APAC AND THE NEW ESG

- Tomorrow's economy is taking shape. Regulators and governments will continue to play a critical role in driving ESG outcomes. In addition, clients, investors and wider society are all making decisions based on ESG criteria.
- Most financial institutions (FIs) have made ambitious commitments to reach net zero financed emissions. The next step will be for senior management to deploy appropriate tools to measure and manage financed emissions. These changes are likely to have a profound impact on client relationships.
- New financing opportunities and client relationships should be considered through a wider lens as opposed to making decisions solely based on bottom-line impact. The multi-faceted nature of ESG objectives can raise potential pitfalls for unprepared FIs.
- Stakeholder expectations on the 'Social' role of both FIs and corporates has changed. The current view is that FIs and corporates have a central role to play in society and should act responsibly. This is a shift from a model which embraces Corporate Social Responsibility towards an expectation of Responsible Social Corporations.
- While demonstrating success on ESG goals will require a medium-long term investment in data capabilities, there is also a large amount of low hanging fruit that can bring tangible short term progress.

INTRODUCTION

Tomorrow's green economy is taking shape. ESG objectives are at the top of the agenda for almost all FIs, both in APAC and globally. Regulators and governments will continue to play a critical role in driving ESG outcomes. In addition, a diverse set of stakeholders are also helping to shape the agenda. Clients, investors and wider society are all making decisions based on ESG criteria.

This article considers the current trends and challenges for corporate banks by exploring:

- The path to reaching net zero financed emissions;
- Managing external stakeholder perceptions by aligning communications, values and actions.

The article then considers the internal changes needed for an FI to embrace the shift from Corporate Social Responsibility to being a Socially Responsible Corporate, as well as considering the way forward for FIs.

Much of this is unchartered territory for FIs. Measuring carbon emissions and understanding a client's performance against a broad range of ESG expectations is not within FIs' traditional remit.

Data is, as ever, essential. Successfully navigating the changes ahead will require difficult decisions be made. While such decisions will never wholly be based on the output of an analytics model, data is nonetheless a critical element to support and guide decision makers on their path towards a greener, more sustainable future.

NET ZERO

In recent years we have seen a tipping point in attitudes to the environment. Governments, corporations and even oil companies have publicly committed to achieving net zero carbon emissions on challenging timelines.

While the Paris Agreement and related net zero commitments are sometimes criticised for being vague and lacking details, it is also argued that this non-proscriptive approach is a key strength of the commitments, as it allows each sector and each institution to carve its own path to meeting the net zero goal.

For corporate banks, there are two distinct actions which need to be achieved to reach net zero:

1. Take account of and plan a path to net zero emissions associated with an institution's own operations and supply chain;
2. Reduce financed emissions to net zero (i.e. aggregate emissions from an FI's role in providing loans, investments or financial services to clients).

Financed emissions are estimated as typically 700 times higher than an institution's own emissions[1] and rightly deserve to take priority. From a practical perspective, this should have an immediate impact on how an FI makes financing decisions. For example, an FI that provides support for a carbon intensive client to expand their operations will take an FI further away from its net zero commitment, unless appropriate mitigants are put in place. In addition, FIs are now faced with a new challenge of implementing standards to measure and monitor their financed emissions.

Recent Developments

In tackling the issue, several global banks have already committed to measuring and monitoring carbon emissions associated with their loans book. In addition, regulators are increasingly focusing on this area. China's regulators recently announced that they plan to require FIs to report the carbon footprint associated with their loans. The Hong Kong Monetary Authority (HKMA) and the International Finance Corporation co-launched the Alliance for Green Commercial Banks. The Alliance brings FIs, research institutions and technology providers together with the objective of supporting FIs in leading the transformation to green finance.

Key issues for FIs

From a practical perspective, an FIs plan to achieve net zero will need to stand up to stakeholder questions. Key questions for FIs to consider include:

- When should their financing reach 'peak carbon'?
- How can they work with long-standing clients in the ultra-high impact sectors?
- To what extent should they be involved in their clients' commitments to reduce carbon and how will this impact their model assumptions?
- What services can they offer to better support their client's needs in their time of transformation?

In answering these questions, there is an emerging consensus that data needs to be obtained directly from clients and their networks as opposed to third party sources. Working with clients to obtain this data is likely to fundamentally alter relationships and present many new challenges and opportunities.

From a data modelling perspective, FIs will need to manage their path to net zero by working with clients who are undertaking fundamental changes to their business to reduce their own emissions. For every milestone that an FI meets in the net zero journey, a client must also meet a related milestone of their own.

1. Carbon Disclosure Project – https://www.cdp.net/en/articles/media/finance-sectors-funded-emissions-over-700-times-greater-than-its-own

STAKEHOLDER PERCEPTIONS ON ALIGNMENT BETWEEN AN FI'S COMMUNICATIONS, VALUES AND ACTIONS

As FIs communicate ESG values, there is a risk of misalignment between public disclosures and the actions with which an FI is associated.

FIs are complex organisations, typically operating in multiple geographies and with multiple lines of business. By supporting all sectors of the economy, FIs deal with a wide range of corporations, each of which are faced with a range of their own ESG related risks. FIs should be aware of how to manage clients that encounter issues that are inconsistent with an FIs own values.

Some practical illustrations of challenges are set out below.

- **The complexity of ESG values and trade-offs**
  Identifying good sustainability standards across a range of industries is challenging. Assigning one raw material with a sustainability score and comparing it to another raw material is significantly more difficult than it may sound. Considering additional ESG factors further complicates matters. For example:

1. To what extent should an FI support a manufacturer that excels in the use of sustainable raw materials but falls short on ethical working standards or fails to meet basic Diversity and Inclusion goals?
2. Should an FI deploy bright line tests or is a case-by-case analysis the way to go?

   Regardless of the answers to these questions, FIs should be prepared to face more discerning stakeholders as well as increasing scrutiny from regulators and activists.

- **Consistency across locations and lines of business**
  Stakeholders view some ESG matters, such as carbon emissions, as having global applicability. In this context, NGO and transparency groups are actively reporting on the extent to which a business's balance sheet is covered by carbon measuring disclosures. Providing in-depth disclosures for some business units but failing to explain why other business units are not providing disclosures is likely to attract attention.

  As carbon reporting continues to develop and refine, FIs should consider client provided data on carbon with reference to a client's operations that are not subject to disclosure. Activist groups may continue to uncover clients that 're-book' carbon by attributing existing emissions to a business unit which is not subject to disclosure.

- **Managing sensitive topics and regions**
  Some sectoral activities in some regions should be considered high risk when it comes to specific ESG goals, such as basic ethical working conditions.

  Multinational corporations are continuing to dig deeper into their supply chains and discover more about their own networks. In doing so, FIs should be prepared for issues to arise with their clients that will challenge their own ESG values. Knowing how to act and communicate before an incident manifests can prevent unnecessary issues.

FROM CORPORATE SOCIAL RESPONSIBILITY (CSR) TO RESPONSIBLE SOCIAL CORPORATIONS[2]

New ESG expectations are not limited to interactions between FIs and their clients. The shift in expectations is also having an impact on FIs' own operations and their role within society.

For many FIs, CSR functions were at the centre of some key social changes, such as improvements to Diversity and Inclusion, as well as the wider role that corporates can play in society. In this respect, the CSR function can be seen as the forerunner to some important elements of the ESG movement. On the other hand however, CSR functions have been traditionally viewed as a siloed channel for FIs to 'give something back to society'.

Across both financial services and the wider economy, there has been a fundamental change in expectations for FIs and businesses. The 2019 Business Roundtable provided an illustration of this change in expectations when 181 CEOs signed a declaration at the stating that they would lead their corporation for the benefit of all 'stakeholders' (meaning customers, employees, suppliers, communities and shareholders). Since then, the World Economic Forum and the Davos conference have both notably embraced the term 'stakeholder capitalism'.

Why does this matter?

FIs are now expected to be aware of their role in society and how they are impacting all stakeholders. 'Bottom-line' impact is no longer the only measure of success for management actions.

We see two key steps to managing increased stakeholder expectations:

1. **Communicating clear ESG priorities**
   Allowing stakeholders to understand what your FI sees as important can provide a base for future disclosures. Values differ across geographies. Showing which values an FI is putting at the top of their list is important.

2. **Defining appropriate metrics to monitor progress on ESG priorities**
   It is not simply defining the metrics that will be reported, it is also the metrics that need to be managed in order to achieve the right results.

This means that ESG values and metrics need to be set in a consistent manner across multiple business units and a consistent approach developed to manage and monitor data needed for disclosures. Setting clear ESG priorities is a first step to becoming a Socially Responsible Corporation. Providing transparent disclosures on actions taken to achieve those goals is the key next step to building trust with all stakeholders.

2. Ex-Unilever CEO and UN advisor Paul Polman coined the term "Responsible Social Corporations".

WHAT IS THE WAY FORWARD?

Our view is that FIs need to adopt a two-pronged approach.

Firstly, having a coherent ESG data strategy is critical. FIs will need to source, manage and analyse data to provide insights on:

- Understanding the environmental impact of their clients' operations;
- Tracking progress against new ESG KPIs;
- Provide stakeholder disclosures on actions taken that are supported by objective data.

While there is an immediate need to make progress on developing a data strategy, there are also very real challenges in this area. Developing the analytics capability to accurately monitor and measure financed carbon emissions, as well as the other ESG goals, is likely to be a multi-year journey.

Secondly, FIs should recognise that there are a range of actions which they can take in the short-term. Establishing that an FI has achieved net zero will require reliable and auditable data analytics. However, making progress towards that goal can happen in parallel to establishing an appropriate data strategy. There are a range of actions and transparent disclosures that FIs can provide to stakeholders which demonstrate real commitment to their net zero and other ESG goals, even in the absence of perfect data.

MEETING THE CHALLENGE

Management choices in this 'decisive decade' will be challenging. The scale of the transition to meet net zero commitments is enormous, with John Kerry, US Special Presidential Envoy for Climate, noting that meeting the objectives will involve the "biggest economic transformation since the industrial revolution".[3] In addition, there are increasing expectations regarding broader ESG goals. Putting in place the structures, platforms and tools to support the challenging decisions will be critical to support future decision making.

The challenges with emerging ESG trends follow familiar trends for many FIs. Ambitious objectives have been communicated to stakeholders, key responsibilities have been assigned and plans on how to best use data from a fragmented, complex data landscape are being developed.

However, the task at hand should not be underestimated. Many FIs will know from experience how challenging it can be to manage data in a manner which can be turned into insightful analytics in a useful timeframe. By focussing attention on the challenge now, data can be turned into a major asset for supporting ESG decisions.

3. https://news.un.org/en/tags/john-kerry/date/2021-04

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