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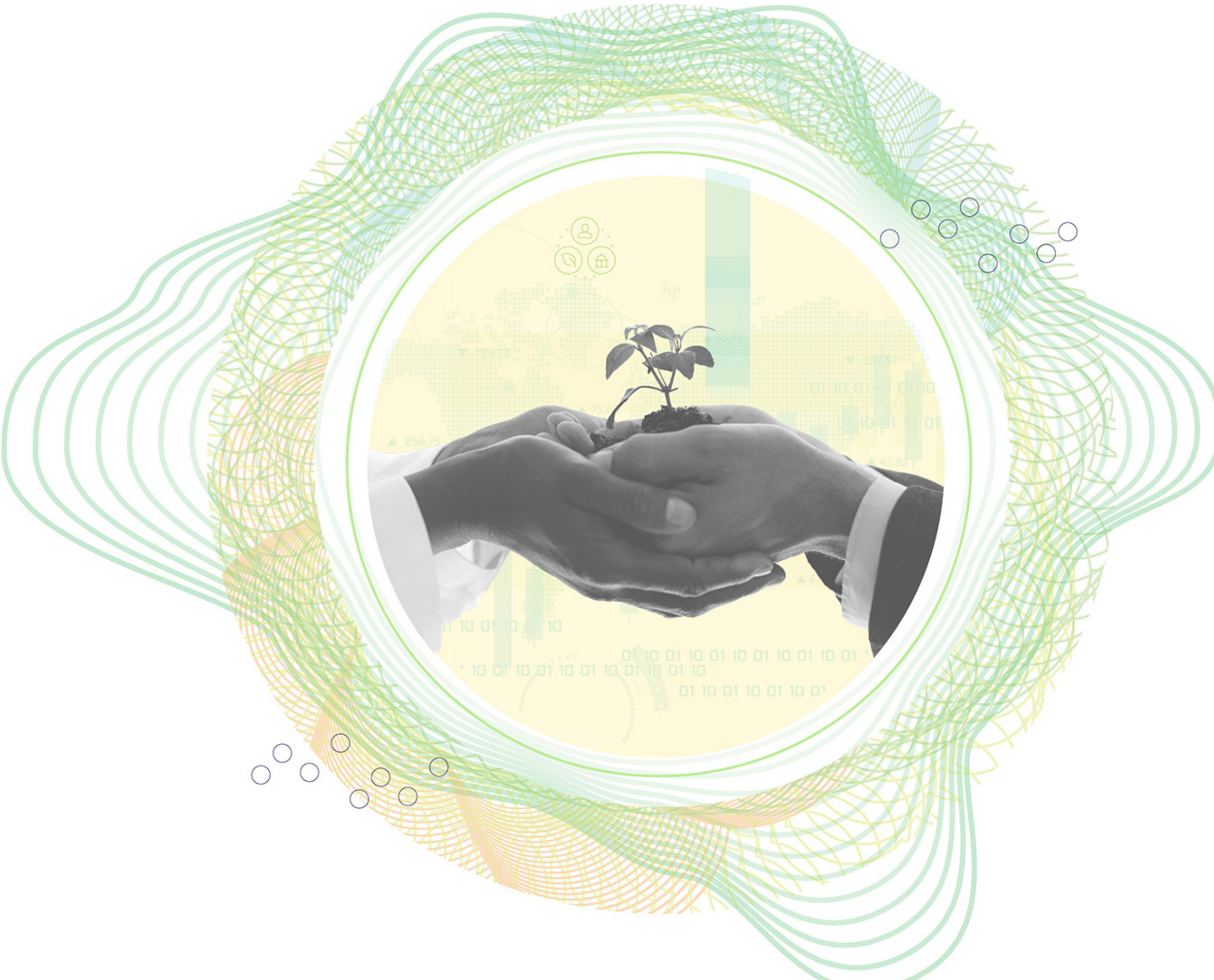

ESG-infused governance

How financial institutions can meet expanding stakeholder expectations

Center for Board Effectiveness

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Introduction

Is the big push in the global financial services industry in support of environmental, social, and governance (ESG) objectives adequately being enabled inside those organizations? Or are those pledges and initiatives at risk of falling through the cracks in the face of competing priorities, leaving such firms open to claims of greenwashing?

Around the world, financial institutions are catalyzing and accelerating the transition to a new economy that is more environmentally sound and better aligned with societal priorities. At the 2021 United Nations Climate Change Conference (COP26), financial institutions with more than $130 trillion in assets under management committed to reaching net-zero by 2050.[1] Individually, multinational banks have committed hundreds of billions of dollars to improve economic opportunities in local communities. In recent years, investment management firms have introduced a wealth of ESG funds that have captured more than $35 trillion in assets under management worldwide, a number expected to grow to $53 trillion by 2025.[2] Pension funds, significant ESG investors themselves, are among the biggest supporters of ESG shareholder resolutions in the United States.[3] And insurers are using their insured's ESG performance scores in their underwriting and portfolio management decision-making.

And yet, many in the industry continue to rely on internal governance policies and practices that were devised years ago, before ESG became an important discussion point at board meetings and when corporate social responsibility initiatives were formulated without consideration for tracking progress against them and measuring impact. In *Bank Director's* 2023 Risk Survey, more than 60% of the banking executives polled said their bank doesn't yet focus on ESG issues in a "comprehensive manner," and just 13% described their ESG program as mature enough to publish a disclosure of their progress.[4] Compensation incentives, for the most part, remain tethered to traditional performance metrics, failing to incorporate ESG-related targets and an important measure of executive performance.[5] More than four in 10 audit committee members at the corporate board level noted an increase in the risk of fraud in their ESG disclosures in a 2022 joint study by Deloitte and Center for Audit Quality.[6]

An expanding array of stakeholders are taking note. In the past, financial institutions didn't face much scrutiny when they published well-intentioned and ambitious corporate sustainability reports, including commitments related to ESG initiatives. But that's no longer; from consumers holding banks to higher ESG standards, to employees demanding action that aligns with their values, to activist investors introducing shareholder resolutions at annual meetings, the pressure is being ratcheted up.[7] With the increased focus on nonfinancial performance measurement comes heightened risks, including financial, operational, and reputational concerns (see figure below).

Against this backdrop, financial institutions need to take additional steps to infuse ESG considerations into their governance frameworks to meet the expectations of an expanding array of stakeholders, build stronger relationships with them, and strengthen oversight of the commitments they're making. ESG-infused governance can also lead to better investment returns, higher valuations, lower capital costs, and stronger risk management.[8]

Before the real work can begin, though, financial institutions may first need to shift their mindset around whose interests they are serving by examining the governance factors dictating every decision they make.

Risks to financial institutions from ESG-light governance

Governance risks to financial institutions

A sound governance structure helps financial institutions achieve their ESG commitments while mitigating and managing many types of risk that may materialize as a result of poorly designed and/or implemented governance programs

Financial

- **Deteriorating financial performance** due to customer dissatisfaction
- **Increased credit losses** due to lack of ESG factors in credit evaluation
- **Liquidity shortage** due to customer withdrawals and loan defaults
- Financial distress due to **sanctions and fines** from regulators

Operational

- **Poor risk management infrastructure** and internal controls for ESG factors
- Inadequate integration of **key ESG risk indicators** in day-to-day operations
- **Poor integration of ESG reporting and compliance** in record-to-report process

Reputational

- **Loss of brand image and value** due to unethical practices
- **Stakeholder dissatisfaction** due to reputational loss
- Customer and client **loss of confidence** resulting in **deteriorated sales** numbers
- **Negative publicity** threatening ability to attract and retain top talent, investors, and new customers

Regulatory

- **Noncompliance with sustainability and ESG reporting** regulatory requirements
- Deceptive practices like **"greenwashing" and "impact washing"** resulting in regulatory
- **Inadequate quality check and oversight** of ESG disclosures resulting in regulatory investigations

Conduct

- **Increased risk of doing business** due to malpractices within firm (e.g., corruption, money laundering)
- **Increasing risks** due to non-transparent and/or incorrect reporting of ESG initiatives
- **Negative impact** on environment and society due to inappropriate decisions impacting firm's social llcense to operate

Migrating to a multistakeholder model

For decades, boards across the spectrum have been governed by the concept of shareholder primacy, which posits that a board's primary fiduciary responsibility is to maximize value for shareholders. They have sought to accomplish this by:

- Emphasizing financial returns and profitability.
- Measuring company performance based on financial indicators such as earnings per share and return on investment, for example.
- Favoring short-term gains over long-term viability.
- Considering social and environmental concerns as secondary to the above.

Companies have sought to defend these tactics in a variety of venues, most notably in the courtroom.[9] The courts have repeatedly recognized that a board's ability to consider other stakeholder interests is a fundamental component of strategic planning, a critical aspect of risk management, and central to their fiduciary responsibility to enhance the corporation's long-term value.[10] In many cases, boards have been able to point to the Business Judgment Rule,[11] which holds that directors should not be held liable for good faith decisions made on behalf of their company.

Support for a multistakeholder governance model was furthered in 2019, when 181 CEOs from some of the world's biggest, most recognized companies formally signed the Business Roundtable's "Statement on the Purpose of a Corporation," which committed them to abandon the principle of shareholder primacy and lead their companies for "the benefit of all stakeholders."[12]

Meanwhile, new rules enforcing ESG considerations in board deliberations are taking shape. Supervisors are clamping down, unveiling new requirements they hope will continue the dialogue, increase accountability and collaboration, and introduce new or tighter standards and metrics for achieving ESG-related goals (see "Regulations supporting ESG transparency" sidebar). California, for instance, passed new laws in 2023 that require companies above certain annual revenue thresholds to submit an annual report on greenhouse gas emissions and report on climate-related financial risk and disclose measures to reduce such risk.[13] With increasing regulatory scrutiny of ESG disclosures, expanding the audit committee's role to include oversight of nonfinancial reporting becomes even more compelling.

Of course, regulators aren't the only stakeholders pressing for change. Employees now expect employers to achieve diversity in promotions and senior leadership and equity in pay, and to promote their well-being. Customers demand seamless services and quality while protecting their privacy and security. Regulators demand accurate and timely disclosures and reporting, including risk assessments. And community members expect banks and others to promote financial inclusion and economic development through ethical and sustainable financing activities. And that's just a start. In fact, investors themselves have started to clamor for increased disclosure of ESG risks.[14]

Financial institutions are gradually shifting to a multistakeholder model to meet the needs and concerns of other stakeholders beyond investors while acting in the best interest of the company to enhance and protect its long-term value and viability. If we accept that the fiduciary duty of a board is the legal and ethical obligation to act in the best interests of the organization and all its stakeholders, then financial institutions that haven't done so already may need to revisit and revamp their governance models to account for their needs and input in the decision-making process.

Regulations supporting ESG transparency

Supervisors across the globe have established or proposed rules governing what information companies must disclose and how they plan for ESG-related risks, in some cases even restricting certain business activities that run counter to ESG objectives. The following are a few noteworthy examples.

US Securities and Exchange Commission (SEC): The SEC already requires listed entities to submit information regarding ethics, environment-related initiatives and risks, and director objectivity as part of their annual Form 10-K filings. The regulator has proposed enhancing fund disclosure requirements for investment companies and advisers that consider ESG factors. In September 2023, the SEC voted to impose new regulations that would require funds to review portfolios each quarter to "help ensure" they invest 80% of their assets in line with their stated focus.[15]

Nasdaq: This US-based stock exchange requires all listed companies to annually disclose board-level diversity statistics and provide explanation for not having at least one diverse director as of 2023, and at least two diverse directors beginning in 2025 or 2026.[16]

European Union: The European Commission introduced the Sustainable Financial Disclosure Regulation (SFDR) to impose mandatory ESG disclosure obligations on asset managers and financial intermediaries.[17] The recently adopted European Green Bonds Regulation (EuGB) regulates the use of the term "European green bond" and mandates that the proceeds of such bonds be invested in certain activities.[18]

UK Financial Conduct Authority: This regulator of financial services firms requires that listed companies make disclosures consistent with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), including disclosures related to scope 1 and scope 2 emissions.[19]

The four pillars of ESG-infused governance

An ESG-infused governance model helps an organization achieve not only its ESG goals, but also its financial, regulatory, and strategic priorities.

There are certain foundational elements of any effective governance framework. We believe that four pillars stand out for their potential for financial institutions to infuse ESG considerations into their long-term strategic planning: oversight structure, compensation structure, policies and risk management, and transparency and accountability. In each case, we'll describe what different levels of maturity in moving toward a multistakeholder model would look like in a financial services organization.

Oversight structure

How the board, its committees, and the senior management team are structured either allows for ESG matters to rise to prominence or remain a sidebar discussion. For the former to happen, the board should understand how management is implementing a systematic and strategic approach to identify material ESG issues and programs to manage ongoing ESG-related risks.

The board also advises and challenges a company's strategic direction—giving it the opportunity to regularly articulate ESG priorities and goals. This means it needs to fully understand and communicate who owns ESG-focused goals within the organization and provide adequate tools and resources to those leaders and their teams.

Meanwhile, management should inform the board as to what mechanisms are being used to track the company's progress against those goals, using specific key performance indicators (KPIs) that tie back to ESG initiatives (see "Measuring ESG performance" sidebar) with adequate opportunity for credible challenges.

Where to start? At the very least, boards should confirm that management is undertaking a materiality assessment of ESG expectations and goals to help understand what is important to all stakeholders and challenge its approach when warranted.

More advanced organizations build on these initial moves by taking two additional steps: (1) they form a new board committee or repurpose an existing one for oversight of ESG-related risks, issues, and initiatives; and (2) they form an ESG management reporting structure and working groups to execute on the work and report back to the board committee. They might also develop a set of ESG governance performance indicators to help measure the company's progress, including areas such as commitment to ESG, board diversity, equal treatment of minority shareholders,[20] and stakeholder engagement. These factors can then be embedded into decision-making to ensure the company meets its nonfinancial goals along with its financial objectives.

Measuring ESG performance

Through their audit committees, companies have long used tailored KPIs to track their financial performance from period to period. Now, an emerging crop of metrics is helping them keep track of their progress against nonfinancial goals as well, allowing them to assume increased responsibilities in the emerging multistakeholder model. Here's a sample of ESG-linked KPIs in use today:

- **Climate KPIs**: Decrease in energy consumption and financed emissions
- **Nature-positive KPIs**: Decrease in quantity of waste generated, reduction in water consumption, investments in renewable energy projects or infrastructure with biodiversity net-gain measurements
- **Human rights KPIs**: Percentage difference in pay for men and women; percentage increase in the number of minorities in client-facing and senior roles; increase in financial well-being programs and utilization, number of financially inclusive products, and dollars invested; percentage utilization of financial services in underserved markets

Compensation structure

People do what they're financially incentivized to do. Executive compensation is a powerful lever for boards to prompt change and increase accountability throughout their organizations. Research has shown that imposing long-term incentives on executives improves business performance.[21] And yet, according to Capital Monitor, only about a quarter of the world's 100 largest banks by assets link CEO compensation to at least one environmental target.[22]

Having an objective basis for evaluating ESG performance is key in this effort, as is understanding industry expectations and sources of competitive advantage. But so is subjectivity—boards may need to regulate ESG integration with their compensation structure based on their risk appetite or grant a certain amount of flexibility in judging ESG performance in tandem with other priorities.

Management might be encouraged to incorporate stakeholder inputs into their evaluations of executive performance and design standard protocols for ESG-infused incentives and compensation calculations. Those evaluations could incorporate industry benchmarks along with assessments of other approaches used to link ESG goals to executive pay. A more advanced step would be to set compensation KPIs and targets; some organizations have designed customized scorecards or scoring systems for this purpose, tailored to ESG goals.

Policies and risk management

Rules, regulations, practices, and processes have a direct correlation with the effectiveness of corporate governance. A company-wide code of conduct, for example, helps set expectations for appropriate conduct by making it official policy. In most cases, the extent to which internal policies and programs are aligned with external ESG commitments and disclosures will determine how successfully an organization walks the walk and avoids claims of greenwashing.

The same is true of how ESG risks are integrated into enterprise risk management (ERM) and other risk management approaches alongside traditional risks. When business decisions are guided by risk boundaries that include ESG considerations, there's a far greater chance stakeholders will be satisfied with the company's progress. For example, if a bank has a sustainable finance goal of committing $10 billion in capital by 2030 on such projects, then its commercial lines of business need a policy that maps out specific inclusion criteria and a process for validation and oversight in order to support this target. In so doing, financial institutions have an opportunity to build a decision cycle that creates more value for the firm overall than each practice does individually. Statements of risk appetite for environmental and social risk can also support such goals by allowing for consistency of practice and accountability to ESG commitments.

Boards intent on building such capabilities can use strategy workshops hosted by management to challenge its determination of key ESG risks, frameworks, and KPIs. For instance, when addressing the risk of forced labor or modern slavery in their value chain, financial institutions should be guided by related metrics and controls that proactively identify such risks, triggering intervention. Boards might also work to create a repository of ESG-related legislative and regulatory updates, along with analysis and capacity for regularly monitoring new developments.

From there, more advanced organizations will work to assess their policy gaps and build a road map for addressing them. They will design and develop an environmental and social risk management (ESRM) policy to identify, assess, and manage ESG risks associated with their clients and business relationships based on their company's risk appetite and risk boundaries. The ultimate end state is an ERM program that fully integrates ESG risks, ensuring they become a de facto ingredient in the governance factors driving everyday decisions across the organization.

Transparency and accountability

Transparent and accountable business practices instill confidence among stakeholders and help drive enterprise value. Regular reporting on ESG and nonfinancial performance is becoming as important as the reporting of financial data, including clear communication of goals and targets for creating internal and external goalposts. Regular disclosure of progress against those targets (using the types of KPIs discussed above)—including plans to take corrective actions—prevents others from drawing their own conclusions and can counter claims of greenwashing or impact washing. Those that rely on an independent, external review of their financials are also less prone to producing incorrect reports.

Boards should help ensure that all ESG communications are aligned across corporate disclosures—from annual regulatory filings to sustainability reports—and that it accounts for stakeholder expectations regarding transparency, even in the face of dire events. Take, for example, the case of a bank that finances the operations of an industrial plant that is connected to an incident of toxic waste entering the local water supply. The bank should have a transparent mechanism for receiving community grievances, understanding its role in the remediation process, and disclosing what the process is for managing its obligations in relation to the accident and related harm to the community.

Boards working to be more transparent and accountable start by refining their communication strategy so that they have a plan for engaging stakeholders across the spectrum, including the design of new channels for communicating and a method for tracking stakeholder questions or concerns so that they inform future ESG strategy. More sophisticated companies will then seek to bring in outside vendors to conduct a materiality or saliency assessment, help identify their ESG gaps, and integrate ESG data to present potential remedies. All this work ultimately bubbles up to the design of a full-fledged reporting and disclosure strategy that includes guidance on how to execute in a way that provides confidence for compliance.

Conclusion

The days of companies being valued solely on financial performance are over. The governance factors that drive everyday decision-making must account for the wants and needs of all stakeholders, including those focused on ESG objectives. This means ESG considerations must be infused into the fabric of every financial services organization, and not simply sprinkled into already-baked financial plans and priorities.

Companies that can successfully migrate to a multistakeholder model may be justly rewarded, and not just with stronger relationships. Fulfilling their expectations is a path to better returns, valuations, and risk management—in other words, real and measurable results.

How do you rate?

The path to realizing the benefits of ESG-infused governance starts with assessing how your organization currently rates in terms of infusing ESG considerations into the four pillars covered in this paper. Deloitte has developed specific governance scorecards to rate how our clients fare across these four areas, looking at issues as diverse as pay ratios to gender diversity on the board to whistleblower protection programs. Engage with us today to help mature your ESG governance approaches and capabilities.

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