Culture and people

Growing ESG commitment driven by consumers and regulators

The banking sector has been one of the leaders in the growing movement to emphasize environmental, social and governance (ESG) factors as one of the raisons d'etre for the modern organization. There are many indications to that ESG will increasingly become central to the economic equation globally, and Saudi Arabia will be no exception in the 'new reality' of the post-Covid world.

It is clear that banks across the globe now recognize that their ESG agendas are a tool for returning to prosperity, as well as a deciding factor for many would-be customers and investors. New ESG-tied products and models are being developed, tested and commercialized. Banks can no longer afford to overlook ESG and must embrace it to avoid constrained growth and increased regulatory and public scrutiny.

ESG in the Kingdom

Emblematic of the changing nature of ESG programs during the pandemic was the cancellation of Hajj in 2020. In previous years, many organizations in Saudi Arabia funded Hajj for their employees or customers – a unique aspect of ESG in the Kingdom. With this expenditure removed from their 2020 ESG budgets, organizations either diverted the funds to other ESG programs or simply spared other parts of their ESG budgets from pandemic-related cuts. Banks in Saudi Arabia have long been at the forefront of the national ESG conversation. As some of the Kingdom's most international institutions, banks have been most exposed to the global trends shaping ESG agendas, such as climate action, diversity, and the rise of the activist investor. Also, as one the world's largest oil producers, Saudi Arabia itself has a particularly important role to play in the 'E', or environment, part of the equation.

Help arrives

In Saudi Arabia, SAMA quickly stepped in to provide support to the economy as it showed signs of unraveling due to pandemic. The unprecedented financial packages, among other support measures, include support for the banking and SME sectors, an allocation to ensure that government dues to the private sector are paid in a timely manner, a wage subsidy of 60% of Saudi employees' salaries in the private sector, generous assistance to SMEs, and measures that promote continued employment despite the restrictive work environment.

SAMA's measures set a tone in the Kingdom that banks picked up on – the pandemic is a societal crisis that can only be eased through direct support to people. The stimulus packages also ensured the continued operability – and profitability – of the banking system, which may have proved instrumental in allowing banks to continue their ESG programs.

Pressure for change

Though future regulatory assistance and stimulus measures are uncertain, what is certain is that pressure from regulators, investors and the public for greater adoption of ESG will increase in the future. Regulators recognize that moving towards a low-carbon economy will create additional complexities for financial services firms. They are worried that banks are not fully for the types of prudential and conduct risks that could arise — both in terms of the direct risks (i.e. the physical impact of climate change on assets) and the transition risks (i.e. the challenges inherent in a wholesale move towards a low-carbon economy). Nonetheless, governments will prioritize the effectiveness of ESG-related regulations in reaching climate change goals over the difficulties faced by banks.

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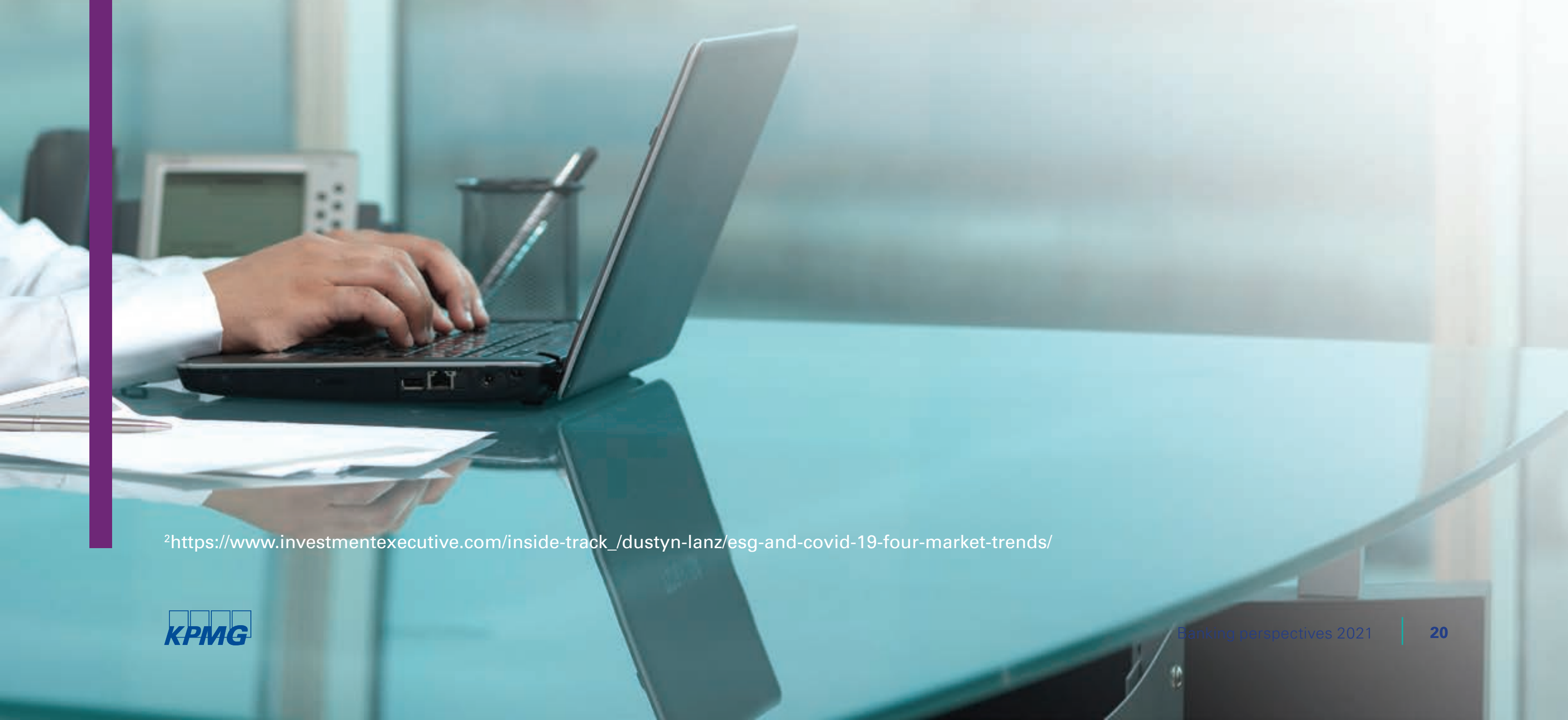
Investors will also be ramping up pressure on banks, and will want to ensure they can continue to earn a return on their investment. Interestingly, recent data suggests that ESG-related funds outperformed the markets over the first quarter of 2020 - when the Covid-19 economic crisis started. According to Morningstar, 70 percent of responsible investment funds outperformed their peers in the first quarter.[2]

At the same time, banks are also starting to feel pressure from their customers and from the public at large. Customers want to bank with a firm that reflects their views and beliefs; younger generations, in particular, are said to be choosing their bank based on their ESG credentials. That said, in Saudi Arabia, most of the pressure to change is felt from investors and regulators. According to KPMG's 2020 CEO Outlook, 70% of CEOs in the Kingdom saw the most demand for ESG reporting from institutional investors and regulators, compared with only 30% from employees and customers.

Ratings clear the fog

Traditionally, investors have used banks' annual reports to judge their ESG agendas. Having few reliable reporting or rating mechanisms for ESG programs, there has been little incentive for banks to be overly forthright about the impact - or lack thereof - of their ESG programs.

The introduction of ESG ratings systems and stock indexes of companies with leading sustainability programs has changed this investment paradigm. In the ratings field, Morningstar's Sustainalytics is driving innovation through its 'ESG Risk ratings', which takes a quantitative approach to gauging a company's effort allocated to ESG initiatives. Dow Jones, MSCI, and other finance companies have introduced sustainability indexes, which have boosted appeal for the stocks of companies with strong ESG programs.



[2]https://www.investmentexecutive.com/inside-track_/dustyn-lanz/esg-and-covid-19-four-market-trends/

KPMG member firms' work with banks and other organizations across the financial services ecosystem suggest there are four key actions that bank executives should be addressing today.

Understand your current baseline
More than simply quantifying the financial risks and probabilities, banks should create an understanding of common ESG expectations of key stakeholders and build awareness of leading ESG practices, in particular amongst senior management and board members. This includes taking time to understand their current practices and exposures, including whether they have the right data, the right capabilities and the right processes to monitor and manage ESG appropriately going forward.

Know what's expected
While regulatory and supervisory authorities are exploring approaches as to how they might provide specific targets or expectations, bank executives should be talking to their regulatory authorities to understand what is expected of them and how those expectations may change over the short to medium-term. They should also be working proactively with their regulators and authorities to seek out facts, develop standards and identify solutions.

Put it on your risk radar
For many banks, ESG factors remain a reputational risk. But they need to be more than that. Bank executives (and particularly boards) should be ensuring that ESG risks are a lens through which all decisions are made, especially in relation to credit and valuation risks in their portfolios, reflecting the strategic nature of these risks.

Develop a strategy
ESG risks cannot be managed off the side of a desk. It requires banks to develop a robust strategy that is integrated into the overall business strategy for the organization. While the strategy must retain a level of flexibility, it must also be actionable and measurable.

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