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SUSTAINABLE SME FINANCE
In Collaboration with CIB

Sustainable financing, SME, Sustainability risks

SUSTAINABLE SME FINANCE

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Outline:

- What is sustainable finance
- What are sustainability risks
- Impact of Sustainability risks on financial performance
- Importance of SME
- Why sustainability is important for SME

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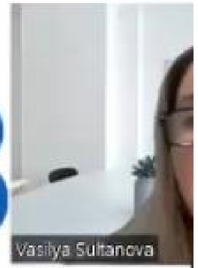

Definitions

Sustainability

Is concept of encouraging businesses to frame decisions in terms of financial, environmental (including climate, biodiversity), social and human effects ensuring resilience and long-term value creation.

FERMA Sustainability Committee.

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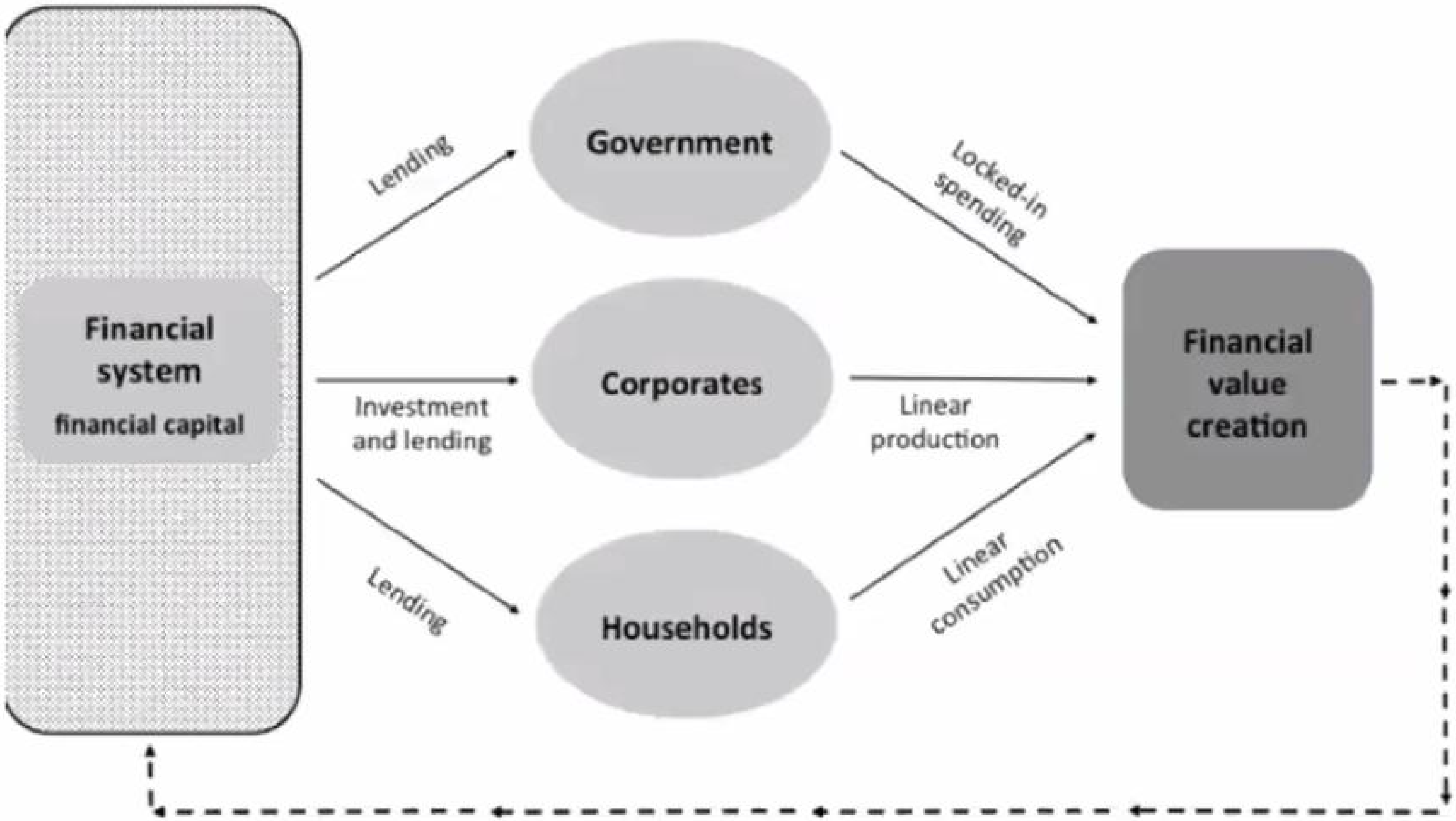
Function of financial system

The financial system traditionally is preforming following functions:

- Produces information ex ante about possible investments and allocate capital;
- Monitors investments and exert corporate governance after providing finance;
- Facilitates the trading, diversification, and management of risk;
- Mobilizes and pool savings;
- Eases the exchange of goods and services.

Traditional model



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Sustainable finance refers to the integration of environmental, social, and economic (ESG) factors into financial decision-making processes.

It involves considering the long-term impact of investments and financing activities on the environment, society, and overall sustainable development.

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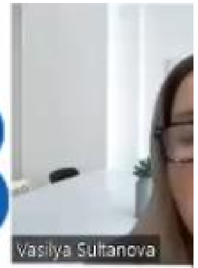

ESG Definition

Environmental criteria addresses a company's operations environmental impact, and environmental stewardship.

Social criteria refers to how a company manages relationships with and creates value for stakeholders including community development.

Governance criteria refers to a company's leadership & management philosophy, practices, policies, internal controls, and shareholder rights.

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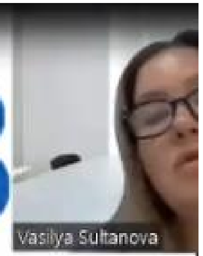

Understanding the link between Sustainable Finance and ESG.

- ESG criteria are essential in defining the nature and purpose of Sustainable Finance.
- ESG factors provide the framework that aligns financial activities with sustainable development goals.

ESG	→	Sustainable Finance	→	Sustainable Development
Defining Criteria and Risk Factors that distinguishes sustainable finance from any other type of finance	→	Powerful tool and channel to implement	→	New Growth Approach

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Key Principles of Sustainable Finance

1. Environmental Considerations:

- Promoting investments that contribute to environmental sustainability.
- Assessing the impact of projects on climate change, natural resources, and pollution.

2. Social Considerations:

- Supporting investments that foster social well-being and equitable development.
- Evaluating the social impact of projects on communities, labor rights, and human rights.

3. Governance Considerations:

- Encouraging investments in companies with strong governance structures and practices.
- Assessing transparency, accountability, and ethical behavior of organizations.

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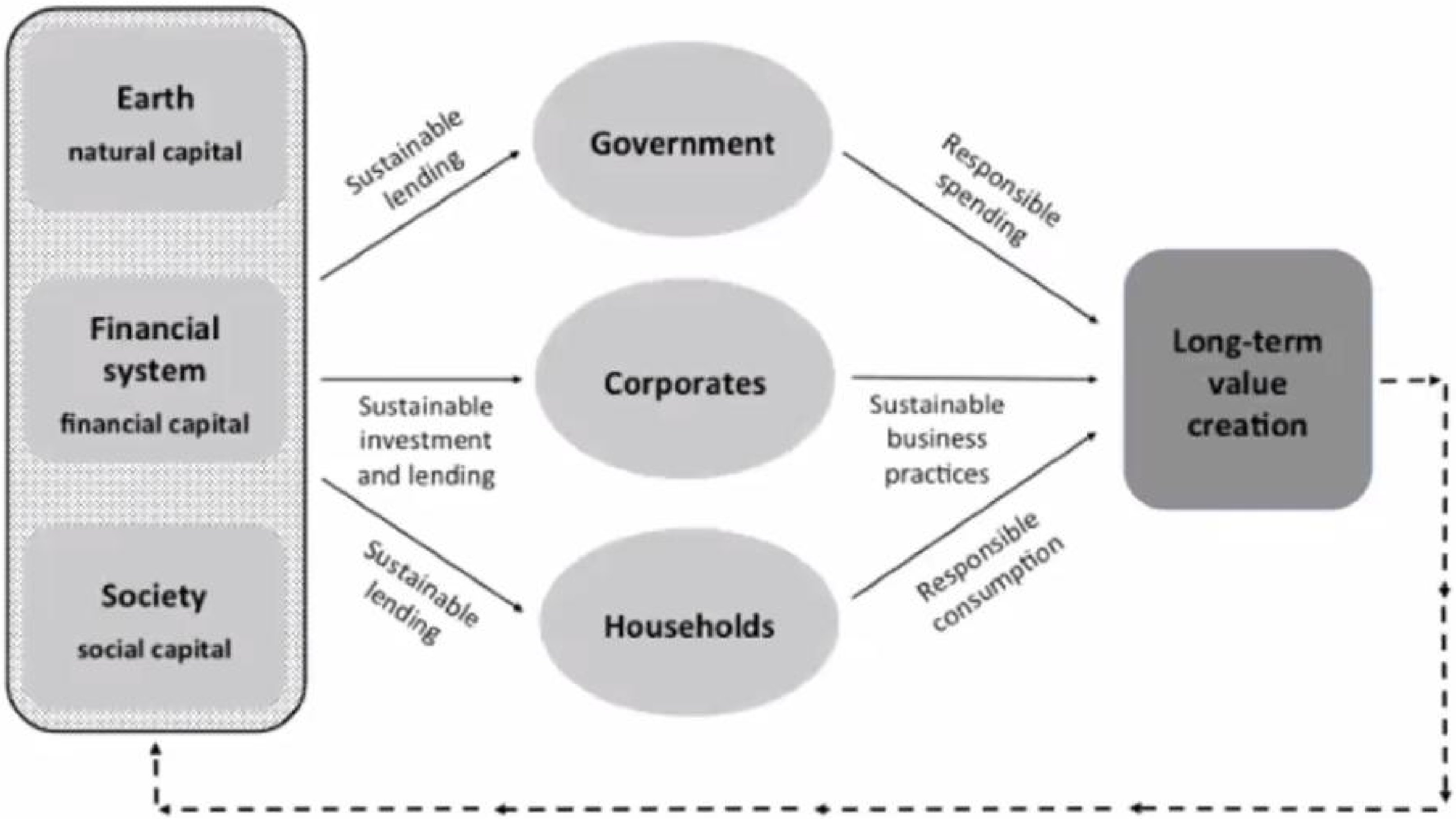
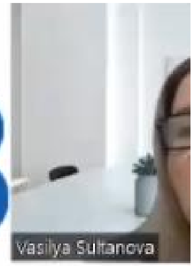
Desired model





Importance of Sustainable Finance

Sustainable finance plays a crucial role in addressing environmental and social challenges.

1. Because of Environmental Challenges (climate change, biodiversity loss, pollution and waste)
2. Social challenges(poverty, social inclusion, human rights)
3. Investors demand and market opportunities

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From Traditional to sustainable

Traditional Finance → **Sustainable Finance** → **Ethical and Philanthropic Donations**

- Primary focus: Financial Performance (RAR)
- Desired financial Returns Plus Positive Social and environmental Outcomes
- Primary Focus: Social and Environmental Performance

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The Relationship between the Finance Sector and Sustainability

The finance sector has a vital role to play in enabling us to respond to social and environmental challenges:

- Providing capital.
- Exerting positive influence on companies and other actors.
- Supporting government efforts to build a more socially and environmentally sustainable economy.
- Acting as an example for others to follow.

In recent years, companies across the finance sector have committed to sustainability, through/by:

- Funding companies and activities that have positive impacts.
- Encouraging others to better manage their own impacts.
- Managing and disclosing the social and environmental risks they are exposed to.
- Establishing collaborative initiatives.
- Developing new financing instruments.
- Calling on governments to take further action on climate change and biodiversity issues.

However, there are significant barriers to progress:

- Emphasis on short-term financial performance over longer-term sustainability considerations.
- Lack of consensus on what constitutes green or sustainable companies, projects or activities.
- Weaknesses in regulatory frameworks.
- Lack of demand from customers and clients.

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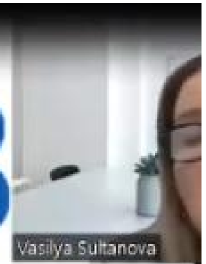
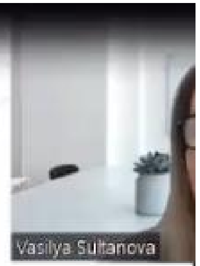


Definitions

Sustainability risk:

Is uncertain social or environmental event or condition that, if it occurs, can cause significant negative impact on the company. It also includes the opportunity that may be available to an organization because of changing social or environmental factors

(wbcsd and COSO).



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ESG is Not only a defining Criteria but also act as a non-financial risk framework

ESG has three defining dimensions

Defining Criteria + Risk Factors + Opportunity Determinant

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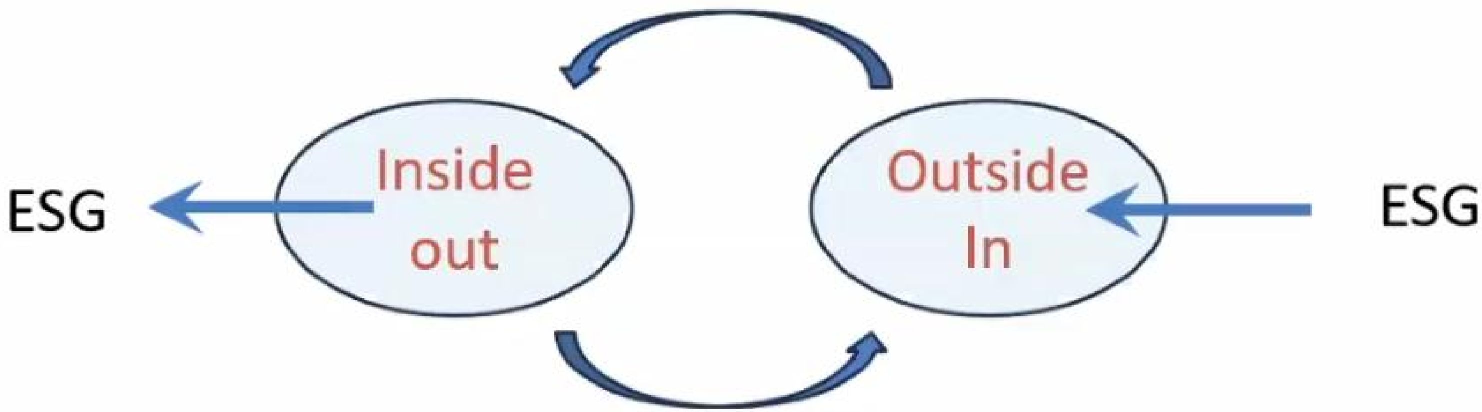
ESG as a Risk Factor

- ESG risk refers to the potential negative impact on a company's financial performance and reputation due to inadequately managing Environmental, Social, and Governance factors.
- It also refers to the potential negative Environmental, Social, and Governance impact on the market and society at large.



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ESG as Risk Factor

Environmental Risk relates to environmental factors such as climate change, pollution, and resource depletion.

Social Risk pertains to social factors like labor practices, human rights, and community relations.

Governance Risk involves governance factors such as board structure, executive compensation, and transparency.

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ESG as a Sustainability Risk Factor

- After understanding the risk dimension of ESG, this section discusses the scope of ESG risk .
- ESG risk has two main streams :

  - Intensifying traditional risks
  - leading to physical and transitional risks

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ESG-Related Financial Performance Risks:

- ESG (Environmental, Social, and Governance) risks can have significant impacts on traditional financial risks that a company faces. Here are potential impacts and how they relate to traditional financial risks:

1. Credit Risk:

- **Impact:** ESG risks can affect a company's creditworthiness by increasing the likelihood of default on debt obligations.

Example: If a company faces increasing environmental liabilities or reputational damage due to social issues, it may have a harder time securing loans at favorable terms.

ESG-Related Financial Performance Risks:

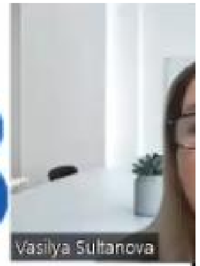
2. Market Risk:

- **Impact:** ESG factors can influence market risk, including volatility in stock prices and asset values.

3. Operational Risk:

- **Impact:** ESG risks often translate into operational risks, which can disrupt a company's business activities and impact its bottom line.

Example: Supply chain disruptions due to environmental factors like extreme weather events can lead to production delays and increased costs.



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ESG-Related Financial Performance Risks:

4. Reputational Risk:

- **Impact:** ESG risks are closely tied to reputational risk, which can result in significant financial losses if stakeholders lose trust in the company.

Example: A scandal related to poor governance practices can lead to customer boycotts, reduced sales, and brand devaluation.

5. Legal and Regulatory Risk:

- **Impact:** Non-compliance with ESG-related regulations and legal obligations can result in fines, penalties, and increased legal expenses.

Example: Violating environmental regulations may lead to substantial fines and costly cleanup efforts.

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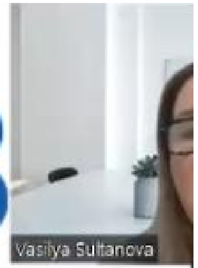

ESG-Related Financial Performance Risks:

6. Liquidity Risk:

- **Impact:** ESG risks can affect a company's liquidity by limiting access to financing and capital markets.
- **Example:** Investors may avoid companies with poor ESG practices, making it difficult to raise funds through bond offerings or equity issuances.

7. Investment Risk:

Impact: ESG risks can influence investment decisions, potentially affecting a company's access to capital.

Example: Investors may shift their portfolios away from companies with poor ESG records, reducing demand for their shares and bonds.

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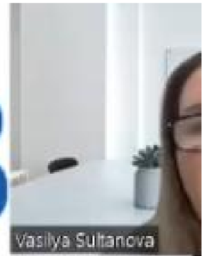
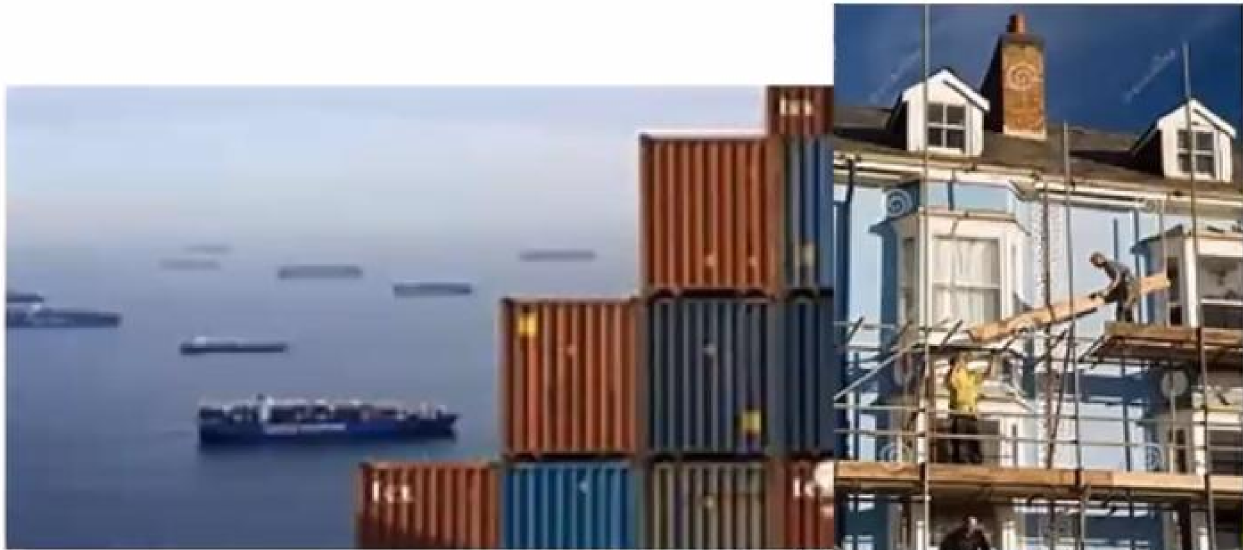
ESG-Related Physical Risk:



- Definition: ESG-related physical risk refers to the potential financial and operational impacts that arise from the physical manifestations of environmental and social factors.

- Nature: These risks result from climate change-related events (e.g., floods, wildfires, storms), resource scarcity, and social disruptions (e.g., labor strikes, community protests) that directly affect a company's assets, operations, and supply chains. Examples?



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ESG-Related Transition Risk:

Definition: ESG-related transition risk encompasses financial risks associated with the transition to a more sustainable, low-carbon, and environmentally responsible economy.

- **Nature:** These risks arise from changes in regulations, technologies, consumer preferences, and market dynamics that may impact a company's existing business model and assets. Examples ?

JAGUAR AND LAND ROVER RECALL

Over 44,000 vehicles affected due to excessive CO2 emissions

Model	Years affected
2.0-litre petrol	
Land Rover Discovery	2016-2018
Land Rover Discovery Sport	2016-2018
Range Rover Sport	2016-2018
Range Rover Velar	2016-2018
Range Rover Evoque	2016-2018
Jaguar XE	2018
Jaguar XF	2018
Jaguar F-Pace	2018
Jaguar E-Pace	2018
Jaguar F-Type	2019
2.0-litre diesel	
Range Rover Evoque	2016-2018
Jaguar XE	2016-2018
Jaguar XF	2016-2018

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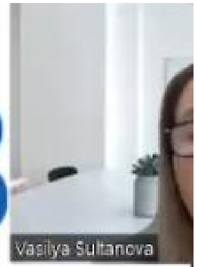
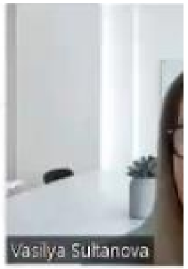


ESG as Opportunity Determinant

- The other side to ESG risk factors is the ability to scout for market and business opportunities in markets both domestic and international depending on the scope of operation of organisations.

- Understanding your ESG risks and points of strength can help create value to the business by determining new market niches and products and opportunities that align with business priorities and growth trajectories.

- Often determining ESG risk and opportunity drivers come hand in hand and developed within the same risk framework.



ESG is good for Business

- Corporate Reputation
- Opportunity Management
- Risk Reduction
- Culture & Intrinsic Value

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Introduction to SMEs

- Small and Medium enterprises (SMEs) represent the main catalyst of economic development.
- Small and medium sized businesses contribute intensely to achieving the fundamental goals to any national economy, becoming the backbone of social-economical progress.
- The SME sector plays an extremely important part in modern economy, proving to be the most attractive and tremendous innovative system.
- The vital contribution to SME in economic development is a reality unanimously recognized. Showing their economically and socially beneficial effects led to the consideration of the SME sector as a field of strategic interest for the economy.

Introduction to SMEs

- SMEs have always played a very important role in economic and social life of any country, being the basis of the development of the economy.
- SMEs are categorized by their dynamism, flexibility, adaptability, mobility and their innovative potential.
- SMEs are considered to be essential for the harmonious development of the economy, and may ensure the cohesion of the economic structure, good economic growth and, of course, creation of new jobs.

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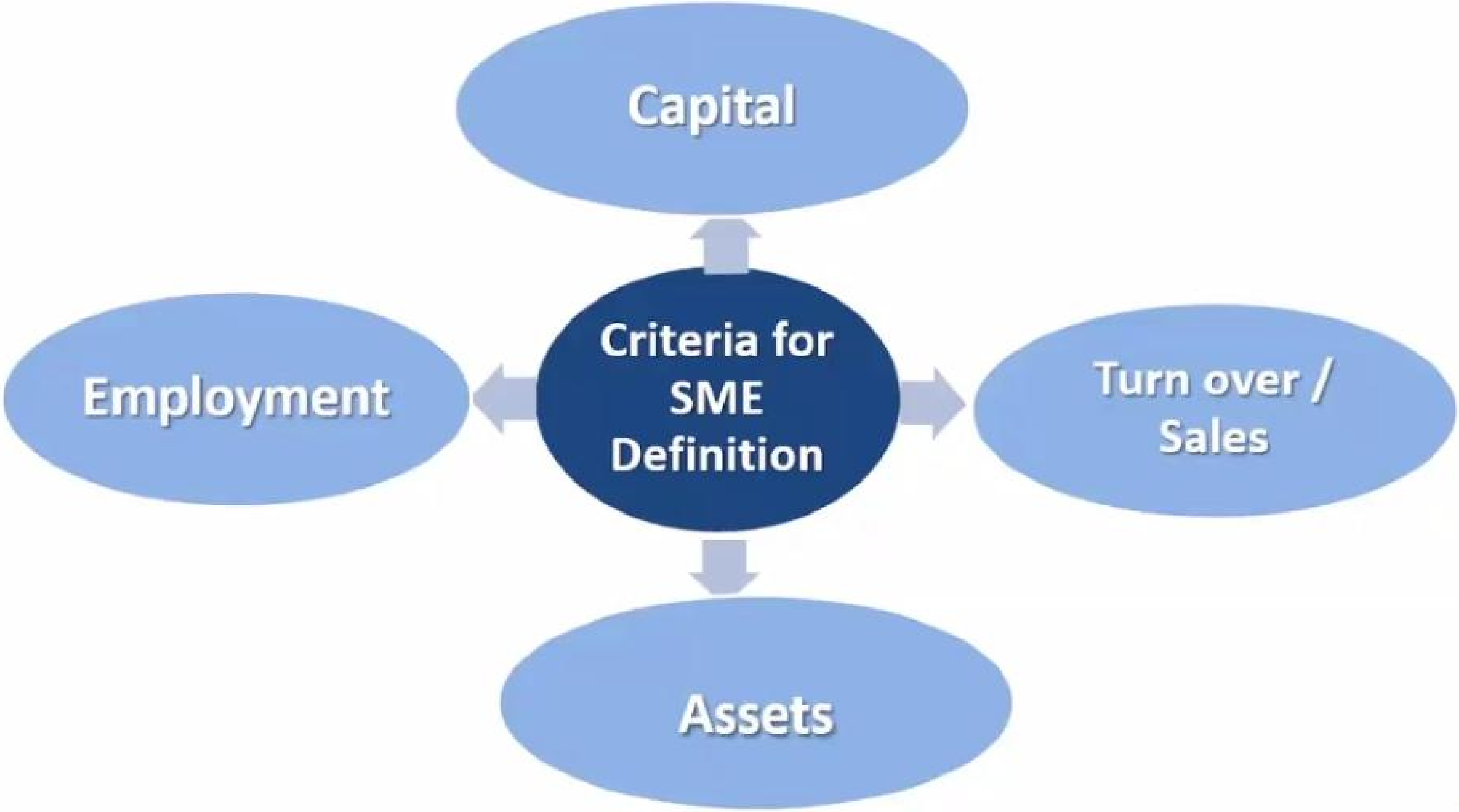
But how do we identify enterprises as Small and Medium Enterprises (SMEs)? What are the common criteria for a definition?

Introduction to SMEs - The Definitions of SMEs – Criteria



Introduction to SMEs - Selected Definitions of SMEs

- To understand the global structure of SMEs, we are presenting some selected examples of SMEs worldwide

Source	SMEs	
	Small	Medium
IFC/World Bank (Employees)	10-50	300
OECD	20-99	100-499
USAID (Employees &Assets)	<15 and <L.E.25,000	
EU Countries		

EU Countries:

Company category	Staff headcount	Turnover	or	Balance sheet total
Medium-sized	< 250	≤ € 50 m	≤ € 43 m	
Small	< 50	≤ € 10 m	≤ € 10 m	
Micro	< 10	≤ € 2 m	≤ € 2 m	

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Introduction to SMEs - SMEs Definition in Egypt

- The updated definition of MSMEs in Egypt as per law 152 of the year 2020 distinguishes between micro, small, and medium enterprises. It also differentiates between existing and startup enterprises as follows:

	Annual Turnover (EGP) (existing)	Newly Established Enterprise** Capital (EGP) Manufacturing Sector	Newly Established Enterprise** Capital (EGP) Non-Manufacturing Sector
Micro	< 1 mn	< 50 K	< 50 K
Small	1 mn - < 50 mn	50 K - < 5 mn	50 K - < 3 mn
Medium	50 mn - < 200 mn	5 mn - < 15 mn	3 mn - < 5 mn

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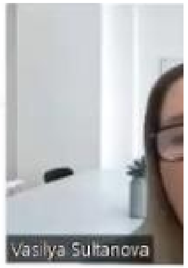
How can SME play a role

in the Economic Development ? .



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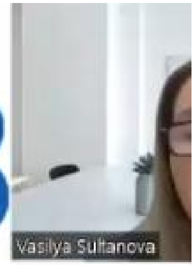

Role of SME in Economic development

- 99% of the world Economic Enterprises are SMEs
- Around the world, SMEs account for 55-95% of country GDP
- More that 50% of the world Labor Force are employed by SMEs
- Globally, SMEs generate the largest number of new employment opportunities each year
- SMEs are the most dynamic components of the world economy
- SMEs are essential for economic and social progress

SMEs and Finance

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The Importance for SME Financing for Banks

Financing SMEs through banks contributes to:

- Avoiding concentration level in banks' Portfolio
  - Financing SMEs results in less concentration in lending portfolios
- Reducing risk in banks
  - Distribution of lending over a larger number of clients working in diversified activities reduces risks
- Increasing the number of clients and achieving financial inclusion
  - Offering financial services to a larger number of clients expands banks clients base and contributes to financial inclusion.

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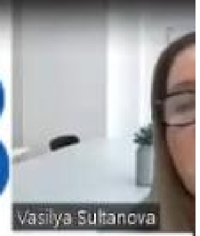

The Importance for SME Financing for Banks (cont.)

Financing SMEs through banks also contributes to:

- Increasing the number of financial operations and transactions in banks
  - Offering financial services to SMEs achieves an increase in profitability over the long term as it contributes to the increase in number of transactions
- Building up client base with growth potentials
  - SMEs tend to grow their operation and hence move up-wards into larger enterprises.

If Banks that do not offer services to SME clients their client base will not expand and hence will not develop and grow their activities and profitability

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Why is it important to engage SME in sustainability

Consumer Behaviour

There are many reasons why SMEs should embrace sustainability but the most compelling of all is the change in consumer behaviour. Gen Z was the first to champion sustainable buying and has since influenced the buying trends of older generations. A World Economy Forum survey reports that consumers of all generations are more willing to spend on sustainable products compared to 2 years ago. Therefore, it is just good business sense to adopt ESG.

The Edelman Trust Barometer Report 2022 which surveyed over 1,500 respondents found that 81% of Malaysians consider climate change a cause for concern and feel that institutions are not responding adequately to tackle climate and societal (economic inequality, systemic injustice) issues.

Attracting Talents

The younger generations in the workforce are more aware of the effects of climate change on the environment and are more inclined to work with ESG compliant companies. In a study conducted by Deloitte across 45 countries, 49% of people aged 18-25 and 44% of people aged 26-38 chose to work for ethical and environmentally conscious companies. With the direction the employment market is taking, sustainable companies would find it easier to attract highly skilled and motivated talent.

Supply Chain Due Diligence

Multinationals around the world are demanding that their value chains adopt sustainability, whether by their own initiative or by a government / regulator push. Being ESG-ready is a huge plus for any SME in bidding for contracts, and improves the company's competitiveness in not just the local market, but internationally. In the local setting, more large Malaysian corporations are ramping up their sustainability reporting efforts and enforcing requirements on their value chain partners to adopt sustainable practices, engage in sustainable procurement and keep track of sustainability-related data.

Access to Finance

Adopting ESG practices means reducing the risk perceived by bankers and financiers, allowing SMEs access to cheaper funding. Non-compliance with ESG criteria results in SMEs experiencing difficulty in accessing financing or being sidelined by investors.

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What are benefits of ESG to SME

- For small and medium-sized enterprises (SMEs), ESG may seem like a daunting or irrelevant topic. SMEs may think that ESG is only relevant for large corporations or that they lack the resources or expertise to implement ESG initiatives. However, this is not the case.

ESG can offer significant benefits for SMEs, such as:

1. Enhancing competitiveness and innovation: ESG can help SMEs differentiate themselves from their competitors and attract new customers who value sustainability.
2. Improving operational efficiency and resilience:
3. Increasing access to finance and markets:
4. Boosting human capital and stakeholder relations

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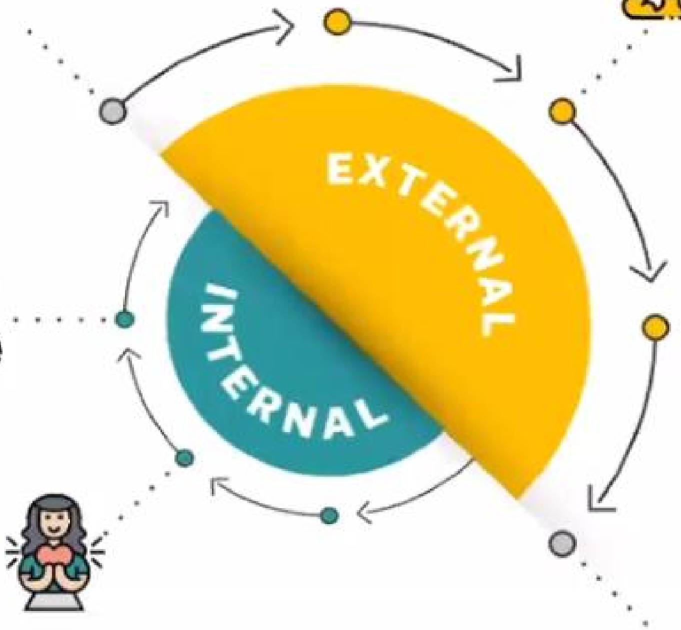
What are benefits of ESG to SME



Boosts Competitiveness & Resilience

> Markets are more keen to do business with ESG compliant companies

Improved Cost Effectiveness

> Efficient use of resources and recycling of materials go a long way in managing costs

Reputation & Positioning

> ESG compliance ope new market segmen and attracts new customers

Increased Employee Motivation & Loyalty

> An alignment in the employee's and employer's sustainable visions creates emotional bonds and builds loyalty

Sustainability related risks for SME

On top of the systemic, economic and societal threats for businesses (and livelihoods) that climate change will bring, some of the most immediate sustainability risks that SMEs may face include the following:

- Outdated business model:
- Losing out in competition:
- Regulatory requirements:
- Non-regulatory requirements:
- Less access to finance:
- Stranded assets:
- Supply chain related risks:

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What could be solution

The purpose of risk management is not to eradicate all risks, but rather to enable taking the right risk for the right return

. This requires:

- knowing the nature of potential risks affecting one's business
- being aware of the likelihood and possible impact of the risk materializing
- deciding what risks to focus mitigation on
- designing and executing the risk mitigation strategies

Based on these general principles, a robust sustainability risk management framework for SMEs consists of the following five key steps:

1. **perform a risk assessment by mapping your supply chain, business model and operations to identify potential sustainability risks and impact**
2. **prioritize the identified risks**
3. **take action to integrate risk mitigation techniques in business processes and where relevant, collaborate with supply chain partners to address risks**
4. **monitor progress and evaluate**
5. **communicate and report about your policies, activities, progress and metrics**

Obstacles for SMEs in reach of sustainability

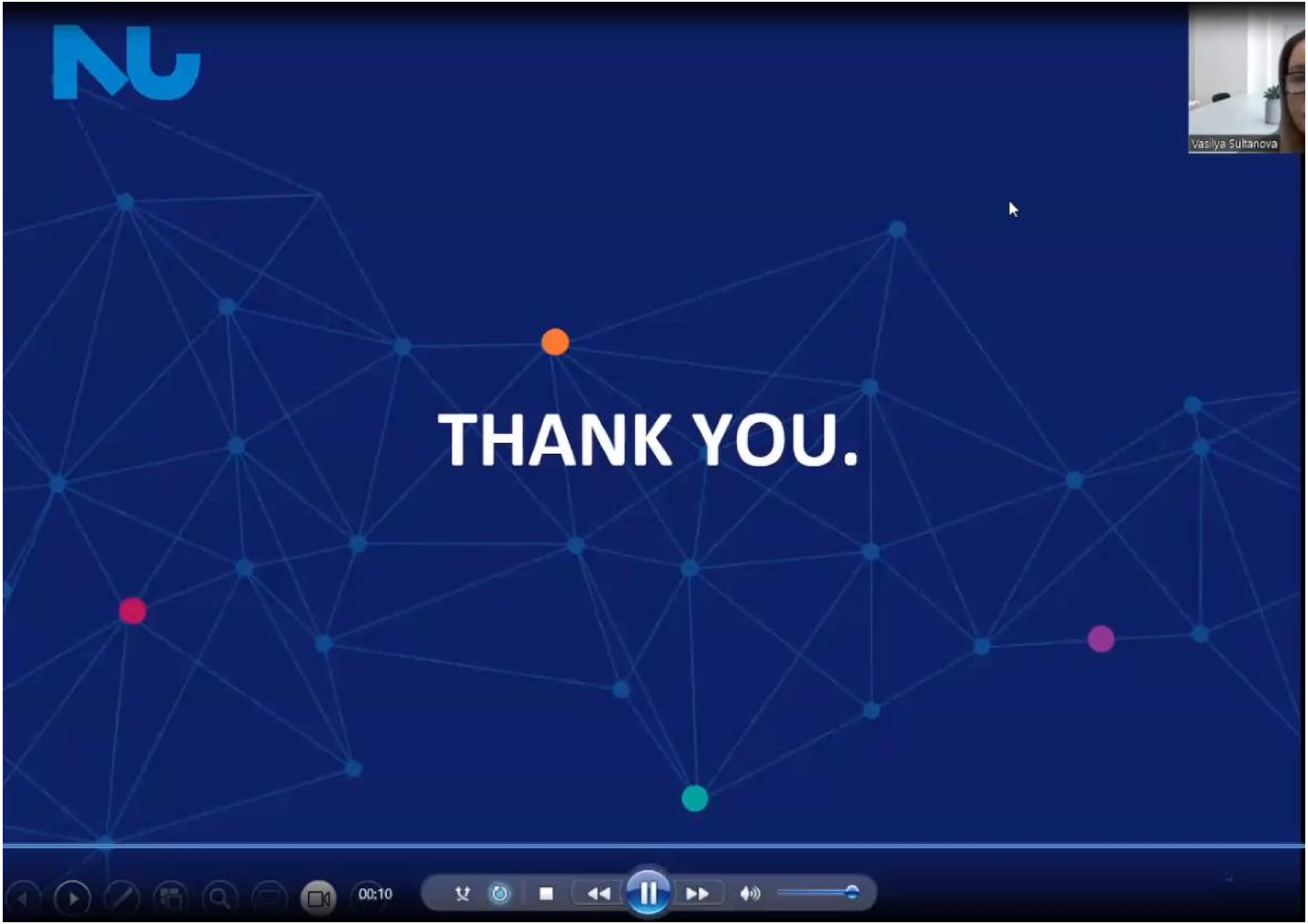
Without involving the SME sector, generating a meaningful and resilient sustainable transition of the economy will be impossible.

Although some SMEs are already highly active in environmental, social and governance (ESG) issues, many others have not yet addressed them.

This can be seen for example with ESG reporting, where in the Global Reporting Initiative's (GRI) Sustainability Disclosure Database only between 10 -15% of all the sustainability reports in 2017- 2018 came from SMEs – despite them being far more numerous than larger firms in purely quantitative terms.

The reasons for this include SMEs' lack of:

- resources: most SMEs have a very lean management model with key staff and owner managers having multiple roles in the day to day running of their business. They often lack the internal resources to plan for the medium to longer term and deal with such issues as sustainability.
- awareness among business owners and employees about sustainability's importance and potential impacts
- access to financing


THANK YOU.
Vasilya Sultanova
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