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Do sustainability or environmental, social and governance (ESG) practices influence emerging Asia banks performance during COVID-19 pandemic?

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ABSTRACT

As the COVID-19 crisis unfolds, the banking industry has once again come under scrutiny, particularly due to the recent collapses of notable financial institutions in the United States and Switzerland. This warrants an urgent reassessment of regulations, financial governance, and risk management practices. This research aims to investigate the relationship between Environmental, Social, and Governance (ESG) practices and bank performance within emerging Asian economies. Its urgency is underpinned by these recent financial disruptions and the need for resilient banking systems geared for sustainability. By exploring bank-specific performance indicators like the Net Interest Margin (NIM) and Capital Adequacy Ratio (CAR), this study offers an approach differentiated from traditional profitability measures, namely Return on Assets (ROA), Return on Equity (ROE), and Tobin's Q. This paper's quantitative approach includes multivariate regression analysis of unbalanced panel data from all publicly listed banks in these economies between 2018 and 2022. This research not only provides reflections on these institutions' performance during a global crisis but also illustrates the imperative for ESG assimilation in bank strategy and operations as a safeguard against future uncertainties.

INTRODUCTION

The financial services industry has a significant impact on the lives of individuals, households, and businesses in a country's economy (Choo, 1995). The economic performance of a country, particularly in emerging economies in Asia with bank-based financial systems, is significantly influenced by the banking performance (Hassan et al., 2018). The significance of banks' stability and soundness for financial stability, as well as the basic role of the system in which they operate, were emphasised in a consultative document released by the Basel Committee on Banking Supervision (BCBS) in 2014. This document highlights the crucial link between the well-being of banks and overall economic strength. Evidently, while advancements

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in several nations, the lingering effects of the 2007 global financial crisis persist, necessitating heightened vigilance on the part of institutions.

The latest failures of the top three American banks plus Credit Suisse signify that most banks and their respective supervisory authorities might not have adequate responsible banking and governance. Notably, the Swiss Finance Minister emphasised that scandals and irregularities contributed to Credit Suisse's failure (Keller-Sutter, 2023). Moreover, the recent banking crisis in America was triggered by bad bank management practices on the balance sheet (William, 2023). Epstein (2023) revealed that among the primary causes of American bank collapses that could possibly affect other countries are the corruption and self-dealing that often result from banks' insufficient supervision, whereby several financiers funnelled back their huge profits to politicians to buy support for the prevention of adequate regulation.

The pertinent institutions, supervising bodies, investors, and many more have always tried to adopt new approaches to improve the business operations and resilience of banking and non-banking firms comprehensively. In fact, the implementation of Environment, Social, and Governance (ESG) practises has emerged as a contemporary strategy embraced by numerous banks on a global scale. This is primarily due to the recognition that banks are obligated to prioritise not only financial performance but also governance and social responsibilities (Miralles-Quiros et al., 2019). The presentation of Principles for Responsible Investment (PRI) in 2005, which emphasised ESG issues, paved the way for the globally recognised implementations of ESG (Chang et al., 2021). Subsequently, the UN further proclaimed the 17 Sustainable Development Goals (SDGs) of the 2030 agenda for sustainable development in 2015 (United Nations, 2015). Evidently, both ESG and SDGs encourage sustainability, but SDGs are wider and encompass many parties and broader aspects of life.

The COVID-19 pandemic has had a significant impact on both the global health industry and the broader economy. Given their crucial role as intermediaries in the economy (Karray & Chichti, 2013), it is worth noting that banks across the globe have been adversely affected by the pandemic. As of April 15, 2022, despite a declining trend in weekly data about daily new cases, the recorded figure on that specific day remained significantly elevated, amounting to 321,659 cases (World Health Organisation, 2022). However, numerous governments across the globe, particularly in Asia, have officially recognised the endemic nature of the epidemic. Consequently, these countries have implemented more liberalised economic policies, resulting in a reduction of Standard Operating Procedures (SOPs) pertaining to the pandemic.

It is noteworthy highlight that the assessment of a bank's performance differs from evaluating the performance of a typical company, as emphasised by Koller et al. (2010), who argue that evaluating banks has conceptual challenges. Hassan et al. (2019) contend that the primary source of revenue for a bank is derived from the interest differential between the funds it receives from providers and the interest it charges on borrowers. Additionally, banks make income through the provision of various services to their depositors, lenders, and other clientele. This study will utilise net interest margin (NIM), a bank-specific statistic, as the principal measurement for evaluating the performance of banks. Other proposed indicators include stock returns (a market-based indicator) and the Capital Adequacy Ratio (CAR), which is a regulatory requirement.

Subsequently, the measurement was verified against the proposed ESG determinants to ascertain which and how the ESG mechanisms influence the performances of banks in emerging Asia from 2018 to 2022, before and during the financial catastrophe caused by the COVID-19 pandemic, using a panel data analysis regression model. Hence, this study exhibits distinctiveness in comparison to previous research pertaining to ESG considerations within the banking sector.

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PROBLEM STATEMENT

Undoubtedly, the global outbreak of COVID-19 has inflicted significant damage on many industries on a global scale. According to the International Monetary Fund (IMF), global economic activity has remained weak since 2019. The future of the global trading system, cooperation, and business confidence has become increasingly questionable due to the escalation of trade and geopolitical conflicts. Banks, as intermediaries in economies, are not immune to the worldwide impacts of the pandemic (Hassan et al., 2021). KPMG International Limited (2020) highlighted the necessity for banks to amplify ESG practises during the pandemic, whereby banks play crucial roles in providing essential support to customers and businesses as well as protecting their employees. According to previous research conducted by Broadstock et al. (2021) and Bhaskaran et al. (2021), it has been demonstrated that the implementation of environmental, social, and governance (ESG) initiatives by banks, which were examined throughout the pandemic, has had a substantial impact on their overall performance. In response to the financial suffering caused by the global economic crisis, banks have stepped up their ESG initiatives in an effort to regain over the trust of their investors and other stakeholders (Bhaskaran et al., 2021).

Similarly, growth in East Asia and the Pacific was deteriorating, falling from 6.3 percent in 2018 to 5.9 percent in 2019, even before the COVID-19 pandemic (The World Bank, 2020). This study aims to examine the impact of ESG practises implemented by banks amidst the COVID-19 pandemic. As a result, banks have the ability to take proactive measures to address any shortcomings and identify opportunities for enhancing their performance in order to implement more effective operational strategies in anticipation of complete globalisation. Hence, the primary focus of this study is to ascertain the specific ESG mechanisms that have the potential to boost the performance of banks. These identified mechanisms may then be utilised as benchmarks for banks to develop effective strategies for mitigating risks and enhancing overall performance in the future. The establishment of a financial system that is hybrid and global in nature is of utmost importance, as it must possess the ability to endure economic fluctuations and maintain essential robustness, even during times of crisis. In order to address the objective of this study, the present paper seeks to explore the relationship between ESG practices and bank performance in emerging Asian countries throughout the phase under review.

UNDERLYING THEORIES FOR ESG

The best two prominent theories to define ESG are stakeholder theory and agency theory. The former describes environmental and social practices, while the latter explains governance mechanisms. Although agency theory describes the fiduciary manners of agents in connection with shareholders, it does not cover the protection of other stakeholders' interests, including the closest ones, for example, employees and creditors (Culpan & Trussel, 2005). Trailer et al. (2004) claimed that agency theory exclusively focuses on shareholders' interests, whereby managers will be under the scrutiny of shareholders who are simply concerned about short-term interests instead of long-term plans and profit.

The above concerns changed perceptions towards stakeholders, particularly after the formation of stakeholder theory by its founder, namely Freeman (1984), which is contrary to agency theory. While agency theory solely concerns making the most of the shareholders profits, stakeholder theory emphasises all parties who are directly or indirectly connected with the activities of a corporation and its outcomes (Wearing, 2005). Basically, the concept addresses ethics and morals in a firm's management. Freeman (1984) suggested that corporations must identify and model their respective groups of stakeholders and, thereafter, decide the ideal methods that management can undertake in response to the interests of those groups, based on particular priorities. In a nutshell, it endeavours to address the "principle of who or what really counts". The foundation of stakeholder theory is that the effect of companies on the community is influential, and besides shareholders, companies must also be attentive and respond accordingly to other parts of the community as well.

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The increasing importance of good corporate governance over the past few years is a result of the agency theory, which underlines that a conflict between shareholders and managers occurs when management interests are not aligned with those of the shareholders (Jensen & Meckling, 1976). Good corporate governance aims to align the interests of shareholders and managers for better cooperation between both parties to strengthen firm performance (Chang et al., 2021).

ESG AND PERFORMANCE OF BANKS

To date, there has been much research performed to evaluate the impact of ESG on the performance of firms, but less on banks. Nonetheless, to the best of the author's knowledge, no similar paper had been accomplished on banks in Asia's emerging markets. There were only a few papers that investigated ESG against the performance of banks in emerging Asia, but exclusively in a specific region or a single country. The past studies also used different periods as their time basis for data analysis and did not take into account the consequences of the COVID-19 pandemic. Moreover, most prior studies applied different formulas and models to derive bank performance, and the majority of the studies employed profitability instead of bank-specific performance measures to gauge the banks' performances.

Most of the previous papers, including Bhaskaran et al. (2021), Ahmed et al. (2019), Bussoli et al. (2019), Miralles-Quirós (2019), Daszyńska-Żygadło (2021), La Torre (2021) and Azmi et al. (2021), have emphasised the limited and inconclusive nature of research on the relationship between sustainability or ESG factors and the performance of the banking industry. Consequently, there is a need for additional empirical investigations in this area.

GAPS IN EXISTING STUDIES

Sample

According to Azmi et al. (2021), most studies on the connection between ESG activity and firm value are focused on non-financial firms in developing economies. Therefore, research on ESG and banking institutions in emerging markets is still scarce. Most of the similar analyses were performed on European banks, such as Bătae et al. (2021), Lippai-Makra (2021), Chiaramonte et al. (2021), and Di Tommaso and Thornton (2020). There were studies on the Asian banking sector, but with different coverage, such as Ahmed et al. (2019) for banks in Bangladesh only; Alam et al. (2022) for Islamic and commercial banks in four Middle East countries; and Broadstock et al. (2021) for banks in China only. The only paper that employed Asian emerging markets as samples was Chang et al. (2021), but the study analysed 60 Asian developed economies and 85 Asian developing economies. Azmi et al. (2021) also used emerging Asia as samples, but only as part of the total global emerging economies.

It is notable that Asia was the largest regional banking market in the world for the last decade, and overall, Asian banks generated pre-tax profits exceeding $700 billion, which accounted for 37% of the global banking profit. The selected sample in this study is appropriate since it signifies an emerging market with multiple growth and structure factors in banking systems, market capitalization, and trade volume. A comprehensive investigation of the banks in these markets could epitomise insights into other emerging markets with comparable features (Chang et al., 2021).

Period

Despite the growth of the financial sector, banks are affected by systemic risks, which arise when a set of adverse events in the markets threaten to disrupt the bank's functions of intermediation (Gemar et al., 2019). Chang et al. (2021) underlined that the systemic risks in the economy, such as a decline in the gross domestic product (GDP) and a high unemployment rate, could lead to the instability of the banking system. Likewise, the global economy has been experiencing similar negative impacts during the COVID-19 pandemic.

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Broadstock et al. (2021) is the only paper that studied the impacts of ESG on bank performance in relation to COVID-19 pandemic is Broadstock et al. (2021) i.e., from 2015-2020 but exclusively on banks in China. The other research examined various time spans, including periods following the financial crisis or during the implementation of certain policies. The period specified ranges from as early as 2002 to 2019.

Post COVID-19, ESG will be crucial for ensuring economic resilience, and policymakers will place increasing emphasis on ESG adoption (Bhaskaran et al., 2021). Therefore, the chosen time frame in this investigation holds significant importance for the implementation of preventive measures within the banking industry to effectively address forthcoming pandemics and calamities.

Performance Indicator

Instead of employing bank-specific measures to assess bank performance, the majority (62%) of the literature reviewed by the author utilised indicators such as Return on Equity (ROE), Return on Assets (ROA), or Tobin's Q. These indicators were often used individually or in combination with other measures of profitability and market value. According to Davidson et al. (1990), the utilisation of accounting data for performance evaluation is fraught with numerous challenges, particularly when attempting to make extensive cross-sectional comparisons between industries and over time. Furthermore, it was their perspective that companies could manipulate their net earnings through the strategic adjustment of their accounting systems. The endogeneity concerns associated with Tobin's Q have been subject to criticism, as pointed out by Grove et al. (2011). Furthermore, Dybvig and Warachka (2010) underscored the presence of ambiguity in the evaluation of corporate governance through Tobin's Q. They highlighted that robust governance practises might have contrasting effects on Tobin's Q. On one hand, strong governance can enhance Tobin's Q by reducing costs. On the other hand, it can also diminish Tobin's Q by buffering underinvestment.

It is worth mentioning that Azmi et al. (2021) were the only researchers to incorporate the use of NIM in conjunction with additional measurements when assessing bank performance. In the prevailing majority of banking institutions, a significant portion of their assets is comprised of loans, bonds, and fixed assets. Conversely, the primary components of liabilities consist of deposits and equity. The measurement employed in this study to assess the performance of banks is net interest margin, which aligns with the methodology proposed by Hasan and Dridi (2010). It is important to note that this measurement is based on individual banks.

The measurement provided in this study appears to possess a higher level of resistance to manipulation compared to measurement models that utilise accounting and market-based data, such as ROA, ROE, and Tobin's Q. The measuring component in this study holds greater relevance and constitutes a significant portion of banks' assets and liabilities, such as interest revenue derived from loans. This aligns with the findings of the CFA Institute-Financial Crisis Insights on Bank Performance Reporting (2014), which said that banks typically hold a maximum loan portfolio equivalent to 86 percent of their total assets at a specific period.

Therefore, it is imperative to prioritise the evaluation of criteria that are closely aligned with the inherent characteristics of banks when assessing their performance. In contrast, the profitability measurements commonly utilised in prior studies, such as return on assets (ROA), return on equity (ROE), and Tobin's Q, do not encompass comprehensive indicators specific to banks. These indicators solely reflect the performance derived from a bank's assets and equity, respectively, without providing a precise assessment of the core activities undertaken by banks, namely deposit acceptance and loan granting.

RECOMMENDATIONS – VARIABLES, RESEARCH DESIGN AND DATA SOURCES

The section outlines the planned approach for future empirical data analysis processes for this study.

Dependent Variable (DV)

The DV in this study encompasses various performance measures of banks, specifically the Net Interest Margin (NIM) as an operational-based measure, market capitalisation as a market-based measure, and the Capital Adequacy Ratio (CAR) as a crucial regulatory-based indicator for banks. These variables come from a combination of bank websites, regulatory authorities, and reputable financial databases such as Refinitiv Datastream and the Bloomberg Terminal.

Independent Variable (IV)

The key IVs under investigation are ESG factors. These ESG variables are derived from Refinitiv ESG Scores, as shown in Figure 1, given that they offer comprehensive coverage of ESG measures, with over 630 metrics and a historical record dating back to 2002. According to Refinitiv (2022), its ESG database is widely regarded as one of the most extensive in the business. It encompasses a substantial portion, around 80%, of the worldwide market capitalisation, representing over 1,000 companies.

Control Variable (CV)

CV are those that are included in the study and take into consideration the banking industry and market characteristics. Bank-specific criteria include asset and liquidity considerations, whereas market-specific elements include bond issuance volume and the stock exchange index.

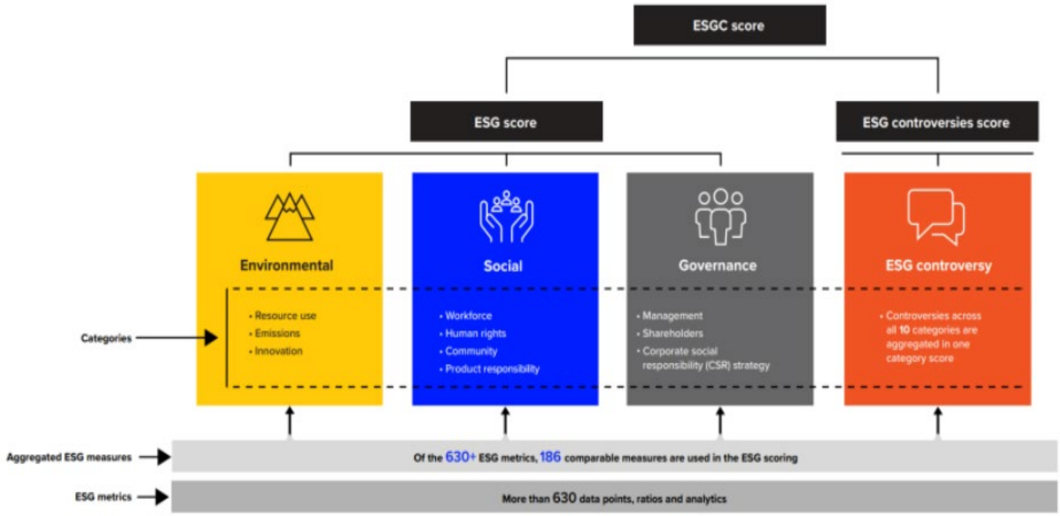

Fig. 1. ESG scores from Refinitiv

Source of Figure 1: Refinitiv

As per Figure 1 above, the model comprises two overall ESG scores, namely:

1. ESG score: measures the company's ESG performance based on verifiable reported data in the public domain.
2. ESGC score: overlays the ESG score with ESG controversies to provide a comprehensive evaluation of the company's sustainability impact and conduct over time.

These are grouped into ten categories that reformulate the three pillar scores and the final ESG score, which reflects company's ESG performance, commitment and efficacy based on publicly available information. The details are as follows:

Table 1. Details of ESG scores in Refinitiv Datastream

Environmental	Social	Governance
Resource use	Workforce	Management
Emissions	Human rights	Shareholders
Innovation	Community	CSR strategy
	Product responsibility	

Source of Table 1: Refinitiv

The ESG Scores have already been used by other authors (Daszyńska-Żygadlo et al., 2020; Shakil et al., 2019; Chiaramonte et al., 2021; Lippai-Makra et al., 2021; Batae et al., 2021) who have carried out research on ESG-bank performance or value/efficiency relationships in the past.

While it is noble to create a fresh set of ESG scores, the findings from the new scores might not be comparable to other similar studies on bank performance that employ standard ESG scores available in Refinitiv, Bloomberg, and many more. Daszyńska-Żygadło et al. (2021) emphasised that problems with CSR measurements result in numerous biases and problems in the existing studies, which lead to inconclusive results. Moreover, some unconvincing outputs on the link between sustainability and financial performance are a result of complexity in sustainability measurement plus failure to isolate the effects of each other (Waddock & Graves, 1997). Therefore, it is imperative to employ ESG scores that are generally accepted by prominent parties to alleviate the aforementioned statistical problems.

Research Design

This research is designed to employ a quantitative research approach to empirically investigate the relationship between ESG factors and bank performance in emerging Asian markets. The study employs panel data analysis and regression modelling techniques, drawing upon secondary data sources for analysis, and the study aims to identify the most suitable model for panel regression analysis. The regression model employs panel data analysis to examine all hypotheses during the whole sample period, employing two-tailed testing. Panel data refers to the aggregation of observations from a certain group of individuals or entities across multiple time periods. Hence, the utilisation of panel data analysis enables the incorporation of both cross-sectional and time series effects within the sample, thereby facilitating a more comprehensive comprehension of the influence of ESG processes on bank performance. Panel data models are considered to yield more accurate and reliable outcomes due to their ability to account for variation across different groups and incorporate individual-specific effects.

Data Sources

The research focuses on emerging Asian markets, specifically those characterised by growth and transitioning stock markets within middle- and low-income countries. Based on Standard and Poor's (S&P), an emerging market refers to a stock market that is undergoing a process of transition, characterised by a growth in size, activity, or level of sophistication. This study can utilise imbalanced panel data encompassing publicly listed banks in emerging Asian countries. The data spans from 2018 to 2022, enabling an examination of the effects both prior to and during the COVID-19 epidemic. According to the study conducted by Hassan et al. (2019), a set of eight countries to serve as representative examples of emerging markets in Asia have been chosen, including China, India, Indonesia, Malaysia, South Korea, the Philippines, Thailand, and Taiwan. The aforementioned countries have been chosen due to their widespread recognition as rising markets in Asia by key global institutions, such as the International Monetary Fund, the Financial Times Stock Exchange (FTSE), and Morgan Stanley Capital International (MSCI), among others.

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Furthermore, the focus of this study pertains to the examination of publicly listed banks operating within emerging Asian countries. Banks included should have complete and relevant data available from 2018 to 2022, including English-translated annual reports and accessible websites. Banks that do not meet these criteria would be excluded from this research.

IMPLICATIONS AND CONCLUSIONS

Practical Implications

Post COVID-19, ESG will be of utmost importance for economic resilience, and policymakers will require increased ESG adoption. According to Bhaskaran et al. (2021), in light of the new normal, banks are compelled to reallocate their investment towards environmentally friendly and sustainable businesses, which are expected to provide significant improvements in their overall performance.

Hence, this study aims to serve as a valuable resource for stakeholders, including current and potential ones, in assessing the impact of ESG initiatives and external factors on the performance of banks during the COVID-19 pandemic. Therefore, it is imperative for bank management to establish strategic plans and promptly implement appropriate measures to enhance their financial performance.

Furthermore, it is possible for regulators and policymakers to modify regulatory obligations to provide incentives for banks that engage in ESG activities that have been previously underlined. These could potentially provide advantages to various stakeholders, including but not limited to employees and customers.

Theoretical Implications

Most of the previous research examining the impact of ESG factors on bank performance have primarily concentrated on profitability ratios and/or other valuation models that rely on forecasted figures as indicators of a bank's performance. Most of measurements employed in previous studies are inadequate in compensating for the unique features of banks. Therefore, considering the limitations of existing methodologies, this study aims to offer equivalent performance data for banks, while also providing different views and a more comprehensive understanding of their core business operations using the NIM.

Furthermore, this study contributes to the expansion of the existing literature by analysing the influence of ESG on the performance of the banking industry, with a focus on banks in emerging Asian economies that have not been analysed previously. The period covered by this paper in relation to the COVID-19 pandemic may also contribute to the advancement of pertinent research.

CONCLUSION

This study highlights the significance of the relationship between ESG practises and bank performance in emerging Asian economies. Recent financial upheavals and the ongoing COVID-19 pandemic have demonstrated the imperative need for a banking system based on sustainability, responsible banking, and strong governance. The presented evidence reaffirms the significance of ESG practises in enhancing the performance and resilience of banks, particularly during economic crises. By analysing panel data from publicly traded banks, this study aims to shed light on the connection between ESG practises and financial performance indicators such as net interest margin (NIM), stock returns, and capital adequacy ratio (CAR).

These findings will benefit banks, policymakers, and other stakeholders by promoting sustainable banking practises and facilitating the attainment of long-term economic and environmental objectives. Reflecting on the performance of banks during this unprecedented global health crisis, the study highlights the significant role that ESG implementation plays in navigating future uncertainties. Therefore, banks are urged to incorporate ESG practises into their overarching operational strategies, not only to serve their

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investors' interests or satisfy regulatory requirements, but also to create a robust and resilient banking sector that can withstand any storm, exhibiting sustainable growth and greater stability. Moving forward, more exhaustive, and regional-specific studies are recommended to widen the understanding of ESG practises and their implications for banking sectors worldwide.

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CONFLICT OF INTEREST STATEMENT

The authors agree that this research was conducted in the absence of any self-benefits, commercial or financial conflicts and declare the absence of conflicting interests with any party.

AUTHORS' CONTRIBUTIONS

Mustapa Abdullah and Hasroleffendy Hassan carried out the research, wrote and revised the article. Hasmah Laili Jamalurus conceptualised the central research idea and provided the theoretical framework. Mustapa Abdullah and Hasroleffendy Hassan designed the research, supervised research progress; Hamizah Hassan anchored the review, revisions and approved the article submission.

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