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Implementation of Environmental, Social and Governance Principles in the Banking Business

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ABSTRACT

At the present stage of the development of the global business community, we pay more and more attention to the principles of environmental, social and governance (ESG) responsibility. Financial intermediaries in their activities considered the influence of natural and climatic factors. Their risks sometimes turn out to be more tangible than, for example, the financial condition of customers. The subject of the study is the development of measures to implement ESG principles in banking products, and its purpose is to study implementing the above principles in Russia at the present stage of business models and setting tasks aimed at overcoming the difficulties of software in sustainable development. The research used the methods of comparative, statistical and factor analysis, identification of trends, graphical comparison, etc. The existing studies on this topic allowed us to determine the need to use ESG principles in banking business models and to identify the motives for their implementation. In the author's conclusion, Russian banks are guides and an example of making business in line with the principles of environmental, social and governance. The speed, depth and sustainability of their application by other financial intermediaries will depend on economic incentives, government support, and the development of regulatory requirements. The transformation of the business community (according to the new rules of conduct) will bring the entire economy of the country to sustainable development. The author considers a promising topic for further study as the introduction by the mega-regulator of mandatory standards for the activities of financial intermediaries for assessing climate and environmental risks, as well as the development of a supplier audit directive on the criteria for implementing ESG principles. This determines the scientific and practical significance of the study.

Keywords: banks; natural and climate risks; ESG principles; banking products; sustainable development

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INTRODUCTION

The principles of environmental, social and managerial responsibility have become increasingly important. Note that they were formed not so long ago — sustainable development as an ongoing activity, aimed at addressing the needs of society and without causing tangible harm to nature and future generations, was first mentioned in the UN report “Our Common Future” in 1987.¹

In “Agenda 21” 1992, the program of implementation of the concept of global sustainable development was described.² In Russia this idea was reflected for the first time in the Decree of the President of the Russian Federation from 04 February 1994 No. 236 “State strategy of the Russian Federation for environmental protection and sustainable development”.³

The insufficient level of implementation of ESG principles in the Russian banking sphere determined the purpose of the study and allowed to formulate the following tasks:

- study of theoretical aspects of application of ESG principles in banking business;
- identification of factors that constraining the development of ESG principles in this field;
- development of measures, activating banks in order to expand of use of ESG principles;
- determination of the potential of ESG principles implementation in Russia in modern conditions.

¹ Development and international economic cooperation: environmental issues. UN General Assembly, 1987. URL: <https://www.un.org/ru/ga/pdf/brundtland.pdf> (accessed on 06 September 2021).

² Agenda 21. Adopted by the United Nations Conference on Environment and Development, Rio de Janeiro, 3–14 July 1992. URL: https://www.un.org/ru/documents/decl_conv/conventions/agenda21.shtml (accessed on 10 September 2021).

³ Decree of the President of the Russian Federation from 04 February 1994 No. 236 “State strategy of the Russian Federation for environmental protection and sustainable development”. URL: <https://legalacts.ru/doc/ukaz-prezidenta-rf-ot-04021994-n-236/> (accessed on 12 February 2022).

Based on the general scientific methods of research (comparison, statistical and factor analysis), determine the current trends in the development of ESG principles in Russia.

INTERPRETATION OF ESG PRINCIPLES

ESG principles, relating to environmental, social and management responsibilities are considered by foreign authors as strategic directions of enterprise development, based on respect for the environment, integrity in dealing with colleagues and customers, and rational corporate governance. [1, 2]

Most international financial institutions and national development banks, for example, the Green Climate Fund,⁴ European Investment Bank, European Bank for Reconstruction and Development, French Development Agency, German Development Bank, World Bank, Asian Development Bank, Asian Infrastructure Investment Bank, have made a significant contribution to the implementation of climate protection projects and realize combined financing instruments. [3]

Achieving sustainable development requires new partnerships with intermediaries such as financial companies, banks, insurance companies, both public and private. Private enterprise innovates more readily and is willing to take risks with new forms of financing. [4]

The United Nations Environment Association programme is implemented on this principle.⁵ This international project as-

⁴ Green Climate Fund — is a global fund established to support developing countries’ efforts to respond to climate change. The Fund helps developing countries limit or reduce their greenhouse gas emissions and adapt to climate change. It was established by country parties to the United Nations Framework Convention on Climate Change.

⁵ United Nations Environment Programme (UNEP) established in 1972. Its purpose is to provide leadership and promote partnerships for environmental respectfully by enabling the improvement of the quality of life of States and peoples without detriment to future generations.

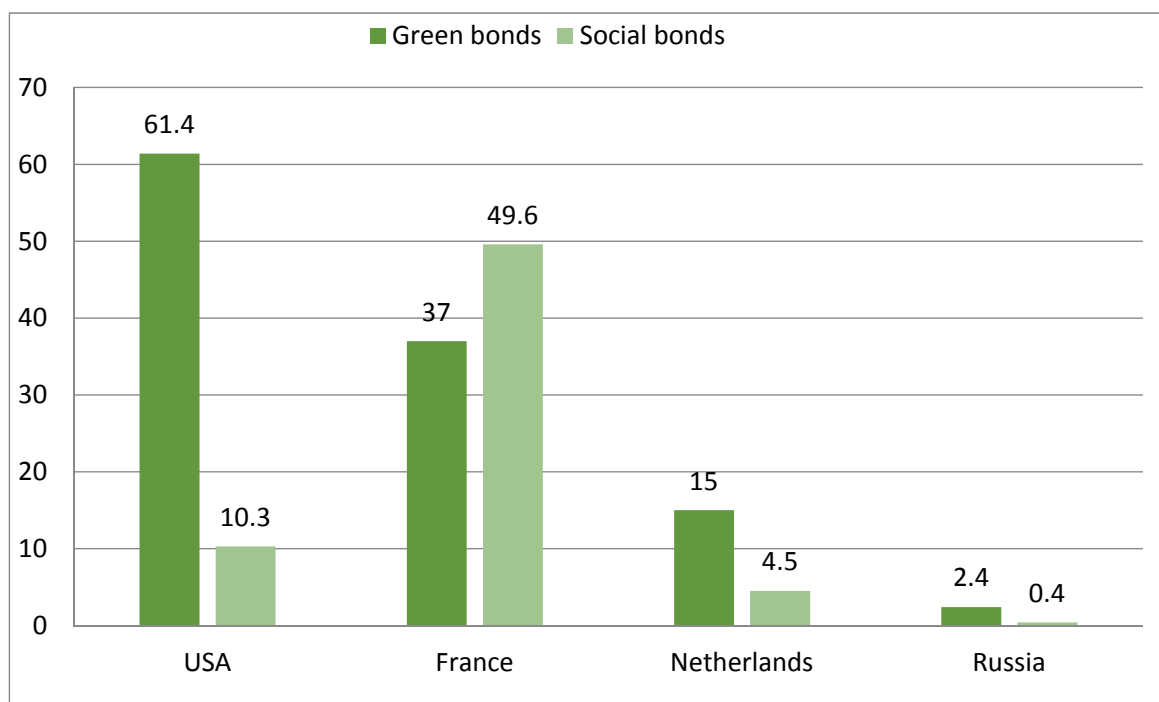


Fig. 1. Comparison of the volume of ESG issue instruments for 2020, bln USD

Source: developed by the author based on [9].

sumes following to common ESG-principles (in banking, insurance, investment, etc.) which are recommendatory, but most of the financial institutions implement them. [5]

Sustainable development principles clearly expressed T. Van Holt, T. Whelan: “As a minimum, do not harm people or the planet, create value for interested parties, focus on improving sustainability there, where the company has significant environmental or social impact”. [6]

IMPLEMENTATION OF ESG PRINCIPLES IN RUSSIA

Paris Climate Agreement ratified by many countries in 2015, which is a framework agreement on the subject, according to which by 2030 European countries are obliged to reduce greenhouse gas emissions by $\frac{1}{2}$ of the 1990 level. [7] Russia joined this agreement in 2019. Since then, the attention to the issue of ESG from investors, financial and insurance companies, regulators, mass media, and

activists of applied sciences has significantly increased.

As a result, there have been significant changes. From August 2019 on the Moscow Stock Exchange, there was a sector of sustainable development, i.e. the place where social and green bonds can be placed. To enter this sector, the issuer is obliged to report on the accumulated resources, as well as assessment of sustainable financing instruments, which include both the above-mentioned bonds and loans, aimed at social and environmental development. To expand the use of these tools, the Moscow Stock Exchange has developed and issued recommendations for issuers of green bonds that meet world standards.

Need for apply the channel of accumulation of resources through the issue of social bonds, in particular for purpose of financing programmes for the development of mass sports, is justified in economic researches. For example, I.V. Solntsev created a set of

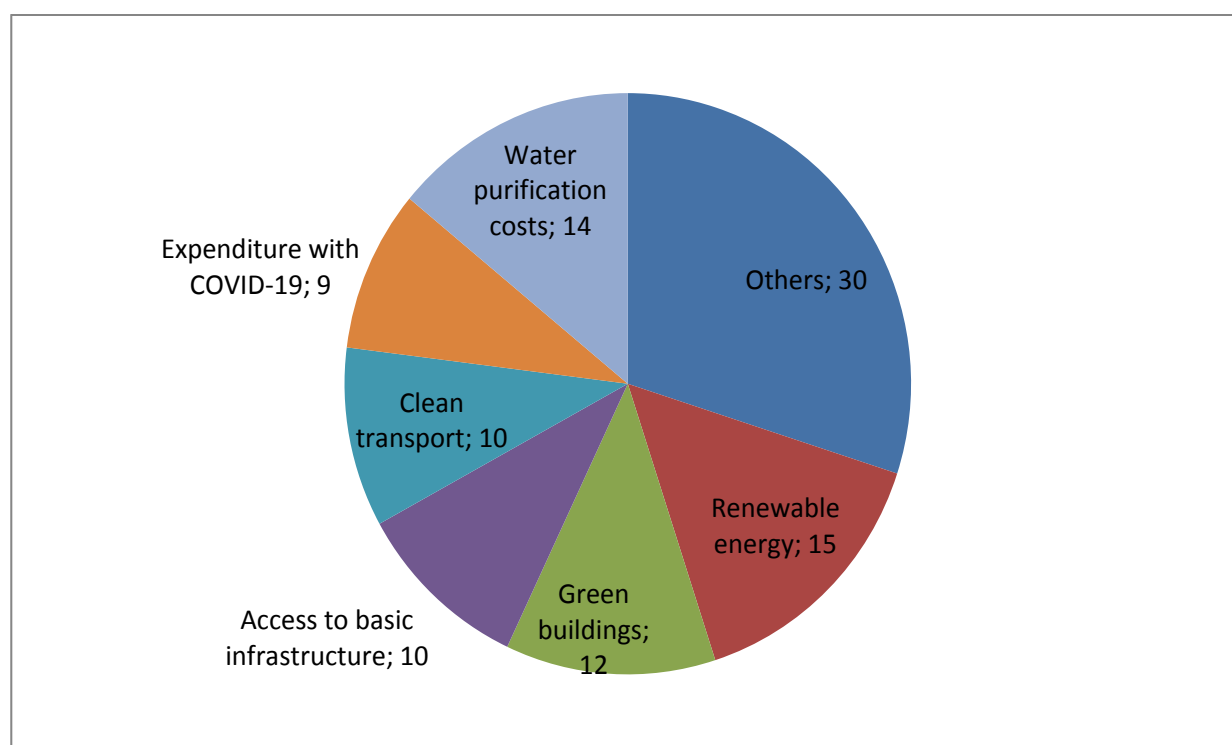


Fig. 2. Purpose of ESG instruments in foreign countries, %

Source: developed by the author.

targets including social return on investment (SROI). [8]

However, by the end of 2020, Russia is significantly inferior to world leaders by volumes of ESG-instruments emissions (fig. 1), despite the fact that their use is gradually gaining momentum. [9]

As for the special purpose of ESG-tools, in the Russian sustainable market can be identified only 2 directions: clean transport (76%) and socio-economic empowerment (15%). While the foreign structure in 2020 is extremely diverse (fig. 2).

In Russia, the use of ESG-tools is only gaining momentum, and the methodology of their circulation is under development. However, as the relevance and need for sustainable development there is no doubt, it is likely that global levels in terms of the volume and targeted use of green and social bonds will be reached over time.

It is important to underline, that the Central Bank of the Russian Federation in 2019 joined the international regulators on greening the financial sector and in 2020 introduced regulatory requirements to take into account the impact of climate risks on the activities of financial intermediaries. State Development Corporation "VEB.RF" from March 2020 to May 2021 developed methodological recommendations on taxonomy and development of the national system of financing green projects.⁶

It should be noted that this market in the monetary dimension is insignificant, but has huge prospects for development. Large companies have emerged in Russia issuing green bonds and prioritizing development that implement sustainable growth strategies.

⁶ VEB.RF. URL: <https://veb.ru/ustojchivoe-razvitie/zeljonoe-finansirovanie/zelenye-finansy-i-rol-veb-rf/> (accessed on 10 February 2022).

The issuers of the bonds, verified according to the “VEB.RF” methodology, have already become SC “Atomenergoprom”, JSC RZD, the Government of Moscow and SC “Sinara Transport Machines”.

SC “Atomenergoprom” all funds from the bond issue is directed to refinancing the green project “Construction of 660 MW wind farms”,⁷ which is characterized by the absence of emissions of pollutants into the atmosphere or the generation of waste. RZD is working on the implementation of up to 2030 environmental strategy, providing for use electric train to reduce the negative impact on the environment.⁸ The Government of Moscow implements environmental program from 2020 to 2030,⁹ aimed at qualitative transformation of the transport system, clean air, noise reduction and significant reduction of anthropogenic emissions. “Sinara Transport Machines” in the framework of the strategy to 2025, through the issuance of green bonds, produces environmental machinery (electric locomotives, electric trains).¹⁰

⁷ RA “Expert”. Report on the expression of an independent opinion on the conformity of the bonds of the series 001R-01 JSC “Atomic Energy Industrial Complex” principles of green bonds and on the compliance of projects financed by them with internationally recognized principles and standards in the sphere of ecology and “green” financing. 2021. URL: <https://veb.ru/upload/iblock/3fc/3fcedf34791327a39c74060fe19cc0af.pdf> (accessed on 13 January 2022).

⁸ RA “Expert”. Report on the expression of an independent opinion on compliance of the perpetual bonds of JSC “RZD” series 001B-03 with the principles of “green” bonds. 2020. URL: <https://raexpert.ru/docbank//ff8/5ca/d62/227992a54ea8cfaa4d3753d.pdf> (accessed on 13 January 2022).

⁹ RA “Expert”. RA expert expressed independent opinion on compliance of bonds of the Moscow Government with the principles of green bonds and on compliance of projects financed by them with internationally recognized principles and standards in the sphere of ecology and “green” financing. 2021. URL: <https://veb.ru/files/?file=f4c8bfb58285f88907d661a9a39557d1.pdf> (accessed on 13 January 2022).

¹⁰ ACRA. ACRA confirmed compliance of the projects financed within the issue of bonds of JSC “STM” with internationally recognized principles and standards in the sphere of ecology and/or “green” financing (ICMA’s “green” bond principles).

An important event in 2021 was the formation of the legal basis for the application of ESG principles in Russia. Thus, signed the Federal Act of 02 July 2021 No. 296 “Limitation of greenhouse gas emissions”,¹¹ that banks can offer their services (information, consulting and project finance) and financial products (such as green loans), directed at the sustainable development.

Measures to increase the number of green loans:

- attracting quality investors, including foreign companies;
- national economic support;
- improving the environmental situation, reducing the negative impact on the environment;
- following the principles of ESG;
- increased green instruments: bonds and loans;
- preferences from the state, subsidies for the implementation of investment projects to introduce the best available technologies, etc.

SUBSIDIZATION AS A MEASURE OF STATE SUPPORT FOR THE INTRODUCTION OF THE BEST AVAILABLE TECHNOLOGIES

A promising instrument for expanding green lending, according to the author, is subsidized by the state, which can expect on companies whose projects meet the following requirements:

- promote the adoption of best available technologies on objects of 1 category negative impact on the environment,¹² i.e. the largest

URL: <https://veb.ru/files/?file=db48d392b577e1f3877c2ac75c62ea81.pdf> (accessed on 13 January 2022).

¹¹ Federal Act from 02 July 2021 No. 296 “Limitation of greenhouse gas emissions”. URL: <http://www.kremlin.ru/acts/news/66061> (accessed on 01 February 2022).

¹² In accordance with the order of the Ministry of Natural Resources and Ecology of the Russian Federation from 18 April 2018 No. 154 has approved the list 300 objects, related to 1 category and having an adverse impact on the environment,

industrial enterprises of the Russian Federation, which are more threatening to the environment;

- are implemented for the purpose of obtaining or prolongation a comprehensive environmental permit. In the 2022–2024 period, large companies and objects of 1 category are obliged to pass to the new technological norms of production, approved by the order of the Ministry of Natural Resources of the Russian Federation¹³;

- are aimed at achieving the best technology standards for allowable discharges and emissions; i.e. improve eco-efficiency by modernizing production;

- provide for equipment, construction and installation, commissioning and other works for the purpose of modernization of the existing enterprise (but not new production).

However, the procedure for obtaining subsidies is complicated by the fact that it is registration in stages, which discourages companies that are the target audience, i.e. doing economic activities in the areas of best available technologies: ferrous and non-ferrous metallurgy, chemical and oil and gas industries, ceramics production, etc.

Passport of investment project (in the set of documents) these companies provide the Ministry of Industry and Trade of the Russian Federation (MIT RF) — the organizer of this funding.¹⁴

MIT RF announces the acceptance of subsidies applications, which are selected within 1 month: initially on a formal basis, and then on the resulting from a feasibility es-

timate (FE) of the projects. 80 experts from different industries using the best available technologies carry out the FE points system. The expert estimate is informative, identifies the conformity of the investment project with the technological processes and determines its cost-effectiveness in general. Based on FE an inter-Ministerial Commission, approved by the Government of the Russian Federation, decisions to subsidies or reject. Within the framework of the concluded agreement, the enterprise has the right to apply for a subsidy twice a year.

The advantage of this financial support is the availability of a platform — State Industrial Information System (with electronic documents turning), generally optimize the entire project appraisal process and shorten the subsidies period. Difficulties encountered by enterprises in its registration, related to the incomplete submission of documents, insufficient information for FE, as well as incorrect completed bank documents and lack of purpose of funding.

PARTICIPATION OF BANKS IN THE IMPLEMENTATION OF INVESTMENT PROJECTS TO IMPLEMENT THE BEST AVAILABLE TECHNOLOGIES IN RUSSIA

Banks have been able to integrate sufficiently well into the system by providing services such as: informing clients of the possibility of receiving a subsidy from the State; assistance in processing the necessary package of documents and development of the investment project; implementation of credit product. These investment projects have large enough financing and contribute to the development of syndicated lending and expansion of the loan portfolio. At the same time, banks have increased guarantees of repayment as part of the money will be reimbursed by the State, and the borrower has a high level of creditworthiness.

which contribute at least 60% to total emissions of pollutants in the Russian Federation. URL: <https://docs.cntd.ru/document/542623710?marker=6500IL> (accessed on 03 February 2022).

¹³ New working conditions with the waste I and II hazard classes from 1 March 2022. URL: https://www.profiz.ru/eco/blog/post_7917/ (accessed on 11 February 2022).

¹⁴ Ministry of Industry and Trade of the Russian Federation. URL: <https://minpromtorg.gov.ru/> (accessed on 11 February 2022).

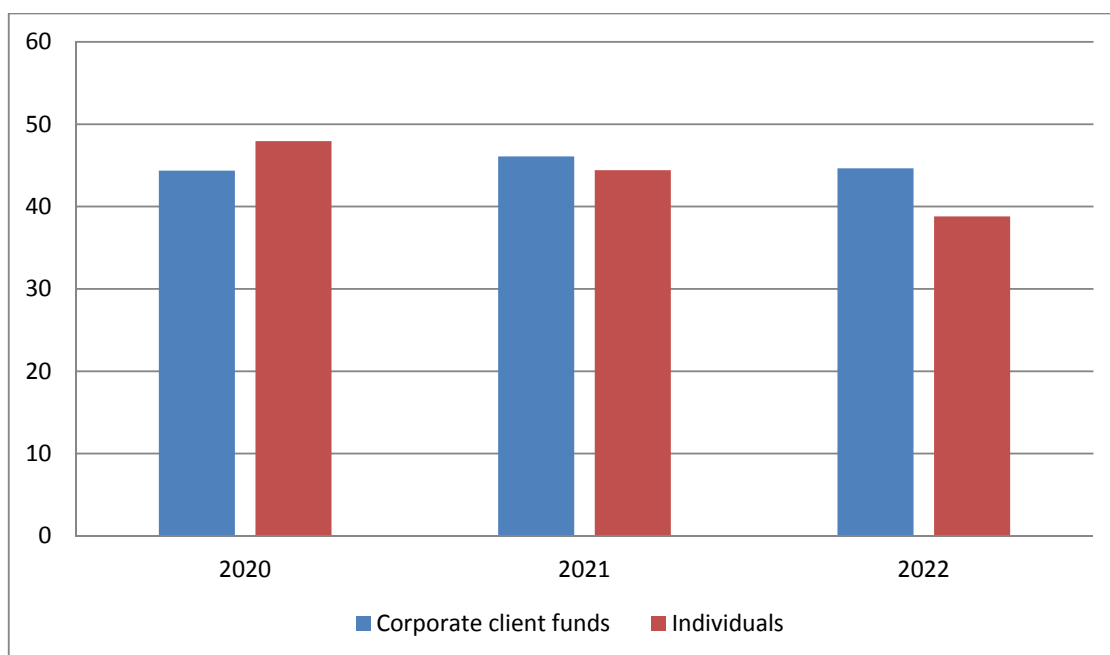


Fig. 3. Structure of banks' liabilities, %

Source: developed by the author based on the statistic indicators of the bank's sector of Russian economic. URL: https://cbr.ru/statistics/bank_sector/review/

Note: * – 2022 data are predictive.

Sustainable growth is possible through capitalization, interaction of the real sector, creation of new value, increase of the role of the Central Bank in economic growth. Economic development forecast for 2024¹⁵ the State are responsible for pointing the way on stimulating technological development and modern technologies; growth of non-energy export operations, medical and transport development; developing an investment cycle with more private financing. Public investment will be directed towards expanding private accumulation infrastructure and maintaining macro-stability as a condition for long-term growth.

An illustration of the above is fig. 3, which means that in 2021, the share of corporate

clients in bank accounts is higher than individuals.

In 2020, the share of funds of individuals amounted to 47.94% of total bank liabilities, and 2021 has already seen a slight decrease, due to the increase in the structure of liabilities of the banking sector in the growth of public funds (from 5 to 10% for the period under analysis). This trend is projected to continue in 2022.

It should be noted, that government programmes are now in fact budget appropriation planning documents in implicitly linked to the main activities of the authorities. K.N Samkov claims, that it is necessary to allow the regions of the country to independently implement not only federal, but also regional projects according to socio-economic policies and specific characteristics of the country's region,¹⁶ and should be developed in the

¹⁵ Forecast of socio-economic development of the Russian Federation for 2022 and for the planned period 2023–2024. URL: https://www.economy.gov.ru/material/directions/makroec/prognozy_socialno_ekonomicheskogo_razvitiya/prognoz_socialno_ekonomicheskogo_razvitiya_rf_na_2022_god_i_na_planovyy_period_2023_i_2024_godov.html (accessed on 10 February 2022).

¹⁶ Open Working Group proposal for Sustainable Development Goals. Sustainable Development Knowledge Platform. United Nations.

form of financial institutions, to this should be changed budget legislation to allow for expenditure planning in the formulation of these projects. [11]

Individual subjects of the Russian Federation, as well as the country as a whole, are interested in achieving the goals of sustainable development up to 2030. However, there are a number of problems in financing and implementing regional projects:

1) a small part of activities within the framework of national projects, which can independently implement subjects of the Russian Federation;

2) insufficient funding of regional projects due to inconsistencies in agreements between federal authorities and constituent subjects of the Russian Federation;

3) inaccurate calculation of federal project indicators by region: without taking into account regional specifics, the possibility of increasing the target values of the constituent subjects of the Russian Federation within the framework of regional projects;

4) lack of co-financing by the Federal Centre in some directions.¹⁷ In turn, the regions should provide co-financing under the state programs in the amount of from 5 to 30%.¹⁸

FINANCING OF ESG-PROJECTS IN RUSSIA

The implementation of all sustainable development goals¹⁹ (SDG) is influenced by multilateral factors, such as:

¹⁷ United Nations. Consensus Reached on New Sustainable Development Agenda to be adopted by World Leaders in September. URL: <https://www.un.org/sustainabledevelopment/blog/2015/08/transforming-our-world-document-adoption/> (accessed on 13 February 2022).

¹⁸ Sustainable Debt Market Summary H1 2021. URL: https://www.climatebonds.net/files/reports/cbi_susdebtsum_h12021_02b.pdf (accessed on 13 February 2022).

¹⁹ Analytical Center under the Government of the Russian Federation. Sustainable Development Goals of the UN and Russia. URL: <https://ac.gov.ru/files/publication/a/11068.pdf> (accessed on 13 February 2022).

• global trends — *fig. 4*. Statistics show an increase in green bond issuance in both developed and transition economies. Europe and Asia — Pacific region became major issuers, more than doubling their overall output [12];

• international capital markets and investors;

• development of companies according to ESG principles;

• composition and rating of assets of companies and financial intermediaries (*fig. 5*) [13];

• level of development of commodity markets, their merger, pressure on export-import operations;

• composition and impact of financial and non-financial factors for the actual and sustainable growth of the company [14];

• product quality and consumer demand. While the latter is focused only on price-quality ratio and does not take into account other properties of products:

• bank lending. Previously, banks were focused on assessing customer reliability from the point of view of financial risks, and now, when entering into agreements with potential users of their services, they consider climate and environmental concerns since the latter have a negative impact comparable to the damage caused by financial risks, for example, COVID. [15]

This position is important for banks, as ESG factors had a negative impact on ratings of corporations and infrastructure companies (cumulatively reduced by 15%) and reduced banks' credit performance. According data by RA "Expert" (*fig. 6*), financial intermediaries either already testing borrowers for commitment to ESG-principles and KPI,²⁰ existence of appropriate internal procedures, or plan to integrate

²⁰ What are the six Principles for Responsible Investment? URL: <https://www.unpri.org/pri/about-the-pri> (accessed on 10 February 2022).

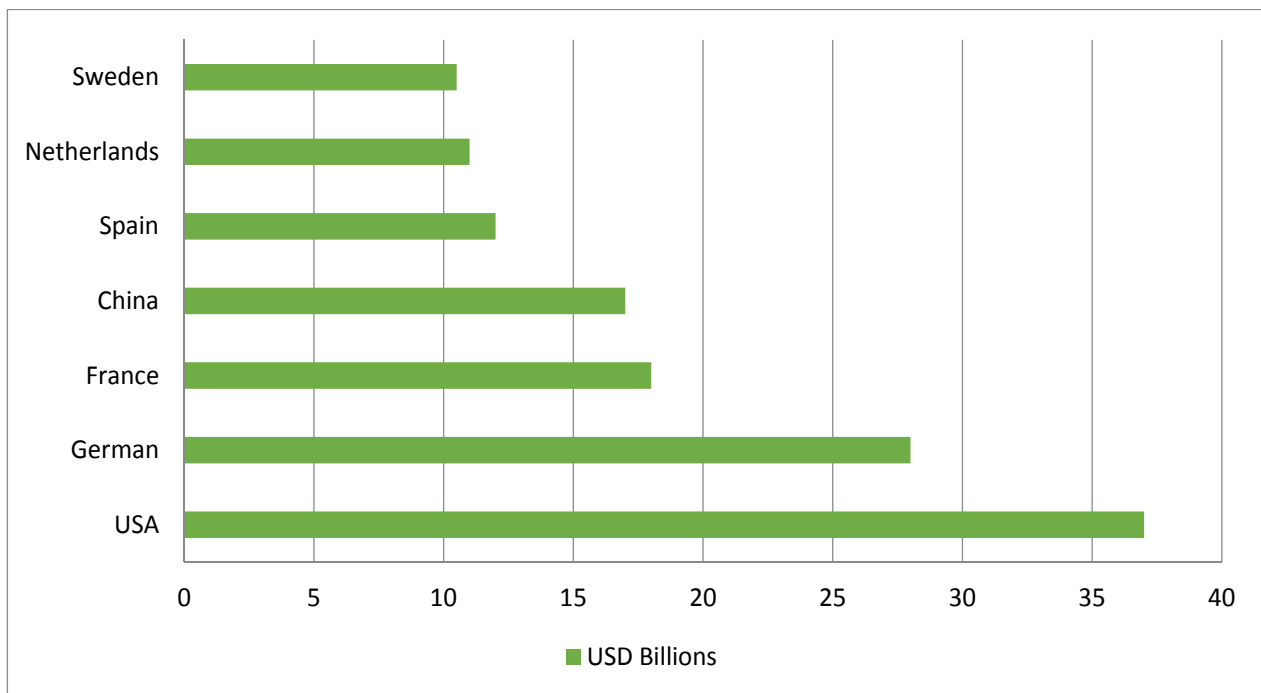


Fig. 4. The volume of green bond issues in foreign countries

Source: developed by the author.

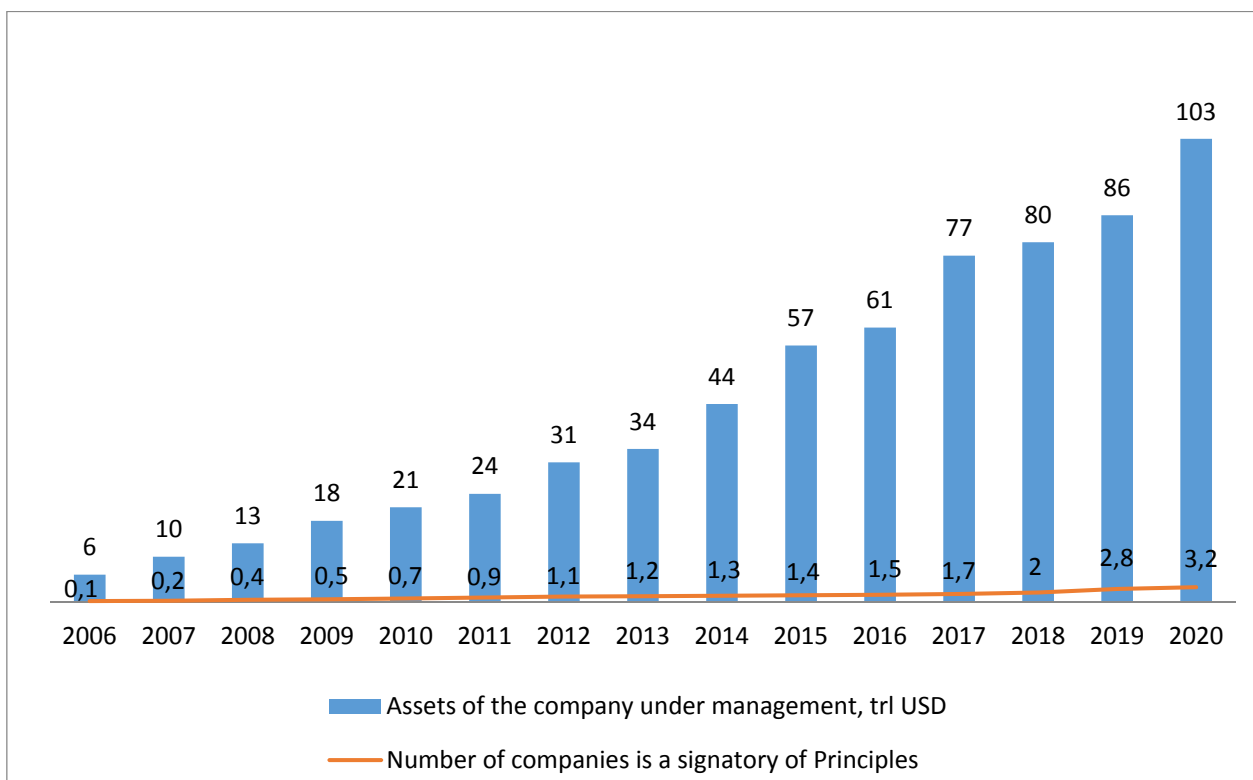


Fig. 5. Dynamics and volume of assets of companies joined the ESG principles

Source: developed by the author based on [16].

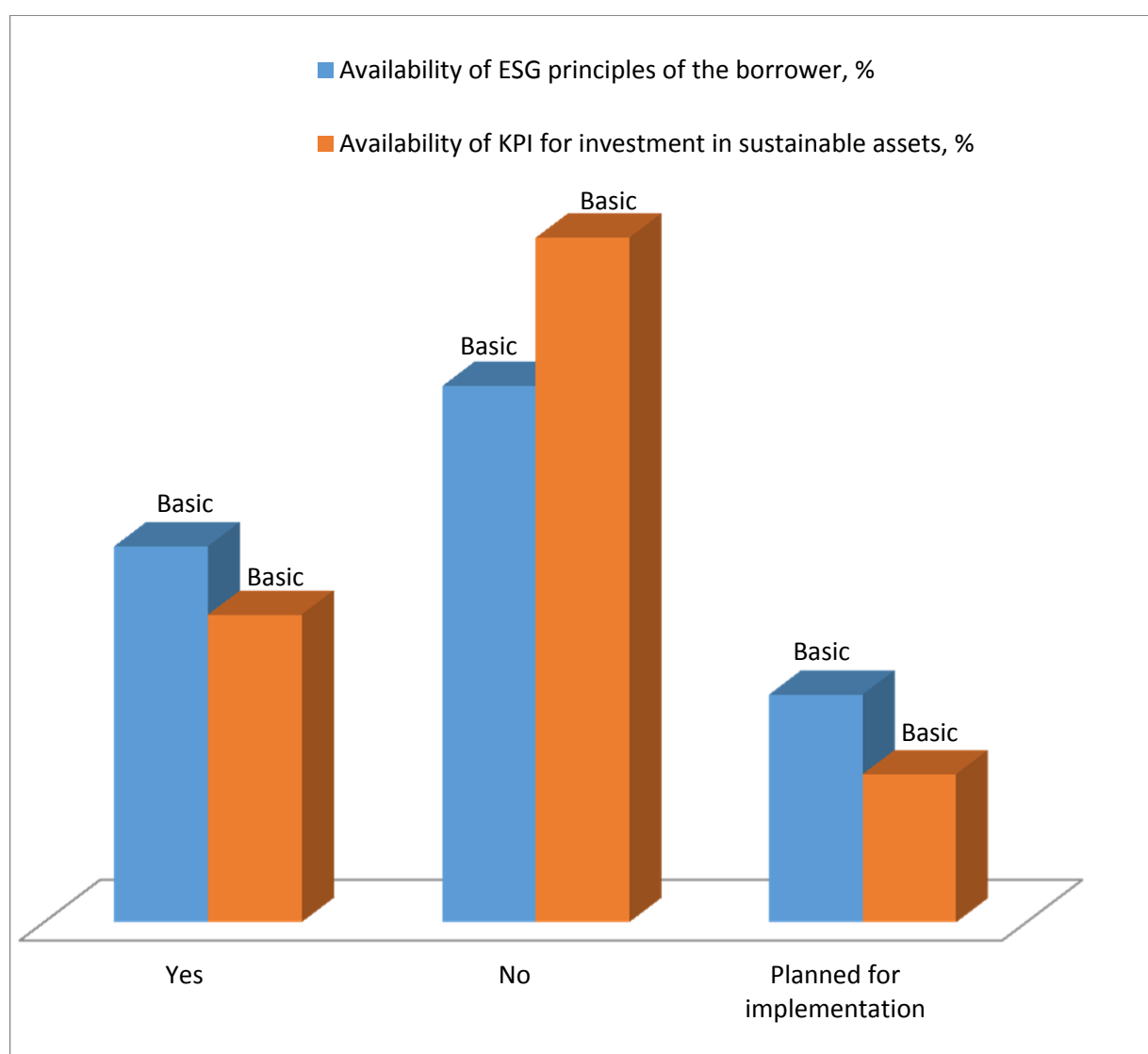


Fig. 6. The level of implementation in the credit process of obligors' ESG-assessment, %

Source: RA Expert [9].

this audit into their investment process. As a result, the demand for green and social bonds in the financial market is expected to increase significantly.

Recently, many companies have focused on the commercial value of ESG-factors. Strategic managers strive to include them,²¹ because they see the connection between the company's activities in this field

²¹ ESG oversight issues: guidance for directors. URL: <https://www.pwc.ru/ru/publications/collection/esg-guidebook-russian.pdf> (accessed on 10 February 2022).

and its long-term success. In addition, correlation of factors of sustainable development with non-financial risks has been determined, which are not included in the market valuation of companies. ESG-investing creates asymmetric advantages and provides "insurance effect", i.e. protection from negative effects, especially during a social or economic crisis. [17]

Implementation by major banks with significant financial resources, ESG-evaluation of the borrower will lead to the inevitable

formation and introduction of principles of sustainable development in companies from the real sector. And the introduction of KPI on responsible investments will serve as an incentive for future issuers.

Banks in their development strategy should consider all climate change and other ESG-factors not only as risks, determining the dependence of the financial result on its impact on ongoing projects (changes in prices of services, real estate, assets, etc.), but also as incentives for green ecology. An important advantage for banks in this direction is access to cheaper funding: despite the lack of ESG-lending experience, they are ready to reduce the cost of resources. At the same time, in order to increase the incentive of sustainable development of clients, applied financial instruments can be structured so that the cost of funding the borrower decreases depending on the results of sustainable development. Retail customers also actively support ESG-principles and are interested in cooperation with companies, offering them relevant products and advising them on their implementation. In this way, banks that are able to implement ESG-practices expand their customer base not only in the domestic market, but also provide opportunities for interaction with foreign investors.

Many banks in their organizational structures create departments of strategy, innovation and marketing, whose function is to develop and implement “sustainable” projects, which underline their commitment to sustainable development and economic growth in general.

Because the mega-regulator also considers environmental and natural risks (along with liquidity and capitalization of assets, financial sustainability) as the most important for the financial results of banks, that it is possible to introduce mandatory norms

to assess the impact of these factors on their activities (lending, mainly). As well as the implementation of the directive, concerning the auditing of suppliers for compliance with ESG-principles. Also, the Bank of Russia plans to develop green mortgage, which will allow the population to take preferential housing loans for the purchase of apartments in energy-efficient and environmentally houses.²²

In general, Russia is making progress in the sphere of regulatory regulation of sustainable development, including in terms of sustainable financing. However, this forward-looking direction requires a clear designed strategy, informed decisions and effective interaction of government, financial sector and economic sectors. Russia studies world experience and implements it, considering national specifics. However, according to the author, it is necessary to be proactive, to develop and gradually implement the long-term sustainable development strategies needed in our country.

Despite the fact that banks have recently started to apply ESG-principles in their activities, there is already a successful experience of implementing appropriate social and environmental projects. Large-scale construction campaigns implemented in Russia, including construction of transport and medical infrastructure, creation of enterprises in the sphere of culture and sports, energy, socially significant facilities, etc. Close cooperation between the real and banking sectors that can bring the country's economy to a new level of development.

Having examined the materials of such researches, may be noted that it is advisable

²² IA Banki.ru. Banks introduce environmental risk assessment of borrowers. URL: <https://www.banki.ru/news/lenta/?id=10949195> (accessed on 12 February 2022).

to classify the model portfolios of ESG-principles and neutral companies belonging to them. [18] The portfolio of ESG-oriented enterprises, taking into account the degree of risk and non-financial value drivers shows high profitability in comparison with the portfolio of ESG-neutral companies. It is important to assess the investment attractiveness of enterprises (and regions), based on the use of cost-oriented indicators and the index method. [19] Based on researches of calendar regression of equity portfolio yield and panel regression at the level of firms revealed, that wins those with good sustainability ratings.

CONCLUSION

The global community strives to minimize the negative impact on nature, and at the present stage, the environmental, social, governance principles (ESG) are relevant for it. Foreign countries began to develop ESG-tools rapidly since the late 1980s, however, in Russia their implementation began relatively recently, the volume of their use in our country is still low, and the areas of use are few. A significant gap between Russian practice and global practice in this direction can be reduced by strengthening relations with financial institutions, public and private sectors, megaregulator. Since 2020,

the Central Bank of the Russian Federation has been actively implementing regulatory requirements to consider the impact of climate risks on the activities of financial intermediaries. Apparently, those banks are interested in introducing ESG-principles into their business (as they help to develop a new niche in the market and attract significant long-term resources). And to jointly achieve the goals of sustainable development, they are modernize their organizational structure, develop strategies for innovation and marketing; seek to reduce the cost of resources by using low-cost funding sources; expand their product line, etc. They have also begun to pay considerable attention to the impact of climate and environmental factors, among other risks typical in the industry.

The above underlines the theoretical significance of the research, namely identifying the motivations that encourage banks to implement their business on the principles of environmental, social and governance responsibility. Its practical importance consists in the development of a mechanism to ensure sustainable growth through capitalization, close interaction with the real sector of the economy, the formation of new value, strengthening the role of the State.

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