ESG in everything we do

Financial institutions play a pivotal role in providing funding to combat climate change, challenge and incentivize best ESG practices, and support organizations in addressing the UN Sustainable Development Goals (UN SDGs). Fadi Alshibabi argues that ESG is no longer a choice: it is an imperative.

The banking sector is subject to mounting pressure from stakeholders and an ever-increasing list of regulations which require ESG to be considered and embedded in the way the financial institution operates. In fact, in a global survey by KPMG International in 2021, 75% of Financial Services (FS) CEOs are looking to lock in the sustainability and climate change gains made during the crisis, and 34% plan to invest more than 10% of revenues in their sustainability efforts.

As ESG becomes a critical success factor for financial institutions, there are a breadth of considerations and adjustments which may be required:

- **Understand your current baseline**
This involves much more than simply quantifying the financial risks and probabilities. Financial institutions should create an understanding of common ESG expectations of key stakeholders (including regulatory authorities) and build awareness of leading ESG practices, current expectations, and emerging areas, particularly amongst senior management and board members. This includes taking the time to understand their current practices and exposures, including whether they have the right data and technology, the right capabilities, and the right processes to monitor and manage ESG appropriately going forward.

- **Develop/optimize ESG strategies, frameworks, and products**
Once the ESG sentiment and expectations are understood, these should be used to Optimise strategies, operational frameworks, and products with an aim not only to comply but to create competitive advantage. The ESG strategies should outline the organizations' objectives, focus areas and targets and the operational frameworks should facilitate decision-making regarding who to loan to and invest in. Financial institutions are increasingly adopting the principles of responsible banking and principles of responsible investing (PRI) as outlined by the United Nations Environment Programme Finance Initiative.

- **Optimize governance frameworks**
Governance frameworks should be adapted to ensure that ESG (especially climate) is a board level consideration, ESG committees are established with the requisite climate expertise to evaluate projects and support in ESG decision making, and ESG teams are established to monitor and manage ESG within the organisation. Additionally, to ensure accountability, best practices involve including ESG in role descriptions and performance evaluations where appropriate and, at a board level, including ESG as one of the KPIs linked to directors' remuneration.

- **Risk identification and frameworks**
Many financial institutions are concerned they are ill-prepared for the types of prudential and conduct risks which could arise because of climate risk and the move to a low carbon economy. For many, ESG factors remain a reputational risk, but they need to be more than that. Financial institutions should ensure that ESG risks are a lens through which all

decisions are made, especially in relation to credit and valuation risks in their portfolios, and risk frameworks should be adapted to allow for that to occur.

— **Reporting**
With scrutiny on financial institutions (which in some jurisdictions is a regulatory requirement), many financial institutions produce reports to convey their ESG performance to the market. In most cases, this includes reporting only on their internal ESG performance, but market pressure is building to see impact investing reporting for financial institutions too, which would consolidate the ESG performance of their invested and funded assets.

— **Assurance**
With over USD 40.5 trillion[17] of global assets using ESG data to drive decisions, the need for Assurance to look to the credibility of the information being produced is becoming ever more critical. While there are few global regulations mandating Assurance, many organizations are recognizing the imperative and opting for voluntary assurance.

Wholistically incorporating ESG will not only improve the resilience of the financial institution but will also drive value for the stakeholders by providing them access to the broader pools of capital, and tangible debt pricing benefits if they can demonstrate that a positive ESG impact is delivered.

An evolving regulatory environment

Seventy-two percent of global banks[18] indicated that climate change is a financial risk which will impact their businesses in the medium to long term. International regulators are setting out expectations for stress testing and climate risk management for banks. These may include climate stress testing to identify risks, not only at an operational level, but also at a lending one to predict the balance sheet evolution and related losses over the years. Organizations will also need to build on the climate stress testing capability as the requirements become more stringent.

The search for consistency also remains a priority. The key to achieving this, and to enabling the development of reliable market data, will be standardized definitions of E, S and G, globally. Recognizing the challenges that companies are facing in making ESG disclosures, standard-setting bodies are seeking to enhance and align their approaches to corporate reporting, both financial and non-financial. The emergence of mechanisms to drive consistency, such as the WEF (World Economic Forum) stakeholder capital metrics, and the recent formation of the International Sustainability Standards Board (ISSB), is expected to drive some level of consistency over the coming years.

Within the UAE, however, the lack of formal regulation from the central bank and regulators mean that unless individual banks have links to international regulators who mandate these areas, many UAE specific financial institutions are not considering ESG (including climate) in sufficient detail. Nevertheless, with the UAE having set a net zero target and COP28 (Abu Dhabi 2023) being held within the region, there is an expectation that the competitive and regulatory landscape will significantly shift over the coming years and align to some degree with the international market. This provides UAE financial institutions the opportunity to be frontrunners in the region, securing competitive advantage.

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