Thomson Reuters market insights.
A podcast for tax, legal and compliance professionals around the globe.

Episode title: ESG report demonstrates growing importance in global financial services industry

Release date: November 1, 2021

Gina Jurva: Thank you for joining us for our Thomson Reuters Market Insights Podcast. My name is Gina Jurva, Attorney and Manager of Market Insights and Thought Leadership here at the Thomson Reuters Institute for our corporate and government businesses. Today we will be discussing a new report from Thomson Reuters Regulatory Intelligence, looking at the fast emerging challenges for financial institutions in the still changing environment of ESG initiatives and investments. Now new corporate requirements come as ESG related investments have exploded. Sustainable investments in 2020 reached an estimated 35.3 trillion or more than 1/3 of all assets under management in five of the world's largest markets, which we're going to be talking about further today. And of course, there is the backdrop of the Conference of the Parties, also known as COP 26, an annual event that brings governments together to discuss and review how climate change is being managed domestically and internationally. 20,000 heads of states, diplomats and activists are expected to meet in person starting October 31st to set new targets for cutting emissions from burning coal, oil and gas that are ultimately heating up our planet Earth. Joining me today is Henry Engler, primary author of the report, chief correspondent, and senior regulatory intelligence expert here at the at Thomson Reuters Regulatory Intelligence, or the acronym TRRI, Henry always a pleasure to have you with me.

Henry Engler: Same here, Gina. Thanks very much for the invitation.

Gina Jurva: Well, let's start with ESG itself. It's such a big concept for those that don't know who could use some, you know, clarification on this acronym, can you explain specifically what ESG is in the context of the global financial services industry?

Henry Engler: Well, the “E” part, environment or environmental, primarily relates to climate change and climate risk, specifically for financial institutions, so I would say when you talk about, you know, rising temperatures and increased incidences of hurricanes and such, and you look at the impact on financial services I think you need to sort of look at it in two different ways. One is the banking sector and the other is the sort of investment sector, asset management firm security firms. And it affects climate risk, affects them in different ways because banks are lenders to industries such as oil and gas or, you know, into other industries or sectors that could be impacted by safe forest fires in California, where you live Gina, and so they need to, the banks need to be able to quantify that risk. Measure it. And try to assess, you know, longer term how they're going to manage it. On the investment side as you just mentioned, there's been an explosion of investment. Increasingly, investors are looking for opportunities to invest in companies that have very good credentials in terms of, you know, managing their climate risk and exposure and their carbon footprint, let's say going net zero, so to speak in terms of their activities is a big, big focus. Now the “S” part of ESG social, well, that relates to what I would say, and this is not just simply for financial services, but for any company, any industry it relates to their employees or human capital as many like to call it. And how companies treat their employees. Are they giving employees a voice in terms of, you know, how they manage their companies, how they manage their products. Is there diversity among the employee staff. Diversity is a huge issue as we all know and diversity not only among the rank and file, but diversity at the senior management level. Diversity in the boardroom.

Those are all critical elements of the “S” part in ESG. And you know, again, it's something that financial services companies are, you know, dealing with and tackling, but it's it, you know, it affects every company in every industry sector. Now the “G” part governance which doesn't get a lot of attention, unfortunately, is really important with regard to the first two, because governance refers to the seriousness with which the management and the board takes these issues and some companies at that level you will find that they're taking this very seriously. They've created committees on ESG. They have a special, you know, they have senior people whose role is simply to monitor these issues within the organization, but there are other companies who are lagging who are not taking this as seriously. So really, for any company to manage their ESG risk, so to speak, you really need to start at the top of the organization. You really have to have buy-in from the board from the management, delegate the resources to these issues and really go from there. And so, you know, without that governance portion, without that, buy in that most companies are unfortunately going to struggle. Certainly, in financial services. You know, as we're going to get more regulations coming up in the next year or two, it's imperative that really the strategy and the direction comes from the top of the organization.

Gina Jurva: Yeah, and you know, two things you said there that really stood out to me and I think when we when we talk about the “S” part on the social aspect of ESG, the other thing and you and I have recorded a webinar on this in the past with the Thomson Reuters Foundation a couple months ago and I thought it was interesting too, that the “S” in the United States or North America is really focused on diversity. Diversity, equity and inclusion, both in, like you said, the rank and file as well as in senior leadership. When you go to the EMEA region they have, they are also obviously diversity, equity and inclusion is important, but they also have an emphasis on human rights and how important that is to you and I think that's also something I actually I found interesting because we do a lot of work on human trafficking, human slavery, global supply chain here at Thomson Reuters. And I know your team does too. The other thing, the governance part, and we're going to get into that in a moment, but you are so right that if you do not have that buy-in at the top the other two will fall to the wayside, and so, I'm so excited to ask you since you've done a lot of research here on what's happening across the globe. I'd love to talk about the report, so let's talk about, you know, just some of the basics. Why did you do it? Who was the target audience, and how did you write the report? I was involved in some manner, but you guys did the heavy lifting, so tell me more.

Henry Engler: Sure, well, first of all, it's a collaborative effort. I mean, this is such a huge topic that, you know, it's impossible for me, to me anyway, for one person to pull together something like this and do it in a comprehensive manner. ESG issues are, you know, increasingly top of mind here in the United States, but you're just talking about other regions in the world. In Europe they are very much the focus of governments, regulators, and they're actually, no surprise, ahead of the United States and in many of these areas. Asia a little, you know, a little more fragmented, a little bit different, but the impetus for the report was really that ESG is now a major issue for financial services firms full stop. And it's you know, if, particularly if you're global company and you have operations across United States, North America, Europe and Asia it's imperative that you focus your, you know, energies. Make sure that you're you know, organized properly to deal with the different you know aspects of this across different regions because and we'll get into that. It is a mixed picture, but it was a collaborative report. My colleagues in Europe and Asia contributed a lot of effort and work into providing what the picture is in their respective regions. And you know they did a great job and the audience, really, I mean, I think it's primarily many of you know, the people that your audience, the legal community, people in risk management, compliance, human resources, and certainly all of the newly formed groups and units within financial services firms that are responsible for ESG issues now. And I'd say, you know, many of the largest firms ,I think they're well ahead of, you know, let's say small or medium sized firms and in creating groups and units that are dedicated to these issues. So yeah, it was a great effort by everyone and, you know, I really, I mean it's a great team and we did, I think we did a pretty good job of trying to capture most of the issues. I mean, there's some that we didn't. It's almost impossible to cover everything, but I think we, hopefully we covered some of the some of the most salient issues for the industry.

Gina Jurva: And I have to 2nd and 3rd and 4th that because this report really is so comprehensive and you know each person that contributed to it is truly an expert in their region in their field, so, you know, congratulations on it and so with the research you did with you and your team, what can you just tell us about how countries around the world are dealing with these emerging risks and just the changing rules and regulations around ESG and the financial services industry that, like did something stand out to you in the report itself or as you were writing for this report and researching, was there anything that stood out more than others or?

Henry Engler: Right, well I have to say, yeah, it’s fragmentation, right? That these issues are in a state of flux in this state of evolution. You have different regions, different countries at different speeds in terms of their focus and investment, and the right rules and regulations that they're developing around these issues. Europe is clearly ahead of everyone else. European Union and separately United Kingdom, since they're not part of the EU anymore. Both of those, both of those countries, are much more advanced than say we are here in the United States from the regulatory side they already have put forward rules on disclosure what they expect companies to disclose in terms of, say, the diversity issues that we were just talking about. Disclosure in terms of how they're managing climate risk. The Bank of England is very much advanced in that respect. The European Central Bank, also, and the individual central bank regulators in individual countries, they're all down this path, shall we say, more than here in the United States. In Asia I'd say the picture there is also one of fragmentation. You have some countries, as we mentioned in the report, Singapore is very focused on ESG issues and the financial authorities there have made a lot of progress in terms of ESG regulation, less so in other parts of the region. And so there the picture is again fragmented more it's mixed. It varies from country to country. Here in the United States, we are playing catch up with our European counterparts. Our regulators have even admitted that. Recently Fed Governor Lael Brainard gave a speech and she effectively said we are behind Europe. And we need to catch up. Which is a signal that US regulators are taking a very close look at what Europe has done and I think if you read between the lines of her remarks and also some other right US regulators recently, they don't want to reinvent the wheel so, what we see emerging, what has emerged in Europe, might serve as a sort of road map or blueprint for what some you know for what some US regulators here will eventually propose. The Securities and Exchange Commission is working on disclosure rules. Which are expected, at least an initial draft, are expected either later this year perhaps more likely next year, the first half of next year, and that will be a critical component to US. regulation on ESG because it will those disclosure rules will cover what companies are doing on climate risk, as well as diversity and inclusion. And also, how they're structured internally in terms of their governance of these issues. The Federal Reserve is also working with banks on climate risk, in particular. They are using what they call scenario analysis to try to see, you know, how banks could perhaps model or anticipate future climate risk events, so it's a very mixed picture, Gina, and I think, you know, for any again sort of going back to a global organization where you have a footprint in all these different regions, you really have to be very nimble and you have to be up to speed on what's happening in each region and different, you know, there'll be different demands on your organization regarding ESG, depending on, you know, where your operations are, so it's I think that's what really kind of jumps out if you read the report and, you know, from everything that we've tried to put together.

Gina Jurva: Yeah, I think the way you put it, fragmentation is exactly right, and keeping our eye on what EMEA is doing in that region, I think, will be critical and we'll pay attention next year for the SEC the disclosures and others. The other thing we talked about before we got on the podcast, today is the Biden administration and several federal agencies recently just put out for the first time ever indicating that climate risk is now a national security threat, that was very interesting to me. I think it, of course, it does impact financial institutions of course, we're going to talk in a moment about environmental crime, but that was something else too that I think we just - it's very clear that as a world economy, as a global society, we are paying attention to ESG and 5, 6, 7, 8, ten years ago this this term didn't come up as much and maybe in silos like we talked about, diversity, inclusion and social in one aspect, but maybe not all wrapped together as an ESG, so. The other thing as I just mentioned the environmental crime that really stood out to me in the report. I think my audiences are very interested in that as well. So, the link between environmental crimes and money laundering. What did you find as you research for this report and maybe I should also have you explain a little bit about what is environmental crime?

Henry Engler: Sure, well it was something that sort of jumped out to me as well, because I had not been as aware of environmental crime before delving into the, you know, pulling this report together. It's an issue that's really growing, and there are reports that there's could be anywhere from 50 to 150 billion annually in money that's flowing illegally from just what FATF, the Financial Action Task Force, found in terms of forestry crime. In other words, illegal cutting down of forests and using the logs and then using the proceeds from selling those products to be used in other, you know, illicit activities and it's an area that really is, I suppose if you look at regions such as South America, in particular Brazil, and other what I what I recently came across it is a growing issue for the Brazilian Government is illegal gold mining in the Amazon region, where people are coming in and they're also cutting down huge parts of the Amazon and they're mining for gold. And they're using all kinds of chemicals to unearth the gold, and those chemicals then flow into the, you know, the streams and the rivers of the Amazon and create additional environmental problems. And it’s something that I think from a from a financial industry perspective as FATF argues, and everyone I think should probably take a look at their recent report on this, is that the proceeds from selling the gold or selling the lumber will find its way into countries such as Venezuela or Colombia and then get into the financial system and be used for, you know, other illicit crimes. And so, what FATF if is really urging and the other point that they also make, is that environmental crime is something that internationally is not being overseen in a coordinated fashion. So, the regulation around this is lacking, shall we say, and the oversight of it from country to country varies, so it's really - we don't hear a lot about it, but it's growing, and I think that you know from a financial industry standpoint when you talk about money laundering in general, it all goes back to KYC, right? Knowing Your Customer and so, these kinds of activities I think particularly for firms that have clients in these industries, whether it's commodities, precious metals, lumber, wood products, so on and so forth, you need to perhaps dig a little bit deeper into what they're doing to know them better and whether or not, they might be engaged in in this type of environmental crime.

Gina Jurva: Yeah, and also just to know the typology is around like you said, like whether it could be wildlife trafficking, it could be the mineral trafficking. All of those things and how it gets into our bank and what is it that you should be, as your transaction monitoring, what stands out is key. I'd like to go back for a moment and give the “G” in ESG sometime so we discussed it at the beginning of the podcast, but really, truly like as you were doing this report how crucial did you find that buy-in at the top is for financial firms to achieve sustainable finance objectives and who's doing it well? Where could there be some growth? What did you find?

Henry Engler: Well, I think what we found is, again, the picture is mixed up. I think there are certain financial institutions that are taking ESG very seriously at the top of their organizations. They've set up committees. They have people on the board whose responsibility is ESG. There is a sense of accountability. Or there's a path of accountability on these issues that have been instituted in the organization, and so it's not like an add-on or an extra job for, let's say, the Chief Compliance Officer or the Chief Risk Officer. There's actually Chief ESG Officers there, Chief Diversity Officers. There are also, there are lots of senior level positions now at many large financial firms whose job it is to oversee these issues. And, you know, having said that, there is also, I think, more recently some evidence that suggests that while ESG is now being discussed very actively, you know, at the board level, at the senior management level and is informing the strategy of many of these firms, it's not to say that they are really taking it as seriously as one might hope or expect at this stage. And I'll just, you know, this is something that is not in the report, but something that was published just recently. PwC every year does a survey of, annual survey rather, of US Corporate Directors. And the most recent survey which just came out, I think it's been a week ago, it's easy to look up, found that ESG is more important now. Almost 2/3 of directors or 64% now say that strategy, their strategy is tied to ESG issues, which is a 15 point jump from a year ago, so a significant increase there that things you know things are changing in terms of corporate strategy. You know the majority of directors now recognize that this is an issue that they need to focus on. However, when it comes to the disclosure of how they're doing on ESG, a majority of directors, 67%, say they'd rather keep, you know the status quo, in other words, it's voluntary in terms of how much they disclosed to investors and regulators. Only 18% support mandatory requirements on ESG issues, which of course is what the SEC is working on. So that, you know, that's somewhat telling. While on the one hand, companies at the top recognize that they have to focus on ESG, but they still want to keep the regulators at arm's length and give them the flexibility to disclose what they want to disclose and how frequently. And Gina, here's something that that's probably you know, very interesting in terms for you and then the diversity issue. When they polled board members on diversity, they found that 1 in 3 men on boards said the push for more diverse directors results in boards nominating quote “unqualified and unneeded candidates”. Less than 20% of female directors said the same. And then here's another one statistic, almost 6 in 10 Directors said diversity is driven by quote, “political correctness” and an increase from the last two-year survey and half of those surveyed said shareholders are too preoccupied with diversity, a slight uptick from what they found last year. So, where are we at the at the top of the you know corporate hierarchy? I'm not sure I mean this this paints a somewhat, you know, unflattering picture perhaps, shall we say, yeah.

Gina Jurva: It really does and I will make sure that that link to the report goes into our blog post that will be attached to this. I definitely want to read that. Thank you for sharing those statistics. A final question for you, just you know, as a takeaway, as the regulatory environment remains in flux, what are some things that bank managers, insurers and others working in the global financial services industry might want to think about and how to prepare best for these emerging regulations that surely will be coming down?

Henry Engler: Right and I think again this sort of model that I would use is similar to what you would use in your existing AML programs, specifically KYC “Know Your Customer”. So, if you're a large banking organization and you have lots of clients that you lend to companies that you lend to that significant portion in the oil and gas industry, well, those companies are at high risk, right? Because they're under pressure as well to curb, you know their activities, as a banking institution or under pressure to stop lending to them. And of course, that is an issue that will continue to, you know, receive a lot of attention from Congress and it certainly does now from, you know, environmental activist groups. So, here's, you know, so basically in other words, look at your customers. You have the information about their activities, the industries that they're in. How much exposure they have to, let's say climate risk in the southern part of the United States, climate risk in California, wildfires. Yyou can segment your customer base in terms of those types of climate risk parameters already because that is what the regulators will want you to do. They will want to see whether or not you can identify your exposure to companies who are exposed to climate risk and how you're able then to translate that into financial risk, and that that's the tough part because this is different than market risk or liquidity risk or interest rate risk and that is really the challenge that a lot of financial companies are facing. That's the challenge, the same challenge, that the regulators are facing is. How do we take, let's say climate risk and quantify it? Capture it into a risk that we could put a number on that we could measure, that we could track, that we can, maybe hopefully one day predict, right? It’s very difficult, but those are the kinds of things as an organization you can start doing. And in trying to figure that out, of course, then who's going to do it within the organization? Some of your existing risk management groups, certainly are involved, should be involved. Your compliance people should be involved. HR on the diversity issue on the “S” part of ESG. Those individuals should be very much engaged and looking at the organization and going, let's take diversity, looking at the organization understanding. What is our profile? What percentage of our senior management are women are at the board level? Or you know, across the organization? Are we empowering people to speak up? Our employees to speak up? Creating an environment for that. People will want to know, you know, the regulators will start to come in and they will want to see well, what is your diversity program? What kind of you know, give us this information? I mean, one of the points that we make in the report is that you hear this quite often from companies that, well, you know, you want all this information about our employees. It's going to be hard to compile that. Well, it's really often it's not that hard. That information resides somewhere within your organization because you're already obligated to give the government a lot of information about your employees through various types of regulation. And so, I think it's largely more of an effort of collecting and aggregating this information so that it's in a in a more presentable form, or it's easier to report to regulators once they start requiring it. So, these are steps that I think many companies can already, you know, take in advance of what will be emerging from the regulatory authorities.

Gina Jurva: Wow, well this is again such an important topic and really, really happy to have to have folks like you and your team following it. Henry Engler, Senior Regulatory Intelligence Expert here at the Thomson Reuters Regulatory Intelligence group, author of this fabulous report, ESG: Fast Emerging Challenges for financial institutions, a 2021 special report. Everyone, please check it out. And Henry, thank you so much for being a part of the podcast.

Henry Engler: Thank you for having me, Gina.

Outro: Thank you for joining us, for Thomson Reuters Market Insights. For more data driven analysis of today's professional services market and in-depth conversations with industry thought leaders, please visit us online at thomsonreuters.com/institute. You can subscribe to this podcast on your favorite podcast platform or follow us on Twitter @TRIExecutives and LinkedIn under the Thomson Reuters Institute. Thomson Reuters Market Insights is a production of Thomson Reuters. 