UNIVERSITY OF SOUTHERN QUEENSLAND

Environmental Risks, Bank Loan Covenants and the Cost of Bank Loans: An Australian Study

A Dissertation submitted by

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ABSTRACT

There is a growing body of increasingly restrictive environmental legislation surrounding the operation of business within Australia. In conjunction with this, there is heightened awareness and concern from stakeholders who want greater environmental accountability from Australian business. Banks work as a financial intermediary in the economy which is considered as an environmentally friendly sector. However, by extending loans to borrowing firms whose activities impact on the environment, banks’ lending businesses are indirectly related to the environment. Accordingly, banks are likely to be exposed to environmental risks in corporate lending due to borrowing firms’ environmental activities. As such, banks have an incentive to integrate environmental risks into their credit processes. The literature and banks’ practices regarding the integration of environmental risks into banks’ credit processes emphasise the evaluation of environmental risks; however, the subsequent control and monitoring of environmental risks is underdeveloped, especially in the context of Australia.

This study examines environmental risk management in the corporate credit processes of major Australian banks. It particularly investigates the associations between environmental risks and 1) bank loan covenants, and 2) the cost of bank loans in the Australian context. The research problem is as follows:

How are environmental risks associated with bank loan covenants and the cost of bank loans in Australian banks’ corporate lending?

Face-to-face semi-structured interviews were undertaken with senior executive bankers in three of the four major Australian banks. These executives are responsible either for corporate lending decision-making or environmental risk management in corporate lending. Two interview checklists were designed for the interviews in a two-stage data collection process. The interviewees were allowed to elaborate on their answers wherever they thought it necessary and the interviews were recorded and transcribed. Given the small sample size, the researcher used critical judgement underpinned by accepted qualitative methods in the literature to manually analyse and extract themes and patterns to address the research problem.
The results of this study indicate that major Australian banks integrate environmental risk management into each stage of the corporate credit process. However, given that they are in the early stages of taking environmental risks into account and because only limited quantifiable environmental data are available, the integration is not sophisticated.

To effectively control and monitor environmental risks, customised environmental covenants are included in bank loan agreements. These environmental covenants are non-financial and are established based on a comprehensive evaluation of environmental issues at industry, borrower and transaction level. Typical environmental covenants are based on environmental obligation compliance and periodic environmental reporting. The findings also suggest that the cost of bank loans will not reflect environmental risks unless these risks impact on the credit ratings of borrowing firms. Although environmental risks are not a specific input of major Australian banks’ credit rating models, they are a non-financial factor of expert judgement on the credit ratings of borrowing firms.

As the first study investigating the associations between environmental risks and 1) bank loan covenants, and 2) the cost of bank loans in the Australian context, this study validates the relevance of agency theory in dealing with environmental risks in the relationship between banks and their corporate customers. The findings also fill a gap in existing literature by indicating dimensions, determinants and attributes of environmental risks in major Australian banks’ corporate lending. In addition, the findings extend prior literature by identifying the form, contents, tightness, functions and establishment process of environmental covenants used in major Australian banks’ corporate lending. Further, this study adds to previous literature by documenting the conditions under which environmental risks impact on the cost of corporate bank loans. Last but not least, this study fills a gap in prior literature by articulating major Australian banks’ environmental sustainability transformation in terms of their environmental practices in corporate lending.

This study provides a detailed evaluation of the stage that major Australian banks are up to in their journey towards environmental sustainability in corporate lending. It does this by confirming that environmental risk management is incorporated in each stage of the corporate credit process in major Australian banks and identifying the
corresponding activities in each stage. By indicating that environmental risks should be considered in banks’ corporate credit processes, this study has implications for their staff training activities. In addition, by investigating the impact of environmental risks on the cost of corporate bank loans, this study contributes to the enhancement of internal credit rating criteria in major Australian banks by including environmental factors. Furthermore, this study provides insights for the development of borrowing firms’ environmental management practices by indicating the importance major Australian banks place on borrowing firms’ environmental management in corporate lending. This study also provides a platform for Non-Government Organisations to understand corporate lending decision-making by major Australian banks related to environmental issues.
CERTIFICATION OF DISSERTATION

I certify that the ideas, results, analyses and conclusions reported in this dissertation are entirely my own effort, except where otherwise acknowledged. I also certify that the work is original and has not been previously submitted for any other award, except where otherwise acknowledged.

__________________________                   ________________________
Yinshuo Xu                                               Date

ENDORSEMENT

__________________________                   __________________________
Dr Geoff Slaughter                          Date

__________________________                   __________________________
Professor Julie Cotter                          Date
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