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Global Financial System Resilience: Assessing Vulnerabilities and Safeguards

[1]Dr. Manita D Shah, [2]*Dr. Mansi Kukreja
[1]Professor, CMS Business School, Faculty of Management Studies,
JAIN (Deemed-to-be University),
Bangalore, India, dr.manita_shah@cms.ac.in
[2*]Dr.Mansi Kukreja, Professor, CMS Business School,
Faculty of Management Studies,
JAIN (Deemed-to-be University),
Bangalore, India, dr.mansi_kukreja@cms.ac.in

Abstract:

This study examines the complex relationships that exist between sustainability, the global financial system, and Environmental, Social, and Governance (ESG) problems. With an emphasis on sustainable financing, it looks at how ESG components affect the financial system's resilience. The research indicates that financial decision-making processes are increasingly taking ESG factors into account. This demonstrates how crucial it is to match financial procedures with environmental goals. The paper discusses how, despite credit rating agencies giving utmost priority to financial strength, the financial sector is becoming more and extra focused on sustainability. It also discusses the difficulties in adding long-term sustainability issues, including climate change, into credit ratings. The need for a more secure and sustainable global financial system is highlighted by this study's illumination of the shifting ESG landscape, the function of financial institutions, and the standards for evaluating corporate sustainability.

Keywords: Global financial system, ESG, sustainability, credit rating agencies, corporate sustainability.

JEL:G01, G18, G20, G28, E44, F33, O16.

1. INTRODUCTION

In today's global financial system, they are made up of several markets, institutions, and legal frameworks that are knit together like a huge, complex tapestry. This facilitates the transfer of funds across borders, and allows investors to trade goods and services, participate in global markets and raise funds for the company's growth but outside of this tight budget, power stability and flexibility. Just as cracks in an industry can suddenly expand into major mistakes in the event of a financial crisis, the stability of the global financial system is constantly being tested and evaluated. The global financial system exhibits stability and resilience at a time where dynamic geopolitics, market volatility and favourable economic condition prevails.

Compared to earlier decades, modern finance has a far greater influence on markets and consumer behaviour. Specifically, inclusive finance schemes offer an instrument to counter poverty, global warming, marginalisation, or adverse externalities. According to this perspective, sustainability and money are closely related. Henceforth, the main objective of this research is to critically examine the multiple factors affecting the robustness and stability of the system and the aim is to uncover a complex web connecting monetary policy, regulatory policy, and international cooperation by examining their intricate relationships. This study sheds some information on the risks associated with market volatility, the sensitivity of overdrafts, and compliance issues.

Through characteristics related to inflation and monetary policy, a thorough comparison of the current state of the global financial system is conducted. Banks, in particular, have a special responsibility to consider ESG risk given their roles as financial intermediaries and agents for obtaining capital. The financial industry plays a significant role in managing economic development. Internal bank legislation also show that environmental risk must be weighed against the banks' standing, reputation risk, and ethical norms. Financial firms consider ESG aspects significant since they integrate sustainability challenges into their operations and include them in their solution. This paper presents an original approach and contribution that involves ranking the importance of ESG factors considered by financial institutions when making decisions, determining how these factors affect sustainable financial systems, and suggesting a new method for evaluating and contrasting financial systems that distinguish between sustainable and unsustainable financial systems.

2. LITERATURE REVIEW

1. Tettamanzi, P. et al (2022) study offers a thorough examination of the changing sustainability landscape within the framework of financial reporting and accounting. The role of companies is changing dramatically in the modern world, which is regarded as by a confluence of concerns such as the ongoing health emergency and urgent environmental issues like climate change and the COVID-19 pandemic. The research highlights the pressing need to tackle these ecological issues. Conventional business models, which prioritize increasing shareholder value, are being reassessed. These days, a more expansive viewpoint is needed due to the disruptive impact of crises like the continuing pandemic.
2. The research highlights the critical role that corporate governance and disclosure quality play in mitigating these issues. Good corporate governance procedures can support improved disclosure standards, which helps safeguard ecosystems and the environment.
3. The study by Tóth, B. et al (2021) explores the fascinating connection between ESG performance and financial stability in the banking industry. To do a thorough examination, the writers use panel regressive techniques.
4. The European Union (EU) and the European Free Trade Association (EFTA) are the study's sample, which consists of 243 lending institutions that are listed on stock exchanges. The analysis they conducted reveals the significant influence that ESG performance has on these banks' financial stability. The research findings indicate a noteworthy decrease in the ratio of non-performing loans due to strong ESG performance.
5. Environmental (E), Social (S), and Governance (G) ratings, or ESG components, have drawn a lot of attention when it comes to financial stability. By examining the individual and cumulative effects of these ESG scores on bank stability, especially during times of financial turbulence, Chiaramonte, L. et al. (2022) contribute to this field. Their analysis, which uses data from 2005 to 2017, covers European banks that are present in 21 different nations. According to the research, ESG characteristics and their supporting pillars are crucial in lowering banks' vulnerability to financial distress. Crucially, banks with higher ESG ratings get a more noticeable stabilizing effect from ESG.
6. From a didistinct angle based on behavioral economics, Beerbaum, D. et al. (2019) explores the intricacies of sustainability reporting. Their studies focus on the fallout from the 2008–2009 global financial crisis and the subsequent changes to the financial system. To develop a sustainable finance architecture that promotes economic stability, they stress the importance of comprehending non-financial issues and how they interact with financial markets. The study emphasizes how building a truly sustainable financial system requires integrating environmental sustainability, tackling inequality, and improving governance. Although Beerbaum, D. et al (2019) criticize the gains in socially responsible investing, they do acknowledge the progress made in modeling and analysing financial markets during the Global Financial Crisis.
7. With an emphasis on its early detection capabilities, Hanley, K. W. et al. (2019) presented a ground-breaking method for the dynamic interpretation of developing threats within the financial industry. Their study offers a novel approach to forecasting increased risk exposures through the use of computational linguistics, successfully foreseeing the 2008 financial crisis. Prior to the 2008 financial crisis, the authors' approach concentrated on detecting certain risk variables associated with commercial paper, real estate, and prepayment. They specifically highlight the robust predictive power of individual bank exposure for financial returns, bank collapses, and return volatility in their research. Additionally, since 2014, there has been a concerning rise in market volatility, which their analysis mostly attributes to the dynamics of funding sources and mergers and acquisitions. This understanding of the ensuing surge in market volatility highlights the model's usefulness in anticipating new dangers.
8. The study by Bindseil, U. (2020) examines how central bank digital currencies (CBDCs) are changing in response to the development of information technology in the financial sector. An extensive analysis of the benefits and possible drawbacks of making CBDCs available to the general population is conducted in this research. The danger of structural bank disintermediation and the centralization of credit distribution procedures inside central banks, as well as the possibility of encouraging systemic bank runs during financial crises, are the two main concerns expressed by detractors of CBDCs that the author highlights. Bindseil offers a unique remedy to these issues in the form of two-tier CBDC compensation.
9. The study by Battiston, S. et al. (2017) discusses how important it is becoming to evaluate how risks associated with climate change affect the stability of the financial system. In particular, the authors highlight how climate policy risks can spread throughout the financial system and support the application of a network-based methodology to analyse financial interdependencies. A network-based climate stress test is at the heart of their technique, and it is used to assess the resilience of major banks in the Euro Area in both "brown" and "green" scenarios. The results of the study demonstrate large direct and indirect exposures of financial institutions to sectors crucial to climate policy. The

aforementioned exposure is especially noticeable in the equity's portfolios of pension funds and investment firms, underscoring the wider systemic significance of climate risk. The authors also point out that banks' loan portfolios have a notable amount of exposure to these sectors, at levels that are commensurate with their capital. The study emphasises the significance of the timing of climate policy, contending that an early and stable framework would allow for more gradual modifications in asset values, which might result in both winners and losers. On the other hand, a hastily adopted policy framework could have unfavourable systemic effects.

10. Focus is placed on Basel Core Principles (BCPs) compliance and how it affects the financial stability of both conventional and Islamic banks in the study by Bitar, M. et al. (2020). How these rules are followed affects these financial institutions' stability, as the study investigates. Numerous significant revelations are made by the study's findings. First of all, it has been shown that strengthening the stability of conventional banks is greatly aided by compliance with the BCPs. On the other hand, albeit less noticeable, the impact is also favourable for Islamic banks' stability. Importantly, the results show that both types of banks' capital ratios increased as a result of adhering to the BCPs. This suggests that banks of all kinds aim to increase their resilience and stability by maintaining larger capital ratios. For their incorporation into the world financial system, this is especially crucial. The findings of this study further support the Islamic Financial Services Board's 2015 decision to produce guidelines for Islamic banks that are comparable to the BCPs, highlighting the necessity of a regulatory framework that is specific to the distinctive characteristics of Islamic banking.
11. In "Dilemma not Trilemma: The Global Financial Cycle and Monetary Policy Independence," Rey, H. (2015) explores the global financial cycle phenomena and how it affects the independence of monetary policy. A worldwide financial cycle that is marked by coordinated changes in capital flows, asset prices, and credit expansion is discussed in the paper. This cycle is seen to move in tandem with the VIX, which is a gauge of risk aversion and market uncertainty. Asset markets in nations with significant credit inflows are more susceptible to the global financial cycle, according to one of the study's main conclusions. This cycle is independent of the particular macroeconomic circumstances of a country and can cause a variety of symptoms, from benign situations to asset price bubbles and excessive credit creation, which are variables that are frequently linked to approaching financial crises. The study uses a vector autoregression (VAR) methodology to emphasise the central banks' decisions on monetary policy in the core, or centre, country, as one of the major factors influencing the global financial cycle. The international financial system's capital flows, loan expansion, and the leverage of multinational banks are all greatly impacted by these choices. International macroeconomics has long advanced the "trilemma," which holds that independent monetary policies can only be implemented in the presence of unrestricted capital mobility when exchange rates are permitted to fluctuate. But according to Rey's research, this trilemma is put to the test by the global financial cycle, which turns it into a "dilemma" or "irreconcilable duo." It is only possible to implement independent monetary policy when the capital account is actively managed. To tackle this novel predicament, the paper delineates multiple policy alternatives to tackle the global financial cycle. These encompass focused capital controls, measures aimed at the cycle's origins (primarily the monetary policies of prominent central banks), the execution of domestic macroprudential strategies, and the enforcement of more stringent leverage limitations for all financial agencies. The study conducted by Rey, H. (2015) highlights how monetary policy difficulties have changed in the globalisation period and offers insightful information about the intricate relationship between national policy sovereignty and global financial dynamics.

3. OBJECTIVE OF THE STUDY

Analyse how Environmental, Social, and Governance (ESG) elements affect the financial system's resilience, especially in light of sustainable financing.

4. METHODOLOGY

The primary basis for the techniques employed in this study was an extensive literature review. Initially, scholarly articles on corporate sustainability, ESG aspects, the functions of financial institutions, and the influence of credit rating agencies and ESG data providers was collected. The results of this literature study were compiled and disseminated to give a thorough grasp of the function of ESG and the impact of financial institutions on corporate sustainability. This research process ensured that the conclusions and insights are based on the body of current knowledge in the field while enabling a thorough investigation of the issue.

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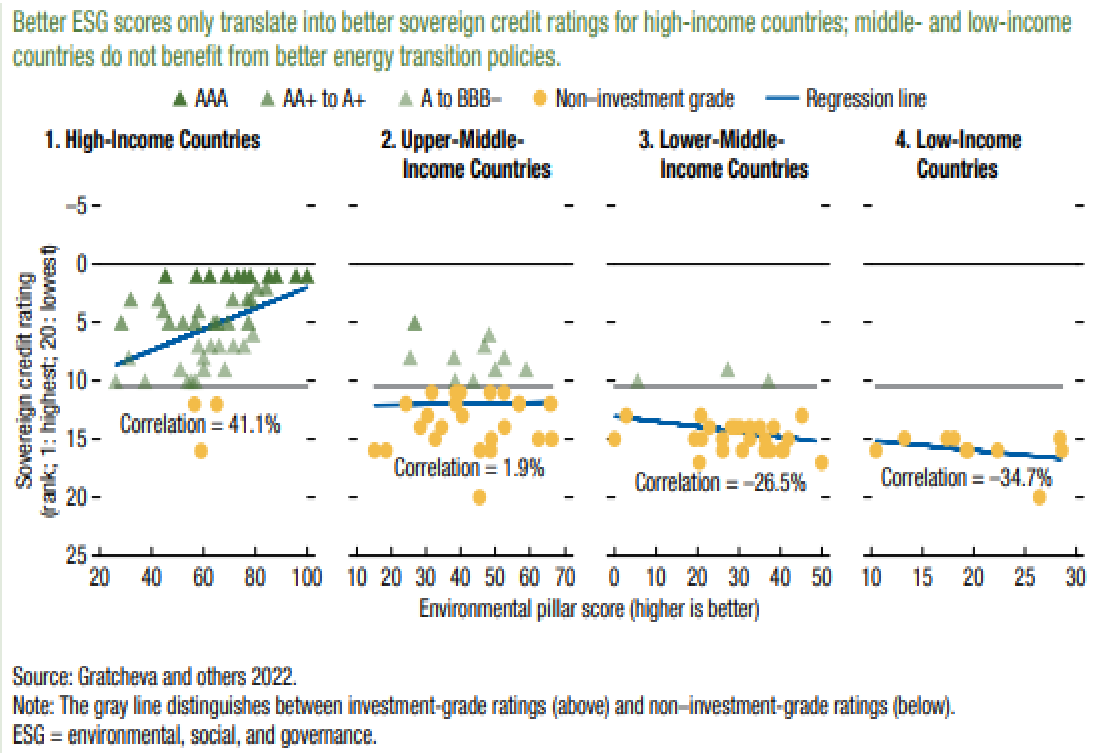
5. DATA ANALYSIS

5.1 The Role of ESG Data Providers and Credit Rating Agencies in Orienting Capital Flows to Climate Investments in EMDEs

The role of credit rating agencies and environmental, social, and governance (ESG) data providers in directing capital flows towards climate projects in emerging market and developing economies (EMDEs) has expanded in the framework of sustainable finance. Credit rating agencies have customarily placed emphasis on assessing an issuer's ability to meet its financial obligations. However, as sustainability gains more and more traction in the financial markets, investors are searching for more details than just conventional financial and economic ones. Due to this change in emphasis, the $7.7 billion ESG industry is expanding and is expected to rise four times by 2030. This field looks at sovereign sustainability through a broader notion of a profitable return on investment. A growing desire for the financial sector to be more involved in transforming the current economic model into a more sustainable one has driven the evolution of sustainable finance into mainstream finance (Boitreaud et al. 2020).

However, there are significant obstacles in the way of credit rating agencies' and ESG providers' capacity to include ESG issues into their procedures, particularly when long-term sustainability factors like climate change are involved. A primary obstacle is the mismatch between the financial industry's investment horizon and the extended period over which certain ESG variables are anticipated to become significant from a creditworthiness standpoint. The complete incorporation of ESG considerations into sovereign credit evaluations is restricted by this mismatch. Furthermore, due to persistent issues with modelling and complete data, our knowledge of the relevance of ESG and sustainability elements and how they affect a nation's creditworthiness is continuously developing. New research shows how these obstacles affect the industry's capacity to allocate funds to more environmentally friendly EMDE developments.

Figure 5.1: Sovereign Credit Ratings and ESG Risks



When making sovereign investment decisions, institutional investors have become more and more reliant on the assessments provided by ESG suppliers. Sovereign ESG techniques are very new and still developing, in contrast to the well-established sovereign credit assessments by credit rating agencies. The environmental pillar's weight increased significantly from 23 percent in 2020 to 35 percent in 2023, demonstrating how responsive these techniques have been to the growing emphasis on environmental considerations. Still, a lot of sovereign ESG rankings fail to sufficiently take climate change into consideration. Moreover, sovereign ESG score providers cannot agree on what constitutes excellent sovereign performance in environmental domains or what environmental criteria are relevant, particularly when taking into account nations with disparate income levels and geographic locations.

5.2 ESG (environmental, social, governance) factors incorporated by financial institutions into the decision-making process:

Decisions made by financial institutions increasingly consider ESG factors. These companies have realised the value of sustainability and ethical business practises in lending and investing strategies because of the ever-changing nature of the global financial sector. ESG rating firms assert that the idea of corporate sustainability has changed over time, especially as a consequence of industry mergers and acquisitions. The modifications align with the increasing focus on thorough evaluations of a business's sustainability that surpass financial indicators.

ESG considerations are now incorporated by financial institutions into their risk analyses and investment plans. They are aware that an organization's reputation and long-term financial performance can be greatly impacted by its social responsibility, environmental effect, and governance practises. A company's operations and capacity to adjust to shifting societal and environmental dynamics are fully shown by looking at ESG elements. Financial institutions are able to recognise possible dangers and possibilities in their portfolios with the aid of this comprehensive methodology.

In addition, the ESG rating industry has changed from isolated market players serving a small financial niche to a vibrant and promising company. Stakeholders and investment decision-makers who want more responsibility and transparency from the companies in which they invest have been the driving force behind this transformation in attitudes and perceptions around corporate sustainability.

The financial firms such as MSCI (Morgan Stanley Capital International) provide the most lucid illustrations of this evolution. By purchasing numerous ESG research companies, MSCI broadened its focus and demonstrated the greater range of ESG data that institutional investors could access. The significance of these data is growing as ESG factors gain traction in investment strategies and are used to create ESG indexes. Financial institutions can enhance decision-making, match investments to sustainability objectives, and foster long-term social, economic, and environmental well-being by incorporating ESG considerations.

ESG aspects are essential to a company's resilience and ability to expand in a changing business environment; financial returns are no longer the only element to be taken into account.

Financial institutions looking to incorporate sustainable and ethical practises into their core operations continue to rely heavily on information provided by the ESG rating sector, which is always evolving and adapting to shifting market needs. It is crucial to know this shift in ESG evaluation criteria in order to understand how financial institutions manage the intricate convergence of sustainability, money, and public expectations (Escrig-Olmedo, E. et al 2019).

6. RESULTS

6.1 Credit rating agencies and ESG data providers' roles in capital flows to climate investments in EMDEs:

- While credit rating agencies have traditionally prioritised a company's financial strength, as sustainability in the financial markets increases, extra information outside traditional financial criteria is becoming more and more important.
- The ESG business has grown significantly and is expected to treble by 2030, reflecting the financial sector's rising interest in sustainability and Environmental, Social, and Governance concerns.
- Long-term sustainability considerations, including climate change, are difficult to include into the techniques used by credit rating agencies and ESG providers. One of the biggest obstacles is the difference in the length of time that some ESG elements become relevant to creditworthiness and the finance industry's investment horizon.
- Research demonstrates how these obstacles make it more difficult to allocate capital to initiatives in emerging markets and developing economies (EMDEs) that are more environmentally friendly.

6.2 ESG Factors Incorporated by Financial Institutions:

- More and more financial organisations are incorporating ESG factors into their decision-making procedures. They are aware that a company's long-term financial performance and reputation are greatly impacted by ESG factors.

- ESG factors include social responsibility, environmental effect, and governance practises in addition to financial measures. These elements are used by financial firms to pinpoint possible hazards and openings in their investment portfolios.
- The ESG rating market has grown from specialised players to a vibrant and attractive business. This change is being driven by stakeholders and investment decision-makers, who place a strong emphasis on accountability and openness in investments.
- The example provided by MSCI demonstrates how the sector is changing. The business grew through the acquisition of other ESG research companies, and it currently supplies institutional investors with ESG data for the creation of ESG indices.

Overall, these findings highlight how ESG considerations are becoming more and more significant in evaluations of sovereign credit and investment plans. Because it understands how important ESG factors are to maintaining long-term environmental, social, and economic sustainability, the financial sector is adjusting to the changing environment by integrating them into its basic activities.

7. CONCLUSION

The complex interactions that exist between Environmental, Social, and Governance factors, the global financial system, and sustainability have been examined in this study. The robustness and stability of the global financial system are constantly put to the test in today's intricate financial environment, particularly in light of the shifting economic conditions, volatile markets, and dynamic geopolitics. The findings show that decisions on financial and commercial strategies take sustainability issues into account. Sustainability and finances are therefore closely related.

The significance of ESG factors has increased despite credit rating agencies' historical emphasis on financial strength due to the financial markets' growing attention on sustainability. The incongruity between investment horizons and ESG timescales, however, makes it difficult to incorporate long-term sustainability issues, such climate change, into credit evaluations. The aforementioned obstacles highlight the necessity of creative methods for funding environmentally conscious EMDE initiatives.

The study also presents the ways in which the financial industry is evolving, with financial institutions increasingly basing their decisions on ESG factors. These companies recognise that an organization's reputation, long-term financial performance, and capacity to adapt to shifting social and environmental conditions are all impacted by ESG concerns. According to the report, a more thorough evaluation of sustainability is taking the place of traditional financial performance measures, which is consistent with the evolving notion of corporate social responsibility.

In conclusion, this study sheds light on how ESG considerations affect investment choices and the dynamics of the world financial system. Additionally, it highlights those financial returns are no longer the exclusive yardstick of success and stresses the significance of coordinating financial practises with environmental goals. These results highlight how crucial ESG factors are becoming in the race to build a more secure and long-lasting global financial system, which has important ramifications for policymakers, financial institutions, and investors. Navigating the opportunities and challenges of the future requires an understanding of the elaborate relationships that exist between sustainability, finance, and ESG considerations.

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