ESG ADOPTION IN THE BANKING SECTOR OF THE WESTERN BALKAN COUNTRIES

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ABSTRACT
Environmental, Social and Governance criteria (ESG) have been raising attention from all the stakeholders – governments, supervisors, businesses, financial institutions, investors etc. ESG has become mainstream in business strategy. Today, ECG criteria are an important and even obligatory part of the corporate strategy and sustainable development of a business. Those criteria are being used to evaluate business practice and performance. Studies have shown that applying ESG criteria properly could create higher value for the business. Western Balkan countries need sustainable financing and investments. In that regard, the banking sector in this region starts introducing ESG criteria in their metrics when approving financing for the companies. Sustainable financing is dedicated now to those companies that apply ESG framework in their business strategies. This paper aims to describe the current level of ESG adoption in the banking sector of the Western Balkan countries using SWOT analysis. Analysis has shown that the banking sector in Western Balkan countries has a good starting point to use strengths and opportunities for stronger development of ESG criteria for themselves and to support business in ESG reporting. In that regard, this paper contributes to the Western Balkans banks to remind them to further use and enhance their strengths and opportunities, but, on the other hand, to pay special attention and to focus more on those ESG criteria that are currently weak and represent threats for the ESG implementation in the Western Balkan's banking sector.

Keywords: *banks, ESG criteria, ESG investing, Western Balkan (WB) countries, SWOT analysis*

JEL classification: *G21, Q01, R11*

1. INTRODUCTION

In the last decade there has been inevitable business talk about ESG criteria (very often are called ESG factors or even standards as well). It has become mainstream in business strategy. ESG stands for Environmental, Social and Governance criteria. Those are a set of criteria related to the influence that organizations have on environment, employees' rights, health, and risk factors of injury to employees at work, as well as factors of stability and effectiveness of the corporate governance system. Non-traditional risk factors can have a key impact on the long-term sustainability of a corporation. Many financial institutions and managers take these criteria into account when making investment decisions.
ECG criteria today represent an important and even obligatory part of the overall corporate strategy and sustainable development of a business. Those criteria are being used to evaluate

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business practice and performance in the aforementioned areas. ESG framework gives insight to stakeholders on the level of managing risks and opportunities that their organization has on environmental, social and governance criteria (Corporate Finance Institute, 2023). On capital markets, those criteria are becoming inevitable part of the analyses of a company's evaluation and performance on capital markets.

Having all this in mind, McKinsey&Company (2019) has stated that applying ESG criteria properly could create higher value for the entity. That results in fact that companies should put in ESG reporting everything that have performed in ESG field. Beforehand, this kind of reporting was used just from the part of those companies that have self-consciousness of practicing ESG criteria. Today, In European Union (EU), there are number of directives regarding sustainable finance and ESG criteria (SFDR-Sustainable Finance Disclosure Regulation; CSRD-Corporate Sustainability Reporting Directive; NFRD-Non-Financial Reporting directive). Some of those directives are already in force, and some of them will be used starting next year (2024).

Financial institutions also have strong regulatory demands regarding ESG criteria. "The number of financial institutions that integrate ESG in their decision-making processes is on the rise globally, and it is expected to increase in a post-Covid economy as studies have shown that companies with high ESG ratings held up better than their competitors during the crisis." (PwC Netherlands, 2023). According to World Economic Forum (2022) sustainable investing (traditional investments that are combined with ESG to achieve long-term returns and positive social impact; its importance has been growing in recent years in line with the growing importance of the concept of sustainability) will become the norm and companies that invest in clean, green businesses will continue to see better returns due to their ability to adapt to changing world.

A commitment to sustainable and socially responsible practices improves the reputation of financial institutions and attracts socially conscious clients and investors. Environmental, social and governance (ESG) risk represents a new risk area for banks. Stakeholders increasingly expect banks to demonstrate responsible practices for environmental protection, social impact, and corporate governance. Failure to address ESG issues, such as air pollution, human rights violations, or inadequate diversity of committees, can lead to a compromised reputation and loss of trust. Banks need to integrate ESG issues into their operations, develop sustainability strategies and report on their performance in the field of ESG (Gyamerah *et al.*, 2020).

This paper analyses the level of involvement of the banks in Balkan countries (Serbia, Montenegro, North Macedonia, Albania and Bosnia and Herzegovina) into the ESG framework. The aim is to describe the current level of ESG adoption in the banking sector of the Western Balkan countries using SWOT analysis. After the Introduction part, literature review is covered and then in the next section, research has been presented on given topic. According to the research results, some conclusions are pointed out as well as shortcomings of the given research. Finally, suggestions for future research have been disclosed, followed with the reference list.

2. LITERATURE REVIEW

2.1. ESG and ESG investing

In the global financial services industry, ESG criteria represent one of the most prominent topics nowadays. It is in focus for all stakeholders: businesses, capital markets, investors, financial institutions, and regulators. According to Syed & Ntim (2017) application of ESG criteria in investment decision making process will decrease inefficiencies and environment, social and governance criteria will enhance the overall management of entities from the view

of all stakeholders. In their study they have analyzed preferences of managers toward ESG criteria. They have pointed out some differences in that view between countries.
When we talk about business sustainability and responsible business practices, we came across two concepts - CSR (Corporate Social Responsibility) and ESG, often used in this context. These two concepts are similar but have different focuses and implications. Both these frameworks are being used by companies to evaluate sustainability, but the difference is that CSR may provide an internal framework for the company to communicate with employees, while ESG provides a measure of assessment for investors (O'Neill). Besides being a quantitative measure of sustainability, ESG, according to previous author, also improves the valuation of the business. Cornell and Damodaran (2020) in their study examined if the socially responsible behavior of a company leads eventually to concrete rise of value for the company itself, but also for the investors.
Study of Whelan *et al.*, (2020) who were analyzed more than 1,000 research papers exploring the relation between ESG and financial performance from 2015 till 2020, arguments to a growing agreement that good corporate management of ESG issues typically results in improved financial performance metrics such as ROE, ROA, or stock price.
Bearing in mind all this information, it is not hard to conclude the importance of including ESG criteria in the investment process. As mentioned before, ESG investing is an upgrade of the traditional investment process with the addition on environmental, social and governance performance of a company. “ESG analysis has become an increasingly important part of the investment process. For investment professionals, a key motivation in the practice of considering environmental, social, and governance (ESG) issues as part of their financial analysis is to gain a fuller understanding of the companies in which they invest.” (CFA Institute, 2023).
Due to numerous supranational institutions’ measures, sustainable finance approach is of great importance for achieving sustainable development goals (SDG). As a result, financial institutions have started heavily incorporating ESG in their investment process, encouraged by the need for the enhanced long-term financial values (OECD, https://www.oecd.org/finance/esg-investing.htm). But, on the other hand, investors should be aware of the findings from the study of Cornell (2020) that a lower cost of capital for the firms with high ESG score implies lower expected returns for them. Furthermore, the same author adduces that the importance of ESG framework “implies that the corporate objective of maximizing shareholder value, which lies at the core of much of finance theory, is outdated and needs to be replaced by a more comprehensive stakeholder model.”
Very interesting research considering implementation of ESG criteria into the investment decision making process of conventional asset managers, has been conducted by Van Duuren *et al.*, (2016). One of the key findings of this survey is that assets mangers were using ESG data especially for red flagging and to manage risk. Authors Bai *et al.*, (2022) in their study investigated if a good ESG score could lead to lesser financial constraints. They revealed that not only did a good ESG score lead to diminished financial constraints but also could encourage institutional investors to increase their share in those companies, with further positive signal to the investment community.
The importance of ESG-oriented investing could be proved by looking into the size of ESG investments. According to Global Sustainable Investment Alliance - GSIA (2020) global sustainable investments reach 35,5 trillion US dollars. It has risen 15% since 2018, and it was 34% rise from 2016. (GSIA, 2018).

2.2. ESG criteria and banks

As awareness of ESG criteria and its effect on business performance are expanding, importance for this topic in financial institutions, especially banks, is huge. Achieving sustainable development, what should be of paramount importance for every responsible entity on Earth, requires large investments. In that sense sustainable finance and sustainable investments are very significant areas and its importance would grow further. In this context, financial services, with banks on the top, should have a prominent role in the process of providing adequate funds (Barjaktarovic Rakocevic *et al.*, 2022). Financial services firms or capital providers to industry and channels for investing individual wealth, are immensely involved directing the move from traditional business activities to those activities that incorporate ESG criteria (Thomson Reuters, 2021)

Authors Azmi *et al.*, (2021) have investigated how ESG criteria effects bank value. Their research among 251 banks from emerging markets revealed that environmentally friendly activities have the greatest effect on bank value, mainly through cost of equity, cash flow and net interest margin positively affect bank value. When considering banking promotion of ESG policies among their clients especially for lending activities, research of Houston and Shan (2022) found out that banks are keener to borrow to those clients that have similar ESG practices as the bank itself have. Also, this kind of practice further improves borrowers' ESG performance.

Interesting research on the impact ESG criteria, individually and jointly, have on bank stability, has been performed by the authors Chiaramonte *et al.*, (2021) within European banks. They have pointed out that the total ESG score decreases bank vulnerability during periods of financial stress. A similar study, with ESG score influencing specifically operation risk of the bank, has been performed in 35 countries. Results clearly suggest that the higher the ESG score, the lower bank operational risk is (Galletta *et al.*, 2023). Shakil *et al.*, (2021) have investigated the effects of ESG performance of banks on their financial performance, in emerging markets. The results showed a positive correlation of emerging market banks' environmental and social performance with their financial performance, but governance performance does not influence financial performance.

As mentioned before, EU legislation has NFRD, as an additional regulatory framework to comply with EU Taxonomy regarding ESG. EU banks, insurance companies and large companies with more than 500 employees will have to start obligatory ESG reporting beginning from next year (2024). What is important to mention is that banks will have to report on their climate change risks exposure, and what are they doing to soothe it. Furthermore, EU banks will also have to report on their level on financed greenhouse gas emissions and how they support the 2050 net-zero gas emissions (Furness, 2022).

ESG reporting has positive impact on bank performances, like shown in the research of Buallay (2019). This author analyzed the impact ESG has on ROA, ROE and Tobin Q. Study concluded that if measured individually, relationship between ESG disclosures differs: "the environmental disclosure found positively affect the ROA and TQ; the corporate social responsibility disclosure is negatively affecting the three models; the corporate governance disclosure found negatively affects the ROA, ROE and positively affects the Tobin's Q." This study was conducted within the European banking system.

Brogi and Lagasio (2018) have conducted research considering ESG reporting in companies as well as financial institutions. They concluded that that ESG activities in financial institutions, with the special focus on environmental activities, have higher positive impact on profitability than for the companies. Banks globally are paying a lot of attention to environmental issues, and Meles *et al.*, (2023) stated that environmental pillar outperforms all other dimensions in terms of risk reduction. Gai *et al.*, (2023) have created a theoretical model for a new scoring model for ESG disclosure in banks, and main results, from their pilot testing, point out the necessity for banks to raise awareness ”to social issues, especially concerning local communities”.

3. RESEARCH

3.1. Descriptive analyses

ESG criteria have brought added value to business strategies, policies, and decision-making process, creating opportunities and challenges as well. As shown previously in the paper, from different studies, ESG criteria can bring economic performance enhancement, too, because of improvement of environmental, social relations and corporate governance framework within an organization. Before being incorporated in laws and directives, ESG criteria were important for those companies that were aware of incentives and expectations from their stakeholders, mainly business partners and investors.

For the banking sector ESG criteria are important twofold, for the banks themselves, to improve their environmental, social, and corporate governance performance, but also important for them as lenders, as financial institution that offers financial services to businesses and in that sense face ESG opportunities but also risks. To fulfill this ESG framework is a big challenge for banks. They have to collect and store important data sets on all ESG elements for themselves but also for the business partners they work for or with. In any case, every bank will have its own ESG framework because there are no two same solutions.

For all these reasons, as a research tool, we have decided to perform SWOT analyses, as situation analyses, to help identify strengths and weaknesses, opportunities and threats for ESG framework in banking sector of the Western Balkan countries. To use all the benefits from ESG implementation, we would like, with this analysis, to reveal current strengths and weaknesses, and future opportunities and threats for the banks in this area. After the analysis has been completed, the idea is to further enhance current strengths and eliminate current weaknesses but also to transform future opportunities into the strengths and be aware that threats could become future weaknesses.

In this section we start with the descriptive analysis of the Western Balkan countries: Serbia, Bosnia and Herzegovina, Montenegro, North Macedonia, and Albania. This part of analyses will support attempt to create SWOT analysis of ESG framework in the banking sector of Western Balkans countries. Analysis of ESG in banking sector has not been performed in this region so far, to the best of authors’ knowledge. Data are segregated and encompass just part of the ESG criteria.

In table 1. are presented relevant data considering economies and banking sector of the Western Balkans countries: population, GDP per capita (PPP parity), number of banks and total bank assets.

Table 1: Relevant data for Western Balkan’s countries

Country	Population[1] 2023	GDP (PPP) per capita[2] 2022 in US dollars	Number of banks[3]	Bank assets 2020[3]
Serbia	7,149,077	23.911	22	39,1 bln EUR
Montenegro	626,485	26.984	12	4,6 blb EUR
Bosnia and Hercegovina	3,210,847	20.377	15	13,2 bln EUR
North Mecedonia	2,085,679	20.162	14	9,5 bln EUR

Albania	2,832,439	18.552	12	12,5 bln EUR

(Source:
[1] https://www.worldometers.info/world-population/population-by-country/, accessed August 2023
[2] https://www.worldometers.info/gdp/gdp-per-capita/, accessed August 2023
[3] https://thebanks.eu/compare-countries-by-banking-sector#ref_4, accessed August 2023)

Serbia has the biggest economy, according to total bank assets. In Serbia, question regarding ESG principles is not weather to apply them but how to integrate them into the bank's strategies. According to the official web page of biggest Serbian banks (considering total assets), they have created ESG strategies and perform activities in accordance with UNs The Sustainable Development Goals (SDGs). Also, those top tier banks are dedicated to green financing, meaning that companies that have higher ESG risks, have restrictions or total cease of long-term financing from the banks. Top banks in Serbia believe and act in direction to educate and support businesses in their effort to include ESG strategies in their business policies and strategies.
Banks individually rate the ESG score of the companies and include the ESG risks in their credit analyses. Bankers in Serbia believe that banks could push companies to sustainable development and ESG principles, because they have financing in their hands and could channel funds to those project that have prefix of being green. This is in accordance with EU Green Agenda for the Western Balkans[1] where EU is looking for decarbonization of Western Balkan countries. Serbia still does not have ESG scoring, but there is preparation of adopting first ESG regulations. Although ESG is still not mandatory in Serbia, there is a non-financial reporting requirement for all large legal entities with more than 500 employees, as well as for all large groups of legal entities with more than 500 employees. ESG's biggest flaw is that criteria are based on data provided by companies themselves, which are not always accurate and complete.
Bosnia and Hercegovina have the second largest banking sector within the Western Balkans. Banks in this country believe that "by investing in sustainable technologies, assets and operations, banks are funding solutions that reduce the impact on the planet for future generations. And in fact, it is not at all a question of whether banks should focus on ESG, but how much they are working in this direction to make the right decisions in this area with as much information as possible, as urgently as possible."[2] Largest banks in Bosnia and Herzegovina, similar to largest banks in Serbia, have prepare and adopt ESG strategies in their business strategies and decision making. There are banks in Bosnia and Hercegovina that, as a part of their banking group, are part of the Net Zero Banking Alliance (NZBA). That is a group of "leading global banks committed to financing ambitious climate action to transition the real economy to net-zero greenhouse gas emissions by 2050. NZBA's framework, guidance, and peer learning opportunities support members to design, set, and achieve credible science-based net zero targets for 2030 or sooner that deliver value for their investors, clients, and customers[3]. Bosnia and Hercegovina also are expecting to adopt its first regulation regarding directly ESG criteria. Also, there are two banks in Bosnia and Hercegovina that are part of NLB group that has received its first ESG rating in the Western Balkans region. This rating gives a score for the entity regarding its ESG performance in every sub element.

[1] https://neighbourhood-enlargement.ec.europa.eu/system/files/2020-10/green_agenda_for_the_western_balkans_en.pdf
[2] https://banke-biznis.com/esg-strategije-u-korporativnom-biznisu/
[3] https://www.unepfi.org/net-zero-banking/

Montenegro has the smallest population in this region, and accordingly the smallest bank sector considering bank assets, but on the other hand it has highest GDP per capita in the region. According to the population of Montenegro, there are too many banks currently operating in the country. Montenegro considers ESG framework as very important on their path to joining EU, and this country went the farthermost in EU approximation form all the Western Balkan countries. It is in Montenegro that the first Western Balkans ESG Summit took place in 2023. and was dedicated to sustainable development in this region.
“While in a better position than most other Western Balkans countries, Montenegro is more energy- and carbon-intensive than the average EU country, mainly because of its fossil-fuel use and aluminum industry. Reductions in capacity or the closure of facilities could hinder regional employment and economic development.” (EBRD, 2022). This is the reason why banks in Montenegro pay strong attention to green financing and approving loans to those companies that have ESG criteria in their business strategies. Montenegro also has several banks that have adopted ESG framework in their business, for the banks themselves but also for the partners they do business with. The Central Bank of Montenegro became a member of the Network for Greening the Financial System (NGFS) (members are also Serbia, Albania an North Macedonia), the group of central banks and supervisory bodies whose goal is to support sustainable financial sector and to support transition to sustainable economy development (NGFS, 2017.)
North Macedonia has also raised interest in ESG information in the business. In 2022. Macedonian Stock Exchange (MSE) developed and launched, together with EBRD, ESG Reporting Guidelines for the listed companies. Those guidelines depict the strong dedication of financial institutions to help business sector include ESG framework in their strategies and business policies, for better performance and dedication to sustainable development. This guide will help listed companies to prepare for better reporting regarding ESG information (MSE&EBRD, 2022). Macedonian Stock Exchange is member of the Sustainable Stock Exchanges Initiative (SSE) (members are also Belgrade Stock Exchange and Banja Luka Stock Exchange), that proves their intention to promote sustainable investment and emphasize the importance of ESG framework.
Banks in Macedonia are on the strong path to promote ESG practices for themselves but also for the companies. The banking sector in Macedonia, in the future period, has intention to raise the loans to those companies with ESG strategies (Hadžispirkoska Stefanova, 2023). European banks, with their subsidiaries in North Macedonia will have to implement regulation in the domicile countries, and that will push forward the ESG practice in North Macedonia too, meaning that they will not finance companies that do not apply to ESG criteria. That is obvious because if they finance those companies with the higher risk, they will have to maintain higher levels of capital in that case and that will lower their profits and performance. Research in North Macedonia has showed that younger generation, that ae starting as banks clients as well as hold management positions in the companies are more aware of and support ESG topics (Hadžispirkoska Stefanova, 2023).
Albania has started already to promote sustainability as the nationally important framework for the government and business sector as well “through collective actions such as UN’s Sustainable Development Goals Agenda persistently promoted by the international organizations present in the country, supported by the Government and embraced by large corporations”
(https://static1.squarespace.com/static/62630ecaf04bfe74d010e50b/t/62acef29ae630420cce58fb0/1655500588292/ESG+in+Albania.pdf).
It is believed that banking sector in Albania should play crucial role in raising awareness for the ESG criteria and develop further ESG reporting. Starting from 2018. non-financial reporting is obligatory for companies with more than 500 employees. In non-financial

reporting, banks in Albania take leading role in preparing those reports. Largest banks in Albania, especially those that are subsidiaries of the foreign banks, have strong incentives to promote ESG with their clients for better performance of bank themselves and of the companies and improve their source of financing,

3.2. SWOT analysis

In this part of the paper SWOT analysis on ESG framework in the banking sector of Western Balkans countries is presented. Previous descriptive analysis on country's relation to ESG, regulations, as well as bank and company's adoption on ESG criteria were input for creating SWOT analysis. Besides previous analysis from secondary sources, web pages of the banks were also valuable insights for SWOT analysis.

Table 2 : SWOT analysis of ESG framework in banking sector of Western Balkan countries.

Strengths • strong will of the banking sector to implement ESG criteria; • every country has already begun progress towards ESG framework; • in banking sector of every country exist, at least initial, ESG framework; • banking sector in the Western Balkan region is aware that they must be initiators, facilitators, supporters and controllers of ESG implementation for the business sector.	**Weaknesses** • lack of ESG professionals and specialists; • no common metrics for ESG reporting; • lack of ESG metrics in current bank credit analyses; • no ESG scoring in countries; • no ESG scoring of banks operating in Western Balkan region (only one for now); • lack of ESG regulation in countries;
Opportunities • building new value propositions; • developing new products and solutions for clients that add value; • maintaining competitive advantage; • driving sustainable growth; • younger generations understand and support ESG criteria; • foreign banks operating in Western Balkan region have expertise to deliver to the subsidiaries; • EU Green Agenda for the Western Balkans;	**Threats** • constant flow of new regulations; • extensive compliance for the banks; • collection of ESG data; • ESG risks of companies; • creation of applicable metrics for companies and their scoring; • applicability of the metrics for the SMEs; • not even consideration between E, S and G criteria in the ESG framework; • when data are presented by companies themselves, they are not always accurate and precise;

(Source: Authors research)

This situation analysis, presented in the form of SWOT analysis, tried to depict the current situation regarding ESG level of adoption in the banking sector of the Western Balkan countries. This is just the first step for further analyses of this topic that has growing attention.

4. DISCUSSION AND CONCLUSION

Western Balkan countries are one of the most affected regions in Europe regarding climate issues. In 2020, those countries have signed Green Agenda for Wester Balkan, with the main goal to reach carbon-neutral status in these countries until 2050 and harmonization with the EU Green Deal. Western Balkan countries lag EU Member States in Central Europe and the Baltics, especially in the field of being green. Those countries are still more energy- and carbon-intensive than the EU average. This is primarily for the reason of fossil-fuel use and aluminum industry.

Achieving those goals could not be done without sustainable finance and investments. ECG criteria today represent an important and even obligatory part of the overall corporate strategy and sustainable development of a business. To be sustainable, business have to include those three letters in their business strategies – E - they have to care about environment, S – social responsibilities - care for people in the organization, and G – corporate governance = adequate management of the entity.

ESG is becoming mainstream in today's business. The banking sector has important role in achieve those ESG criteria. Banks could provide sustainable finance and investment for those businesses that implement ESG framework in their business. The value of sustainable finance and investments are even more significant for the Western Balkan countries.

EU regulations will include obligatory ESG reporting starting from 2024. In that sense, Western Balkan countries, being candidates to join the EU or having EU countries as main trading partners, will have to keep pace with the ESG regulations.

The goal of this paper was to depict the current degree of ESG acceptance in the banking sector of the Western Balkan countries. To portray aforementioned, SWOT analysis of ESG framework in the banking sector of Western Balkans countries have been presented. We have attempted to describe the strengths, weaknesses, opportunities, and threats of current and future ESG criteria in this region. We must conclude that the current position of the ESG topic in the banking sector is affirmative and promising. There are several strengths and opportunities banks should focus on, but also should pay strong attention to weaknesses and especially threats.

From this SWOT analysis, as perceived strengths of the WB banking sector could be highlighted: strong will of the banking sector to implement ESG criteria, and beside that, every country has already begun progress towards ESG framework with, at least initial, ESG framework in banking sector of every country. As main weaknesses were revealed: lack of ESG professionals and specialists, lack of common metrics for ESG reporting and lack of ESG metrics in current bank credit analyses. Main opportunities for the WB banking sector in ESG adoption include building new value propositions, developing new products and solutions for clients that add value, maintaining competitive advantage, driving sustainable growth. Also, the fact that younger generations understand and support ESG criteria gives opportunities for the bank since those generations are soon to be or already are bank' clients, business partners or employees. And finally, threats WB banks could face depict in the constant flow of new regulations, extensive compliance for the banks, extensive and diverse collection of ESG data; numerous ESG risks of companies, as bank clients or partners etc.

Results presented in the analysis could help WB banks to further enhance current strengths and eliminate current weaknesses but also to transform future opportunities into the strengths and be aware that threats could become future weaknesses in ESG implementation in the Western Balkan's banking sector.

This analysis has its limitation in using just secondary resources to reveal current situational analysis in ESG topic in Western Balkan banking industry. Future research is aimed at doing primary research and generating data from the Western Balkan banking sector.

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