Focusing on ESG risks

ESG risks include environmental risk, social risk and governance risk and the resulting impact on banks' P&L and liquidity. ESG risks can affect the bank directly (e.g. storm damage to bank buildings), but also affect customers (change in sales opportunities, production disruptions, etc.) leading to, for example, higher loan defaults.

Due to the current political debates globally, the focus is currently on the environmental risks and the sub-topic of climate change. For their part, environmental risks are divided into physical risks and transition risks:

- Physical risks arise if economic activities or their value are threatened directly by failure to achieve climate-related objectives (e.g. the direct effects of climate change on the water supply of industrial companies). They can materialize as acute risks (i.e. individual, non-regular physical risk events) or as chronic risks (i.e. permanent deterioration in ESG target achievement with lasting adverse effects on own economic activities).
- Transition risks arise if the business model that economic activities are based on is permanently endangered by systemic changes and its own negative ESG impact (e.g. the effects of political measures to combat climate change and their impact on manufacturers of combustion engines).

Figure 2: Examples of ESG risks

Source: ESG risks in banks, KPMG International, 2021

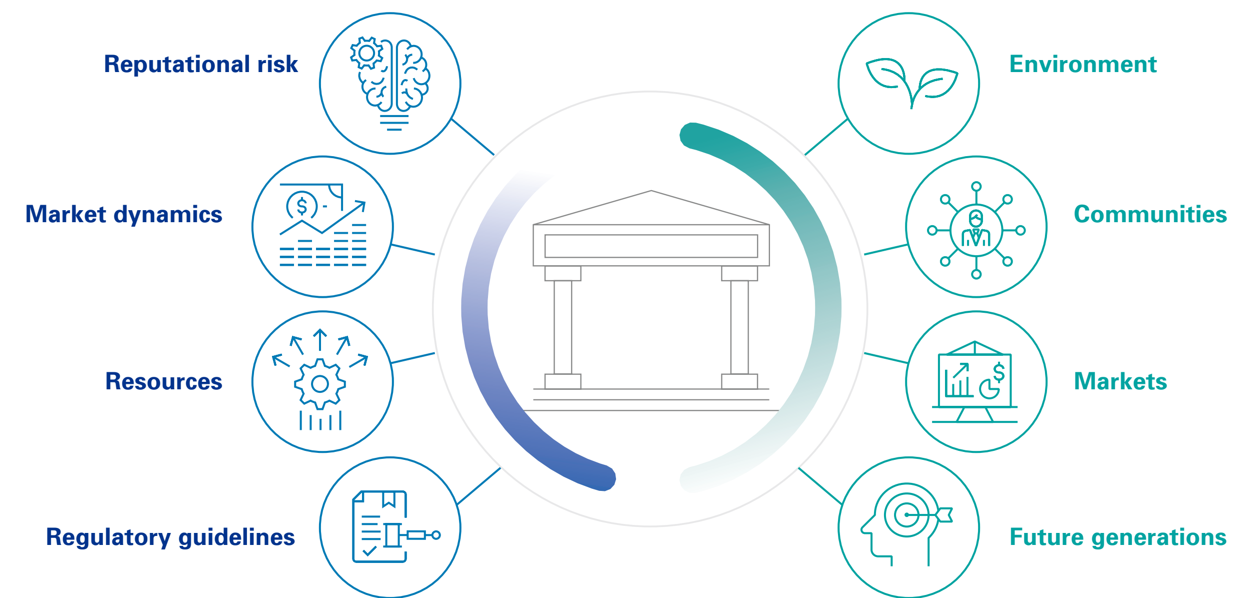

Figure 2b: Dependencies and influences of ESG developments
Source: ESG risks in banks, KPMG International, 2021

Reputational risk

Outside-in effects (dependencies)

Consequences from external actual and expected ESG developments on business

Influencers:

— Regulatory guidelines

— Technology

— Customers

— Quality and availability of resources

— Market dynamics, etc.

Affected market participants:

— The bank itself

— Important investors and customers

Effects on:

— Current status

— Performance

— Economic prospects of success

— Reputation

— Long term viability

Inside-out effects (influence)

Possibilities for influencing the environment and society

Influence:

— Environment

— Communities

— Markets

— Future generations, etc.

In addition to their different characteristics described above, two dimensions can be distinguished regarding ESG risks, a **financial** as well as an **extra-financial** dimension:

— With regard to the financial dimension, the key questions banks must ask themselves are: "What ESG risks and opportunities does the business model of our customers and investments hold and what does this mean for our business model?"

  This dimension is closely linked with the outside-in effects of ESG, i.e. the consequences from external, current and expected ESG developments on businesses.

— In contrast, the extra-financial dimension considers the impact a bank has on the environment and society. The key question is: "What opportunities will arise from sustainable products and sustainable trading, and how can reputational risks be avoided?"

  This addresses the inside-out effect, i.e. the results of a bank's actions on environmental or societal issues.

However, once outside-in and inside-out effects have arisen and triggered further reactions, they are no longer easily distinguishable, at the latest after the occurrence of second-round effects.

Reputational risks in particular act as transmitters between customers and the bank. Inside-out effects harbor reputational risks, which in turn are expected to affect the bank. After a series of rounds of cause and effect relationships, it is no longer possible to distinguish when and where original effects were caused.

"

ESG risks include environmental risk, social risk and governance risk and the resulting impact on banks' P&L and liquidity. The specialty of the topic concerning banks/the banking sector is that **ESG risks can not only affect the bank directly** (e.g. storm damage to bank buildings), but also affect customers (change in sales opportunities, production disruptions, etc.) **leading to, for example, higher loan defaults.**

Similarities between Covid-19 and ESG risks

The current Covid-19 crisis and its impact on banks has a lot in common with ESG risks. Thus, an unexpected opportunity opens up in observing the current crisis: banks can leverage the experience with Covid-19 to better cope with future ESG risk challenges.

Banks are directly affected (akin to physical ESG risks) by Covid-19 via the following factors (among others):

— Higher sickness rates leading to a reduction in workforce

— Shutdowns in various countries, territories and states, which largely requires homeworking, leading to frictions

— Travel bans hindering international business issues with network capacity, cyber risk, and IT security

These developments are particularly effective in the operational risk areas much like ESG risks. They can also exert additional impact on reputation, in case stakeholders' expectations are not fully met even after discounting crisis-induced goodwill for some. Subsequently, business and liquidity risks are likely to surface, while demand for some banking services can decrease and customers can withdraw their deposits.

Just as with ESG risks, the strength of the impact of the changes depends heavily on the industry in which companies operate. That means banks' clients are often hit even harder by the crisis, depending on the industry segment they operate in. In addition to the points above, issues clients are facing include:

— Government orders to shut down various businesses for an undefined period (e.g. restaurants)

— Breakdown of supply chains (hitting global suppliers particularly hard)

— Massive decrease in demand (domestic and abroad)

Outside-in effects, which in turn affect banks due to the issues mentioned, can be noticeable through an increase in defaults. These are expected to occur both in commercial as well as in retail banking, e.g. due to clients becoming unemployed. Also, an impairment of assets (including collaterals) must be expected because, for example, commercial real estate is difficult to rent in times of crisis.

Not only clients are negatively affected by the pandemic, the same can happen to outsourcing partners and suppliers of banks. In this case, services are expected to be of reduced quality or fail completely.

Finally, similar to the transition risks that are described in connection with ESG risks, governments are exerting extensive influence on people and business. Both are expected is expected to affect banks directly (e.g. if employees are put in quarantine) as well as their clients and suppliers (e.g. if additional business segments are forced to close).

The main difference between the Covid-19 crisis and ESG risks is in the relevant time frames. While ESG risks are subject to a multi-year, largely transparent planned transitions, interventions in the Covid-19 crisis are changing almost daily, with little predictability, forcing banks to adapt quickly to changing, unpredictable environments.

In the current pandemic, banks only have the option to react quickly, mostly in an ad-hoc manner. However, if they also use the crisis to investigate direct and indirect effects of external triggers, they can plan for similar transmission channels for future ESG risks.

Banks' ability to cope with the pandemic as well as with ESG risks largely depends on their level of maturity in terms of operational resilience. Frameworks for operational resilience are designed not only to preserve business continuity, but also to enable organizations to permanently adjust to changing conditions. Investing in those frameworks can pay off in multiple ways.

Banks can leverage the experience with the **pandemic** to better cope with future ESG risk challenges.