Sustainable Finance Initiatives and Banking in Kenya: The Inevitable or the Good-to-Consider?

By Jared Osoro

No love lost?

Is it true that the one aspect that easily draws mankind's consensus is the lack of admiration – verging almost in hatred – for bankers? If the answer is yes, then that attitude must be underpinned by the popular caricature of bankers as "those folks that wear suits, talk numbers, strike deals, and leave worrying about the outside world to others".

That attitude may be slowly changing, especially over the past decade, at least in regard to bankers' perception of "the outside world". In June 2003, ten international banks proactively commenced the process of starting to apply social and environmental criteria to their lending. These institutions set up rules and guidelines – the so-called Equator Principles – that were binding on them when it comes to social and environmental assessment.

Initially, these guidelines coalesced around two aspects. One, they apply to project finance; and two, they would work by consensus, implying falling in line with social and environmental standards set by the International Finance Corporation (IFC), the private-sector lending arm of the World Bank.

That the Equator Principles are gaining considerable traction is in no doubt. Ten years down the road and the number of subscribing institutions – so called Equator Principles Financial Institutions (EPFIs) – has risen to 77 and the scope widened to beyond project finance to include project finance advisory services, project-related corporate loans, and bridge loans. The EPFIs span across 35 countries and cover nearly three quarters of international project finance debt in emerging markets.

The outlined progress is in no way driven by the agenda to appease the wider stakeholder community that may be having no kind attitude to banks. It is a business imperative that is increasingly moving to the core of banking. In an economic system, bank fulfils an important role of intermediating between borrowers and savers; indeed they are arguably the most important intermediaries in an economy.

At the centre of the intermediation process is the aspect of risk management, and increasingly banks are finding it necessary to develop capacity to appreciate and manage social and environmental risks as part of their business; in essence this category of risk is "non-traditional" no more. This is what sustainable finance is all about.

When we started seeing the light…

It is slightly more than a quarter of a decade since the concept of sustainable development started receiving global attention. The World Commission on Environment and Development published a report entitled *Our Common Future*[1] in 1987 that laid the pillars for the formulation and implementation of policies meant to buttress sustainable development – which the report defines as "development that meets the needs of the present without compromising the ability of future generations to meet their own needs."

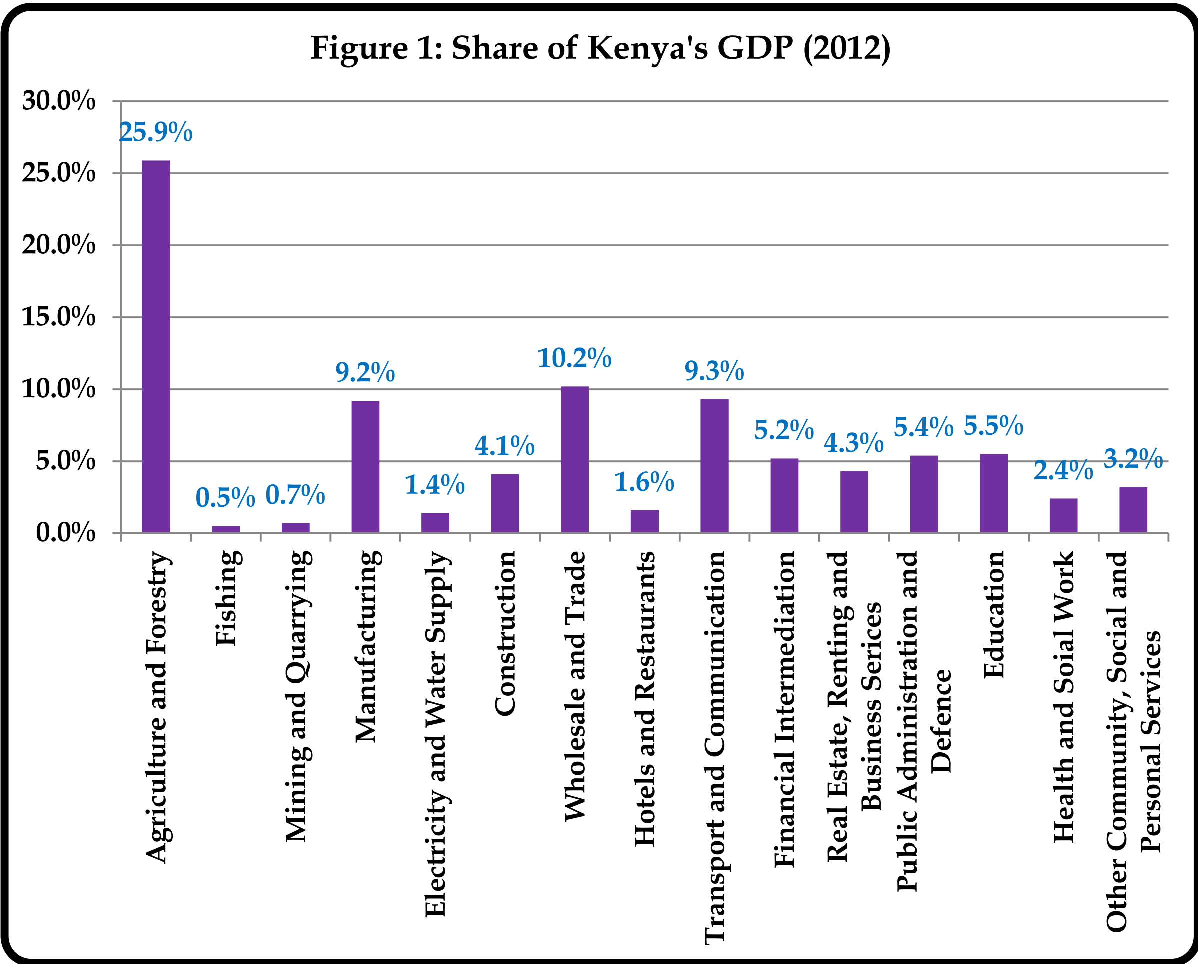
Since then the subject has remained dynamically alive, the current talk being on the "green economy", which United Nations Environmental Programme defines as an economy that "results in improved human well-being and social equity, while significantly reducing environmental risks and ecological scarcities." If the green economy concept is topical, then the recently published *African Development Report 2012* – a publication of the African Development Bank – is clearly spot-on with its "*Towards Green Growth in Africa*" theme.

What is clear from this emerging development is that the twin aspects of environment and social are inevitably at the core of economic management. A good starting point of appreciating that notion in an economy such as Kenya is contextualising its structure and how it is likely to evolve in pursuit of the Government's Vision 2030.

[1] This report is popularly known as the Brundtland Report, named after Gro Harlem Brundtland – the former Norway Prime Minister (1986-1989 and 1990-1996) who establ;ished and chaired the World Commission on Environment and Development.

The Kenyan economy's current structure (**Figure 1)** – where agriculture and forestry, manufacturing, trade, and transport and communications are the dominant sectors – shows how the major sectors of the *real* economy and *driver* (support) sectors are interwoven with the environment. On that account, Kenya has an explicit agenda "to be a nation living in a clean, secure, and sustainable environment by 2030".

The Kenyan financial sector generally, and the banking industry especially, is expected to lubricate the economy's drive towards the stated vision. The attainment of the vision necessitates that an annual real growth rate of 10 per cent consistently for more than two decades is realised. And the realisation of that growth will, of necessity, be investment driven; and the investment target for the period is ambitiously in excess of an equivalent of 30 per cent of GDP.



Source: Kenya National Bureau of Statistics

Let's put the economy's ambition that we outline in the context of environmental and social dimensions in regard to how they are affected by public and private investments.

First, we note that the envisaged investment level of more than 30 per cent of GDP is matched by the levels of gross domestic savings that are currently below 15 per cent of GDP and will even in the best of circumstances not exceed 20 per cent of GDP in the medium term[2]. This will only mean that the achievement of the investment target will necessitate the economy intermediating foreign savings to fill the domestic savings gap.

The intermediation of foreign savings will entail a scenario where banks operating in the domestic market establish partnerships with international financial institutions – banks and development financial institutions (DFIs) – to either support foreign direct investment (FDI) or be a conduit to dedicated lines of credit targeting projects that will propel the anticipated economic growth.

In all likelihood, the international banks whose partnership will be critical will be among the 78 EPFIs[3]. As for the DFIs that may be channelling resources either directly to the government to finance infrastructure projects or through banks, the aspect of environmental and social analysis is already embedded in their practice.

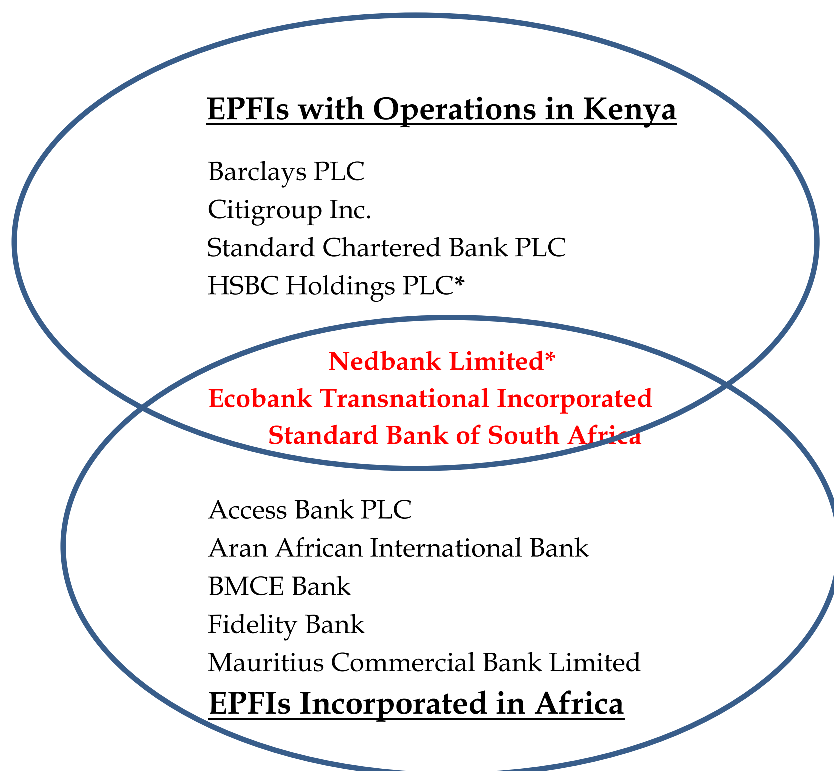
Therefore, the local banks ability to consummate the partnership with international banks and other international stakeholders will to some degree hinge on the willingness and ability to embrace environmental and social aspects in their risk management initiatives. The EPFIs operating in the Kenyan market (Figure 2) have a head-start in the international intermediation process.

Second, the interventions that banks are expected to make in the major sectors of the economy will have to confront the obvious social and environmental risks. Investments in agriculture – the economy's key growth determinant – at whichever level of the value chain has obvious environmental and social risks.

[2] The IMF (World Economic Outlook, April 2013) projects that Kenya's gross domestic savings will remain below 20 per cent while gross investments to support a real growth of 7 per cent in the medium term – a modest rate than the vision2013 target of at least 10 per cent – will remain well over 20 per cent.

[3] As at June 2013, out of the 78 EPFIs, 8 are banks established in Africa. There is no Kenyan-established bank that has subscribed to the Equator Principles. There is only one bank incorporated in China that is an EPFI – notwithstanding the increasing presence of banks from China in project financing in the emerging markets generally, and in Africa particularly.

Figure 2: EPFIs Operating in Kenya; EPFIs Incorporated in Africa



These EPFIs have established Representative Offices in Kenya

So does investments in industry – the type of technology deployed; tourism – the sensitive ecosystem that supports the sector; and energy – the underlying source.

The prominence that the extractive industry is gaining – oil and gas as well as other mineral discoveries whose harnessing has obvious environmental risks – will only mean that the structure of the economy is increasingly evolving towards environmentally and socially sensitive investments. To the extent that the financial sector fuels all these sectors, the risks that emerge on account of its involvement cannot be continually taken as "non-traditional".

We are seeing a number of Kenyan banks take on board environmental considerations as a basis for lending to small and medium enterprises. This happens where environmental considerations may hamper full recovery from an investment or where environmental considerations boost costs saving and boosts efficiency. While this is welcome, it is at best token and discretionary. Were it to be institutionalised, then the thinking on beneficial opportunities like promoting the participation in the billion dollar

carbon credit market will start gaining traction.

Thinking it's somebody else's business? Think again

The issue of sustainable finance may not be at the very top of the agenda for bankers, or so it is largely assumed. The reality is admittedly more assuring; when it comes to sustainable financing, financiers – including bankers – are anything but eavesdroppers at a private conversation between multilateral agencies such as the United Nations and governments.

To assume that they are is a kin to assuming that matters to do with environmental and social challenges, even when they relate to private investment, are a "public good"; such an assumption will obviously be limiting at the extreme. In reality, banks are increasingly recognising that environmental and social issues are for all intent and purposes aspects that are squarely in the risk management domain.

Indeed, banks have demonstrated leadership in the initiatives that led to the formulation of the 'Equator Principles'. It is clear therefore that Banks are keen to be known for more than accomplishing their core objective of optimising on their investments with a view to ensuring that their respective earnings are acceptable to the shareholders. We have seen the Equator Principles either adopted or customised to fit local circumstances in some jurisdictions.

Should the Kenyan banking industry wait until some form of such principles is in future imposed on it? While the industry ponders on that, it could be argued that the embracing of a risk management framework that at the core is as good for the business as it is for the economy is a strategic endeavour for sustainable operations.

It cannot be simply perceived as a moral intervention along the line of corporate social responsibility programmes, for it is a business intervention. Those banks that have adopted risk management framework for determining, assessing and managing environmental and social risk in their projects investment have clearly seen this sense.

These banks have a common attribute of being ambitious, seeking to be global or continental players. Evidently, Kenyan banks are not lacking when it comes to ambition; the regional expansion of a number of then is testimony to this effect. They could well draw inspiration from Chinua Achebe's words that "if a child washed his hands, he could eat with kings."

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