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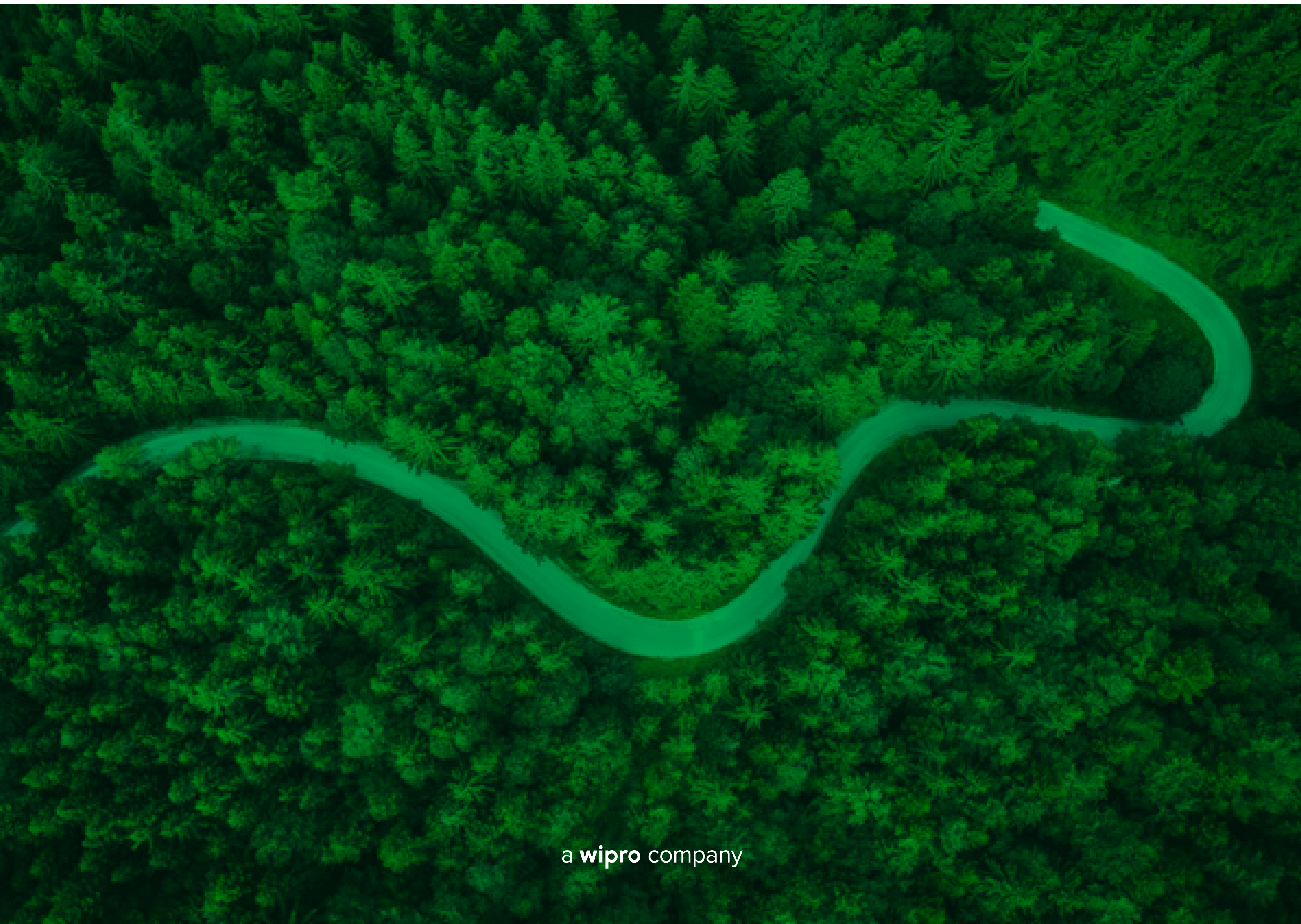
MANAGING RISK AND CAPTURING VALUE

A LOOK AT CANADIAN ESG TRENDS FOR 2022



INTRO

The focus is squarely on Canada's financial institutions to act as wardens of environmental, social, and governance responsibilities in the Canadian economy – a multi-pronged challenge that encompasses both the need to manage risk and capture value as the market comes to terms with the new ESG realities.

Before Europeans first crossed the Atlantic in the 16th century, indigenous people were operating an expansive trade network to exchange goods derived from the land we now call Canada. As Europeans arrived on the continent, explorers and settlers worked the water and land to develop a prosperous fishing industry and a vast fur trade network. As Canada's mining, agriculture, and energy sectors subsequently grew, natural resources became the nation's bedrock, and Canadian businesses drew heavily upon those resources to produce goods, draw investment, and trade as they built themselves up. Today, Canada's natural resources generate revenue of more than $250 billion and the country is known for exporting these commodities around the world.[2]

As Canadians increasingly recognize the undesired consequences arising from these historical structures, especially on the environment and the indigenous people, they look to the nation's largest organizations to mend the wounds. Pressure – from the private sector, government, and consumers – has consequently mounted on financial institutions to become wardens of environmental, social, and governance responsibilities within the Canadian economy. To rise to this challenge, the efforts of FIs in respect of these ESG considerations will need to be multi-pronged, both to manage risk and capture value as the market settles into its new realities.

Below, we set out Capco's view on the E, S, and G issues and priorities for Canadian financial institutions in 2022.

I. THE E-NVIRONMENT: TIME TO ACT

Financial institutions were front and center at last year's United Nations Climate Change Conference (COP26). The signing of the Glasgow Financial Alliance for Net Zero agreement (GFANZ) launched a global effort amongst leading financial institutions to go green. The pledge, signed by all big five banks in Canada, sets them on course to reach Net Zero financed emissions by 2050. With the goal now set, Canadian financial institutions need to begin charting their course.

As economies transition to Net Zero, Canada, a commodities exporter, is particularly exposed.[3] Our energy markets will transform drastically over the coming decades as renewable energy production overtakes the fossil fuel sector. While the Canadian government has not established environmental disclosure requirements, increasing pressure is surfacing outside of EU starting with SEC in USA publishing draft ESG disclosure guidelines. This will have high impact on most Canadian banks due to their sizable operations in the US. Domestically, we expect Canadian government to follow suit and policy to be penned soon.

Canada needs to go green

Canadian businesses will need to reassess their capital structures to align with the transformation in energy markets. Expanding current risk frameworks to include and promote the importance of environmental risks is a good first step. Those who build these capabilities earliest will be best prepared to manage changing asset values and incoming policy requirements. Given this level of uncertainty, Canadian financial institutions should adopt an iterative approach, so they are adaptable to policy and market changes. Teams should embrace a fail-fast and learn-faster philosophy to deliver small, consistent wins on the road to developing their environmental assessment and reporting capabilities. FIs will also need to have an eye on the wider 'E' in ESG, rather than just focusing on climate risk. With the March 2022 publication of the Taskforce on Nature-related Financial Disclosures (TNFD) Beta Framework, the direction of travel is moving towards holistic integration of climate, nature, and biodiversity, rather than just those components individually.

Sustainable transparent products will continue to grow

New ESG product offerings will continue to grow. Globally, investors – both institutional and retail – want banks to deliver more transparent and responsible products. In the first month of 2022, we witnessed a record month of 37 new ETF launches in Canada, with over half of the products as part of the ESG umbrella.[4]
All major Canadian financial institutions now offer at minimum one sustainability fund. In the next five years, ESG funds are on pace to make-up a third of global assets under management.[5] Not to be outdone, the Canadian government plans to launch a sovereign Green Bond this year.

We expect funds' pursuit of ESG strategies to be a driver of sustained growth in the investment product space. Financial institutions' ability to track sustainability factors through superior data and reporting capabilities will deliver a modern investing experience aligned to consumer preferences. As disclosure requirements are defined and tightened, these capabilities will move from a product feature to a regulatory obligation. Banks who invest in their data capabilities will limit their operational disruptions, sustain trust with their clients, and ultimately maintain their competitive advantage as leaders in the ESG space.

Don't start from scratch

If Canadian financial institutions face a long road ahead, they need not travel it alone. Firms can kickstart their green initiatives by leveraging their domestic and international networks. The Canadian government has launched the Sustainable Finance Council which will develop infrastructure necessary for a well-functioning sustainable finance market in Canada. Financial institutions can collaborate by participating in studies run by the likes of the Bank of Canada and the Office of the Superintendent of Financial Institutions (OSFI).

Firms would also be wise to seek learnings from adjacent European banks who are years ahead given their work to align with EU ESG policies. In tandem, policymakers can use their power as an accelerator for ESG maturity. Defining requirements for climate-related risks disclosures and financial statement metrics will force financial institutions to act. Such a blend of domestic collaboration, foreign experience, and official policy mandates will be instrumental – providing playbooks and battle-tested knowledge –in setting the direction for Canadian financial institutions to pursue their sustainability efforts.

II. THE S-OCIAL: THINKING LONG-TERM

Companies, for better or worse, are active players in the social arena. Investors and consumers are holding companies to an increasingly high standard, and their influence and effect are significant. The continued depressed state of Spotify's share price – still down 25% since the Joe Rogan podcast controversy in early February – highlights the link between social and financial factors. As we move through 2022, Canada's financial institutions will need to consider this dynamic more seriously and think broadly about their own role in pursuing and fostering a more equal and inclusive society.

Redefining your purpose

Financial institutions must focus long-term on the S. To deliver on their broader objectives, they need to build toward their social goals thoughtfully and with purpose, understanding that gradual deliberate action is more valuable than 'knee-jerk' reactions. They need to strike the balance between upholding a greater purpose and the pursuit of financial value – these need not be separate endeavors and can be united by a purpose statement that recognizes the expectations of a broader set of stakeholders than just their shareholders.

Using this as a North Star, financial institutions can build an ecosystem of like-minded organizations that are motivated to affect change across a shared set of goals. From a distribution network perspective, a robust partnership assessment program focusing on diversity and sustainability should be integrated. In 2019, Canadian grocers were exposed as indirect participants in child labour in respect of over $3 billion worth of grocery imports,[6] highlighting the importance of supply chain audits to identify any irresponsible downstream business practices. Beyond strengthening existing relationships, this could be key a differentiator that would allow financial institutions to partner with the right organisations and attract new clients.

Humanizing banks

As Canada emerges from COVID, financial institutions need to take an active role to support humanitarian causes beyond those associated to the pandemic, never underestimating their ability to affect change using their infrastructure, services, and products. Financial institutions can leverage their vast networks to provide stability to crises, both domestically and abroad, such as last year's floods in British Columbia and the ongoing crisis in Ukraine. Internally, they must also act proactively to assess their existing social risks, including defining their own social risk appetite and reaffirming red lines across sectors and counterparties.

Social movements bare their teeth and come to the boil quickly, and financial institutions need to address their social risks in a proactive fashion, objectively assessing their current social realities and exposures, closely monitoring social norms and beliefs, and minimizing reputational gaps by uplifting current practices to meet expectations. To affect this successfully, organizations must coordinate across geographies, lines of business, and functions to ensure one group's actions are not out of alignment with the rest of the business – a local misstep that will quickly erode an established global reputation. Externally, financial institutions can begin by scrutinizing their current investment positions and relationships from a social perspective is necessary to understand their risk exposure holistically. Adopting this lens on risks is a powerful response to hold organizations accountable to social causes.

Extending Canada's economic inclusion

Market trends have opened the door to developing socially aligned products. Historically low interest rates and a growing investor appetite for non-traditional financing have meant an expansion of capital access to more Canadians. While interest rates are expected to increase over the coming years, the cost of capital remains low, meaning financing is more affordable than ever. Financial institutions can launch new products, such as microfinancing and microinsurance, to provide support to vulnerable populations. By doing so, they are investing in economic mobility and building new relationships with an emerging demographic. Certain organizations have made strides in this direction, offering products and services to improve financial security of historically underserved populations and incorporating them into a broader sustainability strategy.[7] Similar opportunities should be explored specific to indigenous and aboriginal banking in Canada. Relationships, such as these, are an attractive source of growth while also delivering economic resilience to the Canadian population.

With great power comes great responsibility

It must be acknowledged that stepping into the social arena brings significant responsibility. Financial institutions need to be aware that, in expanding their role beyond the pursuit of shareholder value, they are using their significant reach and influence to promote social values. Accordingly, the onus is on recognizing all stakeholders equally. A financial institution's platform is a powerful one, and should be calibrated to ensure all voices, not just those of Canadian's largest corporations, are heard.

III. THE G-OVERNANCE: EMBEDDING AND ELEVATING ESG

Integrating ESG into performance metrics, decision making, and risk frameworks across the entire operating model is critical to any holistic, balanced approach to corporate responsibility. Financial institutions can start this process by taking a top-down approach: defining their environmental and social ambitions, setting their goals, building the capabilities needed to meet those goals, reporting their current performance against their objectives, and acting to close the gap if it exists.

If you can't measure it, you can't manage it

The elephant in the ESG room is data. While some ESG data is available, the quality of metrics and varying data standards remain a perennial problem. Intelligent oversight is fundamentally linked to data – without it, decision making is underpinned by nothing but opinion. Organizations therefore need to strengthen their data sourcing, aggregation, and analytics capabilities. Today, the data they need – whether relating to assets that are traded or financed, to companies within supply chains, or to firms' own clients – is too often incomplete, contradictory, or even non-existent.

While financial institutions can build enhanced data capabilities internally, we expect companies providing ESG data services and products to establish themselves as critical business partners in the coming years. By building a data pipeline that delivers cross-industry consistency and verifiable, actionable insights, organizations will be equipped with the information they need to take tangible steps towards meeting their ESG goals.

The green workforce

Canada's workforce is going green. RBC projects that in the next 10 years nearly 400,000 new jobs will be added as Canada demands more "green-skills."[8] Few organizations have the expertise and resources available to build their ESG capabilities at pace or scale. Failure to address this gap may prove just as prohibitive as any technology and data shortcomings. Financial institutions can develop green skills in Canada by partnering with educational institutions to establish sustainability departments, investing in their workforce by offering training opportunities to "green-skill," and implement a strong recruiting drive to attract talent within our borders and internationally.

As the newly-established Institute of Sustainable Finance at Queens University demonstrates, universities are now mixing business, science, and technology with sustainability – a distinct shift from previously positioning sustainability as a stand-alone discipline. The message is clear – few jobs will be untouched by the ESG trend. To modernize their business, financial institutions need to invest in their people with the same enthusiasm as they do their technology.

Raise your voice

ESG cannot be a separate silo within organizations. Setting targets and building data capabilities is just the beginning. Embedding ESG factors into decision making, risk assessments, and performance assessments will elevate the importance of ESG across all business operations. Banks and insurers have already begun introducing ESG targets as part of executive compensation strategies and the expectation is that this will come to apply to all levels within organisational hierarchies. By giving their ESG priorities greater importance, financial institutions will motivate their teams to attain sustainability targets and deliver a strong message externally that ESG performance is an integral part of doing business.

IV. SUMMARY

Millennial and Gen Z investors are set to become the largest asset owners globally over the next decade, and three out of four of them are now considering ESG factors when making an investment decision.[9] Short-term solutions like carbon offset initiatives, let alone straight up 'greenwashing,' will no longer satisfy investor, consumer, or government appetite for substantive action. Organizations need to ready themselves for action, focus on the long-term, and embed ESG into their operations.

Canada is lagging behind other countries and the time to act is now. The longer we wait, the more vulnerable organizations and the overall economy will be, especially when it comes to climate risks.[10]

How Capco can help facilitate your ESG journey

At Capco, we leverage our global team to complement our creative thinking to provide solutions for our clients. Our global coverage provides expertise and lessons from existing global ESG guideline implementations; including benchmarking, identify opportunity & visions, and target developments. Coupled with our local experience with risk management and data solution implementations, including reporting and disclosure - Capco is uniquely positioned to help your firm tackle the imminent ESG challenges.
If you are interested in learning more about our take on ESG, how our data capabilities and risk expertise are helping our clients make a difference, please contact us at **Ian.Lee@capco.com.**

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ABOUT CAPCO

Capco, a Wipro company, is a global technology and management consultancy specializing in driving digital transformation in the financial services industry. With a growing client portfolio comprising of over 100 global organizations, Capco operates at the intersection of business and technology by combining innovative thinking with unrivalled industry knowledge to deliver end-to-end data-driven solutions and fast-track digital initiatives for banking and payments, capital markets, wealth and asset management, insurance, and the energy sector. Capco's cutting-edge ingenuity is brought to life through its Innovation Labs and award-winning Be Yourself At Work culture and diverse talent.

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