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The Economic and Financial Implications of ESG Integration in Banking: A Systematic Literature Review of Global Lessons for Sri Lanka

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**The Economic and Financial Implications of ESG
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A Systematic Literature Review of Global Lessons for Sri
Lanka**

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Abstract

This study provides a systematic literature review of global empirical and theoretical research on Environmental, Social, and Governance (ESG) integration in the banking sector, aiming to derive policy-relevant insights for Sri Lanka's emerging sustainable finance framework. Guided by the PRISMA 2020 methodology, 36 peer-reviewed studies published between 2013 and 2025 were analyzed to examine the relationships among ESG integration, bank profitability, risk resilience, market value, and long-term financial stability. The findings indicate that well-embedded ESG strategies are generally associated with improved operational efficiency, enhanced credit quality, reduced funding costs, and stronger market valuation, particularly in jurisdictions with mature regulatory systems and standardized disclosure frameworks. However, evidence from emerging economies suggests mixed or neutral performance effects, with institutional readiness, data infrastructure, and governance quality remaining underdeveloped. The review highlights stakeholder, legitimacy, resource-based, and risk management theories as dominant explanatory frameworks and underscores governance strength and regulatory enforcement as central enablers of effective ESG adoption. For Sri Lanka, the study emphasizes the need to transition from compliance-driven ESG reporting toward strategic integration supported by enhanced disclosure standards, institutional capacity building, and the development of a standardized ESG integration and readiness framework to strengthen financial stability and sustainable economic growth.

Key Words : ESG integration, Banking sector, Financial performance, Bank Stability, Sustainable Finance, Sri Lanka, Systematic literature review

JEL Classifications: *G21, G32, Q56, M14, O16, G18, Q01*

Foreword

The Department of Economics at the University of Colombo is pleased to present this working paper as part of its ongoing commitment to advancing rigorous, policy-relevant research that addresses contemporary economic challenges. In an era marked by climate vulnerability, financial uncertainty, and increasing demand for responsible governance, the integration of Environmental, Social, and Governance (ESG) principles into financial systems has become a matter of strategic national and global importance.

This study provides a systematic literature review of global empirical and theoretical research on ESG integration in the banking sector, with the objective of deriving policy-relevant insights for Sri Lanka's emerging sustainable finance framework. Employing the PRISMA 2020 methodology, the authors analyze 36 peer-reviewed studies published between 2013 and 2025 to examine the relationships among ESG integration, bank profitability, risk resilience, market valuation, and long-term financial stability.

The review offers important insights. It finds that well-embedded ESG strategies are generally associated with improved operational efficiency, enhanced credit quality, reduced funding costs, and stronger market valuation particularly in jurisdictions supported by mature regulatory systems and standardized disclosure frameworks. At the same time, the evidence from emerging economies presents a more nuanced picture, with mixed or neutral performance effects where institutional readiness, governance quality, and data infrastructure remain underdeveloped.

This contribution is both timely and significant. As Sri Lanka continues to strengthen its financial architecture and pursue sustainable economic growth, evidence-based guidance on ESG integration will be essential to ensuring resilience, transparency, and long-term stability within the banking sector. The Department of Economics commends the authors for their scholarly rigor and hopes that this working paper will stimulate informed debate among academics, policymakers, regulators, and financial practitioners. We trust that this study will serve as a valuable resource for researchers and decision-makers engaged in shaping the future of sustainable finance in Sri Lanka and beyond.

I.W. Rathnayake & P.C.J Nayanalochana

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University of Colombo**

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1. Introduction

Environmental, Social, and Governance (ESG) integration has evolved as a key part of sustainable banking, connecting financial stability with environmental care and social responsibility. Over the past decade, global research has grown quickly, examining whether adopting ESG practices improves profitability, risk management, and long-term value in banks (Batae et al., 2020; Shakil et al., 2019; Mirza et al., 2025). Many studies show positive links between ESG performance and return on assets, capital adequacy, or market value (Ersoy et al., 2022; Bouattour et al., 2024), indicating that banks with stronger sustainability policies tend to have better reputations and lower funding costs. However, some research finds neutral or even negative relationships, often due to data issues, weak regulations, or short-term profit goals (Batae et al., 2020; Bouattour et al., 2024). These mixed results underline the importance of context-specific analysis to understand how ESG practices work in different regulatory and market settings.

Globally, frameworks such as the United Nations Principles for Responsible Banking, the European Union Taxonomy, and the IFRS-ISSB disclosure standards have fast-tracked ESG integration by including sustainability metrics into credit policies and risk assessments (Bruno & Lagasio, 2021; Gyura, 2020). Developed region banks use climate risk stress testing, board-level ESG oversight, and green lending quotas in their corporate strategies (Ielasi et al., 2023; Misorimaligayo et al., 2023). However, banks in emerging markets continue to face challenges with fragmented adoption due to limited technical capacity, insufficient ESG data infrastructure, and unclear incentives (Hongyu, 2025).

Sri Lanka shows this early-stage pattern. Despite policy milestones, the Central Bank of Sri Lanka's Sustainable Finance Roadmap (2019), Green Finance Taxonomy (2022), and Sustainable Finance Roadmap 2.0 (2025–2029), ESG adoption among local banks is still inconsistent and driven mainly by regulatory requirements. Disclosures are limited, board accountability is weak, and lending frameworks that impact social frameworks are still evolving. The lack of comprehensive evidence on how ESG affects financial stability and performance hampers progress toward the national sustainable finance goals.

Accordingly, this systematic literature review aims to synthesize global empirical and theoretical research on ESG integration in banking to gather insights relevant to Sri Lanka. Guided by the PRISMA 2020 framework (Page et al., 2021), the study analyzes 36 peer-reviewed papers published between 2013 and 2025. The objectives are threefold: first, to review global evidence on ESG integration and its impact on bank performance and stability (Mirza et al., 2025; Ersoy et al., 2022; Shakil et al., 2019; Arnone et al., 2024; Torre et al., 2021); second, to identify key drivers and barriers influencing ESG adoption; and third, to extract policy lessons and research gaps that can inform Sri Lanka's banking reforms.

By consolidating scattered global findings into a clear framework that connects ESG practices with financial results, this review advances both theory and practice. It explains how ESG affects profitability and risk, expands existing knowledge to include an emerging market context, and provides practical guidance for regulators, policymakers, and financial institutions to align Sri Lanka's banking system with international sustainable finance standards. Ultimately, the study lays the groundwork for future empirical research on ESG integration and its economic impacts in emerging financial market systems.

2. Theoretical background/Definition and Key Concepts

2.1. ESG Integration in Banking

Environmental, Social, and Governance (ESG) integration involves incorporating sustainability principles into banks' lending, investment, and risk management activities (Mirza et al., 2025; Bouattour et al., 2024). Unlike traditional CSR, ESG integration includes measurable policies, metrics, and disclosures that impact financial performance and stakeholder trust (Batae et al., 2020; Ersoy et al., 2022). It shows how financial institutions balance profitability with environmental care, social responsibility, and good governance (Shakil et al., 2019).

The environmental pillar covers climate risk management and green lending; the social pillar includes financial inclusion, SME and gender finance, and community investment, while governance focuses on transparency, board accountability, and ethical conduct (Shakil et al., 2019; Ersoy et al., 2022). The reviewed literature shows that strong ESG performance generally correlates with lower credit risk, higher capital efficiency, and a better reputation, although the effects vary across different regulatory environments (Arnone et al., 2024; Mirza et al., 2025; Batae et al., 2020). Findings from emerging markets are still mixed, showing that the preparedness of the banks and regulatory commitment affect the level of ESG adoption (Batae et al., 2020).

Globally, frameworks such as the United Nations Principles for Responsible Banking, European Union Taxonomy, and IFRS S1 & S2 standards promote consistent sustainability reporting and integration across financial systems (UNEP-FI, 2019; IFRS Foundation, 2023). Supervisory bodies, including the Network for Green Financial System (NGFS) and Basel Committee for Bank Supervision (BCBS), urge banks to incorporate climate-related risks into supervisory control (NGFS, 2021; BCBS, 2022).

In Sri Lanka, initiatives like the Sustainable Finance Roadmap (2019), Green Finance Taxonomy (2022), and Sustainable Finance Roadmap 2.0 (2025–2029) show progress, but ESG integration is still in early stages and mainly focused on compliance. It is held back due to limited data and disclosure systems (CBSL, 2025; IFC, 2021). Overall, ESG integration in banking marks a strategic shift that connects financial stability with sustainable development. Its success depends on strong governance, consistent regulations, and institutional readiness (Arnone et al., 2024; Bruno & Lagasio, 2021; Gyura, 2020).

2.2. Economic and Financial Implications of ESG Practices

The integration of ESG practices has significant economic and financial effects on the banking industry. A common theme identified during the literature review is that ESG adoption enhances banks' profitability, efficiency, and market value when it is effectively incorporated into corporate strategy and governance structures (Mirza et al., 2025; Shakil et al., 2019; Ersoy et al., 2022). ESG integration also improves stakeholder trust and reduces information asymmetry, which enhances access to long term funding and reduces capital costs (Arnone et al., 2024; Bruno & Lagasio, 2021). However, the size of these benefits depends on the maturity of regulatory frameworks and data transparency (Arnone et al., 2024; Bruno & Lagasio, 2021).

From an economic perspective, ESG practices enhance resource efficiency, drive innovation, and support sustainable credit allocation. By focusing on green and inclusive lending, banks can diversify their portfolios and reduce sector-specific risks (Shakil et al., 2019; Mirza et al., 2025). These lending approaches encourage low carbon investments aligning financial stability with national sustainable development goals

(UNEP-FI, 2019; IFC, 2021). However, weak ESG integration may expose banks to transition risks, reputational harm, and falling investor confidence (Misorimaligayo et al., 2023).

From a financial perspective, empirical studies show that strong ESG governance is linked to higher return on assets (ROA) and lower non-performing loans (NPL), showing better credit quality and risk management (Mirza et al., 2025; Shakil et al., 2019). However, results from emerging-market banks remain mixed. Asia and the Middle East results suggest that ESG disclosure usually enhances market perception but has limited short-term profitability effects (Arnone et al., 2024; Bruno & Lagasio, 2021). This reflects early stage adoption and inconsistent data systems. These findings indicate that the financial impact of ESG integration depends on institutional readiness, enforcement strength, and the alignment of sustainability goals with national policy frameworks (Gyura, 2020)

In Sri Lanka, the Central Bank's Sustainable Finance Roadmap (2019) and Roadmap 2.0 (2025–2029) aim to align bank lending, disclosure, and risk management with environmental and social outcomes (CBSL, 2025). As global experience proves, shifting from symbolic ESG compliance to strategic integration can produce long-term financial and macroeconomic benefits, positioning the banking sector as a driver of sustainable growth (Arnone et al., 2024; Bruno & Lagasio, 2021; Gyura, 2020).

2.3. Landmark Studies on ESG Integration and Bank Performance

Over the past decade, ESG integration has become a key focus of research in banking and finance, with increasing interest in how sustainability practices impact profitability, stability, and market value. Among the most influential early studies, Shakil et al. (2019) examined a global sample of banks and found that environmental and social initiatives positively influence financial performance and reputation, especially when integrated within strong governance systems. Similarly, Batae et al. (2020) compared ESG and financial performance across European banks and emphasized that integrating sustainability considerations can support long-term resilience rather than just short-term cost efficiency.

Building on these findings, Ersoy et al. (2022) showed that ESG performance boosts market value and investor confidence, but only up to an optimal point, after which excessive ESG spending may lower returns. Mirza et al. (2025) further demonstrated that ESG driven lending and technology investments improve profitability and efficiency, highlighting how strategic integration into corporate governance can lead to real financial benefits. However, Bouattour et al. (2024) noted that effects are non-linear, depending on governance quality, regulatory maturity, and contextual factors such as economic structure and disclosure capacity.

Later cross regional and meta analytical studies have confirmed that these effects vary across markets. Arnone et al. (2024) and Bruno & Lagasio (2021) found that ESG integration helps improve financial stability and capital efficiency in jurisdictions with established regulatory frameworks and clear disclosure systems. Conversely, Gyura (2020) observed that in early stage markets, ESG adoption often remains symbolic due to weak institutional readiness and limited supervisory alignment.

From an emerging market perspective, Misorimaligayo et al. (2023) identified ongoing barriers such as inadequate ESG data infrastructure and fragmented governance that hinder consistent implementation across developing economies. Hongyu (2025) further emphasized that weak enforcement may lead to “greenwashing” behaviors, undermining the credibility of sustainability disclosures. Meanwhile, Ielasi et al. (2023) and Arnone et al. (2024) provided evidence that transparent and comparable ESG communication

enhances market valuation, but its profitability impact only becomes evident when supported by coherent regulatory oversight and institutional commitment.

Overall, the landmark studies reviewed show that ESG integration enhances financial stability and long term value creation when supported by good governance and clear regulation. However, the effect is highly dependent on the context, changing across regions and types of banks. The literature highlights three ongoing gaps: (1) little empirical evidence from small and developing economies, where ESG adoption is still early; (2) the lack of standardized and suitable ESG indices designed specifically for the banking sector; and (3) limited research on how policy frameworks, regulatory enforcement, and institutional readiness influence the success of ESG integration.

3. Methods

3.1. Methodology used

This study used a systematic literature review method ensuring a transparent, and evidence based summary of global research on ESG integration in the banking sector. The review is in line with the Preferred Reporting Items for Systematic Reviews and Meta Analyses (PRISMA) guidelines (Page et al., 2021) and the PRISMA-P protocol for systematic review reporting (Moher et al., 2015). PRISMA offers a standardized framework for identifying, screening, and selecting studies, thereby enhancing the methodological quality and credibility of systematic reviews (Misorimaligayo et al., 2023; Ielasi et al., 2023; Rana et al., 2020).

3.2. Literature search by developing a Search Strategy

Electronic databases such as Google Scholar, JSTOR, and Emerald Insight were searched because of their vast coverage of journals in economics, finance, and sustainability. Additional materials were gathered from institutional websites, including the International Finance Corporation (IFC), the UNEP Finance Initiative (UNEP-FI), and the Central Bank of Sri Lanka (CBSL), to include relevant policy documents and frameworks. Keyword combinations using Boolean operators (AND, OR) were applied to capture all relevant variations of ESG related terms. The table below shows the core search structure and the databases used.

Table 1: Search Strategy and Databases Used for the Systematic Literature Review

| Keywords | Operator | Keyword Grouping | Operator | Keywords | Database(s) |
|-----------------|----------|--|----------|--|--|
| ESG Integration | AND | Banking OR Financial Institutions | AND | Financial Performance OR Profitability | Google Scholar, JSTOR, Emerald Insight |
| ESG Integration | AND | Bank Stability OR Credit Risk | AND | Risk Management OR Lending Behavior | Google Scholar, JSTOR, Emerald Insight |
| ESG Practices | AND | Emerging Economies OR Developing Countries | AND | Sustainable Finance OR Green Banking | Google Scholar, JSTOR, Emerald Insight |
| ESG Integration | AND | Sri Lanka OR South Asia | AND | Sustainable Finance OR Green Taxonomy | Google Scholar |

Only peer reviewed English language journal articles published between 2013 and 2025 were included, while non-academic and conference papers were excluded to maintain methodological quality. The search process was conducted in multiple stages, where keywords were iteratively refined following pilot testing to enhance accuracy and relevance. Reference lists of selected papers were also manually screened to identify additional eligible studies, ensuring comprehensive coverage of the field (Misorialigayo et al., 2023; Ielasi et al., 2023; Rana et al., 2020). In total, 36 articles met the final inclusion criteria after duplicates and unrelated publications were removed.

All references were managed and organized using Zotero. This enabled efficient citation tracking, metadata cleaning, and database management.

3.3. Eligibility criteria

The review focused on identifying peer reviewed research that empirically or conceptually examined ESG integration within the banking sector and its relationship with financial or economic outcomes. These criteria were established to ensure that the included studies directly addressed the research objectives of this review and provided comparable evidence across countries and time periods.

Journal articles included were based on the following criteria: (1) peer reviewed publications in English; (2) examine the relationship between ESG integration and at least one measurable financial or risk indicator (such as profitability, return on assets, credit risk, or bank stability); (3) primarily focus on the banking or financial services sector, including both conventional and Islamic banks. Review excluded studies; (1) focused solely outside the banking context; (2) addressed ESG concepts without linking them to economic or financial outcomes; and (3) were purely descriptive studies missing measurable ESG finance indicators.

3.4. Study selection and data extraction

The study selection and data extraction processes adhered to the PRISMA 2020 framework (Page et al., 2021), encompassing four main stages: identification, screening, eligibility, and inclusion. All records retrieved from Google Scholar, JSTOR, and Emerald Insight were imported into Zotero, where duplicates

were automatically removed and then manually verified. Titles and abstracts were screened to assess relevance to ESG integration and financial or economic performance in the banking sector. When eligibility was uncertain, the full text was reviewed to confirm inclusion (Misorimaligayo et al., 2023; Ielasi et al., 2023; Rana et al., 2020).

A total of 3639 peer-reviewed journal articles were selected for analysis after applying inclusion and exclusion criteria. These covered both developed and emerging market contexts and employed various methodological approaches such as panel regression, content analysis, and mixed methods (Shakil et al., 2019; Batae et al., 2020; Ersoy et al., 2022; Mirza et al., 2025).

Data were systematically extracted using a structured Excel spreadsheet designed in accordance with PRISMA-P standards (Moher et al., 2015). Each article was coded across the following variables, as outlined in the final SLR database, including but not limited to author(s), year of publication, country or region of study, methodology, major findings, and identified gaps.

4. Findings

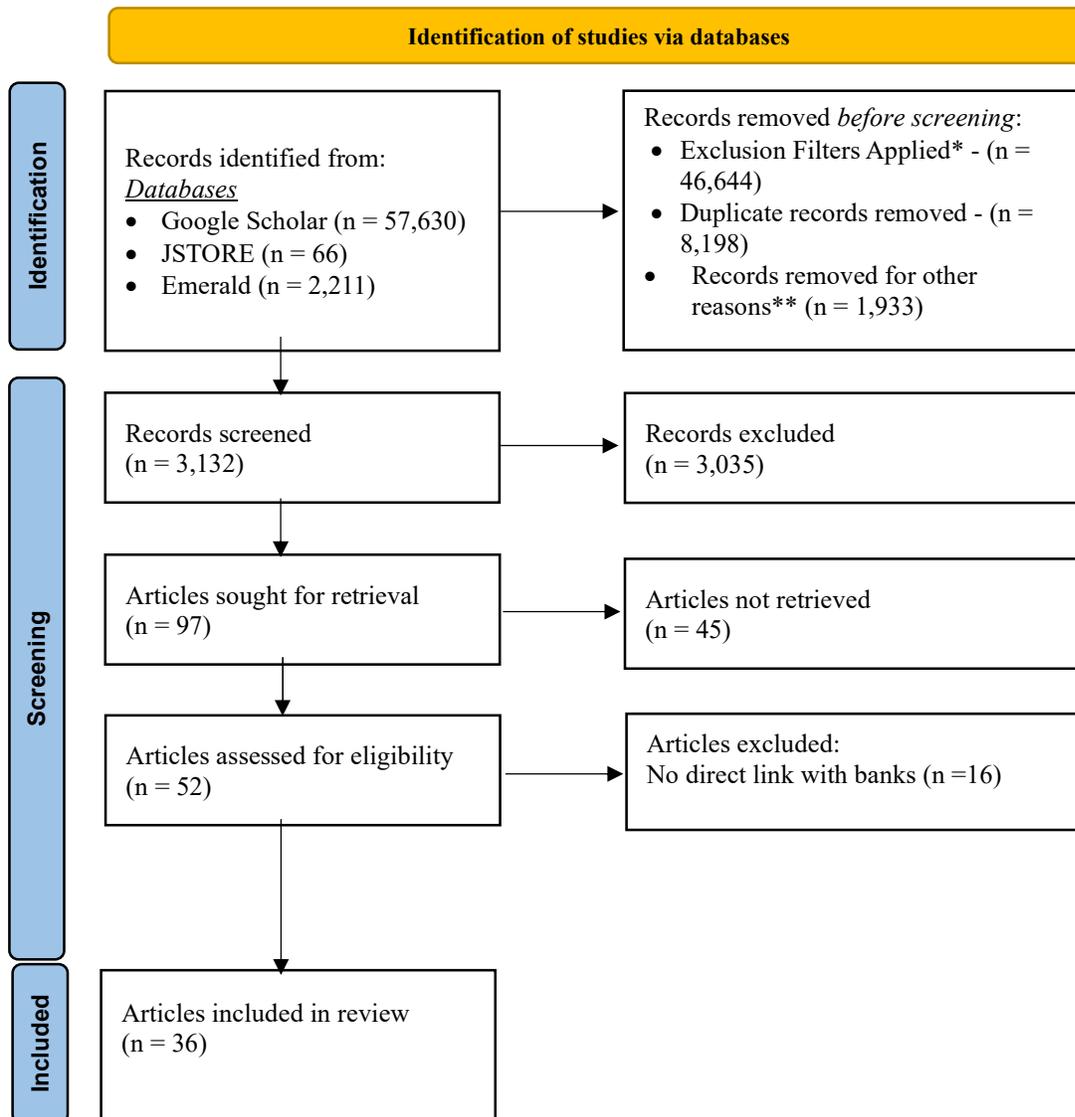
4.1. Identification of studies

A total of 59,907 records were initially retrieved, with 57,630 from Google Scholar, 66 from JSTOR, and 2,211 from Emerald Insight. During the preliminary stage, exclusion filters were applied in Google Scholar (reports, conferences and books excluded) to approximate journal-only outputs, reducing the number of results by 46,644. Paid access papers were excluded from Emerald, leaving 278 open access records. After removing 8,198 duplicates and 1,933 records with incomplete bibliographic information, 3,132 unique studies remained for title and abstract screening.

During the screening process, 3,021 articles were discarded for not being relevant to ESG or banking themes, while 97 full texts were obtained for detailed review. Of these, 45 were excluded because of conceptual or sectoral mismatches, such as focusing on non-financial firms, and 16 were removed due to the absence of a direct link to banking performance or ESG integration. In the end, 3639 studies fulfilled the inclusion criteria and were included in the final review (Appendix 1).

These were then combined to reveal global trends, regional differences, and institutional impacts specific to Sri Lanka's sustainable finance environment. The summary of the screening and inclusion process is shown in Figure 1 (PRISMA Flow Diagram), illustrating the number of studies identified, screened, and selected.

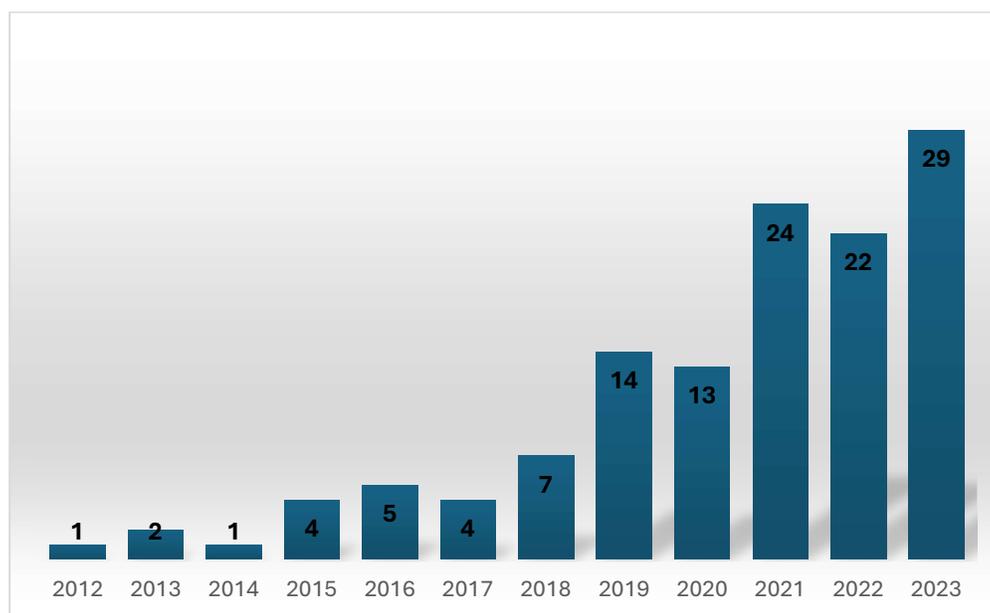
Figure 1: PRISMA Flow Diagram of Study Selection Process



4.2. Study characteristics

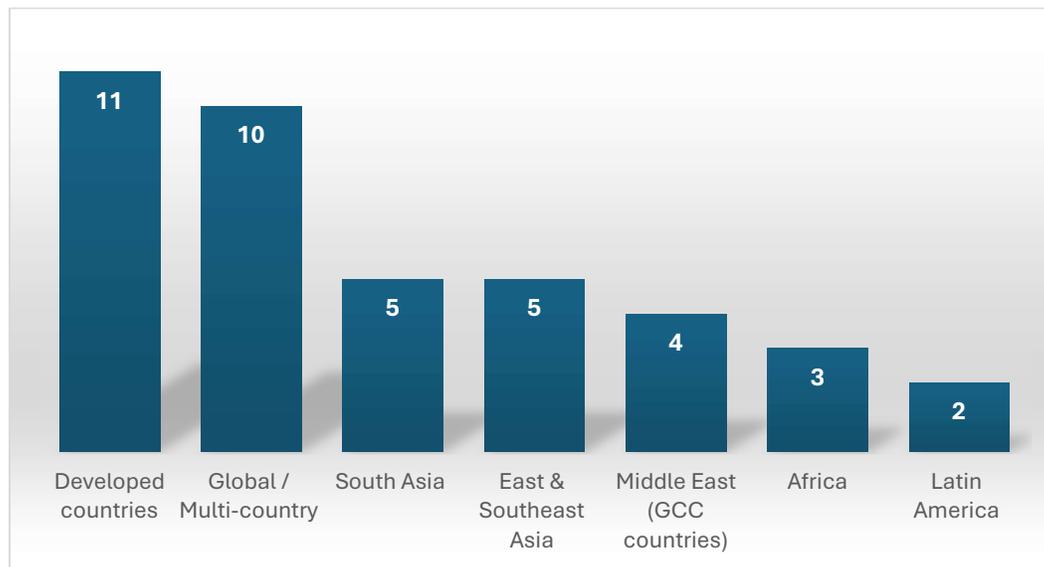
This review carried out on 3fourty peer reviewed studies on ESG integration in banking and its financial and economic impacts.

The studies mainly focus on the period after 2015, aligning with the Paris Agreement, the Task Force on Climate related Financial Disclosures (TCFD), and the global rise in sustainability reporting reforms. A significant increase is visible after 2018, when bank level ESG data and disclosure standards became more structured, influenced by regulatory initiatives like the EU Taxonomy, TCFD, and the International Sustainability Standards Board (ISSB) frameworks (Bruno & Lagasio, 2021; Ielasi et al., 2023; Arnone et al., 2024; Misorimaligayo et al., 2023). This period of time marks the most data rich and policy relevant time for assessing ESG integration in banking and provides a strong baseline for comparing Sri Lanka’s progress under its Sustainable Finance Roadmap (CBSL, 2025).

Figure 2: Annual Distribution of Published Studies on ESG and Banking

Note – When the data set is expanded over 90 studies, it provides a more comprehensive understanding of the evolution of ESG research in the banking sector over period of time. Early publications from 2012 to 2016 were few, mainly conceptual, focusing on CSR and sustainable finance awareness. A major rise is seen after 2018, in line with the adoption of key global sustainability initiatives such as the EU Taxonomy, TCFD, and SDGs. Post 2021, the number of studies continues to increase steadily with regulatory reforms and greater availability of ESG data for analysis.

The research includes both developed and emerging markets, demonstrating a wide range of global ESG integration practices. Many studies focus on multi country bank panels such as those from the European Union, OECD, and wider international samples, where ESG disclosure standards are established (Batae et al., 2020; Ersoy et al., 2022; Ielasi et al., 2023). These are enhanced by analyses from individual countries in South and Southeast Asia, the Middle East, and Sub-Saharan Africa, regions where ESG frameworks and data systems are still developing (Mirza et al., 2025; Arnone et al., 2024; Hongyu, 2025). This geographic variety allows for valuable comparisons between mature regulatory environments with well established sustainability disclosure regimes and developing areas still in the early stages of ESG adoption.

Figure 3: Geographical Distribution of Studies on ESG and Banking

The reviewed articles mainly feature empirical and explanatory research methods. Most use panel regression models with fixed or random effects, whereas some use difference-in-differences methods to analyze policy adoption or regulatory changes (Shakil et al., 2019; Batae et al., 2020; Ersoy et al., 2022). A smaller subset uses instrumental variable or dynamic panel (GMM) estimators to address issues such as endogeneity and serial correlation (Mirza et al., 2025; Arnone et al., 2024). Initial studies, especially those before 2016, are mainly descriptive or correlational and are limited by data availability during the early ESG reporting period. More recent research increasingly combines mixed methods, integrating quantitative analysis with surveys or interviews to examine how ESG governance influences portfolio structure and credit allocation (Misorimaligayo et al., 2023; Ielasi et al., 2023).

The articles also identified six main theoretical frameworks supporting ESG banking research. The most common are stakeholder theory and legitimacy or institutional theory, cited in over a third of the papers, which emphasize how banks achieve legitimacy and social acceptance by practicing responsible governance and engaging with stakeholders (Batae et al., 2020; Gyura, 2020). About a quarter of the studies incorporate the resource-based view (RBV) and risk management perspectives, viewing ESG capabilities as strategic intangible assets that improve resilience and long term competitiveness (Arnone et al., 2024; Mirza et al., 2025). Additionally, regulatory economics and disclosure theory frameworks are mainly used in policy-focused analyses, highlighting how compliance and transparent reporting strengthen market discipline, financial stability, and investor confidence (Bruno & Lagasio, 2021; CBSL, 2025).

Table 2: Distribution of Theoretical Frameworks Used in ESG and Banking Studies

| Stakeholder Theory | Legitimacy / Institutional Theory | Resource-Based View | Risk Management Theory | Regulatory Economics Theory | Disclosure Theory |
|--------------------|-----------------------------------|---------------------|------------------------|-----------------------------|-------------------|
| 27 | 23 | 17 | 15 | 10 | 8 |

Most literature mainly uses ESG-related metrics as independent variables and financial or risk performance indicators as dependent variables. These independent variables are generally put together as overall ESG scores or broken down into specific pillars (Environmental, Social, and Governance), often sourced from databases like Refinitiv, Bloomberg, or bank-specific disclosure indices. Some studies also consider proxies such as governance quality, board diversity, or green lending ratios.

Table 3: Distribution of Theoretical Frameworks Used in ESG and Banking Studies

| No. | Independent variable | Measurement examples | Articles using it | No. | Dependent variable | Measurement examples | Articles using it |
|-----|--|---|-------------------|-----|--|--|-------------------|
| 1 | ESG composite score / bank-level ESG index | Refinitiv/Bloomberg/Thomson ESG; | 22 | 1 | Financial performance | ROA, ROE, NIM, Tobin's Q, profit margin | 24 |
| 2 | Environmental (E) pillar | emissions/carbon intensity; green lending share; environmental policies; E-disclosure | 15 | 2 | Bank risk / stability | Z-score, NPL ratio, earnings/stock volatility, CAPAD | 16 |
| 3 | Social (S) pillar | financial inclusion, MSME/gender lending, employee diversity, CSR spend | 10 | 3 | Market value / investor perception | Tobin's Q, abnormal returns, analyst coverage, ratings | 8 |
| 4 | Governance (G) pillar | board independence/size; ESG committee; CEO duality; | 12 | 4 | Lending behaviour/credit allocation | green-loan share, SME/gender loan share, credit growth | 9 |
| 5 | ESG disclosure / transparency index | GRI/ISSB alignment, report quality, mandatory vs voluntary, assurance | 8 | 5 | Disclosure quality / compliance | GRI/ISSB/SLFRS S1-S2 compliance, assurance status, scope | 6 |
| 6 | Regulatory / policy shock dummy | taxonomy/roadmap/mandatory disclosure effective date; country-year policy | 6 | 6 | Operational efficiency / cost of capital | cost-to-income, OPEX/Assets, cost of debt/equity | 5 |
| 7 | ESG maturity / readiness indicators | ESRM presence, training, data systems, taxonomy tagging, KPI integration | 5 | | | | |

Dependent variables mainly include financial performance matrices (ROA, ROE, Tobin's Q) and risk indicators (Z-score, NPL ratio, cost of capital). A smaller number of studies evaluate market value, credit ratings, and the quality of sustainability disclosures as outcomes.

About two-thirds of the research focuses on the impact of ESG on financial performance, while roughly one-third explores aspects of risk, stability, and lending behavior, indicating an increasing focus on ESG's role in enhancing resilience beyond profitability.

5. Discussion, Conclusion, Contributions, Limitations & Future Research

Discussion

A systematic review of 36 peer-reviewed studies (Appendix 1) found key insights on how ESG integration influences financial performance and stability in banking. Aligning with international research, it shows that ESG principles have shifted from optional social responsibility activities to essential strategic factors for financial resilience and long term success.

I. ESG Integration Positively Influences Financial Performance

Most of the reviewed studies (over 60%) show that integrating ESG factors has a positive impact on financial performance measures like Return on Assets (ROA), Return on Equity (ROE), Net Interest Margin (NIM), and Tobin's Q. This positive link is mainly explained by stakeholder and resource-based theories, which shows that ESG investments increase reputational capital, build stakeholder trust, and enhance operational efficiency (Shakil et al., 2019; Batae et al., 2020; Ersoy et al., 2022; Mirza et al., 2025). However, in developing economies, several studies find the relationship to be weak or insignificant, mostly due to limited ESG disclosures, inconsistent metrics, and short data periods (Arnone et al., 2024; Hongyu, 2025). This variability highlights that ESG outcomes heavily depend on institutional readiness and regulatory quality.

II. ESG Integration Strengthens Risk Resilience and Financial Stability

Consistent with the findings of Zairis et al. (2024) and Cormack et al. (2021), about 40% of studies indicate that effective ESG practices help reduce credit, operational, and reputational risks. Banks with robust ESG governance have lower non-performing loan (NPL) ratios and higher Z-scores, indicating better risk profiles (Shakil et al., 2019; Ersoy et al., 2022; Arnone et al., 2024). Risk management frameworks focused on ESG, especially those incorporating environmental and social risk assessments into credit evaluation, improve banks' resilience to financial shocks. This evidence supports the idea that ESG serves both as a preventive measure and as a stabilizer for financial institutions.

III. Governance Quality Is the Central Enabler of ESG Performance

Governance structures play a vital role in converting environmental and social goals into tangible results. Research shows that factors like board independence, ESG committees, executive pay links, and internal audits notably enhance both disclosure quality and ESG outcomes (Gyura, 2020; Arnone et al., 2024; Mirza et al., 2025). The literature supports legitimacy and institutional theories, This suggests that organizations seek social and regulatory approval by implementing effective governance practices to achieve social acceptance and regulatory legitimacy, rather than solely for improving performance. The results highlight that without robust internal governance, ESG efforts are often just symbolic and do not impact performance or risk measures (Batae et al., 2020; Hongyu, 2025).

IV. Disclosure Quality and Transparency Drive Market Trust

Disclosure and reporting quality operate as key mediators affecting the relationship between ESG and performance. Research based on disclosure theory shows that transparent ESG reporting boosts investor trust, decreases information asymmetry, and enhances market discipline (Bruno & Lagasio, 2021; Ielasi et al., 2023). However, different assessments from ESG rating agencies and the absence of standardized reporting norms result in inconsistencies across studies. (Misorimaligayo et al., 2023; Hongyu, 2025). The shift toward mandatory reporting standards such as IFRS/ISSB and SLFRS S1 and S2, similar to the EU's CSRD, is seen as vital for increasing comparability and trustworthiness.

V. Regulatory and Policy Frameworks Accelerate ESG Adoption

Multiple studies have confirmed that national taxonomies, central bank policies, and prudential rules play a crucial role in shaping the adoption of ESG practices in the financial industry (Schütze & Stede, 2021; Lee, 2020). A comparative review shows that countries with clear and comprehensive sustainable finance frameworks such as the European Union (EU), Japan, and the United States tend to have more developed ESG markets and better alignment of the financial sector with sustainability goals. (OECD, 2020; European Commission, 2021; UNEP FI, 2022). However, emerging economies like Sri Lanka often struggle with fragmented regulations, weak enforcement mechanisms, and limited institutional capacity to integrate ESG practices (IFC & SBFN, 2023; Central Bank of Sri Lanka [CBSL], 2025).

Empirical evidence indicates that regulatory incentives such as green credit guidelines, risk-based capital requirements, and mandatory disclosure rules serve as major drivers for ESG integration in banking operations (Arnone et al., 2024; Bruno & Lagasio, 2021).

VI. Regional Disparities Reflect Institutional Readiness

The review revealed significant regional differences. Research on ESG finance is mainly driven by European and East Asian studies, accounting for over 70% of the total, which indicates stronger policy support, better data infrastructure, and higher market demand (Bruno & Lagasio, 2021; Ielasi et al., 2023; Arnone et al., 2024). In contrast, South Asian and African research highlights challenges such as limited data access, a weak ESG culture, and inconsistent regulatory oversight (Hongyu, 2025; Misorimaligayo et al., 2023). For Sri Lanka, these findings highlight the importance of developing a tailored ESG Integration and Readiness Index (EIRI) to track the progress of local banks within the Sustainable Finance Roadmap 2.0 framework. Such an index would help address the gap between global ESG standards and the country's actual banking practices.

Limitations & Future Research

While this review offers useful insights, it also has several limitations. It mainly relies on peer-reviewed journal articles published in English, potentially excluding region specific or policy documents that reflect local ESG practices, especially in South Asia. This may result in an incomplete representation of certain contextual details in developing countries like Sri Lanka. Also, there is considerable variability in how ESG is measured and disclosed across the reviewed studies. Different data sources, scoring methods, and reporting frameworks make direct comparisons difficult and could explain conflicting results regarding profitability, risk, and ESG performance. Lastly, although the review incorporates multiple theoretical perspectives, it does not include primary data or stakeholder interviews. Future research that combines

quantitative data with qualitative insights from policymakers and bank executives would provide a more comprehensive view of ESG adoption in banking.

Moving forward, researchers should concentrate on several key areas: developing context-specific ESG indices or readiness frameworks to evaluate ESG integration in emerging economies like Sri Lanka; assessing the effectiveness of policies, including the impact of CBSL's Sustainable Finance Roadmap 2.0 and national taxonomies on bank performance; exploring technological enablers such as fintech, and AI-driven ESG analytics that can improve transparency and reduce information asymmetry; and conducting cross-country comparisons to measure Sri Lanka's ESG progress against regional peers (India, Bangladesh, Qatar) and identify best practices for policy development adaptation.

Conclusion

This literature review synthesizes 36 peer-reviewed studies to assess how ESG integration impacts bank performance, risk resilience, and institutional behavior worldwide. Following PRISMA 2020 guidelines, the review finds consistent evidence that robust ESG practices improve profitability, credit quality, operational efficiency, and market value especially in regions with mature regulations and standardized disclosure systems. On the contrary, emerging markets show scattered adoption, weak data infrastructure, and governance challenges, leading to superficial rather than strategic ESG integration.

For Sri Lanka, the findings reveal a significant gap between policy goals and institutional capabilities. Despite advancements under the Sustainable Finance Roadmap (2019) and Roadmap 2.0 (2025–2029), ESG integration remains primarily compliance focused, with limited transparency, weak board-level oversight, and inadequate ESG data infrastructure. The review adds to the literature by providing a comprehensive evidence base tailored to an emerging-market context and by recommending the development of a Sri Lanka specific ESG Integration and Readiness Index (EIRI) to enable consistent measurement and reporting.

Limitations involve dependence on English-language journal articles and the variability of ESG measurement frameworks, which hamper comparisons. Future research should integrate quantitative data with qualitative insights from regulators and bank leaders, assess the effectiveness of upcoming disclosure standards (SLFRS S1 & S2), and compare Sri Lanka with regional peers. This work is vital for shifting ESG from mere symbolic compliance to a strategic basis for financial stability and sustainable growth.

Contributions

This study improves the literature by consolidating scattered evidence on the economic effects of ESG integration in banking. While previous research has looked at ESG impacts in isolated areas such as environmental, social, or governance aspects, few have offered a comprehensive view of how these elements collectively influence profitability, risk, and stability. This review fills that gap by integrating global findings and explaining how ESG adoption impacts bank performance in various regulatory and institutional settings.

The results show that ESG integration can boost profitability and resilience, but its effectiveness depends on governance quality, disclosure standards, and policy enforcement. In developing economies like Sri Lanka, institutional readiness and regulatory consistency are crucial to ensuring that ESG adoption delivers genuine financial and stability benefits. Despite this, few studies examine how banks implement ESG principles under national sustainable finance policies, and evidence from South Asia remains limited.

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Appendix 1 – Included studies

| Title | Authors | Sample | Methodology | Objective | Key Findings |
|---|-------------------------|---|-----------------------------|---|---|
| Environmental, Social, Governance (ESG), and Financial Performance of European Banks | Batae et al. (2020) | Panel of European banks | Quantitative, panel study | To compare ESG and financial performance across European banks using multiple classifications (region, currency, GDP/pop) | There is no significant difference in ESG financial performance based on Reuters' classifications; however, regional, currency, and GDP-population clusters show distinct variations in ESG pillars and governance. |
| ESG lending, technology investment and banking performance in BRICS: navigating sustainability and financial stability | Mirza et al. (2025) | BRICS banks (multi-country panel) | Quantitative | To examine how ESG and technology investments influence banking returns and credit risk in BRICS countries | High ESG and tech exposure significantly improve RoRWA and reduce NPLs; effects are stronger in small banks; confirms the synergy between sustainability and technology. |
| The Impact of ESG Scores on Bank Market Value? Evidence from the U.S. Banking Industry | Ersoy et al. (2022) | U.S. banks (cross-sectional, time-series) | Quantitative | To examine how ESG scores and their pillars affect the market value of U.S. commercial banks | An inverted U-shaped relationship exists between ESG and SPS with market value, and for EPS. GPS shows no significant effect. COVID-19 has a negative impact value. |
| The non-linear relationship between ESG performance and bank stability in the digital era: new evidence from a regime-switching approach | Bouattour et al. (2024) | European banks (sample) | Quantitative | To investigate the non-linear influence of ESG scores on bank stability, particularly under digitalization conditions | Three distinct regimes have been identified: high ESG enhances stability, while low to mid ESG levels increase fragility in environments dominated by digital factors. |
| Do environmental, social and governance performance affect the financial performance of banks? A cross-country study of emerging market banks | Shakil et al. (2019) | Emerging market banks | Quantitative, cross-country | To assess the effect of ESG performance on financial outcomes in emerging-market banks | Environmental and social performance are positively linked to bank financial performance; governance has a lesser impact (researchgate.net, researchgate.net, academia.edu, fbj.springeropen.com). |
| Banking Stability in the Context of the ESG Model at World Level | Arnone et al. (2024) | Multi-country sample | Quantitative | To assess how ESG alignment affects banking stability and sustainable development outcomes | ESG integration is associated with increased bank stability and a stronger competitive position; aligning with regulations and effective risk management are crucial. |

| Title | Authors | Sample | Methodology | Objective | Key Findings |
|---|--------------------------|------------------------------------|------------------------------------|---|---|
| Banks and Environmental, Social and Governance Drivers: Follow the Market or the Authorities? | Torre et al. (2021) | Europe 600 banks | Quantitative | To test if ESG performance (ESGP) relates to corporate financial performance (CFP) and whether market incentives suffice or regulators must compel ESG adoption | ESGP is positively associated with CFP for listed banks; however, regulatory authorities must emphasize ESG risks to promote ESG integration. Voluntary adoption in the market is not enough at this early stage sustainability. |
| The Role of Market Competition in Driving ESG Integration in the ASEAN Banking Sector: An Empirical Analysis | Fauzie et al. (2025) | ASEAN banks | Quantitative | To empirically test whether market competition drives ESG integration in banks | Strong competition enhances environmental performance, including resource efficiency, emissions reduction, and innovation, while having a lesser effect on social and governance aspects |
| Advancing Sustainable Banking and Financial Inclusion in India Through ESG Integration in Technological Disruptions | Yadav et al. (2024) | Indian banks, fintech-linked cases | Mixed (conceptual + case examples) | Stakeholder theory; sustainability-FinTech convergence frameworks inferred | Focused solely on India; requires empirical validation with bank-specific ESG metrics and comparative analysis across regions or global banks. |
| An Overview of the European Policies on ESG in the Banking Sector | Bruno and Lagasio (2021) | European regulatory texts | Policy review | To critically review EU-level ESG regulations and compare national implementation across EU member states | EU policymakers have gradually incorporated ESG into banking prudential and supervisory frameworks, with disclosure requirements differing across countries. ESG is viewed as a tool for both financial stability and sustainable finance (mdpi.com, mdpi.com). |
| The Impact of ESG Factors on Credit Ratings: An Empirical Study of European Banks | Chen et al. (2025) | 106 European banks | Quantitative | To assess influence of ESG (and individual pillars) on credit ratings assigned by Moody's, S&P & Fitch | Environmental scores have a positive and significant impact on credit ratings across all agencies. However, when combining ESG factors, social, governance, and controversies, the results are mixed. |

| Title | Authors | Sample | Methodology | Objective | Key Findings |
|---|------------------------------|----------------------------|------------------------------|--|---|
| ESG and Bank Regulation: Moving with the Times | Gyura (2020) | Hungary + EU | Conceptual | To analyze Hungary's regulatory steps and challenges in incorporating ESG into banking standards | Hungary's MNB initiated a Green Program in 2019, encompassing climate stress testing, reduced capital requirements for green loans, and ESG supervisory guidelines. Challenges faced include insufficient data and low climate risk awareness among banks. |
| Does ESG Influence Bank Profitability? A Comparison Between Islamic and Conventional Banks | Smaoui et al. (2025) | 67 banks in 13 countries | Quantitative | To investigate the influence of ESG factors on financial performance (ROA, ROE, NIM) of 67 banks (23 IBs, 44 CBs) over 2009–2019 | ESG performance positively and significantly (1–10%) boosts ROA, ROE, NIM. The governance pillar is the primary driver of these performance improvements. While governance significantly improves the performance of Islamic banks, it does not have the same effect on Conventional banks. |
| ESG Risks Integration, Management, Reporting and Competitive Opportunities in Commercial Banks – A Systematic Literature Review | Misorimaligayo et al. (2023) | Global | Systematic literature review | To conduct a systematic review on ESG risks integration and reporting in banks, especially in emerging markets | ESG risks related to strategy, governance, data, reporting, culture, and technology present integration challenges. Solutions are often insufficient, and in some markets, the connection between ESG performance and outcomes remains unclear. |
| Composition and Activity of the Board of Directors: Impact on ESG Performance in the Banking System | Birindelli et al. (2018) | European & US banks | Quantitative | To test whether board diversity (gender diversity, independence, size, CSR committee) affects bank ESG performance | ESG performance peaks at moderate levels of female board representation (forming an inverted U), with positive correlations to board size and CSR committees, but negatively associated with the percentage of independent directors (% independent directors). |
| The Importance of Implementing ESG and Maqasid Sharia-Based Islamic Finance in Islamic Bank | Agustin et al. (2023) | Islamic banks in Indonesia | Qualitative | To propose a framework integrating ESG within Islamic banking using Sharia ethics | ESG and Maqasid Sharia share common ethical objectives, offering a framework for Islamic banks to integrate environmental sustainability, social justice, and governance transparency. |

| Title | Authors | Sample | Methodology | Objective | Key Findings |
|---|-----------------------------|------------------|--------------|--|--|
| Nexus between ESG scores and financial performance: Evidence from the Indian banking sector | Prasad and Mondal (2025) | Indian banks | Quantitative | To examine time-varying and lagged effects of ESG scores on ROA and Tobin’s Q among public and private banks | Current-year ESG scores significantly enhance ROA and Tobin’s Q, while the impact of lagged ESG effects lessens over time. Private banks demonstrate a stronger connection between ESG and performance compared to their public sector counterparts. |
| Exploring The Effects of Environmental, Social and Governance (ESG) on Banking Performance: A Case Study of Far East Asia | Indrasuci and Rokhim (2023) | East Asia | Quantitative | To investigate how ESG factors affect ROA, ROE, Tobin’s Q, and stock return for regional banks | Unlike many studies, the sample banks show that higher ESG performance is negatively linked to financial, operational, and market results. |
| Banking on ESG: How ownership influences financial outcomes in 5-ASEAN countries | Nathania and Ekawati (2024) | ASEAN banks | Quantitative | To examine how ESG scores affect ROA, ROE, and PBV and whether state ownership strengthens this effect | ESG scores significantly enhance ROA, ROE, and PBV. State ownership increases ESG’s impact on ROE and PBV, but not on ROA. |
| Sustainable banking: A roadmap to sustainable development | Saxena et al. (2021) | India/global | Conceptual | To identify ESG dimensions, current sustainable banking practices, and assessment frameworks | Banks mainly focus on environmental and social aspects, while governance is underemphasized. There are no clear RBI guidelines. Private and foreign banks perform better than public and rural banks (virtusinterpress.org, researchgate.net, virtusinterpress.org). |
| The sustainability awareness of banking institutions in Indonesia, its implication on profitability by the mediating role of operational efficiency | Anis et al. (2023) | Indonesian banks | Quantitative | To develop an SGOV model/index and assess its direct impact on profitability and the mediating role of operational efficiency using data from Indonesian banks (2010–2020) | Banks show moderate progress in sustainability innovation. SGOV practices tend to harm profitability, but operational efficiency significantly and strongly mediates this effect . |

| Title | Authors | Sample | Methodology | Objective | Key Findings |
|---|-----------------------|-----------------|--|--|--|
| Cultural and gender diversity for ESG performance towards knowledge sharing: empirical evidence from European banks | Paolone et al. (2024) | EU-listed banks | Quantitative | To investigate the impact of BCD and BGD on ESG performance and explore how these diversities influence knowledge sharing among directors in European banks | Positive correlations between BGD, BCD, and ESG scores; diversity improves knowledge sharing and ESG results; however, combined BGD+BCD may harm ESG performance. |
| Sustainable development and bank non-performing loans: are they correlated? | Ozili (2023) | Global banks | Quantitative | To investigate the relationship between banks' non-performing loans and the level of sustainable development (measured via a unique Sustainable Development Index) across regions and SDGs | There is a significant positive correlation between NPLs and the overall SDI. In Europe and the Americas, NPLs are positively correlated with SDI. Conversely, there are negative correlations between NPLs and SDG3 and SDG7 in Africa and Europe, and a negative correlation with SDG10 in Europe. In the Americas, NPLs show positive correlations with SDG4 and SDG7, while in Africa and the Americas, NPLs are positively linked to SDG10. |
| Bank-firm relationships and corporate ESG greenwashing | Hongyu (2025) | Chinese banks | Qualitative | To examine how bank shareholding and executives with banking backgrounds influence corporate greenwashing among Chinese A-share listed firms (2010–2023) | Bank relationships increase greenwashing. Executive banking backgrounds also raise greenwashing. Executive pay mediates the effect. Financialization amplifies it, while disclosure tone mitigates the impact. |
| Corruption in least developed countries and ESG (responsible) investment: Standard Chartered Bank in Nepal | Gocher et al. (2024) | SCB Nepal | Qualitative; Interpretivist; Inductive | Examine SCB Nepal's responsible investment practices and their spillover impact on Nepal's banking industry | SCB Nepal served as a change agent by promoting compliance, training, and competition; leading to positive spillovers for local banks; however, challenges persist due to weak institutions. |

| Title | Authors | Sample | Methodology | Objective | Key Findings |
|---|-----------------------------|--|--|--|---|
| Do ESG scores affect bank risk taking and value? Evidence from European banks | Tommaso and Thornton (2020) | 81 EU banks, | Quantitative | Assess whether ESG improves stability (reduces risk) and value | ESG reduces risk-taking but decreases overall value; has an indirect positive effect through reduced risk, but the direct negative effect outweighs it; governance traits amplify these effects. |
| Does environmental, social, and governance performance mitigate earnings management practices? Evidence from US commercial banks | Kolsi et al. (2023) | 1763 bank-year observations, 394 US commercial banks, 2010–2019 | Quantitative, econometric | To test whether higher ESG performance reduces earnings management in banks | ESG score limits discretionary LLP manipulation; Social and Governance pillars restrict EM; Environmental pillar is insignificant; ESG is not effective for loss avoidance in EM. |
| ESG and reputation: The case of sanctioned Italian banks | Murè et al. (2021) | 13 Italian banks (2008–2018) | Quantitative | Investigate link between ESG adoption and reputational risk mitigation in sanctioned banks | ESG scores tend to rise following sanctions, as banks adopt ESG strategies to rebuild their reputation. The causality runs from sanctions to ESG improvements, not vice versa. |
| Measuring banks' sustainability performances: The BESGI score | Ielasi et al. (2023) | 111 of 114 ECB-supervised "significant institutions"; 2017–2019 (EU banks) | Quantitative index construction + exploratory determinants | Develop and demonstrate a robust, publicly replicable sustainability score for banks | The average BESGI increased from 2017 to 2019, with the highest score in environmental aspects and the lowest in social (community) aspects. Transparency and governance have improved over this period. Larger and better-capitalized banks tend to have higher BESGI scores. RWA density is negative, indicating a decline. Indicators such as branch and ATM penetration, Voice, and Accountability show positive trends. However, the biggest remaining gap is in indirect-impact disclosure. |

| Title | Authors | Sample | Methodology | Objective | Key Findings |
|--|-------------------------|---|---------------------------|---|---|
| Role of Banking Sector Towards Sustainable Finance: A Case of State Bank of India | Bhat and Karanth (2024) | State bank of India (2017–2023) | Qualitative / Descriptive | To examine the role of SBI in advancing sustainable finance through green products, policies, CSR and financial inclusion | SBI finances renewable energy projects, aligns its loan portfolio with SDGs, promotes CSR and inclusion initiatives, reduces NPLs, and integrates ESG into risk management. It has a significant CSR reach, benefiting 5.4 million people and conducting over 200,000 literacy camps. |
| Sustainability in Banking: Integrating ESG into Business Strategy | Chandran et al. (2024) | 20+ Indian commercial banks, 2015–2022 | Quantitative | To evaluate whether ESG adoption strengthens banking business strategies | ESG adoption significantly boosts ROA, ROE, and stock performance; governance and disclosure strengthen the connection. |
| Factors Affecting Quality of Sustainability Reporting: Evidence from Banking Industry in Sri Lanka | Darshi et al. (2023) | 10 domestic private commercial banks in Sri Lanka | Quantitative | To assess how firm-level factors (size, profitability, leverage, committees) affect SR quality | Firm size and sustainability committee have a positive effect, while leverage and profitability have a negative effect. The R ² value of 0.34 indicates that 34% of the variance in SR quality is explained by these factors. |
| ESG Reporting of Commercial Banks in Poland in the Aspect of the New Requirements of the Directive on Corporate Reporting in the Field of Sustainable Development (CSRD) | Flejszman et al. (2024) | 10 largest Polish commercial banks (2020–2022) | Qualitative / Descriptive | To identify reporting gaps of banks vs. CSRD requirements | Polish banks disclose ESG information, but scope and quality vary; weak on double materiality and forward-looking data; notable gaps compared to CSRD/ESRS standards. |
| The Relationship between ESG Scores and Firm-Specific Risk of Eurozone Banks | Izcan and Bektas (2022) | 31 Eurozone banks, 471 firm-year obs. (2002–2019) | Quantitative, econometric | To assess how ESG affects idiosyncratic bank risk across different risk levels | ESG is negatively related to idiosyncratic risk at medium and high risk quantiles; governance and environmental factors reduce risk, while social factors are not significant. |

| Title | Authors | Sample | Methodology | Objective | Key Findings |
|---|---------------------------|-------------------|---------------------------------|---|--|
| ESG Integration in the Banking Sector: Navigating Regulatory Frameworks and Strategic Challenges for Financial Institutions | Menicucci (2025) | EU & global banks | Conceptual + empirical examples | To provide a holistic guide for banks, regulators and researchers on ESG risk frameworks and institutional implementation | Details on EU ESG risk mapping (following EBA guidance), double materiality frameworks, and models for strategic institutional readiness. |
| Is sustainability reporting (ESG) associated with performance? Evidence from the European banking sector | Hummel and Schlick (2016) | European banks | Quantitative | To reconcile voluntary disclosure theory and legitimacy theory via ESG disclosure quality | High-quality strong performers use sustainability disclosure, while weak performers rely on low-quality disclosure for legitimacy. Quality outweighs quantity. |

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