Why ESG represents big opportunities for financial services firms

AN RSM REPORT

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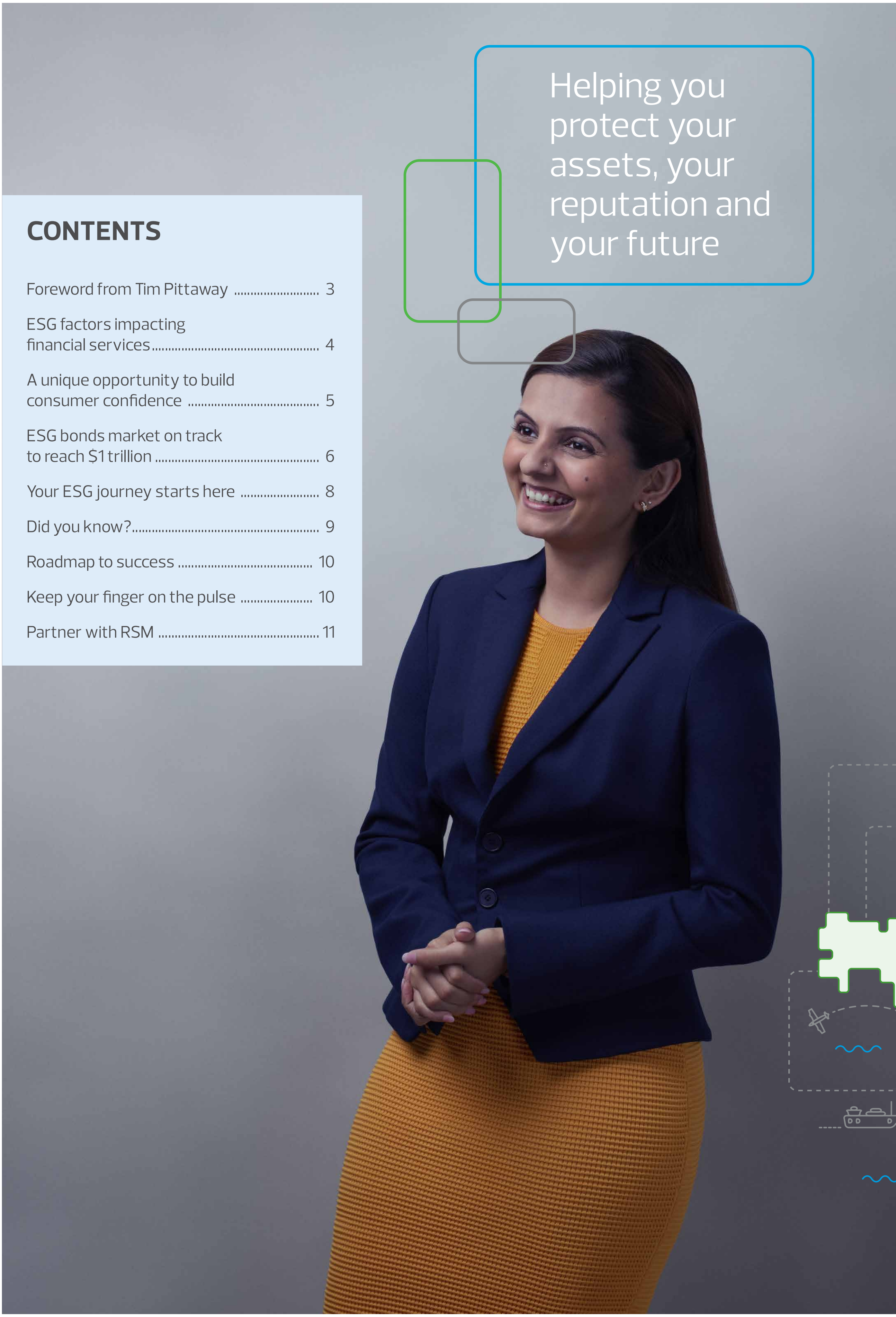

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Foreword from Tim Pittaway

National Director of Climate Change and Sustainability Services, RSM

Amid a global health crisis, rising economic uncertainty and social change, there is a growing need to measure individual and collective responsibility within our communities.

One initiative that seeks to achieve this is Environmental, Social and Governance (ESG). While the elements of ESG vary greatly between industries and organisations, the principle remains the same:

Can we demonstrate good behaviour in how we treat people and the environment?

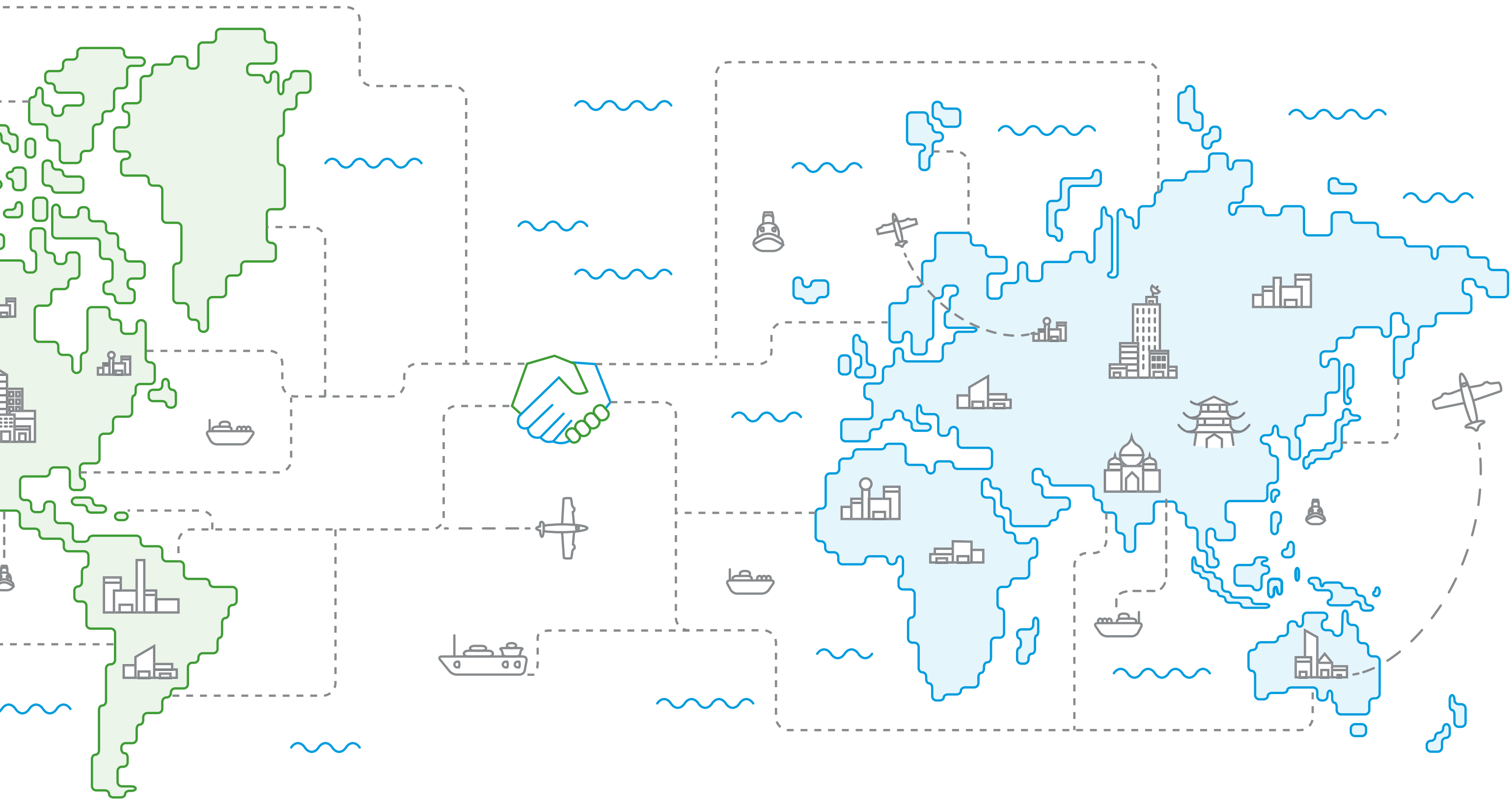
In the finance sector, the emergence of ESG has a dual impact. First, it's an opportunity for financial firms to re-shape public perception and build consumer trust. Second, ESG will play a major role in how investments are analysed for risk and opportunity.

As ESG grows in importance, financial services firms will need to respond. RSM's ESG experts are currently working with companies across a broad range of sectors to provide consulting and internal audits in line with ESG considerations.

In this report, we discuss some of the ESG factors that are set to disrupt financial services and the steps you can take to prepare.

I'm always interested to hear others' thoughts on ESG within their unique setting, so if you would like to have a conversation please reach out on (02) 8226 4806.

Tim Pittaway
National Director of Climate Change and Sustainability Services,
RSM Australia



ESG factors impacting financial services

ESG impacts different organisations in different ways, but centres around these common themes:

Social

- Equal opportunity – do we have a diversity policy, and are we conscious in how we retain and promote people in our business?
- Health and wellness – do we encourage health and wellness in the workplace, and follow best practice in our policies?
- Human rights – do we have a human rights policy and conduct due diligence to ensure businesses we engage with also value human rights?

Environmental

- Resource use – how do we monitor our resource usage (water, paper, energy, etc.) and can we improve?
- Emissions – do we use best practice methods to calculate carbon emissions and are we taking steps to decrease our carbon footprint?
- Innovation – are we leveraging new technologies and methods to reduce our environmental impact?

Governance

- Ethical standards and practices – do we develop policies ethically, and maintain ethical practices?
- Compliance – are we compliant with regulations that impact our business (including tax) and do we engage with compliant businesses?
- Shareholder rights – are we transparent with shareholders and stakeholders?
- Financial services firms can use these and similar themes to evaluate their own ESG performance, and the performance of companies they intend to invest in.
- ESG "scoring" is designed to make this evaluation easier, where a third-party conducts an assessment and rates the company based on the sustainability of its operations. ESG scores impact not only how customers view brands, but how investors decide where to direct their funds.

A unique opportunity to build consumer confidence

The financial services industry has not had an easy ride when it comes to consumer trust. Past errors, negative media focus, and the difficult task of shifting century-old practices to meet changing consumer demands have all had an adverse impact on the reputation of the sector as a whole.

A 2021 study by comparison website Finder discovered that consumer trust in the Big 4 banks had plummeted in recent years. Trust by baby boomers was the lowest, with only 41% of respondents saying they trusted big banks.

This has created an opportunity for smaller, innovative lenders which are scooping up new customers as they turn away from larger institutions. Those that position themselves as environmentally and socially conscious (both in how they do business and who they do business with) are well placed to succeed in this new era.

Metropolitan Bank in the US is a good example of this, which has seen a large increase in its share price while being ranked in the top 10 of "2021 Best ESG Companies" by Investor's Business Daily.

We expect to see this trend unfold across all areas of financial services – with stronger interest in smaller insurance and superannuation companies, investment houses, real estate brokerages, and so on.

> *ESG represents a great opportunity for smaller financial services firms to differentiate themselves with today's consumers.*

ESG and investment governance

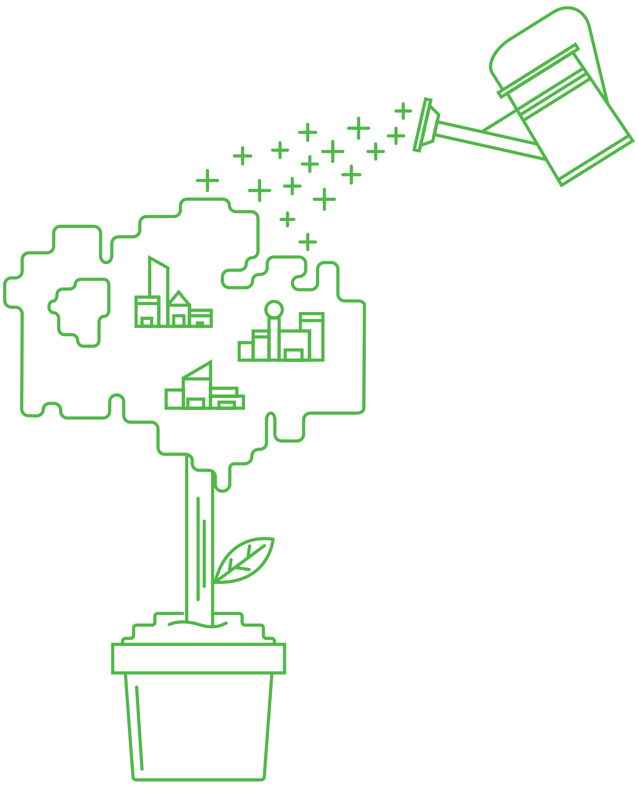
In weighing the risks of an investment, financial services firms can no longer ignore ESG factors.

As an example, the long term potential of investments in coal mining carried near certainty just a decade ago. These days, changing regulation and the rise in renewable energies have left the longevity of coal investments in serious doubt.

Emerging ESG-related regulations and public scrutiny are now key factors in any investment decision. There is now a very real risk of stranded assets under intensifying ESG pressures – from carbon emissions to the introduction of the Modern Slavery Act.

On the flip side, ESG provides the same injection of exciting investment opportunities as we saw with the technology boom. Interest in innovative brands such as Tesla, Sodastream and the like have gone a long way towards engaging a new generation of investors.

Awareness of green investments will allow financial services firms to hedge their bets while capitalising on consumer demand and showcasing a commitment to responsible investment practices.



ESG bonds market on track to reach $1 trillion

Dr Luke Kirke, Chief Executive Officer, Green Bond Corporation

Green bonds (aka climate bonds) and sustainability bonds are shaking up the bonds market in ways we have never seen before.

The issuance levels of Green Bonds (whose proceeds are directed towards projects that deliver environmental and/or climate benefits) reached USD$517bn in 2021, as interest continues to grow in funding projects which have positive environmental impacts.

So what are Green Bonds and how do they work?

Green Bonds

A Bond is a fixed income, financial instrument that essentially represents a loan between the Issuer (i.e. the Borrower) and the Investor. The Issuer commits to re-paying the underlying Principal Amount (i.e. the borrowed amount) of a Bond at a certain date in the future – what is commonly referred to as the Maturity Date. In addition to committing to repay the Principal Amount, up until the Maturity Date the Issuer also commits in paying Coupon Payments (i.e. interest payments), determined by the Coupon Rate of the Bond at periodic intervals (i.e. quarterly, semi-annually or annually).

Because of their inherent simplicity, bonds have been used to support transactions for over hundreds of years, with reliable evidence indicating that they were used during and possibly prior to medieval times. Consequently, a bond is a well-established, effective way for Issuers – be they countries, governments, banks, corporations and projects – to raise capital to fund operations and development.

A Green Bond – being a subset of Sustainable Bonds or Climate Bonds – is structurally the same as a traditional Bond, yet proceeds generated from a Green Bond are required to fund projects that deliver positive environmental or climate benefits. By way of example, a Green Bond can fund a broad range of renewable energy projects such as:

- Hydrogen energy or solar projects;
- Development and building projects that are classed as green per local, national and/or
- International regulations, standards or guidelines; or
- Agriculture projects that improve the way we utilise the land via undertaking circular processes.

Due to climate change and the critically required traction achieved by the 2015 *COP21 Paris Climate Agreement* and the *United Nations 2030 Sustainable Development Goals*, Green Bonds have grown in prominence and understanding. Since the first Green Bond issuance in 2007 by the European Investment Bank and followed shortly thereafter in 2008 by the World Bank, Green Bonds have seen strong year on year growth, where by the close of 2021, Sustainable Bonds witnessed 50% growth upon 2020 issuances, with 2021 total issuance levels reaching USD$646bn.

Green Bonds (labelled per the Climate Bonds Standard as issued by the Climate Bonds Initiative (CBI) whose proceeds are directed towards projects that deliver environmental and/or climate benefits) were the largest contributor to the impressive growth rate constituting USD$517bn alone. Because of such volumes, 2021 has taken the climate bond labelled sustainable bond market to an aggregate issuance amount of USD$1.5tn since 2014.

Importantly and based on such growth, the CBI believes 2022 could see annual issuance levels exceed USD$1tn alone, affirming that capital is being shifted at scale towards initiatives that move us collectively towards a more sustainable global economy. Whilst signs are positive, estimates indicate that closer to USD$9tn per year is needed and given the size of the global bond market is circa USD$120tn, greater year-on-year exponential growth needs to be seen.

The Climate Bond Initiative and the Climate Bond Standard

Established in 2010, the CBI is an international organisation created to promote large-scale, certified investment that will help in delivering a climate-resilient, environmental regenerative global economy per the goals of the 2015 COP21 Paris Climate Agreement.

In 2014, the CBI launched the Climate Bond Standard and Certification Scheme, a robust framework that builds upon the broad principles contained within the International Capital Market Association's (ICMA) Green Bond Principles so as to allow investors, governments and other stakeholders the ability to confidently identify and prioritise investments.

Within the realm of Sustainable Bonds, the Climate Bond Standard and Certification Scheme provides the most comprehensive bond certification framework, ensuring that proceeds for certified bonds are directed towards projects that provide environmental and/or climate benefits both pre-and-post issuance.

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Presently, the Climate Bond Standard and Certification Scheme is the only, globally recognised certified climate bond standard. Whilst voluntary, the CBI advises of a number of benefits associated with certification including:

- The avoidance of greenwashing
- Enhanced investor diversification and confidence
- Potential lower cost of capital rates and higher chances of oversubscription

From the perspective of investors, certification reduces the burden of having to make subjective judgements during their due diligence on the green attributes of bonds. However, as an independent non-government organisation, the CBI cannot provide financing, nor can it help Issuer's structure debt offerings or advise on pricing.

That is the role of a Bond Arranger and a role that Green Bond Corporation performs.

Your ESG journey starts here

There are several best practice guidelines and frameworks that financial services companies can consult to benchmark their practices and guide their investment decision making.

It's important to note that not all ESG issues will be relevant to your business, or the businesses you seek to invest in. For these reasons, working with a third-party adviser will provide the expertise and guidance necessary to navigate ESG confidently.

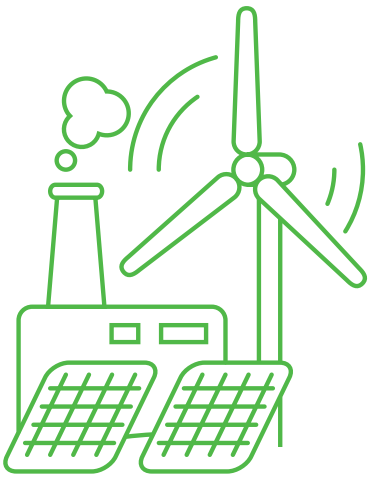
In the first instance, you might consult with stakeholders and your adviser on which specific ESG issues impact your business and to what extent.

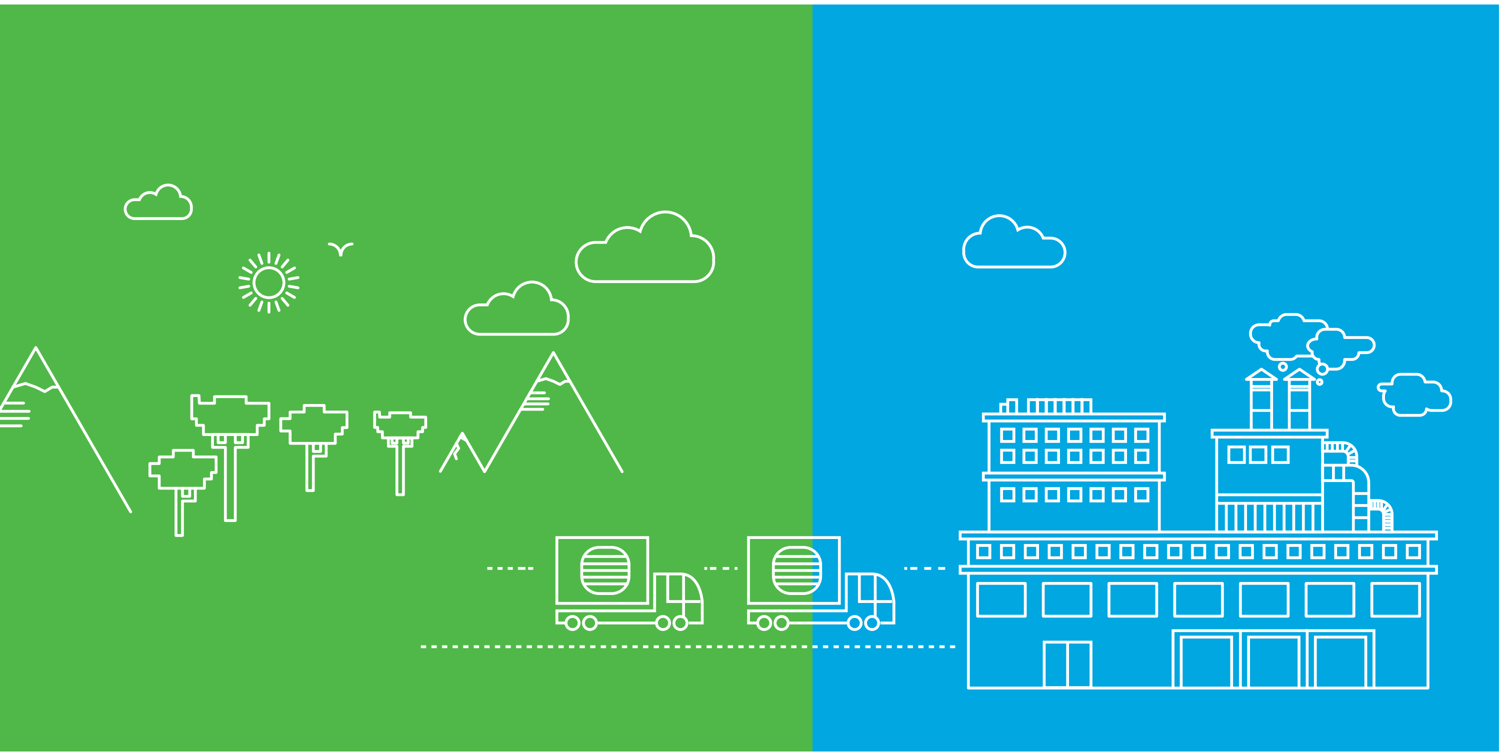
Once this is understood, conducting an internal audit is a great way to:

- measure existing performance against key ESG areas
- deep dive into ESG risks and opportunities
- understand areas for improvement
- develop targets

Your ESG adviser should be well-versed in global standards and guidelines, and can consult with you on how to prioritise certain ESG objectives to achieve the maximum benefit in the shortest time period.

While taking advantage of low hanging fruit – such as reviewing company policies or taking steps to reduce resource wastage – offers the opportunity for quick wins, keep in mind that ESG is a long game and will require a well thought out strategy and ongoing evaluation.



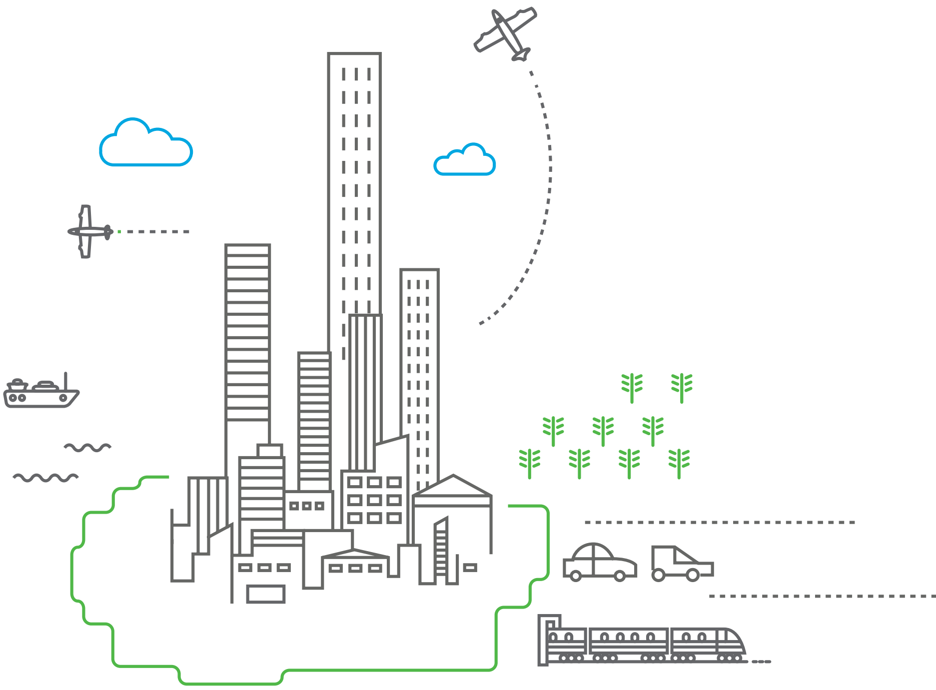


Did you know?

APRA recently released a practice guide on climate change financial risks to help banks, insurers and superannuation trustees manage the financial risks of climate change. It includes sound practice in areas such as governance, risk management, scenario analysis, and disclosure of climate-related financial risks.

You can find the guide here.

> Your ESG adviser can assist you in determining the best approach to follow within the guide based on your business size, strategy and customer base.

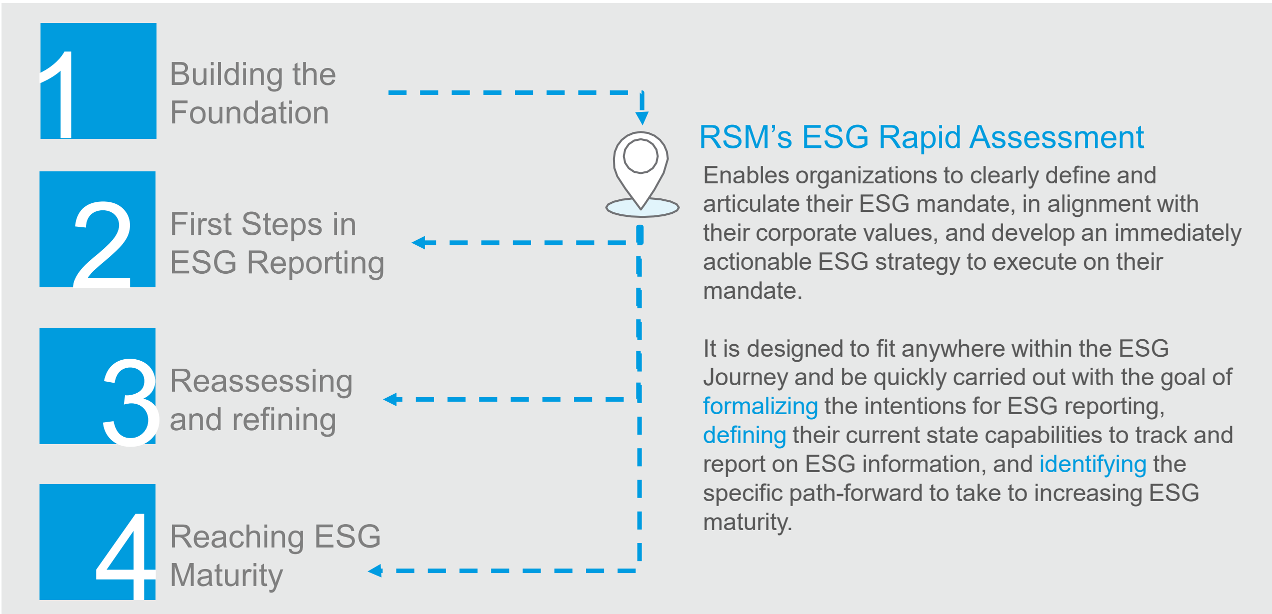


Roadmap to success

While an initial internal audit provides the foundations for ESG success, it's important to stay the course and measure improvements. A third-party adviser offers the assurance and objectivity needed to correctly assess how your business is performing, while guaranteeing transparency for internal and external stakeholders.

For financial services firms seeking to build an ESG-aware culture for the purposes of guiding investment decisions, your adviser can act as a sounding board to ensure you're up to date on the latest ESG developments.

This is particularly valuable for boards and committees that understand the need to establish and monitor ESG improvements in line with global trends, as we journey closer towards the 2030 Agenda for Sustainable Development and net zero emissions by 2050.



Source: RSM US (ESG Journey: Reaching Reporting Maturity)

Keep your finger on the pulse

ESG remains an emerging area, so you will want to keep your finger on the pulse to understand industry changes and the impact to your firm and its investments.

Particularly for mid-sized financial services firms seeking to differentiate themselves in the market, understanding the risks and opportunities that will undoubtedly arise in coming years is vital to success.

Ideally, select an ESG partner who has your continued success at heart and will act as an extension of your business to keep you informed as situations change.

While the Australian financial services sector may still be catching up to its European and American counterparts, working with a global firm such as RSM will give you access to a network of experienced professionals who not only know ESG – but are highly engaged with ESG transformation within major cities all over the world.

Partner with RSM

Even with the best of intentions, it's easy to get derailed with ESG projects. Partnering with a recognised and respected firm such as RSM will provide the clear sight your firm needs to make informed ESG decisions with confidence.

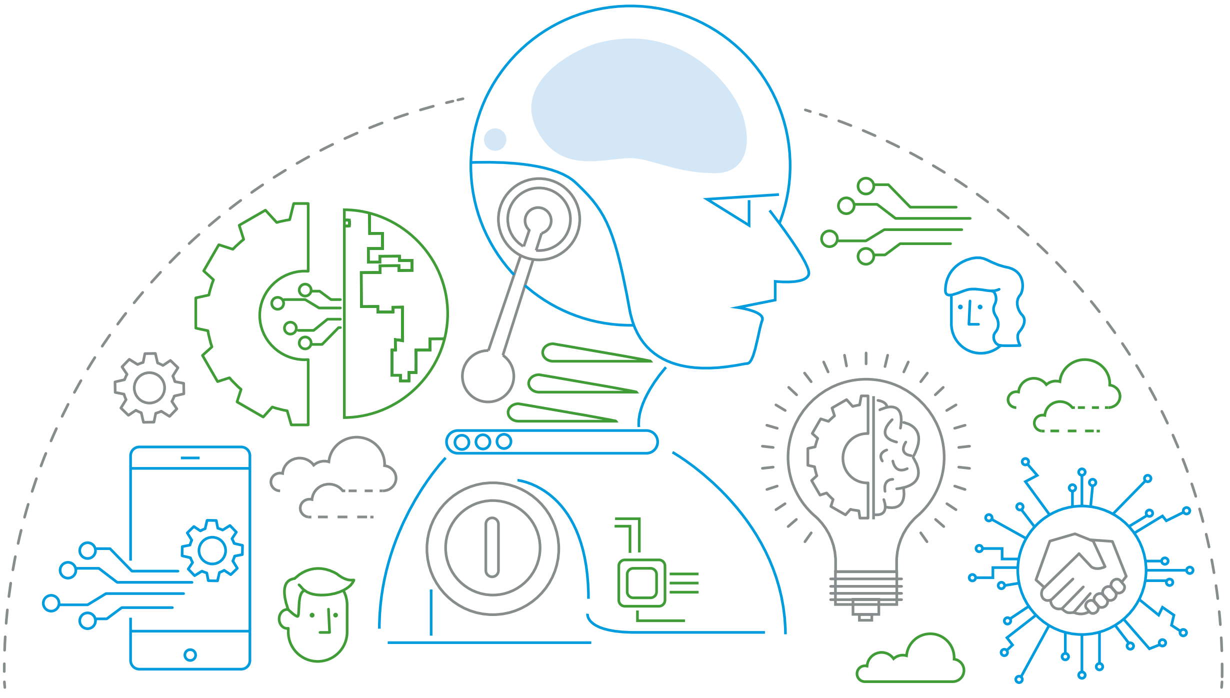
As trusted advisors, we support organisations to promote improvements in efficiency and business practices. Our internal auditors have a vast depth and breadth of skillsets, and are well placed to advise on ESG risk and how addressing ESG can support the achievement of strategic objectives.

We will work closely with your internal stakeholders to elicit their vision, ethos and purpose so we can assist in providing a common ground to promote improvement.

RSM provides a friendly, value for money service with access to a multi-disciplinary team with a strong culture that places our clients' needs above all else.

- **Understand the implications of ESG**
- **Benchmark performance against global standards**
- **Develop ESG monitoring and reporting frameworks**
- **Break down silos to enable a holistic view of ESG**
- **Evaluate partnerships or investments in line with ESG**
- **Verify the integrity of sustainability schemes**
- **Integrate ESG into shareholder reporting**

To start a conversation with an ESG adviser from RSM, please click here.



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