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ESG Integration in the Banking Sector

Navigating Regulatory Frameworks and Strategic Challenges for Financial Institutions

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ISBN 978-3-031-81676-5 ISBN 978-3-031-81677-2 (eBook)
https://doi.org/10.1007/978-3-031-81677-2

This Palgrave Macmillan imprint is published by the registered company Springer Nature Switzerland AG.
The registered company address is: Gewerbestrasse 11, 6330 Cham, Switzerland

Competing Interests

The author has no competing interests to declare that are relevant to the content of this manuscript.

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CHAPTER 1

Introduction

Abstract The environmental, social, and governance (ESG) dimensions have attained a dominant role for financial institutions in recent years and in particular the practical initiatives to incorporate ESG into business and operating models have become one of the most significant issues for European banks. The three letters E, S, G—which form the acronym ESG—identify a comprehensive setting that have changed and will continue to have a huge influence on banking. Why ESG topics matter for financial institutions and banks? What impacts do ESG dimensions have on banks? The significance of ESG matters has never been more prominent since the society has to deal with environmental and social challenges such as climate change, social inequality, and governance failures. In this context, ESG is increasingly becoming a relevant issue for doing business in banks as it can support in managing risks, enhancing reputation, complying with regulatory requirements, driving innovation, and growing access to capital. Banks that prioritize ESG are likely to attain long-term success because they are better appropriate for creating a more sustainable and fair future for all stakeholders. ESG themes are progressively important for customers, investors, and other stakeholders who want to recognize banks as responsible entities. Banks that prove their commitment toward sustainability are more able to fascinate customers, as well as to raise funding from ESG-interested investors.

E. Menicucci, *ESG Integration in the Banking Sector*,
https://doi.org/10.1007/978-3-031-81677-2_1

Keywords ESG • Environmental • Social • Governance • Banks

In recent years, macroeconomic dynamics, social transformations, and regulatory and technological developments have determined significant changes in the banking sector, with significant consequences also for its future and developing trend. Considering the profound transformation of the global environment, banks and financial institutions are progressively challenged to incorporate environmental and social issues into their strategic planning to go beyond financial performance.

The environmental, social, and governance (ESG) dimensions have assumed a central role for financial institutions in recent years and in particular the practical initiatives to integrate ESG into business and operating models have become one of the most important topics for European banks. The three letters E, S, G—which form the acronym ESG—cover a comprehensive setting that have changed and will continue to have a massive impact on banking.

Why ESG issues matter for financial institutions and banks? What effects do ESG dimensions have on banks? It is shared that sustainability purposes and specifically the environmental, social, and governance (ESG) dimensions have already been increasingly incorporated in capital investments recently, and especially the COVID-19 pandemic period has intensified this trend. Hence, ESG factors identify an umbrella concept that should drive the investment choices. In this regard, the ESG investing offers even conventional investors an opportunity to foster sustainable businesses through their investments. Arguably, when numerous investors incorporate ESG dimensions in their investment choices, and thus directly and indirectly, they affect investee companies, and achieving sustainable development is clearly facilitated. The novelty compared to the past is also the priority that ESG issues have assumed in the global political agenda and, consequently, the major awareness of all stakeholders on the ESG concerns' centrality in ensuring the sustainability of business models of the intermediaries. Thus, the commitment toward sustainable business represents both a regulatory compliance obligation within a constantly evolving framework and a value creation opportunity in line with the double materiality paradigm.

The relevance of ESG considerations has never been more prominent since the society has to deal with environmental and social challenges such as climate change, social inequality, and governance failures. In this context, ESG is gradually becoming a significant issue for doing business in banks as it can aid in managing risks, enhancing reputation, complying with regulatory requirements, driving innovation, and growing access to capital. Banks that prioritize ESG are likely to achieve long-term success because they are better suited for creating a more sustainable and fair future for all stakeholders.

ESG issues are increasingly important for customers, investors, and other stakeholders who want to recognize banks as responsible entities. Banks that demonstrate their commitment toward sustainability are more able to attract and maintain customers, as well as to access funding from ESG-interested investors. For example, a bank that finances renewable energy projects or promotes social programs in its local community is probably positioned more positively than a bank that does not materialize ESG dimensions. For these purposes, banks must review their ESG strategies and their impact on profitability and risk to confirm their role in society in the perspective of sustainable finance. Then, banks should start to assess the implications that ESG factors may have on their core operations and business model in order to identify and prioritize the crucial functions to be revised (e.g. compliance, audit, product governance, risk management, risk controls, investment processes, etc.) in line with the already publicly available regulatory guidelines and market trends on ESG.

The growing relevance of ESG factors in the global economy has inevitable implications on the European banking industry. While EU authorities are designing the new ESG regulatory framework, banks are already addressing demands by their stakeholders (institutional investors, rating agencies, clients, etc.) for more real ESG solutions. Embedding ESG metrics into banking processes and testing their applications—for example, in product design, pricing and sales decisions, risk management, compliance functions—has become a sustainability challenge for banks and a critical topic for fostering bank revenues. Besides, regulators and authorities in the banking sector are deeply interested in this theme and they issued new requirements to foster the integration of ESG factors and risks in the banking system. The effective strategies of banks should include ESG dimensions into bank risk frameworks considering that ESG risk is not a fully stand-alone risk type. Based on a holistic approach to banking risks within the risk management process, ESG risks influence financial and non-financial banking risks through complex cause-effect-relationships.

This book explores ESG issues in the banking sector and it is expected to spark interest among stakeholders who are interested to the substance