



POINT OF VIEW

Drivers and Strategies for the Shift to ESG



DRIVERS AND STRATEGIES FOR THE SHIFT TO ESG

COVID-19 proved that the economy, the environment, physical health and social stability are all intertwined. As a result, financial institutions (FIs) are increasingly evaluating not only the risk, but also the societal impact of their portfolios and businesses. In fact, 75 percent of 2,130 clients surveyed around the world by the CIO of Deutsche Bank said investments should have a positive impact and 57 percent said the pandemic contributed to that view.¹ As companies are now expected to have a positive social impact in addition to being financially profitable, environmental, social and governance (ESG) has been the center of global conversation around corporate responsibility and quantifiable change.

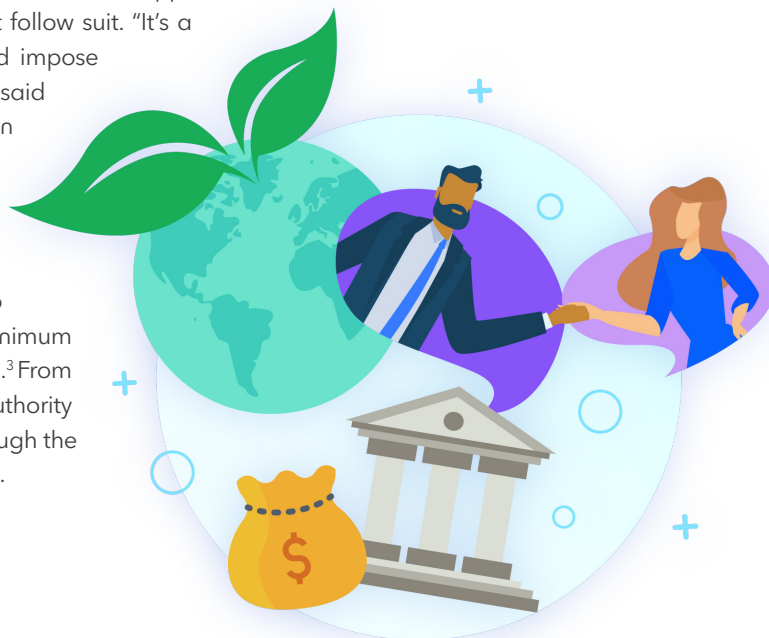
ESG is a set of standards for company operations that investors use to screen potential investments and includes three key components:

- **Environmental:** the company impact on the environment. Examples include the company's carbon footprint and resource depletion.
- **Social:** how an institution manages relationships with employees, suppliers, customers and even the communities where it operates. This includes everything from racial diversity, LGBTQ+ equality, working conditions, health and safety and more.
- **Governance:** company leadership, executive pay, audits, internal controls and shareholder rights.

DRIVING FORCES FOR ESG

Regulatory efforts to quantify change and government agreements around ESG have spurred global dialogue and action around corporate responsibility. The European Union (EU) is leading with measures including the Sustainable Finance Disclosure Regulation (SFDR), which is broadly aimed at ensuring financial market participants and their advisors identify and publish information about how they account for sustainability risks in their decision-making. While the SFDR applies to companies in Europe, it is highly likely other countries will adopt follow suit. "It's a virtual certainty that the SEC will follow the European lead and impose enhanced ESG disclosure requirements on public companies," said Brad Karp, a chairman of the law firm Paul, Weiss, Rifkind, Wharton & Garrison LLP during a recent virtual meeting on ESG.²

In the US, there are also pending shareholder suits regarding board and management diversity that will likely spur board regulation at the state level, with California being the first state to require public companies headquartered in California to have a minimum number of female directors or face sanctions, set to increase in 2021.³ From an Australian standpoint, the Australian Prudential Regulation Authority (APR) has initiated guidance of climate-related financial risks, though the push for ESG reporting and disclosure is largely driven by investors.



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FIs face pressure from their shareholders, who are actively calling for ESG changes for both social and fiscal reasons. A recent study from the Harvard Law School Forum on Corporate Governance found that companies with a higher ESG score were associated with higher profitability and lower volatility.⁴ By integrating ESG into business strategy, FIs can enhance their performance and differentiate themselves with a strategic sustainable position.⁵

Above all, companies are faced with high societal expectations. Reputational risk will be impacted should they not comply with ESG standards. FIs are expected to be good stewards of the environment and care about the wellbeing of the local communities they serve, and as such, ESG is a positive way of ensuring these values are carried out. JPMorgan Chase has committed to facilitating more than \$2.5 trillion over the next ten years to address climate change and contribute to sustainable development, including \$1 trillion for green initiatives.⁶ Several companies have also committed to achieving carbon neutrality using a net zero approach, including Barclays and AIB. In Australia, some of the largest banks are expanding their sustainable finance teams. For example, Commonwealth Bank of Australia recently doubled the size of its sustainable division while Australia and New Zealand Banking Group grew its division to fourteen people.⁷ Beyond individual initiatives, Australia's four major banks have aligned with insurers and superannuation funds to form the "Australian Sustainable Finance Initiative," which focuses on all issues covered by ESG investment criteria including poor labor standards and executive remuneration.⁸

Along with the larger banks, ESG is also proving to be a priority across all asset sizes, even though the strategies may look different. Rather than copy and pasting Tier 1 strategies, smaller organizations are prioritizing what's most important to their individual business goals and stakeholders. In fact, community banks often have the social and governance aspects covered better than most industries since they are heavily regulated, and while they are just beginning to assess the environmental risks, they are quickly gaining traction.⁹ Glacier Bancorp developed a community and social responsibility report, along with other governance documents such as its code of ethics, to be available on the investor relations page of its website to lift its ESG score.¹⁰ Regardless of asset size, climate and ESG issues are coming to the forefront of executive agendas. In fact, 60 percent of global CEOs now plan to change their long-term investments in sustainability and ESG initiatives over the next three years, as a result of the COVID-19 crisis.¹¹ In order to create a true impact, committed leaders must connect their ESG initiatives with their organization's goals and the right technological resources.

ALIGNING STRATEGY WITH TECHNOLOGY

While it is clear many companies are eager to keep pace with the expectations of their customers, employees, and the community, many FIs face technological limitations. Though 54 percent of small and medium-sized enterprises regard climate change as the main ESG issue in their business, only 26 percent have a dedicated ESG strategy.¹² Therefore, many institutions are turning to technology partners to aid them with the tools needed to gather the data for performance tracking, benchmarking, stress testing and developing a credit risk methodology. Tools are also needed for reporting on the performance on the ESG goals and commitments set as well as embedding ESG strategy throughout the organization. For most banks, ESG began in a single department and needs to be scaled across the organization. Therefore, setting goals is only half the battle – institutions must also consider how their digital roadmap and implementation aligns with their ESG goals.

Companies around the world are facing environmental and social pressure with high expectations to serve their stakeholders and shareholders alike. Beyond regulation and penalization concerns, FIs must understand the mutual dependencies between financially sound investment, ESG goals and societal goals to recognize the full potential of ESG investing. While FIs are expected to provide higher levels of transparency and auditability for decisions, proper data management must be driven by kinder and more humane lending. Oxford academic Ludovic Phalippou points out that ESG should not be viewed as a route to superior financial performance, but the fulfillment of a moral imperative.¹³

As institutions continue to evaluate their ESG goals and strategies for assessing risk, gathering data and reporting on performance, they must recognize that ESG is not only meant to contribute to the financial return on the portfolio but the long-term health and stability of the market as whole.

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FOOTNOTES

- 1 https://www.db.com/news/detail/20210519-pandemic-prompts-private-banking-clients-to-turn-to-esg-for-positive-impact-and-risk-management-survey-finds?language_id=1
- 2 <https://www.wsj.com/articles/companies-brace-themselves-for-new-esg-regulations-under-biden-11610719200>
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- 4 <https://corpgov.law.harvard.edu/2020/01/14/esg-matters/>
- 5 https://www.ey.com/en_us/board-matters/five-ways-boards-can-unlock-esg-s-strategic-value
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- 7 <https://www.bloomberg.com/news/articles/2021-04-20/australia-s-top-banks-step-up-hiring-in-sustainable-finance-push>
- 8 <https://www.afr.com/companies/financial-services/big-four-banks-form-climate-investment-initiative-20190324-p5172j>
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- 13 <https://www.ft.com/content/f794162c-3e45-4078-a7be-2e34fea5dd37>