ENVIRONMENTAL AND SOCIAL RISK MANAGEMENT GUIDELINES

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GUIDELINE NOTE

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Aerial view of vegetable farms in Baguio City, the Philippines (Nikada/iStock)

EXECUTIVE SUMMARY

Financial regulators globally are addressing the need for improved risk management practices amongst lending institutions that consider financial exposure to both environmental and social risks.

Throughout the Alliance for Financial Inclusion (AFI) network there are initiatives underway by financial regulators to provide guidance to financial institutions which serve inclusive segments on environmental and social risk management (ESRM) implementation.

This report presents challenges and policy recommendations from the IGFWG and is intended as a tool for regulators or policymakers who are developing ESRM guidelines. The guideline consists of three sections.

SECTION 1 - PREPARATORY CONSIDERATIONS

Before issuing ESRM regulatory policy guidance, certain preparatory activities and conditions have been identified to support the policy making process and avoid policy implementation that has adverse effects such as financially excluding certain segments.

These include strategic considerations for banks including; definitions of sustainability and data requirements, scope and applicability of regulatory guidance, coordination mechanisms, exploratory activities such as diagnostic studies, and potential incentives such as concessionary refinancing opportunities and directed lending policies that focus on inclusive segments.

SECTION 2 - POLICY GUIDANCE

Once the pre-conditions have been addressed, the formulation of an ESRM regulatory policy for the target regulated entities is needed.

A wide range of policy and regulatory guidance applicable to ESRM implementation from within the AFI network has been synthesized for the purposes of this guideline note. The result of this work has been the development of ESRM Guiding Principles for financial institutions (FIs). Recommendations for each principle are included later in this guideline note, as well as a comparison table of interviewed jurisdictions (Annex 1) and cases studies for cross-border cooperation initiatives seeking to align ESRM practices regionally (Annex 2). The principles are summarized below.

PILLAR 1: GOVERNANCE & STRATEGY

Supervisors should expect FIs to define and assign environmental and social (E&S) responsibilities within existing governance arrangements.

1.1 **Guiding principle:** the foundation of effective ESRM lies in corporate governance, and should be catalyzed by an understanding between the FI's shareholders, the board of directors, and senior management.

- **1.2 Guiding principle:** ESRM is an issue of strategic importance, and should be anchored in the FI's strategic plan and strategic management framework.
- **1.3 Guiding principle:** the strategic plan should consider ESRM as a source of reward as well as risk by emphasizing the effective risk-based pricing of E&S risk.
- **1.4 Guiding principle:** there should be communication of expected values and behaviors in relation to ESRM by the FI's senior management team.
- **1.5 Guiding principle:** ESRM practice is an evolving discipline, but early action is essential,

PILLAR 2: RISK MANAGEMENT

Supervisors should expect FIs to have policies and procedures in place to identify, assess, monitor, report and manage all material E&S risks.

- **2.1 Guiding principle:** ESRM should form part of a holistic risk management framework and not be managed in a silo.
- **2.2 Guiding principle:** ESRM should be embedded into the credit risk management culture, and considered from the perspective of both physical and transition risks.
- **2.3 Guiding principle:** in addition to credit risk, ESRM is a source of operational, market, and liquidity risks and should be integrated into these functions.
- **2.4 Guiding principle:** ensure that risk monitoring and reporting is a pillar of the ESRM framework.
- **2.5 Guiding principle:** ESRM should be covered by the internal audit and compliance functions, and recommendations for improvement promptly and fully acted upon

PILLAR 3: DISCLOSURE & STAKEHOLDER MANAGEMENT

Supervisors should expect FIs to disclose information and metrics on the E&S risks they are exposed to, their potential impact on the safety and soundness of the institution, and how they manage those risks.

- **3.1 Guiding principle:** prepare for the evolving requirements of regulators in relation to the disclosure of E&S risks.
- **3.2 Guiding principle:** follow international and local developments in corporate ESRM reporting and disclosure, and adopt proportionate and appropriate enhancements.
- **3.3 Guiding principle:** ensure that ESRM disclosure and reporting forms a key pillar of the approach to public relations and communications.
- **3.4 Guiding principle:** underpin successful adoption of the expected ESRM value and behaviors by management and staff through effective internal communications, and training and development.
- **3.5 Guiding principle:** help customers through their sustainability journeys through frank but sensitive communications about the institution's expectations of them in terms of ESRM.

SECTION 3 - IMPLEMENTATION RECOMMENDATIONS

Once ESRM regulatory policy guidance has been formulated, the implementation of guidance can be supported by a variety of activities.

Engagement with the financial sector (banking, non-banking FIs, insurance providers, etc.) through a formal consultation process followed by respective industry discussion forums gives regulated entities and broader stakeholders a chance to provide feedback. Supervisors will need to calibrate and communicate their compliance expectations accordingly. While adjusting capital adequacy requirements are not recommended at an early stage, the introduction of supervisory oversight activities will be relevant in the near-term.

INTRODUCTION

The objective of this report is to provide practical guidance on the development of ESRM guidelines for financial institutions.

Globally, financial regulators are providing guidance to regulated entities on ESRM through the development of ESRM guidelines. Across the AFI network, financial regulators acknowledge the need for improved risk management practices among lending institutions that consider financial exposure to both environmental and social risks. This presents a particular challenge in relation to under-banked segments such as micro, small and medium enterprises (MSMEs), predominantly women-owned, that may have received less support in adapting to the global transition towards sustainability.

> Finance is likely to present an even larger challenge for SMEs going forward, as financial institutions seek to comply with mandatory environmental reporting requirements.[1]

A key structural shift required towards sustainable banking is identification and management of environmental and climate-related physical and transition risks facing projects and borrowers. In addition, clients of credit institutions face increased reputational risks associated with greater responsibilities for social impact and human development.

Banks will need to strengthen their respective risk management frameworks by integrating ESRM approaches and reassess their business strategies in this new context. Financial regulators will need to promote and support them in this process.

Whilst AFI member jurisdictions are at varying stages of implementation, this report identifies common approaches to implementing ESRM in the banking sector and provides procedural considerations for regulators to issue such guidelines.

The intended audience for this publication is mainly financial regulators in emerging and developing economies that seek to “green” their countries’ banking systems. The guidance provided here will require considerable tailoring to each country’s circumstances, including its financial system structure, national environmental and social objectives, and the capacity of its financial sector. The guideline note is organized into three sections:

THE GUIDELINE NOTE IS ORGANIZED INTO THREE SECTIONS:

1

PREPERATORY CONSIDERATIONS

This section identifies preparatory activities for regulatory policymakers that can be undertaken such as identification, assessment and prioritization of E&S risks in the system, and setting the scope of ESRM regulatory policy.

2

POLICY GUIDANCE

This section presents guiding risk management principles for the development of ESRM policy, from the perspective of financial institution governance, risk management, and disclosure practices.

3

IMPLEMENTATION RECOMMENDATIONS

This section provides recommendations for the implementation of ESRM regulatory policy and potential follow-up monitoring and supporting activities that financial regulators can undertake.

1 Organization for Economic Cooperation and Development (OECD). No date. Financing SMEs for Sustainability: Drivers, Constraints and Policies – Policy Brief. Paris. OECD Publishing. Available at: https://www.oecd.org/cfe/smes/Financing%20SMEs%20for%20Sustainability%20Drivers%20Constraints%20and%20Policies%20-%20Policy%20Brief.pdf

PREPARATORY CONSIDERATIONS

The successful implementation of ESRM practices in the banking sector requires well-conceived, coordinated action, where multiple stakeholders will need to implement incremental change simultaneously.

As with any new regulatory initiative, a holistic view needs to be taken and unintended consequences considered. It can be helpful to think of the transition to sustainable finance as a rising tide, where all stakeholders ideally undertake reform in a harmonized manner in order to avoid first-mover disadvantages and a level playing field that is not level.

The following section identifies preparatory considerations for financial regulators and policymakers that can be studied or performed in advance of issuing ESRM regulatory guidance. This section was informed by a series of in-depth interviews with members of the AFI Inclusive Green Finance Working Group (IGFWG) who have recently undertaken steps to implement ESRM policy.[2]

STRATEGY AND INCENTIVES

A concern regarding inclusive or vulnerable segments is that many MSMEs lack awareness and capacity needed to transition to more sustainable business and operating models. Without awareness building, engagement and adequate incentives, MSMEs will likely continue with their existing "brown" business activities and increasingly find themselves without access to finance due to the enhanced lending requirements set forth in ESRM regulations. Furthermore, the ability of many MSMEs to make the strategic transition to sustainability is hampered by their lack of access to both financial and human capital.

2 AFI Member interview. Annex 1 Overview of ESRM Guidance Established (AFI Member Interview Cohort). Available here.

3 This is an issue that is not confined to emerging markets, and is of considerable concern in developed markets also. However, MSMEs in the latter are often buffered by robust economic sector and segment advocacy groups that can more effectively intermediate with policymakers, making the concern more acute in developing and emerging markets.

THE ISSUE OF FINANCIAL EXCLUSION

A particular area of concern among financial regulators and policymakers when making new regulatory policy is the issue of financial exclusion. While the causes for financial exclusion vary and are widely understood within the AFI network, there are potential challenges introduced by ESRM regulations that may end up excluding micro, small and medium enterprises (MSMEs) in particular.

In the context of ESRM policy implementation, potential financial exclusion drivers are twofold:

1. The evolution of ESRM standards globally is becoming increasingly complex and financial sector actors are not homogenous entities; additionally, they have varying capacities and resources available to implement new standards. There is a risk that FIs who serve the most underserved segments of the population may cease serving customer segments or industries altogether if ESRM requirements are not implemented properly. Applying an appropriate level of proportionality and considerations for sequencing of ESRM regulation will be especially important to support these FIs.
2. By definition, MSMEs are smaller enterprises and often have less capacity and fewer resources to manage and disclose ESRM performance.[3] In order to enable MSMEs to meet new green lending criteria set forth by lending institutions and avoid being financially excluded from green financial products, special assistance and incentives may be required to equip MSMEs with the necessary knowledge and incentives to transition to green finance.

The development of national strategies and policies such as a sustainable finance roadmap are commendable in this regard. These initiatives send useful signals to businesses, investors, and credit institutions regarding how and when the sustainable finance transition will affect them, and give them time to prepare for the shift.

As public-sector policy and legislation allocates new sustainability mandates and responsibilities for economic development, careful consideration by the regulators and supervisors of the financial sector of the resulting national-level commitments and initiatives will be important. In many cases, fiscal commitments to support sustainable financing in particular sectors or segments of the economy sector may come into play as well. To that end, the nature and timing of ESRM requirements should be aligned with the wider national sustainable economic development agenda to ensure that the strategy and incentives are aligned.[4]

4 Section III of this report provides recommendations on sequencing and phasing.

A NOTE ON TERMINOLOGY: ESG, ESRM, AND CRM

Environmental, social and governance (ESG) refers to the three central factors that shape the sustainability and ethical impact of a company or organization. Environmental and social risk management (ESRM) is a framework (sometimes referred to as an ESRM system) that helps organizations identify, assess, and manage environmental and social risks in their operations, supply chains, and investments. Climate risk management (CRM) is the process of identifying, assessing, and mitigating the potential financial impacts of climate-related events on an organization.

All three approaches are important considerations for banks and other financial institutions as they can be used to describe elements of financial risk they face and ensure the long-term sustainability and resilience of their operations.

In the context of financial regulation, the terminology can vary due to the different emphasis a regulator may want to have on policy guidance to regulated financial institutions and the perspective of the guidance (i.e., addressing financial risks of counterparties, versus an FI's management and operational approach).

The consideration of governance factors – both from an FI's underwriting perspective as well as an FI's own governance processes – has been evolving for some time. Banking regulators have been issuing guidance and requirements on governance issues for decades. For that reason, many regulatory frameworks already address the governance component. When new regulatory guidance is published that emphasizes E&S risks, it does not mean the governance factors are not important, only that governance factors are likely already considered in the current regulatory and supervisory framework.

The same is the case for the environmental "E" and social "S" factors. Many advanced jurisdictions have already required lenders to ensure borrower compliance with health, labor, and environmental standards for some time, and so are seeking to elaborate a specific approach for climate change risk, given that it is one of the greatest emerging threats to soundness of financial systems.

For the purposes of this guideline note, the focus is on the E&S risk approach which recognizes that good governance practices are already implied, and that climate risk is a sub-set of the environmental risks. This guideline note also recognizes that climate risk management is still at an early stage of development for many AFI member jurisdictions, given its inherent complexity and need for advanced analytical approaches.

PERCEIVED BENEFITS TO FIS AND THE BUSINESS CASE FOR ESRM

There are many perspectives from which to measure the performance of banking institutions and there is broad case study literature and public opinions seeking to understand the link between performance of banking institutions and the implementation of ESRM. There is much debate as to whether or not the investment costs associated with implementing ESRM creates firm shareholder value. As the implementation of ESRM by banks becomes more common globally, there is mounting evidence that there are direct financial benefits to banks which take a serious approach to implementing ESRM. Below are some examples that highlight findings of the literature.

Improved quality of loan portfolio

It is widely understood that a more accurate assessment of credit risk improves loan portfolio quality, and thus it follows that gaining more insight into a business's performance through E&S assessment should uncover more information about a borrower's risk profile. Researchers have found that incorporating additional sustainability criteria into the CRM process improved correct risk classification of loans to SMEs.

8%

One prominent example in a study of 40 German banks found the inclusion of E&S criteria in the loan assessment process improved classification of loan defaults by nearly eight percent.[5]

In conclusion, the more a borrower can demonstrate sustainability, the more it influences creditworthiness as part of a financial performance assessment. It follows that E&S criteria can in fact be used as an indicator to predict financial performance of a borrower and improve the predictive validity of a credit rating process.

Improved reputation and brand value

There is an increasing recognition that integrating ESRM can avoid reputation risks, and can lead to improved reputation and increase brand value amongst FIs. A finding in a report[6] by the IFC indicated that many banks in emerging markets that undertake strong environmental sustainability work in general are rewarded with public recognition, inclusion on sustainability indices, and promotion from partners.

Conversely, the risk of negative publicity from the actions of clients to which they lend (reputation risk) can be especially significant for FIs. A survey[7] conducted by the United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP) of FIs in selected least-developed nations in the region found that ignoring E&S risks and failing to address them in their processes increases their financial risks and risks to their reputation. The primary motivators of E&S performance included the need to enhance the FI's reputation, financial pressure, pressure from stakeholders, and regulatory and third-party requirements. Reputation risk drives E&S performance, and it was particularly important among the larger FIs in developing countries.

Attracting funding sources and investment

The process of implementing ESRM in a bank requires real commitment and will reduce resources for funding activities. This, however, is often appreciated by long-term investors, who recognize that improved performance will materialize in the years to come. Many institutional investors today will not invest anymore in FIs that do not have ESRM policies in place.

Findings from the report noted that FIs in emerging markets benefit from such things as preferential loan pricing,[8] technical and advisory support, smoother and faster transactions, and introductions to other business opportunities – all accrued because of ESRM implementation.

5 Weber, Olaf. Scholz, Roland W. and Michalik, Georg. 2008. Incorporating Sustainability Criteria into Credit Risk Management. Volume 19, Issue 1, 39-50. Business Strategy and the Environment. Available at: https://onlinelibrary.wiley.com/doi/10.1002/bse.636

6 International Finance Corporation (IFC). 2014. Evaluating the Business Case for Environmental and Social Risk Management in Financial Institutions (English). Washington, D.C. World Bank Group. Available at: http://documents.worldbank.org/curated/en/481991520946554585/Evaluating-the-business-case-for-environmental-and-social-risk-management-in-financial-institutions

7 Martin, Patrick. Elbeltagy, Zeinab. Hasannudin, Zenathan Adnin and Abe, Masato. 2021. Factors Affecting the Environmental and Social Risk Management of Financial Institutions in Selected Asia-Pacific Developing Countries. MPFD Working Papers. ESCAP/1-WPUNESCAP. 2021. Available at: https://hdl.handle.net/20.500.12870/3439

8 International Finance Corporation (IFC). 2014. Evaluating the Business Case for Environmental and Social Risk Management in Financial Institutions (English). Washington, D.C. World Bank Group. Available at: http://documents.worldbank.org/curated/en/481991520946554585/Evaluating-the-business-case-for-environmental-and-social-risk-management-in-financial-institutions

PERCEIVED BENEFITS *continued*

A report by the World Bank Group says that "… partnership and funding opportunities can result from both an emerging-market FI's current ESRM processes and an emerging-market FI's willingness desire to develop ESRM processes. Respondents emphasized the importance of openness and a shared set of values towards environmental and social issues when partnering with and funding emerging-market FIs."[9]

Another example of improved investment potential from a cross-country comparison[10] found that in developing markets the share price reaction to adoption of the Equator Principles by FIs (a set of best practice principles to guide banks that are involved in project finance on ESRM)[11] was significantly positive and supported the idea that adoption of ESRM is a strategic choice even though it involves substantial investment.

Increased business opportunities and competitiveness

Interestingly, the findings on the hypothesis that FIs operating in emerging markets that adopt ESRM have competitive advantage are mixed.

On the one hand, literature on the topic reveals that banks in emerging markets do tend to agree that "adoption of ESRM practices provides a competitive advantage to those banks that successfully adopt and implement it (in the form of increased access to partners and clients, preferential pricing, and new business opportunities)."[12]

However, on the other hand, many banks spoke of the perceived competitive disadvantage of ESRM that many emerging-market FIs believe to be case. In some countries where adoption across FIs is not widespread, emerging-market FIs believe that "the use of ESRM will slow down their loan processes and preclude them from working with certain local clients."[13]

Resolving this tension appears to be critical in successful adoption of ESRM across emerging markets and should be a learning lesson for regulators to ensure a level playing field.

DATA AND DEFINITIONS

Banks implementing ESRM will require enhanced environmental risk due diligence on borrowers. This will require upgraded processes for obtaining, evaluating and monitoring E&S information about MSME borrowers and their projects. In developing these processes, lenders will need to consider the industrial sectors in which a borrower operates, as well as the location of these operations and related assets. It will also be necessary to consider the commitment and capability of borrowers to managing climate-related, environmental and social risks.

Banks use E&S data in several ways:

> **Risk assessment:** data is used to assess the possible environmental and social risks associated with a project or activity. This helps the bank to understand the potential impacts and determine the level of risk associated with financing the project.

> **Due diligence:** data is used to perform due diligence on the client, the project, and the sector. This helps the bank to identify any prospective issues and to determine the best course of action to manage the risks.

> **Monitoring and reporting:** data is used to monitor the environmental and social performance of the projects and activities the bank finances over time. This helps the bank to track progress and to ensure that the projects and activities are being implemented in a responsible and sustainable manner.

9 International Finance Corporation (IFC). 2014. Evaluating the Business Case for Environmental and Social Risk Management in Financial Institutions (English). Washington, D.C. World Bank Group. Available at: http://documents.worldbank.org/curated/en/481991520946554585/Evaluating-the-business-case-for-environmental-and-social-risk-management-in-financial-institutions)

10 Finger, Maya. Gavious, Ilanit. Manos, Ronny. 2018. Environmental risk management and financial performance in the banking industry: A cross-country comparison. Journal of International Financial Markets, Institutions and Money. Volume 52. 2018. Available at: https://doi.org/10.1016/j.intfin.2017.09.019.

11 The Equator Principles Association. Accessed 26 April 2023. Available at: https://equator-principles.com/

12 International Finance Corporation (IFC). 2014. Evaluating the Business Case for Environmental and Social Risk Management in Financial Institutions (English). Washington, D.C. World Bank Group. Available at: http://documents.worldbank.org/curated/en/481991520946554585/Evaluating-the-business-case-for-environmental-and-social-risk-management-in-financial-institutions

13 International Finance Corporation (IFC). 2014. Evaluating the Business Case for Environmental and Social Risk Management in Financial Institutions (English). Washington, D.C. World Bank Group. Available at: http://documents.worldbank.org/curated/en/481991520946554585/Evaluating-the-business-case-for-environmental-and-social-risk-management-in-financial-institutions

- **Risk mitigation:** data is used to identify and implement risk mitigation measures that can help reduce the potential environmental and social impacts of the projects or activities.
- **Compliance:** data is used to ensure that the bank is in compliance with relevant environmental and social regulations and standards. This helps the bank avoid potential legal and reputational risks.

SMEs risk losing out on sustainability-linked finance due to their limited capacity to produce data on their sustainability performance, including ESG assessments.[14]

On the borrower side, MSMEs will have certain E&S data requirements when applying for a loan from a bank. The data requirements vary depending on the size, complexity, and type of project or activity being financed, but some common requirements include:

- **Project description:** detailed information on the project or activity, including the objectives, timeline, budget, and expected outcomes.
- **Environmental and social impact assessment:** a comprehensive assessment of the potential environmental and social impacts of the project or activity, including a description of the methodology used, data sources, and results.
- **Environmental and social management plan:** a plan that outlines how the borrower intends to manage the environmental and social risks and impacts associated with the project or activity.
- **Compliance with regulations and standards:** evidence that the project or activity is in compliance with relevant environmental and social regulations and standards, including any relevant permits, licenses, and certifications.
- **Stakeholder engagement plan:** a plan for engaging with affected community stakeholders, including a description of the consultation process and a summary of the feedback received.
- **Monitoring and reporting plan:** a plan for monitoring and reporting on the environmental and social performance of the project or activity over time, including the data sources and methods used, and the reporting frequency.

These borrower data requirements are necessary for the bank to assess the environmental and social risks associated with the project or activity, and to make an informed decision about whether to finance a project. The requirements also help the borrower to demonstrate their commitment to responsible and sustainable project implementation.

While explicitly solving the data challenges with MSMEs may not fall within the scope of an ESRM guideline, understanding and supporting both borrowers and lenders in developing E&S data for their projects through capacity building and know-how will be useful preparatory and ongoing activities for the effective implementation of ESRM.

SUSTAINABILITY DEFINITIONS

Connected to the issue of E&S data is the need for definitions around sustainability in terms of the real economy and to financial sector actors. Without consistent sustainability terminology and definitive guidance on how to classify activities as “sustainable” or “green”, the ability of regulators and financial institutions to measure the effectiveness of E&S policies will be difficult. Further complicating this is a lack of alignment at the global level, which complicates cross-border sustainable financing and investment.[15]

The ongoing development of a green finance taxonomy is an important preparatory consideration because it can help to improve the quality and consistency of ESRM practices in the financial sector. Specifically, it is a set of standards and criteria that help to define what constitutes a "green" or environmentally sustainable project or activity. A taxonomy can support ESRM implementation in the banking system by providing a standardized and transparent way of evaluating the environmental sustainability of projects and activities, which helps to ensure that decisions about financing are made in a consistent and objective manner. Importantly, it also ensures that the financed projects and activities align with national sustainability goals.

14 Organization for Economic Cooperation and Development (OECD). 2022. Financing SMEs for sustainability: Drivers, Constraints and Policies. OECD SME and Entrepreneurship Papers. No. 35. Paris. OECD Publishing. Available at: https://doi.org/10.1787/a5e94d92-en

15 Annex II of this report highlights examples of regional initiatives that seek to align green and sustainable finance definitions.

SCOPE AND APPLICABILITY

The scope and applicability of ESRM guidelines and regulations can vary considerably depending on the structure of the financial system of different jurisdictions. For example, in advanced economies such as those in the G20, ESRM guidelines and supporting guidance documents are often issued to the respective capital markets, insurance, and banking sectors. In many emerging economies, where capital markets are nascent, the banking sector tends to be the focus for policymakers.

Applicability is typically defined by the oversight mandate of the issuing regulatory agency. However, in many cases, there are efforts to synchronize ESRM expectations between the different financial sub-sectors. In the case of inclusive financial services segments, they may be supervised by different agencies, in which case, coordination is essential.

For example, non-bank FIs or credit unions may serve the same MSME clients as licensed banks but have distinct regulation, in which case alignment of the ESRM requirements around precise customer segmentation criteria is essential to avoid confusion among borrowers.

LEVEL OF DETAIL

An analysis of ESRM guidance documentation issued by the respective agencies of the AFI IGFWG members illustrates a wide range of approaches and level of detail. In more advanced jurisdictions, there is often a tendency for financial market participants to self-organize around guiding principles set forth by their regulators. In other cases, especially in developing and emerging market contexts FIs may require more prescriptive-based ESRM guidelines from regulators.

Often, multiple iterations of the ESRM regulation are issued over time, with an increasing level of detail; typically starting with general guidelines to sensitize regulated institutions, followed by increased compliance expectations with more detailed and specific guidelines. The following are some illustrative examples from within the AFI network:

16 Analysis of AFI sub-group members reveal different approaches to determining applicability; this table aggregates the different applicability criteria that are used.

17 In more advanced jurisdictions, financial regulatory policy (including ESRM policy) tends to take a principles-based approach, moving away from reliance on detailed, prescriptive rules and relying more on high-level, broadly stated rules or principles to set the standards by which regulated firms are expected to conduct business.

EXAMPLES OF APPLICABILITY CRITERIA[16]

BY SEGMENT

> Debt capital markets
> Equity markets
> Insurance
> Banking

BY FINANCING INSTITUTION

> Investment bank
> Commercial bank
> Insurance provider
> Credit union
> Cooperative
> SME bank
> Development/policy bank
> Microfinance institution

BY TRANSACTION TYPE

> Project finance
> Corporate lending
> Trade financing
> SME lending
> Agriculture finance
> Microfinance

PHILIPPINES

In the Philippines, the Bangko Sentral ng Pilipinas (BSP) issued the Sustainable Finance Framework circular on ESRM in April 2020, requiring the implementation of the ESRM guidelines and its integration into the existing enterprise-wide risk management system of banks.

This issuance was complemented with the release of the ESRM Framework in October 2021 that provides granular expectations in considering E&S factors when analyzing and managing credit and operational risks exposures of banks, and annual reporting disclosure requirements.[18]

BANGLADESH

In Bangladesh, the initial publishing of Bangladesh Bank's (BB) Environmental Risk Management Guidelines was in 2011. After conducting follow-up analysis on implementation, it was found that a lack of adoption by FIs could be attributed to a need for sector-specific guidelines.[19]

The BB responded in 2017 with the issuance of an update to the Environmental Risk Management Guidelines, titled ESRM Guidelines. This takes a more exhaustive approach, making the assessment of E&S risks more objective.

The updated guideline provides a robust quantitative risk rating system, E&S due diligence checklists according to sectors, and specific organizational roles and responsibilities with regard to FI risk assessment, and the decision-making process based on E&S risk ratings.[20]

In considering level of detail, it is also important to consider the capacity of bank supervisors and supporting financial infrastructure such as professional consultancies and accounting and auditing services so as not to overburden them with unrealistic expectations. The expectations of the ESRM guidelines should be commensurate with the state of banking and financial sector development at the time.

COORDINATING MECHANISMS

All AFI interviewees strongly recommended the creation of coordinating mechanisms as a prerequisite for the successful development and implementation of ESRM guidance. Coordination is required both internally (within the regulatory agency) and externally (with banking sector participants). The coordinating mechanisms are useful to:

- undertake research activities;
- develop the appropriate guidance documentation;
- lead future revisions of regulatory policy; and
- share specialized sectoral knowledge (e.g., environmental, energy, mining, agriculture) and/or regulatory skills needed (e.g., policy, research, supervision).

INTRA-AGENCY COORDINATION

Internally, regulatory agencies will benefit from identifying and assembling existing knowledge assets through cross-cutting or interdepartmental working groups or committees. These can also serve as coordinating points for internal capacity building such as management-level coaching to department training and peer learning activities. While these activities will likely be ad hoc at the beginning, as institutional knowledge builds up within the organization, and supervision of ESRM implementation in banks becomes more intensive, systematic learning around E&S topics will likely be needed.

18 Office of the Governor. 2021. Subject: Environmental and Social Risk Management Framework (Corrected Copy). Circular no.1128 Series of 2021. Manila. Bangko Sentral Ng Pilipinas. Available at: https://www.bsp.gov.ph/Regulations/Issuances/2021/1128(Corrected%20Copy).pdf

19 International Finance Corporation (IFC). 2014. Moving Forward with Environmental and Social Risk Management Findings from FIC Country Baseline Surveys. Washington, D.C. World Bank Group. Available at: https://www.ifc.org/wps/wcm/connect/b00a0df5-0a3d-4503-b4f4-b11cca957316/ESRM-Report-Final.pdf?MOD=AJPERES&CVID=kjQl2Nj

20 Sustainable Finance Department. 2017. Guidelines on Environmental & Social Risk Management (ESRM) for Banks and Financial Institutions in Bangladesh. February. Dhaka. Bangladesh Bank. Available at: https://www.bb.org.bd/aboutus/regulationguideline/esrm_guideline_feb2017.pdf

THE INTERNATIONAL FINANCE CORPORATION (IFC) E&S PERFORMANCE STANDARDS

The IFC Performance Standards for Environmental and Social Sustainability are some of the most common globally recognized benchmarks for ESRM in the private sector. The standards are used by development FIs, commercial banks and other similar institutions, and may serve as a useful reference for institutions required to implement ESRM.

The Performance Standards provide guidance on how to identify risks and impacts and are designed to help avoid, mitigate and manage risks and impacts as a way of doing business in a more sustainable way. Since 2012, the Standards apply to all IFC clients whose projects go through IFC's initial credit review process.

8

The eight Performance Standards define clients' responsibilities for managing their environmental and social risks, and provide a useful reference for how FIs can benchmark their institutional E&S performance.

The following aspects are included:

1
RISK MANAGEMENT

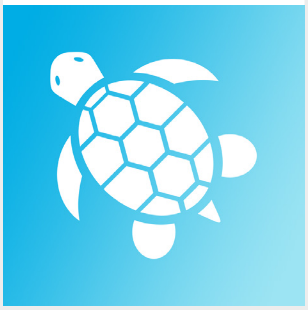
2
LABOR

3
RESOURCE EFFICIENCY

4
COMMUNITY

5
LAND RESETTLEMENT

6
BIODIVERSITY



7
INDIGENOUS PEOPLE

8
CULTURAL HERITAGE

Source: International Finance Corporation (IFC). E&S Performance Standards. Available at: https://www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/Sustainability-At-IFC/Policies-Standards/Performance-Standards/

INTER-AGENCY COORDINATION

Externally, the respective issuing regulatory body will likely initially need to cooperate with other regulatory agencies (especially in the case when ESRM guidance is also being issued to the capital markets or insurance sector), as well as with regional coordinating bodies.[21] Having a dedicated touch point within the agency to liaise with local government and international cooperation agencies on E&S related issues will be useful for external stakeholders.

SECTOR COORDINATION

Sensitization and feedback about ESRM expectations from industry (either bilaterally or through industry associations) will be important. Many jurisdictions have standard protocols for implementing regulatory policy that often includes activities such as administering a baseline survey, running a public comment process, hosting policy dialogue workshops, etc. These may be coordinated solely by the regulator, or in other cases, by a mix of industry participants.

PARAGUAY'S ROUNDTABLE OF SUSTAINABLE FINANCE

In Paraguay the private sector is quite active and FIs self-organized to build capacity and share knowledge throughout the sector. Currently there are 18 members of the Sustainable Finance Roundtable.

Meetings of the working group are frequently held. Representatives from banks, businesses, and the public sector come together to discuss relevant topics in a collegiate manner, with a view to avoid competition between banks on E&S issues (i.e. to avoid undermining competitors on E&S requirements for borrowers to achieve a competitive advantage) and ensure a level playing field for implementation of ESRM matters.

Multidisciplinary working groups lead by industry may be especially necessary in the case that the ESRM guideline includes custom requirements at a sectoral level to ensure that the different industry specific E&S risks are identified.

Whichever coordinating mechanisms are chosen, they can also serve as a natural point of engagement for stakeholders during the awareness building and sensitization phases of ESRM guideline implementation.[22]

THE PHILIPPINES "GREEN FORCE"

In the Philippines, an initiative dubbed "The Green Force" is a high-profile interagency task force charged with coordinating and building awareness for sustainable finance nationally. Led by the Department of Finance (DOF) and the BSP, along with support from international multilateral agencies, it is committed to greening the country's economy.

The Green Force, consisting of 18 government departments and agencies, is the country's response to adopt a "whole-of-government" approach in mitigating climate change and other environment-related risks, building resilience against these risks, and ushering the flow of finance to green or sustainable projects.

The Green Force endeavors to harmonize all government policies concerning green and sustainable projects as the need to establish a cohesive action plan that will cut across all sectors has been identified.

Among the key milestones of the Green Force is the development of the Philippine Sustainable Finance Roadmap and the Sustainable Finance Guiding Principles which were launched in October 2021. The Roadmap sets out the high-level strategic plans to promote sustainable finance and address climate change, and the Guiding Principles provide the standard considerations in identifying which economic sectors or activities can contribute to sustainable development with special focus on addressing climate change.

Source: Speech by Mr Benjamin E Diokno, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the Asia-Pacific ESG Investors Summit, Manila, 9 February 2022. (Diokno, Benjamin E. 2022. Sustainable Finance and Its Impact on the Philippines' Post-pandemic Economic Outlook. Asia-Pacific ESG Investors Summit. 9 February. Manila. Available at: https://www.bis.org/review/r220225g.pdf)

21 In Appendix 1 of this report, there are two regional case studies (Southeast Asia's ASEAN Taxonomy and Central America's CCSBSO Initiative) which provide context on cross-border regulatory coordination and alignment.

22 Section III of this report provides guidance on promotional activities.

DIAGNOSTICS & EXPLORATION OF RISKS

EVIDENCING RISKS THROUGH A DIAGNOSTIC STUDY

In order to identify and prioritize E&S issues that may present financial risk to regulated entities, many AFI members recommended undertaking exploratory exercises at the outset such as diagnostic study. Utilizing a mix of interviews, surveys and data requests (quantitative as well as qualitative), supervisors can learn much about the material E&S risks facing the industry, and can determine the transmission channels and identify data gaps.

The goal of exploratory exercises should be to estimate the type, likelihood and magnitude of the exposure to environmental and social risks. For example, in the context of exploring climate risks, it is recommended that supervisors assess different determinants of physical risk (e.g. climate sensitivity of sectors, climate vulnerability, geographical location, etc.) and transition risk (e.g. policy sensitivity). In a more advanced stage, supervisors may also consider developing scenario analysis and stress-testing methodologies.

Potential stakeholders of such a study should include the participation of FIs, climate and environmental specialists, NGOs, scientists and discussions with peer supervisors. The Network for Greening the Financial System (NGFS) recommends a three-phase approach to running a diagnostic study:

> preparation phase
> analytical phase
> concluding phase[23]

23 For an illustrative example see: “Conducting a climate-related and environmental risk assessment” (Network for Greening the Financial System (NGFS). 2020. Guide for Supervisors: Integrating climate-related and environmental risks into prudential supervision. Technical Document. May. Paris. Network for Greening the Financial System (NGFS). Available at: https://www.ngfs.net/sites/default/files/medias/documents/ngfs_guide_for_supervisors.pdf)

E&S RISK DRIVERS IN THE FINANCIAL SECTOR

The NGFS and the Global Association of Risk Professionals (GARP) identify the following categories of risk where environmental factors should be considered (these can be considered both from a macro and micro perspective):

OPERATIONAL RISK

EXAMPLE: Supply chain disruptions, forced facility closures

CREDIT RISK

EXAMPLE: Defaults by businesses and households, collateral depreciation

LIQUIDITY RISK

EXAMPLE: Increased demand for liquidity, refinancing risk

UNDERWRITING/ INSURANCE RISK*

EXAMPLE: Increased insured losses, increased insurance gap

MARKET RISK*

EXAMPLE: Repricing of equities, fixed income, commodities, etc.

SOVEREIGN RISK*

EXAMPLE: Vulnerability to physical climate risks, proportion of budget revenues from fossil fuels, political risk

* These risks may be less relevant for MSME lenders but are included as this is the financial sector view.

RELATIVE STATE OF RISK MANAGEMENT PRACTICE AND PROPORTIONALITY

Since environmental and social risk drivers can affect the financial soundness of FIs through a number of risk categories, including operational and market risk, as well as credit risk, a best practice for integration of ESRM is to use a holistic approach such as an enterprise-wide risk management (ERM) framework. Several AFI member regulators have issued ESRM guidelines that make reference to banks' ERM frameworks and recommend implementing ESRM through this framework. It can be useful to consider the ERM approach when developing ESRM regulatory guidance, as this leverages an existing and well-developed risk management approach.

In some emerging and developing markets, the abilities of FIs to manage risks and implement new processes, such enterprise level approaches, may not be as well developed in smaller FIs as compared to larger peers or foreign banks. In that case, proportionality may be applied and the risk profile of the respective FI considered with regard to ESRM supervisory expectations (i.e. the expectation for ESRM should be adapted to the relative complexity and asset size of the institution). AFI interview respondents[25] suggested that ESRM guidance should set a "minimum standard" for all banking institutions, but that supervisory expectations could be adapted on a case-by-case basis, especially for systemic banks. Ultimately, a balance needs to be struck between simplicity, risk sensitivity and supervisory capacities.

24 Committee of Sponsoring Organizations of the Treadway Commission (COSO). 2017. Enterprise Risk Management Integrating with Strategy and Performance - Executive Summary. COSO. Available at: https://www.coso.org/Shared%20Documents/2017-COSO-ERM-Integrating-with-Strategy-and-Performance-Executive-Summary.pdf

25 AFI Member interview. Annex 1 Overview of ESRM Guidance Established (AFI Member Interview Cohort). Available here.

ORGANIZATIONAL ENTERPRISE RISK MANAGEMENT

ERM is a comprehensive approach to managing risk across and within an organization and can be implemented by larger FIs. One of the most widely used frameworks for ERM was developed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), originally released in 2004 and periodically updated.

The latest version, from 2017, includes actions and responsibilities across five broad areas, from governance and strategy to performance, review, and communication. Importantly, ERM is not considered as simply a function or a department. Rather, it consists of "culture, capabilities and practices that organizations integrate with strategy-setting." ERM is not simply about compiling a list of risks, having internal controls, or using checklists, rather, COSO argues, it is a holistic modus operandi across an entire firm.[24]

RNTERPRISE RISK MANAGEMENT

Source: Committee of Sponsoring Organizations of the Treadway Commission (COSO). 2017. Enterprise Risk Management Integrating with Strategy and Performance - Executive Summary. Available at: https://www.coso.org/Shared%20Documents/2017-COSO-ERM-Integrating-with-Strategy-and-Performance-Executive-Summary.pdf)

POLICY GUIDANCE

As noted in the above section, there are important preparatory considerations for financial regulators and policymakers in advance of developing regulatory policy for ESRM. Once the status quo and desired outcomes are well understood, the next step is to articulate systematic guidance for financial institutions for upgrading risk management practices to account for E&S risks.

To support the develop of such guidance for the banking sector, an analysis of the IGFWG members' regulatory policy documents was conducted, and common themes have been identified and presented in this section.

In order to account for the variance in the structure, depth, and maturity of financial sectors amongst the IGFWG members, a principles-based approach for ESRM policy guidance formulation for the banking sector has been developed with input from AFI members and further observation of global trends and best practices.

The principles below are intended as a guide for the development of regulatory policy for regulated credit institutions, so that they can effectively implement ESRM within their business and operating models.[26] They were endorsed by the AFI IGFWG during the 8th IGFWG Meeting held from 7-10 March 2023 in Kathmandu, Nepal (see Annex 1 for a comparative table and references to different published guidelines from respective member.)

The importance of a holistic approach to ESRM is recognized, as it seeks to embed ESRM within all relevant features of a credit institutions business and operating model, rather than a siloed or bolt-on approach that may lead to ESRM falling into a compliance-driven risk culture, and likely becoming a source of cost and frustration for FIs.

The scope of the principles deliberately extends beyond the remit of protecting FIs from E&S risks; they also recognize the role and, to some extent, the responsibility of credit institutions in financing sustainable economic development.

These principles can also serve as a starting point for the development of a simple framework for supervisors seeking to assess the level and quality of adoption of ESRM by regulated entities. However, this is an area that will require further development.[27]

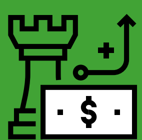
26 The policy guidance is described as "principles" because they do not make prescriptive recommendations to banks, rather, they rely on the experience and expertise of management and staff to translate them into tangible and actionable change. In some cases, the formulation principles refer to types of documentation that might typically be found in a credit institution, however, it is understood that jurisdiction and institutions will vary in the way they plan, manage, and document their business and operating models.

27 The AFI report on "Measuring Inclusive Green Finance" identifies some further examples for how regulators can collect data points on relative state of implementation of ESRM regulatory policy. (Inclusive Green Finance Working Group (IGFWG) and Financial Inclusion Data Working Group (FIDWG). 2022. Measuring Inclusive Green Finance. 8 November. Kuala Lumpur. Alliance for Financial Inclusion (AFI) Available at: https://www.afi-global.org/publications/measuring-inclusive-green-finance/)

THE ESRM PRINCIPLES ARE ORGANIZED INTO THREE PILLARS:

I
GOVERNANCE

Supervisors should expect FIs to define and assign E&S responsibilities within existing governance arrangements.

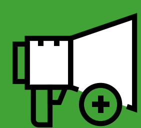


II
RISK MANAGMENT

Supervisors should expect FIs to have policies and procedures in place to identify, assess, monitor, report, and manage all material E&S risks.

III
DISCLOSURE

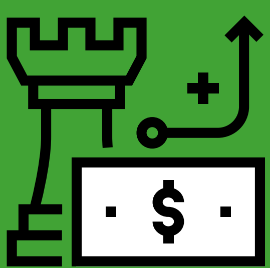
Supervisors should expect FIs to disclose information and metrics on the E&S risks they are exposed to, their potential impact on the safety and soundness of the institution, and how they manage those risks.



PILLAR I: GOVERNANCE & STRATEGY

Environmental and social risks, and particularly that of climate change, represent an existential risk to the financial soundness of credit institutions and the systems in which they operate.

Therefore, it is essential that they are tackled strategically at the enterprise level. However, the principles in this section also recognize the importance of identifying a credit institution's role in financing a sustainable transition, and also identifying the shareholder value that rests in this opportunity.



1.1 GUIDING PRINCIPLE

The foundation of effective ESRM lies in corporate governance, and should be catalyzed by an understanding between the FI's shareholders, the board of directors and senior management.

ESRM should be a matter of active interest to shareholders of credit institutions with a view to preserving and growing shareholder value and protecting and enhancing the reputation of the brand. This would be evidenced through the appointment of a proportion of the board directors with some experience in advocacy for ESRM practice.

Typically, this would translate into a mandate to address ESRM in the instructions by the board of directors to the CEO, the management board, or the senior management team (such as through the letter of intent guiding the overarching business and operating model parameters and the risk appetite statement).

1.2 GUIDING PRINCIPLE

ESRM is an issue of strategic importance, and should be anchored in the FI's strategic plan and strategic management framework.

An FI's board of directors is expected to provide guidance to the senior management team (either through a management committee or the CEO and their direct reports) to ensure that ESRM is appropriately considered in the institutions strategic plan. This should cascade into enterprise-level policies guiding risk management in particular, but also the asset-liability committee, audit, compliance, marketing, human resources, and other enterprise-level policies where there is overlap.

An FI's strategic plan should also include suitable key performance indicators for the senior management team that relate to ESRM performance. Ideally, these indicators should form part of the performance and reward framework for the FI's senior management team, assessed by the remuneration committee. In turn, ESRM objectives and targets should cascade through the institution so that every staff member has some accountability for delivering these.

1.3 GUIDING PRINCIPLE

The strategic plan should consider ESRM as a source of reward as well as risk by emphasizing the effective risk-based pricing of E&S risk.

For a credit institution to fully embrace the transition to a sustainable financing model, ESRM must be considered a source of reward as well as risk, in a similar way to other business risks such as credit, operational, and market risks. By exploiting their expertise and economies of scale in financing sustainability, a long-term and holistic approach to ESRM should also emphasize how credit institutions can help identify opportunities to create or improve customer lifetime value through improved risk-adjusted returns.

For example, the enterprise sales and marketing plan should emphasize sustainability opportunities in customer segmentation strategy, and product development and management plans. Divisional sales and marketing plans should reflect these opportunities through clear targets. In addition, any risk-based pricing models should incorporate appropriate ESRM criteria that reflect the benefits of borrowers who adopt sustainable business and operating models.

1.4 GUIDING PRINCIPLE

There should be communication of expected values and behaviors in relation to ESRM by the FI's senior management team.

The CEO or president and the rest of the senior management team of the FI should clearly and consistently communicate to employees the importance of ESRM as an essential feature of the credit institutions' business and operating model. The strategic plan and the cascade of key strategic initiatives and key performance indicators throughout the institution are essential elements of this communication.

The senior management team may need to reinforce this message through other formal internal corporate communications as well as informally in their interactions with their senior management team and all employees. Importantly they also will need to exemplify the values and behaviors expected of officers and staff. Participation by the senior management team in both formal (e.g. participation in conferences, press releases, and public appearances etc.) and informal knowledge exchange with peers and other subject matter experts is important.

Adopting effective ESRM represents a major change for many credit institutions, and all organizations have an innate resistance to change. Embedding ESRM into the risk management culture takes strong leadership.

1.5 GUIDING PRINCIPLE

ESRM practice is an evolving discipline, but early action is essential.

ESRM will evolve into a much more mature and sophisticated framework over time. Therefore, it is important for credit institutions to continually monitor developments in the discipline and actively identify potential enhancements to the management of these risks that are suitable for their institutions, and implement them in a timely manner. Waiting for the global consensus on best practices to emerge is dangerous and risks a result of too little, too late.

Credit institutions should already have tangible targets for the development of human capital embedded in their strategic plan. Just as with any other topic within banking and finance, it is vital that relevant training and development is provided to management and staff in the topic of ESRM. These can include formal training and development including academic, professional, vocational, or informal approaches such as internal and external peer learning.

PILLAR II. RISK MANAGEMENT

This section follows on logically from the previous. Building on the idea that effective ESRM is financially inclusive, it must include principles that relate to more than simple risk control and mitigation.

Risk identification and assessment are fundamental characteristics of an effective risk management system. Effective identification of risk considers both internal factors and external factors.

In general, sound risk assessment allows an FI to better understand its risk profile and allocate risk management resources and strategies most effectively. ESRM, just like traditional credit risk management, must be considered a source of reward as well as risk, and that taking a risk-based rather than compliance-based approach where possible is optimal.

2.1 GUIDING PRINCIPLE

ESRM should form part of a holistic risk management framework and not be managed in a silo.

As described in Pillar I, ESRM should feature in the risk appetite statement for the credit institution. This means it should cascade into the enterprise-level risk management policy or policies approved by the risk committee. The risk management division should ensure that their proposals to the risk committee for enterprise-level risk management policy effectively encompass the ESRM elements of the board's risk appetite statement. In turn, the risk committee should reassure themselves that in approving enterprise-level risk management policies, that ESRM is covered to the board's satisfaction.

While a policy statement of specific ESRM principles may be helpful, it is strongly recommended that ESRM is embedded within an ERM framework rather than siloed into a distinct discipline. As described in Principle 7, ESRM is a key feature of existing and well understood risk transmission channels. Integrating ESRM within the current risk management culture is optimal as it supports the evolution of ESRM practice based on stronger foundations, rather than attempting to establish an entirely new discipline. That said, the appointment of expert ESRM advisors within the risk management division may support the identification and adoption of best practice.

2.2 GUIDING PRINCIPLE

ESRM should be embedded into the credit risk management culture, and considered from the perspective of both physical and transition risks.

As already established, environmental and social risks represent potential threats to the financial soundness of financial institutions. Without diminishing the importance of other E&S risks, none are as existential as that of climate change. Indeed, climate change is directly or indirectly the cause of many ancillary E&S risks. Historical analysis increasingly shows that climate change due to natural causes, and the resultant upheavals in established patterns of settled agriculture and nomadic pastoralism, have been closely associated with periods of social and political upheaval.

Guidance from the Network for the Greening of the Financial System (NGFS) helpfully points credit institutions to two interesting categories of risk transmission for climate change, though these can equally apply to many different types of E&S risk. Physical risk is the tangible damage to assets from climate-related weather events and resulting financial losses. Transition risk leads to falls in the financial value of tangible and intangible assets through the inevitable changes in politics, economics, technology, and demographics resulting from climate change. Failure by borrowers or their lenders to forecast these more nuanced yet material changes can result in an effect known as “stranded assets”.

Credit institutions should ensure that the CRM framework fully captures the physical and transition risks of E&S factors to borrowers. This includes all borrowers of all types of enterprise, including financial institutions counterparts. This would be evidenced by the inclusion of E&S criteria within credit policies, procedures, tools, models, and methodologies, as well as the training and development of credit risk management and lending officers.

28 The Bank of England which ran its first exploratory scenario exercise on climate risk involving the largest UK banks and insurers in 2021. The analysis identified notable data gaps in the climate risk management processes

A NOTE ON INTEGRATING CLIMATE RISK DATA INTO THE RISK MANAGEMENT PROCESS OF MSMEs

An excerpt from AFI’s report: Measuring Inclusive Green Finance

> View here

“Integrating environmental and particularly climate risk data into risk management processes is inherently challenging for banks, but even more so in inclusive segments. A recurrent theme across FIs is a lack of data on many key factors which participants need to understand to manage climate risks.[28] A more developed and nuanced approach to risk management that utilizes more granular climate risk data (for example, climate scenario modeling of client production metrics, reliance on energy sources, and data on the geolocation of assets) would allow MSME lenders to more accurately reflect climate risks in their business decisions.

The quantitative and qualitative information that needs to be collected for climate risk measurement is very broad and FIs apply different approaches to obtain data. Many FIs use a combination of client and third party-sourced data (for example, mortgage lenders may utilize specialized third-party firms to model flood risks at a property level).

However, coverage of third-party data is often limited for smaller counterparties. While already used by larger international FIs, an increased reliance of domestic FIs on third-party sourced data is expected in the future. This fosters comparability, saves resources, reduces effort, and allows banks to rely on approaches grounded in climate science.

Due to the informal nature and relatively high administrative cost barriers of micro and small businesses, microfinance lenders are particularly challenged to provide the level of detailed financial and risk information that can be obtained by corporate lenders. Alternative data and digital solutions are, therefore, increasingly playing a role to improve the visibility of MSME credit risks, but this has not happened yet with regard to climate risks.

Banks serving MSME segments will need to prioritize progress on climate risk data and may need to put in place interim measures to better inform on risk management until these data challenges at the inclusive green level are resolved.”

This special report examines the intersection of trends between green finance measurement approaches and supply-side financial inclusion indicators.

The interest reflects widespread concern about the impact of climate change on their economies as well as the potential opportunities for green finance to support a just transition to a sustainable economy.

Source: Inclusive Green Finance Working Group (IGFWG) and Financial Inclusion Data Working Group (FIDWG). 2022. Measuring Inclusive Green Finance. 8 November. Kuala Lumpur. Alliance for Financial Inclusion (AFI) Available at: https://www.afi-global.org/publications/measuring-inclusive-green-finance/)

2.3 GUIDING PRINCIPLE

In addition to credit risk, ESRM is a source of operational, market, and liquidity risks and should be integrated into these functions.

Credit risk managers should be readily comfortable with the concept of physical and transition risks. Any mature credit assessment methodology for enterprises should be highly cognizant of the importance of guarding physical assets on the balance sheets, as well as that of a business model and strategy which anticipates political, regulatory, fiscal, economic, technological, and demographic risks.

However, it also important to appreciate that E&S risk can present in other risk functions including the following.

> **Market risk** includes volatility and loss of value in investments due to changes in investor appetite or asset allocation (which qualifies as a type of transition risk) due to E&S criteria.

> **Operational risk** includes the physical risks to the fixed assets of a credit institution and the potential disruption to operations by E&S risk, and particularly climate- related extreme weather events. It also includes potential legal liability and reputational damage as a result of poor ESRM practice.

> **Liquidity risk** includes unexpected calls on the liquid assets of a credit institution caused by the need to immediately remedy physical losses to its own operations, as well as calls on deposits and contingent or off-balance sheet credit facilities resulting from disaster scenarios. In addition, this may be exacerbated by a lack of funding appetite by institutional investors for credit institutions that do not have a well-developed ESRM framework, for both reputational as well as credit risk rationales.

2.4 GUIDING PRINCIPLE

Ensure that risk monitoring and reporting is a pillar of the ESRM framework.

As with all effective risk management practice, developing a robust and relevant monitoring and reporting system is essential. The first step involves identifying or building relevant data points that would support the development of appropriate KPIs for the senior management team initially, with a view to then cascading the indicators throughout the institution. The SMART[29] approach to developing indicators is an excellent starting point for developing good indicators.

Reporting should be as timely and informative to decision-making as the indicators support. As with any other management information, the goal of ESRM reporting should be to support quicker, more consistent, and higher quality E&S risk decision-making from the senior management team and cascading these practices throughout the institution. Risk management dashboards are useful ways for decision-makers to assimilate a relatively complex mix of indicators, and it would be expected that E&S risk indicators would feature in this mix.

When designing E&S management information, take care to consider the requirements of the full range of stakeholders described in the Disclosure and Stakeholder Management section of this guideline note. Foremost of these are regulators who are likely to make the earliest demands for E&S risk data to support their role in macro-prudential and system risk management.

2.5 GUIDING PRINCIPLE

ESRM should be covered by the internal audit and compliance functions, and recommendations for improvement promptly and fully actioned.

Typically, risk management in credit institutions is organized along three lines of defense: Management, Risk Management, and Internal Audit. ESRM should be no different. The first line of defense has been extensively covered by the principles described in the Governance and Strategy section of this guideline note. Principles 2.1 through 2.3 cover the risk management line of defense. Internal audit is considered the third and final line of defense.

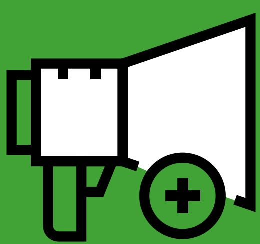
This means that ESRM should form a fundamental element of internal audit plans and practice. This includes ensuring alignment of enterprise-level ESRM policy with the risk appetite statement, and making certain that divisional policies and procedures are appropriate for the enterprise level. In addition, inspections should explore the effectiveness of compliance by staff with ESRM procedures. Where breaches occur or unexpected risks arise, then root causes in procedural design, training and development, and values and behaviors should be explored and described in audit reports. Audit reports should be promptly disclosed and discussed with the relevant counterparts. Action plans should be agreed upon, and effective monitoring and reporting of remedial action put in place.

29 SMART goals are: Specific; Measurable; Achievable; Realistic; Timely (for more info see: Corporate Finance Institute (CFI). SMART Goals. Accessed 1 April 2023. Available at: https://corporatefinanceinstitute.com/resources/management/smart-goal/)

PILLAR III: DISCLOSURE & STAKEHOLDER MANAGEMENT

Having effectively established the internal infrastructure through governance, strategy and management, and risk management, consideration should be given to the principles underpinning the disclosure of E&S risk data to external stakeholders.

There are distinct audiences for E&S risk data with varying rationales and relationships that differ with the institution. Note that disclosure should not be approached from a defensive position, and the principles describe a proactive approach that will emphasize the benefits of embracing effecting ESRM.



3.1 GUIDING PRINCIPLE

Prepare for the evolving requirements of regulators in relation to the disclosure of E&S risks.

Regulators have been the catalyst in the development of ESRM, recognizing the growing existential danger of E&S risks to the soundness of national and global financial systems. They have thus adopted a range of approaches to include ESRM in their respective jurisdictions. Credit institutions will need to adapt to emerging local requirements to support guidelines with practical evidence of effective ESRM.

Supervision of ESRM is likely to be explorative and explanatory in the first instance, before graduating to formal inclusion in the supervisory review and evaluation process (SREP). Credit institutions should expect early enquiries about ESRM covering:

- governance, strategy, and management of ESRM
- ESRM policies and procedures
- E&S risk management information systems
- expertise of management and staff in ESRM
- E&S risk exposures by entity, sector, segment, and type
- assessments of impact and likelihood of E&S loss events
- actual or potential E&S Risk loss events

In the future, it is likely that E&S risk will form part of internal capital adequacy assessment processes (ICAAP) and even internal liquidity adequacy assessment processes (ILAAP). Building a collegiate and constructive dialogue with regulators around the nature of E&S Risk disclosure will make the transition to a heightened supervision process easier for both parties.

3.2 GUIDING PRINCIPLE

Follow international and local developments in corporate ESRM reporting and disclosure, and adopt proportionate and appropriate enhancements.

Anyone even remotely exposed to the corporate accounting and audit professions will be aware of the plethora of emerging codes of E&S risk reporting and disclosure. These codes or principles are still maturing, and going through a process of harmonization before they settle into a more stable state. Credit institutions must comply with the relevant existing mandatory local standards in relation to ESRM reporting and disclosure.

This including those that pertain to exchanges upon which they are listed.

However, it is also worth paying attention to developments in wider regional or global markets in order to facilitate easier access to capital or finance in the future. Due diligence on a credit institution's ESRM is likely to be an increasing element in accessing debt or equity from international investors, either in the form of commercial or development finance.

3.3 GUIDING PRINCIPLE

Ensure that ESRM disclosure and reporting forms a key pillar of the approach to public relations and communications.

Credit institutions that invest in and excel in ESRM should make the most of the benefits to their brand. E&S factors increasingly form a key element of consumer values and behaviors, and find their way into purchasing decisions. Indeed, the failure of a credit institution to anticipate changes in consumer trends resulting from heightened awareness of E&S risk is a type of transition risk.

The awareness and reputation of the brand can also be enhanced by emphasizing the credit institution's sustainability journey. In the event of reputational risks or potential liabilities due to public exposure of E&S breaches, the standing of the brand, and a proactive and transparent approach to public relations is the best defense.

3.4 GUIDING PRINCIPLE

Underpin successful adoption of the expected ESRM value and behaviors by management and staff through effective internal communications, and training and development.

In principle 1.4, the importance of reinforcing the values and behaviors expected of staff through effective communication by the senior management team was described. This principle builds on this by emphasizing the role of both internal communications, and training and development in underpinning a permanent change in risk culture. Transparency means earnest reflection on where there have been institutional ESRM failures as well as successes. Training and development should not only emphasize skills and knowledge, but also help staff situate their important role within the broader context of sustainability and financing a just transition.

3.5 GUIDING PRINCIPLE

Help customers through their sustainability journeys through frank but sensitive communications about the institution's expectations of them in terms of ESRM.

Last but by no means least, the role of customer communications must be considered. It is a notable failing of many credit institutions that they are unable to provide adequate feedback to borrowers on their bankability, particularly in the event that an application fails. As ESRM will become an increasing feature of future credit risk assessment processes, it is essential that credit institutions address this weakness.

ESRM has the potential to create further barriers to accessing finance for MSMEs, in particular. Failure to adopt a more mature approach to communications with this under-banked segment will ensure this outcome. Credit institutions already need to provide better guidance to their customers on improving financial management, and business and operating models. The additional dimension of ESRM represents an opportunity to start a much-needed conversation with MSME borrowers about the institution's expectations of them. This may also present an opportunity for credit institutions to expand their offering into enterprise development services to MSMEs that simultaneously enhance both their sustainability and bankability.

IMPLEMENTATION RECOMMENDATIONS

Once the banking regulatory authority has formulated ESRM policy guidance for the respective regulated entities, supervisory expectations for implementation by the FIs need to be considered and communicated, and supporting activities identified. As this is a relatively new topic globally, many developing and emerging market FI supervisors are at the earliest stages of implementing supervisory approaches for ensuring ESRM adoption and effective implementation by FIs.

In addition, much of the ESRM regulatory guidance that has been issued is initially for voluntary adoption, which consequently implies lower oversight and disclosure. Nevertheless, some initial implementation recommendations for banking supervisors have been identified by the IGFWG. These may prove useful for jurisdictions beginning their sustainable finance journey. Some members are moving towards implementing the guidelines and developing monitoring tools to improve and strengthen enforcement of the same.

INDUSTRY CONSULTATION

As is the case for introduction or reform of any financial regulatory policy, an optimal approach is through a consultation process with industry. For example, circulation of a draft of ESRM policy guidance through a formal consultation process affords industry a chance to respond in a systematic manner, and gives supervisors advance warning of any potential issues.

AFI interviewees[30] recommended that the consultation process elicit formal written responses from stakeholders, followed by an industry discussion forum to facilitate feedback and continued dialogue with regulated entities.

This is also an important activity for potential future revisions and clarifications of the ESRM policy guidance. In some cases, multiple iterations of the ESRM guidance are issued, as the industry grapples with the implementation challenges.

SEQUENCING

The guiding principles in Section 2 should support FIs in the timely development of an ESRM policy that is fit for purpose. However, the extent of the internal change required for FIs to effectively implement policy should not be underestimated. Lenders will need to develop new processes and identify new data points that allow them to effectively calibrate credit risk decision-making systems and assessment processes to account for E&S factors.

Upgraded risk management systems also need to be back-tested with data and new procedures need to be designed and trialed by management. Management and staff will need extensive training and development to adapt to the evolving business and operating model, and to the values and behaviors expected. All this change needs to cascade from the board-level down, and integrate with other change programs with a view to regulatory compliance and commercial viability.

On the borrower's side, it will also take time for MSMEs to adjust to evolving E&S requirements that lenders will require to make loans (see Section 1 on Data and Definitions).

A balance needs to be struck between improving compliance with E&S criteria without overwhelming MSME borrowers with E&S requirements which could lead to them being excluded altogether from sustainable finance product offerings.

Setting appropriate timelines for supervisory expectations in relation to implementing such reforms is difficult but critical to ensure a balance. Lending to creditworthy MSME borrowers should not stop because financial institutions cannot fulfill the ESRM standards; on the other hand, lending needs to be done in a prudent manner that takes into account E&S risks.

The IGFWG members have taken different approaches to this challenge. For example, some regulators recommend a voluntary approach, giving FIs the latitude to implement an ESRM framework based on the expert judgement of the management team and external consultants. In other cases, a phased approach was preferred, with a mandatory deadline announced. Phased approaches often give consideration to size of FIs, and apply a level of proportionality (i.e. smaller institutions are given more time to implement the

30 AFI Member interview. Annex 1 Overview of ESRM Guidance Established (AFI Member Interview Cohort). Available here.

changes). As most jurisdictions are only at the beginning of this journey the extent to which these different approaches are effective remains to be seen.

PROMOTION

The growth and exchange of knowledge between borrowers, lenders, regulators, and other stakeholders (e.g. professional services, industry associations, academic and training bodies, government agencies etc.) is a foundation for capacity development in sustainable finance. For the successful implementation of ESRM, it is important to highlight that not only do lenders need to take action, but critically, borrowers will need to develop an understanding about the E&S risks that they face. Borrowers will have to adopt and integrate E&S management into their business and operating models. This will help them to identify, assess, mitigate, and monitor E&S risks. Naturally, lenders will then have to ensure E&S risks are well assessed during the credit process to ensure that these risks are being adequately managed before extending credit.

Jurisdictions should encourage collegiate and collaborative relationships among companies, regulators, academics, and other stakeholders in the field of ESRM. They should aim to build a shared understanding of ESRM and its role in protecting the environment and promoting sustainable development. This could include hosting national conferences, workshops, and other events to bring people together and facilitate the exchange of ideas.

To equip banking professionals with skills in green finance and applied knowledge, training institutes and education bodies will need to develop an array of courses across various levels – undergraduate, postgraduate, and continuing and professional education. This will develop a strong pipeline of green finance talent which FIs and service providers can tap into as they expand teams and deepen green finance capabilities to serve growing needs.

SUPERVISORY ACTIVITIES FOLLOWING ESRM POLICY ISSUANCE

Currently, the consideration of E&S factors as sources of prudential risk as part of a supervisory review process under the Basel framework is relatively limited. However, the inclusion of environmental risks, especially climate risks are very much endorsed by the

31 Adapted from: Network for Greening the Financial System (NGFS). 2020. Guide for Supervisors: Integrating climate-related and environmental risks into prudential supervision. Technical Document. May. Paris. Network for Greening the Financial System (NGFS). Available at: https://www.ngfs.net/sites/default/files/medias/documents/ngfs_guide_for_supervisors.pdf

ACKNOWLEDGING DIFFERENT INSTITUTIONAL APPROACHES[31]

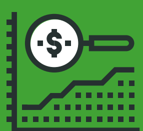
ADVANCED INSTITUTIONS

These FIs have sophisticated governance bodies and take a risk-based view towards E&S factors. Examples are given below.

> implementing exclusion criteria at the application phase

> making strategic decisions at the portfolio sectoral level to limit exposure to calculated transition risks and identifying new opportunities

> developing metrics to monitor implementation (e.g. calculating the carbon footprint of their balance sheet)



“WAIT-AND-SEE” APPROACH

These FIs may prioritize a corporate social responsibility (CSR) approach to addressing E&S risks rather than a risk-based approach. Examples are as follows.

> E&S challenges are addressed more from a reputational risk perspective

> sectoral policies are influenced by public perception or industry trends (i.e. an aim to avoid lending to sectors deemed to be publicly immoral or controversial or promote sectors that improve image) rather than based on internal quantitative assessments of risk and reward

NGFS[32], BCBS[33] and advanced jurisdictions such as the EU. It is fair to anticipate that the BCBS will inevitably take the lead on developing guidance on climate-related financial risks that may be captured in the Basel Framework's Pillar 1 capital adequacy standards.[34]

In future, the effectiveness of ESRM implementation could be evaluated during review by the supervisor of an institution's business model, internal governance, and risk management arrangements such as might occur through a supervisory review and evaluation process (i.e. SREP). This, however, is an area that needs considerable further development.

From the perspective of capital adequacy, a financial institution's exposure to E&S risks could also theoretically be evaluated (i.e. included as part of an institution's ICAAP). However, the imposition of regulatory capital allocation requirements for E&S risks requires common definitions of "green" and "brown" assets, quantitative assessments for qualifying E&S risks, and historical data to evidence risk differentials between such assets. Currently, in most jurisdictions, there is insufficient reliable data to support such an approach. For these reasons, it can be said that supervisors within the AFI network and globally are still in the earliest stages of investigating how to implement potential capital requirements with a view to mitigate E&S risks.

On the disclosure side, it can be anticipated that under Pillar 3 of the Basel Framework, financial institutions will need to prepare shareholder and public annual reporting on their process for identifying, assessing, and managing E&S risks, and ascertaining how those risks are integrated into the organization's overall risk management. To this end, the International Sustainability Standards Board (ISSB)[35] is planning to issue harmonized sustainability disclosure guidance for corporate reporting that will be relevant for FIs. These will be built on existing frameworks and guidance including the Task Force on Climate-related Financial Disclosures recommendations, the Climate Disclosure Standards Board framework, the Integrated Reporting Framework, the Sustainability Accounting Standards Board, and the World Economic Forum's Stakeholder Capitalism Metrics. Banking supervisors should pay close attention to the development of these standards, and how they may be applicable to institutions within their respective jurisdictions.

The other perspective that will be important for supervisors to monitor is the potential impact on financial inclusion indicators. As banks change their risk appetites and business models to account for E&S factors, there will likely be shifts in the composition of their MSME loan portfolios. Supervisors should watch for early warning signs of credit contraction among target groups and enquire as to whether or not ESRM implementation is a driver of these.

Following the publication of ESRM guidance, in the near-term, supervisors can consider some of activities listed below.[36]

> Hold targeted bilateral meetings with FIs on E&S risk so that it is clear that the topic will continue as part of ongoing supervisory engagement. This activity should prioritize the largest FIs.

> Require FIs to conduct and share results of a baseline E&S risk self-assessment, which can form a benchmark for subsequent enquiry. This should include a plan on how and when the FI intends to implement the ESRM guidelines.

> Establish a questionnaire and use it to collect information on implementation progress during on-site reviews.

> Conduct ongoing periodic high-level dialogue with banking industry executives to discuss progress in the current state of ESRM practice.

> Encourage FIs to include ESRM compliance within their institutional audit plans, and inspect the results and implementation of recommendations.

> Continue to monitor financial inclusion indicators in the context of environmental risks and opportunities as they are identified through the implementation of ESRM policy guidance. This is especially relevant in the context of climate adaptation activities.

32 Network for Greening the Financial System (NGFS). 2019. A Call for Action: Climate change as a source of financial risk. Executive Summary. First Comprehensive Report. April 2019. Paris. Network for Greening the Financial System (NGFS). Available at: https://www.ngfs.net/sites/default/files/medias/documents/synthese_ngfs-2019_-_17042019_0.pdf

33 Basel Committee on Banking Supervision (BCBS). 2022. Principles for the effective management and supervision of climate-related financial risks. 15 June. Basel. Bank for International Settlements (BIS) Available at: https://www.bis.org/bcbs/publ/d532.htm

34 The Basel Committee on Banking Supervision (BCBS) has recently issued responses to frequently asked questions (FAQs) to clarify how climate-related financial risks may be captured in the existing Basel Framework. For more info see: Basel Committee on Banking Supervision (BCBS). 2022. Frequently Asked Questions on Climate-related Financial Risks. 08 December. Basel. Bank for International Settlements (BIS). Available at: https://www.bis.org/bcbs/publ/d543.htm

35 For more information about the latest initiatives of the ISSB see: International Financial Reporting Standards Foundation (IFRS). No date. International Sustainability Standards Board (ISSB): Frequently Asked Questions. Canary Wharf. International Financial Reporting Standards Foundation (IFRS). Available at: https://www.ifrs.org/groups/international-sustainability-standards-board/issb-frequently-asked-questions/

36 Further examples of data points that supervisors may consider collecting are presenting in AFI's "Measuring Inclusive Green Finance" Report. Available at: Inclusive Green Finance Working Group (IGFWG) and Financial Inclusion Data Working Group (FIDWG). 2022. Measuring Inclusive Green Finance. 8 November. Kuala Lumpur. Alliance for Financial Inclusion (AFI) Available at: https://www.afi-global.org/publications/measuring-inclusive-green-finance/

ACRONYMS

4P	Four Policy: Promotion, Provision, Prevention and Protection
AFI	Alliance for Financial Inclusion
ASEAN	Association of Southeast Asian Nations
BB	Bangladesh Bank
BCBS	Basel Committee on Banking Supervision
BIS	Bank of International Settlements
BMWK	German Federal Ministry for Economic Affairs and Climate Action/ Bundesministerium für Wirtschaft und Klimaschutz
BNM	Bank Negara Malaysia
BSP	Bangko Sentral ng Pilipinas
CCSBSO	Central American Council of Superintendents of Banks, Insurance and Other Financial Institutions
CNBS	Comisión Nacional de Banca y Seguros de Honduras
COSO	Committee of Sponsoring Organizations of the Treadway Commission
CRM	Climate Risk Management
CSR	Corporate Social Responsibility
DFI	Development Finance Institution
DOF	Department of Finance
ERM	Enterprise Risk Management
E&S	Environmental and Social
ESG	Environmental, Social and Governance
ESRM	Environmental and Social Risk Management
EU	European Union
FI	Financial Institution
FMO	Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V.
ICAAP	Internal Capital Adequacy Assessment Processes
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards Foundation
IGF	Inclusive Green Finance
IGFWG	Inclusive Green Finance Working Group
IGO	Inter Government Organization
IKI	International Climate Initiative
ILAAP	internal liquidity adequacy assessment processes
ISSB	International Sustainability Standards Board
MAS	Monetary Authority of Singapore
MFI	Micro Finance Institution
MSME	Micro Small and Medium Enterprises
NBFI	Non-Bank Financial Institutions
NGFS	Network for Greening the Financial System
NRB	Nepal Rastra Bank
OECD	Organization for Economic Cooperation and Development
SBS	Superintendencia de Banca, Seguros y AFP
SDG	Sustainable Development Goals
SEPS	Superintendente de Economía Popular y Solidaria
SREP	Supervisory Review and Evaluation Process
SME	Small and Medium Enterprise
TCFD	Task Force on Climate-related Financial Disclosures
UN	United Nations
UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific
UNFCCC	United Nations Framework Convention on Climate Change
UN SDG	United Nations Sustainable Development Goals.
WG	Working Group

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ANNEX 1. OVERVIEW OF ESRM GUIDANCE ESTABLISHED (AFI MEMBER INTERVIEW COHORT)

COUNTRY/ AGENCY	ESRM GUIDANCE DOCUMENT	DETAILS OF ISSUANCE	STAKEHOLDERS	SCOPE
ECUADOR Superintendente de Economía Popular y Solidaria (SEPS)	*Control Standard for the Management of Environmental and Social Risk*	**2022** Mandatory application Effective immediately	Credit cooperatives Mutual savings and credit associations	ESRM system procedural manual Categories of economic activity E&S performance checklists
PARAGUAY Banco Central Del Paraguay (BCP)	*Guide for the Management of Environmental and Social Risks for Entities Regulated Entities*	**2018** One-year implementation period (extended due to Covid-19 pandemic)	Banks	Minimum ESRM system standard for all banks Specific guidance on credit cycle integration Not part of SREP yet
MALAYSIA Bank Negara Malaysia (BNM)	*Value-based Intermediation Financing and Investment Impact Assessment Framework (VBIAF)* *VBIAF Sectoral Guides for Oil & Gas, Manufacturing, and Construction & Infrastructure issued in 2022* *VBIAF Sectoral Guides for Palm Oil, Renewable Energy and Energy Efficiency, issued in 2021*	**2019** Intended as a voluntary implementation aide	Islamic FIs	Policy guidance Value-based framework takes a Sharia/Islamic perspective on ESG risk management
	Climate Change and Principle-based Taxonomy	**2021**	Banks (conventional & Islamic) Investment banks Insurers and reinsurers Akaful and retakaful operators Development FIs	Policy guidance
	2024 Climate Risk Stress Testing Exercise	**2022**		Discussion paper
	Climate Risk Management and Scenario Analysis	**2022** Staggered mandatory timeline		Policy guidance
	Climate Data Catalogue	**2022**		Reference source
NEPAL Nepal Rastra Bank (NRB)	*Environmental & Social Risk Management for Banks and Financial Institutions*	**2018** - First published **2022** - Revision Mandatory reporting started in 2022 Roll out by loan size (priority to larger borrowers)	All banks	Guideline sets mandatory regulatory minimums Incorporates prescriptive ESRM tools, templates, and checklists to enable non-technical FI staff to implement Will start incorporating into SREP

METHODOLOGY/APPROACH	INTERNATIONAL ENGAGEMENT
> Diagnostic study (macro & micro analysis) > Sensitization efforts performed with FIs on climate risks > Capacity building > Concessional green funding identified > Not being enforced yet – implementation schedule considering the size of the controlled entity	
> No one size fits all > Creation of a sustainable finance roundtable > Public-private alliance created	
> E&S journey began with advocacy, followed by exposure drafts with a feedback process > Priority on managing climate risk Coordinating Mechanisms: > Joint Committee on Climate Change (JC3) set up in September 2019 (covering banking, insurance and capital market) > The JC3 has five sub-committees responsible on matters relating to risk management, governance and disclosure, product and innovation, engagement and capacity building, and bridging data gaps. Members include representatives from the banking, insurance and capital market. A TCFD Application Guide for Malaysian Financial Institutions was issued in 2022. Various capacity-building programs have been implemented since 2020 to increase technical expertise of industry.	Engaged peer regulators and industry players during development of policy documents Became member of NGFS Potential ASEAN Green Map Member of ASEAN Taxonomy Board
> Advisory committee led by dep governor, including supervisors and FIs > Informal engagement with industry via Bankers' Association > Sought feedback on draft from Bankers' Association > Prescriptive approach was deemed necessary to avoid greenwashing > May introduce regulatory incentives in the future > Had to create coordinating mechanisms between agencies (Ministry of Finance and Ministry of Forests and Environment)	Journey started with Sustainable Banking Finance Network (SBFN under the IFC) Learning lessons and shared experience from Bangladesh, Ghana, and Nigeria Preliminary discussions with the Network for Greening the Financial System (NGFS)

COUNTRY/ AGENCY	ESRM GUIDANCE DOCUMENT	DETAILS OF ISSUANCE	STAKEHOLDERS	SCOPE
PHILIPPINES Bangko Sentral Ng Pilipinas (BSP)	*Sustainable Finance Framework*	**2020** Board-approved transition plan required within six months Three-year transitory implementation provision	All banks	Broad principles on the integration of sustainability principles in the governance, risk management, strategies, and operations of banks, considering the principle of proportionality
	Environmental and Social Risk Management Framework	**2021** Mandatory implementation in 2023 (as announced in the 2020 Sustainable Finance Framework)	All banks	Additional guidance on the Sustainable Finance Framework covering E&S factors considered in credit risk and operational risk management frameworks
	Guidelines on the Integration of Sustainability Principles in Investment Activities of Banks	**2022** Mandatory implementation in 2 023 (as announced in the 2020 Sustainable Finance Framework) Sought to establish buy-in rather than force compliance	All banks	Additional guidance on the Sustainable Finance Framework covering E&S factors considered in the investment activities of banks
	Implementation of the Environmental and Social Risk Management (ESRM) System	**2022**	All banks	Clarificatory guidance on the Sustainable Finance Framework Describes the BSP's minimum expectations as embodied in the previously issued circulars Recognizes principles of proportionality
PERU Superintendencia de Banca, Seguros y AFP (SBS)	*Management of Social and Environmental Risk* *Resolution SBS 1928-2015.*	**2015**	Mostly banks	Applies to financing projects in which the total estimated investment exceeds USD10 million
	SBS Regulation of Investments of Private Pensions Funds Administrators. *Resolution SBS Nº 01657-2021*	**2021**	Private pension fund (PPF) administrators	Regulation that affects investment policies
HONDURAS Comisión Nacional de Banca y Seguros de Honduras (CNBS)	*Environmental and Social Risk Management Standard*	**2020** Institutions have two years to apply	Public banks Private banks Financial corporations	Provides a minimum E&S standard for FIs to integrate into credit operations Applies by business activity (regardless of loan amount) and by geographic location Applies proportionality with respect to the level of environmental risk Due diligence is required according to criteria set at three defined levels of E&S risk

METHODOLOGY/APPROACH	INTERNATIONAL ENGAGEMENT
> Sustainability-related guidelines initially apply to banks; other types of FIs may be covered in the future > Phased approach to issuance of regulations intended to set minimum standards > Establishment of internal working group with members representing the areas of policy development, supervision and examination > Multisectoral/inter-agency working groups set up (i.e, Green Force, Technical Working Group on Sustainable Finance under the Financial Sector Forum) > FI's adoption of transitory period providing banks the ample time and flexibility to implement (principles-based) however guidelines provide reference to illustrative tools and models > Underscore good governance and effective management of E&S risks to ensure stability of individual banks and unlock financing opportunities > Posting of consultation drafts on the BSP website to solicit comments from banks and other stakeholders > Conducting of bilateral meetings with FIs rather than large working groups for effective discussion and resolution of issues > Partnership with banking industry associations, relevant government agencies and other multilateral development organizations for the roll out of awareness and capacity-building activities as well as conducting technical studies related to climate stress testing and vulnerability assessment	Journey started with SBFN (IFC) Study tours (UK Foreign, Commonwealth & Development Office) Guidance is anchored in NGFS and Basel Committee on Banking Supervision (BCBS) publications ASEAN Taxonomy features prominently
> FIs must request that their clients complete a questionnaire detailing background information, due diligence, evaluation of potential impacts, mitigation measures, participation and dialogue, and complaint mechanisms. Based on this information, the bank will have to categorize the projects according to the levels of social and environmental risk (high, medium and low).	
> Requires PPF administrators to integrate environmental, social, and corporate governance factors into their investment decisions and the risk management of pension funds investment > Comply or explain approach	
> implementation divided into two phases: 1) categorization of environmental risk of the loan portfolio 2) implementation of the ESRM procedures (application of ESRM system). > The guidelines are based on the IFC model and the equatorial principles. It does not include physical and transitional climate risks yet, but will incorporate these in a second stage. > CNBS worked for four years with the banking association and FIs. Given that FIs are aware of environmental risks, there was no resistance from the sector. Additionally, some banks with an international presence had previously adopted the ESRM guidelines in other countries (e.g. Colombia) and this facilitated their adoption.	support from IFC, Norfund, FMO (the Dutch entrepreneurial development bank) -peer reviews done with Panama, Columbia, Peru, Paraguay -World Bank support for quantitative analysis of natural disaster risk

ANNEX 2. REGIONAL E&S POLICY INITIATIVES

ASEAN TAXONOMY AND CLIMATE RISK ANALYTICS

The Association of Southeast Asian Nations (ASEAN) has made significant strides in incorporating the United Nations Framework Convention on Climate Change (UNFCCC), the Paris Agreement (PA) and the UN SDGs into the region's economic development agenda.
Two interesting initiatives for advancing ESRM from a regional context are the development of a shared climate risk data and analytics platform and a shared green taxonomy for aligning green definitions.

ASEAN TAXONOMY FOR SUSTAINABLE FINANCE

Within ASEAN, there is an increasing need for taxonomy interoperability across markets which may already have their own green classification approach or are developing one. The ASEAN sustainable finance taxonomy, now in its first version (published in 2021), establishes a common language for sustainable finance among the 10 ASEAN member states, supporting the strategic policies of ASEAN member finance ministries and central banks. The ASEAN taxonomy seeks to provide an overarching framework for existing regional approaches, including the BNM principles-based taxonomy and the work being undertaken by the Green Finance Industry Taskforce (GFIT) coordinated by the Monetary Authority of Singapore (MAS).

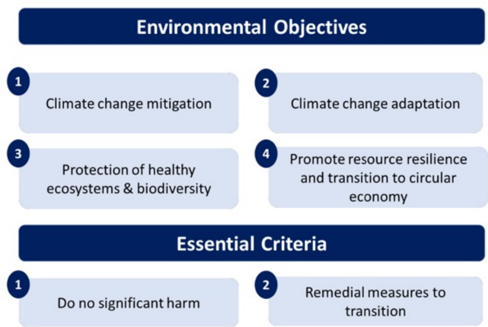
Image: ASEAN

The regional approach intends to boost confidence in financial products in ASEAN and enhance transparency through the common framework by setting comparable sustainability benchmarks and classify activities to avoid greenwashing.

"The ASEAN taxonomy is designed to aid the flow of capital towards sustainable investment opportunities and in particular, to scale climate finance, providing a level of confidence for investors that they are funding activities that will be significant in the transition to a low carbon economy."[37]

Fung said this in an article that appeared on 7 January 2022 in IFLR. In order to recognize the diversity between the member countries' economic activities and level of financial- sector maturity, the taxonomy was designed with a principles-based Foundation Framework that provides a qualitative assessment of activities agnostic of any sector and a Plus Standard with metrics and thresholds on certain priority sectors to further qualify and benchmark eligible green activities and investments, as member states become more advanced in their sustainability transition. This effectively means for each activity, there are potentially multiple decarbonization pathways and thresholds, depending on the starting point of entities.

Key components include four environmental objectives and two essential criteria for the assessment of economic activities that promote transition to low carbon practices.



The taxonomy contains specific greenhouse gas (GHG) emissions and gross value added (GVA) parameters for identifying and prioritizing sectors such as agriculture, electricity, and manufacturing. It also includes as a sector-agnostic decision tree for classifying economic activities under the Foundation Framework and a more prescriptive tiered stack approach is used to determine thresholds and technical screening criteria under the Plus Standard.[38]

37 Helena Fung, head of sustainable investment, APAC at the London Stock Exchange. (Lai, Karry. 2022. Primer: ASEAN Taxonomy for Sustainable Finance - Version 1. January 07. International Financial Law Review (IFLR). Available at: https://www.iflr.com/article/2a647e1ubbp4gena2y9s0/primer-asean-taxonomy-for-sustainable-finance-version-1)

38 For more information, see ASEAN Taxonomy Board (ATB). 2021. ASEAN Taxonomy for Sustainable Finance. Jakarta. The ASEAN Secretariat. Available at: https://asean.org/book/asean-taxonomy-for-sustainable-finance/

ASEAN RISK DATA AND ANALYTICS PLATFORM

From the perspective of financial stability, it is vital for financial regulators to measure, assess, and supervise the potential effects of climate risk at a regional level, given the interconnectedness of financial systems (i.e. financial contagion can cause spillover effects causing systemic instability of a region) and the regional nature of climate risk exposures.

To support the need for harmonized quantitative climate risk measurement, ASEAN is in the process of establishing a regional risk data and assessment platform,[39] to assist member states in identifying risks arising from climate disasters, and construct a high-resolution database for ASEAN stakeholders. “The platform will use remote sensing technologies such as satellite imagery, and advanced extraction techniques, to produce top-down economic exposure data. Such data include building attributes like age and type of construction, as well as building values, will be fused with bottom-up insurance exposure and loss data, to form a holistic and more accurate picture of risk,” said Jacqueline Loh in a keynote address delivered in 2019.[40] Loh is deputy managing director at the Monetary Authority of Singapore (MAS).

This initiative, supported by a network advisory group and a capacity-building program, will empower regulators and FIs to make informed decisions on climate risk management and help in the design of both national and regional climate and disaster risk financing solutions.

CCSBSO ENVIRONMENTAL AND SOCIAL RISK INITIATIVE

The Central American Council of Superintendents of Banks, Insurance and Other Financial Institutions (CCSBSO) is an international non-profit association, composed of the institutions responsible for exercising banking, insurance and other financial activities of the Republics of Guatemala, El Salvador, Honduras, Nicaragua, Costa Rica, Colombia, Panama, and the Dominican Republic. Founded in 1976, it seeks to be an association that consolidates the application of the best supervisory practices adapted to the region among its members, thereby contributing to regional financial stability.

In 2021, the members with support from the IFC, FMO and Norfund signed a Cooperation Agreement on Environmental and Social Risk, thus reaffirming the commitment made to strengthen the supervision of environmental, social and climate risks in the region.[41]

Among the objectives of this agreement is the adoption of international standards and best practices for social and environmental performance in the regional financial sector, seeking articulated efforts that lead to the achievement of sustainable objectives, and the development of the participating jurisdictions.

Although currently in an early stage of development, the application of best practices in the financial sector through regulatory bodies, in the assessment and management of social risks, as well as environmental and governance standards, should allow banks to better support their clients in managing some of the E&S challenges faced by their operations.

The agreement consists of four components:

- Taxonomy of Sustainable Finance
- Environmental, Social and Governance Investment Criteria
- Climate Risks
- Social Risks

39 The ASEAN Secretariat. 2019. Launched: ASEAN Disaster Risk Financing and Insurance Phase 2. 2 August. Jakarta. ASEAN. Available at: https://asean.org/launched-asean-disaster-risk-financing-and-insurance-phase-2-2

40 Loh, Jacqueline. 2019. A Coordinated and Forward Looking Approach towards ASEAN Disaster and Climate Risk Resilience - Keynote Address. NTU-ICRM’s 10th Annual International Symposium on Catastrophe Risk Management. 1 August. Singapore. Monetary Authority of Singapore. Available at: https://www.mas.gov.sg/news/speeches/2019/a-coordinated-and-forward-looking-approach-towards-asean-disaster-and-climate-risk-resilience

41 International Finance Corporation (IFC). 2021. Sector financiero en Centroamérica acuerda adoptar estándares y mejores prácticas internacionales para promover la banca sostenible. 6 August. Miami. International Finance Corporation (IFC). Available at: https://pressroom.ifc.org/all/pages/PressDetail.aspx?ID=26560

The agreement also promotes the exchange of the region's best environmental, social and governance practices and sharing of knowledge of how the member jurisdictions undertake activities related to sustainability strategy, ESRM implementation and prudential oversight.

Sanaa Abouzaid, Regional Manager, IFC in Central America, said "the development of a green taxonomy will facilitate the measurement of the progress of national policies and climate financing objectives, reorienting resources to sectors and projects that contribute substantially to environmental sustainability and emission reduction."[42]

Ethel Deras Enamorado, President of the CCSBSO, indicated that the signing of the Cooperation Agreement will bring with it at the regional level and for each of the countries, benefits such as those listed below.[43]

- to be a global reference in the establishment of a supervisory process in the field of environmental and social risk
- monitoring of environmental and social risks
- promoting the education and financial inclusion of sustainable finance through inter-institutional networks and interest groups; and
- moving towards the development of a banking system with the principles of sustainable and responsible banking

The agreement also seeks to develop a technical assistance mechanism that will focus on facilitating the adoption of international standards and best practices related to social and environmental performance standards in the financial sector of the countries that make up the CCSBSO, through its participating superintendencies. These entities will become part of the IFC Sustainable Banking Network (SBN).

Within the framework of this alliance, IFC, Norfund, and FMO will provide the participating institutions with capacity-building initiatives, including a series of workshops to ensure the proper understanding and implementation of best practices, social and environmental standards based on the IFC Performance Standards, and the guiding principles of the United Nations Organization for Business and Human Rights.

In addition, they will provide support to the participating superintendents who are members of the CCSBSO in the design of roadmaps for each institution in accordance with its priorities and strategic objectives.[44]

42 International Finance Corporation (IFC). 2021. Sector financiero en Centroamérica acuerda adoptar estándares y mejores prácticas internacionales para promover la banca sostenible. 6 August. Miami. International Finance Corporation (IFC). Available at: https://pressroom.ifc.org/all/pages/PressDetail.aspx?ID=26560

43 International Finance Corporation (IFC). 2021. Sector financiero en Centroamérica acuerda adoptar estándares y mejores prácticas internacionales para promover la banca sostenible. 6 August. Miami. International Finance Corporation (IFC). Available at: https://pressroom.ifc.org/all/pages/PressDetail.aspx?ID=26560

44 Consejo Centroamericano de Superintendentes de Bancos, de Seguros y de Otras Instituciones Financieras (CCSBSO). Accessed 26 April 2023. Available at: https://ccsbso.org/

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