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The Need to Implement an Environmental, Social and Governance (ESG) System in Banks

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Abstract: The article mentions the emergence of global environmental and social problems today and their economic consequences. It is also necessary to develop the green economy, create an ESG system in banks, assess and manage environmental and social risks.

Keywords: economy, green economy, sustainable economic development, ESG, banking, environmental risk, social risk, risk assessment and management.

INTRODUCTION.

Today, as a result of the constant growth of the population, humanity's ruthless attitude towards nature is increasing more and more. The serious systemic risks of climate change to the global financial system have been regularly debated by regulators and environmentalists for years.

At the moment, the role of the financial sector in confronting the problems of global climate change is receiving serious attention in the global policy arena. Regulators are working with commercial banks around the world to improve green finance.

LITERATURE REVIEW.

Environmental risk management requires a systematic and comprehensive approach from financial institutions. Climate change is making parts of the world uninsurable, ecosystem degradation or collapse is disrupting supply chains, water insecurity is affecting companies through foreclosed assets, and air pollution is affecting debt costs.

The global trend towards achieving the goals of sustainable development sets a new task for financial institutions - the task of building a business model focused on the principles of environmental (E-environmental), social (S-social) and management (G-management) responsibility. In particular, large banks have been actively incorporating ESG standards into their lending processes for several years, encouraging customers to reduce their negative impact on the environment and society.

Investors today increasingly understand that performance on relevant environmental, social and governance (ESG) factors directly affects their long-term profitability. Many managers and boards of directors of companies and organizations are beginning to understand that environmental, social and governance factors should inform their strategy.

The ESG system is playing an important role in determining investment, corporate governance, information disclosure and competitive advantages in the economy. Compliance with ESG principles for companies is important for sustainable development.

John Elkington, an English scientist, says “ESG is the three main factors that reflect the environmental, social and management consequences of companies. These factors cover almost all areas of activity of companies” [1].

Also, British scientists explained ESG issues as follows.

In environmental components:

- focus on environmental issues such as climate change, carbon emissions, air, water and land pollution;
- study the issues of rational use of natural resources, recycling and safe waste management;
- also recommend solutions for biodiversity, forest and sea protection, ecosystem restoration.

Social components are:

- focus on human rights, justice, equal opportunities, health and safety;
- studying issues related to the well-being and quality of life of local communities, employees and consumers;
- also analyzing the importance of education, training, social protection and social innovation.

And in the Governance component:

- study of transparent and responsible management systems in companies;
- analyzing the activities of companies within the framework of legislation, policy and local and international standards;
- are also working on anti-corruption, ethical behavior and accountability measures.

The definition of Australian scientist K. Green is that “ESG is a method of considering and evaluating environmental, social and corporate governance factors in the activities of companies. This approach is aimed at ensuring the long-term stability of companies” [2].

And French scientist Edith Ginglinger says, “ESG is a systematic approach that reflects the moral, ethical, environmental and social responsibility aspects of companies' activities. This approach serves to ensure sustainable development of companies” [3].

American scientists Robert G. Eccles “ESG is a way of evaluating, analyzing and recommending companies. It studies the environmental, social and corporate governance qualities of companies and helps to make decisions based on them” [4].

ANALYSIS AND RESULTS

Today, according to the UN report on climate change, the average temperature of the globe in the last decade has increased by more than 1 degree Celsius compared to the average temperature in the years 1850-1900, that is, in the post-industrial period. increased

Global temperature increase has negative effects on food and water security, human health, society and economy as a whole.

Today, environmental and social problems are causing problems on a global scale. That is why much attention is being paid to sustainable development to ensure long-term stability.

“Green” economy means an economy aimed at reducing environmental risks, efficient use of resources and sustainable development without harming the environment.

In the next decade, humanity will begin to face very urgent problems such as climate change, scarcity of natural resources, loss of biodiversity, and increasing social inequality. It is emphasized that all these systemic global crises are interrelated and cannot be solved in isolation, and the traditional economic approach cannot balance both environmental and social goals aimed at solving these problems. While the traditional economic approach leads to excessive consumption support, social exclusion and the drastic depletion of natural resources, the “green” economic approach rejects all these and serves to ensure a balance of social welfare and ecological stability.

A green economy takes a long-term perspective and focuses on ways to use resources to deliver value to society. It is not only about using low-carbon fuel sources, but also about how to increase resource efficiency and sufficiency to create wealth, sustainability and prosperity for humanity today and tomorrow, while respecting the planet's ecological resources. It is a model that guarantees a significant reduction in environmental risk and resource scarcity while improving well-being.

Attract public and private investment in economic activities, infrastructure and assets that enable employment and income growth in a green economy, reduce carbon emissions and pollution, improve energy and resource efficiency, and prevent the loss of biodiversity and ecosystem services is done through

The United Nations Environment Program (UNEP) has defined a green economy as “an economy that improves human well-being and social equity while significantly reducing environmental risk and environmental scarcity.” In its simplest terms, a green economy can be thought of as a low-carbon, resource-efficient and socially inclusive economy.

Today, the role of banks in financing the green economy is increasing. So, what is the role of banks in green economic development?

1. Banks support green economic development by contributing to the financing of green projects. Financing of green projects such as renewable energy projects, energy efficiency investments and waste recycling projects is becoming an important part of banks' portfolios. Banks help to implement these projects by offering appropriate credit products, low-cost loans or special financing terms to finance green projects.

2. Banks promote green economic development by considering sustainability criteria in credit and investment decisions. They assess environmental and social impacts and finance projects with high sustainability. This includes supporting projects that reduce environmental impact, ensure energy efficiency and use clean technologies. They are also wary of financing projects that do not meet sustainability criteria.

3. Banks determine their risk management strategies by assessing environmental and climate change risks. Green economic development requires managing environmental risks and increasing green finance. Banks assess the environmental risks that affect their financial performance and take measures against these risks. At the same time, financing green projects and sustainable investments can diversify risk and contribute to portfolio diversification.

4. Banks provide innovation and consulting services to promote green economic development. They support green projects by developing innovative financial products and services. They also provide sustainability advice to companies and clients. This includes assisting with environmental and social impact assessments, creating sustainability strategies and sustainability reporting.

Today, “green banks” (green banks) are spreading widely in financing the green economy. Green banks are today's fastest growing financial institutions. The network of green banks is developing at a rapid pace globally.

Green banks are expanding their investment portfolios and entering new sectors (energy, industry, construction, etc.). They support not only renewable energy projects, but also resource efficiency, climate change adaptation and other green sectors.

Also, new financial instruments (green bonds, green loans, green leases, etc.) are being introduced by Green Banks. This is helping to attract new sources of green investment.

Green bonds are a growing category of fixed-income securities that raise capital for projects that benefit the environment.

Although green bonds make up a small portion of the overall bond market, they are gaining more attention because meeting emission reduction goals will require trillions of dollars in capital from the public and private sectors.

In 2016, global green bond issuance totaled nearly $82 billion. In November 2017, for the first time, it passed the annual threshold of 100 billion dollars. By December 2020, the market had passed the milestone of totaling USD 1 trillion.

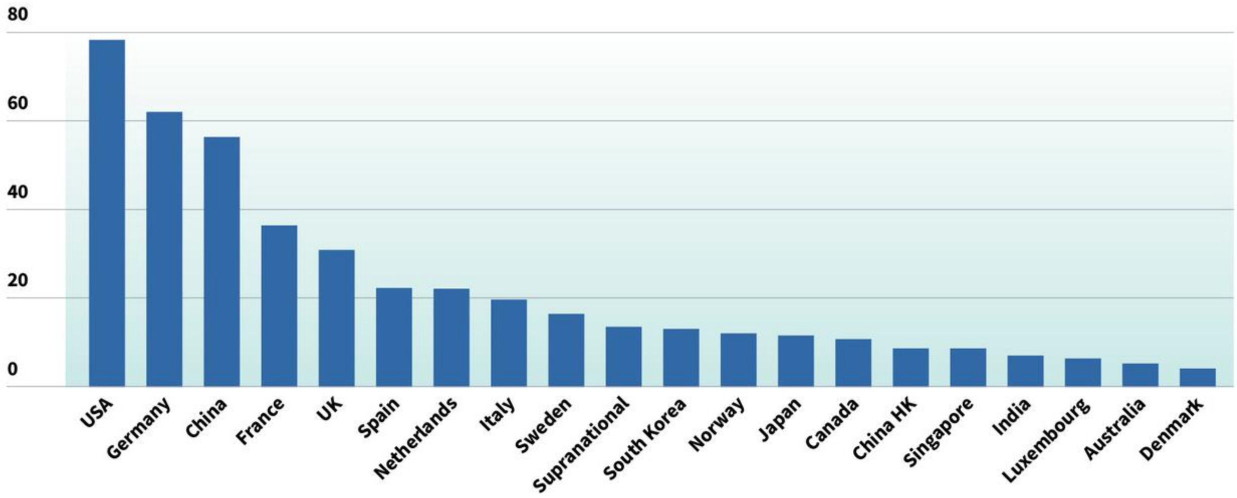

Figure 1. The largest countries issuing green bonds (in billions of dollars)

The developed countries of the USA and Germany are the largest green bond issuers today. Also. China is also the largest player in the green bond market (Figure 1) [5]. Since 2016, it has been actively engaged in issuing green bonds and attracting investment. By 2022, the volume of green bonds issued in China will exceed $300 billion in total. The main countries that issue green bonds are located on the European continent.

Banks, as one of the main institutions that invest in projects aimed at the sustainable development of society, must take into account environmental and social risks in their activities.

Engage consulting companies to diagnose banks' loan portfolios and prioritize decarbonization and manage ESG risks. In this:

"greening" of credit and investment portfolios of banks;

increasing the position of banks at the international level;

it was determined that several important works should be carried out, such as expanding the possibilities of climate financing through international financial institutions and the Green Climate Fund.

The Central Bank also has a role in the correct implementation of the practice of environmental and social risk assessment in commercial banks. The Central Bank is considered the body that directly regulates the activities of existing commercial banks in the country, and has the authority to impose mandatory requirements on their activities. In order to effectively promote green growth by commercial banks, the development role of the central bank is important.

The complex relationship between climate, nature and pollution requires more research and collaboration between forward-looking organizations. Addressing climate change in isolation fails to address broader environmental risks. Integrating biodiversity and ecosystem health into financial risk assessments provides better understanding and management of interrelated issues.

At the World Economic Forum meeting in Davos in 2024, UNEP FI announced the establishment of a new Risk Center. It will be a one-stop shop for financial institutions to offer integrated solutions and resources to manage climate, nature and other sustainability risks and address the triple planetary crisis.

The financial sector is facing unprecedented challenges that require new ways of managing risks. The increasingly complex landscape of sustainability risks, interlinked with climate change, nature degradation and social issues, is one challenge that requires financial institutions to develop new expertise and skills. The UNEP FI Risk Center provides UNEP FI members with the solutions they need to comprehensively address these emerging risks, helping them to significantly improve their institutions' risk assessment and disclosure capabilities, and to address risk-related issues. provides an opportunity to cooperate with experts, regulatory organizations and industry representatives.

Today, the following steps can be taken to assess environmental and social risks in banks based on aggregated information:

Risk Identification: A bank should be aware of and identify environmental and social risks. These risks may include factors such as climate change, depletion of natural resources, water resource management, environmental pollution and human rights violations.

Risk measurement: The severity and impact of identified risks should be measured. This includes the financial side of the risk, potential costs, reputational damage and customer demands. Risk measurement helps banks determine the magnitude and priority of risks.

Risk Assessment: It is important to prioritize risks by assessing their likelihood and impact. This includes understanding the impact of risks on financial performance, reputation, customers and stakeholders. Risk assessment helps the bank to determine where it needs to do more.

Develop a risk management strategy: Banks should develop strategies to deal with identified risks. These strategies may include establishing environmental and social responsibility policies, adopting credit and investment policies based on sustainability criteria, reducing or modifying risky assets, and investing in environmental efficiency and renewable energy projects.

Monitoring and reporting: Banks should monitor and regularly report on the effectiveness of their risk management strategies. This includes monitoring environmental and social performance indicators, preparing sustainability reports and ensuring transparency with stakeholders. A monitoring and reporting process helps banks assess their progress and update their risk mitigation strategies.

Collaboration and Stakeholder Engagement: Banks should collaborate with stakeholders and take their views into account when assessing and managing environmental and social risks. NGOs, customers, regulators and other stakeholders can help banks better understand risks and create more effective solutions.

These steps help banks effectively assess and manage environmental and social risks. Each bank can implement and develop these stages according to its own needs and strategies.

CONCLUSIONS AND SUGGESTIONS

Based on the above, the development of the green economy is becoming one of the most important priorities in all countries of the world today.

Considering that commercial banks have penetrated into all sectors and industries, their role in the development of the green economy is very important. Banks can make an impact by not only developing a green economy, but also by assessing and managing environmental and social risks. Therefore, the establishment of an ESG system and the right selection of industry experts are the most important tasks in all existing commercial banks.

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