NEDonBoard

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ESG & Strategy

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ESG – developing an effective strategy to create value

Industry experts speaking today

Steve Holt (Chair) | Partner, Forensic and Investigations

Steve is a **partner in Grant Thornton**'s forensic and investigations practice, where he advises boards navigating complex risk and reputational issues. His recent work has involved helping clients involved in Operation Car Wash in Brazil, investigations connected with the 1MDB scandal in Malaysia and assisting the independent review of Boohoo Group plc's Leicester supply chain in the UK. If you want to know more, please contact steve.c.holt@uk.gt.com.

Sonia Shah | Associate Director, Financial Services Group

Sonia is an experienced regulatory professional who has worked in industry and practice for over 20 years, advising a wide range of FTSE 250 clients across banking, asset management and insurance. Sonia has worked closely with C-Suite, NEDs, boards and other senior leadership teams on a wide range of projects including regulatory implementation and impact, assurance, change management, governance. She currently leads on the ESG and Climate Risk for Financial Services at **Grant Thornton** in the UK and support globally, as well as overseeing matters of regulatory governance in the finance, risk and compliance team. If you want to know more, please contact sonia.h.shah@uk.gt.com.

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Agenda: what we will discuss today

1. Introduction to ESG
2. Developing an effective ESG strategy
3. Addressing ESG with the board
4. Embedding ESG
5. Embedding ESG - NED experience with Darshita Gillies

Introduction to ESG

What is ESG?

Programmes within the business community aimed at addressing issues:

- net zero pathways
- integration of UN SDGs
- sustainable investments
- shareholder value creation
- B2B and B2C supply chain governance
- labour practices
- diversity and inclusion
- employee retraining programmes
- data security
- financial crime
- culture and conduct
- senior management remuneration policies

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Who is talking about ESG?

UN Sustainable Development Committee

The UN General Assembly in 2015 adopted the 2030 Agenda for Sustainable Development that incorporated 17 SDGs at its core.

UK Taskforce of regulators and Government departments

Established to consider how the expectation in the **Green Finance Strategy** could be met. HM Treasury (Chair), attendees – PRA/FCA; Financial Reporting Council Department for Business, Energy and Industrial Strategy; the Department for Work and Pensions; Local Government and Pension Regulators.

The 2015 Paris Agreement

United Nations Framework Convention on Climate Change, aims to strengthen the global response to the climate crises and keep global temperate rises to well below 2°c.

TCFD – Task Force on Climate-related Financial Disclosures

The TCFD a private sector led group convened by the FSB in 2015 to "develop voluntary, consistent climate-related financial disclosures that would be useful to investors, lenders and insurance underwriters in understanding material risks".

Its 2017 final report sets out overarching recommendations in four thematic areas: **Governance; Strategy; Risk Management; Metrics and Targets**.

Who is talking about ESG? (continued)

Regulatory bodies	• **PRA** – Supervisory Statement | SS3/19 Enhancing banks' and insurers' approaches to managing the financial risks from climate change, April 2019. 'Dear CEO Letter', published by the PRA in July 2020 • **FCA** – FCA Climate related disclosures PS 20/17 • **CFRF** – Climate Financial Risk Forum Guide 2020 – chaired by PRA / FCA and includes banks, insurers and asset managers • **BOE** – The 2021 biennial exploratory scenario on the financial risks from climate change • **EBA** – Sustainable Finance • **EU Commission** – Action plan on financing sustainable growth • **ECB** – Climate change strategy covering economic analysis, banking supervision, monetary policy and financial stability
Central banks	• **Network for Greening the Financial System (NGFS)** – 83 central bank members, strengthening global response to meet goals of the Paris Agreement, to enhance the role of the financial system to manage climate change risks and promote green investments.
Other industry bodies	• **GRI** – Global Reporting Initiative Sustainability Reporting Standards (GRI Standards), October 2016 • **CDP** – The CDP (formerly the Carbon Disclosure Project) Reporting Guidance 2019 • **SASB** – Sustainability Accounting Standards Board Technical Bulletin on Climate Risk, April 2021 • **2 degrees** – 2° Investing Initiative (2DII) Reports • **IFRS task force** – sustainability reporting consultation paper covering investors, central banks, public policy makers, auditing firms etc

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Developing an effective ESG strategy

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ESG Strategy

What should the strategy consist of?

Environmental

- Climate change and greenhouse gas (GHG) emissions
- Energy efficiency
- Resource depletion, including water
- Hazardous waste
- Air and water pollution
- Deforestation
- Remuneration v climate targets

Social

- Human rights
- Working conditions, including slavery and child labour
- Local and indigenous communities
- Conflict
- Health and safety
- Employee relations and diversity
- Supply chain oversight
- Employee retention
- Employee training/upskilling

Governance

- Executive pay
- Bribery and corruptions
- Political lobbying and donations
- Board independence, diversity and structure
- Tax strategy
- Transparency
- Shareholder rights

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Addressing ESG with the board

ESG considerations for the Board

Roles and responsibilities

Board
Set strategy and risk appetite for firms approach to ESG framework

CEO
Business model design to incorporate ESG initiatives

CFO
Financial impact of sustainability initiatives and communication programmes with investors and stakeholders

COO
Development of an efficient operating model that incorporates sustainability initiatives around carbon, power and water usage

CRO
Scenario/stress testing development around climate change impacts – portfolio transition and green initiative assessments

Business leads
Client ESG programme assessments, new product development and portfolio transformations

Culture

- Tone from the top in relation to the ethos behind the ESG Agenda
- Senior Leader messaging across business and support functions
- Developing relationship between a strong culture and effecting sustainable change in relation to ESG
- Transition plans that consider ESG investments balanced against carbon based profitability
- Ongoing reinforcement of ESG cultural attitudes through training and development
- Developing work force to ensure appropriate balance of ESG technical capabilities

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Risk management considerations

Risk management framework

- Risk governance
- Risk appetite
- Roles and responsibilities – 3LOD
- Assess – credit, mkt, op risks
- Data, tools and MI/metrics
- Training and culture

Risk governance

- Board approved Risk Appetite
- Senior Mngt Responsibility
- Policies – ESG risk types
- Risk mandates, reflecting the materiality of risks
- Controls - risk identification, assessment, accept or approval, monitoring and
- Firm education and awareness

Risk reporting

Periodic regular board updates:

- Firm's progress implementing the framework
- Risk Appetite and metrics
- Scenario development and testing

The board to provide review and challenge on:

- Climate risk concentrations
- The firm's strategy/plan, over S/M/L term
- Materiality assessments/ scenario analysis
- Emerging regulatory, reputational and legal obligations

1LOD activities

- Integrate climate risk assessment onboarding clients/periodic reviews
- Understand client business plans for mitigating climate risk
- Develop understanding of timing and channels of risk

2LOD activities

- Set-up and own central risk frameworks
- Develop the tools for identifying and assessing climate risks
- Deliver climate risk training
- Develop scenarios and undertake stress testing
- Support 1LOD activities

3LOD

- Independent review of control design and execution

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Considering transition/physical risks

ESG risk assessment time-scales =

Short term | 1 – 2 years	Medium term | 3 - 5 years	Long term | 5 - 20 years

Transition risks

- Determination of ESG strategies
- Portfolio analysis aligned with short, medium and long term time horizons
- Risk management issues resulting from scale and speed of legislation creating unintended consequences
- Knee jerk reaction to portfolio reshaping, pushing against green washing temptations
- Increased due diligence requirements with regard to investments with green declarations
- KYC due diligence around green programmes
- Changes to credit risk management client assessments/credit ratings, incorporating newly determined ESG metrics
- Requirement to develop ESG scenarios and stress tests over variable time horizons
- Supporting and appropriate MI for Board and EXCO
- Deeper supply chain due diligence to ensure robust green programmes
- Reputation risk impacting market appetite for issuance programmes
- Firm wide training programmes

Physical risks

- Increased storm surges
- Flooding
- Heatwaves/cold waves
- Wildfires
- Sea level rises
- Rising mean temperatures
- Pestilence and crop damage
- Climate rebellion – physical disruption and collateral damage

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Biennial Exploratory Scenario (BES)

Bank of England – 2021

- Wide participation - BES will test the resilience of both the UK's largest banks and insurers to climate-related risks.
- 3 scenarios - Early, late and no scenario
- 2 phases - Phase 1 is magnitude of the financial risks and Phase 2 is actions taken to respond to the risks.
- 30 year modelling horizon
- 2 channels of financial risks - Physical and Transitional
- Integrated climate and macro financial variables
- Counterparty-level modelling
- Approach to different sectors - Corporate exposures, Household exposures and Government exposures

Table 4.A Indicative scenario variables for the proposed BES scenarios[a][b]

Climate risk variables		Macrofinancial variables	
Physical variables	**Transition variables**	**Macroeconomic variables**	**Financial market variables**
• Global and regional temperature pathways • Frequency and severity of specific climate-related perils in regions with material exposure (including UK flood, subsidence and freeze) • Longevity • Agricultural productivity	• Carbon price pathways • Emissions pathways (aggregate, and decomposed into world regions and sectors) • Commodity and energy prices (including renewables), by fuel type	• Real GDP (aggregate and decomposed by sector) • Unemployment • Inflation • Central bank rates • Corporate profits (aggregate and decomposed by sector) • Household income • Residential and commercial property prices	• Government bond yields for major economies • Corporate bond yields for major economies (investment grade and high yield) • Equity indices • Exchange rates • Bank Rate

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Embedding ESG

Embedding the ESG framework

Climate Financial Risk Forum
Climate change framework which can be translated into the overall ESG framework

- Integrate ESG risk into governance and risk management framework
- Conduct ESG assessment
- Invest in necessary enablers
- Build consistence approach with scenario analysis disclosure

Building Blocks G			
Risk Governance	Risk Management Frameworks	Risk Appetite	
Credit risk	Market risk	Underwriting risk	Operational risk
Other related risks: Litigation risk, reputational risk, conduct risk, other risk			
Data and tools	Training and Culture		
Scenario analysis (separate workstream)	Disclosure (separate workstream)		

Disclosures

Reporting on ESG

Disclosure Regulations

- UK Companies Act
- UK Accounts Regulations
- Capital Requirements Directive/Regulation (CRD) IV, CRD V and CRR II affecting banks and investment firms
- Solvency II for insurers
- IAS/IFRS Rules
- UK Corporate Governance Code and Listing Rule 9
- UK Stewardship Code 2020 that require companies to disclose material issues, including in relation to environmental matters, which covers climate change
- EU Non-Financial Reporting Directive (NFRD) to report on environmental matters which may include climate change
- The Prospectus Regulation
- EU Sustainability Disclosures Regulation
- Shareholder Rights Directive II (SRD II)
- The PRA Supervisory Statement (SS3/2019)

Content description

- Analysis and decision-making process that should underpin disclosure
- Use of qualitative versus quantitative information
- Forward-looking statements comply with wider market regulations
- Importance of considering long, as well as, short term timeframes
- Explain uncertainty in information being disclosed
- The need for the information to be important to a reasonable investor
- Application across sectors and geographies
- Comparability against benchmarks over time

Metrics

- Basic: widely used
- Stretch: some use; at an early stage of development/acceptance
- Advanced: likely to be useful but methodologies not yet developed

Who is the audience

- Investors
- Regulators
- Standard Setters
- Inter-bank relationships
- Credit rating agencies
- Fund raters
- Insurers
- Supply chain relationships
- Clients
- Lobby groups

Liability implications

Annual Report

- Directors - personally exposed to liability, including criminal sanctions under the Companies Act.
- FCA sanctions imposed - publicly traded securities firms

Prospectus liability regime

- Higher standards and/or risk expected at the point at which an issuer offers new securities or is admitted to trading on a regulated market.

Product related liability regime

- In relation to other disclosures at product level, banks, asset managers or insurers.

CEOs and CFOs a particular focus as they ‘control’ the company

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Financial Reporting Council 12 November 2020

Reporting on ESG

FRC will monitor how companies and auditors are responding to the impact of climate change

- Compliance with reporting requirements in respect to climate change
- Auditors assessment of climate change impact
- Resources available within audit firms to support audit teams
- Disclosures under the new UK Corporate Governance Code
- Reporting in line with TCFD

To meet investor disclosure requests, the FRC encourages companies to:

- Provide environmentally focussed strategies
- Transparent terminology, explanations and progress against climate based targets and what assurance will be sought.
- Describe how climate policies and targets have been incorporated into business plans, business impact utilising KPIs as appropriate.
- Describe businesses impact on the environment, including supply chain oversight.
- Segment/disaggregate revenue disclosures where climate change presents substantially different risks and opportunities.
- Additional climate reporting measures could include:
  - impairment of individual assets as well as cash generating units
  - useful economic lives of assets
  - expected amounts and timing of cash outflows
  - fair values of assets and liabilities
  - disclosure of key accounting judgements, uncertainties and related sensitivities.

“Auditors have a responsibility to properly challenge management to asses and report the impact of climate change on their business.”

“The FRC has high standards for company disclosure including climate change. Company reports and accounts are essential to understanding how organisations are responding to the challenge of climate change.”

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External and internal implications

Incorporating ESG risks into an organisation's financial resources externally and internally

External impacts	Internal impacts
• Change in strategy to incorporate ESG programmes • Portfolio re-composition • Asset valuation impacts • Underwriting • New ESG initiatives/investments/green washing considerations • Firm's marketability for asset manager green fund inclusion • Reputation – lobby groups and Influencers • Regulators – increased emphasises on disclosure accuracy • Legal risks – litigation from poorly structured ESG programmes	• ESG governance framework – Board and sub-committees • Designated and engaged Senior Manager • Disclosures – regulatory requirements to have explicit ESG/climate change disclosures across all financial and non-financial organisations • Credit risk management – reassessment of client relationships and ratings • Risk of green investment concentrations • Scenario analysis/stress testing development • ICAAP/ILAAP/Pillar 3 – regulatory requirement to incorporate climate change risks within documents • Operational Resilience – incorporation of climate change in OR frameworks • Recovery resolution/wind-down plans – impact of stress tests on these plans

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EMBEDDING ESG FIRST-HAND EXPERIENCE FROM A NED

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Embedding ESG

Darshita Gillies’ experience embedding ESG as a NED

Sharing experiences from the board perspective is Darshita Gillies. Darshita is the Founder and CEO of Maanch, a UK-based B Corp developing technology to measure, monitor and report on the impact of investments, organisations and philanthropy, through the lens of the UN Sustainable Development Goals. Darshita’s professional foundations are as a Chartered Accountant, Operational Risk Manager, Investment Banker, Executive Coach as well as FinTech-Blockchain Specialist and ESG-Impact Evangelist. She serves on the Boards of several for-profit and non-profit organisations.

Q&A
SESSION

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THANKS FOR WATCHING AND LISTENING

Notes relating to NEDonBoard

All NEDonBoard engagements are subject to a binding contract, fully setting out all terms and conditions. A full summary of terms and conditions is available on request.

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