UNEP **Finance Initiative**
Innovative financing for sustainability

2007 Report

Banking on Value: A New Approach to Credit Risk in Africa

A report of the
United Nations Environment Programme Finance Initiative (UNEP FI) African Task Force (ATF)

UNISA | centre for corporate citizenship

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This report was commissioned by
United Nations Environment Programme Finance Initiative (UNEP FI)
African Task Force (ATF)

Prepared in partnership with the University of South Africa
Center for Corporate Citizenship (UNISA CCC)

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Abbreviations

ATF	African Task Force
BASA	Banking Association of South Africa
BBBEE	Broad Based Black Economic Empowerment
ECRA	Environmental Credit Risk Assessment
EIA	Environmental Impact Assessment
ESG	Environmental, Social and Governance
FDI	Foreign Direct Investment
FEPA	Federal Environmental Protection Agency (Nigeria)
FMO	The Netherlands Development Finance Company
FSC	Financial Sector Charter (South Africa)
GAAP	General Accepted Accounting Principles
GDP	Gross Domestic Product
GRI	Global Reporting Initiative
IDA	International Development Association
IFC	International Finance Corporation
IoD	Institute of Directors
JSE	Johannesburg Securities Exchange
NEMA	National Environmental Management Act (South Africa)
PFMA	Public Finance Management Act (South Africa)
RIMAN	Risk Managers Association of Nigeria. Formally known as CRIMA
SCRA	Sustainability Credit Risk Assessment
SRI	Socially Responsible Investment
UNEP FI	United Nations Environment Programme Finance Initiative
WBG	World Bank Group

Introduction from the Chairs

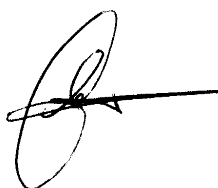
An increasing number of financial institutions are embracing sustainability and in particular environmental, social and governance (ESG) issues in decision-making processes. While international frameworks such as the Equator Principles have pioneered these concepts – especially in the context of project finance – these issues generally receive little consideration in the credit decisions made by banks when providing loans to small businesses and individuals. Furthermore, many banks are faced by a lack of practical guidance for implementation of ESG issues into credit risk processes.

As part of our mandate to extend sustainable banking practices in Africa, the United Nations Environment Programme Finance Initiative (UNEP FI) African Task Force (ATF) commissioned this study to provide an assessment of how leading financial institutions in Africa's largest financial centres – South Africa and Nigeria – currently integrate ESG issues in their financing activities. We aim to provide practical guidance for African institutions seeking to include these issues in their financing activities, through formal sustainability credit risk assessment (SCRA) policies.

More than 25 financial institutions and supporting stakeholders were interviewed and have contributed to this study. While interviews are limited to South Africa and Nigeria, we provide this study and its findings to assist financial institutions, throughout the continent, in embedding ESG issues in their management structures and lending practices.

We believe that this practice can create the conditions that lead to sustainable growth in Africa, and new opportunities for financial institutions.

It is our view that embracing sustainability at the heart of decision-making in Africa can offer the clearest opportunity for people, planet and prosperity.



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Introduction and Background

Financial institutions play a critical role in society. Through the products and services they provide, financial institutions are uniquely placed to influence the direction and pace of a country's economic development and by default, its long-term sustainability.

Finance in Africa is complex. The severity of poverty[1] poses an enormous challenge for African countries and contributes to a cycle of dependence on finances provided by multilateral lending institutions[2]. Sub-Saharan countries receive the largest share of International Development Association (IDA) lending of any region in the world[3], and the World Bank Group (WBG) continues to play a significant role in shaping policy and directing investments, through structural adjustment lending, poverty reduction strategies, and support for direct investments.

Nevertheless, local financial institutions and banks have a pivotal role to play in the future of Africa's development. Their ability, and importantly, the manner in which they provide capital, has the potential to encourage Africa's development trajectory. Indeed, it is an awareness of this role, and the need for a sensitive approach to the acute environmental, social and governance issues on the continent, that is increasingly bringing leading financial institutions in Africa to embrace the concepts of sustainable banking and finance[4].

African banks provide credit and loans to thousands of businesses and individuals throughout the continent, and, ultimately credit risk managers, financiers and loan officers are the lifeline to businesses and the gatekeepers to capital. It in this context that financial institutions can significantly influence the economic growth and development of societies, and potentially bring about change. By including ESG issues in credit risk management[5], banks can allocate finance in a manner that mitigates the negative impact of corruption, poor governance, and other issues detrimental to the African social and environmental fabric. If financial institutions are successful in this, they could help to both lift African business to a new level of growth, based on accountability and transparency, and influence business to responsibly manage environmental and social issues.

The links between ESG issues, company value and risk are increasingly being documented[6] and the receptivity of the financial community to these issues is growing. Analysts, asset managers and investors are beginning to understand the potential consequences of these risks on long-term investment value and are increasingly committing to include ESG issues in investment processes[7]. These issues have also grown in importance to the project finance community, especially in the context of the potential environmental and social impacts of infrastructure and extractive industry projects[8]. When turning to the world of credit, financing and loans, which is traditionally risk adverse, it would therefore seem natural that banks would consistently integrate ESG issues in their policies to protect value and minimise risks. After all, an over-riding objective of credit risk management is to avoid bad debt[9].

1 34 of the world's 48 poorest countries are found in Africa. Source: Bank Information Centre USA http://www.bicusa.org
2 Such as the World Bank Group (WBG)
3 http://www.bicusa.org
4 For an overview of Sustainability Banking and the challenges to implementing sustainable banking in Africa please see Appendix 2.0.
5 Credit Risk Management is the process by which banks attempt to limit the risk that those owing money to the bank will not repay.
6 To view reports produced by a partnership between the UN and asset managers see "Materiality Research" on http://www.unepfi.org/. Other emerging market specific research is available on the IFC's website, see http://www.ifc.org/. Finally, the Enhanced Analytics Initiative, an incentive driven collaboration between asset owners and asset managers aimed at encouraging better investment research, and in particular, research that takes account of the impact of extra-financial issues on long-term investment, also documents ESG links, see http://www.enhanced-analytics.com/
7 The Principles for Responsible Investment (PRI), launched by UN secretary-general Kofi Annan together with global investors at the New York Stock Exchange in April 2006, are a major commitment by signatory institutional investors and asset managers to integrate ESG issues into decision-making processes and provide a significant platform for their inclusion in mainstream investment practice. More than USD 4.5 trillion in assets under management have committed to the PRI, a figure rapidly approaching 10% of global capital markets, estimated at $50 trillion. For more information see http://www.unpri.org
8 The Equator Principles are a benchmark for the financial industry to manage social and environmental issues in project financing. The Equator Principles have consequently become the standard for assessing and managing environmental and social risk in project financing. This has helped accelerate momentum in other areas of environmental and social responsibility in the financial industry. For more on the Equator Principles see the Appendix 3.0 or visit http://www.equator-principles.com/
9 A debt that is not collectable and therefore worthless to the creditor.

The objective of this study is to firstly assess the extent to which ESG issues feature in South African and Nigerian credit risk assessment policies; and secondly, to provide guidance for implementing environmental, social and governance issues, or sustainability issues, in credit risk assessments.

This study is expected to serve as guidance for financial institutions seeking to define sustainability policies in the field of credit risk management. Furthermore, it is hoped that by providing insight to the opportunities presented by embracing sustainability in the financial sector, it allows financial institutions throughout Africa to identify their relative strengths and weaknesses, and assist in improvement.

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