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How to boost sustainable financing through the different options of leasing and credit green finance?

By Amina Chakchouk, COO Leasing; Marwa Trabelsi, iMX Application and Business Expert, CODIX

THIS IS A DIFFICULT TIME, the world is burning, we continue to use fossil fuels as if there is no tomorrow. "*With every day, the global energy system is increasingly driving us towards a climate catastrophe*". These words were said by António Guterres, the General Secretary of the United Nations Organisation, after the release of the Climate State Report 2021, which was published by the World Meteorological Organization (WMO). Also, the sanitary crisis (COVID-19) increased humanity's awareness of the importance of sustainable development.

The only way to overcome the energy crisis is to invest in renewable energy.

In Europe, the Green Deal is the best diversification outcome of the crisis. As a result, the EU continues to work to diversify its energy sources and plans on massive investments in renewable energy sources, energy efficiency and Sustainable Financing. As part of the EU's plan for the ecological transition, the European commission aims to increase the share of renewable energies in the energy mix to 38%–40% by 2030 and to increase the obligation to save energy. For example, the EU plans to reduce annual energy consumption from 1.5% to 0.8%. The Russo-Ukrainian War accelerated this plan, which must unfold sooner than later.

Green Finance includes all financial operations in favour of energy and ecological transition as well as the fight against climate change. Its main tools are green bonds. These loans are used to finance projects contributing to ecological transition, including management of water, waste and energy, as well as leasing and credit financing products.

In this article, we will discuss how to improve and strengthen the Leasing and Credit IT system, which in various ways can boost Sustainable Financing.

What are the objectives of green lease and credit finance? Credit institutions and insurance undertakings play a key role in the transition towards a fully sustainable and inclusive economic and financial system, in line with the European Green Deal. They can have significant positive and negative impacts via their lending, investment and underwriting activities.

The objective of green finance leasing is to finance green economic activities, which significantly contribute to the achievement of environmental objectives. The relevant six environmental objectives are:

1. Climate change mitigation
2. Climate change adaptation
3. The sustainable use and protection of water and marine resources
4. The transition to a circular economy
5. Pollution prevention and control
6. The protection and restoration of biodiversity and ecosystems

Also driven by these environmental objectives, green lease and credit finance gain major importance for financial market participants (thus, also banks and institutional investors), and companies of public interest, for whom the Taxonomy Regulation mandatorily applies. Green lease agreements are relevant not only for financial market participants who own or rent such properties, but also for financial institutions which finance "green" activities.

What are the different green assets and green economic activities? The assets or economic activities that can be covered by green finance must be those included in the EU taxonomy.

The EU taxonomy is a classification system, establishing a list of environmentally sustainable economic activities. It could play an important role in helping the EU scale up sustainable investment and implement the European Green Deal. The EU taxonomy would provide companies, investors and policymakers with appropriate definitions for which economic activities can be considered environmentally sustainable. In this way, it should create security for investors, protect private investors from greenwashing, help companies to become more climate-friendly, mitigate market fragmentation and help shift investments where they are most needed (ref. https://ec.europa.eu/).

The EU taxonomy provides an overview of economic activities that can make a substantial contribution to mitigate climate change:

1. Whether the contribution is based on own performance or enables improvements in other sectors
2. Whether the activity is considered as transitional
3. Which environmental goals also have "Do No Significant Harm" objectives.

All reporting, risk management, provisioning, accountancy and "green" regulation is driven, based on this classification.

What are the different approaches of green leasing finance? Different incentives can be used in green finance:

- Participation in client rate or rate sharing, or even 0% on ecological assets finance
- Possibility of setting up tax bonification or tax penalties based on the CO_2 emission of the purchased asset
- Possibility of setting up a tariff on services and insurances, based on consumption and CO_2 emissions
- Possibility of setting up an extension with advantage of the use of sustainable assets
- Leasing as a service and sharing the use of sustainable assets
- Setting of seasonable pricing template for agricultural change to sustainable assets
- Special offers for real estate adopting the ESG regulations

Hereafter, some examples of the European incentives for green finance:

Incentive for the development of electric vehicles. To promote the development of vehicles emitting less CO_2, a bonus-penalty system is set up to reward, via a bonus, buyers of new cars emitting the least CO_2, and to penalise those who opt for the most polluting models.

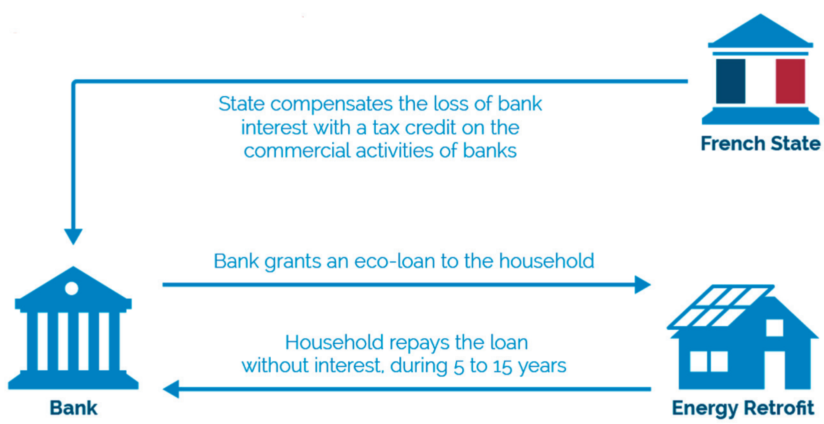
Incentive framework to support the biomethane sector. To support the biomethane sector, an incentive framework has been put in place to encourage the use of biomethane in the transport sector (biomethane used as fuel is known as bioNGV).

Under the current framework, biomethane buyers can recover guarantees of origin for the biomethane produced and benefit from a support mechanism. These guarantees of origin attest to the fact that the gas sold and injected into the network is of a renewable source. Also, these guarantees of origin are registered in a national register.

Incentive for the development of hydrogen vehicles. Hydrogen electric vehicles are part of clean mobility solutions. Complementary to battery-powered electric vehicles for certain uses, they benefit, like all electric vehicles, from the bonus-penalty system mentioned above. The development of hydrogen vehicles is still emerging and currently being at industrial deployment phase, but it has significant advantages for recharging in a short time (less than 5 minutes) and having greater autonomy than battery-powered electric vehicles. France has transposed the optional part devoted to hydrogen into the national action framework for alternative fuels and has set itself a target of 30 to 50 charging stations by 2025.

Eco-loan at zero rate (Eco-PTZ). The Eco-PTZ is one example of an incentive, introduced in 2009. The principle allows the financing of energy renovations trough a zero-rate eco-loan scheme. The principle is showcased in Table 1.

Table 1: The zero-rated eco-loan scheme



Reference: https://projects2014-2020.interregeurope.eu/fileadmin/user_upload/tx_tevprojects/library/file_1618469750.pdf

Table 2 shows the number of EPTZ loans taken up from the beginning of this incentive. The borrowing rate of this type of loan is lower than expected, particularly for the period preceding the COVID-19 crisis.

This incentive remained rather insufficient for the past 10 years, because even the borrowing ceiling could not cover the cost of Eco renovations.

For example, the cost of major renovations can easily exceed €40,000. So, the barrier of €30,000 is not sufficient to encourage the consumer to even begin such renovations. This example shows that when an incentive is introduced, a projection plan with real parameters should be made. Such a plan must also take into account all costs and different opinions, and provide solutions on how to make the proposal feasible.

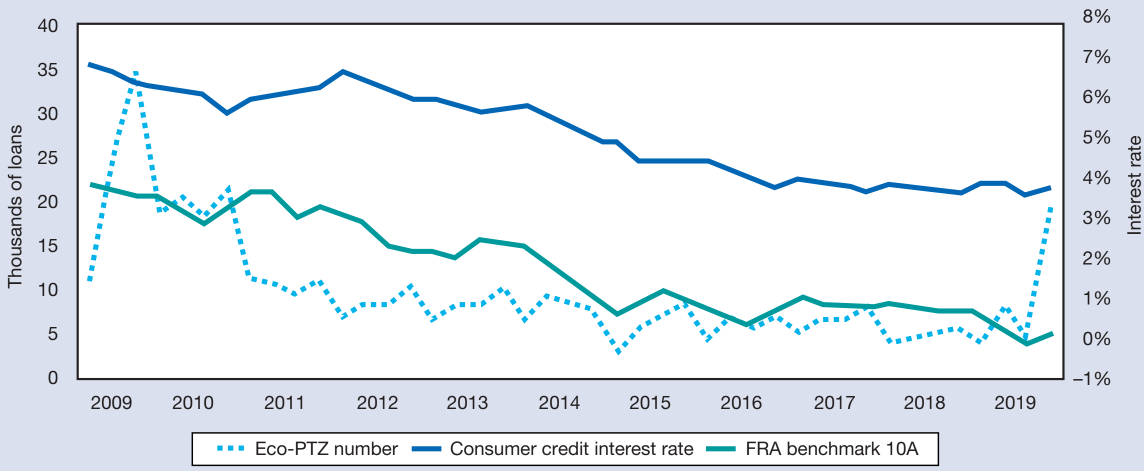
In conclusion, the EPTZ remains to be strengthened and extended over the next few decades. As proposed by the Citizens' Climate Convention (2020) in France, it is imperative to remove the barriers that hinder it. The first solution suggestion was to increase the borrowing rate of zero-rate eco-loans.

It is necessary to add other complementary initiatives to green finance in order to attract and make efficient the green finance incentives, but what should they be? As shown in the previous example of the ECO-PTZ incentives, complementary green finance actions must be proposed, in order to successfully proceed with the Eco Transition. Examples below:

The Heat Fund. The Heat Fund supports the development and the use of thermal renewable energies, including biomass (forestry, agricultural, biogas, etc.), geothermal energy (in direct use or through heat pumps), solar thermal energy, recovery as well as the development of heating networks using these energies.

The sectors concerned are: collective housing, the third sector, agriculture and industry. For these sectors, the objective of additional production of renewable heat by 2020 represents nearly 5.47 million tons of oil equivalent (toe), i.e. more than a quarter

Table 2: Take-up of EPTZ loans



Reference: https://hal-enpc.archives-ouvertes.fr/hal-03278386/document

of the overall objective set for 2020 at European level within the framework of the energy-climate package (20 million toe of additional renewable energy).

Established in December 2008, the Heat Fund was set up to support the production of heat from renewable sources. It was backed by a €1.9bn package for the period 2009-2017 and enabled the support of nearly 4,300 operations, which generated an investment amount of €5.8bn and a production of 25TWh/year.

General tax on polluting activities (TGAP) and biofuels. The TGAP encourages the incorporation and distribution of biofuels by penalising operators who release a proportion of biofuels below the set threshold for consumption. The TGAP rate was set at 7% in energy for the diesel and petrol sectors for 2010. Since 2014, this rate has been increased to 7.7% for the diesel sector and maintained at 7% for the petrol sector.

How do European enterprises measure the share of their financing allocated to sustainable economic activities? Following the Paris Agreements of 2015 and in response to the action plan launched by the European Commission in 2018, the European Banking Authority calls on credit institutions to put in place key performance indicators, entitled « Green Asset Ratio » (GAR), so that institutions can measure the share of their funding allocated to sustainable economic activities. It is a performance indicator, measuring the share of their banking portfolio associated with environmentally friendly economic activities.

This GAR is a fraction, calculated as follows:

The numerator shows the proportion of assets on the balance sheet of financial institutions, which is invested in 'green' economic activities and thus, aligned with the European taxonomy as:

- Credits
- Bonds
- Equities
- Collaterals included on the basis of 'green' economic assets in the European Taxonomy, based on KPI indicators of both investment in fixed assets or Capex, and turnover of underlying assets.

Excluded from the numerator of the ratio, however, are:

- All financial-type assets held for trading purposes
- On-demand interbank loans
- Assets excluded from the scope provided by the Non-Financial Reporting Directive (NFRD), i.e., those loans to SMEs that are outside the scope of the NFRD and therefore do not publish information on their alignment with the European green taxonomy and for which the BTAR will be calculated
- Non-EU exposures and, also, hedging derivatives.

The denominator of the Ratio, on the other hand, contains:

- The financial institution's total assets
- Total loans
- Total bonds and equities in the portfolio
- Total collateral recovered
- The other assets in the balance sheet.

The calculation takes into account the main instruments in the assets of the banking book (i.e. loans and non-sovereign bonds and equity securities), excluding assets held for trading purposes, due to their volatility, as well as sovereign securities.

The calculation and publication of their GAR by the major European banks is part of the extra-financial reports (dedicated in particular to the fight against climate change), which large organisations must provide since 2018 under the Directive on extra-financial information (NFRD – Non-Financial Reporting Directive).

Calculating this new ratio represents a serious challenge for credit institutions. To do this, financial organisations must have reliable information systems, which allow them to generate this kind of detailed report based on a detailed classification (by type and sub-type of asset rather than sector of activity).[1]

Risk Management in Green Finance. In order to manage the climate change risk, a list of disclosure reports is requested by the ESG regulation. A list of reports and annexes is required from the bank institutions. These reports and annexes are mainly based on the classification of the assets by the taxonomy and their ecological activity financings and calculate in detail the different risk KPIs. Here below are the main ones:

Qualitative information on environmental risk, on social risk and governance risk. In application of Article 449a, in conjunction with Article 435 of CRR, bank institutions should disclose information on their exposures towards non-financial corporates operating in carbon-related sectors, and on the quality of those exposures, including non-performing status, stage 2 classification in IFRS9, and related provisions as well as maturity buckets.

Institutions should apply qualitative information on social risk on their top 5 Business Strategy and processes, governance and risk management.

Institutions should also apply qualitative information on governance risk, in order to describe the integration of such a risk in the overall governance and risk management policy.

Quality of exposures by sector, maturity buckets and GAR KPI. Following Article 449a CRR, large institutions with securities traded in an EU regulated market shall disclose information on ESG risks, including physical risks and transition risks, as defined in the report referred to in Article 98(8) of Directive 2013/36/EU.

Conclusion. In the current political and economic context of Europe and the world in general, as well as the urgent need for a transition to clean energy, taxonomies can play an important role in the architecture of countries' financial systems, if properly and appropriately designed.

It is important to remove all the boundaries to access the different incentives in order to accelerate the transition to green finance. Therein the IT system plays a central role in this transition, by easily managing all related processes and regulation rules. The IT leasing/loan software should be sufficiently powerful and flexible, comprising:

- An asset and collateral parametrisation module and different classification levels, in order to set up all the necessary information required by any regulation.
- A robust IRR calculation tool and flexible and accessible financial calculation module, in order to set every type of incentive, flexible payment schedules, guarantees, commissions, bonifications, GAR integrated.
- A robust scoring module with multiple types of scoring that can easily be set up, taking into account different risk management in Taxonomy.
- A fully parameterised process to make fully automatic as many processes as possible, with easily managed criteria on a taxonomy matrix in all the processes and calculations.
- An integrated risk management module to be able to calculate in real time the risk staging and to take into account the IFRS9 impact changes in the ESG regulation.
- Intelligent risk modelling, using AI to easily include different scenarios in the PD, ECL calculation and GAR calculation.

Fortunately, such software packages exist, such as, for example – iMX Leasing and Credit. Such technological solutions can be of immense benefit in a world of continuous change, especially ones that are constantly acquiring richer and stronger features thanks to sustained investment over the years by their respective editors. We do encourage you to explore how the iMX Leasing and Credit solution can address the issues described in this article, in the specific context of your company and the challenges it faces.

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Amina Chakchouk

Marwa Trabelsi

Authors:
Amina Chakchouk,
COO Leasing, CODIX
200 rue du Vallon, Sophia-Antipolis, 06560 VALBONNE
France
Tel: +33(4)89 87 77 77
Email: info@codix.eu; **Website:** https://www.codix.eu

Marwa Trabelsi,
iMX Application and Business Expert, CODIX
200 rue du Vallon, Sophia-Antipolis, 06560 VALBONNE
France
Tel: +33(4)89 87 77 77
Email: info@codix.eu; **Website:** https://www.codix.eu