ESG Framework for FI and DNFBPs

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ComplianceAid®
ANTI-MONEY LAUNDERING & FINANCIAL CRIMES PREVENTION HYBRID CONFERENCE

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Mr. Frank Morisano is an internationally recognized executive and acclaimed storyteller who has developed a unique style of combining highly emotional stories and strong visual artistry with emerging technologies.

He has over 30 years of proven financial services accomplishments: globally growing businesses, steering profitable growth in new markets, guiding product development, leading the acquisition, divestment and restructuring of companies, promoting risk proficiency in companies, and implementing ESG standards, frameworks, and disclosure reporting software to comply with global regulatory requirements.

Previously, he was the Chief Risk Officer of the largest bank in the world with responsibility for the Americas risk profile, strategic planning, governance, consolidated enterprise risk management, AML/BSA, sustainable finance, compliance, credit risk management, liquidity, crisis management, fraud and operational resilience. He also established their compliant cybersecurity framework and activities as the Chief Information Security Officer.

Prior roles include the leadership of revenue generating businesses at PwC, GMAC, JPMorganChase, and Bank of America. He serves on private and public boards as a non-executive and independent director, where he is a member of the Audit, Risk, and Strategy committees and is known for establishing and implementing effective Board governance.

Defining ESG

ESG is a short acronym composed of three components, outlining an approach to investing, risk mitigation, and decision-making tools.

Environment, which examines human impact on the natural eco-system;
Social concerns, which focuses on human activity and civil society challenges, and;
Governance, which scrutinizes organizational frameworks to judge whether legal entities and individuals make appropriate, sustainable decisions

ESG Factors

Environmental	Social	Governance
Air and water pollution	Community relations	Audit/board structure
Biodiversity	Customer satisfaction	Board independence
Carbon emissions	Data privacy and security	Bribery and corruption
Climate change	Employee engagement	Fair competition
Deforestation	Gender and diversity	Fair tax and accounting
Ecosystem integrity	Health and safety	Shareholder rights
Energy efficiency	Human rights and labor practices	Transparency
Natural resource management		Whistleblower programs
Waste management		

Regulatory Focus

All economic activities face climate risk. This includes the financial services industry, both through physical impacts of environmental events (e.g., customers in affected sectors being unable to repay loans) and transition risks from moving to a lower carbon economy (e.g., litigation risk relating to financing activities).

While international environmental, social and governance (ESG) voluntary standards and frameworks have been around for a while, new European ESG-related regulatory requirements impacting most industries have substantially emerged in recent months. The Plan aims to reorient capital flows towards a more sustainable economy and integrate ESG factors into risk management processes.

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Awareness

As of December 2023, EU market data suggests that activity around sustainable funds is growing.

- US$5.62 Trillion in AUM was linked to either SFDR Article 8 or 9 financial market participants or financial advisers.
- 47.4 percent of investment funds reported being classified as either Article 8 or 9 funds.
- Article 8 funds represented 55.5 percent of market AUM and Article 9 represented 3.5 percent.

Major Global Regulations

- **USA:** The U.S. Securities and Exchange Commission (SEC) Climate Disclosure Standards is a standardized reporting format and method, allowing investors and other stakeholders to confidently interpret, compare, and use data for decision making.
- **EU:** The Sustainable Finance Disclosure Regulation (SFDR) is regulation designed to accelerate flows of finance to sustainable investments, level the playing field, increase transparency in relation to sustainability risks, and reduce the potential for greenwashing of investment products. SFRD is different from both NFRD or the CSRD as it pertains to future investors more than it does to companies.
- **India:** Business Responsibility and Sustainability Report (BRSR) - BRSR was initiated by the Securities Exchange Board of India (SEBI). SEBI created the BRSR in a way that would align with other international reporting frameworks including the Global Reporting Initiative (GRI), Sustainability Accounting Standards Board (SASB) and the Task Force on Climate-Related Financial Disclosures (TCFD).
- **Canada:** Disclosure of Climate-Related Matters [Proposed] - The climate-related disclosure requirement for financial institutions follows the TCFD framework, which, as of 2023, now falls under the International Sustainability Standards Board (ISSB) standards.
- **Australia:** Climate-Related Financial Disclosure [Proposed] - The proposed climate disclosure requirements align closely with the TCFD framework, meaning companies who already follow this framework should be well positioned to meet the new requirements.
- **UK:** Financial Conduct Authority Climate-related Disclosure Requirements – This regulation supports the U.K.'s goal of mandatory climate-related disclosures across the U.K. economy and is expected to be expanded to incorporate the IFRS' International Sustainability Standards Board (ISSB) standards in due course as regulators and standard setters across jurisdictions continue to welcome the adoption of the ISSB standards.

Principals and Standards

- The Equator Principles – 10 principles for ESG risk management framework
- G20 Financial Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD) Recommendations
- Green Bond Principles – the guidance handbook provides principles and guidelines
- International Labor Organization's (ILO) Core Conventions – 8 conventions aimed at social and governance issues
- Paris Agreement Capital Transition Assessment (PACTA)
- Principles for Responsible Banking
- Poseidon Principles – an industry group aimed at international shipping
- RE100 – a climate initiative to accelerate change
- Roundtable on Sustainable Palm Oil (RSPO)
- United for Wildlife Financial Taskforce
- United Nations Environment Programme
- United Nations Global Compact Principles
- United Nations Guiding Principles on Business and Human Rights
- United Nations Universal Declaration of Human Rights
- Wolfsberg Principles – a source of anti-financial crime best practices

The New Big Four

- **The Corporate Sustainability Reporting Directive**, (CSRD), is EU legislation that mandates companies to disclose information about the environmental and social effects of their business operations, together with the business implications of their environmental, social, and governance (ESG) actions.

- The **International Financial Standards Board** released IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information and IFRS S2 Climate-related Disclosures in June 2023.

- The **EU Taxonomy for Sustainable Activities** sets out to answer was created to help the EU meet its goal to reduce emissions by 55% by 2030 and become a climate neutral continent by 2050.

- The **SEC** issued a final rule that requires registrants to provide climate-related disclosures in their annual reports and registration statements.

Disclosure

- On March 6, 2024, the SEC issued a final rule that requires registrants to provide climate-related disclosures in their annual reports and registration statements, including those for IPOs, beginning with annual reports for the year ending December 31, 2025, for calendar-year-end large accelerated filers. The final rule scales back the proposed, for example, companies will not have to provide Scope 3 GHG emission disclosures, their financial statement disclosure requirements will be less extensive, and they will have more time to implement the disclosures and related assurance requirements.

- In the footnotes to the financial statements, registrants must disclose financial statement impacts and material impacts on their financial estimates and assumptions due to severe weather events and other natural conditions.

Reframe your ESG perspective

Executing an authentic ESG strategy entails more than making donations and disclosures. It means reexamining and rethinking the value drivers of the business.

Those institutions with the courage to embrace the discomfort by rethinking their assumptions, tackling the intractable issues, and telling their story even when it's imperfect are the companies that will be well-tuned to thrive in the era of stakeholder capitalism.

A climate risk assessment is becoming increasingly crucial for institutions across various sectors to lay a solid foundation, identifying strategic priorities, embracing change, and staying informed about policy developments.

Changing the Narrative

Greenwashing: the practice of inaccurately portraying a companies' operations, products, or services as environmentally friendly or sustainable

Social washing: when a company misrepresents or exaggerates the “social” side of ESG either intentionally or unintentionally

Decarbonization: a catch-all term that refers to the actions a company takes to reduce or eliminate greenhouse gas emissions in its operations, products, and across its supply chain

Emissions (Scope 1, 2, 3): categorize a company’s greenhouse gas emissions based on recognized reporting standards and guidelines, such as GHG Protocol Corporate Standard

Climate risk: the potential adverse effects of climate change on a company’s operations, assets, supply chain, financial performance, and reputation

Materiality: refers to an ESG issue that has a financial or operational impact on a company, or the company has a substantive impact on the issue

Human Rights: Companies’ responsibility to respect and protect human rights and remediate any violations in workplace operations, supply chains, business relationships

Challenges

Addressing ESG risks in AML practices requires expertise in both ESG factors and AML compliance.

- Financial institutions need professionals who can navigate the complexities of ESG data analysis and integrate it into their AML monitoring processes. However, a shortage of individuals with expertise in both areas can pose a challenge.
- Both ESG investing and AML analysis heavily rely on data, making data quality and consistency crucial for accurate assessments and decision-making. Data quality and the lack of standardized ESG and AML metrics hinder effective risk assessment and reporting.

Staying abreast of evolving regulations, understanding customer demands, leveraging technology, and investing in the necessary expertise, financial institutions can navigate the intersection of ESG and AML to ensure compliance and mitigate risks.

Case Studies

Failure to develop the appropriate AML program

On September 25, the U.S. Securities and Exchange Commission (SEC) announced a US$19 million settlement with the investment adviser DWS Investment Management Americas Inc. (DIMA) for material misstatements and shortcomings in its policies and procedures related to Environmental, Social and Governance (ESG) investing.

The SEC focused on lack of: (1) training, (2) testing, (3) controls, (4) standards for management, (5) consistency in approach, and (6) remediation once it recognized the inconsistencies.

Key Takeaways

- No bold statements. FIs need to ensure that such statements are supported in practice.
- Appropriate policies, procedures, and controls to prevent ESG-related misstatements as well as provide clear expectations to analysts and enabling supervisors and compliance teams to tell whether analysts are adhering to guidance.
- Compliance teams should be adequately staffed and have appropriate authority to safeguard reports

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Thank you all!

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