BOX 7
A New Era in Banking : Green and Beyond

Introduction

Sustainable Finance can be broadly defined as financial services integrating environmental, social and governance (ESG) criteria into the decision-making process and business activities of firms, aiming at long lasting benefits for the firm, its clients and the society at large. However, there is no single, agreed global definition on what constitutes Sustainable Finance.

Green Finance is a component of Sustainable Financing. Green Finance, in general, refers to the channelling of financial flows towards meeting the challenges of climate change and the transition into a low-carbon economy. The Organisation for Economic Co-operation and Development (OECD) defines Green Finance as finance for achieving economic growth while reducing pollution and greenhouse gas emissions, minimising waste and improving efficiency in the use of natural resources.

Today, as a consequence of population growth, environmental degradation, climate change, poverty and inequality, Sustainable Finance practices are fast becoming the future in banking. The United Nations (UN) also recognised the importance of sustainable development and introduced the Sustainable Development Goals (SDGs) to address such challenges and call for action by all countries to promote prosperity while protecting the planet.

Sustainable Finance Journey and Roadmap of the Central Bank of Sri Lanka

The importance of initiating Sustainable Finance in Sri Lanka has been widely discussed among the stakeholders of the financial sector. In 2016, the Central Bank joined the International Finance Corporation (IFC) supported Sustainable Banking Network (SBN), which represents 86 per cent of banking assets in emerging markets.

In 2017, the Central Bank initiated the process of developing a Roadmap for Sustainable Finance in Sri Lanka to facilitate and promote sustainable finance practices in consultation with relevant government agencies, the banking industry and a wide range of financial sector stakeholders. The Central Bank also appointed a steering committee to facilitate developing the Sustainable Finance Roadmap for the financial sector in Sri Lanka through an inclusive multi-stakeholder process.

The Roadmap for Sustainable Finance was launched in June 2019 with the financial assistance of the Biodiversity Finance Initiative (BIOFIN) of the United Nations Development Programme (UNDP) along with technical assistance of the IFC. The Roadmap was developed in consultation with stakeholders including the Sri Lanka Banks' Association (Guarantee) Ltd. (SLBA), the Finance Houses Association of Sri Lanka, the Insurance Regulatory Commission of Sri Lanka and the Securities and Exchange Commission of Sri Lanka.

This Roadmap provides a broader direction to financial regulators and financial institutions to effectively manage ESG risks associated with projects they finance, and promote assistance to businesses that are greener, climate-friendly and socially inclusive. It attempts to scale up the contribution of the financial sector, including banking and finance, capital markets and insurance industry, and help build a more resilient and sustainable green economy.

The SLBA launched the Sustainable Banking Initiative (SL-SBI) in July 2015. Its purpose is to provide a platform to enhance understanding and action on responsible banking practices that can facilitate sustainable economic growth in Sri Lanka. Since its inception, the SL-SBI has successfully crafted and launched a set of 11 Sustainable Banking Principles. These principles, developed by a committee of participating banks, define how the Sri Lankan banking sector can conduct business to facilitate more sustainable economic growth locally.

Each country has adopted a unique route to promote Sustainable Finance in response to its local context and priorities. In countries such as Bangladesh, Brazil, China, Indonesia, Morocco, Nigeria and Vietnam, regulators have taken the lead through policy-based initiatives. On the contrary, in countries such as Colombia, Ecuador, Kenya, Mexico, Mongolia, South Africa and Turkey, banking associations have coordinated voluntary, industry-led initiatives. Sri Lanka is in a unique position with the SLBA launching the SL-SBI, the Central Bank collaborating with stakeholders, and launching the Roadmap where both approaches have been harmonised.

Most of the large licensed banks in Sri Lanka have already set up Sustainable Finance banking units and have launched sustainability initiatives focusing on areas such as renewable energy, entrepreneur development, environment protection and women empowerment. Many Sri Lankan licensed banks have been reporting on 'Sustainability' in their Annual Reports for over a decade using the guidelines published by the Global Reporting Initiative. Further, SLBA led initiatives and the Centre for Banking Studies have conducted many programmes to enhance the awareness and capacity on Sustainable Finance within the banking industry, and the SL-SBI also launched an e-Learning platform to facilitate capacity building on Sustainable Finance.

Banking Regulation and Sustainable Finance

The Central Bank is currently in the process of implementing the Action Plan as set out in the Roadmap to achieve targeted actions with the support of relevant stakeholders.

A key issue identified by many of the Green and Sustainable Finance initiatives is the need to develop standard definitions, a taxonomy of what constitutes Sustainable Finance, comparable metrics, and methodology for measuring the impact of Sustainable Finance. A sustainable taxonomy is a classification system, establishing a list of environmentally and socially sustainable economic activities.

In operationalising the actions of the Roadmap, the Central Bank has recognised the need for devising an applicable taxonomy, which is a key requirement in facilitating the financial sector towards sustainable finance. Currently, the Central Bank is in the process of developing a taxonomy for the financial sector of Sri Lanka to serve as a classification system that enables categorisation of economic activities/sectors that play key roles in climate change mitigation and adaptation in the Sri Lankan context.

The Regulatory Toolkit available for regulators on Sustainable Finance includes tools such as:

- Introduction of ceilings on credit extension to certain carbon intensive or polluting activities
- Green Finance Guidelines and Frameworks
- Climate-related stress testing
- Disclosure requirements on climate related and green financing risks
- Directed Green Credit Policy Instruments, and
- Green Differentiated Reserve Requirements.

Sri Lanka intends to initiate suitable instruments for the purpose of promoting Sustainable Finance, in line with the Roadmap of the Central Bank, considering market developments and needs. Sustainable Finance tools such as Green Finance Guidelines and Frameworks will be considered for implementation in the future after giving due supervisory considerations.

Regulators around the globe have thus far not explicitly taken into account the green or brown nature of the underlying assets when computing their perceived riskiness. Some central banks and supervisors have further integrated climate-related risks into the supervisory framework by adjusting and communicating their supervisory expectations.

Going forward, banks could also look at the feasibility of incorporating scenarios that estimate the potential impact on financial stability from supplying credit to environmentally unsustainable or sustainable activities over time into the banks' Pillar 2 Supervisory Review stress tests under the Basel Capital Framework.

Challenges

Currently, no uniform Sustainable Finance taxonomy has been implemented globally. This has led to ESG factors considered in the assessment of Sustainable Finance being inconsistent and incomparable.

Lack of expertise and capacity will be a barrier faced by all stakeholders including the regulators. Especially new green products and technologies will evolve dynamically, and expertise and experience will be required to assess viability. Therefore, capacity building efforts and technical guidance are paramount for the successful implementation of the Sustainable Finance initiative.

Information asymmetry on Sustainable Finance from both loan origination and risk management may hinder Sustainable Finance initiatives. Therefore, information systems and information flows must be improved to cater to evolving Sustainable Finance needs.

In the future, financial institutions will be expected to integrate ESG risks comprehensively into the risk management framework to ensure ESG risks are considered holistically in risk management practices. Accordingly, going forward, finding the right recipe for Sustainable Finance initiatives to thrive in the Sri Lankan context would be a challenge for all stakeholders involved.

Way Forward

The Roadmap of the Central Bank articulates a series of strategic activities to implement Sustainable Finance in Sri Lanka, while detailing an action plan to be implemented over the short, medium and long term by the respective stakeholders. The Central Bank expects to issue a taxonomy on Sustainable Finance in collaboration with stakeholders by the end of 2021. Disclosures by financial institutions and other entities on material information on sustainability should be further strengthened giving due consideration to all ESG aspects.

The economic shock stemming from the COVID-19 pandemic has highlighted the need for enhanced resilience in the global economy. Accordingly, policymakers across the globe will focus on ensuring that the recovery from the pandemic is carried out in a sustainable manner. Going forward, coordinated policy actions are needed to ensure enhanced readiness for Sustainable Finance initiatives across regions and countries. Accordingly, in the new era of post pandemic banking, Sustainable Finance will become an essential lever for achieving social, economic and environmental goals in an economy.

References

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