Insight Report

Economic Research Unit

March 2022

Sustainability in Banking

Sustainability Basics – Beyond the hype

What is Sustainability?

Global economy has grown steadily in the last 60 years at a CAGR of 3.4%, driven by industrial and technological revolution[1]. While the growth is heartening, emission of greenhouse gases (GHG) such as carbon di-oxide from industrial activities, vehicles etc. have caused global warming and change in weather patterns. Such changes have had a telling effect on the Earth's ecosystem – a third of earth's natural resources had been lost in 25 years[2].

Such deterioration has highlighted the importance of sustainable development. Sustainability refers to meeting the needs of the present without compromising the resources available for future generations to meet their needs. It is a holistic approach that includes environmental integrity, economic progress, and social equity to ensure long-lasting prosperity. Sustainable development is expected to result in economic gains of USD 230 billion by 2050[3].

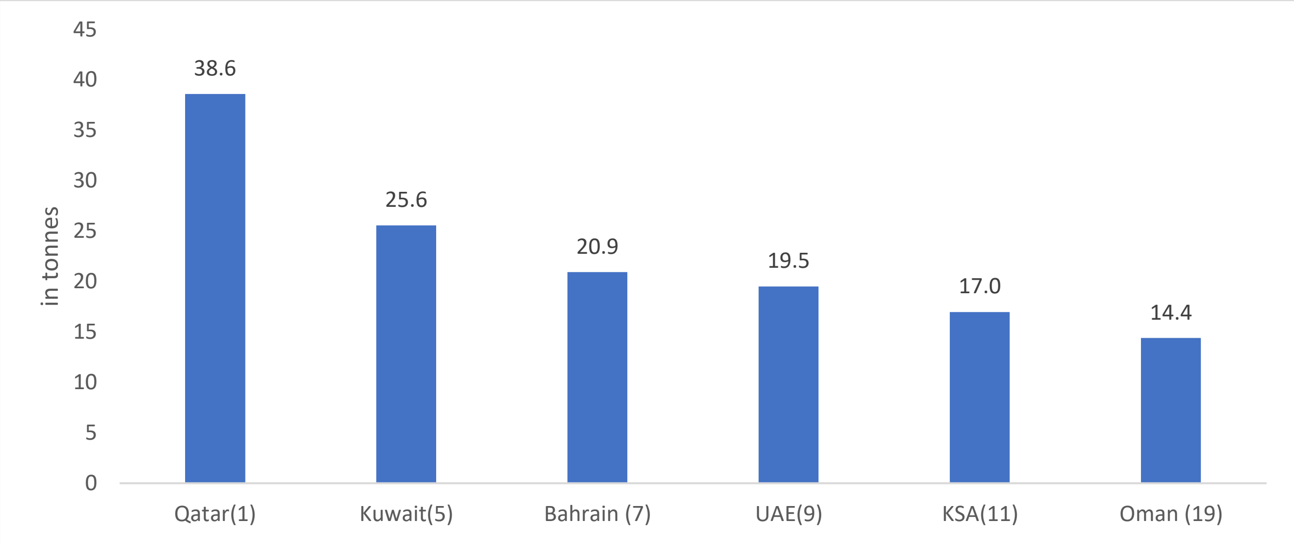
Importance of Sustainability for Kuwait

The impact of climate change on Kuwait has reflected in its rising annual temperature, higher airborne dust, change in rainfall patterns and increase in dust storms in recent years. Going ahead, expected effects of climate change in Kuwait include further increase in temperature (1.84°C by 2060), coastal erosion/inundation due to rise in sea level by 0.16-0.63m by 2050 and water scarcity among others[4]. This would impact non-oil sectors (agriculture, fisheries etc.) and the overall quality of life.

Being hydrocarbon-based economies, GCC countries rank in the top 20 in terms of per capita CO2 emissions. Kuwait also ranks 113 out of 165 in the Sustainability Development Goals Index (SDG) 2021 with the report indicating stagnation in parameters such as climate action and sustainable cities. The estimated impact of climate change and lower ratings in related indicators highlight the need for sustainability-oriented measures in Kuwait.

[1] World Bank; Real GDP – 1960 to 2020
[2] World Wide Fund for Nature (WWF) - 25 years spanning 1970-1995
[3] WWF
[4] WHO, LSE

Figure: Per Capita CO2 Emissions (2019)



Source: Our World in Data; Numbers in braces indicate global ranking

<u>Is sustainability contradictory to Kuwait's hydrocarbon-based economy?</u>

Sustainability is a broad concept involving good health, quality education, affordable and clean energy etc. which are applicable across countries. In SDG 2021, some parameters that Kuwait has improved in are clean energy, clean water and sanitation.

Hydrocarbons are considered to negatively impact environmental sustainability due to their high carbon footprint. However, Kuwait could incorporate sustainability initiatives within its hydrocarbon sector. Some measures that could be explored are lower emissions through use of solar energy in upstream production process, downsizing subsidies to lower local energy consumption, carbon capture and storage and conversion of hydrocarbons to hydrogen, a cleaner energy source.

In the long term, as the world moves to a low carbon economy, demand for oil and in turn its prices are likely to be lower due to wider adoption of cleaner alternatives, supported and governed by policy initiatives. Measures such as fossil fuel taxes might increase production costs. Kuwait's Vision 2035 which includes diversified sustainable economy and sustainable living environment as its pillars intends to adapt to these changes.

Relevance of sustainability in the broader financial sector and banking

Positioned at the crux of the business ecosystem in a country, different segments of the financial sector such as banking, asset management, and insurance would be impacted by the risk of climate change and the mitigation efforts. Risks associated with climate change include damage to life and property due to extreme weather events, increased business risk in sectors like fisheries owing to global warming and loss of biodiversity. Obsolescence of non-environment friendly technologies, change in consumer preferences to more sustainable alternatives and change in corporates and regulatory policies in the transition to net-zero economy are some risks related to mitigating the level of climate change.

Impact of these risks on financial sector would include adjustment of asset allocation and compliance to regulation such as greenwashing rules for asset managers and measuring and modelling climate risk for insurers.

Impact of climate risks on banking industry

Credit risk

Extreme weather events, for instance the heavy rains in 2018 in Kuwait, are attributed to climate change that is brought about by the deterioration of the environment.[5] Such events could pose credit risk as they might damage property held by banks as collateral or affect a business' activities thereby impacting its ability to repay. Businesses that are likely to be negatively impacted by climate policy also pose credit risk.

Operational risk

Banks' own business operations and property are negatively affected by adverse weather events and their impact on utility services like electricity and transport. Such events could also increase insurance costs and repair costs, affecting profitability.

Transition Risk

The transition to a low-carbon economy would impact banks through decline in value of assets and investments held in carbon-intensive sectors, increased reputational risk due to closer scrutiny on lending to sectors with high greenhouse gas emissions and changes in operation to accommodate energy saving technology.

Opportunities for Banks

i. *Enhancing Brand Value*

Undertaking initiatives that contribute to sustainable development, be it increasing vegetation cover, or offering skill development to aid social equity, conducting trainings and workshops that address climate risks, that would help in building a positive brand image for a bank.

ii. *Increasing customer base and attracting investments*

Customers are increasingly being environmentally conscious. In GCC, over 80% of consumers have expressed willingness to adopt sustainable lifestyles.[6] In this context, sustainability-based product offerings could help in widening customer base. An example is the award of credit points against sustainability initiatives undertaken by customers, which could then be redeemed by them for benefits. Eligible initiatives could be purchase of an eco-friendly product, usage of public transport, performing paperless transactions. For listed banks, such offerings could help them score on ESG (Environment, Social and Governance) criteria and in turn attract ESG linked equity investments. Banks could also offer green bonds, the proceeds of which could in turn be used to fund environmental projects.

iii. *New avenues for financing*

New technologies to lessen climate impact provide additional avenues for financing. Electric vehicles, energy efficient building solutions, large scale projects and micro installations of renewables are some examples. Transition finance is another area of opportunity which involves financing initiatives by high-carbon sectors to lower their emissions.

iv. *Green securitisation*

---

[5] Director General of Kuwait's Environment Public Authority, Kuwait Times; Donat (2016), More extreme precipitation in the world's dry and wet regions, Nature.
[6] BCG Survey, Jan 2021

As interest in ESG investments increase, securitisation of green and sustainability-linked loans could see good uptake. This would help banks free up capital while facilitating a broad funding base for environment friendly projects.

v. *Ensuring sustainable non-oil economic growth*

Diversification away from oil would entail growth of non-oil private sector and their credit uptake. Making up 90% of Kuwait's financial sector, banks are well-positioned to play a key role in facilitating sustainable development in the non-oil economy[7]. By providing sustainability linked loans, as a chain effect, they encourage sustainability initiatives in the broader economy.

Sustainability initiatives in Kuwait

The government and players in the financial sector have implemented different initiatives towards ensuring sustainability.

a. Government

- Signatory of United Nations Framework Convention on Climate Change, Paris Agreement and Kyoto Protocol. Adoption of U.N Sustainable Development Goals in 2015.
- Establishment of National Sustainable Development Committee to facilitate implementation towards sustainability goals.
- Renewable Energy Target - 15% of electricity to come from renewables by 2030.
- Kuwait National Adaptation Plan 2019-2030 to address the impact of climate change.
- Plans to develop Kuwait Metro and Electric Vehicle City

b. Banking sector

i. Banking products and services that focus on sustainability
  - Online and Mobile Banking, Digital Account Opening aid in reducing commute to banks and paper usage.

ii. Other sustainability initiatives by Gulf Bank
  - Clean up drive on World Cleanup Day with employee participation in collaboration with a non-profit, Alnowair
  - Ensuring Inclusion and Diversity with women making up 43% of the workforce and employment opportunities to people with special needs. The bank is a signatory of U.N's Women's Empowerment Principles and has also launched Women of Wisdom initiative.
  - Skill Development through AJYAL program, participation in Fikra Program and INJAZ, a NGO for education and training in workforce readiness.
  - Sponsoring initiatives such as Central Agency for Public Tenders Forum for SMEs, Kuwait Tech Expo 2020, Qout Market, National Union of Kuwaiti Students Conference
  - Waste recycling in partnership with United Waste Management Company and Omniya
  - Environmental Awareness and Financial Literacy through social media posts.

c. Other players in the financial sector

i. Boursa Kuwait
  - Member of Sustainable Stock Exchanges initiative.
  - Launched ESG Reporting Guide for listed companies
  - Plans to launch ESG index in the future
  - Reduced energy and water consumption by 1.03 million kilowatts and 85,000 gallons respectively in 2020.

ii. Others

[7] CBK Annual Report 2019-20

- Adoption of Corporate Social and Economic Responsibility (CSER) strategy for investment decisions

Potential sustainability-linked banking products

Sustainability-linked banking products offer the benefits of spreading awareness on sustainability and offer opportunities to make an impact.

a. Green Deposits

These are deposit accounts which would be used to finance companies operating in renewable energy and sustainability initiatives of corporates. Add-ons to make these deposits attractive could include competitive interest rates, option to track performance of loan portfolio and transparent criteria for financing.

b. Debit and Credit cards

The number of debit and credit cards issued by local banks in Kuwait equals 4.89 million with 310 million transactions in 2020[8]. The carbon footprint in making these cards (21 grams/card) and their non-biodegradable nature make them less environment friendly. Making debit and credit cards from recycled plastic or biodegradable materials, awarding rewards or credit points for environmental/social contributions of customers, tracking environment impact of purchases made through the cards are some sustainability-linked options.

c. Financing businesses and initiatives that have a positive ESG impact

Businesses that have positive ESG impact, say a recycling and waste management company, could be given preferential loans. It could also include project financing for renewable energy, financing initiatives such as installation of rooftop solar panels in buildings and skill development for people with disabilities.

d. Sustainability linked financing

Sustainability linked loans involve linking loan terms of corporate loans to borrower's sustainability achievements. While the use of loan proceeds is not restrictive, loan terms, say interest rates are increased/decreased based on achievement of pre-agreed sustainability targets. Additionally, as businesses face risks due to climate change and transition to a low carbon economy, inclusion of ESG criteria in credit assessment would help in comprehensive evaluation of these risks.

e. Green home loans and auto loans

Green home loans refer to loans given to construction or purchase of energy efficient houses. Instalment loans form about 33% of total private sector credit in Kuwait[9]. Given the high residential demand for electricity in Kuwait, green home loans could offer a good opportunity for ensuring sustainability in the segment[10].

Transportation is the third most GHG emitting source in Kuwait[11]. Auto loans for electric vehicles and adjustment of interest rates depending on the GHG rating of the vehicle are some options to make an impact in the segment.

[8] CBK, 2020
[9] CBK, 2020
[10] Kuwait Voluntary National Review 2019/ IEA
[11] National Adaptation Plan 2019-2030

Challenges in sustainable banking products

a. Selecting the right businesses for lending

Challenges such as greenwashing (diversion of funds assigned for green activities) and non-standardized disclosures on ESG that are mostly voluntary, make it difficult to select the right initiatives/businesses for banks to lend. Measurements, reporting and verification of targets like CO2 reduction are also not easy[12].

b. Longer payback period and high risk in projects with green financing

Developers of renewable energy projects typically look for loans of longer tenors of about 20-25 years. These projects are also prone to technology risk, regulatory risk etc. Business ventures in many sustainability related technologies are likely to be new to the market and may be perceived to be of higher risk.

Conclusion

Sustainability related disclosures could see wider uptake in Kuwait in line with global trends, supported by initiatives such as launch of ESG reporting guide by Boursa Kuwait. The increased transparency could encourage sustainability linked loans. Identifying local ESG projects and market size, offering interest rates on ESG products, cooperation with multilateral development banks for on-lending and technical expertise for projects, awareness workshops are some other measures that could help banks play a greater role in sustainable development.

[12] Standard Chartered