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POLICY BRIEF

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THE CENTRE FOR RESEARCH ON FINANCIAL MARKETS AND POLICY®

Commercial Banks ESG integration and MSMEs support: Evidence from Kenya

Executive Summary

Amid the changing global financial terrain, financial institutions have been in the forefront of adoption and implementation of Environmental, Social and Governance in their pursuit of offering sustainable financing to businesses. This is underpinned on the ability of ESG adoption in unlocking access to green financing from development partners by commercial banks. However, despite commercial bank's pursuit for sustainable financing Micro, Small and Medium-sized Enterprises continue to critically suffer from sustainable financing challenge. Against this backdrop, the study examines how banks' ESG integration affects MSMEs support through entrepreneurial training and lending. The key finding is that banks ESG adoption significantly increases the MSME. Conversely, banks' ESG adoption has a positively but insignificantly effect on MSME lending. The results conclude that banks' training to MSMEs is necessary but not sufficient for increased MSME lending. The finding calls for capacity enhancement among the MSMEs beyond training to create a viable pipeline for absorption of sustainable funding by businesses. Furthermore, is the Fastracking on banks' sustainability tracking and reporting that is crucial for Kenya Green Finance Taxonomy implementation.

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The Centre for Research on Financial Markets and Policy®

The Centre was established by the Kenya Bankers Association in 2012 to offer an array of research, commentary, and dialogue regarding critical policy matters that impact on financial markets in Kenya. The Centre sponsors original research, provides thoughtful commentary, and hosts dialogues and conferences involving scholars and practitioners on key financial market issues. Through these activities, the Centre acts as a platform for intellectual engagement and dialogue between financial market experts, the banking sector and the policy makers in Kenya. It therefore contributes to an informed discussion that influences critical financial market debates and policies.

1. Context and Importance

Micro, Small and Medium-sized Enterprises play a crucial role in economic growth and development. In Kenya, it the most recent analysis estimates that the sector employs over 15 million people and contributes about 30% to the national value-added. However, despite their pivotal role in the economy, MSME's access to formal credit has been hindered largely by lack or inadequate collateral. In efforts to support MSMEs operations commercial banks have been intentional in setting aside sizeable proportions in their balance sheet directed towards MSMEs support. Evidently, in 2024, banks did commit Kes150 billion towards supporting MSMEs over the next three years as part of the banking sector's commitment to support MSMEs access more affordable credit to boost their growth and development. In addition, commercial banks have mobilized different lines of credit from development partners directed towards MSMEs lending across various sectors.

The quest for sustainable financing has gained traction among Kenyan banks currently. This is evidenced by banks' pursuit for sustainability in their lending and internal operations. Environmental, Social and Governance adoption is one of mechanisms banks are integrating in furthering their sustainability agenda. A review of Environmental, Social and Governance score cards among Kenyan commercial banks' sustainability reports, reveals presence of Environmental, Social and Governance targets that are MSMEs specific. This confirms the bank's keen focus on MSMEs as key economic growth driver. Against this background, it is important to examine how the adoption and integration of ESG practices among Kenya banks affects MSMEs support.

2. Methods and Results

The study utilized bank – level based focusing on Kenyan commercial banks that have integrated Environmental, Social and Governance practices in their operations over years. Specifically, the study utilized data for 5 tier 1 banks that have pioneered Environmental, Social and Governance practices adoption and publish annal sustainability report. Data is extracted from banks' ESG performance scorecard collaborated with data from annual integrated reports. MSME support is measured by MSME entrepreneurial training and MSME lending. Environmental adoption is measured by bank's green lending portfolio in a year, while social responsibility adoption is measured by number of bank branches, net loans and advances, economic value distributed and percentage of transactions on digital channels. Corporate governance principles adoption is measured by percent of women in the board, board independence and proportion of female staff in total workforce.

Panel data analysis is employed with random effect model adopted in fitting the empirical models. The results indicate that integration of ESG practices among banks has a positive but insignificant effect on the number of MSMEs supported by banks via training. However, on the contrary adoption of ESG practices by banks does not translate to more green lending by banks to the MSMEs implying inadequate capacity for MSMEs to access green financing despite banks holding such portfolio.

3. Policy Recommendations

The key policy issues arising from the study are:

- Importance for capacity enhancement among the MSMEs on sustainability to create a viable pipeline for drawing down of green finance credit line from development financing institutions is hereby underscored. The study findings indicate that MSMEs training does not necessarily translate to more MSME lending. Therefore, MSMEs capacity enhancement beyond training is crucial for increased absorption of green and sustainable funds mobilized by the commercial banks. This is crucial in lowering costs mainly associated with green and sustainable credit line for the commercial banks.
- Secondly, there is the need for phased adoption and implementation of ESGs among commercial banks. Given the different effects of different ESG attributes on MSME training and MSME lending, there is need for incremental adoption of ESG practices among commercial banks. This is crucial for a learning curve around ESG adoption and effects on MSMEs. Further, this is crucial in cushioning the bank from subjecting itself to stringent ESG audit in attempt to access green finance from development financial institutions and development partners but later be faced with difficulty in fund draw down by targeted MSMEs thus being costly to the bank in the long run.
- Lastly, is the sensitization on ESG reporting through sustainability reports among commercial banks given the low reporting rates. As we near the mandatory ESG reporting deadline, more capacity enhancement on reporting and sensitization is needed for effective adherence and compliance. This will also be crucial for the implementation of the Kenya Green Finance Taxonomy developed by the Central Bank of Kenya.

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