

ESG – The irreversible mega-trend

Why ESG and sustainable finance are the new normal for financial institutions



Environmental, social, and governance (ESG) and sustainable finance can no longer be thought of as nonessential niceties. They are game changers that together will reshape the financial services industry. As such, they will become a driving force behind banking, their impact felt both broad and deep, and in ways that will touch all aspects of every leading financial institution, from business lines, segments, products/services, pricing, processes, and data, through to interactions with clients/suppliers, distribution models, and even talent management. This is reflected in the way some large financial institutions, like Bank of America and BNP Paribas, have already expressed their commitment to becoming net zero banks and have adopted ESG as a key strategic element accordingly.

The move toward ESG

How has ESG gone from little more than a footnote once dismissed by some as hype to being worthy of attention not just by those “woke” to such matters but by all stakeholders in both the financial and nonfinancial communities? The predominant catalyst has been climate change, now a top agenda item for many politicians who have enshrined their ambitions in landmark agreements (e.g., the UN 2030 Agenda for Sustainable Development, the Paris Agreement, and the EU Green Deal). While the environmental repositioning of the US under President Biden has given this issue renewed credibility, the COVID-19 pandemic has injected added impetus by focusing attention on the roles and responsibilities of high-profile organizations within wider society.

Today, major financial institutions are beginning to appreciate ESG’s potential to create substantial value if business models are suitably redesigned to accommodate it. Consequently, ESG will significantly impact how banks manage their relationships with clients, other banks, and suppliers. Indeed, it seems inconceivable that ESG and sustainable finance could ever be “put back in the box,” since this mega-trend likely will take us irreversibly toward a new normal. This is not about any one institution becoming carbon neutral; it is about a refocusing of the entire market toward sustainability that will see “green money” flowing from the EU and others to climate-neutral economic activities.

But while institutions have begun to discuss ESG and sustainable finance with greater intensity, too often there is still a lack of substance or real direction. There is potential for any internal or external statements of ambition to be categorized as little more than “greenwashing.” Yet, there does seem to be a growing recognition that this is a time for action, and that sitting on our hands to “wait and see” is no longer a viable position.

Market developments & challenges

While there is general enthusiasm for ESG and sustainable finance, not all financial institutions in Europe are embracing this trend to the same degree, with some seeing themselves as potential leaders in this area and others taking a more minimalist approach. Effective delivery will certainly require setting up a proper governance structure, with clearly defined roles, responsibilities, and incentives. This will typically entail one person, or a small team, being given responsibility for ESG, and attached, for example, to the CEO’s office, the investor relations and communication department, or the head of strategy.

Irrespective of whether a centralized or decentralized model is used, ESG will need to be integrated into an organization’s fabric. The appointment of “ESG ambassadors” to sell new initiatives across the whole organization is one highly effective approach, which could be used in conjunction with education programs and ESG certification to help build knowledge and understanding and to implant ESG into daily actions and decision

making. Internally, intensive discussions will be required about which ESG products/services to develop for different segments (it is common to offer multiple products and services that cover investment, lending, bonds, and advice), how to price them, and what distribution channels should be employed to deliver them.

How best to create value for shareholders and stakeholders in the mid- to long-term from ESG and sustainable finance should now be a key consideration for all banks. But, to have a credible value proposition that's attractive to a "sustainability-switched-on" audience, financial institutions need to do more than just pay lip service to ESG's guiding principles. Thus, much more is needed than checking the boxes in a sustainability report, or merely relying on a materiality matrix to decide which corporate social responsibility initiatives to invest in. This may satisfy the sustainability ambitions of the board and shareholders, but it doesn't translate into a well-executed sustainability strategy, which means opportunities are being missed either to innovate or to better engage with internal and external stakeholders. In other words, financial institutions must commit fully to taking action. Leading banks have already begun remodeling their relationship management programs to better serve the needs of their clients by setting up ESG early warning and opportunity detection systems. They are also developing green financing products, but this is still a work in progress, and there is still much room for improvement.

However, for many institutions, the primary focus is on meeting the growing wave of ever more complex requirements and expectations of regulatory and supervisory authorities around taxonomy, risk management, reporting, and disclosure (e.g., see

taxonomy regulation, NFRD, CRR/IFR, and SFRD). This is not optional; it is a "must."

Progress is further hindered by uncertainty about the definition of key terms, leading to a frustrating degree of guesswork. This vagueness is compounded by the unavailability of quality ESG data to underpin decision making, the absence of market standards when it comes to managing ESG risks, and the thinness of appropriate knowledge within the organization itself.

Then there is the whole question of whether to take a top-down or bottom-up approach to implementation. Whichever route is chosen, it will require a cultural shift to ensure ESG becomes permanently embedded in a bank's DNA in a way that meets the needs of all stakeholders.

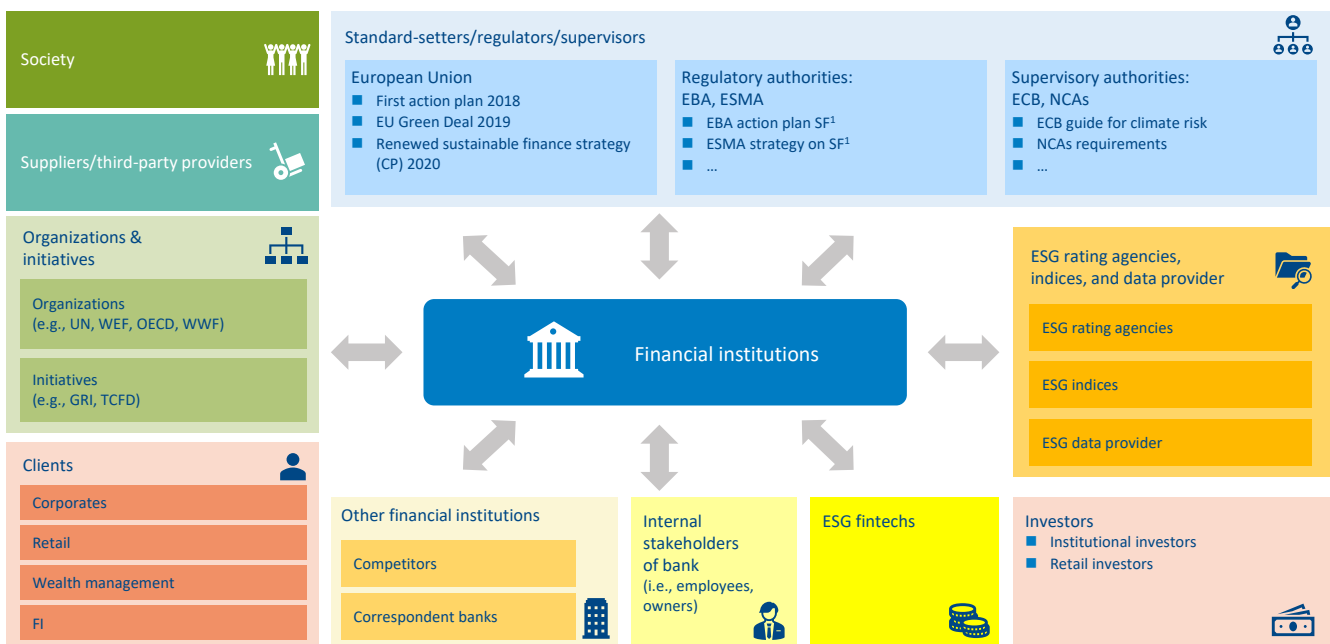
ESG/sustainable finance stakeholder map

As shown in the figure below, the ESG and sustainable finance stakeholder map is disparate and diverse since it includes those from both the financial and nonfinancial communities.

When defining and implementing their ESG strategy, financial institutions need to pay attention to how key stakeholders, including standard-setters and regulatory or supervisory authorities like the EU Commission, the ECB, and the EBA, might influence matters.

There will be pressure from investors, too (for the moment, mainly institutional) pushing for further, faster action. And there are the ESG rating agencies, indices, and data providers,

ESG & sustainable finance stakeholder map



Source: Arthur D. Little analysis
¹SF: Sustainable Finance

as well as the growing number of ESG-focused fintechs, with their different payment, lending, data, and savings and investment offerings, that are increasingly becoming part of a bank’s ecosystem. There are also corporate, retail, and wealth management clients, along with other financial institutions, that are increasingly interested in ESG and sustainable finance-oriented strategies and business models. Moreover, suppliers and service providers will have to ensure that they, too, are green if they are to stay aligned with a bank’s sustainability positioning and thus remain an acceptable third-party provider. ESG data providers to financial institutions are an additional stakeholder group. Finally, there are organizations like the UN, with its Sustainable Development Goals and Principles for Responsible Investment (PRI) and Banking, as well as the Global Reporting Initiative (GRI) and the Taskforce on Climate-Related Financial Disclosures (TCFD), all shining an ever more powerful spotlight on ESG, which in turn captures the attention of internal stakeholders and wider society.

ESG and sustainable finance framework for banking

Financial institutions need to define and develop an ESG strategy that can be articulated in a roadmap that not only sets out the governance framework and incentive programs necessary to reach a desired state but also enables them to strategically analyze risks, identify opportunities, and assess business models over the next five to 10 years.

Such a roadmap for managing the relationship with both external and internal stakeholders, as well as what products and services

will be required to satisfy clients in different business segments, should also explain the process for monitoring and achieving legal and regulatory compliance when it comes to reporting and disclosure, risk management, and taxonomy. For completeness, this framework should set out how data and IT will be used to successfully encourage thinking about ESG and sustainable finance within the organization, something that should be given consideration from day one.

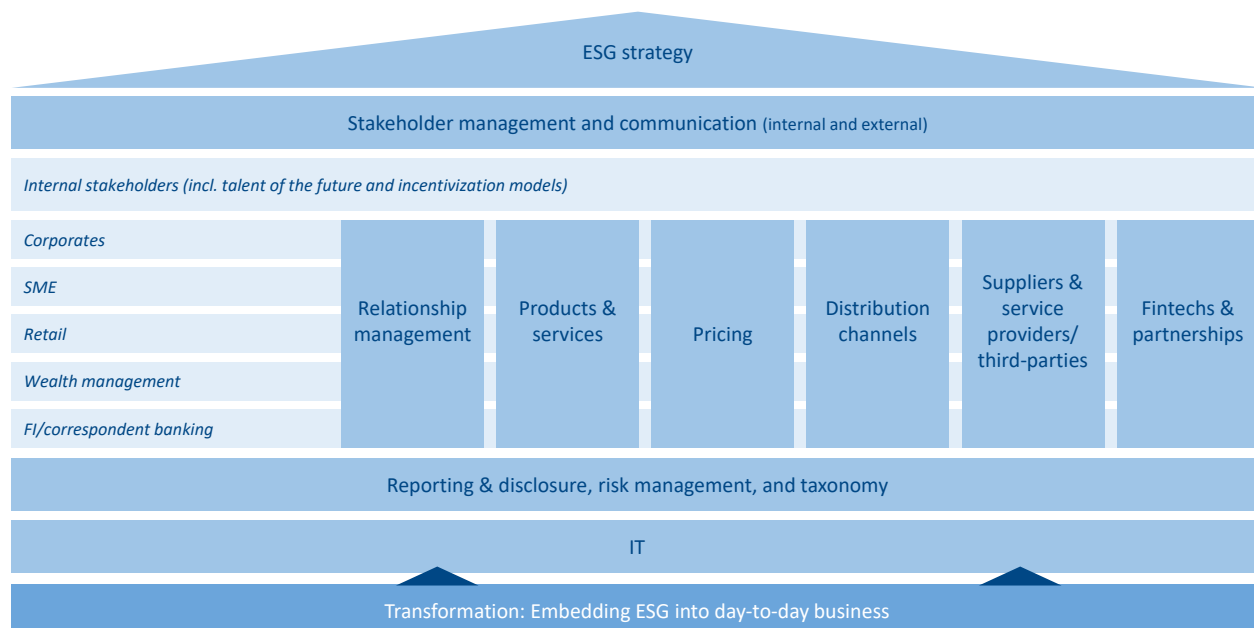
It then becomes a matter of “walking the talk” to ensure that sustainability is actively introduced into the day-to-day operations and processes of the financial institutions – and remains so.

Recommendations

To make ESG and sustainable finance the “new normal,” leading institutions must:

- Have a clear, credible, and holistic sustainable finance strategy that establishes the business case and defines how a bank will position itself from an ESG perspective (for instance, as a leader or compliant player). This should also set out risk options as well as how technology can be used to mitigate risks. All this should be captured in a roadmap for transitioning to a desired ESG state.
- Base their thinking not on today’s worldview, but the one that will apply in five to 10 years, taking into account new and significantly different customer and employee expectations, which will be strongly influenced by technology.

Value creation-oriented ESG and sustainable finance framework



Source: Arthur D. Little analysis

- Ensure their ESG and sustainable finance-oriented strategy and business model prioritizes value creation for shareholders and stakeholders.
- Formulate a bespoke map of all internal and external stakeholders, along with a detailed and institution-specific approach to managing needs and engaging with stakeholders.
- Be prepared to reshape relationship management with clients, counterparties, and suppliers.
- Adopt a holistic view that ensures ESG and sustainable finance aren't siloed or misaligned with other strategic or corporate objectives.
- Take action now because "wait and see" is no longer a viable option, especially so for those looking to gain any kind of first-mover advantage. As it is, customers are already choosing banks based in part on their ESG performance – 10% say they would consider leaving their current high street bank if it were investing in dirty fuels like coal, oil, or gas. This could see banks that are heavily fossil funders suffering a "customer exodus," as the focus falls on them in the run-up to this autumn's *COP26* climate conference in Glasgow. That might not bode well for those historically exposed in this area, like HSBC and Barclays, Europe's biggest fossil fuel financiers, which have invested over £149 billion in high-carbon activity since the signing of the landmark Paris Agreement in 2015. (Source: NGO Market Forces) However, they too are shifting. Barclays, for instance, has committed itself to becoming a net zero bank by 2050.

Conclusion

While ESG and sustainable finance are hot topics in the financial sector, much of the debate and discussion is often still too theoretical. However, given the speed at which both are gaining real traction, it is imperative that financial institutions move as quickly as possible toward practical implementation if they are to stay ahead of the game and meet the expectations of customers, partners, and investors. Those that refocus their business model strategically to embed ESG and sustainable finance sooner rather than later will find themselves much better equipped — not just to capitalize on, but to drive forward a trend that is not only irreversible but unstoppable. We are at the beginning of a new era of "sustainable money," in which the rules of the game are going to be very different from those of the past.

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