IMPLEMENTATION OF SUSTAINABLE BANKING PRINCIPLES IN BANKING RISK MANAGEMENT

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Abstract: In the banking sector the wave of environmental concerns started to rise sharply. Our paper aims to uncover the linkage between sustainability and risk in this sector. We will analyze the reasons that support the necessity of addressing sustainability in the banking sector and will discuss the implication of sustainability principles in banking risk management. It could be concluded that in the next years, a new Basel Accord III, will cover also these issues regarding sustainable banking, environmental and social risks measurement, monitoring, managing, and capital adequacy. The global financial crisis has highlighted how important it is to look ahead to the challenges of the future. Now, we consider that the major challenge of the future is the sustainable development.

Key words: economic and social risk, sustainable development, triple bottom line, performance

JEL classification: G21, Q56

1. Introduction

The global financial crisis has highlighted how important it is to look ahead to the challenges of the future. We believe that by doing this, the financial and banking institutions can provide shared value for shareholders and, also, for wider economy, for environment and society. Now, we consider that one of the major challenges of the future is the sustainable development of the society (Balu and Bran, 2008). That is one of the key themes in the twenty-first century.

In our opinion, the role of banks in the achievement of sustainable development is significant considering the intermediary role that they play in society. A bank transforms money into place, term, size and risk in an economy and, as such, it affects development of the society that requires being “sustainable development”. In this context, we consider “sustainable banking” action as being the banking action dedicated to finance investment projects that comply with sustainable development principles.

The literature in the sustainable banking management field is not too rich because the idea of this management kind is rather new. Sustainable development is one of the key themes in the twenty-first century and in the same time a problem that need solution as soon as possible (WWF, 2006). Companies and countries that reconcile economic, environmental and social objectives not only minimize risks, but also realize significant potentials of added value. This makes them increasingly attractive to international financial markets.

2. Sustainable development –brief review of evolution

Although signals for a sustainable development of society have been given to economy since the second half of last century, they have not felt at the time. So, in 1971, the Club of Rome has given to the world the signal of degradation of planetary balance in the context of overexploitation of natural resources in support of an exaggerated economic and demographic growth. In this context, in 1972, there was the United Nations Conference held in la Stockholm, where for the first time was used the “eco-development” notion, after being replaced with the concept of “sustainable development” (Pearce and Warford, 1993).

Sustainable development, as we can see from the below figure, is a relatively new approach regarding the evolution of our society in the future. The figures show us the key world events, which represents important contributions on the road to sustainable development of the society.
Sustainability is a complex issue which requires multi-sectorial cooperation such as: involvement of the governments, non-government sectors, citizens, companies and implicitly the financial and banking sector (Stancu, 2006). The following figure shows us the main actors of sustainable development:

3. Necessity of sustainable banking

As we viewed in the above figure, the financial and banking institutions are one of the key actors in sustainable development. This is because financial and banking institutions play a fundamental role in public policy and economic performance as well as in all forms of commerce and industry. They are crucial in determining whether society, from governments to individual consumers, succeeds in following an environmentally sustainable path. Until recently, most major commercial and investment banks did not consider environmental and social concerns to be particularly relevant to their operations. Today, however, they and their key stakeholders agree that financiers bear significant responsibility for the environmental and social impacts of the operations they finance.

Starting from the Millennium Development Goal, a study of Mercur Investment Consulting (May 2006) shows that the main factors that will influence future management decisions of corporations and financial and banking institutions are: climate exchange, corporate governance, environmental management. This can be seen from the chart below that represents the drivers of the management in the future:

In the last ten years leading banks have developed practical guidelines and management tools for improving their economic, environmental, and social performance - the Triple Bottom Line of sustainable development. They have improved their profits and reduced their risks, and they are sharing their knowledge with other bankers.
Figure 3: Main Factors for Managers in the Next Five Years

The role of banks in the achievement of sustainable development is significant considering the intermediary role that they play in society. This point explains the concern that governments, the European Union (EU), the United Nations (UN) and non-governmental organizations (NGOs) are showing over the effect of banking activities on sustainability. If sustainable business is to succeed at the macro level, the attitude taken by banks will be critical. A bank transforms money into place, term, size and risk in an economy and, as such, it affects economic development (Eremia and Stancu, 2006). Between borrowers and lenders of money what develops is information asymmetry, including that which concerns environmental aspects. Banks have extensive and efficient lending operations and have a comparative advantage in information (as a result of the knowledge they have of economic sectors, regulations and market developments). By in principle having a solid view of environmental and financial risks, banks fulfill a key role in reducing information asymmetry between entities in the market (WWF & BANKT, 2006). A bank can attach a value or price to reduce that uncertainty. Interest rate differentiation among sustainability aspects is justified from risk perspectives. The scope for interest rate differentiation increases if banks can raise funds more cheaply because they have a relatively ‘well qualified’ credit portfolio. Banks can go a critical step further by applying interest rate differentiation on the basis of the will to stimulate sustainable development. By means of their financing policy, banks can then take specific measures to contribute to sustainable entrepreneurship. This influence is not only quantitative but can be qualitative, since banks can influence the nature of economic growth. Its financing policy is one way for a bank to create opportunities for sustainable business. An example is funds that are specifically designed for investment in environmentally friendly ways, such as green funds. But banks can go a step further by applying premium differentiation (not based on financial values), for instance, in which a certain investment or credit application must satisfy return or risk-management requirements from a sustainability perspective.

The banking sector’s emerging recognition of environmental and social responsibility was driven to a large degree by outside pressures. Beginning in 2000, environmental organizations such as Friends of the Earth (FoE) and the Rainforest Action Network (RAN) challenged the industry with high-profile campaigns that highlighted cases in which commercial banks were “bankrolling disasters”. In 2002, a global coalition of non-governmental organizations (NGOs) including FoE, RAN, WWF-UK and the Berne Declaration came together to promote sustainable finance in the commercial sector. This informal network subsequently evolved into BankTrack, whose vision for a sustainable finance sector was expressed in the Collevecchio Declaration of January 2003. Now endorsed by more than 200 organizations, the Collevecchio Declaration remains the benchmark by which civil society will measure the banking sector’s commitment to sustainability.

In June 2003, ten international banks announced a commitment to environmental and social leadership that surprised many in the financial community. Since that time, an additional ten banks have come forward to make this same commitment. By adopting the Equator Principles, these 20 banks have agreed to use clear, responsible and consistent rules for environmental and social risk management in project finance lending. In taking this step, these banks demonstrated leadership in an area where banks
The Equator Principles, initiated in 2003, mark a turning point in the application of sustainability to the financial sector. For the first time, project finance has a clear and measurable standard of sustainable good practice. Today 67 financial and banking institutions from 28 countries have signed the Equator Principles. These institutions operate in over 100 countries. Because of this, Equator Principles have become social and environmental standards in financial and banking industry and should be considered in the financing of investment projects. But real implementation depends on the successful interaction of a number of parties, from Equator Banks, to environmental, social and legal advisers, to industry leaders on the ground.

4. Global Actions to Implement Sustainable Banking Management

The integration of the sustained development in the banking activity is one of the subjects internationally debated: theoretically most of the times and very rarely practically. Several years ago, the main part of the commercial and investing banks did not consider the social and environmental problems relevant for their operations. Recently, although, the banks and the most important stakeholders began to realize that the financing has a major impact over the way of ulterior development of the society and, implicitly, over the way of creating of the banking value in the future. In this context, the development of a banking management system, based on sustainable principles (Sustained Banking Management) represents one of the provocations of this millennium’s beginning.¹

The main events and actions which brought changes of attitudes in the banking management and defined the role and the necessity of some banking financing based on sustainability principles can be presented in a short way like this²:

Since the late 1990's a coalition of NGOs started campaigns against projects, primarily in the extractive industry sector, which were co-financed by private banks and had hugely adverse environmental and social impacts. The informal network of NGOs, which later evolved into BankTrack, adopted the Collevecchio Declaration in early 2003, which proposed the network’s vision for a sustainable banking sector.

In 1992 UNEP and the five members of the Advisory Committee - NatWest Bank, Deutsche Bank, Royal Bank of Canada, Hong Kong & Shanghai Banking Corporation and Westpac Banking Corporation - were involved in preparing the “Statement by Banks on Environment and Sustainable Development”. All five members of the Advisory Committee became founding signatories to the Statement. By the end of 1992, 23 of the world's leading commercial banks, representing $1.5 trillion in combined assets, 50 million customers and more than 500,000 employees, signed the UNEP statement. Among other things, the signatories declared that they:

- endorse the integration of environmental considerations into internal banking operations and business decisions in a manner which enhances sustainable development;
- recognize that environmental risks should be part of the normal checklist of risk assessment and management. As part of their credit risk assessment, they recommend, where appropriate, environmental impact assessments; and
- support and will develop banking products and services designed to promote environmental protection, where there is a sound business case.

The UNEP Statement has already been signed by 91 commercial banks from 34 countries.

In 1996 The World Bank has demonstrated strong support for sustainable development. By the end of 1996, it had become the largest single source of funding for environmental programmes and projects, with a total portfolio of $11.5 billion covering 153 projects in 62 countries. As the largest international development finance agency the World Bank has a prominent role in directing resources to support sustainability. Its commitment to sustainability continues to influence strategies of the investment and commercial banking sector worldwide.

The 1997-98 Asian financial crisis, however, seems to have been the event that has truly turned the world’s eye toward the relationship finance and sustainability. Since then, the financial sector has

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been slowly responding to increasing shareowner and stakeholder expectations regarding social and environmental performance.

- **September 1999 - Dow Jones Sustainability Group Indexes** GmbH (DJSGI GmbH) announced the launch of the first global indices intended to track the performance of the leading sustainability-driven companies. This is clear proof that sustainable development is felt worldwide.

- **January 2003 - The Collevecchio Declaration was launched.** It endorsed by over 200 civil society organizations. It outlines the unique role and responsibility the financial sector has in advancing sustainability and continues to be civil society’s benchmark of measuring sustainability in the banking sector. The six commitments framed in the Collevecchio Declaration, outline what banks should do to make their operations more sustainable. The six commitments are (Gelder, 2006): responsibility, accountability, transparency, sustainable markets and governance, and “do no harm”.

- **June 2003 – The Equator Principles was launched.** The Equator Principles are the most well-known set of sector policies in the banking sector and are often presented as the banking sector’s answer to the sustainability challenge. They are based on the social and environmental performance standards of International Finance Corporation (IFC), the World Bank’s branch for developing of private sector (Lazarus, 2004).

- **July 2006 – The Equator Principles was revised** conforming to the changes in financial and banking activities. A total of 42 banks and other financial institutions have adopted the Equator Principles, in 2006. Now (2009), 67 financial and banking institutions from 28 countries have signed the Equator Principles. Like Basel II Capital Accord settlements, the Equator Principles are indicative, not imperative.

5. **Conclusions**

At the beginning of the 21st century, the biggest banks in the world have become complex financial organizations that offer a wide variety of services to international markets and control billions of dollars in cash and assets. Supported by the highest technology, banks are working to identify new business niches, to implement innovative strategies, to develop customized services, and to capture new market opportunities. So, the banking system began to play a more and more active role in sustainable development. The major change occurred when the bankers realized that the poor performance and environmental negative effects produced by their clients is in fact a threat to their business success.

6. **References**