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Advancing Green Finance in Sri Lanka: Updates, Prospects, and Challenges

For a recent Roundtable on green finance with financial institutions and development partners, CSF had the opportunity to provide inputs into the design of the session and provide concluding insights at the end of the session. This Analytical Note serves as a recap of the key findings and takeaways on the progress of implementing green finance in Sri Lanka, the near-term prospects, and current and emerging challenges to be tackled.

The session titled, 'Greening the Economy through Circular Economy Green Finance' (05 April 2024) was organized by Biodiversity Sri Lanka (BSL), under the EU-funded PLASTICS project. CSF has been working as a collaborator to BSL on the green finance pillar of this work, under a broader MOU signed between the two organizations in 2023. This work is part of CSF's research thematic of 'Nature and the Economy' and its *Natural Capital Forum* advocacy initiative.

During the session, we heard from an interdisciplinary group including the financial sector regulator, multilateral and bilateral development partners, and banks and non-bank financial institutions. The forum provided an opportunity to discuss the current work being done by these entities, and flag some of the challenges faced. The focus was primarily towards helping financial institutions understand where, and from whom, funding as well as technical assistance for green financing is available and forthcoming, and also to help development partners understand what the current landscape is and what more they can do to support this area.

The rest of this Note is organized along key themes that emerged, and an attempt to provide a useful and incisive snapshot of the session. Towards the end of the Note, we provide some of CSF's own views and observations.

Policy and regulatory landscape is evolving

The Central Bank of Sri Lanka (CBSL) clearly set out two of the most relevant policy and regulatory frameworks applicable to green financing and noted that they provide a sound foundation for advances to be made in this area. The 'Roadmap for Sustainable Finance' (2019) and the Green Finance Taxonomy (2022) have been introduced several years ago, and these are gradually being referenced and adopted by financial institutions (FIs). With the Banking Act Direction No. 5 of 2022 on sustainable finance activities, FIs are now required to report lending progress on a quarterly basis. The regulator noted

> "Our purpose is to to stimulate a discussion about how the financial services sector can help scale the circular economy to drive new and better growth".
> *Green Finance Specialist, BSL*

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that as knowledge among market participants is still low, an expert panel has been set up to respond to FIs' queries and clarifications on the green taxonomy.

The regulator demonstrated a clear willingness to work with FIs to advance the adoption of these, but also noted the need to work on updates to existing frameworks (like the Sustainable Finance Roadmap which is now a few years old). CBSL noted that its intention – at least for now – is to "not set hard and fast rules" but promote greater adoption. FIs were encouraged to develop their own product range, with careful attention to avoiding greenwashing.

The Sustainable Development Council (SDC) also showed several ongoing initiatives in the financing space (albeit not specifically on green financing, but SDGs writ large), including pursuing the set up of a country-level blended finance facility that will aim to bring donor money and private capital together. Discussions have only just started, and more work needs to be done. Encouragingly, the sovereign green bond framework has been completed, and would provide the policy basis for when Sri Lanka is able to tap international capital markets again. Meanwhile, the new 'Strategy for Inclusive and Sustainable Business' developed by SDC and now approved by the Cabinet of Ministers, will also help enhance the pipeline of relevant businesses who can tap into green finance.

Development partners are increasingly prioritizing 'green'

It was clear from the presentations by the development partners – both multilaterals like the World Bank Group) as well as bilaterals like Expertise France, that the area of green growth more generally, and green financing specifically, is coming into greater focus in their programming. On the policy landscape, the International Finance Corporation (IFC) is expecting to work with the CBSL to update the Sustainable Finance Roadmap and Expertise France has helped with a gap analysis on implementing the Green Taxonomy.

The World Bank Group's CCDRs (Country Climate and Development Reports) are becoming a key document in informing the next stage of engagement for climate resilience and finance in a country, and the World Bank expects to complete one of these for Sri Lanka soon. Several agencies' programmes are supporting develop a pipeline of bankable green projects (especially working with SMEs) ranging from USAID's Ocean Plastic Partnership to the EU PLASTICS project. Several agencies also noted that, while continuing technical assistance for green finance, they are also looking at supporting fund mobilization for green projects and launching new products.

"Even though many are asking for it, incentive-based approaches to promote green finance may not be suitable or possible for Sri Lanka. Financial institutions must implement green finance with passion. It shouldn't be the next stage of CSR, just for having it in your annual report". *Representative from Central Bank of Sri Lanka.*

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Plastics and circularity as a new priority

The discussion noted that circular economic models are now recognised as a priority area in tackling environmental degradation and climate change, and this contrasts with the linear 'take-make and dispose' economic model that had been followed historically. The latter model narrowly looks at lowest possible costs of production, while externalizing cost of waste management. Whereas the latter is rooted in traditional principles of conscious use of materials, as well as modern concepts like Resource Efficient Cleaner Production (RECP).

A key observation by the EU was that green financing must go beyond funding renewable energy projects – which has been the most popular in recent years - and instead must increasingly consider projects in the circular economy. This is especially true of projects in the plastics value chain, gven that the Global Plastics Treaty has now been signed by 175 countries and there is a commitment across the value chain, from production to design and recycling. The new EU Green Deal also has a strong emphasis on this - mandating that by 2030, all packaging should be recyclable, with mandatory recycled content quotas for new plastic products. This will have implications for Sri Lankan exporters to the EU, who would need to redesign packaging to use different materials and making it easier to separate and recycle different components. Meanwhile, Sri Lanka has committed to goals of 100% PET (Polyethylene terephthalate) collection by 2025 and a 30% reduction of plastic packaging. Meeting these national and global commitments would require a major shift for businesses in the country, and these are opportunities for green financing to support.

These ideas also link back to some questions that some FI representatives had on the current taxonomy, who urged that the green finance taxonomy be amended to include 'waste to energy' as an eligible category. This is contentious. Globally there is considerable debate on whether waste to energy should be included in green taxonomies. In fact, several countries have excluded it from their taxonomies, most notably the EU. Following that guide, Sri Lanka has also excluded it. The idea perhaps is that, when pursing a more 'zero waste' or 'circularity' approach, it is somewhat of a regressive step to then simultaneously encouraging the generation of energy from waste, as an economic option.

Financing side is nascent but improving

It was evident from the discussion that several FIs have made headway in tapping into green finance sources, be it through the successful accreditation to the Green Climate Fund to raising of capital from green lenders overseas. Much of the lending, though, has so far been largely to renewable energy projects (solar and wind farms, and rooftop solar installations) as well as for electric vehicle leases/purchases by consumers.

One of the consistent issues that arose was the limited technical know-how in FIs, which is perhaps why most of the

"Not knowing how to evaluate green projects is a key challenge for us". *Financial institution representative*

recent lending has been to renewable energy projects which are now quite familiar to credit officers. It is clear that the internal capabilities to assess the business cases presented and commercial viability of green projects needs improving.

An interesting aspect pointed out by some experts was that FIs may be lending to projects that they have not realised are 'green', and borrowing clients themselves may not know they are doing 'green' activities. These gaps pointed to the need for greater awareness of the green taxonomy and its adoption, to better classify green-eligible projects and lending.

The session also noted the potential for Sri Lankan FIs to consider green and blue bond issuances. While renewable energy has dominated issuances before, now a shift can be seen towards other areas like clean transportation, waste-water management, and energy efficiency. Blue bonds have also seen growing demand recently as a separate asset class, channelling funds to marine-related economic activities and sustainable fisheries projects. IFC noted that there has been an uptick in blue issuances since the launch of the IFC blue guidelines, which have helped FIs understand these issuances better. Yet, it was acknowledged by a leading multilateral lender that the Sri Lankan FI industry has more to do in better understanding risks and moving to underwriting risks.

Sri Lanka can benefit from several ongoing development partner-led initiatives to access both technical support and actual funding. Expertise France and Global Green Growth Institute are supporting the issuance of corporate green bonds. The USAID is mooting an Ocean Plastics Venture Fund, that could provide equity financing solutions and ecosystem support (incubation and acceleration) for both upstream and downstream plastic 3R (Reduce, Reuse, Recycle) businesses in Sri Lanka. There are also considerations to introduce a blended finance instrument with potential credit guarantee from the US Development Finance Corporation (DFC).

Enterprise side is improving but needs more support

It was evident from the session that a weakness in the green financing space in Sri Lanka right now is the narrow pipeline of bankable projects. The session was not able to delve into detail on 'why?' this might be, but some speakers from FIs alluded to challenges relating to overall business viability, inability to present compelling proposals, insufficient consideration of supply chain risks by the business, and the small domestic market. This is perhaps why most of the green lending in Sri Lanka has been to rooftop solar installation projects and EV purchases, which are

"FIs must think more broadly about 'green'; it is more cross-cutting than you think. You might already be lending into these, for example energy efficient machinery". *IFC representative* which are seen by FIs as 'relatively easy and uncomplicated'.

Nevertheless, donor projects have been working on improving the pipeline of projects for green financing. This includes programmes to build up the capacity of MSMEs in the plastic value chain (for e.g., the EU PLASTICS project), and partnering with local banks to strengthen bankability of plastics value chain businesses (e.g., the USAID Oceans Plastic Project). Government institutions are also supporting the demand-side in a few ways. The Ministry of Industries also has several programmes for both capacity building of industries in adopting green practices and helping to cover the upfront costs of environmental certifications. The Ministry is also helping train industries in RECP practices, both in assessing their existing ways as well as capacity building for change. The SDC also noted that they would soon begin supporting building up a 'green project pipeline' for banks.

It was observed during the session that some FIs tend to have a narrow perspective of green lending on one hand, and on the other hand tend to consider all their "sustainability initiatives" as green finance activities. On the latter, for instance some FIs cited there CSR projects relating to community water supply also as green financing. On the former, for instance, we heard one bank refer to a green lending "success story" where a credit facility had been granted for purchasing a so-called "high efficiency machine" for granite cutting, and there seemed to be no recognition of the damaging environmental consequences of industrial quarries for granite mining. Therefore, it was evident from the discussion that FIs need to have a much more holistic understanding of what makes projects 'green'.

"For financial institutions this should no longer be a 'sustainability' agenda – it should be a business agenda, and core to your lending". *CSF Director Anushka Wijesinha.*

Key Overall Takeaways

- Sri Lanka's economic future lies in adopting a more nature-positive approach, with a strong contribution coming from the financial sector in meeting environmental objectives.
- Green finance is emerging as a key global opportunity, and the prospects for its advancement in Sri Lanka is also growing, albeit gradually.
- Many development partners are moving towards a green growth agenda globally, and this will increasingly be a prominent feature in their programming relationships with Sri Lanka. In this, green finance is a key focus of their activities, both from a technical assistance, as well as funding, point of view.
- Sri Lankan financial institutions have begun focussing on green finance as both an opportunity for new fund mobilization but also for new lending. Yet, there is wide variation in the degree of adoption of green finance among banks and NBFIs – a handful are market leaders, while many others are only just beginning or are lagging.
- There are gaps in information for financial institutions on the current

- (cont…) and emerging international sources of funds that they can tap into in the near-term. While some banks and larger NBFIs have successfully identified these sources, many are yet to cleverly navigate this landscape. Support from development partners – especially bilateral ones - can assist FIs in plugging these information and network gaps.

- While there have been several green financed projects in Sri Lanka's renewable energy sector, there have not been many projects in other green-eligible sectors. Visibility in investment opportunities is nascent, and bankability of businesses remains a challenge (especially among SMEs). Some government as well as donor-funded initiatives have begun to assist bankable businesses that can seek green financing, and to build a 'green investment pipeline'.

- Through presentations by government agencies like the Ministry of Industries, it was evident that there is great value in Government support to reduce the upfront costs associated with industries getting certified and accredited in environmental aspects. These typically tend to be expensive, and payable to foreign bodies, and may discourage SMEs from seeking them. GoSL support – through subsidies or reimbursements – helps encourage their adoption, which in turn strengthens their access to green finance by improving bankability.

- While several FIs urged the government to consider granting incentives for green financing, it was clear that no fiscal or monetary incentives would be available in the near-term, but the regulator noted that regulatory forbearances on green lending portfolios are being deliberated. Moreover, it was observed that the strongest incentives would be from the market – where a) FIs' customers need to invest in going green to retain and grow market access overseas and so present an opportunity for green financing; and b) FIs increasingly can tap into market sources of green funding overseas to enjoy a lower cost of funds.

Seven Key Messages for Financial Institutions

1/ Support customers' alignment with new market conditionalities

There is a compelling role for FIs to play in supporting Sri Lankan businesses to align with market conditionalities in major export markets - for example, the EU Green Deal. These conditionalities are increasingly becoming 'non-tariff measures' that Sri Lankan exporters must contend with and would require capital expenditure on their part to change products, production processes, and compliance. FIs would need to proactively support their clients to adopt stronger green practices, so that the clients remain competitive and do not risk lose market access.

2/ Think more broadly about 'green' projects

FIs must go beyond renewable energy installation and lend to projects that more broadly address climate change and address environmental challenges, and especially circularity. FIs must also get better at classifying their green lending, recognizing that they might already be lending to green projects without realizing that they are. FIs must recognize the emerging circular economy business opportunities for enterprises and play a financing role in supporting their growth.

3/ Build internal capabilities for green financing

Clearly FIs in Sri Lanka are at the early stages of green financing and so internal capabilities remain nascent. At a Board level, FIs must recognize the strategic importance of green financing. Stemming from this, FIs must conduct internal improvements to their credit officers' capabilities to evaluate green projects and reorient how risk departments view such projects. FIs can set up internal 'Green Finance Academies' to continually train staff, while also obtaining technical assistance from the numerous international entities currently supporting this in the country (IFC, Expertise France, GGGI, EU PLASTICS, etc.). This can be not only for strengthening internal guidelines and frameworks for green lending, but also preparation for green bond issuances, as well as operational practices in green lending customer appraisal.

4/ Proactively engage customers for green financing opportunities

FIs can use customer visits to encourage clients to adopt greener practices and proactively look at what can be done to support their adoption by offering green finance required for capital investments. Like how FIs often proactively push customers to hire better auditors to review their financials, or or to get better warehouse/stock insurance to better secure inventory collateral, FIs can also push customers on adopting RECP practices and obtain certifications. Costs of these can be covered through green loans by the FI, but also through government-supported subsidies (like the existing rebate schemes offered by the Ministry of Industries).

5/ Tap conscious capital for green deposits

FIs can look to mobilise resources from high-net worth and environmentally-conscious customers through products like green savings and green deposits. Our interviews have shown that there are a cohort of individuals willing to accept a lower interest rate in exchange for knowing they are helping to finance green projects.

6/ Be alert on greenwashing and associated reputational risks

Even as FIs become more eager to find projects to deploy green finance for, FIs must be increasingly cautious about mis-tagging projects as 'green' and making unsubstantiated sustainability claims. There is growing vigilance locally and globally around greenwashing and deceptive implementation of 'ESG' practices. As Sri Lanka becomes more attractive to green finance investors, any controversy around greenwashing by even an individual FIs can break trust and lead reputational risks not just for the entity but also for the whole market.

7/ Forge collaborations and partnerships

FIs must utilize the ecosystem of services, programmes, and institutions to improve its green finance offerings to clients (especially SMEs). FIs can collaborate with other stakeholders, to provide packaged solutions to customers that might be beyond the FIs own capabilities. For instance, easing customers' up-front costs by working with Government agencies who are helping SMEs get subsidised environmental certifications and RECP training; reducing cost of customer acquisition by working with donor projects that are already building the business pipeline, and partnering with projects that are already improving bankability among SMEs in the circular economy.

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