BURNING QUESTION
SUSTAINABILITY IN FINANCIAL SERVICES FIRMS
Sustainability has never been more urgent than it is now. When the Intergovernmental Panel on Climate Change (IPCC) released its report in August 2021 outlining the scale of human-induced climate change, the message could not have been clearer: only by acting now can we hope to limit global warming.

What might be less well known is the significant and influential role that the financial services sector can play in this effort. There are several key reasons why.

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on them to lead by example and to take on an advocacy role. Banks have extensive supply chains so they can influence the behaviours of suppliers as well as customers.

For their part, customers are starting to demand more environmentally friendly products. The sector needs to continue developing its own green products such as loans, bonds, and mortgages. Some banks are beginning to offer incentives like lower interest rates for buyers of A-grade energy-efficient houses, or loans to convert their homes to lower-carbon technologies such as solar panels.

Regulations will play a growing role in enshrining sustainability in financial institutions. Today, regulations are already forcing wealth managers to redirect capital to more sustainable investments, and to sustainable products.

In the EU, there are at least 20 regulatory frameworks that are being revised to take account of climate change. The EU Corporate Sustainability Reporting Directive will introduce substantial changes to the current sustainability reporting regime and will apply to all corporates of a certain size.

The EU Sustainable Finance Disclosure Regulation came into effect in March 2021, obliging investment management firms to assess the sustainability risk of a product and make disclosures to the market. This is a relatively unusual case of regulation moving faster than the market; normally it’s the other way around. At some point in the next five to seven years, we expect to see a convergence between regulation and the market, with a common language emerging around company disclosures.
In the past, as financial institutions moved towards a culture of protecting the consumer, sustainability tended to fall to the conduct risk and compliance teams. Now, however, the issue is far too big. It needs to become embedded in the organisation’s operations, starting with the ‘tone from the top’ where the board is bought in to the strategy, there are policies in place, and it’s connected to the bank’s risk appetite.

Boards of banks are skilled in running banks – a task that historically has always been about maintaining share value. Now, however, many banks are hiring climate scientists and risk modellers to assess the financial impact of climate change on the organisation. Those are technical skills and fields of expertise that banks didn’t have before, and consequently boards need to upskill or acquire skills to oversee that activity in the bank.

Enterprise risk management has evolved over the years, and now encompasses both financial risks such as liquidity and capital adequacy, and non-financial risks like conduct risk and money laundering. The sustainability issue requires finance, compliance and risk management to work together horizontally, not in silos. Sustainability is fundamentally about having a strategy that’s intended for the business to survive long after the current executive has finished its term.

Even before the IPCC report, it has been noticeable how momentum on sustainability has picked up speed in the last year. There are still degrees of maturity in the sector: some of the leading global names have been very active, making significant financial commitments to sustainability.
For example, the insurance sector is ahead of the curve on physical assets and risks because that’s their business, assessing risk, which positions them well for the ‘E’ in ESG. However a bank would have needed to develop conduct risk, diversity and inclusion and governance frameworks over the past number of years, which positions them well for the ‘S’ and the ‘G’. The investment management sector already must make sustainability disclosures to investors about risk in the product.

At an industry level, there is a lot of research underway and planned into the social impact of climate change. It is also worth saying that the financial sector in its current form has a significant carbon footprint. Historically, the international financial sector has high volumes of travel, particularly among executives. Many operate their own data centres which are heavy consumers of energy. Many domestic banks still have extensive branch networks, and even after rationalisation there is a large footprint of physical buildings.

Some firms have out-of-date practices like company cars (although this could also become a potential opportunity to convert to electric vehicles). Changes to long-standing practices need to be deep and lasting, not a PR opportunity; regulators are conscious of, and watching for, efforts that come across as ‘greenwashing’.

So, what should Irish financial services providers do to get ready for this changed environment? The first step should be to ensure they are equipped to respond to the various forces of regulatory demand, customer demand, or climate risk modelling demands. There should be a major focus on skills assessment to ensure the bank has the capabilities it needs – or has a clear plan to get them.

Making a difference on climate change is a path everyone must make together. No one organisation can do everything on its own, and without greater collaboration between large organisations, this won’t work. If one organisation is out in front, it will make no difference to the trajectory we are on with climate change. This is not a race for first place; we all need to cross the finish line together.

Therefore, banks need to evaluate with whom they should partner. For reporting purposes, a lot of data needs to be harnessed to make accurate reports to shareholders, investors, and customers.
Financial services providers have a huge societal role – and as large employers themselves, they have an unrivalled position to change the dialogue around climate change.

There may be a digital play to get hold of that data to analyse it. Alternatively, the answer to the partnership question might not be obvious: it could even be a competitor (when it comes to climate change, there is no competition). It is vitally important for the industry to collaborate with other entities and individuals on this issue. It’s not a simple change to financial regulation; there’s much more at stake.

Financial services providers have a huge societal role – and as large employers themselves, they have an unrivalled position to change the dialogue around climate change. The large named banks will need to lead from the front: in how they interact with customers, and large corporate clients, they can have a major influence by sharing best practice and by developing attractive products that encourage sustainable activity.

Read on to learn more about sustainability in financial services firms from a global perspective.
Climate change preparedness has quickly become a business imperative for financial services firms as stakeholders progressively demand accountable action. In the human-centred future of financial services, how a firm addresses issues of climate change will play a vital role in attracting and retaining customers and talent and driving growth. With increasing regulation and potential for systemic risk implications, how can you better assess the impact of climate change on your business while being a responsible corporate steward? Learn how strategic climate risk management can help you thrive in the economy of the future by identifying sustainable investment opportunities that elevate your bottom line while creating opportunities to make a positive impact on the communities in which you do business.
Imagine the financial services industry of the future, where leading banks, securities firms, wealth managers, asset managers, and insurers have incorporated risks relating to climate change – such as extreme weather, the potential for losses, regulatory guidance, and stakeholder pressure – into a broadened risk agenda. These organisations will have navigated, embraced, and even benefited from a journey of centring climate change as a key strategic issue, finding ways to proactively address climate challenges. Capital markets and society-at-large can benefit from their transformation and innovation.

Until now, taxpayers have borne most of the risk involved with transitioning to clean energy and energy-efficient solutions. But in the future, the private sector will need to play a significantly bigger role. The deployment of technologies and solutions to combat climate-related challenges will largely depend on the financial services industry’s willingness and ability to address key funding gaps.

In this not-so-distant future, sustainable finance will become engrained in the business, and the integration of climate risks into day-to-day activities should become the norm. As they prepare for this eventuality, financial services firms can certainly take a page out of the playbook they have used to identify, model, measure, manage, and report non-financial risks that are difficult to quantify and track. But in many respects, incorporating climate risk into existing risk frameworks will be a unique, and sometimes disruptive, challenge.
What a comprehensive climate programme looks like

We believe the industry will rise to the occasion, while recognising it is quite specialised and nuanced. The end state may look quite different for an asset manager, a wealth manager, a bank, a brokerage firm, or an insurer. Business leaders will need to work hard to understand the aggregate effects and benefits of every decision they make.

But certain shared traits will define ‘climate-centred’ financial firms of the future. These organisations will be constantly sensing, monitoring, and communicating climate-related risks and reflexively adjusting their corporate, business, and risk strategy to align with the changing landscape. Specifically, three factors should set climate-centred firms apart from their less-prepared competitors:

01. Climate-infused governance and corporate strategy.
   Firms will incorporate climate considerations into every strategic decision. They will institutionalise this mindset throughout the organisation and promote it more broadly through external partnerships and advocacy.

02. Targeted product and service innovation.
   New offerings will address market demands for environmental sustainability and protection against climate impacts.

03. Enhanced risk management capabilities.
   Climate-centric information should be expanded, which can enable firms to manage the financial implications of climate change on a day-to-day basis, generate new insights, and bolster reporting.

Importantly, these end-state factors go beyond firms’ commitments to reduce their environmental footprint and transition to a carbon-neutral setting. Here, we explore changes only the financial services sector is positioned to implement, given its long-standing role as a capital provider and facilitator of spending and investment decisions across the economy.
Sustainability in financial services firms

Figure 1. Elements of a comprehensive climate programme in financial services.

01 Governance, corporate strategy and disclosures

Clear escalation and decision-making framework for climate risks, as well as the firm’s climate narrative in the market.

- ‘Tone from the top’ and governance structure
- Climate risk alignment with long-term corporate strategy
- Effective climate-related financial disclosures

Chief Executive Officer, Chief Sustainability Officer, Head of Corporate Responsibility or equivalent.

02 Business strategy, products and services

Development and adaption of business strategy and operating models to a low-carbon economy.

- Resilience of business models to climate change
- Market segmentation and prioritisation
- New products and services

Head of Sustainable Finance or equivalent.

03 Risk and compliance

Integration of climate considerations into risk management frameworks and compliance with regulations.

- Integration of climate risk to ERM framework
- Climate risk assessment, capabilities and tools
- Firm’s compliance with climate-related regulations
- Internal audit validation of climate risk

Chief Risk Officer, Chief Compliance Officer, Internal Audit Head, Head of Stress Testing and Capital Planning Executives.

Source: Deloitte analysis
Governance and corporate strategy
A climate-centred firm of the future should have a clear philosophy, position, and intentions related to climate risks. Financial firms will need to realign their business models to integrate climate, as well as other environmental, social, and governance (ESG) considerations, into all business decisions. Climate risks and opportunities will no longer be regarded as separate from the core business; they will become intrinsic to a firm’s success.

The board of directors will play a vital role in setting the right tone at the top. It will need to develop a clearly established structure for climate oversight. Board members will need to become more proficient in climate and other ESG risk matters, and they should be regularly briefed when new issues emerge. This can enable the board to ask relevant and difficult questions that probe management’s direction and strategy.

Specific climate-focused initiatives will be driven by sustainability and climate risk professionals. These will include climate scientists and financial modelers who understand the intricacies and overlap between climate science, policies, and financial risks. Climate-centred organisations may still have a dedicated sustainability team or chief sustainability officer, but they will rely more on issue and topic specialists who will be integrated throughout the company. Meanwhile, the CEO will have overall management responsibility. Climate-related goals will likely cascade down through the organisation by aligning them with employee incentive compensation.

Financial firms can use an integrated management reporting system that quantifies the financial implications of climate-related decisions to inform decision-making. High-quality and reliable climate and other ESG disclosures and external communications should provide insights to market participants, consumers, and policymakers into how effectively the company manages ESG impacts and dependencies.
Already, leading financial firms are forming specialised teams to support enhanced disclosure and transparency of climate-related business risks and opportunities, and how they are being managed. Firms should widely disseminate this information by using a ‘stakeholder first’ lens to help prioritise and get ahead of multiple evolving expectations. Over time, they should establish clear policies and processes that reinforce their positions on climate and ESG goals.

Finally, a key to each firm’s success in this arena will be their ability to effect broader change. To help accomplish this goal, firms could create or join multisector and multidisciplinary industry partnerships and regulatory collaborations that focus on accelerating ESG and climate risk transformation efforts. Modelled on the work of the Commodity Futures Trading Commission’s Market Risk Advisory Committee, these opportunities will bring together stakeholders from all industry sectors, including competitors, to help solve the most challenging issues facing the industry, and can help advance new climate-focused practices. These collaborations should strengthen relationships with regulators and supervisors by helping reduce systemic risks.

**Targeted product and service innovation**

While investors and regulators expect businesses to have a plan for managing climate risks, customers increasingly want product and service offerings that align with their views and beliefs. Some leading firms have already started creating dedicated businesses and offerings built around sustainability, diversity, and other ESG-related mandates, with climate being one of the most prominent themes.

These efforts should crystallise in the future; firms should offer a full suite of climate-related products and services that tie back to their specific business models. Here’s how that may likely develop in each sector:
Banking and capital markets
Having experience funding low-carbon companies and projects, climate-centred banks and brokerage firms should be able to differentiate among degrees of risk and profitability across their client portfolios. Credit decisions may be based on specific and idiosyncratic variables and expectations, with advanced pricing models linked to transparent and established industry taxonomies to categorise activities across the ‘brown-to-green’ lending spectrum. Firms should integrate climate assessments into new product approval processes. They should also continuously assess clients’ existing and potential stranded assets, those prone to write-downs related to climate issues, and use this information in pricing.

Carbon pricing in the United States may become a reality in a few years. With or without a legislative mandate, firms should move forward; they could use derivatives to push more capital toward sustainable investments or allow market participants to hedge risk based on ESG factors. In fact, an entire market of ESG exchange-traded and OTC derivatives is already developing. Many of these products, such as interest-rate or credit-default swaps, have a climate-specific component. While catastrophe and weather derivatives have been used for years to guard against natural disaster losses or provide allowances when temperatures are above or below predetermined thresholds, they will likely become more prevalent and part of the sector’s core offerings and portfolios.

We anticipate retail banks will also tap into consumers’ increased awareness and interest in climate-conscious products. Picture mortgages that incentivise eco-friendly borrowing (for example, to add solar panels to a home), or credit cards that allow borrowers to track the carbon impact of each item or service they purchase.

Insurance
Climate and ESG issues have already become a central focus for the insurance industry. Recent years have witnessed a surge in the number of catastrophic events related to climate change, such as wildfires, heat waves, reduced crop yields, and coastal and inland flooding.

These events will require insurers to develop more dynamic modelling approaches that rely on past loss experience and uncover nonlinear effects, including correlations between climate hazards, social impacts, and economic activity. Climate-centred insurers will likely offer products that cover climate risk more directly, expanding into other ESG effects. To some extent, this is already happening. For instance, you can purchase insurance that protects food supplies against the impact of climate change. In the future, climate-centred insurers will detect, price, and cover a broader range of similar relationships as part of a wider socioeconomic solution.
In addition, insurers will likely expand their offerings from helping customers simply transfer risk to mitigating, preventing, or recovering more quickly from climate-related catastrophes. For example, insurers could offer lower premiums to encourage the use of more resilient construction methods. These firms could collaborate with the public sector (such as municipalities, regulators, and policymakers) to improve construction standards and develop policies that limit growth in areas prone to physical hazards. They could also help governments decide where construction should – and shouldn’t – be developed.

Climate-centred insurers should continue to balance asset and liability management activities, matching risks with corresponding climate- and ESG-driven assets (for example, divesting from thermal coal and reinvesting in green energy alternatives). Insurers will likely focus on optimising risk pools that minimise the asset and liability mismatch related to climate or other ESG risks, recognising that climate-related catastrophes have immediate effects on other ESG risks.
Wealth and investment management

The wealth and investment management industry is already developing and distributing solutions that cater to investors seeking ESG and other nonfinancial objectives. Leading investment managers are currently using these two strategies to incorporate climate risk and ESG metrics into their portfolio construction process:

- **Integration strategies**: Seek to maximise financial return by incorporating ESG principles into the investment process or through engagement activities.6

- **Thematic strategies**: Aim to make a measurable impact on specific issues through their investments, such as investing in renewables.7

In the future, more wealth and investment managers will likely differentiate their products to cater to the demands of institutional and retail investors. As they continue to broaden their product array, they may develop index funds and customised strategies that are aligned with ESG-related goals, such as the United Nations’ 17 Sustainable Development Goals (SDGs), to track the returns of positive-impact companies.8 For each of these products, investment managers will need to share how they compare to the market in terms of ESG climate metrics and how this impacts performance, or how they perform against broadly utilised ESG ratings (for example, MSCI ESG Ratings). These efforts will likely accelerate the classification of green and sustainable products and should include relevant disclosures.

As part of this evolution, climate-centred wealth and investment managers should actively monitor and engage with target companies and advocate active, visible, and credible climate risk management strategies and capabilities. They should also invest in capabilities to identify true climate and ESG impacts. This is important because, as the risk of greenwashing increases and ESG disclosure becomes more common, it may become more challenging to separate ESG leaders from laggards. The Organisation for Economic Co-operation and Development’s Business and

While investors and regulators expect businesses to have a plan for managing climate risks, customers increasingly want product and service offerings that align with their views and beliefs.
Finance Outlook 2020 found that, for Standard & Poor’s 500 companies, ESG scores from major rating firms are highly variable and show low correlation with actual results. This suggests that raters have fundamentally divergent views about ESG performance.9

Advanced wealth and investment firms should have the content and domain expertise to overcome these gaps, particularly where ESG data is unreliable, not available, or where accepted standards do not exist. They should go beyond incorporating self-reported data or climate/ESG metrics from third-party providers and perform deep sector or even firm-level analysis to create bespoke data sets of firms they invest in. At one leading financial firm, their in-house sector analysts’ expertise in firms’ business models, product strategies, operational nuances, and regional characteristics has become a critical component in evaluating ESG and climate (and financial) performance.10

As other investment firms seek to replicate this kind of success, they will need to be transparent about their methodologies, allowing investors to evaluate the quality and granularity of their data and how it is used to build portfolios. Analytical rigour will likely be a major differentiator that sets leading financial firms apart from their competitors.

Large global firms may also be able to influence the political debate about climate change. Sovereign bond ETFs have been designed to weigh countries on their level of risk from climate change.11 This development may prompt countries to change their approach and policies as the link between climate change and creditworthiness may grow stronger.

Enhanced risk management capabilities
In the future, climate-centred organisations will have the capacity to manage climate and other ESG risks. Financial regulators recognise that a changing climate poses systemic risks to the US financial system. Regulation will continue to evolve and grow, and climate-centred financial services firms should actively contribute to the dialogue.

Firms that develop advance climate risk modelling capabilities may be better prepared, resilient, and ready to manage climate risk as part of their credit evaluations. They will also create products that account for similar hazards. Creating this type of enhanced risk management may allow climate derivatives to hedge better against climate-related risks, enabling firms to efficiently invest in green bonds and other instruments supporting a low-carbon future. In reality, nothing should stop individual firms from creating such structured products, customised to specific client needs, as long as they are well informed about the vulnerabilities.

Climate risk should therefore become a regular feature of risk management discussions. Today, financial firms have defined thresholds for market risks they are willing to bear. These include factors such as issuer default and correlations; liquidity risks, such as intraday settlements and maturity gap mismatches; and credit risks associated with counterparties and underlying issuers. Tomorrow, climate risk will be just as narrowly defined – people
will no longer need to explain what they mean by the term. Furthermore, climate risk should be embedded in risk taxonomies that capture climate-related physical, transition, and liability risks, and there should be a comprehensive ERM framework that fully integrates these risks. Frameworks will, of course, take different shapes across sectors. But establishing data quality standards, common models, and operational processes can help set expectations across the industry and harmonise risk taxonomies to incorporate climate risk.

To help develop and infuse these risk capabilities, organisations will need to put dedicated teams in place that explore the overlap of climate change, economics, and financial modelling. The analysis these teams provide may blur the lines between climate change and economic risks, uncovering the intricacies of macroeconomic and microeconomic transmission channels. They will work at the client/counterparty level and at the portfolio or fund level, identifying correlations between climate risk and other ESG issues. Climate-centred firms should also consider employing in-house teams of climate scientists to help develop possible scenarios. To complement their analyses, lead economists in financial firms will likely rely on these climate teams as a main source of information.

Digital solutions can help support these efforts. Firms can use several emerging tools and techniques, such as artificial intelligence–driven risk simulations. Firm leaders should incorporate climate risk and ESG into capital allocation decisions. Geolocation and climate exposure analyses and dashboards should aggregate across climate scenarios. Some of this aggregation will likely be standardised across the industry, allowing for interactions and dialogue with regulators.

A fast-moving opportunity
Without a doubt, climate risk is a growing challenge to businesses and society at large. At the same time, the world is moving toward a cleaner, more sustainable future, and industries of all stripes are transforming their businesses to do their part. Given its vital role in capital formation, we believe the financial services industry has a predominant
role in addressing these interrelated challenges. Shareholders, regulators, politicians, employees, and other key stakeholders all recognise this – and they’re beginning to up the pressure on financial firms to mobilise.

But the onus to act is greater than that. There’s an enormous opportunity on the horizon for those who can effectively mitigate climate risk. Differentiation is as difficult as it’s ever been in the financial services industry. Being climate-centred – and building businesses and practices around the end state discussed above – can be a powerful lever to help firms rise above collective commoditisation. It’s a simple proposition: give the world what it wants and needs, and you’re likely to garner success. And the world won’t wait. Already, leading firms are pushing ahead with climate-driven initiatives and putting teams in place. Transformative opportunities are still there for the taking, but they won’t be for long.

Endnotes

4. For a thorough discussion in determining what is green/brown, please see Network for Greening the Financial System (NGFS): Network for Greening the Financial System, A status report on financial institutions’ experiences from working with green, non green and brown financial assets and a potential risk differential, May 2020.
7. Ibid.