Financial Services Leadership Summit

October 2020

FSLS

SUMMARY of THEMES

Road to the Summit: Accelerating the ESG agenda

With the heightened urgency of climate risk, the public health and economic effects of COVID-19, and global demands for racial, social, and economic justice, the ESG conversation is now more vital and more complex than ever for leaders of large financial institutions. Most leaders now agree that ESG, once a conversation confined to corporate social responsibility teams, is a set of mutually reinforcing risks that demand attention not only in the executive suite but also in the boardroom. Mismanagement of climate and social risks not only poses reputational risks, but also the potential for financial harm, unhappy customers and employees, and investor and regulatory scrutiny.

On September 17, senior executives and board members of banks and insurance companies headquartered in North America and Europe joined senior leaders from EY to discuss the evolving ESG agenda.[1] Participants exchanged perspectives on how the ESG agenda has changed in 2020, the actions leaders are taking in response, and the challenges to future progress that persist at the firm and systemic levels. The conversation will inform Bank and Insurance Governance Leadership Network discussions through the end of 2020, including the Financial Services Leadership Summit. Three major themes surfaced:

- **The events of 2020 have accelerated the need for progress on ESG.**
- **Financial services firms are embedding ESG more deeply within their organizations.**
- **Challenges remain for effective oversight and execution of ESG strategies.**

The events of 2020 have accelerated the need for progress on ESG

At the beginning of 2020, climate change was rapidly moving up on senior management and board agendas. While COVID-19 and widespread calls for racial equity may have shifted some attention from climate, leaders of financial services firms are drawing lessons about ESG from the pandemic and its economic impact.

COVID-19 has highlighted risks from inaction on climate change and ESG

COVID-19 has been a deeply traumatic experience. Its lessons for the heads of large financial institutions are becoming clear and difficult to ignore.

- **The costs and risks of climate change are becoming more vivid.** COVID-19 caused a sudden decarbonization of the global economy and the results underscore the opportunity and need to take significant and rapid steps toward a low-carbon economy. A bank executive reflected, *"We've now seen what an abrupt decarbonization is about… It's messy, it's painful, and it has consequences in the form of job losses. We've seen the cost of unpreparedness and what a climate crisis could look like."* Moreover, the immediate costs of climate change are increasingly evident: *"It's very clear that the financial penalty for incurring climate risk is going up and it's going up meaningfully; we see that year by year. Underwriting results are worse than anticipated. The cost of risk transfer has gone up significantly. The cost to reinsure climate risk is going up significantly,"* said one director.

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– Executive

- **ESG issues are increasingly interconnected.** The events of 2020 demonstrate that environmental and social issues are related in ways previously unappreciated. An executive said, *"Social equality and climate change are not separate issues. It goes both ways. Climate change, like COVID 19, disproportionately impacts the poor, and poverty can force behaviors that harm the climate. Deforesting farmers don't do it for fun. It is often the result of having no other way to survive."* Another executive noted, *"The events of the past several months demonstrate a strong connection between nature and health. As we deforest and get the animal world interconnected with human world, we now see what happens."*

Clients are seeking ESG solutions

Increasing awareness of environmental and social issues is driving change across the spectrum of financial institutions' clients. Consumers are increasingly concerned about health, wellness, and the environment. One executive explained, *"We surveyed people in 2016 and July 2020 and not surprisingly, the percentage of people concerned about disease and* *pandemics went from 15% to 50%, climate went from 19% to 42%, and pollution went from 9% to 34%. Customers aren't just concerned about the immediate crisis, they're concerned for their future and what may be coming down the tracks."* Large institutional clients are elevating ESG within their organizations and asking questions about how to operationalize change and establish effective governance. A bank leader commented, *"As this acceleration has happened, I do think it has been an opportunity for a lot of our institutional investors, asset managers, and corporates, who kind of knew and sensed this was important in certain pockets of the organization, to really elevate ESG in terms of focus and priority."* Some clients are also developing strategies to reduce their carbon footprints and transition to more sustainable business models. *"The oil and gas industry is a great place to look at,"* commented an executive. *"You've actually got a spectrum of responses from the supermajors. I think for all of us, that group of supermajors will be fascinating to watch in terms of their share price… Who will win in this world? Hopefully it's the ones trying to make the world a moderately better place."* The increased focus on ESG among clients is turning into a revenue opportunity for financial services firms. Flows into ESG-linked financial products and services have increased significantly. An executive said, *"For the first time, we've topped $1 trillion globally in investment towards ESG related funds. We saw Alphabet issue the largest sustainability bond for a US corporate in history. We're still in a relatively early stage for the social bond market, but that has accelerated tremendously – we've seen more than all of last year already."* Advisory opportunities are also emerging. " *Year to date, I've had over 600 client meetings on ESG. A lot of these meetings are heads of strategy, heads of M&A, C-suite level executives… you're definitely starting to see this come together more."*

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– Executive

Financial services firms are embedding ESG more deeply within their organizations

As the focus on ESG has accelerated, financial services firms are changing how they respond. Like their clients, they are asking: *"How do I really operationalize this in a credible way? What is the appropriate governance structure we need in our organization?"* Participants discussed evolving approaches to ESG.

- **Firms are thinking more holistically about ESG risk.** The events of 2020 have shown that ESG issues and risks are interconnected and mutually reinforcing. Exposure to climate risk presents not only the potential for financial penalties, underwriting challenges, and higher risk transfer costs, but also the widening of income and racial inequalities. Mismanagement of ESG can lead to employee demotivation, activist campaigns and regulatory interventions. The cumulative nature of ESG risk is causing firms to think of these issues in more holistic terms. A director said, *"Rather than think of E, S, and G as three competing things, we might think that doing what is good for the climate is also good for society at large. It is the same for social and for governance."* Such an approach that captures the cumulative risk across ESG components is helpful, but nonetheless requires a tailored approach for each. An executive stated, *"You're no longer solving just one item, ESG has a halo effect across the multitude of issues that we're talking about. How then do you execute behind a broad message, but do it in a way that solves some of those individual challenges?"*

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– Director

- **The ESG agenda is being elevated and integrated into the organization.** Firms increasingly view ESG in strategic terms; it calls for decision making and oversight at the highest levels. A director said, *"ESG really is a broad strategic problem for the organization. I am less interested in scorecards. They're important, but I'm far more interested in how the evolving assessment of risks within ESG are shaping the strategy of the company, the risk appetite of the company, and then how rapidly we can adapt."* One executive described the integration of sustainability into the business: *"The interplay between what we do in sustainability and the investment group is very tight. They are very, very interested in not only the strategic view of what we're doing but also operationally how we make it happen, how we measure, and how the measurements drive the right behavior."*
- **Firms are implementing more robust governance structures.** As, banks and insurers work to embed ESG more deeply into strategy and operations, ad hoc arrangements such as ESG taskforces are being replaced with top executives -- Chief Sustainability Officers (CSOs) with teams to support them; in some cases this is happening because of regulatory mandate. A director remarked, *"We have someone with the responsibilities but not the title… I will be going back to the board with the hope that we can name someone officially in this role."* While the people filling these roles come from a range of backgrounds, they are generally tasked with working broadly across the organization to integrate ESG into the firm's strategy and business models. An executive explained, *"We had a lot of teams working on this from a grassroots level, but what brought this all together was having a CSO*

"We had a lot of teams working on this from a grassroots level, but what brought this all together was having a CSO and updating goals around financing activity and achieving net zero."

– Executive

and updating goals around financing activity and achieving net zero. That caused senior management to aggregate information and communicate better. It kept us organized and aligned a lot of the internal efforts that were already going on at the bank." Building that connectivity across the organization also helps with reporting to the board. *"We would drain the board meeting with the amount of time we could spend talking on ESG,"* a senior executive said. *"So we tend to merge the ESG work happening in my group with the work in the ERM group and with the investment group to make sure we're having a conversation aligned with our strategy."*

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– Executive

- **Firms are identifying ways to meet client ESG needs.** Financial institutions increasingly recognize that managing ESG means not just handling their own risks, but also pursuing client service opportunities. A director said, *"Some think that doing good for society involves a trade-off from profits, but my experience is that a well-executed commitment to the betterment of our environment, society, and governance drives real value and benefits. It drives intrinsic motivations amongst employees. Customers are demanding it."* Banks and insurers are creating teams tasked with generating revenue as opportunities emerge. Rising client awareness of ESG and government backed campaigns to "build, back better" or "cleaner, fairer, greener" offer firms with the right level of expertise the chance to drive topline growth while supporting local economies in a positive way. An executive remarked, *"There are things we can do as a firm to link client concerns and their focus on ESG to provide them with sustainable financial returns."*
- **Firms are also calculating how they want to position themselves relative to their peers.** For now, financial institution leaders don't appear keen to get too far out in front, though they cannot afford to be left behind. An executive said, *"The uncertainty in this moment is a challenge. The lack of standards, methodologies, and policies makes it tough… I think you want to be in the leading pack right now but maybe not leading by yourself."* A board member agreed, *"It's pretty clear that there are firms in the bottom quartile and bottom second quartile with regard to their approach to ESG. There are definitely disadvantages to being in those places. You may not want to be a first mover, but there are very clear disadvantages to being on the other end of that spectrum."*

Challenges remain for effective oversight and execution of ESG strategies

"When you think of strategy, risk management, etc. getting all aligned for net zero, the devil is in the details. When we say, 'net zero', what do we mean by both of those things?"

– Executive

"Trying to translate high and important sounding statements into concrete actions and trying to sort out with management what that should look like in practice is a real challenge."

– Director

Despite renewed focus on addressing ESG issues in recent months, barriers to progress remain. Executives and directors identified challenges that must be confronted to deal with the risks and opportunities that ESG presents.

- **A lack of standard definitions and benchmarks.** The lack of a common taxonomy to define, measure, and compare progress remains a challenge. Multiple initiatives involving public and private sector entities around the world are currently trying to address it, but in the meantime, financial institutions have to manage a tangled web of standards, metrics and terms. An executive said, *"Two of the hardest words to define in English are 'Net' and 'Zero', particularly in terms of where we're going. When you think of strategy, risk management, etc. getting all aligned for net zero, the devil is in the details. When we say, 'net zero', what do we mean by both of those things?"* The lack of commonly accepted definitions makes reporting difficult whether a firm is trying to track emissions or new deal flow. *"The challenge we have is just trying to think about a framework for what is really a sustainable deal or an impactful transaction. Green bonds are relatively easy to quantify, but what about other products? When is an IPO green? When is an M&A deal sustainable? How do you pull that all together for a clean summary for the board?"* Boards recognize that management teams are working hard to provide the right information. A director commented, *"The problem isn't information not making it to the board. To me, it's more related to the challenges around measurement, benchmarking, and ensuring information accuracy."* A director stated, *"What will drive change in this industry, which is not typically the most rapid to evolve, is an ability to quantify these things and then an ability to strategically adapt to them."*
- **Gaining alignment between public commitments and actions.** Many financial institutions and their leaders have made proclamations in support of issues like racial and gender equity or financing a greener economy. Stakeholders are increasingly insisting that these commitments must be followed by real action. This can be easier said than done. *"Trying to translate high and important sounding statements into concrete actions and trying to sort out with management what that should look like in practice is a real*

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– Director

"Even talking about a green recovery in the US doesn't work with a large part of the political base. It creates real operational challenges in just getting our work done."

– Executive

challenge," according to a director. This has become particularly problematic in managing exposure to clients in carbon-intensive industries. As a director acknowledged, *"The emerging ESG conversation should lead to a conversation about the kinds of risks we'll accept in the portfolio. You have to ask, 'Will we accept energy companies?'"* Firms need new tools to evaluate how their holdings contribute to climate change under multiple scenarios and align against public commitments and goals. An executive said, *"We can't just focus on the financial impact of climate, we also need to understand the impact of our portfolios. This is the challenge today. We really need to get alignment at the sector level on how to evaluate this."*

- **Navigating geographic, cultural, and political differences.** Firms feel an obligation to support local economies, and in many areas of the world, fossil fuel companies or other carbon-intensive industries are key drivers of employment, the tax base, and firm revenue. An executive remarked, *"There's a very different point of view regarding our underwriting appetite on climate depending on the region we're talking to. We find the US and Europe are often wiling to move more quickly than in Latin America or Asia."* While a global Chief Sustainability Officer can help to coordinate a response, gaining alignment on sensitive issues across organizations operating on many countries can be daunting. In addition to cultural and economic differences, policy and regulatory regimes are moving at different speeds. An executive said, *"In Europe, the regulatory focus from a supervisory perspective and also the political drive is obviously drastically different from the US."* Another participant added, *"Even talking about a green recovery in the US doesn't work with a large part of the political base. It creates real operational challenges in just getting our work done."*
- **Managing external perspectives.** Financial services firms grapple with trying to manage key external stakeholders with often conflicting agendas. Investor expectations are top of mind for bank and insurance leaders. *"We have key investors who really understand where we're going and how we're going to get there. I spend most of my time engaging with these organizations."* Not all investors, however, are satisfied with the status quo. Leaders therefore expect a potentially difficult transition in the days ahead. A director said, *"From an investor perspective, we have a long way to go to quantify the*

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– Director

cost of climate risk. For traders, equity analysts, and fixed income analysts, this is a huge issue. As we make progress, it's going to prompt some major rebalancing of investment portfolios as companies deemphasize some lines of business and emphasize others." If stakeholder expectations get too far ahead of policymakers, this could further complicate matters. An executive acknowledged, *"We're very active in the policy discussion here even though it's very challenging. There are still all sorts of redlines no one wants to cross which are impediments. We do feel like we're caught between some rocks and hard places."*

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About the Bank Governance Leadership Network (BGLN) and Insurance Governance Leadership Network (IGLN)

The BGLN and IGLN address key issues facing complex global banks and insurers, respectively. They primarily focus on the non-executive director, but also engage members of senior management, regulators, and other key stakeholders committed to outstanding governance and supervision in support of building strong, enduring, and trustworthy financial institutions. The BGLN and IGLN are organized and led by Tapestry Networks, with the support of EY. *Summary of Themes* is produced by Tapestry Networks and aims to capture the essence of the network discussion and associated research. Those who receive the *Summary of Themes* are encouraged to share it with others in their own networks. The more board members, members of senior management, advisers, and stakeholders who become engaged in this leading edge dialogue, the more value will be created for all.

About Tapestry Networks

Tapestry Networks is a privately held professional services firm. Its mission is to advance society's ability to govern and lead across the borders of sector, geography, and constituency. To do this, Tapestry forms multistakeholder collaborations that embrace the public and private sector, as well as civil society. The participants in these initiatives are leaders drawn from key stakeholder organizations who realize the status quo is neither desirable nor sustainable and are seeking a goal that transcends their own interests and benefits everyone. Tapestry has used this approach to address critical and complex challenges in corporate governance, financial services, and healthcare.

About EY

EY is a global leader in assurance, tax, transaction, and advisory services to the financial services sector. The insights and quality services it delivers help build trust and confidence in the capital markets and in economies the world over. EY develops outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, EY plays a critical role in building a better working world for its people, for its clients, and for its communities. EY supports the BGLN and IGLN as part of its continuing commitment to board effectiveness and good governance in the financial services sector.

tapestry NETWORKS

EY Building a better working world

Meeting Participants

- Antoni Ballabriga, Global Head of Responsible Business, BBVA
- Zelda Bentham, Group Head of Sustainability, Aviva
- Agnes Bundy Scanlan, Non-Executive Director, Truist Financial
- Lara de Mesa, Group Executive Vice-President, Head of Responsible Banking, Executive Chair's Office, Santander
- Hervé Duteil, Chief Sustainability Officer, BNP Paribas, Americas
- Francis Hyatt, EVP, Chief Sustainability Officer, Liberty Mutual
- Joan Lamm-Tennant, Non-Executive Director, Equitable Holdings and Hamilton Insurance Group
- Nick Le Pan, Audit Committee Chair, CIBC
- Jed Lynch, Head of Americas, Sustainable & Impact Banking, Barclays
- Kara Mangone, Chief Operating Officer, Sustainable Finance Group, Goldman Sachs
- Ariel Meyerstein, Senior Vice President, Sustainability and ESG, Citigroup
- Deb Perry, Finance and Risk Committee Chair, Assurant; Non-Executive Director, Genworth Financial
- Alan Smith, Senior Advisor, ESG and Climate Risk, HSBC
- Jennifer Waldner, Chief Sustainability Officer, AIG

EY

- Mike Lee, EY Global Wealth & Asset Management Leader
- Gillian Lofts, UK Wealth & Asset Management Leader, EMEIA Sustainable Finance Leader
- Brandon Sutcliffe, Principal, Sustainability, Climate Change, Risk Management
- Steve Varley, EY Global Vice Chair, Sustainability

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- Dennis Andrade, Partner
- Eric Baldwin, Principal
- Jonathan Day, Vice Chair
- Brennan Kerrigan, Senior Associate
- Tucker Nielsen, Principal

Endnotes

[1] A complete list of participants is included in the appendix. *Summary of Themes* reflects the network's use of a modified version of the Chatham House Rule whereby comments are not attributed to individuals, corporations, or institutions. Network participants' comments appear in italics.