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ENVIRONMENTAL, SOCIAL AND GOVERNANCE PRACTICES AND FINANCIAL PERFORMANCE OF LISTED COMMERCIAL BANKS IN AFRICA

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ABSTRACT

Purpose of Study: This research evaluated the impact of environmental, social and governance (ESG) practices on the financial performance of listed commercial banks in Africa.

Statement of the Problem: Since the 2008 global financial crisis, bank profitability has been a concern, with a notable decline in Africa's top five banking markets since 2016. On the other hand, the costs associated with ESG compliance have been increasing. This study examined the impact of ESG practices on the financial performance of listed commercial banks in Africa.

Methodology: The study adopted a positivist research philosophy and an explanatory non-experimental approach, using purposive sampling to select 15 banks from 145 listed in Africa. Secondary data on ESG scores and financial performance were analyzed using descriptive and inferential statistics, with panel multiple regressions to account for time and cross-sectional dimensions.

Result: The direct effect regression results revealed that environmental practices had a negative but statistically insignificant impact on financial performance as measured by Tobin's Q. Similarly, social practices also exhibited a negative relationship with Tobin's Q, but this impact was insignificant. However, governance practices showed a negative and significant relationship with Tobin's Q. The study further investigated the moderating effect of bank size on the relationship between ESG practices and financial performance, finding insufficient statistical evidence to support that bank size significantly moderates this relationship when using Tobin's Q as the performance measure.

Conclusion: The study concludes that environmental and governance practices negatively affect Tobin's Q, social practices have no significant impact, and bank size does not moderate the relationship between ESG practices and Tobin's Q.

Recommendation: The study recommends prioritizing solid governance structures for financial performance and further research on ESG practices, bank size, and financial performance interactions.

Keywords: *Environmental practices, social practices, governance practices, financial performance, Tobin's Q, commercial banks, Africa, bank size.*

INTRODUCTION

Banks play a critical role in the financial stability of both local and global economies, providing essential services such as credit, investments, and liquidity to businesses and governments (Batae, Dragomir & Feleaga, 2020; Kaplan & Rao, 2017). In Africa, commercial banks significantly support agricultural production by offering credit to farmers, thus promoting economic growth (Jadhar, 2020). The financial performance of these banks is vital for economic stability, with Kenya's largest banks contributing significantly to tax revenues and holding substantial assets (PwC, 2022; Maluki, 2021). Despite the challenges posed by the global financial crisis of 2008 and the COVID-19 pandemic, banks have demonstrated resilience, although profitability has declined in recent years (McKinsey, 2022).

The profitability of African banks, particularly in major markets like Egypt, Kenya, Morocco, Nigeria, and South Africa, has been declining since 2016 (McKinsey, 2022). For example, Kenya's return on equity dropped significantly from 30% in 2012 to 14% in 2020 (CBK, 2021). Despite these challenges, the banking sector showed signs of recovery between 2021 and 2022. Concurrently, the introduction of the African Union (AU) Agenda 2063 and national initiatives like Kenya's Climate Change Act of 2016 highlight the growing importance of Environmental, Social, and Governance (ESG) practices in bank operations (DeGhetto, Gray & Kiggundu, 2016).

ESG practices have become essential for banks, influencing their financial performance and operational strategies. Guidelines from the Central Bank of Kenya (CBK) and the Nairobi Securities Exchange (NSE) mandate the integration of ESG principles in bank governance (PwC, 2022). However, the cost of implementing ESG practices is projected to rise significantly, with global investments expected to exceed USD 130 trillion by 2030 (Deutsche Bank, 2020). Studies have shown mixed results regarding the impact of ESG practices on bank performance, with some reporting positive correlations and others finding negative or insignificant effects (Buallay, 2019; Khoury, Nasrallah, & Alareeni, 2023).

Despite the increasing focus on ESG, the adoption and reporting of these practices among African banks remain in the early stages. Only a few banks in Kenya and across Africa have consistently published comprehensive ESG reports, and many still lack standardized guidelines for ESG metrics (Kenya Bankers Association, 2022). Research utilizing ESG scores from the London Stock Exchange Group and other global providers has highlighted the critical role of standardized metrics in evaluating the influence of ESG practices on financial performance

(Berg, Fabisik & Sautner, 2021). This study aims to contribute to this growing body of knowledge by focusing on the relationship between ESG practices and the financial performance of listed commercial banks in Africa, using Tobin's Q as the performance measure.

Statement of The Problem

The stability of the banking sector directly contributes to overall economic growth, given the critical role of banks in promoting savings and investments (Abisola, 2022). Notably, the stability of the banking industry is largely anchored on performance (Maluki, 2021). Poorly performing banks have higher risks of being delisted (Kroes & Manikas, 2014). Beyond profitability, firm value is also critical to shareholders for value maximization (Gitagia, Wamugo & Omagwa, 2020).

Globally, the financial performance of financial institutions has experienced a general decline (Timoumi, Mohamed & Zeitun, 2015). On average, the return on assets (ROA) for banks worldwide decreased consistently from 3.7% in 2013 to 1.36% in 2020, with a gradual recovery beginning in 2021 (Global Finance, 2023). Specifically, the banking sectors in Egypt, Kenya, Morocco, Nigeria and South Africa have witnessed a significant decline in profitability since 2016, with an average annual decrease of 2 percentage points in ROA (McKinsey, 2022). This trend reflects various challenges faced by these economies, including regulatory changes and market volatility.

The declining profitability of banks poses a threat to global economic growth, as banks are integral to financial systems (Hussein, 2010). While banks are expected to lead in ESG initiatives, the costs could affect profitability unless aligned with shareholder value. Research on ESG's impact on African bank performance is limited (El Khoury, 2021), despite Africa's growing investment importance (Ngida, 2024). This gap is due to inconsistent ESG metrics and disclosures. This study addresses these issues by using secondary data from the LSEG, a recognized source of ESG metrics (Berg, Gabisik & Sauntnes, 2021).

OBJECTIVES OF THE STUDY

The main objective of this study was to assess the effect of environmental, social and governance (ESG) practices on the financial performance of listed commercial banks in Africa

Specific Objectives

The specific objectives of this study were:

i. To evaluate the effects of environmental practices on the financial performance of listed commercial banks in Africa.

ii. To evaluate the effects of social practices on the financial performance of listed commercial banks in Africa.

iii. To evaluate the effects of governance practices on the financial performance of listed commercial banks in Africa.

iv. To establish the moderating effect of size of the bank on the relationship between environmental, social and governance (ESG) practices and the financial performance of listed commercial banks in Africa.

Hypotheses

This study sought to test the following null hypothesis:

i. $H_{01:}$ Environmental practices do not have a significant effect on the financial performance of listed commercial banks in Africa.

ii. $H_{02:}$ Social practices do not have a significant effect on the financial performance of listed commercial banks in Africa.

iii. $H_{03:}$ Governance practices do not have a significant effect on the financial performance of listed commercial banks in Africa.

iv. $H_{04:}$ Size of the bank does not significantly moderate the relationship between environmental, social and governance (ESG) practices and the financial performance of listed commercial banks in Africa.

THEORETICAL LITERATURE

This study uses various theories to analyze the impact of ESG practices on financial performance, including shareholder value theory, stakeholder's theory, legitimacy theory, agency theory, signaling theory, and slack resources theory.

Shareholders Value Theory

Introduced by Friedman in 1970, this theory emphasizes maximizing shareholder wealth by enhancing profitability and minimizing costs, including those associated with ESG initiatives. Proponents argue that the primary goal of a firm is to increase profits for shareholders, suggesting that resources spent on social responsibilities could deplete company resources and negatively affect profitability (Saleh, Zulkifli & Muhamad, 2011; Lagoarde, 2012).

Stakeholders Theory

Proposed by R. Edward Freeman in 1984, this theory extends a company's responsibility beyond its shareholders to include all stakeholders, such as employees, communities, suppliers, and government agencies. It emphasizes the importance of building strong relationships with all stakeholders to ensure long-term success, encouraging transparency and broader value creation beyond mere financial gains (Jones et al., 2018; Harrison & Wicks, 2013).

Legitimacy Theory

Introduced by Deegan (2002), this theory posits that organizations must align their actions with societal norms and expectations to maintain legitimacy and social approval. Companies are motivated to engage in ESG practices to enhance their reputation and justify their operations to society, ensuring long-term survival and success (Deegan & Unerman, 2011; Suchman, 1995).

Agency Theory

Developed by Jensen and Meckling in 1976, this theory explores the relationship between company owners (principals) and managers (agents), highlighting potential conflicts of interest. Effective governance structures are essential to align managers' actions with shareholders' interests, reduce agency conflicts, and improve financial performance (Miller, 2002; Lee & Isa, 2020).

Signaling Theory

This theory, developed by Spence in 1974, suggests that companies can use ESG performance to signal their quality and commitment to sustainability to stakeholders, particularly investors and creditors. Positive ESG signals can enhance a company's market performance by reducing information asymmetry and attracting favorable funding terms (Muttanachai, 2023; Lo & Kwan, 2017).

Slack Resources Theory

Introduced by Waddock and Graves in 1997, this theory posits that companies with surplus resources are better equipped to invest in ESG initiatives, which can enhance their competitive edge and long-term cost savings. Firms with available slack resources are more likely to engage in social activities, reflecting their capacity to address stakeholder demands and improve corporate social performance (Miles & Covin, 2000; Agusti-Perez et al., 2020).

Conceptual Framework

This research explored the relationship between ESG practices and the financial health of banks in Africa, using Tobin's Q as a financial performance proxy and bank size as a moderating factor. Figure 1 illustrates the relationships among these variables within the study framework.

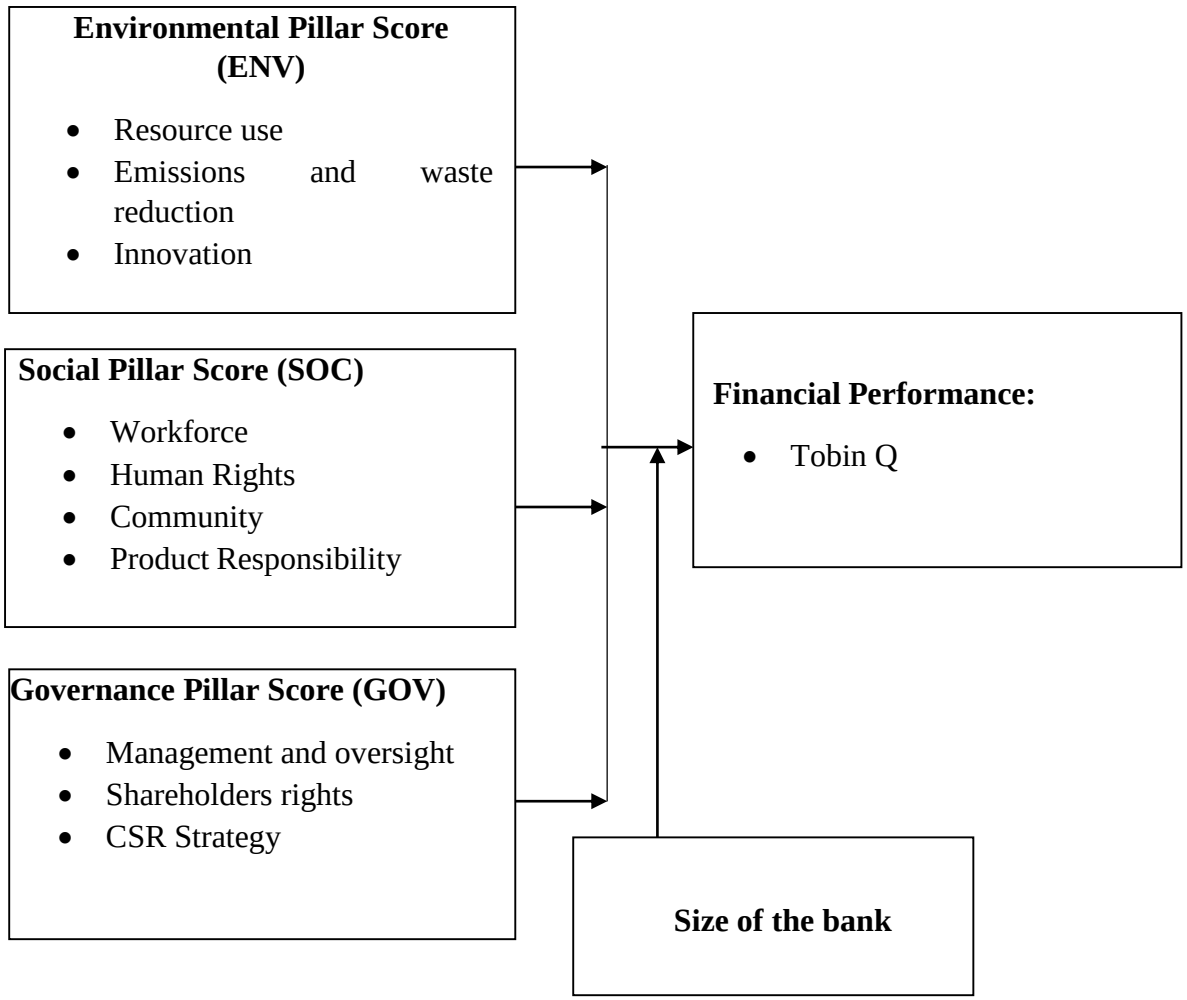

Figure 1: Conceptual Framework

RESEARCH METHODOLOGY

This study adopted a positivist research philosophy, emphasizing objective measurement and analysis of social reality. The research utilized an explanatory non-experimental design to investigate the relationship between Environmental, Social, and Governance (ESG) practices and the financial performance of listed commercial banks in Africa. Tobin's Q was the primary measure of firm performance, while bank size, measured by the log of total assets, acted as a moderating factor. The empirical model included panel data regression to account for time and cross-sectional dimensions, incorporating a dummy variable for the Covid-19 pandemic to control for its potential effects. Secondary data from the London Stock Exchange Group

(LSEG) database provided ESG scores and financial performance metrics for 15 banks in South Africa, Egypt, and Morocco, selected through purposive sampling.

Comprehensive statistical techniques, including descriptive and inferential analyses, were employed to analyze the data. Diagnostic tests ensured the robustness and validity of the regression models, addressing issues such as normality, multicollinearity, heteroscedasticity, autocorrelation, endogeneity, and stationarity. Ethical considerations were upheld by obtaining necessary permissions from Kenyatta University and the National Commission for Science, Technology and Innovation (NACOSTI). The study aimed to provide valuable insights into the dynamics between ESG practices and financial performance in the African banking sector, contributing to the broader understanding of sustainable banking practices. The direct effect model employed for the study was as follows:

$$TQ_{it} = \beta_0 + \beta_1 ENV_{it-1} + \beta_2 SOC_{it-1} + \beta_3 GOV_{it-1} + \grave{E}_{it} \quad \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots (i)$$

Where:

TQ_{it}= Tobin's Q ratio of bank i at time t

β_0= Regression constant

β_s=are the coefficients of the explanatory variables

ENV_{it-1} = Environmental practices of bank i at time $_{t-1}$

SOC_{it-1} = Social practices of bank i at time $_{t-1}$

GOV_{it-1} = Governance practices of bank i at time $_{t-1}$

$\grave{E}^{it}$= Error term.

The moderation model for the study is documented as follows. Size (SIZ) was proxied by the natural log of total assets.

$$TQ_{it}=\beta_0+\beta_1 ENV_{it-1}+\beta_2 SOC_{it-1}+\beta_3 GOV_{it-1}+\beta_4(ENV_{it-1}*SIZ_{it-1})+\beta_5(SOC_{it-1}*SIZ_{it-1})+\beta_6(GOV_{it-1}*SIZ_{it-1})+\grave{E}it \quad \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots (ii)$$

RESULTS

This section presents the direct and moderated regression analysis results for the study. As guided by the objectives, the study sought to establish the effect of ESG practices on financial performance of listed banks in Africa, as well as establish the moderated effect of bank size in the underlying relationship. The direct effect model results are shown in Table 1:

Table 1: Direct Effect Model

TobinQ	Coef.	Std. Err.	z	P>z
Environmental Score ENV	-0.0017	0.0150	-0.11	0.909
Social Score SOC	-0.00004	0.0039	-0.01	0.990
Governance Score GOV	-0.01552	0.0043	-3.62	0.000
Bank Size	-0.0413	0.0693	-0.6	0.551
Dummy variable Covid	-0.5178	0.2119	-2.44	0.015
_cons	3.78569	1.118	3.39	0.001
Wald chi2(5) = 21.65				
Prob > chi2 = 0.0006				
R-square= 0.0427				

$$TQ_{it} = 3.78569 - 0.0017ENV_{it-1} - 0.00004SOC_{it-1} - 0.01552GOV_{it-1} - 0.5178\ Covid\text{-}19_{t}$$

Source: Study data (2024)

The regression analysis using Tobin's Q as a proxy for financial performance of commercial banks in Africa found varied impacts of ESG practices. Environmental and Social Scores showed no significant relationship with Tobin's Q, indicating that these practices may not substantially influence market valuation in this context. Specifically, Environmental Score had a coefficient of -0.0017 (p = 0.909) and Social Score had a coefficient of -0.00004 (p = 0.990), suggesting that neither had a notable impact on Tobin's Q.

Conversely, Governance Score had a significant negative impact on Tobin's Q with a coefficient of -0.01552 (p = 0.000), implying that higher governance scores are associated with lower market valuations for listed commercial banks in Africa. This finding contrasts with some studies that highlight positive effects of strong governance but aligns with others that suggest increased governance can lead to higher operational costs or reduced flexibility, negatively impacting market valuation.

The study also assessed the moderating effect of bank size on the relationship between ESG practices and Tobin's Q. Results indicated that bank size did not significantly moderate the relationship between Governance Score and Tobin's Q (β = 0.0001, p = 0.742), Environmental Score and Tobin's Q (β = -0.0001, p = 0.940), or Social Score and Tobin's Q (β = 0.0008, p = 0.391). This suggests that the scale of bank operations does not significantly influence the impact of these ESG dimensions on market valuation.

Overall, the findings underscore the complex and context-dependent nature of the relationship between ESG practices and financial performance. While governance practices significantly impact market valuation, environmental and social practices do not show a substantial direct effect. Additionally, bank size does not moderate these relationships, highlighting the need for nuanced strategies in integrating ESG practices to enhance financial performance in the African banking sector.

The study's findings regarding the impact of ESG practices on Tobin's Q were corroborated by various studies across different contexts, highlighting both consistencies and discrepancies. The insignificant effect of environmental practices on Tobin's Q aligns with Awadzie et al. (2022) and Buallay (2019), who found no significant correlation between environmental efforts and market valuation in African banks and other contexts. However, this contrasts with Savić and Bonic (2022) and Kaakeh and Gokmenoglu (2022), who reported positive impacts of environmental performance on market valuation in European and Chinese firms, respectively, indicating regional and industry-specific variability.

Similarly, the lack of a significant relationship between social practices and Tobin's Q supports findings by Oyewumi et al. (2018) in the Nigerian banking sector, suggesting that social initiatives do not necessarily enhance financial performance. In contrast, Chang'kwony and Omwono (2019) reported positive effects of social practices on firm performance, emphasizing the context-dependent nature of these relationships. The negative impact of governance practices on Tobin's Q is consistent with certain aspects of Ochego, Omagwa, and Mwathe (2019), who noted complex effects of governance structures on financial outcomes, while contrasting with the generally positive view of governance practices highlighted by Baidoo et al. (2023).

The study further sought to establish the moderating effect of bank size in the relationship between ESG practices and financial performance as proxied by Tobin Q. The results are shown in Table 2 below:

Table 2: Moderation Effect Regression Results with Tobin's Q

Tobin's Q	Coef.	Std. Err.	z	P>z
Environmental Score ENV	0.0050	0.0176	0.290	0.774
Social Score SOC	-0.0089	0.0110	-0.810	0.417
Governance Score GOV	-0.0187	0.0092	-2.030	0.043
Bank size	-0.1242	0.1302	-0.950	0.340
Environmental score*bank size	-0.0001	0.0007	-0.080	0.940
Social score*bank size	0.0008	0.0009	0.860	0.391
Governance *bank size	0.0001	0.0004	0.330	0.742
_cons	4.5866	1.6466	2.790	0.005

Source: Study data (2024)

The moderation effect regression analysis explored the relationship between ESG scores, bank size, and Tobin's Q for listed commercial banks in Africa, revealing key insights. Environmental and Social Scores showed no significant direct impact on Tobin's Q, with coefficients of 0.0050 ($p = 0.774$) and -0.0089 ($p = 0.417$), respectively, indicating no effect on market valuation. However, Governance Score had a significant negative association with Tobin's Q ($\beta = -0.0187$, $p = 0.043$), suggesting that stronger governance practices are linked to lower market valuation, potentially due to investor concerns. Bank size did not significantly affect Tobin's Q ($\beta = -0.1242$, $p = 0.340$), nor did it moderate the relationship between ESG scores and market valuation, indicating that the scale of operations does not influence the impact of ESG practices on market performance. Table 3 is a summary of moderation results:

Table 3: Summary Results for Moderating Effect

	Before Moderation		After Moderation		Significance of Change	
Variable	**B**	**P-value**	**B**	**P-value**	**B**	**p-value**
Environmental Score ENV	-0.0017	0.909	-0.0001	0.940	0.0016	0.94>0.05
Social Score SOC	-0.00004	0.99	0.0008	0.391	0.0008	0.391>0.05
Governance Score GOV	-0.01552	0.000	0.0001	0.742	0.0156	0.742>0.05

Source: Study data (2024)

These findings align with existing literature highlighting the complex and context-dependent nature of ESG practices' impact on financial performance. Studies such as Awadzie et al. (2022) and Buallay (2019) support the insignificant impact of environmental practices on market valuation, while Savić and Bonic (2022) and Kaakeh and Gokmenoglu (2022) report contrasting positive effects in different regions. Similarly, Oyewumi et al. (2018) and

Chang'kwony and Omwono (2019) provide mixed insights into the impact of social practices, suggesting variability based on contextual factors.

The significant negative impact of governance practices on Tobin's Q aligns with the notion that stringent governance requirements might increase operational costs, as noted by Kamau, Machuki, and Aosa (2018), while Baidoo et al. (2023) highlight the positive effects of good governance on financial performance. Studies by Basuony et al. (2014) and Ochego, Omagwa, and Mwathe (2019) emphasize the complexity of governance practices' impact on market valuation, reflecting the nuanced and context-specific nature of these relationships.

CONCLUSION

The study concludes that Environmental and Social (ES) practices have minimal impact on the market valuation of listed commercial banks in Africa, as measured by Tobin's Q. However, stronger Governance practices are linked to lower market valuations, likely due to increased transparency raising investor concerns. Additionally, bank size does not significantly moderate the relationship between ESG practices and market valuation, indicating that the scale of operations does not affect the impact of ESG initiatives. These findings highlight the complexity of ESG practices and call for further research to better understand their influence in the African banking sector.

RECOMMENDATIONS

The study recommends that commercial banks in Africa prioritize environmentally sustainable initiatives, such as adopting green technologies, reducing carbon footprints, and investing in renewable energy, to enhance financial performance and contribute to regional sustainability. Additionally, banks should strengthen their social responsibility efforts by investing in initiatives addressing poverty, education, healthcare, and environmental conservation, fostering goodwill and trust among stakeholders. It also emphasizes the importance of strengthening governance frameworks by appointing competent directors, ensuring transparency, and enhancing financial reporting, including ESG disclosures, to drive long-term sustainability and mitigate risks. Regulators should support these efforts by creating frameworks and incentives that encourage corporate social responsibility and enforce robust governance standards to ensure a resilient and responsible banking sector.

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