WHITEPAPER

ESG RISK MANAGEMENT IN FINANCIAL INSTITUTIONS- TOP 5 CHALLENGES AND WAY FORWARD

A Joint point of view from Infosys and IBM

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Contents

Introduction

As the world becomes more aware of the impact of businesses on the environment, society, and governance, companies are increasingly adopting ESG (Environmental, Social, and Governance) strategies to not only meet the expectations of stakeholders but also to create long-term value for their business.

The importance of ESG lies in the fact that businesses today are expected to not only create value for their shareholders but also to operate in a socially and environmentally responsible manner. ESG factors can have a significant impact on a company's reputation, risk profile, and long-term value creation. Companies that adopt ESG strategies can benefit from increased stakeholder trust, better risk management, and improved financial performance. However, the fact remains that enterprises are still struggling to assess the complete impact of ESG and implement it to an extent that creates real impact.

ACCORDING TO "IBM CEO STUDY: OWN YOUR IMPACT 2022" RESULTS

53% CEOs rate sustainability as a TOP priority

87% of them expect sustainability investments to produce improved results in next 5 years

63% of them expect Digital capabilities & AI will play a critical role in driving sustainability

Let's consider the top **5 challenges and opportunities for organisations looking at their ESG Risk Management**. We believe that these 5 challenges if addressed well, will help financial institutions move towards not only compliance to ESG regulations, but also to long-term value creation for all its stakeholders.

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Key challenges and good practices

1 Incorporating ESG strategy into the decision-making processes

Incorporating ESG risk management into investment decision-making processes and strategies requires a comprehensive and systematic approach.

The first step in this process is to create a strong base by aligning the institution's overall sustainability objectives and risk appetite with their ESG integration strategy. Once the institution's direction is clear, risk and compliance leaders can incorporate ESG into risk management by conducting a materiality assessment to identify ESG issues with the most significant impact, integrating ESG research and analysis into investment decisions and engaging with companies and ESG experts (both internal and external)

Access to reliable ESG data and metrics from reputable sources is essential. Practices like scenario analysis (either using predefined scenarios, for example, IPCC scenarios for climate change or in-house scenarios to measure investment performance) and stress testing (incorporating ESG risks to understand the potential impact of adverse ESG events on existing portfolios), provide requisite analysis and data to support decision making.

Once ESG factors have been incorporated in existing processes, it is important to **regularly monitor the ESG performance of investments**, report findings and include in relevant disclosures.

Financial institutions are interested in allocating capital or financing projects that adhere to strong ESG principles, which incentivize businesses to adopt responsible practices. They are also looking for ways to help their customers adopt sustainable practices to achieve ESG goals.

Several financial institutions have publicly committed to the Net Zero Banking Alliance (NZBA), thereby pledging to align their lending and investment portfolios with net-zero emissions by 2050. Incorporating ESG risk management in strategic decisions plays an important part the achievement of this aspiration.

2 Driving ESG outcomes in business scenarios

Financial Institutions (FIs) have a major role to play in driving positive ESG outcomes. While in some geographies the first mover advantage is incentive enough, even without it, in the light of upcoming regulations, sooner or later, this will be a mandate. Following are some ways of achieving the same:

Investment Decisions – FIs can direct capital towards sustainable and socially responsible projects. By integrating ESG factors in their project evaluation criteria, institutions are not only encouraged to adopt sustainable practices but also realise the importance of ESG factors

Build an ESG data platform - Establish a central data utility, an ESG score methodology for listed companies and a formal process for obtaining sustainability information about non-listed businesses. Ensure that the data platform can evolve, scale, and strengthen security.

Transform lending value chains - Adjust credit products, policies, and processes. Create an industry-specific ESG front office and ensure that all lending operations are sustainable. Patchwork solutions and labour-intensive tasks are unlikely to succeed.

Reskill the lending practice - Prioritize the training of staff in ESG lending using modular instruction courses, certification programs and a forum where participants can share educational experiences and best practices.

Expand the risk management framework - Establish a governance process to identify ESG risks that need to be included in the organization's risk management framework. Integrate ESG risks with financial risk management policies, processes, and systems.

ESG Reporting – Maintain transparency by disclosure of relevant information.

Sustainable products and services - Offer suitable products, enabling investors to align values with investments.

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3 Navigating the regulatory impact

The impact of regulatory frameworks on ESG risk management is twofold. While they may create regulatory burdens with additional reporting and disclosure requirements, they also have the power to drive positive change and accelerate the adoption of responsible and sustainable business practices in the following ways:

Mandatory reporting and disclosures - Many countries have implemented or are considering mandatory ESG reporting requirements for financial institutions. These compel FIs to disclose their ESG performance and enhance accountability.

Incentives and penalties - Some regulatory frameworks offer incentives such as tax benefits or government funding to institutions that demonstrate a strong ESG performance while non-compliance may result in fines and reputational damage.

Climate-related regulations - Governments may enact regulations related to climate change, such as carbon pricing mechanisms, emissions reduction targets, or renewable energy mandates. These have the potential to influence operations, supply chains and long-term strategies.

Sustainable finance initiatives - Regulatory frameworks may support and promote sustainable finance initiatives such as green bonds, sustainability-linked loans or encourage investments in environmentally and socially beneficial projects.

Best Practices for Compliance:

Materiality Assessment - Establish ESG criteria and using the same to identify ESG Risks and Opportunities

ESG Data and metrics - While most financial institutions might have the data required for regulatory filings, both existing and upcoming, it is imperative to house this data, identify gaps and ensure it is fit for reporting purposes.

Scenario analysis - Incorporate climate risk into respective stress testing frameworks and internal models to understand how ESG related risks and opportunities can impact financial performance in short and long term.

Supply Chain Management – Identify and manage ESG risks within the supply chain. Work with suppliers to improve sustainability practices and ensure adherence to responsible sourcing.

4 Delivering and communicating ESG commitments

Effective communication of ESG commitments is the key to building trust and can be achieved in the following ways:

Voluntary disclosures and reporting – The availability of ESG data, like the ESG strategy, goals and progress using standardized platforms like ISSB demonstrates a willingness and dedication to not only ESG risk management but also its consideration in investment decisions, risk management and governance practices.

A dedicated ESG section on the company website can be used to house details related to ESG strategy, reports, success stories and ESG compliance status. Engage with stakeholders through regular communication including meetings, townhalls etc. Media and press releases are another way to share important milestones, partnerships, and initiatives.

Another important facet of effective communication of ESG commitments is ensuring that the leadership actively communicates key information related to an institution's strategic direction with regards to ESG, to the workforce in the form of regular updates, trainings and access to educational resources and content.

Clear and measurable ESG performance metrics should be utilised to showcase progress over time. Investor communication is key to provide information on inclusion of ESG factors in investment decision making.

5 The balancing act: preparing for the relevant risks

The potential risks and challenges associated with the integration of ESG factors into financial institutions' risk management models are mainly related to data quality and availability, modelling complexity, greenwashing and social washing risks, uncertainty accompanying the correlation between traditional financial risks and ESG risks, uncertain regulatory landscape, and the trade-off between short term vs. long-term focus.

The mitigation of these risks requires financial institutions to focus on improving data quality and transparency, developing robust ESG risk models, conducting ESG stress and scenario testing, implementing rigorous due diligence processes and collaborating with industry peers and regulatory bodies in developing best practices and standards.

Infosys & IBM

The Infosys and IBM partnership assists institutions in addressing these issues by creating an impactful offering which brings together the best of consulting, advisory, industry knowledge and technology solutions.

Infosys – being a Sustainability leader in its own right – brings forward its deep understanding of ESG regulations and leads by example in this space. **We help customers navigate through this highly regulated space with our deep expertise, next generation AI solutions and global experience.**

As a global technology partner, IBM offers a suite of tooling to support ESG management such as Envizi and Maximo. IBM OpenPages focuses on the Risk Management element of ESG and is a configurable solution that aligns to the Infosys skills and practice.

IBM OpenPages Risk Management for ESG helps organisations identify, assess, and manage ESG risks effectively. It brings together financial, operational, and ESG data to provide a consolidated view of the risks faced by an organisation, and help them maintain compliance while promoting sustainable business growth.
Its capabilities extend into several ESG requirements including:

- **ESG Objective Management**
- **ESG Risk Management**
- **Compliance assessments**
- **Risk and requirement monitoring**
- **Issue Remediation**

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About the Authors

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