ESG Risk: a new paradigm for risk management

This paper (part two of a series) discusses a new paradigm for risk management.

Produced by the Risk, Regulatory and Compliance segment of Be | Shaping the Future UK.

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In the previous paper on this topic, we discussed how risk management can help accelerate the transformation to a sustainable business model – through the application of risk capabilities and methodologies to estimate sustainability impacts and risks, therefore enabling better decision making.

In this paper, we explore how the scope of risk management should evolve to contribute to achieving sustainability for banks.

The scope of risk management

Over the last couple of decades, we have witnessed a spectacular evolution in the practice of risk management in banks. From significant developments related to financial risk management to progress related to non-financial risk management; and more recently the assessment of climate change implications to financial risks.

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The key purpose of risk management is to understand the future possible variability in the value of the bank's assets to achieve an optimal risk / return ratio through appropriate management actions. So risk quantification is at the core of risk management as it enables measurement and management.

To date, the scope of risk quantification in banking has been limited to assess the change in value of internal assets (in both the trading and banking books); this is because the traditional assumption is that the value of the bank and its future expected profitability depends on the value of its internal assets.

However, is this assumption completely true when we consider sustainability?

Three key sustainability themes

Three key themes are emerging for businesses as part of the new considerations related to sustainability.

1. **Sustainability and profitability are both required by businesses** – there must be no trade-off between achieving sustainability and better profitability. The businesses that can survive and thrive in the long-run are only those that are sustainable.

2. **Businesses operate in one interconnected ecosystem** – internal and external assets (i.e. environment, society, governance (ESG)) are both directly (and indirectly) correlated to business value and performance. In other words, ESG factors can directly impact business performance, therefore protecting (and developing) external assets is just as important as internal assets.

3. **Banks have committed to a key role in achieving a sustainable future** – over 270 banks, representing about 45% of global banking assets, have now joined the Principle of Responsible Lending movement of change, a framework for banks to align their strategy and practice with the United Nations sustainability objectives and make a positive contribution to people and the planet. Banks endorsing the Principles commit to improving their governance structures and measuring the societal impact of their activities. Regulators' expectations reinforce the need for this journey in financial services; which in fact triggers a virtuous cycle, creating a multiplier effect in the market, which improves financial viability, reduces risks to banks and in turn benefits financial stability.

These key themes point to a new business scenario for the banking ecosystem. A scenario where both stakeholders and shareholders are increasingly expecting banks to become part of the 'green' solution, transforming their purpose, strategy and value drivers.

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A new paradigm for risk management

As banks are expected to not only transform their business to become sustainable but also facilitate the green transition of their clients, they will have to set, monitor and manage new objectives around sustainability, i.e. targets that relate to those ESG factors that are relevant for the bank.

For the first time, banks are required to achieve targets that relate to external assets: meaning they will have to understand the impacts of bank operations on external assets, as these become as important as internal assets to achieve long term performance and sustainability targets.

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This requires banks to evolve the scope of risk management to include the quantification of risks related to external assets, supporting metrics, measurements and analytics that will drive and control the required transformation. Risk management should identify those risks that have an impact on the achievement of sustainability targets related to the ESG factors (i.e. 'ESG risks'), measure and report them, thus enabling management of the business in an appropriate way.

This is a new paradigm for banking risk management, which requires rethinking the entire risk framework, governance, data, metrics and reporting. This differs from the current assessment of strategic risks, where banks are looking to assess the impacts that external factors have on the achievement of the bank strategy.

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The new paradigm requires banks to consider how their operations impact the achievement of sustainability targets that are set on external ESG factors relevant to the bank's success.

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New measures of risk will have to be developed to assess 'ESG risk', which is now being partially addressed by scenarios and stress testing (albeit with the different objective of assessing impacts on the long term value of bank's internal assets).

Banks could measure 'ESG risk' as the potential change in value of those external assets that are relevant to the business, which are dependent on the changes in the bank balance sheet composition, internal business drivers and operations.

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Banks will then be able to consider the implications of business decisions to their internal risk profile as well as to their external risk profile. Risk frameworks, governance and accountabilities should be aligned to consider ESG risks, enabling better management and strategic decision making.

A recent example of a similar development relates to the consideration of biodiversity and its importance to business sustainability.

A few banks have already started to include natural capital risk in their business and investment decision process and are pioneering metrics and methodologies to assess this.

In the meantime, the Task-force on Nature-related Financial Disclosures (TNFD) has been launched aiming to develop a risk management and disclosure framework for nature-related risks. Further action is also being taken by the Science Based Targets Network that is also developing a framework for companies to set science-based targets for natural capital.

Parting thoughts

Risk management in banks has evolved massively, providing a better understanding of the risks related to bank's internal assets which is critical to the achievement of strategic objectives.

However, with the evolution of banks' strategic objectives, there is now a case for risk management to take a more holistic approach in assessing not only the impacts but also the risks related to those external assets that are relevant to the success of the bank; such information is of vital importance to drive both sustainable and profitable business decisions.

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This is a new paradigm for risk management; and one that has the power to be the driving force for a radical evolution and contribution towards a sustainable future for banks around the world.

About us

Be | Shaping the Future UK (**Be UK**) is a subsidiary of Be | Shaping the Future, a well-established management and technology consultancy with over 1,800 consultants located across 12 European countries.

We work with the leading financial services organisations to shape their future through our transformation consultancy and advisory services, covering the following sectors:

• Cards and payments
• Retail and commercial banking
• Capital markets
• Finance
• Risk, regulatory and compliance

We take pride in building relationships with our clients and we work collaboratively to drive change for a bigger and better future.

The risk, regulatory and compliance team at **Be UK** is composed of specialists and advisors. Our key service areas include:

• Enterprise risk management
• Recovery and resolution planning
• Capital management and optimisation
• Financial crime
• Operational risk and resilience
• Sustainability, ESG and climate risk

Contact

For more information on how we can help with your ESG, climate and risk initiatives, please get in touch.

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With many years of experience in the international financial services industry, Alessandro has a wealth of experience in risk, regulation and compliance, gained through international roles, both as a consultant as well as a banker, including CRO roles in the UK and CH. His experience ranges from strategy and governance, AI / ML risk applications, risk transformation, system implementations to compliance and regulatory assurance.

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