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Banking in A Changing World: The Rise of ESRM

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INTRODUCTION

The financial sector shapes the world, but traditional practices are shifting as environmental and social issues gain prominence. Environmental and Social Risk Management (ESRM) is becoming crucial for responsible banks.

Why is ESRM important? This framework helps manage financial risks related to environmental challenges (climate change, resource depletion) and social injustices. It also allows banks to find sustainable businesses, build stakeholder trust, and contribute to a better future. ESRM is gaining traction in Vietnam's banking sector. While the concept may be new, its impact is significant, influencing both domestic and foreign banks operating in the country. This growing focus reflects the increasing awareness of environmental, social, and governmental factors that can impact financial stability and risk management.

ESRM is more than a trend; it's a necessity. By integrating ESRM, banks can navigate a changing landscape, secure long-term stability, and foster a sustainable future for all.

***Keyword**: ESRM, Banking, Finance*

1. Theoretical Basis

1.1 Research Objectives

The main goal of this report is to optimize risk management practices, such as developing industry-specific frameworks for identifying, assessing, and mitigating environmental and social risks tailored to different banking and financial activities (e.g., lending to specific sectors, project financing), and evaluating the effectiveness of existing risk management procedures in capturing and managing environmental and social risks, identifying areas for improvement and tailoring them to specific risk profiles.

1.2 Scope and Limitations of the Research

This research on ESRM in banking and finance covers a wide range of topics, including: research into the various types of environmental risks (e.g., climate change, resource depletion) and social risks (e.g., labor rights, community impacts) that affect financial institutions and their clients, as well as research into the effectiveness of various ESRM practices on financial performance, risk reduction achieving sustainable development goals and will go from general issues around the world to Vietnam.

1.3 Concept of ESG and the Importance of Environmental and Social Risk Management in Bank Finance

In the ever-evolving world of finance, a new set of acronyms is grabbing the spotlight: ESG. This seemingly innocuous combination of letters, standing for Environmental, Social, and Governance, represents a comprehensive framework for assessing a company's sustainability and ethical impact. It is not merely a checkmark on a list, but rather a holistic approach that considers the intricate web of factors contributing to a company's long-term success. The environmental pillar examines how a corporation interacts with the environment. It studies its climate change footprint, with an emphasis on greenhouse gas emissions and mitigation initiatives. It goes deeper, evaluating the company's resource utilization, which includes water, electricity, and raw materials. This pillar emphasizes efficient utilization and waste minimization. Furthermore, the environmental component emphasizes the value of biodiversity and ecosystem services. It examines the company's influence on natural ecosystems as well as its dedication to maintaining nature's delicate balance. The social pillar focuses on a company's relationships with its stakeholders and its overall societal influence. It begins with labor practices, which include fair wages, working conditions, and respect for employee rights. It also examines the company's commitment to human rights throughout its operations and supplier chain. Moving outside its own walls, the social pillar evaluates the company's community involvement, which includes social responsibility programs and relationships with local stakeholders. It also assesses a company's commitment to product safety and ethical sourcing, which ensures responsible manufacturing processes and ethical material procurement. The governance pillar is the foundation of a sustainable and responsible corporation. It looks at the company's leadership structure, including the composition and diversity of the board of directors, executive salaries, and overall leadership practices. It also promotes transparency and accountability, requiring open contact with stakeholders, accurate reporting on actions, and adherence to ethical business standards. Recognizing potential threats and difficulties, the governance pillar assesses the company's risk management system to ensure that it can detect, assess, and mitigate risks associated with environmental, social, and governance issues. Finally, it examines the company's compliance with applicable laws and regulations.

Environmental, social and governance (ESG) is a framework used to assess an organization's business practices and performance on various sustainability and ethical issues. It also provides a way to measure business risks and opportunities in those areas. In capital markets, some investors use ESG criteria to evaluate companies and help determine their investment plans, a practice known as ESG investing. While sustainability, ethics, and corporate governance are generally regarded as non-financial performance indicators, an ESG program's role is to ensure accountability and the implementation of systems and processes to manage a company's impact, such as its carbon footprint and how it interacts with employees, suppliers, and stakeholders. ESG activities also help to advance broader business sustainability efforts, which attempt to position firms for long-term success through responsible corporate management and business strategies.

The banking sector, which has traditionally concentrated on financial success, is now negotiating a new landscape characterized by expanding environmental, social, and governance (ESG) concerns. Integrating ESG factors into risk management methods is no longer an optional extra, but rather a necessary step toward long-term sustainability and profitability. This essay examines the significance of this integration, emphasizing its advantages for banks, stakeholders, and the environment. Banks profit greatly from adopting ESG and risk management practices. For starters, it reduces potential environmental and societal dangers. Climate change, for example, offers considerable financial risks through catastrophic weather occurrences and increasing sea levels, which could affect loan performance and asset prices. Similarly, civil unrest and human rights breaches can harm a bank's brand and draw regulatory attention. By proactively recognizing and addressing these risks, banks can improve their resilience and long-term stability. Second, integrating ESG issues promotes better resource allocation and decision-making. Banks can use ESG data and research to analyze the sustainability of possible investments and uncover possibilities in industries that prioritize environmental and social responsibility. This can result in a more sustainable and profitable portfolio, attracting investors who are increasingly valuing ESG issues in their investing decisions. The advantages of ESG and risk management extend beyond the banking sector and help stakeholders as well. Banks can help to advance social and environmental goals by supporting sustainable enterprises and projects. This benefits communities by supporting sustainable practices, creating green jobs, and encouraging responsible business behavior. Furthermore, ESG integration encourages responsible lending practices and ethical corporate governance, providing stakeholders with increased transparency and accountability from banks. Finally, the environment stands to benefit greatly from this transition in the financial sector. Banks can help to accelerate the transition to a low-carbon economy by prioritizing sustainable investments and avoiding environmental risk. This can help to reduce greenhouse gas emissions, preserve biodiversity, and promote resource conservation.

1.4 Relationship between ESG and Bank Financial Performance

The changing face of finance requires a better understanding of the link between environmental, social, and governance (ESG) initiatives and bank financial performance. While intuition may suggest a favorable relationship between accountability and profitability, current research paints a more complicated picture.

On the one hand, research has demonstrated that good ESG practices are associated with improved financial performance. Banks with strong environmental and social policies, as well as good governance frameworks, may attract a larger pool of ethical investors looking for values that fit with their own. Furthermore, ethical practices can contribute to lower operational costs by conserving resources, improving risk management, and boosting brand reputation. This can ultimately lead to increased profitability and shareholder value.

However, other research has revealed no statistically significant link between ESG and financial performance. These studies emphasize the relationship's intricacy, stating that industrial background, regulatory environment, and measuring methodology can all have an impact on the observed results. Furthermore, the long-term nature of ESG advantages is not necessarily represented in short-term financial indicators, making it difficult to establish a clear correlation. The inconsistencies in research findings highlight the ongoing debate and the need for further exploration. Several limitations hinder a conclusive understanding of the relationship. The lack of standardized ESG data makes comparisons across institutions challenging. Additionally, attributing financial performance solely to ESG practices is difficult, as other factors like economic conditions and market trends also play a significant role.

Furthermore, several studies indicate a nonlinear relationship between ESG and financial performance. This suggests that reaching a particular level of ESG investment may not necessarily result in further financial rewards. This could be owing to the cost associated with establishing strong ESG policies, or the prospect of declining returns on investments in certain areas. The inconsistencies in research findings highlight the ongoing debate and the need for further exploration. Several limitations hinder a conclusive understanding of the relationship. The lack of standardized ESG data makes comparisons across institutions challenging. Additionally, attributing financial performance solely to ESG practices is difficult, as other factors like economic conditions and market trends also play a significant role.

The correlation between ESG adoption and financial outcomes remains an intriguing and ongoing debate lacking a definitive answer. While some evidence suggests a positive association, the complexity of the relationship, limitations in research methodologies, and lack of standardized metrics hinder conclusive inferences. Moving forward, further research is needed to address these limitations and explore the mechanisms through which ESG practices might influence financial performance over extended periods, accounting for industry-specific factors and employing robust metrics. This will enable us to paint a clearer picture of how responsible practices contribute to the sustainable success of companies and make informed decisions about the future of sustainable finance.

2. Current Status and Challenges

2.1 Current Situation of Environmental and Social Risk Management in Banks in Vietnam

2.1.1 Analyze the current state of ESG and Social risk management practices in Vietnamese banks.

With the aim of developing a sustainable economy, Vietnam is committed to building a green economic development strategy, as clearly demonstrated in Decision No. 1658/QD-TTg dated October 1, 2021, by the Prime Minister approving the National Green Growth Strategy for the period 2021-2030 with a vision to 2050. In this strategy, green banking activities and green credit, which involve providing capital for projects contributing to environmental protection, play a crucial role in its successful implementation.

Despite some pioneering commercial banks in constructing assessment frameworks and integrating environmental and social risk management strategies into green credit appraisal processes, the development of this sector in Vietnam has yet to fully exploit its potential. This is because the growth momentum of the financial market from 2015 until now mainly stems from the directives of the State Bank and the Ministry of Finance, rather than from market forces.

At the seminar "Attracting Large Capital Sources for Green Credit" held on December 4, 2023, organized by the Investment Newspaper in collaboration with the Agricultural Bank of Vietnam (Agribank), Ms. Pham Thi Thanh Tung, Deputy Head of the Credit Department for Economic Sectors at the State Bank of Vietnam (SBV), shared that during the period 2017-2022, the outstanding loans for green sectors within the system experienced an average annual growth rate of over 23%. As of September 30, 2023, the outstanding green credit reached over 564 trillion VND, accounting for approximately 4.4% of the total outstanding loans in the entire economy. Among the 12 sectors guided by the SBV for credit institutions, lending is predominantly concentrated in renewable energy or clean energy (nearly 45%) and green agriculture (over 30%).

Currently, credit institutions are increasingly enhancing their assessment of environmental and social risks in lending activities, with outstanding loans totaling over 2.67 trillion VND, representing more than 21% of the total lending to the entire economy. However, this is still insufficient to fully tap into the expected resources.

Currently, the green economy, especially green banking or green credit, has not been highly regarded in Vietnam due to the lack of attention from some banks and credit institutions. This may partly be due to the absence of criminal sanctions against organizations providing capital for projects that degrade environmental quality, as such sanctions currently only apply to individuals and organizations directly causing environmental pollution. Without legal constraints and responsibilities, credit officers do not pay much attention to assessing the environmental impact of projects under credit appraisal. Moreover, this does not create sufficient motivation to drive all credit institutions towards green credit development.

2.1.2 Assess the level of adoption of ESG principles and the effectiveness of risk management frameworks.

The State Bank of Vietnam has conducted research and issued policy mechanisms with the direction of developing green banking and green credit towards sustainable development. Currently, the State Bank has collaborated with the International Finance Corporation (IFC) to develop a handbook guiding the assessment of environmental and social risks for the 15 highest-risk economic sectors to encourage and focus funding on projects in the field of environmental impact reduction. Additionally, there is an emphasis on enhancing capacity building for sustainable development to increase awareness among banking personnel.

In response to the guidance of the State Bank, credit institutions are actively developing green financial products including mobilizing and lending to renewable energy projects, clean energy, or carbon-light consumer production sectors. Moreover, commercial banks focus on integrating environmental risk management systems into the risk management structure of the bank.

Furthermore, credit institutions are incorporating ESG factors into their medium and long-term business strategies and visions. Some banks have issued "Green Credit Frameworks" or "Sustainable Financing Frameworks" to provide processes for using and lending to projects or enterprises investing in green sectors.

However, international organizations still evaluate Vietnamese commercial banks as being in the early stages of ESG integration and facing many difficulties in integrating with sustainable goals. On the other hand, many other commercial banks have not established ESG risk management systems or incorporated ESG risk assessment into credit activities. Overall, compared to countries in the region and developed countries worldwide, Vietnamese commercial banks need to improve and make more efforts to strengthen ESG integration.

2.2 Challenges Faced in Applying ESG in the Banking and Finance Industry

Currently, the Vietnamese financial market has not yet matured with small scale and limited financial instruments. Particularly, the stock market, which is considered the primary capital-raising channel in other countries, is still evaluated as small-scale and structurally weak due to the weakness of the Vietnamese dong and limited commodities in the market. Therefore, the main source of capital for enterprises primarily relies on bank credit.

In reality, banks are quite hesitant to provide credit for green energy projects because it demands high technical expertise during the credit appraisal process, but due to legal deficiencies, effective appraisal is challenging. Moreover, credit institutions view this as a risky business sector due to limitations in public awareness of environmental protection, potential penalties for legal violations affecting project progress, and the risk of credit institutions being unable to recover debts. Additionally, the Vietnamese government has yet to impose strict sanctions and clearly demonstrate a green economic direction, which hampers banks' motivation to establish effective appraisal frameworks and increase funding for environmental protection projects.

Another challenge is the lack of national regulations on the list of green projects for industries for credit institutions to determine green credit issuance.

Furthermore, during the credit provision process for renewable energy projects, credit institutions often struggle to balance capital sources, as these green projects have long payback periods and require significant investment costs. However, credit institutions' capital sources are primarily short-term, posing difficulties in ensuring the required short-term capital-to-mid-term lending ratio as per regulations. Additionally, fundraising channels have not developed for green projects such as the green bond market, carbon credit market, which exert capital pressure on the banking system. In reality, green credit issuance activities such as green bond issuance have not yet occurred in the bond market due to unclear legal frameworks.

3. Research Methodology

The growing awareness of environmental, social, and governance (ESG) factors has thrust these issues to the forefront of the financial sector. Banks and financial institutions are increasingly implementing environmental and social (E&S) risk management measures to mitigate potential negative impacts on both the planet and society. Evaluating the effectiveness of these measures is crucial to ensure that they are achieving their intended purpose and driving positive change. Examining the effectiveness of these E&S risk management measures in banks worldwide, including a focus on Vietnam, is essential for understanding their impact and identifying areas for improvement.

Globally, there has been an intense push for the implementation of E&S standards in banking. Initiatives such as the Equator Principles and the Sustainable Banking Network have enabled banks to include environmental and social factors into lending and investment decisions. However, the efficacy of various interventions varies greatly. While progress has been achieved, particularly in developed nations, many banks continue to struggle to completely integrate environmental and social factors into their basic operations. In certain circumstances, compliance with E&S frameworks is shallow, with insufficient due diligence or risk mitigation techniques. Some banks actively examine E&S risks and promote green finance, while others have fallen behind. Limited regulatory guidelines and weak enforcement exacerbate the complexity of E&S risk management in Vietnamese institutions.

3.1 Evaluation of the Effectiveness of Environmental and Social Risk Management Measures in Banks

Vietnam's banking and financial sectors are increasingly adapting environmental and social risk management practices due to the influence of environmental, social, and governance (ESG) factors. Concerns about income inequality, labor rights, pollution, and climate change are driving this shift. Financial institutions are integrating ESG considerations into their strategies to address these risks and align with evolving regulations.

3.2 Discussion of Findings in Comparison to Previous Studies and Potential Trends

3.2.1 Environmental

3.2.1.1 Climate Scenario

Vietnam's banking sector is currently confronted with a substantial new challenge: climate change. Projected to bring about a spectrum of adverse environmental, social, and economic impacts, climate change necessitates that credit institutions adapt and formulate effective response strategies. Under the prevailing climate change trend, marked by an average temperature increase of 0.2°C per decade, several consequences may ensue. These include the escalation in the frequency and intensity of extreme weather events like droughts, floods, and saltwater intrusion, as well as threats to coastal areas from rising sea levels, and diminished agricultural productivity impacting food security.

In a worst-case scenario, characterized by an average temperature increase of 0.5°C per decade, the repercussions could be considerably graver. Coastal areas may experience land loss due to rising sea levels, while pervasive droughts and floods could inflict severe damage to production and livelihoods. Additionally, outbreaks of diseases may be triggered by environmental changes. Conversely, effective control of climate change, maintaining the global average temperature increase below 1.5°C, can significantly alleviate negative impacts, fostering conditions for green and sustainable economic development.

There are specific solutions credit institutions can employ, such as collaboration with international organizations and non-governmental organizations to exchange knowledge and experiences in climate change risk management. They can also participate in programs and projects promoting the development of green and sustainable finance, as well as support businesses and households in adopting climate change response solutions. Additionally, the State Bank of Vietnam should institute policies and regulations to incentivize credit institutions' engagement in addressing climate change. While climate change poses a significant challenge, it also presents an opportunity for Vietnam's banking sector. By proactively responding to climate change, the sector can reinforce its position in the economy and contribute to the country's sustainable development.

3.2.1.2 Carbon Footprint Analysis

The carbon footprint serves as a measure of the greenhouse gases (GHGs) emitted directly and indirectly by an individual, organization, or specific activity over a defined period. In the banking industry, this footprint can originate from diverse activities, encompassing lending activities, investment activities, and various aspects of business operations such as energy consumption, paper use, printing, and transportation. For credit institutions (CIs), lending activities may involve financing projects with elevated GHG emissions, such as coal mining projects and thermal power plants, while investment activities may include investing in companies with environmentally polluting activities.

The analysis of carbon footprint assumes a critical role in environmental and social risk management (ESG) for CIs. This analysis facilitates CIs in evaluating the environmental and social impact of their financial activities, identifying potential risks associated with climate change, natural disasters, and other environmental issues, and formulating strategies to diminish GHG emissions, boost social responsibility, and transition towards sustainable financial operations.

Specific data on the carbon footprint in the Vietnamese banking industry reveals that, according to the State Bank of Vietnam's report in 2020, the total GHG emissions for the entire industry were estimated at 1.2 million tons of CO2e. Lending activities accounted for the majority (approximately 60%) of these emissions, with projects financed by CIs in heavy industry, energy production, and transportation sectors serving as the primary sources of GHG emissions.

To mitigate their carbon footprint, CIs have several solutions at their disposal. Firstly, they can prioritize the financing of green projects that utilize renewable energy, promote energy conservation, and contribute to environmental protection. This involves directing financial support towards initiatives and developments that align with sustainable and eco-friendly practices. Secondly, CIs can choose to invest in companies that demonstrate sustainable business practices and exhibit high levels of social responsibility. By supporting such enterprises, credit institutions contribute to fostering environmentally conscious and socially responsible business models within their investment portfolios. Furthermore, CIs can implement measures to decrease greenhouse gas (GHG) emissions in their own business operations. This includes adopting practices that promote efficient energy use, paper conservation, and the encouragement of public transportation. By integrating these measures into their daily operations, credit institutions actively engage in minimizing their environmental impact and working towards a more sustainable operational framework.

3.2.1.3 Resource Consumption

Limited data exists regarding the energy consumption of the entire Vietnamese banking sector, although some individual banks disclose their energy consumption figures in sustainability reports. For example, VPBank reported a 7.1% reduction in total energy consumption in 2021 compared to 2020. The indirect impact of lending activities to energy-intensive industries contributes to significant energy consumption.

The Vietnamese banking sector heavily relies on paper-based processes despite increasing efforts toward digitalization, with a substantial portion of loan applications, account statements, and other documents remaining paper-based. This high dependence on paper has environmental consequences, leading to deforestation, water usage, and greenhouse gas emissions associated with paper production and transportation. Similar to energy consumption, specific data on water usage across the banking sector is unavailable. Financing water-intensive industries, such as agriculture and textile production, indirectly contributes to water consumption. The banking sector is a major employer in Vietnam, boasting an estimated workforce of over 250,000 individuals.

Effective ESG management necessitates specialized skills and knowledge, resulting in increased training needs for personnel. Implementing ESG practices involves upfront costs, including investments in renewable energy, energy efficiency upgrades, and technology for paperless operations. Despite initial costs, effective ESG management can yield long-term financial benefits, such as reduced operational costs, improved brand reputation, and the attraction of ethical investors.

3.2.2 Governance

Board Composition Analysis

The recognition of the interconnectedness between environmental and social (ESG) factors and financial risks is on the rise. The effectiveness of ESG risk management within banking and financial activities heavily relies on the composition of a bank's Board of Directors (BOD).In terms of board diversity, studies point to a notable lack, particularly regarding gender representation. A 2020 report by the State Bank of Vietnam indicated that women held only 17.5% of board positions in commercial banks, with a simultaneous shortage of board members possessing specific expertise in ESG. The Skill and Experience Gap among board members is a significant challenge. Many lack the necessary knowledge and experience in ESG principles, hindering their ability to assess and oversee the bank's ESG activities and manage related risks. The potential Lack of Commitment within the board may impede the implementation of effective ESG strategies. Inefficient ESG implementation can result from a lack of guidance and oversight, causing banks to struggle with the adoption of effective ESG practices. This, in turn, can lead to missed opportunities and potential reputational damage.Inadequate risk management stems from a lack of understanding of ESG risks, exposing the bank to financial losses and regulatory consequences. Unsatisfactory stakeholder engagement arises from the failure to address ESG concerns, potentially causing dissatisfaction among investors and customers, ultimately impacting the bank's reputation and competitiveness. Promoting Diversity in the board, including gender balance and diverse professional backgrounds, can bring new perspectives and foster more informed decision-making regarding ESG issues. Enhancing Skills and Experience through investment in training and development programs for board members on ESG principles and risk management can equip them with the necessary knowledge and skills to effectively lead and oversee ESG practices. Cultivating Commitment within the boardroom is crucial. This can be achieved by setting clear ESG goals, holding regular discussions on ESG performance, and linking executive compensation to sustainable performance metrics.

Anti-corruption analysis

The issue of corruption in Vietnam is a pervasive challenge that significantly hampers the nation's progress. According to Transparency International's 2022 Corruption Perception Index, Vietnam is ranked 87th out of 180 countries, reflecting the widespread prevalence of corruption.Certain sectors, such as land management, natural resource utilization, and public procurement, are particularly vulnerable to corrupt practices. This susceptibility directly contributes to environmental and social risk factors, thereby intensifying the overall impact of corruption.

One of the detrimental consequences of corruption is environmental degradation. Illegal logging, overexploitation of natural resources, and relaxed environmental regulations are fueled by corrupt practices. Bribes may expedite the approval of permits for projects with severe environmental consequences. Furthermore, corruption exacerbates social inequalities, allowing the affluent and influential to exploit resources for personal gain at the expense of communities and the environment. The distortion of decision-making processes due to corruption misallocates funds away from sustainable projects, resulting in long-term negative social and environmental impacts.

In a corrupt system, accurate information on environmental and social risks may be unavailable to banks and investors. This lack of reliable data can lead to lending or investment decisions based on unreliable or manipulated information, compromising the integrity of risk assessments. Key data highlights include the analysis of environmental fines imposed on companies, which serves as an indicator of corruption leading to environmental offenses. Additionally, scrutinizing bidding and contract awards for public projects reveals patterns of favoritism or bid-rigging, indicating corruption and a high likelihood of associated environmental, social, and governance (ESG) risks. To address these issues, implementing anti-corruption measures becomes crucial for improved ESG risk management. Greater transparency in land-use decisions, licensing processes, and project selection is essential to build trust and reduce opportunities for corrupt practices, directly safeguarding the environment and ensuring projects adhere to social standards. Strong anti-corruption compliance measures within banks and financial institutions play a pivotal role in mitigating the risk associated with funding projects linked to environmental or social violations. Additionally, mechanisms for public scrutiny, whistleblower protection, and independent investigations enhance public oversight, bolstering integrity and limiting the power of corrupt networks. This, in turn, creates a less risky environment for ESG-responsible investments.

Risk Management Analysis

Banking and financial activities are exposed to a variety of ESG risks, encompassing credit, market, and operational risks.In terms of credit risk, the environmental impact of natural disasters and climate change can significantly influence borrowers' capacity to meet loan repayments. Simultaneously, the social impact of epidemics and social unrest can disrupt business operations, affecting borrowers' ability to fulfill their loan obligations.

Market risk, with its environmental and social dimensions, is also a concern. The consequences of climate change can alter the value of banks' collateral, while social unrest and policy shifts can impact asset values and the overall stability of financial markets. Operational risk introduces environmental and social factors as well. Environmental pollution and natural disasters pose threats to the seamless operation of banks' businesses, while social unrest and cyberattacks can disrupt the functionality of banks' systems and operations. Turning attention to the Vietnamese banking industry, specific data on ESG risks sheds light on the situation.

According to a report from the State Bank of Vietnam, the non-performing loan (NPL) ratio for the entire banking industry stood at 3.1% in 2020. Notably, sectors like agriculture, fisheries, and heavy industry experienced the highest NPL ratios. The root causes of these challenges were identified as climate change and natural disasters, emphasizing the critical role of environmental and social factors in shaping ESG risks within the banking landscape. ESG risks can have implications on various aspects of banks, affecting profits, capital, and reputation. Concerning bank profits, challenges such as non-performing loans (NPLs), losses resulting from natural disasters, and the costs associated with environmental remediation can directly impact overall profitability and erode shareholder value. Similarly, risks related to market fluctuations and asset devaluation can impact the capital adequacy of banks, necessitating additional capital injections to maintain regulatory compliance.The social aspect of ESG risks is reflected in reputational damage. Negative publicity arising from involvement in environmentally harmful activities, social controversies, or ethical lapses can tarnish a bank's image, erode customer trust, and deter potential investors and customers. Consequently, this may lead to a loss of market share, decreased revenues, and diminished competitive advantage.

3.2.3 Social

Financial inclusion

Financial inclusion, a critical aspect of the social dimension in ESG, holds profound implications for banks in Vietnam. It has a significant impact on banks in Vietnam, influencing their customer base, product offerings, and overall business strategy.

According to recent data from the World Bank's Global Findex database, Vietnam has made significant strides in expanding financial access, with the percentage of adults having access to formal financial services increasing from 31.3% in 2014 to 69.5% in 2017. Despite this progress, challenges persist, particularly in rural and remote areas where banking services remain limited. The Vietnamese government and financial institutions are increasingly focusing on initiatives to address this gap, including the promotion of digital banking and mobile payment solutions to reach underserved populations. Achieving comprehensive financial inclusion requires collaborative efforts from various stakeholders, including policymakers, regulators, banks, and fintech companies. By expanding access to financial services, banks not only contribute to economic growth but also empower individuals and communities, fostering greater social and economic inclusion across the country.

Let us consider Techcombank, one of Vietnam's largest commercial banks. Techcombank has aggressively promoted financial inclusion through a variety of projects, with the goal of increasing underprivileged communities' access to banking services. As a consequence of its efforts, Techcombank's operations have improved significantly.

By concentrating on financial inclusion, Techcombank has effectively extended its client base across a wide range of demographics. According to Techcombank's annual report for 2020, the bank's client base has grown significantly, with over 8 million individual customers, about 160 thousand business users, and approximately 2,000 business customers. This expansion of the client base has helped the bank's overall growth and market penetration.

Financial inclusion initiatives have also resulted in a rise in deposit mobilization for Techcombank. The bank's total deposits increased by 19.9% in 2020 compared to the previous year, reaching roughly 277 trillion VND, according to its annual financial records. The increase in deposits suggests that formerly unbanked or underbanked people and communities now have better access to banking services.

Financial inclusion measures have improved Techcombank's overall profitability and financial performance. Despite the hurdles created by the COVID-19 epidemic, the bank achieved a net profit of 12 trillion VND in 2020, a 41.4% rise over a five-year period, according to its annual financial report. The expansion of the customer base, coupled with prudent risk management practices, has supported Techcombank in maintaining healthy financial metrics and sustainable growth.

Income Inequality

Income inequality poses significant challenges for banks operating in Vietnam, impacting various aspects of their operations and risk management. Despite the country's impressive economic growth in recent years, income inequality remains a pressing concern.

According to data from the World Bank, Vietnam's income Gini coefficient stood at 0.377 in 2018, indicating a moderate level of inequality. This disparity in income distribution can have far-reaching consequences, influencing consumer behavior, loan repayment rates, and credit risk assessment for banks. Moreover, high levels of income inequality may exacerbate social tensions and affect the overall stability of the financial system. To address these challenges, banks need to adopt strategies that promote financial inclusion and support initiatives aimed at reducing inequality. By offering inclusive banking products and services, banks can play a pivotal role in narrowing the income gap and fostering a more equitable society in Vietnam.

Consider the example of BIDV (Bank for Investment and Development of Vietnam), one of Vietnam's major state-owned commercial banks.

Income disparity can have an influence on the quality of BIDV's loan portfolio since low-income persons may have difficulty repaying loans. According to BIDV's 2020 annual report, the bank has a non-performing loan (NPL) ratio of 1,36%, which represents the proportion of loans that are not being returned on time. Income disparity may lead to a greater NPL ratio since borrowers in lower income brackets may have less financial means to fulfill their obligations.

Income inequality may have an impact on the BIDV client base and deposit mobilization operations. High-income individuals and corporations may make up a sizable share of BIDV's deposit base, as they have greater disposable income to save and invest. However, BIDV's efforts to mobilize deposits from lower-income customers may meet difficulties because of their limited savings capacity. According to BIDV's financial filings, the bank's total deposits reached 1.2 billion VND in 2020.

Income inequality may influence BIDV's market segmentation tactics and product development ambitions. BIDV may provide bespoke loan solutions designed to meet the demands of various income groups. For example, BIDV may offer microfinance loans with reduced interest rates and more flexible repayment periods to encourage low-income borrowers to start businesses and generate revenue. BIDV's efforts to develop inclusive financial products are reflected in its portfolio of retail and SME loans, which accounted for 96,7%% of total loans outstanding in 2020.

Labor rights and working conditions

Labor rights and working conditions are critical issues for banks operating in Vietnam since they have a direct impact on the workforce and the overall socioeconomic landscape. With Vietnam's rapidly developing economy and industrial sectors, providing proper worker rights and working conditions has become critical.

In 2020, the country's labor force participation rate was around 76.7%, with a large proportion working in industries such as manufacturing and construction. However, there are ongoing issues about job safety, fair compensation, and labor law compliance. Banks suffer reputational and operational risks when financing companies in labor-intensive industries because they must verify that their borrowers follow labor norms and legislation. Additionally, banks can play a proactive role in promoting better working conditions by incorporating labor rights considerations into their lending criteria and engaging with clients to improve workplace practices. By prioritizing labor rights and working conditions, banks can contribute to the creation of a more sustainable and equitable labor environment in Vietnam.

Consider the example of VietinBank, one of Vietnam's largest state-owned commercial banks. Labor rights and working conditions have a direct impact on VietinBank's operating efficiency and productivity. Ensuring fair labor standards and maintaining decent working conditions are critical for retaining skilled individuals and creating a healthy workplace culture. In 2018, Vietin had a high turnover rate in the corporate customer department, which indicates the percentage of employees who departed the business that year. The corporate customer department's resignation rate increased from 2016 to 2018, with a rate of 16.7% in 2016 and 21.4% in 2017. In 2018, this department had a greater ratio (35.3%) than others. In its 2020 annual report, VietinBank seeks to lower turnover rates and increase employee satisfaction by prioritizing labor rights and providing a secure and friendly workplace, ultimately boosting operational efficiency and customer service quality.

Labor rights violations and poor working conditions can pose risks to VietinBank's reputation and regulatory compliance. VietinBank is committed to upholding labor laws and regulations to mitigate operational risks and safeguard its reputation. In accordance with labor regulations, VietinBank ensures that its employees receive fair wages, benefits, and working conditions. The bank also conducts regular audits and assessments to identify and address any potential labor rights issues. VietinBank's adherence to labor standards is reflected in its compliance record and employee satisfaction surveys, which indicate high levels of compliance with labor regulations and positive feedback from staff regarding working conditions. Labor rights and working conditions have far-reaching implications for VietinBank's operations, risk management practices, and stakeholder relationships. By prioritizing fair labor practices, maintaining satisfactory working conditions, and engaging in CSR initiatives, VietinBank can enhance its reputation, mitigate operational risks, and contribute to sustainable development in Vietnam.

4. Recommendations and Suggestions

4.1 Specific Measures to Improve Environmental and Social Risk Management in the Banking and Finance Industry in Vietnam

To enhance their ESG (Environmental, Social, and Governance) and risk management practices, banks must adopt a proactive and holistic approach that addresses the evolving challenges and opportunities in today's dynamic financial landscape. This requires a comprehensive strategy encompassing policy development, risk assessment, stakeholder engagement, capacity building, and technology adoption. Firstly, banks should prioritize the integration of ESG principles into their core business strategies and operations, embedding sustainability considerations into decision-making processes at all levels. This entails developing clear ESG policies and frameworks that outline the bank's commitment to environmental stewardship, social responsibility, and corporate governance. Additionally, banks need to conduct robust risk assessments to identify and evaluate ESG-related risks and opportunities across their portfolios. By incorporating ESG factors into risk management frameworks, banks can effectively assess and mitigate potential risks arising from environmental, social, and governance factors, safeguarding their financial stability and reputation. Furthermore, banks should engage with stakeholders, including investors, regulators, employees, and the broader community, to foster transparency, accountability, and trust. This involves regular communication and collaboration with stakeholders to understand their ESG expectations and concerns, as well as to demonstrate the bank's commitment to responsible and sustainable practices. Capacity building is also essential, with banks investing in training and development programs to enhance employees' ESG knowledge and skills. Finally, technology adoption plays a pivotal role in advancing ESG and risk management practices, enabling banks to leverage data analytics, artificial intelligence, and digital platforms to monitor ESG performance, streamline processes, and enhance decision-making capabilities. By embracing these recommendations, banks can strengthen their ESG and risk management practices, drive long-term value creation, and contribute to a more sustainable and resilient financial system.

4.2 Recommendations for Bank Leaders and Government

To foster the adoption of ESG (Environmental, Social, and Governance) principles and robust risk management practices in the banking sector, bank leaders and policymakers must collaborate to create an enabling environment that promotes sustainability, transparency, and resilience. Firstly, bank leaders should prioritize ESG integration into their strategic planning and decision-making processes, demonstrating a commitment to responsible banking practices. This entails establishing clear ESG policies and governance structures within banks, with dedicated oversight from senior management and board members. Additionally, bank leaders should invest in capacity building programs to enhance employees' understanding of ESG principles and risk management techniques, fostering a culture of sustainability and accountability throughout the organization. Furthermore, policymakers play a crucial role in shaping the regulatory framework to incentivize banks to prioritize ESG and risk management. Policymakers should consider implementing regulatory requirements and standards that mandate ESG disclosure and reporting, ensuring greater transparency and accountability across the banking sector. Moreover, policymakers can offer incentives, such as tax incentives or preferential treatment for sustainable investments, to encourage banks to integrate ESG considerations into their lending and investment decisions. Public awareness campaigns are also essential to educate stakeholders about the importance of ESG and risk management in banking. Policymakers should collaborate with industry associations, civil society organizations, and academia to raise awareness about ESG issues, promote best practices, and foster a dialogue on sustainability within the banking sector and the wider community. By implementing these specific recommendations, bank leaders and policymakers can drive meaningful progress towards a more sustainable and resilient banking sector, benefiting both the economy and society as a whole.

5. Conclusion

To summarize, effective environmental and social (E&S) risk management in banking and financial activities is no more a question of "if" but of "how." Financial organizations that include E&S considerations into their core operations can reduce risks, promote sustainable practices, and have a beneficial societal impact. This transition demands strong policy frameworks, clear communication routes, and continuous monitoring and adaptation. Embracing E&S risk management provides a chance for the financial sector to not only guarantee its own future, but also to help construct a more just and sustainable society for all. ESRM exhibits a commitment to responsible and sustainable operations, attracting environmentally concerned investors and building confidence with stakeholders. It also represents an opportunity for sustainable development. The financial sector has the ability to play a revolutionary role in fostering sustainable development. The article presents arguments in a new, coherent, and comprehensive approach, highlighting key points such as the impact of past and potential climate, social, and government trends on finance and banking. Specific metrics and solutions are then provided to lead to more significant improvements. Furthermore, the paper specifically discusses the current state of ESRM in Vietnamese banks, pointing out shortcomings and making recommendations for improvement. Prioritizing ESRM is not just an ethical obligation, but also a strategic need for banks and financial institutions in today's environment. By incorporating environmental and social factors into their decision-making processes, financial institutions can reduce financial risks, improve their reputation, attract responsible investors, support sustainable development, and create new opportunities for growth and innovation. As the financial landscape evolves, ESRM is poised to become a major pillar of responsible and sustainable banking practices in the years ahead.

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