Environmental, Social and Governance (ESG) challenges confronted by the banks

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Abstract: This study aims at examining the evolution of the Environmental, Social and Governance (ESG) Investing in the EU, classification of the ESG methodology and the time frame, and the analysis of the level of application of the accepted standards, politics and recommendations.

Keywords: Sustainable development; Ecology, Climate; Taxonomy

JEL: Q5

Introduction

The actuality of the topic is related with the dynamic of the climate changes, the social structure and the growing aspiration for applying of sustainable solutions, which will guarantee conservation of the natural resources for the next generations.

Theoretical review

According to (Edmans, 2022), ESG investing have dualistic nature [1]. From one side they are crucially important, from the other – they are not more important than any other intangible assets that create long-term financial and social returns, such as management quality, corporate culture, and innovative capability. (Rau and Yu, 2023) examine the problems with the measurement of the quality of ESG data [2]. They find that in the practice a lot of discrepancies between the different measures of ESG are available. (Liu, 2022) analyze the significance of ESG ratings and their implementation in the financial world [3]. The author comes to the conclusion that greater quantitative ESG disclosure, especially disclosure on environmental and social pillars, results in greater divergence of ESG ratings. He also finds that the effect of quantified ESG disclosure on rating divergence is more pronounced when firms are single businesses rather than diversified businesses with poor ESG performance rather than good ESG performance. (Jean and Grant, 2022) pay attention to the connection between the management systems and ESG performance [4]. They find that through a management system plan-do-check-act (PDCA) approach, ESG initiatives can be effectively planned, executed, reviewed, and reported to support ongoing improvement in both ESG as well existing operations. (Chen and Xie, 2022), examine the role of ESG investors [5]. Findings show that ESG disclosure has a favourable effect on corporate financial performance. ESG disclosure has heterogeneous effects on financial performance of the companies. The positive effect is more pronounced in

companies with ESG investors and companies with longer inception, high media attention, and high agency costs. (Beerbaum, 2022) analyse the ESG Taxonomy and the effects from the implementation in the EU economy [6]. The authors' conclusion is that the EU taxonomy represents the most comprehensive classification scheme for sustainability on a worldwide basis. In the same year (Dumrose, Rink and Eckert, 2022), examine the relation between EU Taxonomy and ESG rating [7]. After the using of tobit regressions, the conclude that environmental ratings from three out of four ESG data providers are significantly related to the EU Taxonomy. However, the results suggest that the potential for reducing measurement divergence has not yet fully materialised.

Discussion

More than 30 000 species are included in the United nations list with endangered biological species. The "climate migrants" are more than 5 million people as of the end of 2019 and their number will keep growing. According to the predictions of the World bank, in the end of 2050, the number of the climate migrants will be between 140 and 150 million. More than 70 million people will live in extreme poverty as a consequence of the Covid 19 pandemic. The analyses of the United nations, shows that 250 million children don't have access to education and 54 % from the population will need from requalification. 2019 became the second hottest year on record. Temperatures around the world are expected to rise within 3.2 °C. In 2018, natural disasters affected the lives of 39 million people.

As of April 2020 only 6 countries reporting about full compliance of their national disaster risk reduction strategies with the Sendai Framework agreement. 85 countries reporting partial compliance of the strategies with the framework. Some predictions indicates that 800 million work places will be permanently closed until 2030.

1. **Challenges and leadership role of the banks**

The majority of the bank managers express the opinion that banks should be the main driver in the process of achieving climate neutrality. The smaller part of the challenge for them is to build internal ESG policies and to implement the external regulations in the field in their own banks. Banks, as commercial enterprises, can relatively quickly transform their operations and reduce or achieve almost zero carbon footprint.

The greater challenge is, through their role as a financial intermediary and lender, to steer the economy towards activities with a low carbon footprint, conserving natural resources and exhibiting socially responsible behavior. Often, such activities are unprofitable in the short term and require significant capital investment. Measuring the result of their activity is difficult, and the criteria for this are still unclear. Banks that have set as their strategic goal the financing of green activities are often forced to accept a lower profit margin and take on greater risk, since the activities of such companies still face a number of administrative and business obstacles.

All this also has its social dimensions – the activities with the largest carbon footprint are often those that provide a large number of jobs (for example, the extractive industry, mining, etc.). Refusing to lend to businesses in these areas and redirecting funds to industries that are their greener alternatives sometimes leads to job cuts, shrinking local economies, and reduced consumption. The loss of household income can hardly be compensated, so some banks sponsor retraining programs to help those who have lost their jobs reintegrate into society and bring additional benefits to it through their work.

The Intergovernmental Panel on Climate Change (IPCC) and other scientific bodies have set 2050 as the deadline for achieving net zero emissions, thereby meeting part of the goals set out in the Paris Agreement.

To achieve this goal, some banks, in addition to excluding enterprises with a high carbon footprint from the list of potential borrowers, influence the remaining ones to create programs and modules for sustainable development by creating innovative products and services in enterprises.

Due to the lack of a unified methodology, the measurement of indirect emissions along the value chain (so-called Scope 3) is extremely difficult for creditors. This appears to be in dissonance with efforts to reduce greenhouse gases.

Another serious problem for the commercial banks is the aspiration of shareholders to achieve the highest possible profit margin. Despite the stated desire for sustainable development and support for the process of implementing green technologies in the real economy, some shareholders do not want this to happen at the expense of the bank's profit, which leads to contradictions both between the shareholders and between shareholders and management.

2. Risks

ESG investing and strategies are complicated and multifactorial. The implementation of the ESG politics in the financial world is accompanied by many risks with different structure, effects, possible unwanted consequences and time schedule. The definition for "risk" in the Regulation on disclosure is "Environmental, social or management event or condition, which in occurrence may cause actual or potentially material adverse impact on the value of the investment that results from the adverse impact on sustainability". Some of the possible types of risks are:

- Political risk - for example as a result of political reluctance for implementing of energy requirements efficiency, carbon pricing mechanisms that increase the price of fossil fuels, or policies to promote sustainable use of land resources.
- Legal risks - the risk of litigation due to avoidance or not minimizing adverse climate impacts or failure to adapt to climate change rules

- Technological risks - if less harmful, but very expensive technology replaced a technology which is more harmful to the climate, but with low operational costs, this will generate risk for the company
- Market risk – in countries with high level of poverty and low level of development of the principles of sustainable development, the consumers and businesses customers can prefer products and services that are more harmful to the climate, but cheaper from the other products

Fig. 1

In Figure 1, the different types of risks are schematically presented, with each group combining several possible risks.

3. Climate Sensitivity Analysis

The organizations that apply the principles of ESG investing are obligate to perform climate sensitivity analysis (CSA). Inherently the CSA is activity that does not follow a particular order and that evaluates changes in the risk affecting cash by changing the output data in financial models based on concealment and classification of the presentation of "green" compared to "not green" (which determines the vulnerability of the presentation of climate-related events and policies). The analysis must examine a multitude of ESG factors, which can possibly affecting environmental, social and governance negative (or positive) impact on financial results or on the solvency of the legal entity or the individual. The analysis also includes management related issues that potentially might have positive or negative impact on the profitability or the liquidity of the company. There are also some management risks that are associated with any negative financial impact on the institution and arising from current or future impacts of management factorson participants or investment assets. The physical risks that are associated with any financial impact on the institution and

resulting from the present or future impacts of the physical effects and factors of environment on counterparties and investment activities is crucial part from the analysis.

4. Social risks analysis

Includes examination and observation of the possible risks factors, associated with any negative financial impact on the institution arising from current or future impacts of social factors on its counterparties or investment assets; related to the rights, welfare and interests of people and communities and include factors such as (in)equality, health, inclusion, industrial relations, occupational health and safety place, human capital and communities, etc.

5. Determination of ESG risks – challenges and difficulties

The main challenges arising from the release of ESG risk analysis can be grouped in 6 categories:

- Uncertainty - the timing and the potential impact/effect of policies and the related regulatory interventions whose specific implementation is responsibility of the members of the EU are difficult to be predicted.
- Insufficient data coverage - the lack of relevant, comparable, reliable and user-friendly information arrays is a challenge that limits the understanding of the potential impacts of ESG risks.
- Methodological limitations – the majority of the contemporary risk management models are based on the use of historical data (i.e.historical experience) to assess current or future risks. ESG factors are often not reflected in this data base. For example it is difficult to take ESG risks into account when calculating the probability of default.
- Time - horizon discrepancy - time horizon mismatch between "traditional" management tools and the time frame to materialize the ESG risks: in particular, the full impact of the factors of the environment often develops over decades.
- Multipoint impact of ESG risks - : as it is considered that ESG risks can affect different categories of financial risk, they can affect the financial state of institutions in many ways (for example, in agriculture or construction) can lead to higher credit losses if an institution is exposed to these activities through loans or bonds or suffered a loss in market value
- Non-linearity - most ESG risks, especially those related to risks for the environment, are non-linear in nature. Both physical and transitory risks can create complex chain reactions and cascading effects that in turn could generate unpredictable environmental, geopolitical, social and economic dynamics.

6. Assessment of ESG risks

A significant part from the companies Implement the ESG risk assessment through the traditional categories of financial risks (credit risk, market risk, operational and reputational risks, liquidity and financial risks).

There are different ESG assessment methods available and they are rapidly evolving. The European Banking Authority (EBA), identifies three different approaches:

1. Unification method
2. Risk framing method (including analysis of the situation)
3. Method of highlighting

The stages through which the implementation of ESG risk assessment passes are:

- Identification of the risk – on this stage a classification of the exposures according to their ESF characteristics must be prepared. The classification can be made by sector, asset class, maturity, counterparty, etc.
- Evaluation of the risk – on this stage the ESG risk is estimate with methodological tools and methods. Some of the most popular methods are – risk framework method with included climate change stress test, portfolio alignment method and exposure method.
- Action – the finale stage is related with the incorporation of the ESG risks in the business strategies of the company, the internal governance and the risk management.

7. ISO standards and benchmarks

The ISO standards are represented by a global network of 165 national standardization bodies, which develops voluntary, consensus-based standards that are internationally recognized and which, based on independent validation and verification, provide accreditations for public and private organizations. These market related certificates are mandatory in some countries and include standards, among others, in the field of climate change, environmental management, energy management, social responsibility, health and workplace safety and management systems for prevention of bribery.

On July 17, 2020, the European Commission adopted new rules, defining minimum technical requirements for the methodology of the EU climate benchmarks. The new rules increase the level of transparency and comparability of products, developed by benchmark administrators including the criteria to be labeled as benchmarks of EU on the transition to a green climate and reference values for benchmarks in line with the Paris Agreement on climate change.

8. Taxonomy

ESG taxonomies and standards classify different elements in(e.g. economic activities, social practices or conventions), as the same are defined and associated with different categories based on certain criteria. Thus taxonomies can allow distinctions to be made between assets, counterparties and economic activities based of their ESG characteristics. In accordance with Article 3 of the Taxonomy Regulation ((EU) 2020/852), economic activity qualifies as environmental sustainable when it contributes significantly to one or more of predetermined environmental objectives, does not significantly harm of none of the (other) environmental objectives, is carried out in compliance with certain minimum guarantees (e.g. Guidelines of OECD for Multinational Enterprises and the Guiding Principles of the United Nations on Business and Human Rights) and meets all technical screening criteria specified in the delegated legislation.

Taxonomy is described as a „stock“ for the future, one of the purposes of which is to provide clarity about this what is environmentally sustainable activity. The taxonomy allows measurement of the degree of impact of the environment in regard to the adequacy of the investment product and In the future activities of the company. This specific transition tool is useful for investors and companies which want to plan and report the transition. In this way taxonomy set the goals and direction for various economic activities.

Six interrelated environmental goals have been set:

- climate change mitigation
- adaptation to climate changes
- Transition to a circular economy
- Prevention and control of the pollution
- Sustainable use and protection of water and marine resources
- Protection and recovery of biodiversity and ecosystems

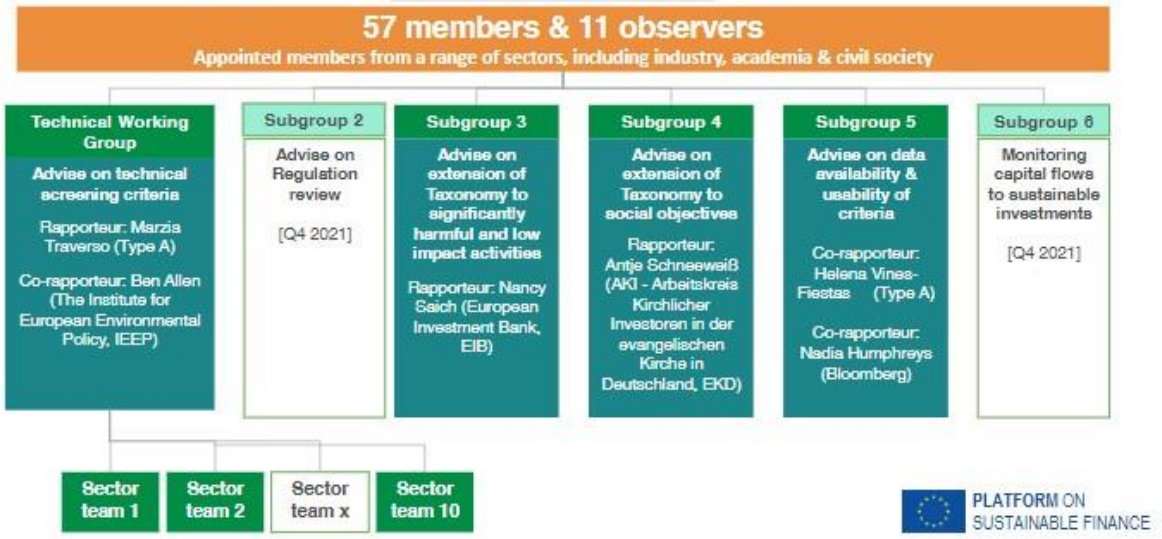
According to taxonomy environmentally sustainable activity is any activity which covers 3 requirments – the sustainability contributes to at least one of the six environmental goals; lack of significant harm to any of the other five environmental goals; observance of minimal protective measures.

9. Platform on sustainable finance

On 15-th of October 2020 the first inaugural meeting of the Platform on Sustainable finance was held. The Platform have advisory function and it is established by the European commission. The members of the Platform makes recommendations for setting criteria as part of the EU taxonomy. They can give advises on revising the Taxonomy Regulations under the supervision of the Commission.

The platform on sustainable finance has 57 members and 11 observers. As it shown on Fig. 2 the Platform have 1 Technical working group and 5 subgroups.

Fig.2 Structure of the platform on sustainable finance



Source:https://finance.ec.europa.eu/sustainable-finance/overview-sustainable-finance/platform-sustainable-finance_en

Conclusion:

The ESG investing will become more and more important over the next decades. The socio –economic life will be dominated by the idea for sustainable development, green deal, conservation of the nature and the resources. At this stage the European union has adopted a significant number of regulations, standards, laws and recommendations. This base is inherently a solid foundation for development and upgrade, but the fact that at this stage communication with the business is at an unsatisfactory level should not be overlooked. The legislative framework is too complex and multifaceted and this creates difficulties in practical implementation. The lack of centralization and a single authority to adopt and implement policy in this area may prove to be a significant problem, which would delay the implementation of a sensible, targeted and sustainable policy.

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