



WHITE PAPER

FACTORING ESG INTO ASSET FINANCE

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ESG IN THE FINANCIAL WORLD

In the global drive to protect the natural environment, maintain a fair and safe society, and ensure corporate responsibility, new environmental, social and governance (ESG) principles are reshaping the way the world invests, banks, lends and leases.

Investors are increasingly making non-financial ESG factors a key consideration in their risk assessments and growth plans. Like many other corporations, financial institutions of all kinds are starting to disclose ESG metrics in their annual reports or standalone sustainability reports.

The overarching challenge for firms is to set—and then stick to—clear, consistent ESG standards. To date, however, there is no single exhaustive list of examples – and as ESG factors are often interlinked, it can be difficult to separate environmental or sustainability issues from social or governance concerns.

Now, as ESG strategies start to infiltrate the lending and leasing landscape, how can auto and equipment finance firms turn complex new requirements into rewarding opportunities?

What does ESG stand for?

Environmental – Matters and metrics involving the conservation of the natural world

Social – Consideration of people and relationships

Governance – Evaluation and measurement of standards for running a company



Lending and leasing in times of change

Finance providers around the world will soon need to show regulators they are sticking to ESG principles. With evolving government policies prompting large organizations to make more sustainable capital investments, there will also be increased scrutiny on the companies that providers are lending and leasing to.

Asset finance firms will be increasingly asked to disclose these factors in formal reports, as well as report on the steps they are taking and the progress they are making to become carbon neutral.

So far, so challenging. But remember that all these requirements are emerging as part of a wider movement to drive positive environmental, social and corporate governance change, led particularly by Millennials and Gen Z entering leadership roles.

Currently, 99% of Millennials are interested in sustainable investing versus 79% of the total population.¹ Set as they are to inherit more than \$68 trillion by 2030 from their Baby Boomer parents², they are deliberately choosing to invest in assets that align with their values and tackle their concerns about climate change and social justice.

In turn, the Millennial mindset is contributing to the rise of the circular economy and a growing tendency to re-use or recycle assets and equipment. The COVID-19 pandemic also played a part in this trend, especially in the automotive industry, as a subsequent shortage of semiconductors pushed up the costs of used cars.

¹Morgan Stanley, Sustainable Signals, 2021

²Forbes, Millennials Will Become Richest Generation in American History, 2019

The double meaning of ESG for asset finance

For auto and equipment finance firms, the rising profile of ESG issues has an impact on two levels.

First, **organizations must review their own internal practices** and set targets in terms of sustainability, social justice and corporate responsibility. For an auto finance provider, embracing the E in ESG could mean, for example, a switch to leasing electric vehicles, batteries and charging infrastructure. For an equipment lessor, it could be a question of leasing more assets on a pay-per-use or servitization basis.

Second, **firms need to look at their customers** through an ESG lens – not just once but at every key stage of the leasing life cycle, as follows.

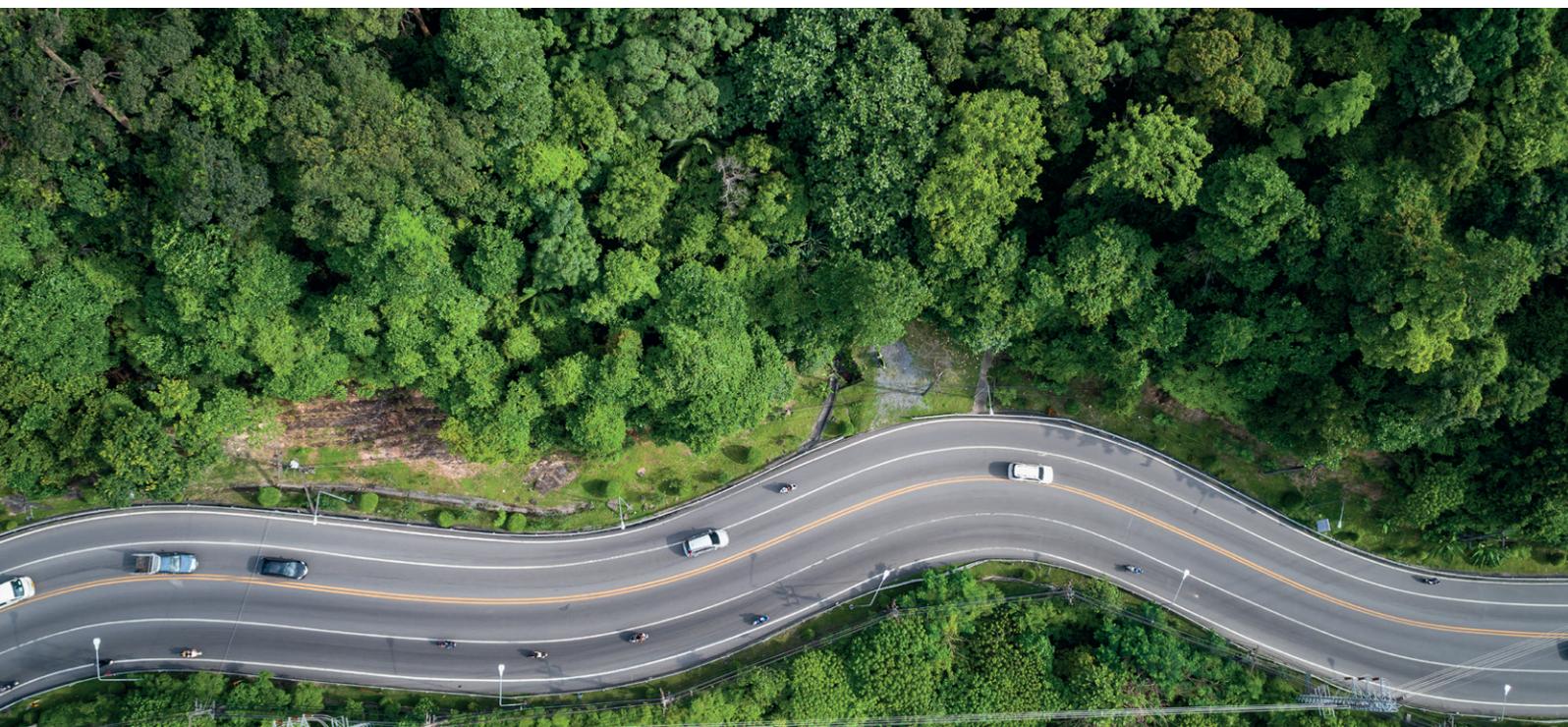
Onboarding

For ESG due diligence on commercial customers, asset finance providers may need to factor ESG into anti-money laundering (AML) and know your customer (KYC) checks.

If the customer is a large organization, this could mean monitoring for news or social media coverage of any controversial issues or activities that contravene ESG requirements. When it comes to smaller businesses, online reviews might indicate poor business practices and therefore more likelihood to default.

Origination

With support for ESG-linked green finance increasing globally, current discounts for “green leases” are likely to evolve into penalties for “brown leases”, with higher interest rates or fees. As governments around the world look to incentivize or penalize asset manufacturers accordingly, the subsidies or penalties must be incorporated into pricing at the origination stage.



Every lease could also come with its own ESG-linked KPIs, relating to not only its environmental impact (e.g., carbon emissions or contribution to the circular economy) but also social and governance concerns, from employee safety to data security.

As well as setting targets and outlining the consequences of any breach, lessors could introduce price reductions if environmental targets are exceeded. Any savings by the customer might be donated to charity or put toward further sustainability objectives.

The onus would be on customers to provide their own independently audited ESG reports on a regular basis and show they are meeting required standards. An exit provision should always be in place to determine the right conditions for returning to a standard leasing contract.

Assessment

Throughout the credit assessment process, assessment practices and score carding need to take into account factors like composite ESG scores, as assigned by ratings agencies.

Monitoring

With ongoing reviews of lease KPIs, the ideal monitoring process will automatically alert lessors to breaches or potential problems at both lease and portfolio level – keeping a constant eye on financial risks stemming from climate change, natural disasters, environmental damage, and social and corporate issues.

ESG challenges and opportunities

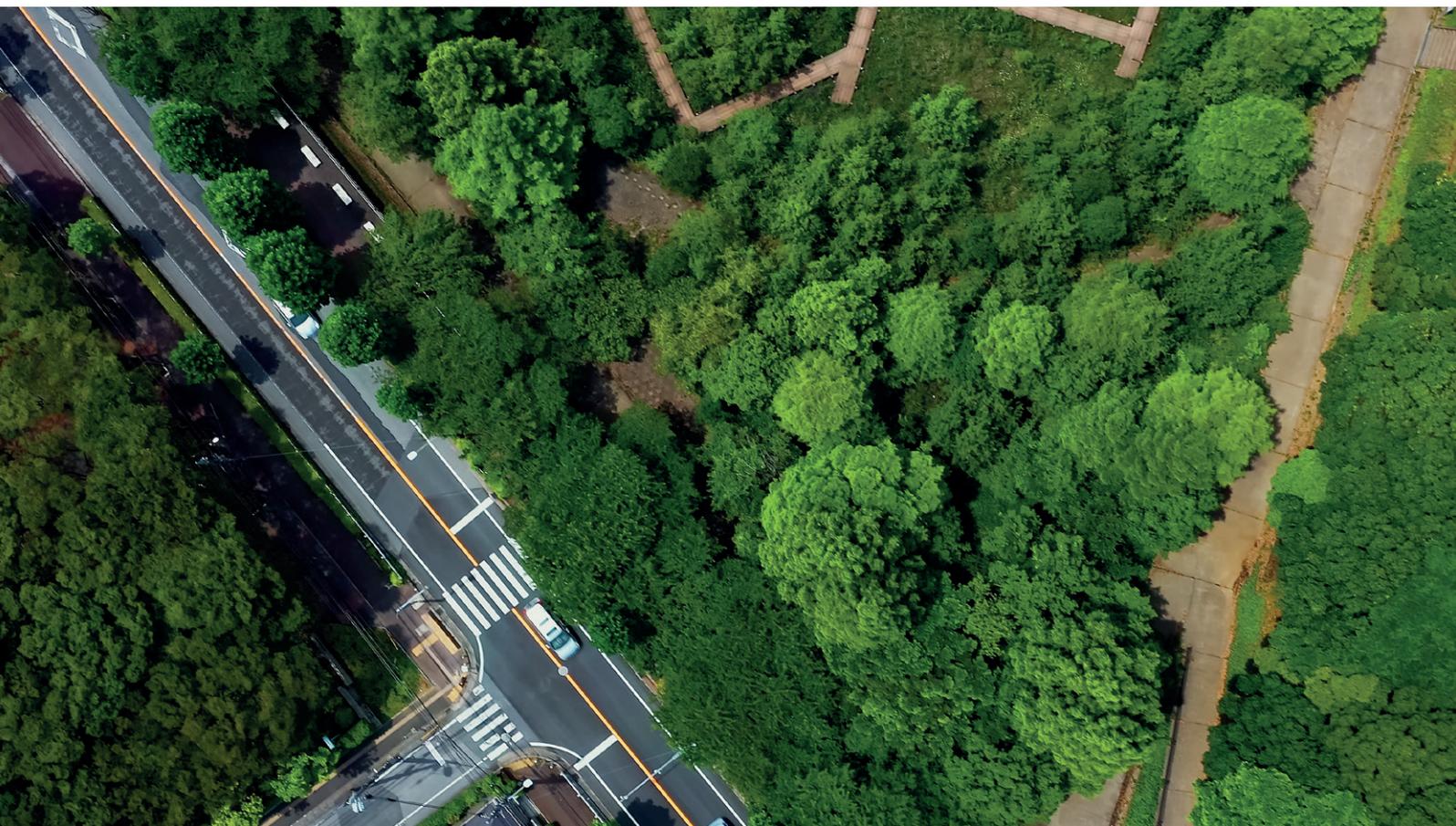
In theory, then, it should be possible for auto and equipment finance firms to define and hit a comprehensive range of ESG targets, in terms of both their own organization and their customer portfolio. In practice, however, there are obstacles in the way.

One major challenge will be to pull in the necessary ESG data on customers. Although ESG ratings are available for large public companies, there's a distinct lack of consistency between the scores that different agencies provide. And critically, there's not much data available at all on the unlisted private companies that make up a large percentage of many commercial leasing portfolios.

At an even more fundamental level, today's asset finance providers lack the flexibility they need to adapt to completely new ways of working. ESG requirements are bringing big changes to the industry and asking a lot of its technology, but few systems can yet service the shift to a sustainability-conscious, servitization-heavy environment.

There's also a continued reliance on manual, physical and paper-based processes which not only impede flexibility but also make operations more costly, less efficient and less sustainable.

With modernized systems and processes in place, there are big opportunities ahead. Potentially, firms could go to market with ESG-centered products for leasing green assets, including infrastructure. They could also extend existing products to offer pay-per-use and servitization options, and support the circular economy by increasingly refurbishing and re-leasing used assets.



AN ESG CHECKLIST FOR ASSET FINANCE

The industry must act and act now. Specifically, firms need the ability to:

- Build assessment models that can interrogate and validate ESG composite scores
- Deliver standardized outputs such as weighted ESG controversy scores
- Flex to a rapidly evolving pricing model and rapidly go to market with subscription or pay-per-use options
- Track assets through their whole life cycle to support the circular economy
- Offer customers highly automated, paperless processes with digital document delivery and e-signature capabilities
- Make greater use of advanced technology, including telematics, emission trackers and APIs

How technology can help

The best modern asset finance systems let you easily adapt the underlying software applications and configure whatever new functionality you need, such as new business rules to interrogate ESG scores. That way a business can easily modify its solution for ESG compliance and more quickly respond to the changing leasing environment.

Workflow automation will also be key to efficiency. And through prebuilt APIs, firms can integrate their systems seamlessly with other third-party technologies and benefit rapidly from the latest innovations in asset finance services – and get standard connectivity to providers of new digital capabilities.

Plus, on a broader scale, leading technology providers like FIS® are building their own ESG hubs to better connect investors and corporations and facilitate the easier exchange of ESG data.

ASSET FINANCE TECHNOLOGY FOR BOLD IDEAS

Now that ESG strategies are demanding a whole bold new approach to asset finance, you can't let legacy systems hold you back. With the choice of a componentized model, an end-to-end platform or a fully managed service with continuous deployment, FIS Asset Finance offers a modern, flexible solution that you can configure and optimize to meet your specific requirements. Through automated operations and innovative technology, you can also deliver an omnichannel experience, quick and flexible finance options and quotations, and on-demand services. Get in touch to find out more.

About FIS

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