Experiences of Sustainable Banking Initiatives from Bangladesh, Brazil & China

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Initiatives for integrating sustainability criteria into the everyday business practices and governance structures of commercial banks have been around since the 1990s, but the field has long been dominated by voluntary and industry-driven initiatives. On their own, non-binding guidelines and recommendations are insufficient to create the change of the magnitude needed to deal with the social and environmental challenges of the 21st century. It is therefore heartening that banking regulators across the world have begun to address the issue of sustainability. In Indonesia, the Otoritas Jasa Keuangan (OJK) published its "Roadmap for Sustainable Finance in Indonesia" in 2014. Its goal is to achieve a transition to sustainable finance by 2024. This is a welcome initiative because motivating or forcing commercial banks to take into account the environmental and social consequences of the activities they finance and to assess the risks to themselves that arise because of their exposure to these industries could help to contain damaging practices like rampant deforestation, land grabbing and labour issues.

This paper explains what regulation for sustainability in banking does and presents some of the experiences that OJK can draw on in its work.

1 What does sustainability mean?

The *Inquiry into the Design of a Sustainable Financial System*, initiated in 2014 by the United Nations Environment Programme, suggests the following definition for sustainable finance: "Sustainable development requires changes in the deployment and relative value of financial assets and their relationship to the creation, stewardship and productivity of real wealth. A sustainable financial system is, therefore, one that creates, values, and transacts financial assets, in ways that shape real wealth to serve the long-term needs of an inclusive, environmentally sustainable economy".[i] Banks, as part of the larger financial system, have an important role to play here.

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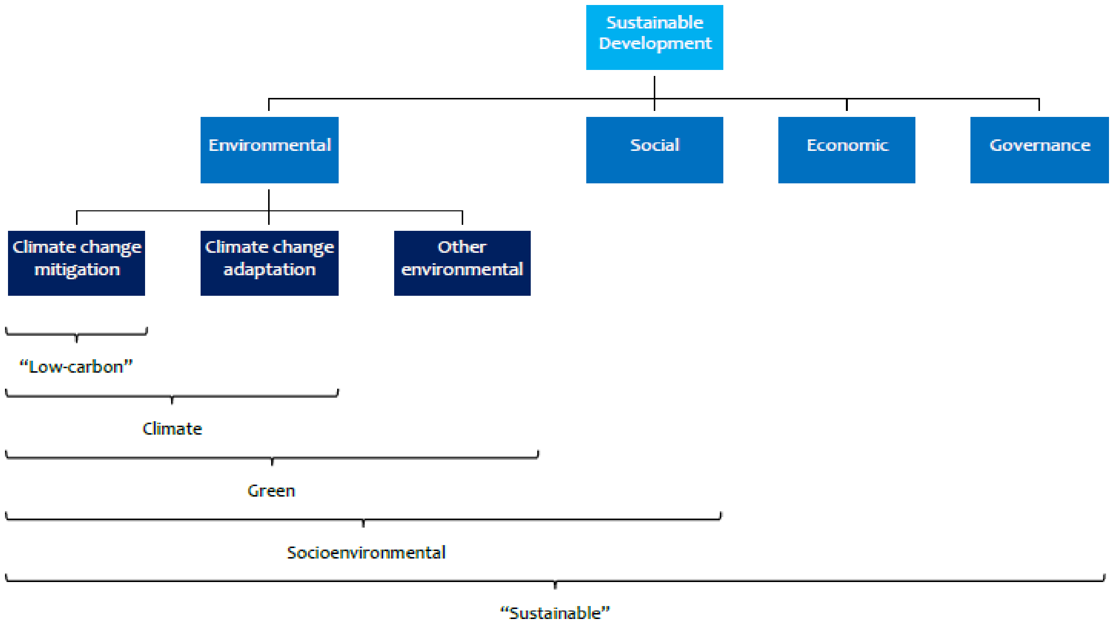
[i] UNEP Inquiry Design of a Sustainable Financial System (2015), *The Financial System We Need: Aligning the financial system with sustainable development*, Geneva, Switzerland: UNEP Inquiry Design of a Sustainable Financial System, p. 13.

The concept of 'sustainable finance' is the broadest in a group of partly overlapping terms, including 'green finance' and 'climate finance' (see Figure 1). A comprehensive definition includes all aspects of sustainable development: environmental, social, economic and governance-related. We use the term 'sustainable finance/banking' in this comprehensive sense.[i] 'Green banking/finance' refers to initiatives that only focus on environmental issues into account.

Figure 1 Dimensions of sustainability



2 The different regulatory tools

The various initiatives to make banks sustainable must be distinguished in terms of their *institutional* and *technical* features. Institutionally, they differ in terms of:

- their voluntary or binding nature;
- which actor or organisation proposes or mandates them, i.e. whether a particular sustainable banking framework is promoted by statute law, a country's central bank or banking supervisor, or by the financial sector itself, typically a country's banking association;
- which financial institutions are covered by it, i.e. whether the framework in question only covers banks or other financial actors as well.

Technical differences arise because banking regulators and supervisors like the OJK have a range of tools at their disposal to inscribe sustainability into the organisational structures and operations of banks. Different frameworks use different tools and target different dimensions or aspects of banks' operations:

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[i] UNEP Inquiry Design of a Sustainable Financial System (2016), *Definitions and Concepts: Background Note*, Geneva, Switzerland: UNEP Inquiry Design of a Sustainable Financial System, p. 10-11.

- Minimum capital requirements ('regulatory capital')
- Internal risk management
- Governance
- Disclosure
- Sustainable (or 'green') lending
- Sustainable (or 'green') financial products for retail investors
- Banks' refinancing operations
- Banks' physical operations

The first four in this list belong to the area of *prudential and supervisory regulation*. The purpose of this is to make sure that banks do not take on too much risk because bank failures do not just endanger the financial system, but entire economies. Apart from supervisory and prudential tools, there is also *monetary policy*, which affects how commercial banks refinance themselves by borrowing from their national central banks. The latter can use monetary policy to create incentives for commercial banks to lend more to sustainable industries or businesses by making cheaper refinancing options available for banks that lend sustainably, and/or by accepting assets such as 'green bonds' as collateral for central bank borrowing.

Most of these aspects of banking activity and regulation can be grouped into two broad fields: *risk management* and *sustainable lending/financial products*. Risk management primarily refers to the processes by which banks assess and monitor the credit risk associated with individual loans or entire loan portfolios, but also with other activities such as securities underwriting. Most sustainable banking initiatives focus on the risk management aspect of banking by suggesting, or requiring, banks to incorporate "environmental and social risks in lending considerations in order to avoid or mitigate financial losses, reputational risk or harm to the environment and people caused by projects banks finance".[i] This is based on what could be called an avoidance logic, the idea being that banks should be forced or given incentives to avoid too much exposure to unsustainable projects, businesses or industries.

Inasmuch as sustainable banking initiatives try to encourage sustainable lending and the sale of sustainable financial products they go beyond an avoidance logic. Rather than merely avoiding the financing of undesirable activities, banks are being encouraged or required to make capital flow to industries whose activities are desirable from a sustainability point of view. They can do so through their own lending or through the investment products they sell to their retail customers.

3 For an overview of regulatory as well as industry-driven sustainable banking initiatives see the Appendix. Pioneers of sustainable banking regulation: Bangladesh, Brazil, China

Bangladesh has pioneered a systematic and comprehensive approach. Bangladesh Bank, the country's central bank and financial sector regulator/supervisor, combines monetary policy and regulatory tools to make banks avoid unsustainable lending and increase their lending to sustainable businesses and industries. To that end, it has devised three policies: a 'green' banking/finance framework, a monetary policy facility for cheaper loan refinancing, and a 'green' lending target. Its dedicated Sustainable Finance Department constantly monitors progress on these policies as well as

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[i] Sustainable Banking Network (2016), *Greening the Banking System: Experiences from the Sustainable Banking Network (SBN) (Input Paper for the G20 Green Finance Study Group)*, International Finance Corporation, p. 3.

the ‘green’ activities of the country’s banks and non-bank financial institutions and publishes quarterly reports. It uses the tools of monetary policy as well as banking supervision to sensitise banks to environmental risks, but also to create incentives for ‘green’ lending. It provides banks with detailed guidance and requires standardised reporting on their 'green' banking activities, which makes it easier to assess whether the measures are successful in changing the daily business practices of Bangladeshi banks. All banks have now created ‘green’ banking units and policies, and the number of loan applications that are screened for environmental risks increases continuously. So far, however, 'green' loans still only constitute a small share of banks' total loan portfolios.

Unlike its Bangladeshi counterpart, the **Brazilian** central bank, which is also tasked with banking supervision, does not use monetary policy to encourage sustainable lending. It restricts its regulatory interventions into the running of commercial banks to risk management and imposing conditions on lending to environmentally sensitive activities. The ‘positive’ channelling of finance to socially and ecologically desirable activities and industries seems to fall largely to Brazil’s public banks, in particular the National Development Bank (BNDES). An interesting feature of the Brazilian case is the role played by legal factors in sensitising lenders to possible negative consequences of environmental damages. The country’s legal system allows non-affected parties to file civil lawsuits against those who are responsible for such damage. Numerous lawsuits over the past ten to fifteen years have established the principle of lender environmental liability. Lenders can now be held liable in principle for the damages caused by the activities of borrowers, which opens an additional avenue for NGOs and activists for putting pressure on banks. However, due to a lack of data and/or studies on the topic it is currently not possible to say whether these initiatives have changed the flow of lending and the way banks conduct themselves.

Brazil has also used targeted measures to make lending to specific sectors or activities contingent on compliance with environmental or labour criteria, including a regulation (Resolution No. 3,545) that makes the granting of subsidised rural credit contingent on compliance with environmental requirements and which has succeeded in significantly reducing the pace of deforestation in the Brazilian Amazon. A simulation suggests that 2,800 square kilometres of forest would have been cleared from 2009 through 2011 had Resolution 3,545 not been passed. [1]

Like Brazil, **China** does not use monetary policy or mandatory credit quotas, but relies mostly on a well-developed ‘green’ banking framework that includes guidance on the management of social and environmental risks, ‘green’ lending, as well as environmental requirements regarding banks’ own operations. The 2012 *Green Credit Guidelines* are the main pillar of this framework. They are flanked and elaborated by additional regulations that provide more detailed guidance as well as standardised assessment and reporting formats, such as the 2014 *Key Performance Indicators of Green Credit Implementation*. There is not (yet) enough data available to judge whether this framework has directly succeeded in redirecting credit flows. However, recent development in China’s energy market – a significant increase in financing provided by Chinese banks to renewable energy projects both domestically and internationally, accompanied by a slow-down of financing to the coal sector in particular – can be considered indications that Chinese financial institutions are adjusting their lending portfolios towards more sustainable business practices in line with government stated objectives.

4 Conclusion

Ultimately, sustainable banking initiatives should be embedded in a coherent economic and political effort. It is not just the supply, but also the demand for ‘green’ and other sustainable finance that needs to increase, and this goes beyond financial sector regulation. Governments, regulators, financial institutions and other interest groups should keep this notion at the forefront of their mind. Sustainable banking initiatives are just one of a number of elements in a coherent set of regulatory initiatives that will mitigate negative social and environmental impacts of business practices, and facilitate economies' on a sustainable development path. It is therefore promising to observe the steps that the Indonesian government is taking on this path through a variety of measures, including the Financial Services Authority's *Roadmap for Sustainable*.

Sustainable banking initiatives have been around for a while, but regulatory sustainable banking frameworks and guidelines that are detailed and sophisticated enough to be implementable are still relatively recent. It is therefore too early to make generalising conclusions about their effectiveness. There are, however, encouraging indicators, like the reduction in deforestation in Brazil or the increase in the number of loan applications that are subjected to environmental risk rating in Bangladesh. Regulators like the OJK can learn from these examples. They should also continue developing these instruments and adapt them to their national contexts, because the creative process of developing the tools for dealing with the challenges presented by the task of implementing the Sustainable Development Goals is not over yet. The experience with voluntary commitments in the financial industry and other sectors suggests that they are not strong enough in that regard. Binding regulation is likely to be more effective, especially when it is accompanied by detailed implementation guidance and standardised disclosure formats, as in Bangladesh and China.

Appendix Existing sustainable banking initiatives

This appendix presents an overview of existing sustainable banking frameworks divided over two tables, one for frameworks developed by an official regulatory or supervisory body, and another one for frameworks developed by the banking industry itself, that is, through the respective national banking associations. They are presented separately primarily for reasons of convenience. Brazil and India appear in both tables, but most countries only have either an industry-led or a regulatory framework. Not all regulatory frameworks for sustainable banking, which are presented in Table 1, are technically mandatory. The Chinese *Green Credit Guidelines*, for example, are formally voluntary but de facto mandatory and have been accompanied by many detailed guidelines. Where applicable and available, the tables include information about which of the two general areas of banking activities are covered by the framework in question.

Table 1 Regulatory sustainable banking initiatives, including monetary policy tools

Country	Name of framework	Issuer and scope of regulation	Risk management	Sustainable lending and financial products
Bangladesh	BRPD Circular No. 1: Environmental Risk Management Guidelines (2011)[2] *Aims to encourage and enable financial institutions to take environmental risks into account in credit risk assessment.*	Central Bank regulation Applicable to banks and non-bank financial institutions	X	
	BRPD Circular No. 2: Policy Guidelines for Green Banking (2011)[3] *Guidelines for moving towards green banking practices, e.g. in credit appraisal process, reporting, banks' own operations, lending etc.*	Central Bank regulation Initially banks only; extended to non-bank financial institutions 2013 (GBCSRD Circular No. 4)[4]	X	X
	Cheaper refinancing for commercial loans to 'priority areas', such as agriculture or renewable energy. E.g. GBCSRD Circular No. 2: Refinancing Scheme for Renewable Energy and Green Financing (2013)[5]	Central Bank Monetary policy incentives for commercial banks		X
	GBCSRD Circular No. 4: Annual Target for Direct Green Finance (2014)[6] *Mandatory 5% allocation of loan/investment portfolio to green finance*	Central Bank regulation Applicable to banks and non-bank financial institutions		X
Brazil	Resolution No. 3545 (2008)[7] *Makes rural credit to agricultural producers in the Amazon contingent on compliance with environmental regulation.*	Central Bank regulations Applicable to financial institutions and other entities authorised by Central Bank	X	

Country	Name of framework	Issuer and scope of regulation	Risk management	Sustainable lending and financial products
	Resolution No. 3813 (2009)[8] *Conditions for loans for sugar cane cultivation*		X	
	Resolution No. 3876 (2010)[9] *Prohibits granting loans to entities or individuals associated with employment of slave-like labour.*		X	
	Circular No. 3547 (2011)[10] *Internal Capital Adequacy and Assessment Process (ICAAP, Pillar 2 of Basel III). Banks to demonstrate how they take social and environmental risks into account in calculating risk exposure; also requires disclosure of ICAAP to central bank.*		X	
	Resolution No. 4327 (2014)[11] *Guidelines on how to implement Social and Environmental Responsibility Policies. Includes guidance on social and ecological risk management.*		X	
China	Green Credit Guidelines, CBRC (2012), No. 4[12] *Operational guidance to implement green banking in environmental and social risk management, green lending, and greening banks' own operations.*	China Banking Regulatory Commission Applicable to banks	X	X
	Green Credit Statistics, CBRC General Office (2013) No. 185[13] *Green loans classified into 12 categories with sub-categories. Includes tool for banks to calculate environmental benefits from green lending. Standardised format for green credit reporting.*			X
	Green Key Performance Indicators (2014)[14] *Banks to assess themselves against these indicators and report to CBRC.*		X	X
	Energy Efficiency Credit Guidelines, CBRC (2015) No. 2[15]	China Banking Regulatory Commission Applicable to banks		X

Country	Name of framework	Issuer and scope of regulation	Risk management	Sustainable lending and financial products
	Defines "energy efficiency credit" and applicable areas; operational guidance to banks extending such credit. Banks called on to increase lending to energy efficiency projects and develop innovative lending products, but no targets formulated.			
India	Priority Sector Lending (PLS) targets (2015)[16] *Renewable energy included in PSL categories; sets 40% target of bank credit that must go to priority areas.*	Reserve Bank of India Applicable to commercial banks		X
Lebanon	Circular No. 84, Decision No. 7835, Reserve Requirements[17] *Cheaper funding to commercial banks for lending to environmentally sustainable projects.*	Central Bank of Lebanon Monetary policy incentives for commercial banks		X
Peru	Resolution SBS No. 1928-2015 for Social and Environmental Risk Management (2015)[18] *Flanked by guidance on "Role of Enhanced Due Diligence in the Regulation of Socioenvironmental Risk Management for Financial Firms"[19].*	Superintendency of Banking, Insurance and Private Pension Fund Administrators (SBS) Applicable to banks and non-bank financial institutions	X	
Vietnam	Directive on Promoting Green Credit Growth and Environmental and Social Risks Management in Credit Granting Activities, No.: 03/CT-NHNN (2015)[20] *Requires lenders to promote 'green' credit growth and introduce procedures for social and environmental risk managements.*	State Bank of Vietnam Applicable to all financial institutions operating in Vietnam	X	X

Table 2 Industry-led sustainable banking initiatives

Country	Industry-led, voluntary	Industry-led, binding	Risk management	Sustainable lending and financial products
Brazil	Green Protocol[21]		X	X

Country	Industry-led, voluntary	Industry-led, binding	Risk management	Sustainable lending and financial products
	Initiated in 1995 by the Ministry of Environment and five state-owned banks; revised in 2008. Adopted by commercial banks in 2009.			
Colombia	Colombia Green Protocol (2012)[22] *Adopted by major commercial and development banks.*		X	X
India	National Voluntary Guidelines for Responsible Financing (2015)[23] *Issued by Indian Banking Association.*			
Kenya	Sustainable Finance Initiative Guiding Principles (2015)[24] *Developed by Kenya Bankers Association (KBA).*		X	X
Mexico	Sustainability Protocol (2016)[25] *Developed by Mexican Banking Association (ABM); provides guidance on risk management and sustainable lending.*		X	X
Mongolia		Mongolian Sustainable Finance Principles (2014)[26] Developed by Mongolian Bankers Association; implemented by all Mongolian banks from 2015. Also issued sector-specific guidelines for agriculture, mining etc.	X	X
Nigeria		Nigerian Sustainable Banking Principles (2012)[27] Originally developed by the Nigerian Banker's Committee, their implementation was later made mandatory by the Central bank of Nigeria.	X	X
Singapore	Guidelines on Responsible Financing (2015)[28]			

Country	Industry-led, voluntary	Industry-led, binding	Risk management	Sustainable lending and financial products
	Issued by Association of Banks in Singapore; define minimum standards for responsible financing.			
Turkey	Sustainability Guidelines for the Banking Sector (2014)[29] *Issued by Banks Association of Turkey.*		X	X

Notes to tables

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