



Sustainable Finance and Credit Reporting

FINAL REPORT

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Comment [JG1]: Title 'Workshop Consultant' very limiting

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Comment [JG2]: Improve on layout. Workshop is a main title and Purpose a subtitle

2 INTRODUCTION

2.1 SUSTAINABLE FINANCE

Sustainable Finance (SF) is the provision of financial capital and risk management of projects and businesses that promote, and minimize adverse impact on sustainable economic prosperity, environmental protection and social justice. When financial institutions are committed to the financing of sustainable development by providing financial services that facilitate economic prosperity while ensuring that the projects and business activities financed protect or enhance the environment and social development, then SF is attained.

Globally, the drive for Sustainable Finance is anchored in what are referred to as the Equator Principles. The Equator Principles is a risk management framework, adopted by financial institutions, for determining, assessing and managing environmental and social risk in project finance. It is primarily intended to provide a minimum standard for due diligence to support responsible risk decision-making.¹

The Equator Principles (EP) have become the financial industry standard for environmental and social risk management in projects. Under the Equator Principles, Financial Institutions (referred to as Equator Principle Financial Institutions or EPFIs) commit to implementing the principles in their internal environmental and social policies, procedures and standards for financing projects.

EPFIs commit to not provide Project Finance or Project-Related Corporate Loans to projects where the client will not, or is unable to, comply with the Equator Principles. While the Equator Principles are not retroactive, EPFIs apply them to the expansion or upgrade of an existing project where changes in scale or scope may create significant environmental and social risks and impacts, or significantly change the nature or degree of an existing impact.

Financial institutions adopt the EPs to ensure that the projects they finance are developed in a socially responsible manner and reflect sound environmental management practices. By doing so, negative impacts on project-affected ecosystems and communities should be avoided where possible, and if unavoidable, should be reduced, mitigated and/or compensated for appropriately.

2.2 KENYA BANKERS ASSOCIATION SF INITIATIVE

¹ <http://equator-principles.com/index.php/about-ep/about-ep>
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The Kenya Bankers Association formally launched its Sustainable Finance Initiative in 2015. The primary objective of this initiative was to get the industry to adopt some core principles in sustainable finance within their banking operations.

The initiative arose from a recognition that for purposes of a comprehensive risk management, it was not just financial viability that should be considered but also economic viability. Introducing Sustainable Finance (SF) principles in the loan process would help achieve the objective of adding economic viability in the assessment of a project's sustainability.

Given financial institutions crucial role of financial intermediation, inclusion of SF factors can incentivize businesses by limiting access to finance for projects that are likely to adversely affect the environment.

Banks can therefore start influencing environmental awareness amongst their clients, especially in the wake of climate change concerns, through introduction of and inclusion of social and environmental impact clauses in loan conditions.

Comment [JG3]: limiting access to finance for...

Comment [JG4]: adversely affect

2.3 CREDIT INFORMATION SHARING IN KENYA

Credit Information Sharing (CIS) was rolled out in the Kenyan financial sector in July 2010. The CIS mechanism is now an essential component of the financial system particularly in credit risk management.

The mechanism entailed establishment of credit reference bureaus (CRBs). CRBs act as the bridge between the lender and borrower by reducing information asymmetry between the two.

By collating demographic and credit transaction information from lenders, the CRBs can create statistically based credit scores. The scores are used as an indicator of the risk profile of a potential borrower and hence enhance credit decisions. Risk profiling in turn enables risk-based pricing to mitigate cost of and ease of credit access.

The initiative is now spearheaded by the Credit Information Sharing Association of Kenya (CIS Kenya). The mandate of CIS Kenya is to expand the CIS mechanism to include non-banks and other credit providers while enhancing use of credit information through utilization of credit scores in credit decisions by all lenders.

2.4 POSSIBLE LINKAGES AND SYNERGIES BETWEEN SF AND CIS

SF calls for extending focus beyond immediate financial gains from lending, to taking cognizance of economic viability and environmental concerns to reduce business risk.

Good approaches to the management of environmental and social factors can reduce non-financial risks enhancing stability of a borrower's cash flows thus reducing likelihood of default. The inclusion of Environmental and Social risk factors is therefore likely to improve the processes of validating and verifying the credit risk profiles of borrowers.

It may be possible to achieve, by considering sustainability related risk factors, linkages between the goal of ensuring sustainable development and the goal to maintain the best possible integrity of credit risk assessments.

The promotion of best practices in the two initiatives calls for a well thought joint strategy to support a risk-based pricing regime and strengthen credibility of the credit granting process in Kenya's financial sector.

2.5 CONSULTANCY

Sustainable Finance introduces an addition layer of risk management that seeks to establish the economic viability of a project as opposed to just its financial viability.

There is a need then to establish how SF, and specifically its related sustainability risk factors, and CIS factors can be integrated, and the extent to which SF factors can be deemed material in credit assessments.

The purpose of this consultancy was exploratory to determine if there are any linkages between SF and CIS and whether any synergies can be achieved between the two initiatives.

The consultancy would seek to explain how Sustainable Finance and related sustainability risk factors can be identified, measured, and incorporated into credit risk assessments. It would explore the linkages between the objectives of sustainability related risk factors and CIS, identify areas of common interest and recommend synergies and means for implementation of the two categories of risk factors.

The consultancy would be conducted through engaging relevant stakeholders and research work and recommend ways to boost the nexus between credit scoring and sustainability related risk factors.

In this final report, we bring together the desktop research and workshop deliberations to arrive at workable recommendations that provide a possible way forward.

2.6 FINAL CONSULTANCY REPORT FORMAT:

This Final Report is divided into 4 main sections:

- The first section reviews the KBA's Sustainable Finance initiative and seeks to establish if there are any linkages with CIS initiative.
- The second section reviews the role of CIS in credit risk management and sets out the possibility of linkages with SF.
- The third section explores sustainability related risk factors and how these can be incorporated in the CIS mechanism to establish a comprehensive risk management framework and thus achieve synergies between the two.
- The final section presents broad recommendations on the way forward.

3 KBA SUSTAINABLE FINANCE INITIATIVE

3.1 KENYA BANKERS ASSOCIATION'S SUSTAINABLE FINANCE INITIATIVE:

The KBA set out on the path of Sustainable Finance through a recognition that the banking sector needed to be conscious of sustainable development in their lending activities.

The process began as far back as 2009 commencing with engagements and sensitization for banks between 2010 and 2012. In November 2012, the KBA's Governing Council adopted the Sustainability Agenda as an industrywide priority with banks adopting the Sustainable Finance Statement and convening the SF Working Group in 2013. These continued efforts culminated in the adoption of the Sustainable Finance Initiative (SFI) Guiding Principles in March 2015 and their eventual launch by the CBK Governor in December 2015.

The SFI Principles are grounded in three main priorities, namely:

1. Equipping the financial services sector to perform **optimally in comprehensive risk management**;
2. Enhancing business practice, leadership and governance; and
3. Promoting industry growth and development by fostering a culture of innovation and inclusivity enabled by new technology

The KBA's SF initiative is well advanced with on-going capacity building in the sector through an e-learning portal that is accessible to all member bank employees, and an award scheme that is designed to incentivize member banks to adopt and include the SF principles in their lending processes.

3.2 KBA SUSTAINABLE FINANCE PRINCIPLES

The following are the 5 SFI Guiding Principles as agreed by the KBA and its members:

Principle 1: Financial Returns versus Economic Viability.

The Guiding Principle is that financial viability is necessary from an investment perspective; but is not a sufficient condition for sustainable economic development.

Principle 2: Growth through Inclusivity & Innovation.

The Guiding Principle is that financial institutions in pursuit of growth should innovate and leverage on existing and emerging technology to reach current and potential markets while economically empowering communities.

Principle 3: Managing & Mitigating Associated Risks.

The Guiding Principle is that firms should seek to mitigate social and environmental risks associated with their financing activities through client engagement and effective policies and risk assessment procedures; and in addition, firms should actively measure and report on the financial impact of these risks on their business performance.

Principle 4: Resource Scarcity and Choice.

The Guiding Principle is that optimal resource management is realized through productivity and efficient utilization of resources; and is guided by comprehensive opportunity cost assessment.

Principle 5: Business Ethics & Values.

The Guiding Principle is that the quest for ethical practice, efficiency, productivity and waste minimization should be fostered from the leadership and enabled by adequate governance structures.

3.3 LINKAGE BETWEEN SF PRINCIPLES AND CIS MECHANISM

After reviewing the Principles, it is evident that some of the principles are applicable to the bank while others are applicable to its customers.

Comment [JG5]: Outward-looking

For purposes of the CIS linkage, it would be best to thus focus on those principles or principle that are applicable to the customer as CIS is designed to provide a better view of the customer, and specifically to narrow down to that principle that is related to risk management.

By following this approach, it is evident that linkages and synergies are best seen in **Principle 3: Managing & Mitigating Associated Risks** that focuses on risks that may emanate from social, humanitarian and environmental concerns.

Principle 3 identifies these risks to the bank as the following:

1. Liability Risk
2. Collateral / Guarantee Risks
- 3. Credit Risk**
4. Reputational Risks

Our view is that this principle accomplishes the 1st priority of the SFI Principles (see above) that aims to equip banks to **'perform optimally in comprehensive risk management'** which is also the primary goal of the CIS mechanism and thus forms the best basis for linkages between the two initiatives.

We shall be able to discuss this further in Section 5 where we seek to identify this linkage.

4 ROLE OF CIS MECHANISM IN RISK MANAGEMENT

Comment [JG6]: I suggest CIS MECHANISM – DISTINGUISHING SCORING VS RATING or THE ROLE OF CREDIT RATING IN IN CIS

4.1 CREDIT INFORMATION SHARING MECHANISM

Credit Information Sharing (CIS) is a process where credit providers (such as banks, microfinance institutions, and other approved credit providers) exchange information on their credit transactions and credit applications from their customers.

The CIS mechanism in Kenya is anchored in the Banking Act, the Deposit Taking Micro Finance Institutions Act, and Central Bank of Kenya Act, and is effected through Credit Reference Bureau Regulations (CRB) 2013.

The legal instruments in effect mandate and make it compulsory for institutions licensed under the Banking and relevant Micro Finance Acts to share information through licensed Credit Reference Bureaus (CRBs). The CRBs are licensed by the Central Bank of Kenya. In effect, the CRBs are the 'mechanism' by which CIS is implemented.

CIS has enabled lenders access Credit Reports on their prospective borrowers from the CRBs. The reports inform lenders about the repayment patterns of a borrower and thus allow them assess the credit risk of the borrower prior to lending.

Both up to date (positive) and late (negative) repayment details of a borrower are shared through monthly electronic submissions to the CRBs. The CRBs use the CIS data to create Credit Scores that aim to predict the likely default of a borrower based on their credit and other data.

In this section, we are going to review the CIS mechanism in Kenya and how it is applied to **manage credit risk**. We shall go further and look at how CIS is being applied in supporting corporate and business risk assessments. This should give us the basis for seeing whether and how sustainable related risk factors can be incorporated in corporate risk management and lending decisions.

4.2 CREDIT REFERENCE BUREAU

The CRB is an entity that collects, collates and aggregates payment performance information on borrowers/consumers of credit from lending institutions and other credit providers.

There are various types of CRBs mainly determined by the type of borrower type they focus on. Consumer CRBs focus on individuals while Commercial CRBs focus on businesses. There is a Hybrid that collects data on both individuals and businesses and this is the type we have in Kenya.

4.3 CREDIT SCORE

The Credit Score is a numerical expression that represents a person's creditworthiness based on analysis of their credit file. It is used by lenders to predict that person's likelihood of defaulting.

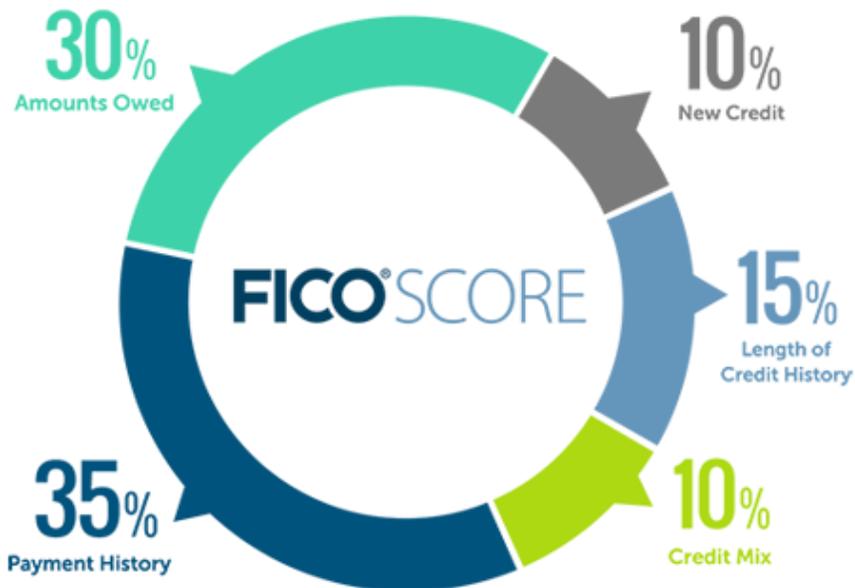
The Credit Score is primarily based on credit information reported to the CRBs. It may also include other data the CRB may have collected on the borrower from public data sources like the civil registries or judicial sources.

The Credit Score is used by lenders, to evaluate the potential risk posed by lending money to the consumer, to mitigate losses due to bad debt, to determine interest rate, and set credit limits.

The Credit Score is therefore the most important **risk indicator** under the CIS mechanism.

4.4 COMPOSITION OF THE CREDIT SCORE:

Below is a schematic that shows the main parameters that are considered in the Generic Credit Scores used by the large bureaus based on the Fair Isaac (FICO) Model.



As can be seen, various parameters carry different weighting in terms of importance in the generation of the Credit Score. This will be an important point when we consider how SF/sustainability related risk factors can be incorporated in a scoring model.

Consumer Credit Scores may range between 100 – 850 or 300 – 900 depending on the CRB with a higher score indicating lower default risk and hence a potentially good borrower.

4.5 TYPES OF SCORES:

There are two main types of Credit Scores depending on how they are developed:

Generic: these are developed using large amounts of data that are held by the CRBs. They use the unique demographic characteristics of the borrower and credit profile to predict their likely credit behavior based on how a similar set of borrowers have behaved in the past.

Custom: these are developed using a combination of CRB data and the lender's internal data on their customer. Customer Scores are used when a lender has to manage specific risk by loan product e.g. card as opposed to mortgage, Institution's risk appetite, by purpose e.g. customer attrition scores, collection prioritization scores, application scores etc.

This distinction is important as we consider how SF risk factors can be included in a scoring model.

4.6 DERIVATION OF CREDIT SCORES:

Derivation of Credit Scores is a statistical exercise that may be either enumerative or analytical.

Enumerative simply applies weightings for instance on specified parameters to arrive at an aggregate number that can then be used to determine what decision to take.

Analytical attempts to go further and seeks to determine if a cause and effect relationship can be established in specified parameters and thus used to predict a future outcome.

By their nature Generic Credit Scores by the CRBs are analytical while Custom Scores are more often enumerative and may be based on the institution's expert knowledge and experience with its borrowers/customers.

As we, consider incorporation of SF in the CIS mechanism these two methods will come into play at specific stages as will be demonstrated in the next section.

4.7 CREDIT BUREAUS AND CORPORATE RISK MANAGEMENT

It is worth to note that, in Kenya, generally the use of Credit Scores is mainly in retail or consumer lending.

There is thus an opportunity to increase the use of Credit Bureau Data to measure Business Risk and support Corporate lending and decision making. In fact, this

opportunity provides some topical relevance to the Sustainable Finance Initiative under discussion here.

Currently, CRB reports on Business and Corporates are mainly on the Full Reported Data without any credit scores. The practice is often to use the business information in combination with a personal credit report for a small-business owner.

Scoring may be currently limited as it is difficult to establish a link in behaviour of different businesses as can be done for the consumer as shown above. It is possible, however under the current CIS mechanism, to create basic Business Credit Scores that may include:

- Information about the business owners and or directors.
- Links and association through common shareholder / associated entities
- Trade reference on payment behaviour from other businesses
- Indebtedness - liens and encumbrances
- Judgments, collections, bankruptcies

Unlike the Consumer Credit Score the Business Score in this instance would not be derived in an analytical but enumerative way and will not be as predictive.

4.7.1 Using Probability of Default (PD) to measure Corporate Risk

The traditional measure of credit quality for a Corporate is a corporate rating. However, ratings are mainly done for the largest firms and not for majority of smaller corporations due to cost implications.

To quantify their credit worthiness, smaller companies are often analyzed using alternative methods, like probability of default (PD) models. PD models are the closest to the Consumer Credit Score for businesses. However, just like for the consumer, calculating PDs requires a large dataset of past defaults for a large universe of firms.

PD modeling entails categorizing financial ratios into six: leverage, liquidity, profitability, size, expenses and asset quality ratios. The process then seeks to identify which ratios or combination of ratios can predict default based on similar profile firms that past defaulted on their financial obligations.

Currently under the CIS mechanism this analysis may not be possible due to the limited amount of business and corporate data being held by the CRBs. This is especially so on the key parameters that are used in PD modeling that are not being reported under the CIS, namely financial ratios.

4.7.2 Credit Rating Approach

A Credit Rating is an evaluation of the credit risk of a prospective non-natural person debtor (a business, company or even a government). A rating seeks to predict the ability of the borrower to pay back the debt and thereby provides an implicit forecast of the likelihood of the debtor defaulting.

The Credit Rating approach improves on PD modeling as it considers and ensures that the unique economic, regulatory, environmental, legal and socio political factors that the company is operating in are properly captured in risk assessment.

Credit Ratings are based on an evaluation of both **qualitative** and **quantitative** information for the prospective debtor. They include information provided by the prospective debtor and other non-public information obtained by the credit rating agency's or corporate analysts.

In our view, this approach is quite important in determining how SF/sustainability related risk factors can be incorporated in a comprehensive risk management framework. It allows for inclusion of non-financial information in the risk management process and thus further enabling adoption of SF in evaluation of loans.

We shall now consider how this can be done conclusively in the next section.

5 SUSTAINABILITY RELATED RISK FACTORS

This section will seek to establish if there are sustainability related risk factors and if so how they can be identified, measured and lastly incorporated into a comprehensive risk management framework.

To determine this, it is necessary to see how other jurisdictions have approached the issue of implementation and whether it is possible to then use their approach to help in identifying the associated risk factors.

First, we need to revisit the KBA Sustainable Finance Principle 3 which we earlier stated in Section 3 provides the best basis for creating Linkages between CIS and SF.

5.1 IDENTIFYING LINKAGES UNDER PRINCIPLE 3

To recap, Principle 3 focuses on Managing & Mitigating Associated Risks through mitigating **social** and **environmental risks** associated with financing activities.

Credit scoring as enabled by the CIS mechanism seeks to identify measurable characteristics that can help identify and mitigate risk when underwriting a loan facility.

The question is then whether it is possible to establish elements under Environmental and Social Risks that can be **quantified** and **measured** to allow for some form of scoring that can assist in managing and mitigating the risks as identified under Principle 3.

To assist, with this it was necessary to consider examples of sustainability guidelines that have been used elsewhere. The most helpful were found to be FMO sustainability guidance for MFIs and SME banks (as found in FMO's Environmental, Social and Governance Toolkits²).

The FMO guidance categorizes the risks under Environmental and Social into 3 as follows:

1. Environmental Risks
2. Health and Safety Risks
3. Labour Risks

Each of these categories has several factors as will be seen below from the relevant FMO guidance page.

From a scoring perspective and using the Custom method explained earlier, it is possible to give each of these factors a weighting. This weighting can then be used to develop an **aggregate** Environmental and Social Risk score (E&S Risk Score).

²<https://www.fmo.nl/esg-tools>

We shall now consider how a Comprehensive Risk Management Framework would look like that incorporates the above Environmental and Social Risk factors with CIS.

5.2 APPROACH TO COMPREHENSIVE RISK MANAGEMENT FRAMEWORK:

There are two aspects to the Risk Management framework – the internal one at the bank and external one under the CIS reporting requirements.

The internal aspect would be the starting point. Each bank must develop a means by which it can capture and measure the risk associated with E&S for any of its project applications.

We will start by looking at how an internal model could be developed. Note that we shall be using a combination of the earlier explained methods of arriving at scoring models including **the credit ratings approach to capture qualitative information** in the process.

5.2.1 Creating a model based on E&S factors:

Going by the above example from FMO guidance, there are 3 risk factors that are to be considered under our E&S model – **Environmental, Health and Safety, and Labour Risks**.

Each of these risk factors has different elements as per below:

Environmental Risks	Health and Safety Risks	Labour Risks
Air Pollution	Fire and Explosion	Bad Working Environment
Deforestation	Infection with HIV/AIDS	Harmful Child Labour
Fish Depletion	Intoxication	Unfair Labour Conditions
Littering, Disease and Pest Occurrence	Disease Occurrence in Animals	
Soil Depletion	Occurrence of harmful bacteria and disease in humans	
Water Pollution	Personal Injury	

For creating the model, first weightings would be given to each of the 3 risk factors based on what the institution may determine to be the most important risk factor. The weightings would total to 100%.

For example, Environment could be given a 50% weighting; Health & Safety 30%; Labour 20% i.e. 50:30:20 ratio or a 60:25:15 weighting ratio could be used. Once the weighting for the risk factors is determined, then a score can be set for each of the parameters within the risk factor.

It is advisable to have differing levels of severity for each parameter as the impact of different projects on a specific parameter may differ. A range can be used to capture the severity level and in our example, we shall use a severity range of 0 – 3 with 3 being the most severe and 0 having little or no impact.

Severity Level	Score
High	3
Medium	2
Low	1
No impact	0

For instance, taking the example of the E&S Risk Score this can be determined as follows for a given project say mining-related depending on type and location:

Environmental Risks	Assessed Project Impact	Score
Air Pollution	Medium	2
Deforestation	High	3
Fish Depletion	None	0
Littering, Disease and Pest Occurrence	Low	1
Soil Depletion	High	3
Water Pollution	High	3

The Environmental Risk severity total in this case is **12 out of a possible worst case of 18.**

Once the total for each risk factor is obtained it is then multiplied by the earlier % weighting. The total of the severity score x weighting gives us the E&S Risk Score for that project. In our example above this would be $12 \times .6 = 7.2$ for Environmental Risk if environment was weighted at 60%.

Continuing with our mining project the other risk factors could score as below:

Health and Safety Risks	Severity Score	Labour Risks	Severity Score
Fire and Explosion	3	Bad Working Environment	3
Infection with HIV/AIDS	1	Harmful Child Labour	3
Intoxication	1	Unfair Labour Conditions	3
Disease Occurrence in Animals	0		
Occurrence of harmful bacteria and disease in humans	2		

Personal Injury	3		
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The resulting H&S Risk score would be $10 \times .25 = 2.5$; Labour $9 \times .15 = 1.35$. Note labour risks are very high with this project. The E&S Risk Score is therefore $7.2+2.5+1.35 = 11.05$

5.2.2 Using the Risk Score to Determining Lending

The cut - off point for a project based on its Risk Score is decided by simply working out what would be the best possible E&S Risk Score and worst possible.

Based on the outcomes the bank can then put a cut – off point for projects based on where their risk score falls.

For example, in our model above the good range would be where the severity scores are low to medium for each risk factor and the bad range where the severity scores are in the high range.

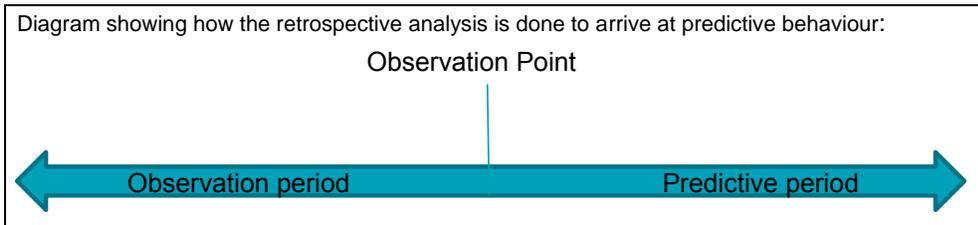
Each bank would be expected to capture the outcomes for each of these E&S attributes and their Risk Score both for their own internal consumption but also reporting to the CIS mechanism.

5.2.3 Developing a predictive score on a generic basis

To apply the inclusion of E&S reporting to the CIS mechanism, a data template that incorporates the E&S attributes for each loan application and their Risk Score would have to be developed under the current data submission template. This would allow for the reporting of the SF related data as part of the CIS and thus permit the development of predictive scores on a generic basis.

Predictive scores require lots of data that can allow for a retrospective view of performance say up to 12 months prior from a given date. If retrospective data is not available, then one would have to collect data over up to a 24-month period to test whether a specified attribute has any predictive ability.

A retrospective view can be obtained if one can apply the attributes to existing customers on a historical basis, i.e., **can one apply the internal model above to a defined good and bad population historically?** If it is possible, then that population would be scored at say 6 months or 12 months prior from the specified date.



Taking the population of 'bads' an analysis of their E&S Risk Scores is then done to determine whether there is a common thread e.g. what E&S attribute if any did most of the 'bads' score poorly against?

The same is done for the goods and the E&S attribute or attributes that most of the goods scored well in is noted. **In this way, the E&S score is now being related to the credit behaviour as seen from CIS.**

Once these attributes are noted another population of goods and bads would be selected to see whether the score on the attributes is consistent. If it is, then that E&S attribute or attributes **are determined to be predictive** and can be used for modeling a generic predictive E&S Risk Score that combines Credit Information.

This is the same approach used to generate the current Credit Scores after a lengthy period of reporting under the CIS so it is possible for us to achieve the same over time.

However, achieving such a model relies on accurate and consistent reporting by the participants in the CIS mechanism and assumes that the E&S Risk factors and their outcomes were correctly captured at the bank.

In addition, it requires a big universe of data on businesses to allow for the analysis to be carried out and the predictive model to be developed and tested.

5.3 ESTABLISHING SYNERGIES

As discussed before, it is possible to establish clear linkages between the Sustainable Finance Initiative as adopted by the banking industry and the CIS mechanism currently in use by the same industry through Principle 3.

In addition, as shown above, by deliberately creating convergence between the two initiatives synergies can be achieved between the two initiatives as it relates to enhancing risk management and risk based pricing in the industry.

However, this will require further work by the industry and certain key stakeholders to align the two.

5.3.1 ACHIEVING CONVERGENCE BETWEEN CIS AND SF

1. Banks need to adopt some specific, common and finite Environmental and Social (E&S) Risk factors in their loan process.
2. Banks must capture the measure of each factor for their corporate and business borrowers and hold this data in electronic format.
3. It should be made possible for Banks to then report this data to Credit Bureaus within the current framework of credit information reporting.
4. The Credit Bureaus should be able to collate this data with the other credit information and merge it to the relevant borrower's Credit File.

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5. Finally, the Credit Bureaus should seek to establish if any correlation can be determined between the measures of E&S factors and the ultimate performance of that borrower.

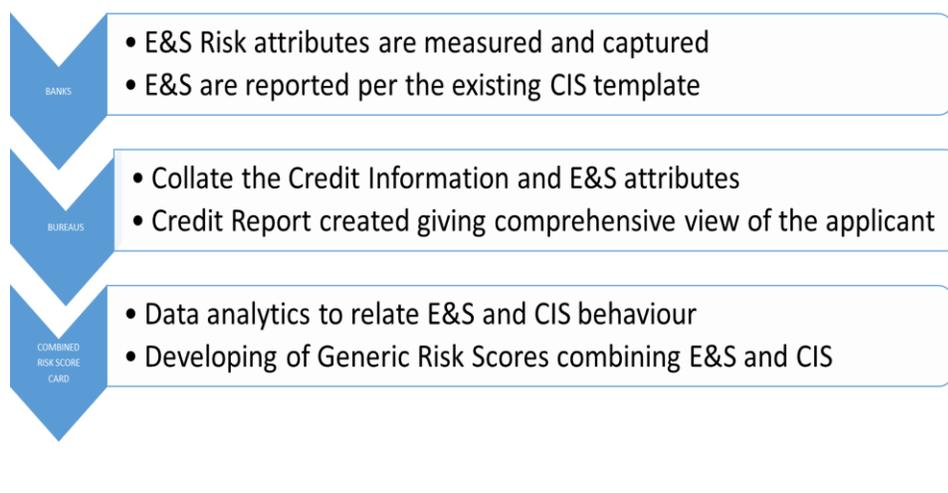
This approach makes it possible to incorporate SF factors in identifying borrower characteristics that could be used in predicting risk behavior.

Business Score Cards can thus be developed to predict probability of default based on a combination of SF and CI factors.

This would enable the industry achieve the earlier stated priority of SF equipping the sector to perform optimally in Comprehensive Risk Management.

Comment [JG7]: This needs to be stated with some conviction, so that the project can be seen to be moving from exploratory to certainty

Schematic on how to combine E&S Risk Factors with the current CIS:



Definite linkages and synergies would thus have been established and achieved with the two initiatives fitting and working perfectly together without any conflict.

5.4 SUSTAINABLE FINANCE CASE STUDY

As noted before identifying the relevant Environmental and Social Risks that would need to be factored required a look at practices elsewhere. It will be necessary to arrive at what is relevant or applicable in our Kenyan Banking Context as relates to Environmental and Social Risk factors.

Our initial observation is that E&S risk factors are yet to be universally standardized amongst the local banking community as it works to effect and implement the Sustainable Finance Principles³. We would therefore like to consider one bank as a case study on how it is approaching SF.

5.4.1 KCB BANK CATALYST AWARD SUBMISSION:

As mentioned earlier, the KBA launched an award programme designed to reward and incentivize the industry towards adoption of SF in their operations. The winner of the inaugural ‘Catalyst Award’ was KCB (Kenya Commercial Bank) having been recognized as the bank that had made the most progress in adoption of SF Principles.

Comment [JG8]: Kenya Commercial Bank (KCB)

As the inaugural winner, we now review KCB as a case study for the adoption and implementation of SF in Kenya.

As early as 2012, KCB embraced SF by formally adopting what it dubbed ‘Social Environmental Management Systems’ (SEMS) into its business practices. The SEMS are an independent assessment tool that the bank uses for lending to Corporate Banking clients.

Further to entrench these principles, KCB’s Group Sustainability Framework is anchored on four key pillars that revolve around the theme “Stability”:

- Financial Stability
- Economic Stability
- Social Stability
- Environmental Stability

The Sustainability Framework aids KCB to identify and manage loans with potential social and environmental risks. This is done by ensuring that a Social and Environmental Due Diligence (SEDD) is conducted for corporate loans. Currently, the SEDD is being conducted for loans of a project value above Kshs.500 million with the intention to keep lowering this threshold up to corporate loans of a value of Kshs.100 million.⁴

Comment [JG9]: restate

It will be would be useful to further engage KCB to understand how the SEDD is conducted, what Environmental and Social factors are considered, and how they are measured.

This would enable us understand how these compare with those proposed by the FMO under its MFI Sustainability guidance for Environmental and Social Risks as set out above as we consider what factors need to be captured and reported under our CIS mechanism.

³ As evidenced from the varied submissions during the inaugural Catalyst Award

⁴ KCB GROUP SFI CATALYST AWARDS SUBMISSION

5.5 ADOPTION AND IMPLEMENTATION APPROACHES – VOLUNTARY VERSUS STATUTORY

Finally, it might be useful to consider the approach to adoption and implementation of SF in Kenya if its true value is to be realized. Currently, though with the evident support of the regulator⁵ the adoption and implementation is voluntary amongst the banking sector.

This means that the industry members are at different levels of adoption of SF. This has consequences if the intended synergies with CIS are to be realized given that CIS encompasses and is mandated for all banks.

The convergence discussed above may only be possible where adoption is global in the industry and implementation is standardized across the industry. As an example, we briefly consider how Nigeria set about adopting and implementing SF in its banking sector.

5.5.1 Nigeria Sustainable Banking Principles

On 24 September 24 2012, the Central Bank of Nigeria launched the Nigerian Sustainable Banking Principles.

The principles may differ from those adopted in Kenya but the intention is broadly the same i.e. to develop a lending approach that balances the Environmental and Social (E&S) Risks identified with the opportunities to be exploited through their business activities.

The Nigerian Sustainable Banking Principles are nine in total⁶:

Principle 1: Environmental and Social Risk Management

Principle 2: Environmental and Social Footprint

Principle 3: Human Rights

Principle 4: Women's Economic Empowerment

Principle 5: Financial Inclusion

Principle 6: Environmental and Social Governance

The **adoption and implementation of these principles are compulsory** and require Nigerian "banks, discount houses and development finance institutions to develop a management approach that balances the environmental and social risks identified with the opportunities to be exploited through their business activities". The Nigerian banking sector has therefore adopted a mix of soft and hard governance in its approach to promoting commitment to sustainability principles.

⁵ CBK Governor officially launched the SF Principles in December 2015

⁶ Nigerian Sustainable Banking Principles

5.6 NATIONAL ENVIRONMENTAL MANAGEMENT

The legal framework for environmental management and conservation in Kenya is provided for under the Environmental Management and Coordination Act (EMCA) whose implementing agency is the National Environmental Management Authority (NEMA)

NEMA is charged with the implementation of all policies relating to the environment, and to exercise general supervision and coordination over all matters relating to the environment. NEMA is empowered to develop regulations, prescribe measures and standards and, issue guidelines for the management and conservation of natural resources and the environment.

We understand there is an ongoing review of regulations under the EMCA and may be worthwhile to seek inclusion of Sustainable Finance within the regulations to entrench environmental issues in finance as a national agenda.

6 RECOMMENDATIONS ON WAY FORWARD

The following are the recommendations that we have arrived at and that we consider provide guiding tenets that would assure institutionalization of SF principles in risk management as had been done with CIS.

6.1 INCLUSIVITY:

The implementation process needs to include all key stakeholders. Other than CIS- K, KBA, and WWF-K, the other stakeholders are the Borrowers, Credit Bureaus, and the Regulator for the banking industry. This is important in aligning the various initiatives with expectations and objectives of each stakeholder as interested and or affected parties. The key stakeholders could be incorporated within the existing Committee of Experts that is overseeing SF in the banking sector.

6.2 COLLABORATION:

Joint efforts and collaboration between CIS and KBA in promoting education and creating awareness on Sustainable Finance that should also target customers to make them aware of SF and its role in mitigating environmental and social risks. The KBA has established a well-resourced e-learning portal that can be used as a starting point and create the content for the education and promotional requirements.

6.3 EXPERTISE:

Engagement of expert and specialist knowledge in environmental and social risks through WWF- Kenya support as part of its sustainability initiative to assist in adoption. The expertise would be necessary to confirm the elements of the E&S and how they can be assessed and measured. It will also assist to establish common terminology and interpretation of the principles across the banking industry and beyond.

6.4 HARMONIZATION:

There is a need to arrive at a harmonization of interpretation and implementation of the SF Principles across the industry amongst institutions as it was observed that each bank may be working with its own interpretation and implementation process when it came to implementing SF Principles.

6.5 ENFORCEABILITY:

It will be necessary to establish some means of enforcement to ensure compliance and entrenchment as currently adoption of SF is voluntary. This is imperative if the bigger objective of having SF as part of a comprehensive risk management framework in the industry is to be achieved. Enforcement can either be achieved through the KBA's self-regulatory mechanism or incorporating SF principles in legal statute or prudential guidelines issued by the Central Bank (as per Nigeria's Sustainable Banking Principles).

Comment [JG10]: Create a heading for each, e.g. Inclusivity; Collaboration; Expertise; Harmonisation; Enforceability; Measurability, etc.

6.6 LEGAL ISSUES

The CIS mechanism is established by statute under the Baking Act. A review of the existing legal framework will be necessary to assure that SF related data can be included as part of the reporting requirements. In addition, as mentioned earlier SF can be included as part of the national environmental agenda under the NEMA if that will help promote the SF initiative in the finance sector.

6.7 SYSTEMS AND REPORTING TEMPLATES

The CIS mechanism requires robust Information Technology within the reporting institutions to allow for the electronic submission of data. Equally, the CRBs must have the capacity to process and validate the mass of data being reported. Finally, reporting is standardized through a Data Submission Template. For the successful inclusion of SF data, reporting institutions and the CRBs will need to assure that their systems can accommodate the new requirements while the Data Template will need to be reviewed to capture SF.

7 CONCLUSION

In conclusion, it has been possible to:

1. Identify linkages and synergies between Credit Information Sharing and Sustainable Finance Initiatives,
2. Provide clarity on the Sustainable Finance principle that works towards comprehensive risk management and specifically identify this as Principle 3 that introduces risks from environmental and social factors,
3. Establish gaps and interventions that may be necessary for the implementation of Sustainable Finance in loan processes, while acknowledging, the great steps taken in adoption of Sustainable Finance in the banking industry, and
4. Finally, come up with workable and actionable recommendations that could provide a way forward towards supporting and furthering the SF initiative of the Kenya Bankers Association.

Comment [G11]:

8 APPENDICES

8.1 GLOSSARY OF TERMS AND ABBREVIATIONS:

CBK – Central Bank of Kenya

CIS – Credit Information Sharing also known as Credit Reporting

CIS-K – Credit Information Sharing Association of Kenya

CRB – Credit Reference Bureau also known as Credit Bureau

Data Submission Template – A template issued under CRB regulations to standardize the submission of data to CRBs

E&S – Environmental and Social factors

FICO – Fair Isaac Corporation

FICO Score – a generic credit score based on the FICO modelling

FMO – The Dutch development bank that invests in the private sector in developing countries and emerging markets.

KBA – Kenya Bankers Association

Prudential Regulations – Regulations issued by the CBK to guide licensed institutions

Risk Management – The practice of mitigating default risk and possibility of loss from lending activities

SF – Sustainable Finance

SF Guiding Principles – Principles issued under SF to guide institutions on how to implement SF in their operations

WWF – World Wide Fund the leading organization in wildlife conservation

WWF – K – Word Wide Fund Kenya that works for conservation of environment and wildlife to stop degradation of the natural environment in Kenya.

8.2 USEFUL REFERENCE LINKS:

CIS Kenya – www.ciskenya.co.ke

Equator Principles – www.equator-principles.com

FMO Environmental, Social and Governance Tool Kit – www.fmo.nl/esg-tools

KBA Sustainable Finance Initiative – www.sfi.kba.co.ke

Nigeria Sustainable Banking Principles –
www.cbn.gov.ng/out/2012/ccd/circular-nsbp.pdf

