ECO:FACT
Environment and Finance

ECOFACT AG
Stampfenbachstrasse 42
CH-8006 Zürich

Tel. +41-1-350 60 60
Fax +41-1-350 60 20
contact@ecofact.ch

# Environmental Management in the Credit Business

- **Environmental management in the credit business is risk management, first and foremost. A lower loss ratio, i.e. a higher-quality loan portfolio will result in higher earnings. That has a positive effect on a bank's enterprise value.**
- **Second, environmental management in credit operations contributes to sustainable development. The influence of financial institutions lies in their role as financial intermediaries. It is more difficult to quantify the contribution of sustainability strategies to a company's enterprise value. These effects are generally long-term and involve value drivers such as reputation.**

## 1 The Risk Management Perspective

**What are the Environmental Risks in the Credit Business?**
A bank's customers are exposed to environmental risks. If a corporate client disregards risks, this can affect that company's cash flow or the value of its assets. The bank can find itself confronted by credit risks or liability risks. Liability risks are associated in particular with transactions involving real estate or entire companies. Serious cases may entail reputation risks, such as when the bank is charged with negligence in handling risks. But the reverse is also true: opportunities for the borrower are also opportunities for the bank.

**Environmental Management as Risk Management**
The environmental risk perspective is widespread today in the credit business. Banks are experts in assessing and controlling risk. Therefore environmental management in the lending sector is often based on concepts of risk management. The benefit of this approach lies in better risk control in credit operations, credit control and handling impaired loans.

## 2 The Corporate Responsibility Perspective

Numerous banks have made it their goal to ensure that their activities have the smallest possible impact on the environment and to promote sustainable development through their banking operations. These goals are often defined in a business policy statement or a corporate responsibility strategy. The UNEP (United Nations Environment Programme) Statement by Financial Institutions, which has now been signed by nearly 200 banks, has pointed the way in this area.

For some years now, banks have been trying out concrete approaches to making the banking business sustainable. Examples can be found in the credit business, asset management business, and operational ecology. Yet there is still scope for progress in the future.

## 3 The Benefit of Environmental Management in the Credit Business

At present, the influence of corporate responsibility strategies on enterprise value can only be shown qualitatively. The benefit of environmental risk management in lending, however, can also be quantified to some degree using the following approaches:

ECOFACT AG
Stampfenbachstrasse 42
CH-8006 Zürich

Tel. +41-1-350 60 60
Fax +41-1-350 60 20
contact@ecofact.ch

- **Individual Transactions:** A peculiarity of environmental risk is that the loss for the lender can be higher than the credit limit. Thus a few cases in which serious risks are identified justify the expense of environmental management. It is rare, that environmental risks are solely responsible for bad debts. They rather tend to be accompanying factors that increase default probabilities and losses in the event of a default.
- **Expected Loss:** Expected loss is a customary measure of risk in the credit business. Models make it possible to quantify the expected loss resulting from environmental risks.
- **Enterprise Value:** Business valuation and credit rating are often based on expected future cash flow. Environmental aspects affect a company's expenses and income over time as well as the reliability of these estimates – factors that are considered in cash flow models.
- **Environmental Management as a Management Indicator:** The rating of a company's creditworthiness can be based on management indicators. It has been shown that customers who exhibit a consciousness of the environmental aspects of their business activities are rarely those with bad debts.

Environmental risk management makes a positive contribution to enterprise value. The higher quality of loan portfolios can be measured in monetary terms. In contrast, the effects on other value drivers such as reputation or stronger customer loyalty are more difficult to quantify. For example a training program for client advisers that also covers environmental aspects will improve not only the consultants' ability to assess risks but will also allow them to better advise the customer.

## 4 Conclusion

Environmental management makes it possible, at a minimum of expense, to better control risks in the credit business and to increase the quality of the bank's services. This has a positive effect on earnings and thus on the enterprise value of the bank.

When environmental aspects are taken into account in fund allocation, it also means that companies with a higher eco-efficiency and fewer environmental risks will tend to get loans on more favorable terms. In consequence, their role as financial intermediaries means that banks may have a greater influence on sustainable economic development than other companies.

ECOFACT AG specializes in advising financial services providers in the area of environmental management, risk management, and sustainability. You can reach us at: contact@ecofact.ch.