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GUIDE

ESG Risk In The Financial Sector

How Firms Can Overcome The Industry's Unique Challenges

ESG Risk In The Financial Sector

Environmental, social, and governance (ESG) issues have become key priorities for corporations around the world over the last decade.

As the imminent threat of climate change forces both governments and businesses to take action, financial institutions have a significant role to play-and one that comes with its own unique challenges.

Because they provide capital to the industry and other avenues for investment, financial services firms are closely tied to our fossil fuel-based economy. And as such, they will have a critical impact on managing the transition to a more sustainable future.

Despite the growing push for regulation, transparency, and investment in sustainable business practices throughout the industry, meeting new and emerging ESG goals and mandates won't be easy.

Below we'll cover why financial services are under pressure right now, the unique challenges the industry is facing, and how they can overcome them.

$50 trillion

ESG-related investments will surpass $50 trillion by 2025

1/3

Of the projected total assets under management globally

89%

Of investors consider ESG issues on some level as part of their investment approach

Why Financial Services Are Under Pressure to Monitor & Evaluate ESG Risk Within Their Supply Chains

Financial firms are in a unique position to influence and impact people and the environment. And as climate and sustainability-related issues become politically and practically more important, this has led to a rise in pressure from regulators, investors, and consumers for the finance industry to prioritize ESG in their operations.

Bloomberg Intelligence estimates that ESG-related investments will surpass $50 trillion by 2025-one-third of the projected total assets under management globally—as consumers prioritize non-financial factors when making investment decisions. In fact, 89 percent of investors consider ESG issues on some level as part of their investment approach, according to a 2022 global study by asset management firm Capital Group.

A Tightening Regulatory Landscape

However, despite increased investment in ESG, tightening regulations regarding ESG risks and impacts are mounting pressure on the financial services sector to do more.

Throughout the European Union (EU) and North America, a wave of new legislation is focused on building ethical and sustainable supply chains:

German Supply Chain Act

The law requires certain German-based companies (and their suppliers) to conduct a risk analysis of their supply chain and take documented action to minimize and prevent harmful impacts on the environment and human rights.

Norwegian Transparency Act

The law requires large companies (foreign and domestic) doing business in Norway to adhere to human rights due diligence based on OECD guidelines along their entire supply chain.

CSRD and CSDD

Pending EU legislation that requires strict ESG due diligence for companies doing business in the EU. It includes robust reporting standards as well as policies for identifying, preventing, and mitigating impacts on people and the environment. There is ongoing discussion that financial firms will be included in these mandates as well.

Canada's Modern Slavery Act

The law requires most multinational corporations that operate in Canada to provide an annual report detailing their due diligence efforts in identifying, addressing, and preventing forced labor in their supply chains.

Even though these regulations are not specifically targeting financial firms, they do impact and include them. Additionally, while the SEC's Climate Disclosure proposals have still not been finalized, it is likely to include standards that put more pressure on public firms on US stock exchanges.

Increased Scrutiny on Greenwashing

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More regulations mean more scrutiny. One of the biggest issues regulators are looking out for is corporate "greenwashing."

Greenwashing is when a company claims to be environmentally friendly or misleads the public or stakeholders into thinking the business has a more positive environmental impact than they actually do. This can happen intentionally or unintentionally. However, a recent audit of green online claims (covering a variety of sectors) by the European Commission found 42% of green claims were exaggerated, false, or deceptive.

While the financial sector is not alone in being guilty of greenwashing, the opaqueness that defines the industry makes it particularly vulnerable to doing so.

For example, several financial institutions have gotten into hot water recently for greenwashing:

1 **Deutsche Bank** was investigated in 2022 for alleged ESG greenwashing activities and later sued by a German consumer group for misrepresenting an ESG fund's green credentials in marketing materials.

2 **Goldman Sachs** was fined $4 million in 2022 by U.S. regulators for failing to properly weigh ESG risk factors in some of its investment products from 2017-2020.

3 **The UK's advertising authority** banned 2 advertisements by a major international bank for being misleading about its green credentials.

4 **The SEC** fined another large financial institution $1.5 million for ESG misstatements and policy failures within their investment management units.

"While ESG investing has gained traction by becoming mainstream and even mandatory in certain jurisdictions, it does not come without challenges. Scrutiny is going play an important role as regulators tackle the risk of greenwashing."

ADELINE DIAB
Director of Research ESG at Bloomberg Intelligence

EU's Sustainable Finance Disclosure Regulation

As part of the European Green Deal-a collection of policies and regulations aimed making the EU carbon-neutral by 2050—the EU passed the Sustainable Finance Disclosure Regulation (SFDR). The SFDR imposes comprehensive sustainability disclosure requirements related to ESG metrics.

The purpose of the SFDR is to:

- improve transparency in the market for sustainable investment products
- prevent greenwashing
- increase transparency around sustainability claims made by financial market participants

As the European Parliament and Council explains:

> *"Urgent action is needed to mobilize capital not only through public policies but also by the financial services sector. Therefore, financial market participants and financial advisers should be required to disclose specific information regarding their approaches to the integration of sustainability risks and the consideration of adverse sustainability impacts."*
>
> EUROPEAN PARLIAMENT AND COUNCIL

European Financial Regulators Progress Reports

In June 2023, the European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA), and European Securities and Markets Authority (ESMA) submitted progress reports to the European Commission. These reports define what greenwashing is and outline associated risks, impacts, suggested mitigation efforts, and challenges for the industries.

The SFDR and EC progress reports tie together the increasing regulatory landscape the industry is facing with a specific focus on greenwashing scrutiny. These regulations and enforcement policies add more pressure on the financial sector to divest from fossil fuel corporations and be more transparent about where they are investing.

As a result, more financial firms are taking net zero pledges— even amidst growing scrutiny. However, with oil & gas firms also facing increased lawsuits, these investments will become even riskier.

Unique Challenges to Developing Robust ESG Programs and ESG Risk Assessment

Setting up an ESG program is difficult enough, but creating and monitoring one that actually achieves its goals of being ethical and environmentally sustainable is a lot harder. Here are a few of the unique challenges financial firms face when developing ESG programs and implementing robust ESG risk assessment policies.

Strict Oversight

The financial services sector is notoriously heavily regulated (outside of sustainability issues), meaning that any robust ESG initiative will also have to go through heavy oversight to ensure that it also complies with a myriad of other laws. Not to mention, greenwashing-whether it's intentional or not—is going to be a lot harder to get away with.

Many small insurance and financial firms that are looking to go public are also under increased scrutiny from regulators as they will have to make more company data accessible for public consumption. Therefore they must ensure they have a robust ESG program in place.

Organizational Siloes + Poor Data

Capital Group found that the lack of consistent and robust data is among the biggest challenges facing investment professionals today and one of the largest barriers to ESG adoption. A big reason for this is the prevalence of organizational siloes within the companies. Organizational siloes lead to inconsistent and disjointed processes, fragmented data architecture, and blindspots within and between departments.

Without clear, reliable, centralized data across the organization and its stakeholders, ESG data governance becomes nearly impossible.

Lack of Transparency and Understanding of Financial "Products"

Another related issue is the general lack of transparency regarding financial investments and financial "products." Currently, institutions are facing the two-pronged problem of lots of consumer interest coupled with opaque access to firms' "products" or investments.

In other words, consumers are looking for financial products and services with positive ESG impacts—but it's still hard to see exactly how these firms are performing.

For instance, while tracking the value chain of physical goods has its own set of complexities, there are ways to visit and audit manufacturing plants and facilities where goods are sourced and assembled. With insurance and other financial service firms, however, investment products have "black box" traits that make it extremely complicated or difficult for a vendor or buyer to view and/or understand.

Additionally, unlike product-based industries, it is so not easy to just "divest" in certain industries, sectors, or companies. With a physical good, you might be able to find another supplier to source material from, but divesting from an entire industry or large amounts of companies requires a lot more planning, and comes with a lot of externalities, or unintended consequences.

How Financial Firms Can Improve ESG Risk Assessment & Monitoring Efforts

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With so many competing priorities and complex challenges to tackle, managing ESG risk is no small task. Here are some ways financial firms can improve their ESG risk assessment and monitoring efforts as they move forward.

Supplier Education

ESG risk management is a team effort. And that goes beyond your immediate company to your extended value chain. To ensure alignment and compliance with policy, educate your suppliers and vendors on the global frameworks that key ESG regulations and initiatives are based on.

All the different regulations are confusing to track, but many are constructed using global frameworks and guidelines, such as UN Global Goals and OECD Guidelines framework. Understanding these frameworks will help compliance and risk professionals digest new regulations more easily.

- Communicate these ESG efforts and expectations to vendors.
- Make sure expectations are baked into contracts-including renewals-and onboarding processes.
- Centralize your policy and ESG resources in one easy-to-find database for employee and vendor reference.

Centralized Supplier Risk Management

One of the biggest challenges firms face is the question of reliable, accessible, and comprehensive ESG data.

Too many companies still rely on subjective vendor surveys that can be biased, limited in scope, and quickly outdated to get their ESG data. Combine this with functionally siloed teams and departments, and you have a mess of data that is disjointed, unreliable, and difficult to make sense of.

The solution is a centralized supplier intelligence platform.

Look for a centralized intelligence platform like Craft that:

- Uses multiple reliable sources of data, coupled with machine learning models to digest a wide range of data and provide comprehensive insights on the risk levels involved
- Assigns easy-to-digest ESG scores across a number of categories but also gives lots of detail and transparency into how they are calculated when needed for reports, further analysis, etc
- Allows you to see other risks within the company in real-time, including cybersecurity and financial, to see how they're able to realistically invest in ESG
- Enables cross-functional collaboration with other teams and the vendor's relationship manager or other stakeholders
- Supports risk professionals' compliance with specific ESG regulations, such as the GSCA, Uyghur Forced Labor, Canada Modern Slavery Act, CSRD, and more.

A comprehensive supplier risk management solution helps you eliminate blindspots in your compliance efforts by mapping your supply chain and monitoring key ESG metrics on transparency, human rights, environmental reporting, and more. Don't get caught on the back foot of ESG risk management.

Craft is your partner on the path to supply chain resilience

Our Proven Solutions:

SUPPLIER INTELLIGENCE

Conduct checks in hours instead of weeks with comprehensive supplier intelligence you can trust

SUPPLIER RISK MANAGEMENT

Continuously monitor potential threats and disruption to your supply chain with real-time alerts and deep insights into your suppliers

SUPPLY CHAIN RISK MANAGEMENT

Expand your visibility beyond tier one suppliers to uncover potential risks and dependencies and take action with integrated collaboration tools

Craft empowers organizations to strengthen their global supply chains

Our advanced data fabric and risk mitigation engine provides 360-degree visibility to quickly explore and evaluate suppliers, AI-driven insights to minimize disruptions, and collaborative tools to optimize supply chain strategies. With Craft, organizations can confidently navigate regulatory environments, uphold ethics, and drive business continuity and growth.

Ready to learn more about our solutions?
Connect with a Craft expert today: sales@craft.co