Credit risk and sustainable development

Question:

Why is sustainability important for Financial Institutions?
Environmental and social issues in companies can impact the risk level of a Financial Institution that finances them:

- **Credit Risk**
  - defaults
  - payment rescheduling

- **Systemic Risk**
  - sector-wide practices
  - market devaluation

- **Security Risk**
  - defunct / devalued collateral

- **Legal Risk**
  - potential transfer of liability from borrower to lender

- **Funding Risk**
  - access to capital (e.g. FMO)
  - cost of funds

- **Reputational Risk**
  - national
  - international
For value and values reasons, FIs do not want to be involved any more in companies that ...

- Do not comply with national legislation: problems with licences
- Are eco-inefficient: relatively high costs
- Do not comply with emerging customer demands: decrease of market share
- Can be a target of NGO campaigns: impact on reputation
So:

Financial Institutions start evaluating their (large industrial high risk) clients against environmental and social benchmarks

For instance IFC Performance Standards – Equator Principles
The FMO approach:

**Direct Investments in Companies / Projects**
- Policy & Management System
- Capacity
- Compliance with international standards – IFC Performance Standards

**Financial Institution Clients**
- Policies
- FI portfolio management (ESMS)
- Different approaches for FIs, Funds and MFIs
- Training + follow-up
Sustainability-related opportunities beyond risk management exist for FIs:

- New financial products
- New business development
2. Environmental and social risk management for MFIs – the FMO approach

Question:

What has this all to do with microfinance?
We are not talking this... but this...

Maybe not large impacts, but there are millions of micro-businesses: Cumulative impacts
and not this ... but this...

So our mission was: Develop a PRACTICAL field guide for MFI loan officers
### Sector table with main risks per sector

* 'X' indicates when there is a significant risk
* '*' indicates when there is a limited risk

#### Indicative E&S category
- **Red**: High E&S risk
- **Blue**: Medium E&S risk
- **Yellow**: Low E&S risk

#### For the sectors...

*...the main risks are*

<table>
<thead>
<tr>
<th>Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>HR1</td>
</tr>
</tbody>
</table>
| HR2    | Charcoal making | X | X | * | * | | | X | *
| HR3    | Chemical industries | X | X | X | * | * | X | *
| HR4    | Forestry / wood production | X | X | * | X | | | |
| HR5    | Laundry services / dry-cleaner | | | | | | | | |
| HR6    | Leather production/tanning | * | | | | X | * | | |
| HR7    | Metal working /forging/electroplating | * | | | | X | | | |

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# Fact sheets per sector

## HR1 - Agricultural crop production with use of chemical pesticides and fertilizers

<table>
<thead>
<tr>
<th>SIGNAL</th>
<th>ANALYSE</th>
<th>DISCUSS</th>
<th>SUGGEST</th>
</tr>
</thead>
<tbody>
<tr>
<td>The main risks are...</td>
<td>There is a problem if...</td>
<td>Acknowledge that...</td>
<td>Suggest the client to...</td>
</tr>
<tr>
<td>... deforestation</td>
<td>Forest is managed unsustainable (illegal and/or without reforestation plan)</td>
<td>Deforestation, if not performed carefully and in a sustainable way causes land erosion and degradation, and in rainy periods increased water runoff and mud floods</td>
<td>Agree only on permitted and sustainable forms of pristine land use</td>
</tr>
<tr>
<td>... intoxication</td>
<td>No safeguards are available and/or used when necessary (mask, goggles, gloves, overall)</td>
<td>Applying/handling toxic substances with proper safeguards prevents illness</td>
<td>Not over-use chemicals</td>
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<tr>
<td></td>
<td>No relevant Chemical Fact Sheets are available</td>
<td>Safe storage prevents chemical reactions, explosion, fire, leakage and intoxication</td>
<td>Provide and use safeguards when working with chemicals (mask, goggles, gloves, overall)</td>
</tr>
<tr>
<td></td>
<td>Storage is unsafe, unlocked or located near sleeping/eating place</td>
<td></td>
<td>Create a separate storage locked away from children and located separately from living/eating place</td>
</tr>
<tr>
<td>... personal injury</td>
<td>Machines look unsafe, are ill maintained or have dangerous parts</td>
<td>Well maintained machines are safe and cheaper in use</td>
<td>Position machines on a safe spot and cover dangerous moving parts</td>
</tr>
<tr>
<td></td>
<td>No safeguards are available and/or used when necessary (mask, goggles, gloves, helmet, proper working clothes)</td>
<td>Operating a machine with proper safeguards prevents accidents</td>
<td>Take up and strictly follow maintenance routine and lubrication practices for moving parts of equipment</td>
</tr>
<tr>
<td></td>
<td>No safety precautions seem available</td>
<td>Machines can leak oil/lubricants, which might spoil drinking water</td>
<td>Keep machines clean and in good shape</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Proper safeguard measures should be available</td>
<td>Employ experienced operators only</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Provide and use safeguards (mask, goggles, gloves, helmet and proper working clothes)</td>
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<td>Re-use scrap/disposals</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>Establish contingency plans for accidents</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>Have first aid kit available</td>
</tr>
</tbody>
</table>

## Also think of...
- "...listening and disease and pest occurrence"
- "...harmful child labour"
- "...unfair labour conditions"

## Background, relevant legislation, minimal requirements
- ILO Conventions 138 and 182
- Don't install diesel generator sets without approval certificate
- Have MSDS available when working with chemicals

## Solutions, tips, further information
- Farmers should use pesticides that are permitted.
- Farmers should consider to carry out integrated pest management (biological – physical – chemical).
- Fix leaks promptly. Dripping joints can waste over 76 liters of water a day.
- In case there is no waste disposal facility: Contact (alone or in collaboration with other entrepreneurs) local council and ask for improved public service.
Guidance to implement environmental and social risk management in the MFI loan process

Figure 1. Coupling Environmental & Social issues into the loan cycle

1. Application
   - Loan application sheet

2. Appraisal
   - Loan appraisal sheet

3. Contracting & Disbursement
   - Loan contract

4. Monitoring & Reporting
   - Management Information system & Reporting (to FMO)

Use your...
- Exclusion list
- Activity Assessment matrix & Sector Fact Sheets
- Contract Clauses
- E&S Performance Reporting Sheet

To include in your...
What’s in it for the microbusiness Client?

• Reduced costs and risks

• Improved (operational) management / increased productivity

• Consumer trust and business opportunities

• Improved reputation

• Access to financial markets

… and if it is good for the client it is good for the MFI too!
So how can an MFI implement this?

The FMO Sustainability Guidance e-toolkit can help
Downloadable from www.fmo.nl