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THE ROLE OF ENTERPRISE RISK MANAGEMENT (ERM) IN BUILDING ETHICAL AND SUSTAINABLE BANKING IN SUB-SAHARA AFRICA. A CASE STUDY OF ZIMBABWE

*Cosmas Kanhai

Researcher at Swiss Institute of Management and Innovation, 74 Goodall Avenue, Emerald Hill, Harare, Zimbabwe.

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*Corresponding Author: Cosmas Kanhai

Researcher at Swiss Institute of Management and Innovation, 74 Goodall Avenue, Emerald Hill, Harare, Zimbabwe.

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ABSTRACT

The purpose of this paper is twofold, namely to analyse how Enterprise risk management (ERM) principles can be used to create ethical and responsible banking and to determine the extent to which banks in Zimbabwe have integrated social and environmental issues into their risk management, business strategies and decision making processes. The study focused on 18 commercial banks operating in Zimbabwe and data was collected through questionnaires. The study found out that locally owned banks in Zimbabwe (*the bulk of which have slightly adopted ERM*) have not integrated ethical, environmental and social considerations into their risk management and decision-making processes. On the other hand, the study noted that foreign owned banks (*the majority of which have fully adopted ERM*), consider social and environmental factors when lending or reviewing facilities to for example, the agricultural sector and industries linked to human rights and pollution. The study established that ERM assists banks to manage environmental and social risks through (i) taking a holistic approach in the identification of sustainability risks, (ii) responsible lending underpinned by environmental and social credit risk assessment and (iii) embedding environmental and social aspects into its operations by aligning it to the ERM processes. The study has shown that banks that have fully adopted ERM are likely to embrace sustainable/ethical banking. It can therefore, be concluded that ERM principles can be used by traditional banks to create ethical and sustainable banking models.

KEYWORDS: Sustainable risk, ethical banking, integration, code of ethics, risk embedding.

INTRODUCTION

The global financial crisis which began in 2007 as well as the many bank failures that occurred in many countries highlighted the need for banks to embrace ethical conduct in their business dealings. A number of researchers cited the unethical behaviors of bank directors and shareholders as the major cause of bank failures in Sub-Saharan Africa. In Zimbabwe insider lending and abuse of depositors' funds were the major causes of bank failures in Zimbabwe (RBZ 2012)

Given the importance of banks in the operation of national payments systems in particular and the economy in general, there is need to ensure that banks exhibit the highest standards of ethical behavior. This call has given rise to the emergence of ethical banks mainly known as socially responsible or sustainable banking.

According to the Scottish Government (2013) an ethical bank operates ethically and responsibly in the world, taking into account environmental and social considerations, as well as the impact they have on the global economy. In other words the profitability of banks should be coupled with a concern for social, environmental and ethical factors if the bank is to contribute to sustainable development.

In that regard sustainable, ethical and socially responsible banking has become a critical way of influencing and contributing towards sustainable development. While banks are not directly affected by some social and environmental factors, it was noted that banks are responsible for the ethical malpractices of customers/organisations they finance or lend to. As a result of this indirect effect banks have to embrace ethical/sustainable banking through integrating social and environmental issues in their operations and business strategies as a control measure. This integration gives rise to sustainability risks which banks have to manage so as to create ethical, socially responsible and sustainable banking. Enterprise risk management (ERM) has emerged as a tool that banks can use for the identification, measurement, monitoring and control of sustainable risks. ERM is the holistic management of all risks facing banking institutions.

This paper will centre on ethical/sustainable banking particularly focusing on environmental and social considerations as a proxy for banking ethics and the role of ERM in building such sustainable or ethical banks.

LITERATUARE REVIEW

Introduction to business and banking ethics

According to Dimitriades (2007) business ethics is defined as the principles and standards that determine acceptable conduct in business organizations. It is concerned with the moral philosophy, values and norms of behaviour that guide a corporation's behaviour within society (Dobson; 1997).

Vilčiauskaitė, (2011) noted in a business survey carried out in 2011 that the biggest ethical issues that business people encounter are greed, withholding facts and accurate information in reports, unfair escalation of prices and blatant cheating in negotiations, conflicts between business organisation and personal interests. In Zimbabwe insider lending, abuse of depositors' funds and creative accounting are the major ethical issues in the banking sector. (RBZ 2012)

Banking ethics is a type of business ethics and according to Jaseviciene (2012) encompasses the norms and principles of morals that regulate behaviour in the banking business. According to Aktan, Masood and Yilmaz (2009) banking ethics is considered critical for the reputation and competitive power of banks.

Ethics concerns formalised principles and codes of conduct as well as value systems that guide how firms behave and apply to ethical situations that may arise in doing business.

The Banks Association of Turkey produced a code of banking ethics to guide and regulate the operations of banks and their relationship with various stakeholders. The general principles of the banking ethics in Turkey as cited by Icke et al (2011) are highlighted in the table below.

General Principles of the Code of Banking Ethics produced by The Banks Association of Turkey in 2006

Ethical Principle	Descriptions
Honesty:	Banks, during their operations, stick to the honesty principle in their relations with their customers, employees, shareholders, group companies and with other banks, organizations and companies.
Impartiality:	Banks should make no discrimination and should avoid

	all forms of bias in their attitudes towards their employees as well as to their customers. Banks should not make any discrimination towards their customers based on their nationality, religion, financial and social standing, and gender during their service.
Reliability:	Banks should offer clear, comprehensible and correct information to their customers within the principle of reciprocal trust during their entire services and transactions; and they should provide the customer services in a timely and complete manner.
Transparency:	Banks should inform their customers in an open, easily understandable and clear way regarding the underlying rights and responsibilities, benefits and risks attached to the products and services offered to them.
Observing Social Benefit and Respect to Environment:	Banks should show due diligence to support all kinds of social and cultural activities in the light of the principle of observing, aside from the profitability, the social benefit and respect to the environment.
Fighting with Laundering of Crime-Originated Assets:	Banks should adopt the fight against corruption, laundering of crime-originated assets, etc. as a significant principle as stipulated by international norms and the provisions of national laws and regulations, and do their utmost for the due cooperation with each other, with other organizations and institutions related with the subject, as well as with the competent authorities. They should also assume the required measures inside their organizations for this purpose, and device training programs to instruct their personnel on the matter.
Insider Trading:	Banks should take all measures in order to prevent the use of insider information for the trading purposes

Source: *The Banks Association of Turkey as cited by Icke, B., T., Caliscan, E. N., Ayturk, Y. & Icke (2011)*

Importance of Ethics in Banking

Ethics are a very important ingredient for any banking institution. According to Chatterjee and Lefcovitch (2009) the importance of ethical standards for banks stems from the fact that banks are leveraged institutions and operate using other people's (depositors) funds and the risk inherent in their operations may generate losses as well as profits. This view was supported by Belas (2012) who pointed out, "*that the importance of ethical standards for financial markets is based on the purpose of commercial banks and other financial institutions, which operate with the money of others*".

According to Aktan, Masood and Yilmaz (2009) one of the key reasons for bank failures across the globe was unethical behavior. Insider lending i.e. lending to group undertakings

and related undertakings; associated companies; directors, controllers and their associates and non-group companies with which the bank's directors and controllers are associated is considered one of the major source of unethical behavior. This view was supported by Jasevičienė (2012) who pointed out that failure to abide by the norms of ethics and, in some cases, lack of business transparency was among the reasons that caused the global financial crisis.

Ethical/Sustainable Banking

An ethical, sustainable or social responsible bank is a bank which is primarily or at least to a large degree interested in not only keeping and profiting from peoples money, but also has an interest in the socio-environmental impacts of its banking habits, investments and personal and business loans to its customers and how their baking practice affects local and national and even global issues.

According to Dimitriade (2007) ethical banking is a philosophy that underpins everything about banking, a value system that says a bank's commercial activities must not only benefit its staff and shareholders, but also its customers and the wider economy, while at the same time preventing, or at least minimizing, any undue effects on society and the natural environment.

The same view was highlighted by San-Jose, Retolaza and Gutierrez-Goiria, (2011) and Icke, Caliskan, Ayturk and Icke, (2011) who pointed out that the aim of ethical banking is to achieve economic benefits while including social goals, which are both relevant to the socio-economic system

According to the European Federation of Ethics and Alternative Banks and Financier (2012) an ethical bank should meet the following essential criteria:

- The environmental and social impacts are important and rank *pari passu* with the value of economic impact;
- It takes into account the social and environmental impact of the actions of customers they lend to;
- It never lends or invest in projects in morally questionable areas such as, for example, nuclear weapons and pornographic productions;
- Supports the initiatives targeted at self employment and for women and youth projects;
- their investment activities are customer centric and are managed in a transparent manner;

- invests their profits in the social and environmental benefits of the bank; and
- does not accept unclean funds or laundered money and does not creation of tax havens for customers.

Hoijtink (2005) highlighted that the banking sector has been slow in embracing environmental and social aspects in their operations and strategic decision making as banks did not consider themselves as 'environmental polluters and were not seen as such by others'. However, Icke et al (2011) argued that banks are indirectly but significantly affected by environmental and social risks of their customers. For this reason it is critical that banks embrace the concept of sustainable/ethical banking.

Integrating Environment and Social Considerations into ERM

There are many ways in which traditional banks can integrate ethical (environmental and social) aspects to embrace the concept of ethical banking. Traditional banks can integrate environmental, ethical and social considerations into their operations and decision making processes through (i) corporate social responsibility (San-Jose, Retolaza and Gutierrez-Goria, 2011 and Icke, Caliskan, Ayturk and Icke, 2011) and (ii) aligning sustainability risks into enterprise risk management processes.

Corporate social responsibility involves the pursuit of environmental and social responsibility in a bank's operations through environmental initiatives (such as recycling programs or improvements in energy efficiency) and socially responsible initiatives (such as support for cultural events, improved human resource practices and charitable donations).

This paper will focus on enterprise risk management and ascertain how traditional banks can leverage on enterprise risk management to create ethical and sustainable banking.

Enterprise risk management is the holistic management of risk and is defined by the Committee of Sponsoring Organisations of the Treadway Commission (COSO) 2004, as

"A process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives."

Stulz, (2004) further define enterprise risk management as the process of planning, organizing, leading, and controlling the activities of an organization in order to minimize the effects of risk on an organization's capital and earnings.

According to Parsons (2013) risks arising from environmental, social or ethical conduct (sustainability risks) are often overlooked by traditional risk management processes which regard them as *softer risks*.

Jeucken (2002) pointed out that changing social demands, and increased knowledge of the effects that banks can have through their lending policies, banks have begun to feel pressure from the general public, non-governmental organizations and governments to go beyond traditional banking risks. This has created the need for a risk management framework that goes beyond the traditional risks inherent in banking and look at social and ethical aspects that affect the bank either directly or indirectly through borrowing customers.

Enterprise risk management therefore has a vital role to play in helping banks operate in an ethical and sustainable way. It enables traditional banks to build or create ethical or sustainable banking principles by providing the framework for these banks to integrate environmental and social considerations into their risk management systems.

A survey by Ernst & Young noted the need to align risks arising from environmental and social aspects (sustainability risks) with a bank's ERM framework as these interact with a number of enterprise-wide risks creating the potential to escalate or affect traditional including those related to strategic, compliance, financial, reputational, and operational risks to create opportunities and risks for banks.

RESEARCH METHODOLOGY

The purpose of this paper is twofold namely to analyse how ERM can be used to create ethical and responsible banking and to determine the extent to which banks in Zimbabwe have integrated social and environmental issues into their risk management, operations and decision making processes.

The study was focused on 22 registered banks operating in Zimbabwe. The data was collected through questionnaires and interviews with the banks' chief risk officers. A total of 18 questionnaires were returned translating to a response rate of 82%. Further, a desktop

review of annual reports for the year ended December 2012 for the surveyed banks was undertaken.

The proxy used for ethical or sustainable banking is the adoption of environmental and social aspects into the banks' operations and decision making processes. Thus this research will specifically seek to ascertain how the following ERM principles are being used by banking institutions to create sustainable and ethical banking through:

- Enterprise wide risk identification that integrates sustainability impacts;
- Incorporation of environmental and social considerations into credit risk assessment processes; and
- Alignment of ethical considerations into ERM framework.

FINDINGS AND DISCUSSION

Status of ERM Implementation

Table 1 below indicates the status of ERM implementation among the 18 surveyed banks. The results highlighted in table 1 shows that eight banks (28%) have fully implemented ERM, three have moderately implemented while the remaining ten banks [which are all locally owned] have slightly adopted ERM. All the five banks that have implemented ERM are subsidiaries of foreign international banks, while only two locally owned banks have moderately implemented ERM. The results suggest that foreign owned leveraged on ERM systems developed at their head offices which are rolled to subsidiaries to standardize risk management processes.

Table 1 Status ERM Implementation by banks in Zimbabwe

Proportion	Number of banks	Percentage
Fully Implemented	5	27.78%
Moderately Implemented	3	16.67%
Slightly Implemented	10	55.55%
Total	18	100%

Enterprise Risk Identification Process and Ethical Banking

The results in table 2 and 3 below show that seven out of 18 banks take into account environment, social and ethical considerations when identifying risks they are exposed to as part of the enterprise risk identification process. In addition to the traditional banking business risks, the universe of risks for these banks also includes sustainability risks (i.e. risks arising from environmental and social aspects).

An analysis of the ERM status of the above seven banks indicates that five of them have fully adopted ERM while the remaining two have moderately implemented ERM. The explanation for this is that the ERM provides a framework that goes beyond the traditional risks and looks at stakeholders and the external environment thus providing the tools for banks using ERM to incorporate sustainable and ethical banking into their operations.

The results also show that the remaining 11 banks that have slightly implemented ERM do not take environmental and social considerations in the risk identification process. These banks focus on traditional risks inherent in banking business (credit, market risk, operational risks, liquidity risk, and legal and compliance risks).

Based on environmental and social aspects as proxy for sustainable/ethical banking, the study shows that there is a relationship between ERM and sustainable/ethical banking.

Environmental and Social Risks Assessment and Ethical Banking

On the assessment of new loans and advances, the results in Table 2 and 3 have shown that five out of the 18 banks consider environmental and social aspects when evaluating applications for new corporate lendings. The credit assessment template for the above banks includes environmental, ethical and social factors which are assigned weights which contribute to the overall score that determine whether a loan is granted or not. This is more pronounced for loans to the agricultural sector where issues pertaining to climate change and rainfall patterns are given much prominence. Based on such credit appraisals, the nature of projects and those in areas deemed morally unacceptable or illegal are not financed.

This is consistent with the assertions by the International Finance Corporation (2007) which noted that banks must, when doing loan appraisals, systematically evaluate sustainable risks arising from possible breaches of rules on environmental pollution, child labour, discrimination, and human rights abuses by their customers.

Alignment of ethical, environmental and social considerations

The findings of the study indicate that 6 out of 18 banks have integrated ethical, environmental and social considerations into their operations and decision making processes. Out of these six banks, five have fully implemented ERM while the sixth bank has moderately implemented ERM. The remaining 12 banks that have not embedded ethical,

environmental and social considerations into their risk management processes have either moderately or slightly implemented ERM.

One of the most important attribute of ERM is that it integrates risk management into the operations and decision making processes of the bank. Thus banks that have fully implemented ERM can easily adopt ethical and sustainable banking by aligning ethical, environmental and social risks into their operations and decision making processes through aligning it to its ERM Framework.

The study shows, based on environmental and social aspects as a proxy for sustainable banking, that banks that have adopted ERM are likely to embrace sustainable banking.

4.5 Code of Banking Ethics

The results indicate that the majority of banks i.e. 14 out of 18 have a documented code of banking ethics. However the study found out that the majority of the banks have not operationalised their code of banking ethics.

A review of the annual reports for the year ended 31 December 2012 indicate that only seven out of the 18 banks have disclosed in their annual report the extent of its compliance to its code of ethics. This is a requirement in terms of the RBZ Corporate Governance Guideline issued in 2004 which requires banks to do such publications. It can therefore be concluded that the majority of banks have not operationalised their codes of ethics.

Table 2 Adoption of Ethical/Sustainable Banking Principles by banks in Zimbabwe.

Percentage of Non Executive Directors	No. of banks that have adopted the principle	No. of banks that have not adopted the principle	Total No. of Banks
Identifies risks arising from social and environmental aspects	7	11	18
Codifying ethics into a code of ethics	14	4	18
Incorporates environmental and social risk assessment when granting loans	5	13	18
Sustainability risks embedded into bank processes and decision making	6	12	18

Table 3 Ethical/Sustainable Banking Vs ERM

	Total No. of Banks that have Adopted Sustainable Banking Principles	Status of Banks that have adopted sustainable banking principles		
		Fully Implemented ERM	Moderately Implemented ERM	Slightly Implemented ERM
Identifies risks arising from social and environmental aspects	7	5	2	0
Operationalising of Code of Ethics	7	5	1	1
Incorporates environmental and social risk assessment when granting loans	5	5	0	0
Sustainability risks embedded into bank processes and decision making	6	5	1	0

Source: *Field Data*

CONCLUSION

The paper established that locally owned banks in Zimbabwe (*the bulk of which have not adopted ERM*) have not integrated ethical, environmental and social considerations into their enterprise risk management and decision making processes. On the other hand, the study noted that foreign owned banks (*the majority of which have adopted ERM*), consider social and environmental issues risks when lending or reviewing facilities to for example, the agricultural sector and industries linked to human rights and pollution.

The study concluded that banks that have fully adopted ERM are likely to embrace ethical/sustainable banking. To build ethical and sustainable banking, banks were found to have leveraged on ERM principles such as:

- enterprise wide risk identification by going beyond the traditional risks inherent in the banking business to include sustainability risks arising from social and environmental aspects;
- risk embedding through aligning social, ethical and environmental risks into the operations of the bank as part of the ERM framework; and
- incorporating environmental, social and ethical considerations in the assessment of loans and advances.

The study therefore concluded that ERM principles can be used by traditional banks to create ethical and sustainable banking models. The study recommended the need for banking institutions to integrate sustainability issues into their enterprise risk management processes and also develop policies that reward and support environmentally and socially responsible corporate customers.

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