INSTITUT DE LA FINANCE DURABLE
PARIS EUROPLACE

IMPACT MARKET GROUP

WHAT ARE THE KEYS TO EVALUATING THE IMPACT OF FINANCING FOR BANKS?

EXPLORATORY NOTE

January 2024

BACKGROUND INFORMATION

A group of Paris market players bringing together several banks to put impact concepts into perspective and define a common language.

Impact finance is an approach that aims to accelerate the just and sustainable transformation of the real economy, by providing evidence of its beneficial effects. This approach is an ambitious extension of responsible finance, which focuses on identifying and limiting negative impacts and managing the risks generated by the financed activity. **Impact finance is based on three pillars: intentionality, additionality and measurement.** Initially considered a niche sector, particularly by the non-listed universe, impact finance needs to assert itself.

Under the aegis of the Paris Sustainable Finance Institute (*Institut de la Finance Durable* – IFD), the market group dedicated to impact had the goal of helping to develop a shared definition of impact finance, and clarifying the associated identification and measurement methodologies. One of the working groups set up for this purpose is dedicated to impact evaluation issues for bank financing. The purpose of this working group bringing together several French banks was to define (i) the criteria and (ii) the methods to help identify and measure the impact for the universe of financing granted by banks.

THE THREE PILLARS OF IMPACT FINANCE

→ **intentionality**, which corresponds both to the financial player's desire to contribute to generating a social and/or environmental benefit and to the desire of the financed company, which has set at the heart of its business model the achievement of one or more sustainable development objectives;

→ **additionality**, which corresponds to the specific contribution of financial players, enabling the beneficiaries of the investments/financing to increase the impact generated by their activities themselves.

→ **measurement**, which refers to the evaluation of the environmental and social effects in the real economy on the basis of targets announced as part of intentionality.

Source: IFD, FIR, France Invest

A need to manage the growth of impact finance

The European Union's sustainable finance strategy is a basis for increasing the financial sector's contribution and transparency regarding sustainability[1], notably by taking into account environmental, social and governance impacts and risks. It is also a basis for the convergence of terms used throughout the entire chain of finance business lines to communicate on financing and investments, from the "greenest" to the most carbon-intensive[2].

While regulations foster transparency within the financial sector, particularly on sustainability issues, they do not yet truly govern the measurability of the impact of financing. However, there is a growing need for banks to measure the impact of their financing[3]. **Identifying financing that makes a concrete contribution to the United Nations Sustainable Development Goals (SDGs) is key to directing financial flows towards the ecological and social transition.**

Voluntary commitments made by banks have been initiated to contribute to these goals, by adhering to initiatives such as the Principles for Responsible Banking (PRB) or by adopting decarbonisation trajectories for their portfolios, aligned with net-zero targets[4].

This need to more effectively measure the impact of financing is all the more necessary given that the range of sustainable finance instruments is broadening to include more and more players (SMEs, individuals, local public sector, etc.) and instruments: while sustainable bonds (green bonds etc.) have existed for several years, "impact-driven" loans characterised by financing rates indexed to non-financial targets for the borrower[5] have developed more recently. However, not all of this financing can claim the impact (as defined in this document), particularly regarding the additionality pillar, due to the lack of shared evaluation tools to measure its scope and the real effects in terms of sustainable transformation. The goal is to be able to evaluate:

a) the relevance and materiality of the indicators chosen with regard to the improvement priorities for each company and

b) the financier's contribution to the client's progress.

This guide aims to support the reflection process of banking players that want to develop impact finance. It may subsequently be extended to banking products, such as "green" savings accounts or others that could develop in the future (e.g. "impact-driven" savings accounts)[6].

1 For an overview of regulations, see the report orse_pwc_guide_finance_durable_banque_juillet_2022.pdf
2 Taxonomy, MiFID 2, Pillar III, CSRD, etc.
3 Even though voluntary initiatives such as those of the ICMA, which has defined methodological guidelines, exist
4 Net Zero Banking Alliance for banks, Net Zero Insurance Alliance for insurers, Net Zero Asset Manager Initiative for asset management companies
5 This mainly refers to Green Loans, Social Loans or Sustainable Development Loans, the general principles of which are set, among other things, by the Loan Market Association working groups.
6 The analysis of banking products may be compared with the analysis of backed financing.
For savings products, the analysis may notably capitalise on the Paris Sustainable Finance Institute's work on evaluating the impact of investment funds.

Approach for a financing analysis framework

How can a bank's intentionality to contribute to impact be evidenced?

What does the concept of additionality mean and what are the interests for the bank in defining it?

What are the purposes of measuring the scope of the sustainable transformation of financing?

These are all legitimate questions, correlated with varying degrees of progress and maturity on the impact of the financial industry and customer segments (and with varying degrees of access to the data needed to answer these questions).

Bringing these questions to the decision-maker level is a decisive step in moving beyond a conceptual and technical perception of impact that is too often confined to expert fields.

It is fundamental to provide a concrete framework for analysis by identifying the key questions to ask in order to determine the impact-driven nature of financing. This is why the working group proposes a simple approach: to identify the key questions, selected from the impact potential evaluation matrix[7] developed by the IFD. These questions aim to qualify the three pillars of impact for banks (intentionality, measurement and additionality) and facilitate their uptake.

For each of the key questions, an impact gradation scale is proposed, from the lowest to the highest, enabling banks to analyse the level of impact of their financing and, if necessary, to improve this by prioritising the most important elements. Supporting examples complement the key concepts such as additionality, which are still difficult to identify, demonstrate and measure for many banks and generally for other financial players.

7 Analysis matrix: All the work by the Paris Sustainable Finance Institute on Impact Finance

QUESTIONS / REQUIREMENTS	DEGREE OF COMPLIANCE WITH THE REQUIREMENT				INFORMATION FOR THE EXPLANATORY NOTE
	0	1	2	3	
A – CHANGE THEORY					
Does the financing/financing category set itself the explicit objective of having an impact in its supporting documents?	No, no notion of impact		Yes, notion of impact		Clear intention of sustainable transformation demonstrated Transparent Level of information suited to the type of document.
Does the financing/financing category show in its supporting documents the intention to limit negative externalities?	No, no notion of identifying and managing negative externalities		Yes, intention to limit, identify and/or prevent negative externalities	Yes, intention to limit, identify and prevent negative externalities + ensure the effectiveness of the measures taken	Intention to limit negative externalities
The bank describes in the documents the actions implemented at the level of the financing/financing category	Not described	Described briefly	Described in detail		Details of the actions implemented at the level of impact finance
Does the bank seek additionality in its planned actions?	No, no intention to present or structure an approach		Yes, implementation of actions to generate additionality		Examples: 1. Contribution to customers unable to access traditional bank loans 2. Development of new capital markets where supply is insufficient 3. Provision of non-financial support 4. Overall bank strategy and green/brown granting policy
B – OPERATIONAL IMPLEMENTATION					
How systematically do the financing recipients meet the impact objectives of the banking product?	No control is in place	Clients meet objectives but no justification possible	Majority of clients meeting objectives can justify this	Over 90% of clients meeting objectives can justify this	The bank must have established financing eligibility criteria and be able to justify this (e.g. verification of the use of funds)
C – MONITORING OF OUTCOMES					
Is there an internal or external control process for the sustainable transformation strategy and its outcomes?	No		Yes		
To what extent are the outcomes observed at the company or project level consistent with the bank's sustainable transformation objectives?	Outcomes and objectives not described or not aligned		Outcomes observed close to the trajectory/strategy targeted ex ante	Outcomes observed close to the trajectory/strategy targeted in advance and quantified according to standards	Example: a bank making climate commitments on its portfolios quantifies the degree of progress of its transition plan (e.g. Act 4 Finance standards)

ANALYSIS MATRIX: THE KEY QUESTIONS AROUND IMPACT FOR FINANCING

Promotion and transparency on impact

Does the financing/financing category set itself the explicit objective of having an impact in its supporting documents?

A bank's intentionality to address impact dimensions must be able to be displayed. This intention must be directly visible to the client when subscribing to their impact finance or in public documents if the bank wishes to more broadly highlight its ability to offer such types of financing. This intention must be based on impact objectives defined ex ante, i.e. upstream of the financing agreement. It is recommended that these objectives be based on widely known standards, such as the United Nations Sustainable Development Goals (SDGs) and the Paris Agreement. The bank is encouraged to be transparent and explain how it intends to achieve these objectives.

The intention to limit negative externalities

Does the financing/financing category show in its documents the intention to limit negative externalities?

The impact intention must also be consistent with the financial player's desire to limit the negative externalities of its financing. The duty of care, the indicators resulting from European regulations[8] and the double materiality objective [9] of the forthcoming CSRD directive are also factors in strengthening the challenges of identifying, limiting and remediating negative impacts. No financing for which negative externalities have not been diligently identified and mitigated can claim to be impact finance[10].

8 Such as the Main Negative Impacts and the Do No Significant Harm criteria resulting from the European taxonomy regulations
9 Double materiality principle: see glossary.
10 See UNEP FI definition: Positive Impact Finance principles

Information on the actions implemented

Does the bank describe in the documents the actions implemented at the level of the financing/financing category?

To educate customers, the bank is encouraged to be transparent about the mechanisms put in place to more effectively manage impact finance. In addition to transparency, the bank must implement a certain number of actions to specify and justify the impact of its financing:

→ Clear identification of the purpose/type of needs, indicators and non-financial targets of the financing

→ Details on possible support by the bank for the borrower in its impact approach

→ Details on the method for evaluating the impact of the financier and/or the financed party defined prior to the marketing of the products and the execution of the financing (e.g. with the support of the key questions proposed)

→ System put in place for monitoring outcomes

The principle of additionality, driving sustainable transformation

Does the bank target additionality in its planned actions?

Defining at what level the impact of the financing occurs is crucial. Are the selection criteria for sustainable development at the level of the player financed, the contributions that the bank puts in place through its financing to provide support in its environmental and/or social transition, or both?

The Working Group proposes key examples evidencing the principle of the bank's additionality, which precisely aims to describe in what way and how the bank contributes to impact beyond the virtuous nature of the customer or the project financed:

1. Contribution to customers unable to access "traditional" bank loans (e.g. by offering them microloans)

2. Development of new capital markets where supply is insufficient (e.g. loans for small green projects with little support from the majority of banks)

3. Provision of non-financial support (e.g. support for customers in carrying out a carbon review)

4. Overall bank strategy beyond regulation (e.g. the bank's granting strategy based on green/brown criteria)

5. Provision of financial assistance or material benefits according to predetermined non-financial criteria

Based on these criteria, the bank specifies the intended scope and the level of requirement for the impact of its financing.

Operational implementation

How systematically do the financing recipients meet the impact objectives of the financing/financing category?

The bank must have established eligibility criteria for financing and be able to justify this (e.g. verification of the use of funds), such as the use of proceeds of green bonds or traceability requirements for taxonomy-aligned financing[11]. If categories of impact-driven loans are distributed, the bank must be able to monitor the achievement of the intended objectives of these loans.

Control process

Is there an internal or external control process for the sustainable transformation strategy and its outcomes?

The bank must have in place a process of measurement and reporting, then control, all to demonstrate that the outcomes in terms of impact are in line with the objectives defined ex ante. A good practice would be for this control to be carried out by an external third party.

Monitoring of outcomes

To what extent are the outcomes observed at the company or project level consistent with the bank's sustainable transformation objectives?

The bank must be able to monitor the outcomes produced by its social or environmental commitments and quantify the degree of progress of the targeted impacts. The Specific Measurable Achievable Relevant Time-bound[12] principles are useful requirements in terms of metrics used to monitor outcomes (and can even be incorporated into the transition plan if necessary). In the case of impact finance or products, this monitoring involves a specific organisation: appropriate governance, dedicated committees, awareness-raising and training of account managers, use of external experts if necessary, etc. While monitoring must be part of a long-term impact objective, it must be carried out annually and corrective actions must be taken throughout the term of the financing. The impact measured must form part of the response to a real and priority need of the people concerned and/or their ecosystem.

11 Example of a requirement: collection of supporting documents from the customer on the green criteria of the loan
12 SMART: acronym introduced by George T. Doran in an article entitled "There's a S.M.A.R.T way to write managements goals and objectives", published in November 1981 in Management Review

PURPOSE OF THE GUIDE AND USE CASES

An educational guide

The main purpose of this guide is to make the concepts of impact for banks more accessible by identifying the key issues and elements to evaluate the scope of their financing in terms of sustainable transformation. It also serves as an instructional tool for disseminating the approach, methods and the language of impact to financial sector players.

This guide also aims to facilitate connections between reflections on investment and financing in this area. Indeed, the interoperability of the means of identifying and evaluating impact throughout the financial industry's value chain is essential, from financing to investment, banking products and savings products distributed by banks and investors.

A preliminary self-assessment tool

The purpose of this guide is to enable banks to test their approach against questions that appear essential and to identify possible areas for improvement. It can also be used by banks to verify that their financing meets the definition of an impact-driven loan.

Going further

While this guide provides keys to identifying and analysing the impact of financing, it is important to mention that **holistic tools for banks to measure the impact of their financing for corporates were developed by UNEP FI 2022 in 2022**[13]. It draws in particular on the UN SDG framework and requirements related to the Principles for Responsible Banking (PRB). It also helps to identify best practices.

"The beginning is more than half of the whole" - Aristotle

This guide highlights the importance of initiating approaches to test reference tools, which when tested will demonstrate their value and potential for improvement beyond financing. The banking model is evolving in line with society's needs. Many banks are already engaged in discussions beyond their economic contribution, which in some cases may even change their status (mission-driven companies). These trends are part of the context of the European Union strongly supporting the consideration of double materiality[14].

This guide is dynamic and is intended to be tested by banks and enriched by their practices to contribute to the sustainable transformation of the real economy.

13 Tool for analysing positive and negative impacts at the corporate and bank level: www.unepfi.org/impact/unep-fi-impact-analysis-tools/portfolio-tool/

14 Double materiality principle: see glossary

GLOSSARY

CONTRIBUTION ACTIONS

Actions deployed during financing to cause a change in the behaviour of issuers or to support their growth in the event that they are already 100% virtuous companies. These are the actions to have an impact and achieve its objectives (e.g. engaging with issuers to improve their performance; offering financing at conditional rates to enable the growth of positive-impact issuers, etc.).

CAUSAL CHAIN

A series of changes caused by each other linking the contribution actions specific to the financial institution with the desired impact objectives.

CONTRIBUTION

Participation in collective action likely to lead to a lasting transformation without research, analysis or management of the additionality of the individual action.

DNSH "DO NO SIGNIFICANT HARM"

The DNSH principle is now the minimum required: no activity or investment can be considered to have a positive impact if it has significant negative impacts on another environmental or social factor.

EXTERNALITY (NEGATIVE/POSITIVE)

A negative externality refers to any unintentional negative impact that may have been generated by the financing. A positive externality refers to any unintentional positive impact that may have been generated by the financing.

IMPACT

Impact is an approach to the sustainable transformation of an agent by seeking additionality of its individual action.

SUSTAINABLE TRANSFORMATION GOAL

Willingness to contribute to sustainable transformation, which is reflected in the statement of a clear and precise objective to be achieved over a given time horizon.

STAKEHOLDERS

All parties whose interests will be affected by an issuer's activities.

SUSTAINABLE TRANSFORMATION PERFORMANCE OF ISSUERS

Degree of achievement of the objectives assigned for each issuer measured via indicators. The KPIs and associated objectives may be taken from an existing or tailor-made database as long as they are precisely defined and this definition is verifiable by a third party.

TRANSITION PLAN FOR BANKS

The European Union, which recently appeared in the debate, has made rapid progress on the issue of transition plans for businesses and banks. First of all, the contribution of the CSRD directive requires each listed company to publish its plan to achieve carbon neutrality by 2050.

The banking transition plans are based on a strategic vision of the transition of all the bank's activities. The bank must have a vision of the transition sector by sector, with a goal of neutrality by 2050 and intermediate goals (the bank can extend these goals to the broader ones of the UN SDGs). For the bank, it is about understanding how each financing provided helps to achieve the objectives of this plan. The banking transition plan must also make it possible to verify that the internal processes are consistent with this vision. Source: Implementing prudential transition plans for banks: what are the expected impacts? - I4CE

DOUBLE MATERIALITY PRINCIPLE

The double materiality principle involves the combination of two types of materiality, financial materiality, which corresponds to the "outside-in" vision, and impact materiality, which takes into account the "inside-out" vision. Financial materiality (also known as simple materiality) only takes into account the positive (opportunities) and negative (risks) impacts generated by the economic, social and natural environment on the company's development, performance and outcomes. For impact materiality (also known as socio-environmental materiality), the company's negative or positive impacts on its economic, social and natural environment must be taken into account.

OUTPUT AT ISSUER LEVEL

The products and services generated by the company's activities. Example: the number of training courses delivered for a company/association offering digital training.

OUTCOME AT ISSUER LEVEL

Impacts on the issuer's stakeholders of its activities and outputs. Example: the number of beneficiaries who have increased their digital skills for a company/association offering digital training.

CHANGE THEORY

Strategy for planning the change process highlighting the causal chain linking the actions of the fund's contribution actions with the desired impact objectives. According to ISO 14097: "Strategy for planning the change process highlighting the causal chain linking the contribution actions of the financial institution with the desired impact objectives."

SUSTAINABLE TRANSFORMATION

The notion that companies' understanding of sustainable development issues must make it possible to anchor this transformation in the company over the long term and to have a real impact on the environment or society through a holistic approach that integrates these issues into all its components at strategic, tactical and operational levels.

ACKNOWLEDGEMENTS

This work was initiated as part of the Institut de la Finance Durable (Paris Sustainable Finance Institute) Market Group on impact finance. The writing work was carried out by the sub-group's co-leads, **Maéva Bourel** and **Chloé Chaufard** (Crédit Mutuel Arkéa), as well as **Maxime Druais** (Natixis Assurances).

The production of this document was made possible by the participation of the IFD's entire Taskforce on Impact Finance, and in particular the mobilisation of the active members of the sub-group, to whom we express our sincere and heartfelt gratitude: **Marie-Aimée Boury** (Société Générale CIB); **Laurence Choisy Lemesle** (Sienna Investment Managers); **Didier Criss** (GLOSCAD); **Mathieu Garnero** (ADEME); **Pierre Herquin** (BNP Paribas); **Charlotte Jurus** (BNP Paribas); **Sona Kessaria** (Ksapa); **Michel Laviale** (ORSE); **Joséphine Magnière** (Société Générale); **Morvan Mallegol** (Natixis CIB); **Guillaume Meyer** (ORSE); **Anastasia Paris** (Crédit Agricole SA); **Sarah Perrier** (Fair Finansol); **Jennifer Ravé** (La Banque Postale); **Yvon Savi** (Société Générale); **Eric Schoumsky** (Société Générale CIB); and **Emmanuelle Simon** (Crédit Mutuel Arkéa).

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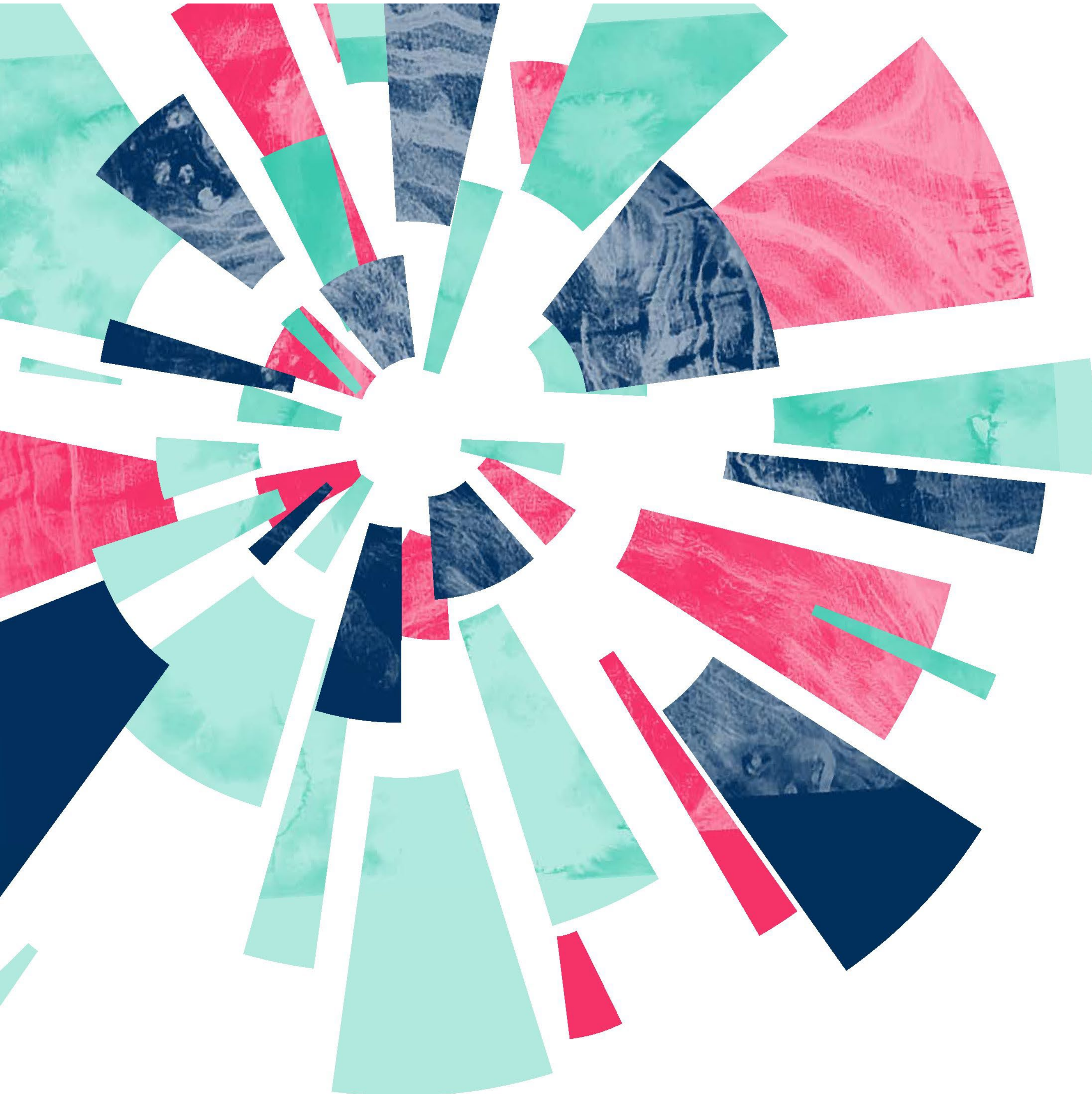

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