ESG commitment driven by investment opportunities

Environment, social, and governance (ESG) programs have increasingly become part of the corporate agendas globally. One factor that pushed for this adoption was the Covid-19 pandemic, during which investors realized that they need to invest in the most sustainable and safe corporate environment to lower their risks. The concept of ESG has gained traction and pushed companies towards more transparency and broader reporting. The banking sector has been one of the leading industries influencing the movement of ESG. In Saudi Arabia, the growing exposure to global financial markets and the heightened attention from ratings agencies have incentivized banks to prioritize ESG.

ESG agenda of regulators and investors

As one of the world's largest oil producers, Saudi Arabia has a particularly important role to play in the environment part of the ESG equation. The Kingdom has responded to the trend by joining the Global Methane pledge to reduce 30% of carbon emissions by 2060, as a part of its long-term commitment and aim to achieve net carbon neutrality by 2060. The government has also committed to the Sustainable Development Goals through proposals to improve productivity and efficiency in the public and private sectors.

In addition to the government's response, a growing segment of investors expect banks to avoid industries with high-carbon emissions or low-corporate rating on the social and sustainability agenda. As a result, ESG-related funds that are currently generating financial returns at par are expected to outperform the market in the near future.

In Saudi Arabia, this drive toward ESG seems to be driven equally by regulators and investors. According to KPMG's 2021 CEO Outlook, CEOs in Saudi Arabia stated that they see increased demand for ESG reporting and transparency coming from regulators (44%), institutional investors (41%), and customers (10%).[1]

The introduction of ESG rating systems and stock indices of companies with leading sustainability programs has further entrenched this investment paradigm. The Saudi Capital Market Authority (CMA) is now emphasizing ESG values through Tadawul, the Kingdom's stock exchange. CMA established principles for responsible investment in addition to promoting ESG initiatives by publishing an updated version of the disclosure guidelines to help companies navigate ESG. The CMA wants to ensure that the guidelines support the sustainable and inclusive growth of the Saudi capital market and aims to benefit all market participants.

> **"Bank executives need to 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 customer-pricing.**

The value of ESG for investments in the banking sector

Investors in emerging markets increasingly perceive compliance with ESG standards as obligatory, which is demonstrated by the growth of ESG investments over the past few years. It is projected that in 2025 the value of the total global assets will be US$140.5 trillion, of which US$50 trillion (35.6%) are restricted to ESG investments.

The weight of Saudi Arabia's emerging market is 3.67% and consists of 36 listed Saudi companies. Of these 36 companies there are 9 listed banks that represent a share of 1.8% of the total emerging market. Considering that the estimated 2025 global assets will be US$140.5 trillion, Saudi Arabia should get a share of US$5.143 trillion, with US$2.53 trillion going to the banking sector. Given the projection that 35.6% of global assets will be restricted to ESG investments, Saudi Arabia could lose a total of US$1.83 trillion from the emerging market, US$0.9 trillion of which will be lost in foreign capital by the banking sector in 2025.

These potential losses stem from a lack of ESG reporting. For banks to be chosen for ESG-restricted investments, they must acquire an evaluation by ESG rating providers recognized by institutional foreign investors, such as large European and US institutional funds, pension funds, and other asset owners.[2] These ratings providers have not covered Saudi Arabia since there has not been sufficient publicly available data to determine the ESG ratings of Saudi companies. Less than 40% of Saudi listed banks have publicly disclosed the requested data and have mostly gotten an insufficient score. This blocks banks' chances of being chosen for the allocated funds in ESG investments.

	ESG assets (US$)	Growth %
2016	22.8	-
2018	30.6	34.2
2020	35	14.4
2025	50	42.9

Looking to the future

ESG factors remain a reputational risk for many banks, but they need to be more than that. Bank executives, particularly board members, need to 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 customer-pricing.

ESG will increasingly become central to the economic equation globally, and Saudi Arabia will be no exception in the post-Covid world. For listed banks in the emerging market, although they are complying with rules and regulations on both national and international levels, they need to address the lack of reporting of ESG data in annual and other publicly available reports.

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