Introducing ESG Criteria in Developing Countries Banking Sectors

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ESG AND BANKING SECTOR REGULATION

- The importance of the environment, social cohesion and corporate governance are unquestioned.
- In banking, the debate verts around whether risks are material, how to set up measurable outcomes/targets, the authorities responsible for the achievement of the ESG goals, the tools that need to be used, the structure of supervision and accountability to the general public.
- Experience suggests that principles-based agreements may work better under certain settings, especially when risks to the banking system are difficult to quantify.
- Rules without monitoring and supervision are ineffective, supervision without accountability impairs social cohesion.
- Incorporating ESG principles in the current regulatory and supervisory architecture in many emerging markets and developing economies (EMDEs) is challenging.
- Public awareness, the sequencing of reforms and accounting for the strength of the institutional environment may help in introducing ESG in EMDEs.

WHO AND HOW

- The case for the central bank to champion ESG principles is growing strong.
- Yet the shift state power to **the all mighty central bank** will put pressure and question even more the independence of central banks.
- It is also unclear how multiple, sometimes conflicting goals, could be achieved.
- Expanding the remit of central banks to include ESG policy issues places more responsibility beyond the current democratic accountability, and it blurs the boundaries between governing and central banking.
- Central banks may instead be better placed in monitoring how ESG principles are related to their main mandate.
- For example, in many EMDEs, central banks now factor in environmental risks in their stress testing exercise to assess whether transition to a greener economy and natural disasters “materially impact” bank stability.

BASICS FIRST

- Extending ESG principles to EMDEs without taking into account the current strength of the institutional environment may backfire.
- First, bank supervisor capacity is severely constrained in several countries.
- Second, it is necessary to clearly identify what principles should be embedded in regulation and whether existing tools or additional ones are needed.
- There should be a careful assessment of whether a specific tool is beneficial to achieve a specific outcome.
- Principles and regulation should be **proportional** to the level of public intervention in the form of rules, restrictions, or sanctions to achieve the desired social objectives.
- Monitoring and appraising government intervention is key to adequately work towards achieving ESG goals.