CHAPTER 9

Credit and Risk Assessment

CSR Tools for Local Government, Financial Institution and SMES

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Introduction

The corporate social responsibility construct (CSR), originally thought for large companies to cope with social and environmental issues for the sake of their brand and the public perception, is today relevant also for small medium enterprises (SMEs). The evolution of the concept so far, according to the last European definition (COM 2011), brought to interconnect CSR and long-term sustainability of business of all size, including SMEs. Considering the networked environment and the relations along the supply chain globally, large companies increasingly work with SMEs as suppliers, and if large companies are committed to CSR, this leads to ask their suppliers to comply with CSR too.

Moreover, the financial instability, sharpened by the crisis, when it comes to management practices in the credit-rating process, increases the attention of financial institutions about assets, securities, lending, loans, and mortgages. In this regard not only the listed companies but also SMEs defining a CSR strategy are more trustful, as they demonstrate the ability to repay their loans thus obtaining credits.

The European Commission has published a CSR Action Plan to spread good CSR principles across Europe, pushing for higher standards and best practice in this area. Moreover, the recent Directive 2014/95/EU of the European Parliament about disclosure of "nonfinancial and diversity information" for listed and large companies, stresses furthermore the relevance to provide nonfinancial information (social and environmental) into the financial reports of balance sheet. Specifically, by measuring a number of social and environmental issues, sustainable companies can better manage their risks and result in a higher credit worthiness. Despite the high number of well-known CSR standards (OECD Guidelines for Multinational Enterprises; UNI:ISO 26000; United Nations (UN) Guiding Principles on Business and Human Rights; ILO Standard; social accounting standard "Global Reporting Initiative" (GRI); Accountability 1000 (AA1000); Social Accountability 8000 (SA8000); Green Public Procurement [GPP] and Social Public Procurement [SPP] framework; COM 2011; the Report of the European Parliament 6.2.2013), at a national level, each member state developed its own CSR role. The Action Plan played by the public actor has always been relevant, rang-ing from financially supporting CSR through specific policy instruments (e.g., incentives, fiscal deduction, etc.), to promoting CSR culture and attention to social and environmental impacts. The development of CSR platforms of indicators supports banks and governments in assessing companies' capabilities to create value and to manage their risks, thus obtaining a lower risk of default. We will analyze the best practice of Italy in the development of such a platform for measuring a strategic, inno-vative, socially, and environmentally oriented competitiveness aimed at determining the impact of companies on society.[1]

The Relation Between Responsible Business and Financial Sector

Lots of studies highlight the advantages to be a socially responsible company: increased reputation and trust of partners, lower costs related to workers and company management, increased productivity of human resources, lower contributions for insurance against industrial injuries,

[1] The Project has been presented in Germany and Denmark in 2014, by the Italian Regions and Ministries, as partners of "DIESIS" EU project. See www.lavoro.gov.it, www.formez.it, http://pcnitalia.mise.gov.it

improved safety in the workplace, more sales and customer loyalty, lower costs of supply, growth of the total value of the company in terms of intangibles (Berman et al. 1999; Christmann 2000; Graves and Waddock 2000; Griffin and Mahon 1997; Margolis and Walsh 2001; Moskowitz 1972; Richardson, Welker, and Hutchinson 1999; Rochlin and Christoffer 2000; Russo and Fouts 1997; Wood and Jones 1995).

Nevertheless, in the relation between businesses and the financial and public system (banks, mutual guarantee societies and guarantee funds, local government), CSR practices do not automatically lead to a positive evaluation by, for example, the financial institutions.

Therefore, the proposal of a CSR platform mapping companies' actions and providing CSR indicators for medium and small business enterprises (MNEs and SMEs), leads to recognize CSR practices as signs of credit capability, value production, and company's riskiness. The CSR platform, whose first goal is to drive companies toward a sustainable competitiveness, serves also as an instrument to detect the main risky areas of companies' value chain and operations. Socially responsible companies in fact, besides producing higher ROE and turnover per worker, are less subject to market volatility, affected by external shocks (Webley and More 2003; Wood and Jones 1995).

In the "overriding procedure" the financial sector, according to the "Basel Capital Accord," began to consider not only the quantitative data taken from financial reports, but also "collaterals," or qualitative components hugely affecting the "risk" factor in the specific sectors of activity.

The adoption of some specific CSR practices (mainly qualitative components) leads also to diminish risks such as a negative impact on cash flows, or worse relations with major stakeholders and strategic partners. A socially responsible leadership is more likely to result in lower absenteeism and turnover, it lowers training costs; by increasing employees' loyalty, it reduces strikes and disputes arising for unfair competition (Fombrun and Shanley 1990; Zyglidopoulos 2002; McWilliams and Siegel 2001); by increasing involvement of local communities and consumers, it leads to lower risks of boycotts and litigations; finally bettering health and safety conditions, it diminishes injuries and social costs (Barney and Hansen 1994; Nahapiet and Ghosal 1998; Waddock and Graves 1997).

An environmentally responsible leadership, adopting procedures and plans for managing crises, or insurances against the environmental risks, reduces costs and losses in case of specific problems in this area (Godfrey, Merrill, and Hansen 2009). Lastly, considering the risks along the supply chain, socially responsible companies controlling the supplier from an ethical point of view (e.g., adopting codes of conduct, safety standards etc.) contribute to limit risks related to safety and the interruption of production, thus providing financial institutions with a higher guarantee of their activity.

One of the main tasks of governments is to promote training programs at company level. The best investment for governments to make human capital grow on CSR is to offer education and training on environmental issues, respect for diversity and human rights, and transparent accountability. Public players are also required to implement rebalancing policies, supporting sustainable competitive system and responsible companies (e.g., incentives and financial helps) and discouraging irresponsible businesses (Albareda et al. 2007; Albareda et al. 2008).

Toward the CSR Italian Platform

The effort to encourage responsible business at regional level leads to develop a mix of compliance requirements and voluntary measures, often difficult to evaluate because of their incomparability. In 2012, the Italian government (including the Ministry of Economic Development, Labor and Agriculture, the Italian Regions, OECD-Italian National Contact Point and the Italian institute against industrial injuries [INAIL]) started a project aimed at creating a common scheme for regions willing to sustain innovative socially responsible oriented firms.[2] The project, in 2014, produced a very simple online check-board tool, through which SMEs—but also MNEs—can proceed with a self assessment, obtaining a CSR diagnosis. One of the best results of this tool is to help SMEs to

[2] The project has been funded by the Italian National OECD Contact Point and the Ministry of Development. The sample of SMEs and MNEs participating in the survey so far is around 7,000 companies and the project is on going.

recognize if they are already a CSR-oriented company. Very often, SMEs are unaware of what they are doing, the so called "implicit CSR" (Matten and Moon 2008) or "sunk CSR." The second result of the platform is that SMEs, recognizing their CSR profile, improve their attractiveness facilitating their involvement in the supply chain of sustainable MNEs.

The tool unifies CSR indicators for MNEs and SMEs, regional standards, INAIL standard, and key performance indicators of GRI standard in a unique platform, capable to evaluate in depth the positive externalities of business, their social and environmental performances, and the respect of requirements included in tenders, and call for funding (e.g., the EU funding program 2014 to 2020).

The Italian Platform of Actions and Indicators for a Strategic, Innovative Socially and Environmentally Oriented Competitiveness

The project was proposed by 15 Italian Regions, supported by the Ministry of Economic Development, the Ministry of Labor and Social Policies and INAIL, committed since years in fostering the social responsibility of the firms through the development of initiatives and specific policy instruments (e.g., incentives, fiscal deduction).

The most common and well-known CSR standards (OECD Guidelines, UNI ISO 26000; UN Guiding Principles on Business and Human Rights; ILO; GBS Standard, GRI, AA1000SES, SA8000; GPP-Green Public Procurement; SPP-Sustainable Public Procurement; COM 2011-A renewed EU strategy 2011-14 for CSR; other 10 regional standards) have been systematically revised in order to filter out principal areas and indicators. Results have been validated by key testimonials (Entrepreneurs, Business networks, Business Association, Academics, public actors, Trade Unions, NGOs).

The final framework recognizes six strategic areas of CSR actions:

- Business organization and administration (governance and business model)
- People and work environment

- Clients, customers, consumers
- Suppliers
- Natural environment, local community, and relation with the public government
- Innovation and competitiveness

For small, medium, and large firms (excluding only the *micro*enterprises), a set of specific indicators, namely indicators for the "management of major risks," identify five major areas of sector-specific risk:

- Food industry and agriculture
- Building, construction and manufacturing
- Pharma
- Business facilities, finance, banking, insurances
- Utilities (energy, water, electricity, gas, waste recycling)

The entire system helps companies of different size to test their CSR areas, through a material evidence: the platform provides information for firms suggesting how they can provide a "proof" of their CSR behavior (internal documents, corporate statement, policies etc.); this, in turn helps the public administrations to check the material evidence of a CSR practice. Moreover, the platform provides concrete indications to companies to enhance their sustainable competitiveness (Porter and Kramer 2006; Porter and Kramer 2011; Crane et al. 2014) by suggesting how to:

- Focus on relevant stakeholders in order to correspond efficiently their needs
- Minimize philanthropy as spot initiative, not aligned with innovation and strategy of the firms
- Select actions leading to economic advantages and competitiveness
- Establish robust relation with stakeholder and reduce their own risk (thus reducing their own capital cost, see the agreements with banks and the calculation of the probability of default, according to Basel-II financial and bank rating standard)

- Build a better reputation, foster commitment of the employees, identify new business opportunities, and reinforce productivity
- Identify the corporate contribute to the society
- Better design the "value chain," by defining organizational process and products in a CSR perspective
- Nurture innovation
- Valorizing the relation between firms, territories, and local communities
- Integrate sustainability into management, planning, control systems performance assessment methods to which are generally associated premium, strategic plans, budget, project management and "management by objective" (MBO)

The main feature of this platform is to link environmental and safety issues to the concept of risk. Risks' analysis, in fact, cannot forget indicators affecting the natural environment or health and safety, according to the sector of activity. An assessment that does not take into account the environmental and social aspects, could not figure out if a company has managed well its own risk. Any action related to ethical and sustainable business process at higher risk, may:

1. Limit the risks of the event that cause a negative impact on cash flow, such as a fine or other penalty tax, economic fine or temporary interdiction
2. Limit the possibility of abandonment of the company, by some of its strategic partners
3. Limit forms of contrast (boycott)

Regarding the usability of the Platform, it is highly company friendly, with a small number of relevant core indicators, strictly related to the core business and to the highest risky internal process. To provide an example, an SME operating in textile and garments, could check actions referred to workers conditions, customers, suppliers, and environment; the tool suggests to check actions regarding the supply chain, because in this sector the main risk concerns human rights of workers located in far countries, where health and safety conditions are not protected as in Europe. Key performance indicators following the international social reporting standard "GRI"[3] are as follows:

- "Operations and suppliers identified in which the right to exercise freedom of association and collective bargaining may be violated or at significant risk, and measures taken to support these rights" (GRI social accounting standard; "Human rights" section HR4)
- "Percentage of new suppliers that were screened using labor practices criteria" (GRI social accounting standard; "labor practices and decent work" section LA14).

In the case of "environment," as the process is recognized as the most risky:

- "Monetary value of significant fines and total number of nonmonetary sanctions for noncompliance with environmental laws and regulations" (GRI social accounting standard; "environment" section EN29);
- "Percentage of new suppliers that were screened using envi-ronmental criteria" (GRI social accounting standard; "envi-ronment" section EN32).

Companies applying this approach—that is, including environmental, social and governance indicators (ESG) or CSR criteria into Basel financial rating are among others: Generali Investment management companies (IMCO), Intesa Bank Imco, Caisse des Dépôts et Consignations, Crédit Agricole, Unep Financial Initiative.

Conclusions

Due to the inter linkage between CSR, finance and risk, the assessment that banks carry out to calculate the probability of default—based on

[3] Global Reporting Initiative standard n. 4, www.globalreportinginitiative.com

Basel standards—includes fields which are specifically monitored through some CSR or ESG indicators, linked to environmental, social, or security risks.

As a result, it is possible to use specific CSR indicators as an acknowledgment of the companies' capabilities to create value and have a low risk of default. Consequently, sustainable companies are more likely to obtain:

a) An interest rate on loans or financings which is lower than the market rate, and which is rewarding in comparison to what other non-CSR companies and customers are able to obtain;
b) A lower spread;
c) Lower fees on services;
d) A longer time period for repaying financing in comparison to the usual time fixed by the bank, having in this way a longer lapse of time to repay disbursed funds.

Therefore, the use of qualitative, relational, intangibles-related and environmental indicators linked to the risk assessment of companies, improves also the application of the Basel rating formula.

Summary

The chapter highlights the link, not yet deeply investigated in the literature, between CSR, risks assessment, and capability to increase trustworthiness within the credit rating processes. According to the recent Directive 2014/95/EU of the European Parliament about disclosure of "nonfinancial and diversity information" for listed and large companies, it is more evident and relevant to provide nonfinancial information (e.g., social and environmental) into the financial reports, in order to prove a good management of major risks. This applies also to SMES as supplier of large companies.

The role played by the public actor in this context has always been relevant, from financially supporting CSR, to promoting CSR culture, and attention to social and environmental impacts. The chapter presents the Italian best practice of a CSR platform of indicators, developed by the Italian government, to map companies' actions and recognize CSR

practices as signs of credit capability, value production, and company's riskiness.

Due to the interlinkage between CSR, finance, and risk, the assessment that banks carry out to calculate the probability of default—based on Basel standards—includes fields, which are specifically monitored through some CSR or ESG indicators. As a result, we suggest the opportunity to use specific CSR indicators as an acknowledgment of the companies' capabilities to create value and demonstrate low risk of default.

Discussion Questions

1. Should CSR be required by law or should it be a voluntary action? What do you think about the recent Directive 2014/95/EU of the European Parliament about disclosure of "nonfinancial and diversity information?"
2. The Italian Government has developed a platform to map CSR companies' actions. What is the main goal of this tool?
3. CSR and financial risk assessment interlinked. Why?
4. What are the GRI CSR indicators measuring risk which can be adopted in the context of bank or financial risk assessment?

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