ESG CHALLENGES AND OPPORTUNITIES

CAPCO INSTITUTE-KING'S COLLEGE BUSINESS SCHOOL SEMINAR

POST-EVENT SUMMARY

Across global financial services there is a growing recognition of the scope and complexity of the evolving landscape around Environmental, Social and Governance (ESG) and its attendant realities. Climate change is accelerating, generating unpredictable physical events from windstorms to floods to wildfires on an unprecedented scale. ESG factors are reshaping investment risks on the one hand while opening the door to green financing and green technologies on the other. At the same time, financial institutions are looking to win hearts and minds by strengthening their ESG credentials while trying to ensure they do not fall foul of greenwashing accusations at the product, portfolio and brand level.

"We are at a critical juncture – or perhaps, the latest critical juncture – in financial services' ESG journey," noted **Richard Lewis, Capco Partner and Head of UK Wealth & Asset Management**, as he welcomed attendees to **ESG in Financial Services: Meeting the Challenge, Maximizing the Opportunity**, the first in a planned series of collaborations between the Capco Institute and King's Business School. "From what we see on the ground, the finance sector is coming under strain as it grapples with ESG. There are many people in the industry deeply committed to building a sustainable future for society, but there is also some growing frustration around how emerging ESG rules and policies can be made to work."

FUNDAMENTAL CHALLENGES

Overcoming those frustrations is critical if the financial services industry is to support the global economy in meeting fundamental net zero challenges and deadlines, which were set out in the seminar's opening presentation – under the banner of **'Net Zero Emissions: Business Risks and Opportunities'** – by **Samuel Fankhauser, Professor of Climate Economics and Policy and Research Director, University of Oxford.**

The fixed nature of the carbon budget underlying the Paris Agreement is such that, "if you use the budget up fast, you have to bring your usage down very quickly later on", Professor Fankhauser said, and delay will only bring more economic pain.

As much as two-thirds of fossil fuel reserves of listed companies may simply need to be written off, and one fifth of 'committed emissions' from existing fossil fuel plants and all emissions from new investment are unviable, he continued. Some industries such as surface transport (cars, trains) and electric power are progressing fast, but too many (aviation, agriculture) are lagging behind. "In the absence of a technological fix, behavioral changes will have to kick in," Professor Fankhauser said, such as a reduction in air travel and an increase in low-carbon meat-free diets.

His calculations of the amount of C02 saved by the 2000+ climate change laws passed worldwide in recent years suggest "we've made a start – but it's nowhere near enough, and we really have to accelerate," he added.

NET ZERO POSITIVES

On a more positive note, Professor Fankhauser highlighted that the carbon transition and clean tech are proving to be a major source of growth – the green sector is now similar in size to oil and gas. In the panel discussion that followed, **Simon Gadd, Group Climate Change Director at Legal & General**, noted that his firm sees carbon transition as both a risk driver and a significant investment opportunity. Pensions and annuities demand long-term fixed returns that are a great match for investing in renewables energy infrastructure, Gadd said.

Much of the global economy is still carbon intensive and needs to speed up individual green transitions. However, the panel were largely sceptical that enforced divestment is the best way to change the behavior of individual companies. Firms with the highest carbon footprints tend to be the ones that need the most encouragement to change, which requires active engagement from their shareholders and bondholders. Gadd himself argued that the focus should instead be on the trajectory of each company's emissions, making it critical that carbon monitoring and metrics are effectively set up.

Gerald Podobnik, Chief Financial Officer, Corporate Bank at Deutsche Bank, said that for banks much of the real work begins only after they have signed up to reducing financed emissions and start setting and operationalizing carbon budgets for regions, sectors and teams. "Banks need good data," he said, ideally "directly from clients, reporting in a standardized way."

"We need data standards and standardized definitions, and now is the time to double down on our efforts on these," he stressed. "We will also need to be allowed to use models for companies which fall below the reporting threshold."

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>
> **Richard Lewis, Capco**

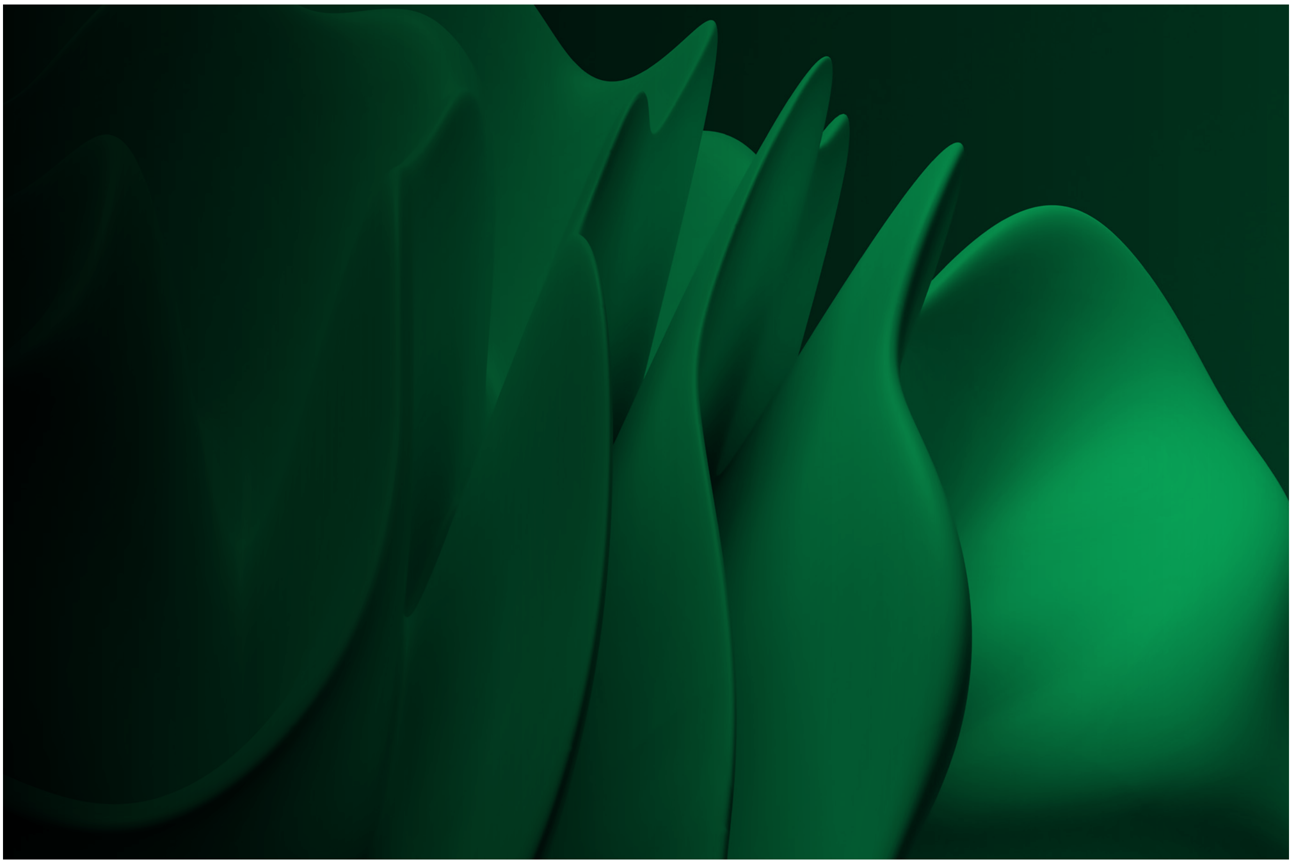
JUST TRANSITIONS

For his part, **John Scott, Head of Sustainability Risk at Zurich Insurance Group**, commented that restrictions in fossil fuel supply have to be matched by reduction in fossil fuel demand. Attention must be paid to the effectiveness of the transition plans of countries, sectors and companies in reducing fossil fuel demand, driven by an increase in the supply of green energy and changes in economic incentives such as establishing a credible carbon price and shifting subsidies away from fossil fuels. Without that we are headed for a disorderly transition, which would make life hard for the poorest in wealthy carbon-intensive economies and for the majority in emerging market economies.

A repeated theme in the discussions was the need for a socially just transition, especially given the risk of tipping points in the public and political mood if the shift away from a carbon economy is not appropriately managed. The UK's cost of living crisis has focused minds, but **Charles Sincock, Capco ESG Lead**, agreed that tensions will also play out on a bigger canvas.

"We need an orderly transition: countries around the world that are trying to get richer will insist on the energy they need to do that – so what is really fascinating is how this might change the geopolitical landscape."

Charles Sincock, Capco



SOCIAL PROGRESS

In the next session – entitled **'Bringing The 'S' Back To ESG: The Role of Organizational Context and Institutions' – Igor Filatotchev, Professor of Corporate Governance and Strategy at King's Business School** noted that "E, S, and G are not orthogonal but interrelated". Co-presenting with Chizu Nakajima from the Institute of Advanced Legal Studies at University of London, Professor Filatotchev said that – while financial institutions have for some years sought to take a more rigorous approach to issues such as living wages, diversity, supply chains, and modern slavery – "we have yet to devise metrics for evaluating 'S' impact and are still at the early stages of devising a methodology".

Introducing the session, **Amanda McCurrach, Head of People & Organization Consulting at Capco**, had touched on how the Social component of ESG can be subjective, with different stakeholders often having different priorities. At the same time, businesses and employees increasingly want to work with or for organizations that can hammer out a clear-cut stance on the social issues of the day.

Defining and managing risks objectively is easier for the Environmental component of ESG than the 'S' as it can be more clearly linked to scientific metrics or disciplines such as atmospheric science. Panellist **Gilles Moëc, Group Chief Economist at AXA**, said that – given E remains the benchmark for technical progress – there are lessons to be learned on the Social side. For example, in respect of building taxonomies, the 'E' community has successfully navigated various pragmatic compromises around divisive issues such as natural gas and nuclear energy.

Dr. Christine Chow, Global Head of Stewardship at HSBC Asset Management, added that while the focus on the Social component was at first centered on specific controversies, such as factory collapses or burst dams and thus backward looking, that focus has now expanded to encompass forward-looking preventive measures based on the identification of salient issues ahead of time, by geography and by products and services. This approach seeks to address systemic issues and create positive social value through early actions. One example is stewardship efforts to address economic inequality and the cost of living crisis in the UK and globally. She explained the rationale behind HSBC Asset Management's co-filing of a shareholder proposal for a UK supermarket. She also shared pioneering work on how technology is impacting human capital management, with areas of risk and opportunity, as outlined in a recent white paper co-authored with MacFarlanes and the London School of Economics ('Investors' Expectations: Ethical AI in Human Capital Management', April 2022).

Andrea Saldarriaga, Director for Environmental & Social Policy at Barclays noted this shift has involved a move away from a simply philanthropic social focus towards acknowledging the negative social impacts arising from a firm's own activities. Saldarriaga pointed to the continuing importance of the United Nations Guiding Principles on Business and Human Rights (UNGPs), endorsed in 2011, flagging that these principles are increasingly influencing regulation around the world.

SOFT LAWS

As investors look to identify concerning or risky 'S' factors, those factors are having a larger effect on investment markets. One particular challenge, Professor Filatotchev noted, is that while some social risk factors are formally regulated, many only fall within 'soft laws' or best practices. Furthermore, cultural norms vary across countries and regions, further undermining efforts to standardize rules in this space. For multinational corporations, implementing a single set of global Social principles can create conflicts with local practices or beliefs. This can be defused by allowing those principles to be set locally – but this can then create tensions across the wider business over what is 'right' and what is 'wrong'. Multinationals will need to balance the various pros and cons to determine the correct degree of corporate standardization, said Filatotchev.

The seminar concluded with a session entitled **'Sustainable Finance: From The Regulators To The Regulated'**, chaired by **Emily Turner, Partner, Capital Markets and UK Head of CSR & Youth Development at Capco**. Presenters **Adam Chalmers, Reader in Politics at King's College London,** and **Robyn Klingler-Vidra, Reader in Political Economy at King's College London**, provided attendees with an overview of their Corporate Sustainability Policy Database, which consists of more than 2,000 public policies, covering more than 130 countries and going back to the beginning of the 20th century. The database tracks policy dynamics, trends in sustainability terminology and, potentially, the relative success over time of different policy formulations. They presented a piece of research that analyzes trends in public policy on sustainable finance, drawing on a sub-set of the database, which finds that there has been a rise in 'E' related terminology over the last 20 years, with terms like 'green bond' and 'climate finance' rising in use while 'S' related terms, such as 'socially responsible' and 'community investing', have been less prominent in public policy between 2001 and 2021. This is just one use-case for how the database can be used to offer insight into policy trends in thematic areas, over time and across countries, and also for corporations to keep track of policies in force in the various countries in which they operate.

The inaugural Capco Institute-King's Business School seminar was held on June 28, 2022 at the King's College Bush House campus in London.

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