Monticello
Consulting Group

The Rise of ESG:

Preparing Financial Services Firms for a Transformational 2022

Fall 2021

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Understanding ESG

The past year has seen a pandemic of unprecedented proportions, increasingly frequent natural disasters, and immense social upheaval. In the last thirty days alone, a hurricane has decimated the coastal South, massive flash flooding has inundated the Northeast, and wildfires have continued to ravage the West Coast. While climate catastrophes have become commonplace, the unanticipated operational challenges posed by the COVID-19 crisis have taken the financial services industry by surprise, and it's not the only major change that the financial sector has had to reckon with in recent months. The impending arrival of significant regulatory changes around climate risk, updated sustainability frameworks, and calls for social engagement have all thrown the importance of environmental, social, and governance (or ESG) considerations into sharp relief.

To put it briefly: ESG and sustainability are not just long-term aspirations or ambitions; they are active, urgent imperatives. Take environmental issues, for instance; extreme weather events, like Hurricane Ida, pose major physical risks to financial services firms' operations. Social considerations, too, have taken center stage in regulatory initiatives, with the SEC and NASDAQ recently implementing a joint initiative to require board diversity in publicly-traded companies. The pace at which governance, transparency, and disclosure requirements are evolving has never been more formidable across the financial services industry. In this climate of rapid, dramatic change, understanding ESG—and acting on it—is more crucial than ever.

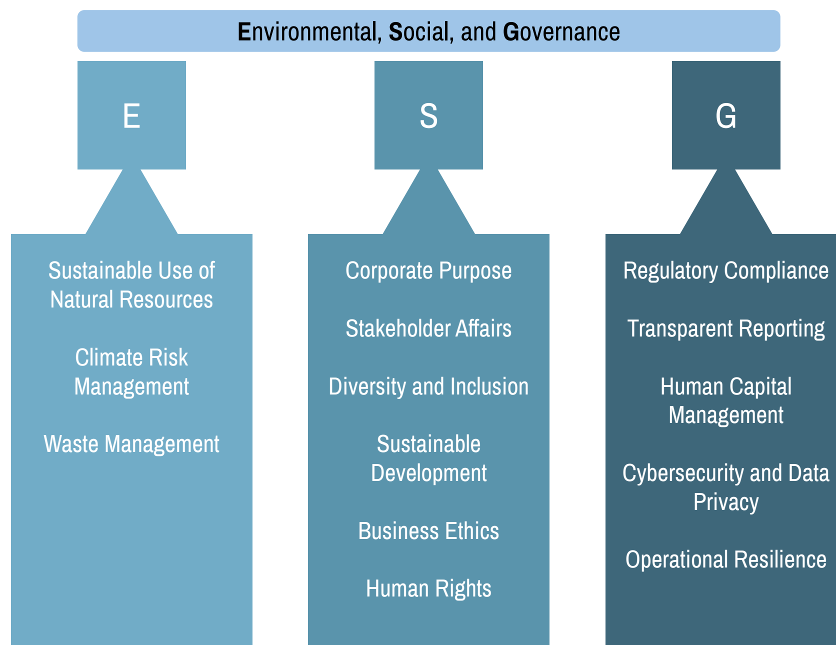

Figure 1: Components of ESG

ESG is a broad set of considerations used to assess corporate environmental, social, and governance practices. It encompasses everything from climate risk management to human rights, steering corporations towards more transparent, resilient, and responsible practices. The ultimate aim of ESG is sustainability—defined by 1987's Brundtland Commission[1] as "meeting the needs of the present without compromising the ability of future generations to meet their own needs"—both in the face of long-term changes and short-term challenges. At first glance, ESG is complex and daunting. Firms need to consider sustainability and governance within their own four walls, but are also required to address issues upstream and downstream with suppliers and customers. Firms are also simultaneously tasked with satisfying seemingly competing stakeholder demands, and adhering to global initiatives and regulations from the Paris Climate Agreement to the Task Force on Climate-Related Financial Disclosures (TCFD) disclosure framework. In today's environment, pursuing sustainability isn't just the right thing to do; it also provides firms with a set of strategic and operational advantages.

The Benefits of ESG

As an opportunity-rich environment with room for growth, ESG carries a host of tangible benefits for those who do it well. ESG-aligned firms are set up for success through reduced operating expenses, improved risk management and boosted revenue streams. Recent Gartner[2] and NYU[3] studies have shown that ESG alignment and successes correspond to lower costs of capital, diminished operating costs, and overall higher levels of financial success.

The benefits of ESG, however, extend well beyond the financials; ESG leaders are also able to leverage their success to achieve intangible benefits with respect to corporate reputation, ethics, loyalty, and trust. Firms with good ESG ratings enjoy increased employee loyalty and satisfaction, and have a distinctive competitive edge when it comes to talent acquisition and retention. Millennials, in particular, value firms' ESG practices as a litmus test for workplace culture and priorities; nearly 40% of millennials have taken one job offer over another on the sole basis of ESG[4].

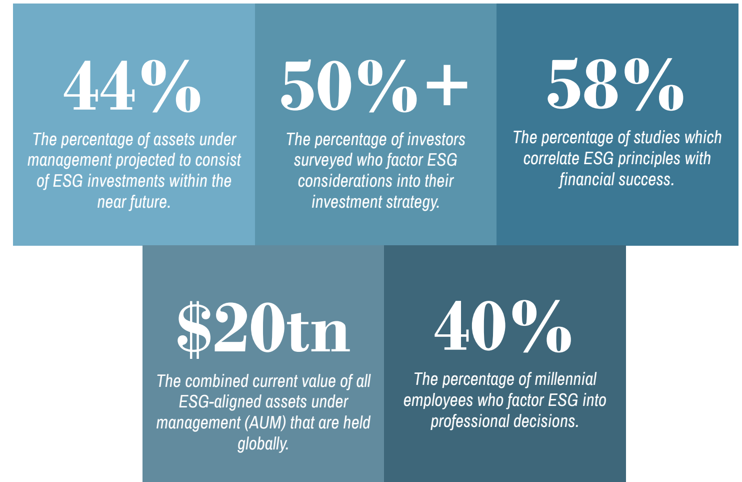

Figure 2: The Benefits of ESG Quantified
Sources: NYU Stern School of Business, FTSE Russell, JP Morgan, Gartner

Similarly, customers and investors make ESG a priority in their strategic and financial considerations. As investors are more discerning now than ever, ESG funds routinely outperform non-ESG funds, and ESG-aligned investments are poised to account for a lion's share of the market within the decade, representing nearly 44% of all assets under management[5]. Firms with higher ESG ratings and stronger policies enjoy reputational advantages alongside empirical ones.

ESG at the Largest US Banks

Examining the six largest U.S. financial institutions by total assets—Bank of America, JPMorgan, Citigroup, Morgan Stanley, Goldman Sachs, and Wells Fargo—offers a comprehensive snapshot of the financial services industry's approach to ESG. By reviewing their self-published annual ESG reports, and corroborating those reports with third-party scores and rankings—including CDP, Newsweek, and MSCI—it's easier to understand the current state of ESG across the industry, and identify areas for improvement to achieve success.

The Current State

The financial services industry occupies a unique position in the world of ESG. Compared to other industries, it is not traditionally regarded as a major contributor to the climate crisis, or to social inequities, yet—in reality—is perhaps the one sector with the single most outsized global effect. The financial services industry is steeped in environmental, social, and governance challenges; massive and multifaceted financing drives ESG impacts on a global scale. With this immense level of involvement and influence comes a responsibility to adequately address ESG considerations beyond a firm's own four walls.

Company Name	CDP	MSCI	Newsweek
BANK OF AMERICA	A	BBB	71.1
WELLS FARGO	A-	N/A	N/A
GOLDMAN SACHS	A	A	79.8
CITIGROUP	A-	A	89.5
MORGAN STANLEY	A	AA	59.4
JPMORGAN CHASE & CO	N/A	BBB	59.4

Figure 3: 2021 CDP, MSCI, and Newsweek scores via company websites

A cursory look at some of the ratings paints a rather flattering initial portrait of the financial services industry as a whole. The CDP's Climate Change score, for instance—which aims to rate corporations' environmental policies and disclosures in an effort to promote more responsible, transparent practices—gives five out of the six banks an environmental score of an "A" or "A-"[6]. It's clear that the largest banks manage their environmental impacts well, and the environmental outlook for the financial services industry is both encouraging and promising.

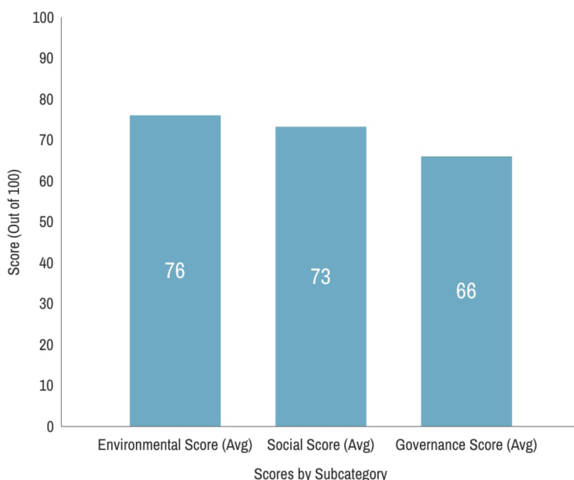

Figure 4: Average ESG Scores by subcategory for the largest 6 US Banks including Goldman Sachs, JP Morgan Chase, Bank of America, Morgan Stanley, Citigroup, and Wells Fargo

As we broaden our lens beyond CDP to a rating agency like Newsweek, however, certain gaps and opportunities become more apparent. Newsweek's America's Most Responsible Companies 2021[7] assesses ESG as a whole—including social and governance issues alongside environmental ones—and calculates scores using a combination of reputation surveys and rigorous KPI performance analysis[8]. The average social and governance scores assigned to the largest U.S. banks are noticeably lower than the average environmental scores, as noted in Figure 4. This suggests that major financial institutions have collective room for improvement on both fronts. Additionally, as can be seen in Figure 3, Citi has obtained industry leadership status—as the top scoring large U.S. bank across the three categories assessed.

Our final set of scores is derived from MSCI. An MSCI ESG Rating is designed to measure a company's resilience to long-term, industry material ESG risks. They use a rules-based methodology to identify industry leaders and laggards according to their exposure to ESG risks and how well they manage those risks relative to peers. ESG Ratings range from leader (AAA, AA), average (A, BBB, BB) to laggard (B, CCC). MSCI ESG ratings—which are geared towards investors—deliver yet another comprehensive and compelling view on this critical topic with a focus on risk[9]. Figure 3 highlights the strength of Morgan Stanley's MSCI score of AA and the average rating of both Bank of America and JP Morgan Chase[10].

Beyond ESG ratings are a number of sustainability and disclosure frameworks established by NGOs and third parties. The four most significant are the Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB), the Task Force on Climate-Related Financial Disclosures (TCFD), and the United Nations' Agenda 2030, which includes the Sustainable Development Goals (SDGs). Though there's considerable overlap between all four, they're unique in their breadth (or scope) and depth (or prescriptiveness).

Figure 5: Significant ESG Frameworks

Between ratings, scores, and frameworks, several things are clear. The first is that the financial services industry, while not the most egregious contributor to climate change, does have a significant effect on the environment—and this influence extends well into the realm of social considerations and governance issues. The second is that—despite recent advancements in sustainability, transparency, and responsibility—the financial sector continues to find room for improvement on all fronts of ESG. Perhaps Laurent Fabius—former cochair of COP21 and leading voice on sustainability in finance—stated the central issue with ESG and finance best at 2021's Green Swan conference[11]:

> *"In spite of a growing awareness… of the problem, we are far from the necessary goals."*
>
> *—Laurent Fabius, former president of COP21*

Managing Climate Risk

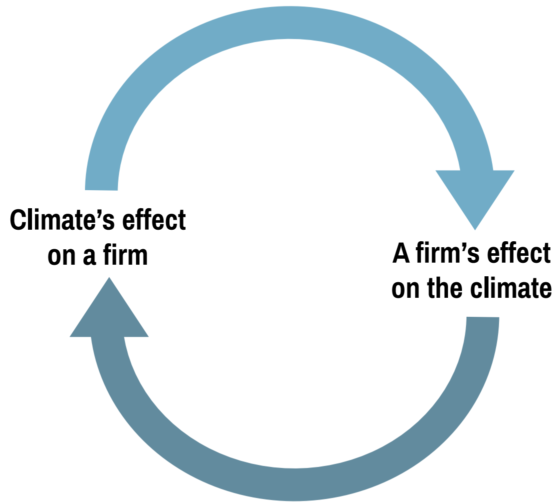

Figure 6: Double materiality of climate risk

Climate change threatens the stability of the global financial landscape. According to CDP, climate change is projected to put over $1 trillion worth of global assets at risk by 2024[12] and swell to $4 trillion by 2030[13]. With so much at stake, the time is now to address climate change and its associated risks. Climate risk management is about measuring operational resilience and vulnerability in the face of climatological changes and disruptions, but it's also about determining risk appetite and risk tolerance, which describe the level of risk a firm is willing to bear in order to maximize returns. Climate risk pervades every level of a financial services firm, ranging from operations conducted within its own four walls to the entirety of its supply and includes investments and loans. Effective climate risk management begins with establishing a risk appetite, addressing specific climate risks, and integrating climate risk management into enterprise risk management and investments.

The Climate's Impact on Financial Services Firms

Climate risks can be roughly divided into two categories: (1) physical risks and (2) transition risks. Physical risks, pertain to the tangible, physical effects of climate change—these include rising sea levels, rapidly shrinking coastal areas, higher average temperatures, and increasingly incident extreme or catastrophic weather, among other things. These physical risks can lead to market and credit losses, alter consumer spending patterns, and constrain operations. Transition risks, as defined by the Task Force on Climate-related Financial Disclosures (TCFD), include policy and legal risk, technology risk, market risk, and reputational risk[14]. Managing shifts in regulation, policy, and practice demands an awareness of transition risk, alongside a willingness to engage with climate risk management as a whole.

"Climate change poses an existential risk to society and the associated financial risks pose safety and soundness risk to banks. To safeguard trust, banks and regulators must begin to take action now."

—Michael Hsu, Acting Comptroller of the Currency

Effectively managing climate risk requires a tripartite approach, which includes standardizing processes and definitions, conducting scenario analysis and stress-testing, and maintaining disclosure and transparency standards.

1. **Standardize processes and definitions:** Maintaining a common lexicon for climate concepts, targets, and principles, while establishing rigorous standards for data measurement and reporting, allows financial institutions to work alongside peer institutions and regulators to more effectively manage climate risk. Clearly communicated standards lay the groundwork for well-executed plans. While organizations like the Sustainability Accounting Standards Board (SASB), the Global Reporting Initiative (GRI), and the Carbon Disclosure Project (CDP) have taken the lead in establishing standardized frameworks and definitions for climate risk management, corporations are responsible for driving widespread adoption and adherence.

2. **Conduct scenario analysis/stress testing:** Managing climate risk demands building operational resilience. Stress testing and scenario analysis allow corporations to deal with potential risks and crises—both physical and transitional in nature—and evaluate their preparedness, helping build resilience.

3. **Ensure disclosure and transparency:** Disclosure helps stakeholders and regulators hold corporations accountable for resilience practices that are outdated or underdeveloped, incentivizing an expanded focus on climate risk management and promoting innovation. In recent months, disclosure and transparency have taken center stage; the Securities and Exchange Commission (SEC) is currently in the process of evaluating a proposal which, if adopted, would require public companies to disclose all climate-related risks to investors as part of their Form 10-K annual reports[15]. This is a move firmly in line with a global trend towards greater transparency; the UK, for instance, has mandated public climate risk disclosure, in alignment with TCFD standards, by 2025[16].

Integrating climate risk management into enterprise risk management (ERM), and treating it as an opportunity for growth, rather than an obligation, allows corporations to make the most of a volatile climate. This integration relies, in part, on strong leadership and clear managerial communication, but it also rests on corporate ethos. Ultimately, through integration, implementation, and emphasis, corporations can effectively improve their resilience and limit their susceptibility to climate risk.

ESG - From Commitments to Regulations

Earlier this year, the United States formally rejoined the Paris Climate Agreement, ushering in a new era of environmental regulation and suggesting a paradigm shift in regulatory and political priorities[17]. One of the Biden administration's priorities is a focus on climate change and sustainability, and the United States' most recent steps towards climate risk regulation are part of a collaborative global effort towards stronger climate risk regulation and controls. Many of the United States' latest initiatives are still proposals; if passed, however, they would carry massive implications for the financial services industry. These initiatives can be generally classified into one of two categories: regulations and goals.

US Regulations

Many of the United States' regulations are spearheaded by lawmakers in Congress, while others are initiatives led by agencies like the SEC, the Fed, and the NYDFS.

ESG has grown into a major Congressional priority over the past year; in February, House Rep. Vargas introduced H.R. 1187, or the "Corporate Governance Improvement and Investor Protection Act," a bill intended to improve disclosure requirements across the financial services sector[18]. More recently, Sen. Warren and Rep. Castern reintroduced H.R. 2570—better known as the Climate Risk Disclosure Act—in April, which directs the SEC to mandate more stringent climate risk disclosures for publicly-traded companies[19].

Despite the fact that neither bill has passed the Senate, the regulations outlined within them are, in many ways, mirrored by recent regulations. The SEC, for instance, is currently deliberating a proposal which would require corporations to disclose their climate risks within their annual 10-K reports—a move firmly in line with the Climate Risk Disclosure Act[20]. In fact, the SEC often leads Congress in cutting-edge regulatory changes; in approving the NASDAQ's board diversity proposal, which requires corporations listed on the NASDAQ to have at least two "diverse board members," the SEC has distinguished itself as a leader in social-centric ESG regulation[21].

US Goals and Commitments

Non-regulatory commitments have also grown increasingly popular in the United States, with the New York Department

of Financial Services' (NYDFS) publication of a "Climate Risk Industry Guidance Letter"—one of the first of its kind—which offered financial services firms a regulatory outlook on operational expectations[22]. The NYDFS isn't alone in setting ESG expectations and making commitments; just last year, the Federal Reserve became a member of the Network of Central Banks and Supervisors for Greening the Financial System (NGFS)[23]. The NGFS, which consists of 83 banks and supervisors, operates with the aim of improving and expanding green finance; in joining it, the Fed suggests that multilateral coordination on green finance is a priority for U.S. regulators. In their Q3 financial stability report, the Fed stated that they expect banks to have systems in place that appropriately identify, measure, control, and monitor all of their material risks, which for many banks are likely to extend to climate risks. Similarly, the FDIC issued comments regarding sustainability risks and change management at the Center of American Progress last year, while ISDA published a set of sustainability principles earlier this year. Each of these commitments and goals lays the groundwork for increased regulatory cooperation and coordination moving forward.

International Initiatives

As is expected, the U.S. isn't alone in introducing new ESG regulations and targets. Here's a short overview of European, UK, and global ESG initiatives.

Global:

- *UN Agenda 2030*
  - Includes 17 Sustainable Development Goals (SDGs) to spur responsible, sustainable growth within the private and public sectors
- *UN Principles for Responsible Investment (PRI)*
  - Roadmaps how corporations should approach an ESG-centric investment strategy in an effort to leverage capital to achieve the SDGs
- *Paris Climate Agreement*
  - Legally binding multinational treaty designed to promote sustainability on a national and international scale, catalyzing domestic regulations on the financial services industry in an attempt to meet the assigned goals

Europe:

- *Sustainable Finance Disclosure Regulation (SFDR)*
  - Makes ESG disclosures mandatory, including transparent reporting of: sustainability risk policies, adverse sustainability impacts at the entity level, and remuneration policies, among others
- *EU Green Deal / European Climate Law*
  - Establishes a set of binding guidelines to help minimize European nations' climatological impact
  - EU Green Deal is given legal backing by the European Climate Law
- *EU Action Plan on Financing Sustainable Growth*
  - Directive to help corporations and countries direct capital towards sustainable initiatives and investments
  - Includes EU Taxonomy, a standardized framework and lexicon

United Kingdom:

- *TCFD Compliance*
  - Latest ESG mandates are aligned with TCFD disclosure recommendations and sustainability standards
  - UK aims to be the world's first fully-TCFD compliant nation by 2025

It is anticipated that the Fed, FDIC, and Basel Committee will issue rules on Climate Change in the very near future. Between the advent of more involved regulatory initiatives, ambitious multinational commitments, and an industry increasingly focused on ESG as a corporate priority, understanding upcoming mandates and commitments—and employing a suitable change-management framework—has never been more important.

The Path Forward

The universally-regarded threshold for irreversible climate change is +1.5°C—and it's a threshold our world is rapidly approaching, with some estimates projecting global temperatures to rise to untenable levels as early as 2027. With a new administration in the White House—and newly-minted priorities for policy initiatives worldwide—financial services firms can expect to see a wave of change over the next few years. Banks, employees, customers, regulators, and investors have grown both more discerning and better-informed; as such, ESG and climate risk management have been embedded into firmwide operations at both a strategic and an operational level. Adopting a holistic approach to ESG allows firms to maximize growth potential and gain a competitive edge, but it also allows them to remain compliant with forthcoming regulatory mandates.

Financial regulators—both domestic and international—now recognize the risks that climate change poses to global financial systems, taking action to quickly and decisively measure, understand, and address climate risks. For banks, climate risk-related guidance and regulations are expected to function as the primary catalyst of change. Managing the subsequent transition risks requires banks to substantially adapt their operations and business practices. They must develop risk management frameworks, make investments into building quality data, and integrate ESG and climate risks into firms' credit analysis, stress testing, and scenario planning processes. Banks can also help reallocate capital in the economy towards ESG-aligned initiatives, and help motivate new behavior among clients, counterparties, and other financial market participants, acting as a transformative force within the financial industry and its associated markets.

Figure 7: ESG Action Plan

The financial services industry must move with a sense of urgency and purpose. There is no singular approach to address the challenges and complexity that ESG and climate change pose to individual firms. What is clear; however, is that banks must move from theory to action with a practical, purpose-led plan to deliver on the sustainability imperative. Industry transformation is expected in 2022 as stakeholder and regulatory priorities continue to evolve, making it essential for bank leaders and decision-makers to stay informed. ■

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