banks are likely to benefit too. Some of the benefits to corporate borrowers from the proceeds of these sustainability-linked bonds include the eventual saving on energy costs, and more reliability and stable power supply. The banking sector claims that this results in a reduction in the pricing being offered by the banks, albeit with various reporting obligations placed on borrowers.

Enhanced net interest margins for banks

What has not yet been fully examined is the financial benefit that this sustainability funding to corporates could provide to the banks. On the face of it, the transaction seems simple: banks borrow money from investors by issuing "green bonds" and use those proceeds raised to lend to corporates for specific green-related projects and initiatives. As the banks issue more green linked bonds, there could be an increased demand for these bonds from investors (especially from investors that are not able to invest directly in green projects), which could reduce the banks' cost of funding. In addition, banks get to enhance their climate reporting and disclosure, which improves their climate score with investors.

Other potential financial benefits for banks

Banks have large client lists and preferred partners that could benefit financially in corporate South Africa's drive to incorporate more renewable energy into their businesses. By having green funding facilities and initiatives available, corporates could borrow from the banks specifically for green aspects. Banks could also connect these borrowers to their preferred suppliers, manufactures and vendors.

By linking corporate borrowers with suppliers and partners in the renewable energy sector, the banks could generate more transactional income, whilst also accumulating data on transactions that could be used to target additional clients.

The accumulated data could be used to determine which products and services customers are looking for, identify pricing points and obtain customer feedback on the additional reporting and disclosure requirement costs - relative to the benefits of the reduction of interest rates charged and other savings. In addition, this data and information collected from suppliers, manufacturers, and corporates, could be used to create products that could eventually lead to green lending to the retail home loan market.

Retail home loan market opportunity

As per the March 2022 BA900 report, household mortgages in the SA retail market were at R1.14 trillion (March 2021: R1.066 trillion), compared to commercial lending (including property finance, asset finance and term and other loans of R1.859 trillion (March 2021: R1.736 trillion). This amounts to about 22% of the total bank loans and advances. Based on that figure, there is a large untapped green funding market that could potentially target the retail consumer.

Consider the following example: currently, retail customers have to draw down on their existing mortgage (or pay cash) to fund solar panels, a water articulation system, or any other devices needed to get off the grid. However, with increased data available from specific partners and networks of green technology providers and manufactures, banks could begin to offer retail customers green loans, intended specifically for their homes, at cheaper rates than their current mortgage rate. This could incentivise demand whlist the credit risk to the banks would remain largely unchanged, as banks could access the equity already built up in existing mortgage bonds thereby reducing their need to raise additional expected credit losses. To ensure that the funds are used specifically for green transactions, banks could continue to leverage their partner/client relationships on their mobile apps (which are becoming large online marketplaces) to connect their clients directly to vendors/suppliers to install these new green technologies. Assuming only 5% of the SA retail market uses this retail product, this is a potential R50 billion market.

As above with corporates, this would result in additional loans and advances, interest income, and transactional income for the banks, without much more credit risk.

Conclusion

In summary, the benefits to the banks could be:

- reduced interest expenses as demand for sustainable bonds reduces the banks' cost of funding;
- growing their loans books to existing clients which would lead to more interest income;
- when construction/installation begins, additional transaction activity would lead to added non-interest income (transactional income); and
- all of the above together would lead to more profits for the banks, at a similar credit risk.

With mortgage bonds amounting to about 22% of totals loans, and ever-increasing electricity and water costs, if retail customers could obtain green funding at a cheaper rates there could be ample demand for sustainability retail lending, resulting in increased profitability for the SA Banking sector – and a commercial and environmental benefit all round.

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