How to implement ESG-linked loans in Uzbek banks?

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Introduction Sustainability-Linked Loans and ESG Rating

Sustainable finance and green lending are on the rise as more borrowers and lenders recognize the potential benefits of green and sustainability-linked loan products for their businesses. According to the Loan Markets Association (LMA), sustainability-linked loans are a "dynamic and innovative product that enables lenders to incentivize improvements in the borrower's sustainability profile." Sustainability-linked loans align the loan terms to the borrower's performance against pre-determined sustainability performance targets such as a company's ESG rating.

The interest rate of these types of loans fluctuates and is linked to improvements in the borrower's sustainability performance or ESG rating. There are penalties that come with a decline in ESG score, but a higher ESG rating can le

While a few organizations have mature sustainability profiles and are well known for their environmental agendas (such as Accor Hotels and Patagonia), other companies face a challenge with respect to sustainability and environmental performance due to their business model or industry. Through Sustainability-Linked Loans (aka ESG-Linked Loans or Positive Incentive Loans) these organizations can access capital to fund initiatives that will support their transition to a greener company. This sustainable financial instrument also gives companies access to commercial and investment banks who have made commitments to sustainable investing.

ESG Ratings and Sustainability-Linked Loans

Typically, the bank or a lender measures the borrower's success (or lack thereof) using a predetermined performance target benchmark, like an ESG rating from a third party. Sustainalyics' ESG risk ratings are a preferred metric to measure and report on an organization's sustainability performance because of their independence, credibility and comparability year over year. ESG ratings, like those provided by Sustainalytics, provide an assessment of a company's management of material environmental, social and governance issues and are a good measure of whether a company has maintained, or improved, their overall sustainability performance.

Sustainability linked lending in the European leveraged loan market

Sustainability linked loans continue to attract attention in the European loan market. Until recently, activity has focused on investment grade loans. However, sustainability features are increasingly being incorporated into leveraged loan agreements, signaling that the European leveraged loan market is beginning to embrace environmental, social and governance ("ESG") issues. The pressure to give greater emphasis to ESG considerations comes not just from legal and regulatory change, but also from investors who incorporate these factors into their credit analysis and from financial sponsors' own funds and investors prioritizing commitments to ESG when allocating capital. With market participants generally aligned on the importance of these issues, the prevalence of sustainability features in leveraged loan agreements, together with an increased focus on disclosure and reporting, are themes that are expected to continue and develop in the leveraged loan market.

Defining sustainability linked loans

A sustainability linked loan should be distinguished from a green loan. Unlike green loans, sustainability linked loans are not conditional on the loan proceeds being used for a green purpose. Instead, the defining characteristic is that the terms of the loan incentivize the borrower to improve its performance against certain predetermined ESG criteria.

In documentary terms, the core feature is a sustainability linked pricing ratchet – if the borrower satisfies certain predetermined sustainability targets, the margin on the loan is adjusted. There will also likely be other provisions, for example, a requirement to provide supporting information which relates to, and evidences, the group's sustainability performance.

Key features of sustainability linked leveraged loans

Over the past few years there have been several green and sustainable finance initiatives in the loan market designed to encourage the integration of ESG factors into loan documentation and to promote consistency and best practice across these products. A joint working group consisting of the Loan Market Association ("LMA"), the Asia Pacific Loan Market Association and the Loan Syndications & Trading Association, published a set of green loan principles in 2018, followed by sustainability linked loan principles in 2019 ("SLLP"), both of which were supplemented by further guidance published in 2020. The SLLP and supplementary Guidance ("SLLP Guidance") are voluntary standards setting out the characteristics of a sustainability linked loan. They do not have the force of law but are widely followed internationally.

There is currently no market standard drafting for the sustainability linked loan provisions in a loan agreement. Naturally, this means that documentation varies between transactions, but some key themes are emerging.

One-way or two-way pricing ratchets

Sustainability linked pricing ratchets can operate on either a "one-way" or a "two-way" basis. The "one-way" basis means if the borrower satisfies the predetermined sustainability targets, the margin on the loan is reduced. If the sustainability targets are not met, the margin does not change.

The alternative "two-way" basis retains the margin discount upon satisfying predetermined sustainability targets, and introduces a margin premium which is triggered where sustainability performance falls below certain predetermined levels. Since the underlying objective is to incentivize borrowers to improve ESG performance, it is perhaps not a surprise that the majority of sustainability linked leveraged loans have adopted a "two-way" rather than "one-way" mechanism.

The size of the reduction or increase to the margin varies but might typically be in the range of 0.02% to 0.075%.

Sustainability criteria

The sustainability linked pricing ratchet relies on setting targets for improvements in ESG performance. In practice, ESG performance is measured either by reference to an overall ESG score or through more specific key performance indicators ("KPIs").

Overall ESG score: An overall ESG score is assigned to the group by an external third party rating agency, with the group's overall ESG score at either the date of the loan agreement or the first utilization date being used as a "baseline". The group's ESG score is reassessed annually, and if the overall ESG score improves above a threshold determined by reference to the baseline, the target is achieved.

Specific KPIs: Performance is assessed across a selection of KPIs, with the number and type varying depending on the nature of the group's underlying business. The SLLP include an indicative list of criteria which can be used to develop KPIs and are clear that the KPIs should be appropriate in the context of the group's business. Examples of specific KPIs in recent facilities include KPIs relating to carbon emissions and wind power.

The approach adopted on sustainability linked leveraged loans is mixed and there are examples of transactions that measure ESG performance based on an overall ESG score, as well as those that rely on specific KPIs.

Experience of Uzbekistan in lending ESG-linked loans

In Uzbekistan, there is a gradual increase in activity in the field of green finance. If initially this segment was presented mainly in the form of grants from international financial institutions, then in recent years other instruments such as green loans and bonds have been introduced.

The Government of the republic was the first in the CIS region and one of the first in the world to place government bonds aimed at financing sustainable development goals — Sovereign SDG Bonds[5]. The volume of the issue amounted to $ 635 million (the first tranche) and $ 235 million (the second tranche), both issues are denominated in Uzbek soums. The first tranche with an annual coupon of 3.9% is designed for 10 years, the second with a coupon of 14% — for three years [6]. The funds received will be used for the implementation of activities and projects to achieve nine priority goals National SDGs: education (SDG-4), water resources management (SDG-6), health (SDG-3), environmental transport (SDG-9 and SDG-11), pollution control (SDG-11), natural resource management (SDG-13 and SDG-15), green energy (SDG-7). The program for issuing SDG bonds of Uzbekistan was implemented with the support of UNDP and developed in accordance with ICMA standards: Principles of Green Bonds (GBP), Principles of Social Bonds (SBP) and Guidelines on Sustainable Development Bonds (SBG). For reporting purposes, it is provided disclosure to investors of information on the use of funds and the impact report, which will be available on the website of the Ministry of Finance Uzbekistan[7].

There is no information on the total volume of ESG lending, but several green loans provided by Uzbek banks are known. In November 2021, the EBRD provided a loan in the amount of $ 10 million to JSCB Hamkorbank. The financing should help national small and medium-sized enterprises, which account for more than 50% of Uzbekistan's GDP to increase investments in green technologies. The funds were provided within the framework of the Green Economy Financing Mechanism (Green Economy Financing Facility, GEFF) of the EBRD, launched in Uzbekistan in 2019 to support green financing. In 2021, JSCB Uzpromstroybank also joined the EBRD's financial program. The projects were planned to be financed under a credit line of up to $ 25 million.

In total, the EBRD invested almost $690 million in 22 projects in Uzbekistan in 2021.The supported projects contributed to the development of renewable energy, green lending, modernization of key infrastructure facilities and small businesses

The Ministry of Finance and the Ministry of Economic Development and Poverty Reduction are mainly engaged in the development of the ESG direction in Uzbekistan. Together with the State Asset Management Agency, the departments are responsible for accelerating the process of transition to a green economy of enterprises with state participation.

In the process of implementing measures to achieve national goals and objectives in the field of sustainable development for the period up to 2030, many other agencies are also involved.

Currently, ESG is not a key issue on the agenda of the banking industry. The main focus is the overall transformation of the banking sector. As of January 2022, there were 33 banks operating in Uzbekistan, 10 of which are state—owned, seven banks have foreign capital, and five are private. State-owned banks own 81.5% of the capital and 84% of the assets of the banking sector, private banks remain relatively small niche players.

In May 2020, the President of Uzbekistan approved a five-year strategy for reforming the banking sector to solve its main problems: excessive state participation, insufficient competition, poor quality of corporate governance and banking services provided. The goal of the strategy was to reduce the state's share in the sector from 84% to 40% and increase the market share of the non-banking sector from 0.35% to 4%. By 2025, the government plans to privatize its shares in six banks and promote the modernization of banking services in the remaining state-owned banks.

In May 2022, the Board of Executive Directors of the World Bank approved the provision of a concessional five-year loan of $15 million to Uzbekistan to support the government's efforts to reform the financial sector [14]. For the purposes of ESG transformation and implementation of green projects, large banks in Uzbekistan is also actively cooperating with multilateral financial institutions.

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Experts of the international financial publication Asiamoney recognized Uzpromstroybank as the winner in the nominations "Best Bank of Uzbekistan" and "Best ESG Bank in Uzbekistan" according to the results of the annual selection in the category Best Bank Awards 2022. The work of the bank together with the International Finance Corporation (IFC) and the EBRD on the transformation, development of green banking and implementation of ERP principles was particularly noted.

In 2020, Sanoat qurilish bank (SKB), in cooperation with the EBRD, IFC and other leading development institutions, launched a platform for green financing and created the necessary internal ESG ecosystem, including marketing, branding, development of new green products, development of sales channels and staff training. SQB is the largest Uzbek lender of key industrial sectors, oil, gas, chemical and other energy industries. The Bank does not limit the support of any projects in these industries[15].

The Association of Banks of Uzbekistan is beginning to get involved in the development of the ESG agenda in the country, but currently its activities are mostly related to information support of companies. In May 2022, the initiative of the Uztextilprom Association and the United Nations Economic Commission for Europe (UNECE) in the development of an ESG strategy for traceability and transparency in the textile industry of Uzbekistan was published on the UN website [20]. It provides for the establishment of an independent testing laboratory for testing sustainable and safe textile materials.

The development of ESG regulation is at the initial level in Uzbekistan. The main focus is to improve the quality of life in the country and simplify business procedures. By decree of February 7, 2017, the President of Uzbekistan approved the Strategy of Actions on five priority areas of the country's development in 2017-2021. They were the improvement of state and social construction, ensuring the rule of law and reforming the judicial and legal system, the development and liberalization of the economy, the development of the social sphere and ensuring security, interethnic harmony and religious tolerance, the implementation of a balanced, mutually beneficial and constructive foreign policy [21]. In October 2018, the Cabinet of Ministers of the Republic of Uzbekistan approved Resolution No. 841 "The Agenda for Sustainable Development for the period up to 2030". With the support of the UN, priority SDGs and targets are gradually being integrated into national strategies and programs. The roadmap for the implementation of the national SDGs was approved, for the purposes of which six expert groups were formed in the areas of "Economic well-being", "Social Protection", "Healthcare", "Education", "Environment" and "Effective Governance". An interdepartmental working group has been established, headed by the State Statistics Committee, whose goal is to develop national SDG indicators.

In 2019, a presidential decree approved the strategy for the transition of the Republic of Uzbekistan to a green economy for the period 2019-2030. It is aimed at improving the energy efficiency of the basic sectors; diversification of energy consumption through the introduction of renewable energy sources; mitigation of the effects of climate change and adaptation to them; increasing the efficiency of the use of natural resources and the preservation of natural ecosystems. In 2021, a portal was launched, which published the results of reforms in Uzbekistan for 2017-2021.

The Ministry of Finance, with the support of UNDP and the French Development Agency (AFD), is reforming the fiscal system to support the transition to a green economy. The methodology of green budgeting is being developed, the introduction of the principles of green and sustainable procurement, the reform of green taxes and subsidies are being considered. Work is underway to link government spending with SDGs, implementation of a monitoring system to track expenditures aimed at the implementation of the SDGs. In parallel, the Ministry of Investment and Foreign Trade focuses on creating a favorable climate for green investments in Uzbekistan through the Green Investment Council.

Integrating ESG into investment process

When evaluating a GP's approach to ESG in investment decision-making, we look for evidence of a consistent process, which ensures that each investment has undergone ESG due diligence. This includes having clearly defined responsibilities within the team, as to what due diligence is done and when. In our view, ESG due diligence can be done effectively either internally or by external consultants, but it can also be a mix of the two. We also want to see evidence that the key findings of ESG due diligence have been discussed within the investment committee, which is ultimately responsible for the performance of portfolio companies. Typically, GPs carry out several levels of due diligence on any given opportunity, starting with an evaluation of the strategic fit for the fund they manage and ending with detailed due diligence on different topics at the target. In our experience, ESG considerations start with a quick sanity check for red flags and excluded industries. If it passes this test, full due diligence on the business can begin, with a focus on identifying material risks and opportunities. For specific topics, such as environmental due diligence, many GPs appoint external consultants, who conduct specialist due diligence similar to outsourced legal due diligence. Summarizing and prioritizing the outcomes is a key responsibility for the manager. Subsequently, GPs consider whether ESG risks can be mitigated, whether they are significant enough to require a price reduction and how they can be addressed going forward. Importantly, GPs should also evaluate ESG opportunities. ESG opportunities and value creation can come from a focus on resource efficiency (including energy consumption) and from social impact such as ongoing employee development and engagement. At this stage, investors might already agree on KPIs to track in the next stage of the investment cycle, the holding period or ownership phase. This facilitates clear and relevant reporting later on. The identification of key ESG issues can also be translated into mitigating action items and specific targets to be achieved.

In order to implement ESG into life, we must pass these stages.

Develop a Strategic ESG Roadmap

An ESG program won't hold up unless it has a framework that clearly outlines where your organization's vision and purpose meet your ESG priorities. A strategic roadmap provides a compelling ESG framework that gives stakeholders a clear picture of your strengths, goals, and direction. Developing a roadmap should outline initiatives, actions, and resources, and ensures accountability for key actions. To get started, we recommend conducting a gap analysis between your current state and your vision and goals to identify what may be missing so you can strategize and plan accordingly for the future. Depending on where you are on the fitness scale, gaps may be as minor as only needing to collect one more metric, or as large as needing to set up a sustainability council to make key decisions moving forward. Understanding your gaps between your current state and your five-year target will help define the initiatives, actions, and resources for your roadmap. This is a time to be reminded of the level of ambition you previously identified during your vision and goals session and to set in place a reasonable approach that you know you can commit to, often through a phased plan with measured steps along the way. When building a framework, it's important to consider how it applies across your organization (by operation type, function, region, etc.) and how you will monitor progress to achieve goals.

Implementation of Action Plans

To effectively implement an ESG program, requires the integration of ESG into business practices and processes. You need to outline programs to stay in shape all year long, so you are prepared when the ESG spotlight shines on your company. Here are a few best practices to ensure successful implementation:

- Identify clear and measurable outcomes that define what success looks like for you.
- Utilize centralized management systems or data software to more easily track and trend key metrics and performance.
- Set a regular cadence of communication and updates for key stakeholders to continuously evaluate goals, update data, and compare best practices. By constantly monitoring your plans, you can stay apprised of adjustments that might be needed to stay on track toward your goals.

While it is valuable to have oversight of ESG at a corporate level, it is important to remember that real progress happens on the ground. Your facilities teams will likely need detailed recommendations and guidance to achieve tangible results as you drive accountability from team members responsible for implementing actions.

Report Your Progress

Similar to goal setting, there is not a “one-size- fits-all” approach to ESG reporting. Regardless of the standards, frameworks, or guidance used to tell your story, the most important component of reporting is communicating your information externally in a concise and clear manner. To develop your report, you first need to decide what you want your report to accomplish. It should ideally be a combination of:

- Communicating ESG strategy to stakeholders while demonstrating alignment to business objectives.
- Highlighting ESG policies and programs already in place.
- Sharing ESG goals and metrics.
- Evaluating your progress and engagements in priority ESG areas.

It is good to start by identifying your key audiences and determine what they want to know. In addition to deciding what to report, you also need to consider how you want to disclose information in a direct and efficient way, ensuring you report on topics most material to your company. It is important for stakeholders to be able to access your ESG information easily. We recommend having a PDF report available on your website and/or organizing a dedicated ESG landing page to signal your commitments and provide clear and timely communications. As you mature and progress, you may integrate key information into broader company reporting, such as proxy or annual reports, investor presentations, or customer communications.

In addition to external communication, it is good to provide regular internal updates to reinforce the importance of ESG to the organization and acknowledge contributions employees have made toward achieving goals.

Finally – review and update your ESG strategy regularly to ensure your company stays aligned with stakeholder and business expectations. This is not a one-time assessment but a living and breathing strategy that you need to continue to nurture and grow.

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