The Accelerating ESG Regulatory Landscape: Gearing Up for Change

September 2020

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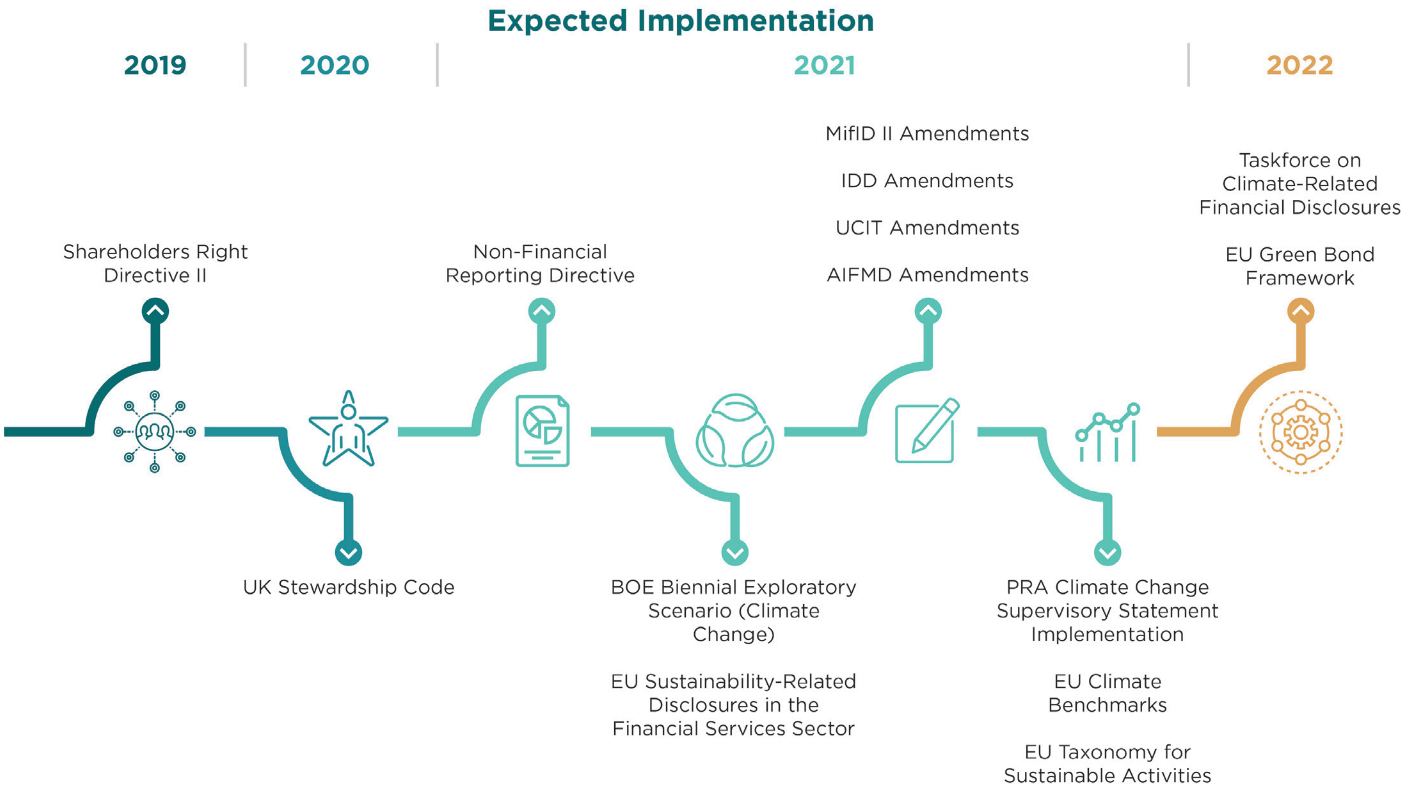
The concept of ESG (environmental, social and governance considerations) is not new to financial services, but the ESG landscape has changed dramatically in recent years. From the launch of the UN's Principles for Responsible Investment in 2006, the focus has evolved beyond voluntary codes to significant regulation at a national and international level. With increased regulatory focus on ESG, the UK financial services industry is expected to comply with several new pieces of legislation in the next few years:



This new wave of legislation will require significant enhancement of internal capabilities, and UK firms should expect all legislation to be upheld regardless of Brexit, with both the PRA and FCA reinforcing the need for increased ESG focus. However, despite the complexity of upcoming legislation, common themes can be identified across a firm's operating model. Applying a holistic lens to managing ESG change will ensure a cohesive and effective ESG framework.

Strategy

Firms need to demonstrate a well-defined ESG strategy as well as integration of ESG considerations into overall business objectives. To do so, firms will need to fully identify and assess ESG related risks and opportunities, at firm, business unit, product level and considering different time horizons. Once assessed, clear and measurable targets should be set and publicly disclosed.

A common challenge in defining ESG strategy is translating high level ESG ambitions into tangible business activity. Engaging with external initiatives, cross industry working groups as well as internal cross department collaboration can provide structure and guidance for developing an effective ESG plan. Senior engagement and sponsorship are critical to support the development of capabilities across the firm. The ESG strategy should be embedded into the overall goals of the organisation and not be treated as a siloed plan exclusively for certain products or services.

Governance

Pro-active demonstration of effective ESG governance is expected by multiple upcoming legislative items. At board and executive committee level, firms should ensure that terms of reference clearly document roles and responsibilities for managing ESG risk and stewardship.

All participants, including NEDs should be provided with appropriate ESG and climate risk training, and committees should have regular access to specialist ESG expertise. Individual accountability is also expected, clear allocation of senior management responsibility for climate risk and wider ESG risk management should be defined.

Sustainability should also be factored into product governance, with clear objectives and monitoring approaches, providing a significant challenge for firms with complex product portfolios. The need to demonstrate appropriate stewardship of assets under management via voting patterns, as well as monitoring the range of ESG factors requires a sophisticated product governance approach. Responsible Investment funds also trigger additional governance requirements, including monitoring investee company behaviour for negative ESG impact. At present, there is significant variance within the financial services industry in classification of products with positive ESG impacts, but adoption of frameworks such as the Investment Association's Responsible Investment framework and the Loan Market Association's Green Loan Principles, in addition to the EU Taxonomy for Sustainable Activities, should increase transparency and effectiveness of product governance.

Risk Management

Significant changes are required to fully integrate ESG factors into risk management frameworks, as highlighted by the Climate Financial Risk Forum, climate risk should be considered a "cross-cutting" risk type that will translate into increased traditional risk exposure in risks such as operational, liquidity, credit or market risk. Consequently, firms should ensure integration into overall risk management framework, including a review of processes across all three lines of defence to assess adequacy for ESG management. A key change in upcoming legislation is the expectation that firms demonstrate active review of all policies to ensure integration of climate and wider ESG risk. It should also be noted that disclosure of the risk management approach will be expected under TCFD, so firms should be mindful of the need to clearly communicate climate risk management frameworks and explain their alignment to wider strategy.

ESG factors also need to be integrated into product level risk management, with clear disclosure of sustainability risk and impact during the client advisory process and throughout the product lifecycle, in order to ensure that client ESG preferences are fully considered. It should be noted that disclosure approaches should be tailored to product objectives; for example, if a product has carbon emission reduction as its objective, ongoing disclosure of carbon emission impact should be provided.

As highlighted by the PRA in their recent thematic review, development of a scenario analysis capability has proved challenging for the financial industry, but it is a key component for climate risk stress testing and will form a key component of effective climate risk frameworks. With the upcoming Biennial Exploratory Exercise focusing on climate change in 2021, firms should ensure a thorough understanding of their climate exposures, considering both physical and transition risk, data enhancements and suitable stress testing methodologies.

Metrics & Reporting

Upcoming requirements for reporting and disclosure arguably provide one of the greatest challenges, with expectations for disclosure of ESG policy, activity and impact at business and product level. Due to the volume of public disclosure required, it is recommended that firms develop an overall policy for ESG disclosure, including allocation of responsibility to ensure accurate disclosure, and demonstration of board level oversight.

Disclosure of ESG policy itself will need to consider stewardship, renumeration, social impact and climate risk to inform shareholders and other stakeholders. In addition, asset managers need to report on how their purpose and investment beliefs have guided their stewardship, investment strategy and decision-making; and an assessment of how effective they have been in serving the best interests of clients and beneficiaries. Qualitative reporting on investment activity is also required, as well as disclosure of voting records, transactions between issuers and director renumeration.

On a quantitative level, firms are expected to disclose climate-related metrics such as carbon intensity of the portfolio, asset value at risk from simulated stress tests, and operational GHG emissions. Alongside actual metrics, firms should also look to disclose methodologies utilised, and provide baseline comparison data where appropriate.

Policy & Process

As well as development of specific policies on sustainability, stewardship, voting rights and principle adverse impact, firms need to fully integrate ESG considerations into policies and processes.

Significant process change will be required, impacting customer journeys, investment management activity and third-party management. Client advisory processes should be formally re-engineered to ensure appropriate assessment and communication of ESG factors. Internal process change is also required, with creation of formal disclosure processes and integration of sustainability risk into due diligence standards required by multiple items of legislation. In addition, requirements to integrate ESG evaluation into investment or financing screening and ongoing monitoring will necessitate the introduction of new tools into existing processes, requiring sophisticated use of technology and development of data capabilities. Firms should also be aware of expected changes to HR policy and processes, with renumeration frameworks and training strategies expected to reinforce firms' wider approach to sustainability risk management.

Developing a cohesive ESG framework

The sheer volume of change outlined illustrates the potential complexity of implementing an ESG framework; without careful co-ordination between multiple functions, contradictory policies and processes can be implemented, and delivery costs can quickly spiral. However, by deploying combined ESG change programmes, firms can efficiently ensure compliance and the development of an ESG strategy that aligns to wider business objectives.

BCS Consulting can leverage our significance ESG expertise to provide targeted support, including maturity diagnostic services, specific governance reviews and tailored senior management training. In addition, our extensive TCFD research and disclosure experience can provide sophisticated support in developing disclosure strategy and enabling supporting capabilities.

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