Banking on a better planet

How ESG is affecting financial services and what audit committees should be asking

By Sander Jansen

Interest in ESG was expected to wane in 2020 as all attention turned to COVID-19. But fast forward to 2021 and interest in ESG has remained remarkably strong and is gaining momentum. So far this year, we have seen several developments reflecting this increased attention to ESG with a strong focus on climate.

The U.S. has rejoined the Paris Accord and the Securities and Exchange Commission (SEC) has announced the creation of a Climate and ESG Task Force, potentially moving us one step closer to some form of mandatory ESG disclosure. In Canada, the Office of the Superintendent of Financial Institutions (OSFI) is seeking feedback on how banks, insurers and pensions are measuring climate risks and factoring them into their operations, balance sheets and risk management efforts. Most recently, in April 2021, the Glasgow Financial Alliance for Net Zero (GFANZ) was announced, bringing together 160 banks, insurers and asset owners worth $70 trillion in AUM to accelerate the transition to net zero emissions by 2050 at the latest.

Momentum for quantifying climate risks is growing and they are being recognized in loan loss provisioning (IFRS9), business valuations (A4S), and through quantifying financed emissions. As climate risk grows in significance for both external disclosures and financial statements, audit committees will want to better understand how management identifies, accounts for and discloses climate risks.

ESG is more than climate change

While climate change arguably remains the defining issue of our time, the pandemic has also increased the focus to social components of ESG, such as human capital, employee health and safety and financial security. COVID-19 has highlighted the critical role banks can play in supporting the resilience of communities. Similarly, diversity, equity and inclusion (DEI) has moved up the investor agenda. In fact, DEI is the second most common ESG issue for engagement by Canadian investors, right behind climate change. This evolution in ESG themes serves as a reminder to audit committees that they need to keep apprised of where the current and future focus of ESG is shifting. For instance, early signs indicate biodiversity and ecosystem services might be up next.

Banks as a force for good

The power of capital as a force for positive change has put banks in the spotlight to integrate ESG considerations into their business and operating models. As countries and companies around the world are committing to a low carbon economy, potentially staggering sums of money will be required to make this transition happen. The energy transition alone is expected to require $15 trillion in new power capacity, $14 trillion in grid upgrades and $1 trillion in critical energy-transition minerals between now and 2050.

Banks are perfectly placed and equipped to help fill this finance gap by redirecting capital flows to projects, technologies and companies that accelerate the transition. There's an opportunity for banks to be the capital provider of choice, with substantial fees to be earned in lending and underwriting. Sustainability-linked lending and green, social and sustainability bond issuance are on the rise. In fact, global sustainable debt issuance increased 29 per cent year-over-year in 2020 and reached an all-time high.

Banks must decide how they're going to meet the challenge and profit from the opportunity presented by a society that's transitioning away from carbon. Management and audit committees will need to ask how much 'financed emissions' the bank is currently funding and willing to fund — and whether they fully comprehend the transition risks around the bank's existing loan portfolio and new lending decisions in light of the growing trend to make mid-century net-zero commitments. They'll also want to stay apprised of the recent transition and green taxonomy developments in Canada and the EU as a filter for assessing eligible investments and lending opportunities.

Institutional investors increasingly integrating ESG

Virtually all large Canadian institutional investors now consider ESG in their investment process to varying degrees. Research suggests that ESG investing provides downside protection and is a potential source of alpha resulting from improved long-term financial performance.

There are a variety of ways that asset managers and asset owners can incorporate ESG issues into the investment process. The prevailing strategies in Canada and the U.S. include ESG integration, which refers to the process of systematically embedding ESG factors into traditional investment analysis and decision making, shareholder engagement and negative or exclusionary screening. Similarly, institutional investors are taking steps to strengthen their risk management by running scenario analysis on how their portfolios might behave under different climate warming outcomes and pathways.

As ESG investing continues to pick up pace, audit committees and management will want to ask questions around how much their fund should pivot its existing return-based asset management business to capture ESG. In the past few months, for example, there has been a dramatic increase in the number of institutional investors committing to net zero portfolios by 2050. However, fund managers must understand that as ESG becomes more prominent, so too will the scrutiny around ESG claims.

The SEC recently published a risk alert cautioning that a subset of institutional investors may be making false ESG claims that are not backed up with substance. The SEC is drawing attention to misalignment between firms' public ESG disclosures and their practices. It's imperative that once firms make ESG commitments and claims they implement the processes and systems needed to live up to those. Otherwise, they may face reputational damage and potential regulatory attention. Accordingly, audit committees will want to ensure that their company's ESG disclosures are consistent with its ESG practices.

Insurers face evolving risks

Insurers are facing the same questions around their investment portfolios but must also address ESG issues on the underwriting side. As such, their approach to ESG has a strong risk component to it, particularly regarding climate change. For instance, premiums will need to factor in the increased risk of flooding and wildfires that accompany global warming. And some insurers are working on select ESG literacy programs to help customers bring claims down. They might, for example, provide educational materials on how to reduce the risk of flooding.

ESG risk is being incorporated into their modelling, and with climate change they must incorporate new assumptions and increased sophistication. It's no longer possible to simply extrapolate past data to predict the future.

Traditional risk forecasting may need to be altered to centre on scenario analysis, and insurers will need to be more agile with their modelling to ensure they're adapting to climate change as the data dictate. Audit committees will want to ensure they thoroughly understand the assumptions being used by management and how they're being incorporated into modelling and underwriting.

ESG offers both opportunity and challenge to the financial services sector. Banks will be challenged in how they will play in the transition to a low carbon economy and address the finance gap, while benefiting from new lines of business that come with this. Investors may be able to improve performance but must ensure consistency between ESG claims and practices. And insurers must remain agile in the face of new modelling challenges brought by climate change. Audit committees have an important role to play in monitoring the changing ESG landscape and ensuring that management is adapting appropriately.

Questions audit committees should be asking

How resilient are our portfolios in the context of the moving parts around climate change and the energy transition?

Is there an appetite for us to put emission reduction targets in place, how are we setting these targets and are they credible?

How can we use our finance capabilities to be a force for good, while making good business sense?

Do our management practices and reporting keep pace with the rapid rise in business expectations surrounding Diversity, Equity and Inclusion?

Which ESG concerns are important to our stakeholders and how are these evolving?

What is the current state of ESG reporting standards and what does this mean for our own reporting and our disclosure expectations of portfolio companies?

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