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JOURNAL
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Engagement as a pathway to a healthier ESG outlook for financial institutions

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ESG

#56 NOVEMBER 2022

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JOURNAL OF FINANCIAL TRANSFORMATION

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CONTENTS

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SOCIAL

GOVERNANCE

DEAR READER,

Welcome to edition 56 of the Capco Institute Journal of Financial Transformation, produced in partnership with King's Business School and dedicated to the theme of ESG – environmental, social and governance.

We all recognize that transformation towards a green economic system via sustainable finance is needed, welcome and inevitable. Our clients have a crucial role to play here. Acknowledging the scope and complexity of the evolving ESG landscape, we are perfectly positioned to prepare them for the ESG era.

With climate change accelerating and generating physical events on an unprecedented scale, governments and societies are considering measures to mitigate carbon emissions via net zero initiatives. The focus is firmly on greater sustainability and more equitable policies in response to shifting public attitudes. ESG considerations are reshaping investment risks on the one hand, and opening the way for green financing and sustainable technologies and innovations on the other.

This edition of the Journal examines all three pillars – environmental, social, and governance, highlighting efforts by regulators and practitioners to create a unified approach.

Moving forward, compliance with emerging ESG standards will be a critical differentiator for long-term business success. Data will also play a critical role in delivering the transparency and insights required to validate the ESG credentials of businesses, and investment strategies. Advances in areas such as machine learning, artificial intelligence and cloud technologies will be key to establishing a future model of sustainable finance.

This edition draws upon the knowledge and experience of world-class experts from both industry and academia, covering a host of ESG topics and innovations including the value of tracking Return on Sustainability Investment (ROSI) and the importance of moving away from purely external risks to addressing issues that can have positive commercial and societal impacts.

I hope that that the research and analysis within this edition will prove valuable for you as you shape your own ESG strategies, policies, and innovation.

Thank you to all our contributors and thank you for reading.

Lance Levy, **Capco CEO**

ENGAGEMENT AS A PATHWAY TO A HEALTHIER ESG OUTLOOK FOR FINANCIAL INSTITUTIONS

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ABSTRACT

As ESG assessments begin to evolve towards an industry standard, financial institutions and their investment approaches find themselves under the microscope of the public and regulators. As a result, a common debate has arisen between the "right" approach of divestiture versus those of engagement. Though there are proponents for both sides, this paper seeks to outline the benefits of, and propose solutions for, engagement, allowing financial institutions to steward the progression to a healthier ESG outlook. Given the surge in ESG stewardship and active ownership, it seems likely that governing regulatory bodies will begin to mandate, and perhaps regulate, active ownership policies; taking action in advance of these mandates will better position financial services for a socially and environmentally equitable future.

1. INTRODUCTION

Environmental, social, and governance (ESG) initiatives have gained significant momentum over the past decade, including a quick ramp-up period under the U.S. Biden Administration, following the European lead. As ESG assessments begin to evolve towards an industry standard, financial institutions, and their investment approaches, find themselves under the microscope of the public and regulators. As a result, a common debate has arisen between the "right" approach of divestiture versus those of engagement. Though there are proponents for both sides, this paper seeks to outline the benefits of, and propose solutions for, engagement, allowing financial institutions (FIs) to pave the way to a healthier ESG outlook.

2. ESG EXPLAINED

While most people have heard of ESG, and know what each letter stands for, it is important to understand the notion from a more practical perspective:

- **Environmental:** the company's position on environmental issues such as climate change, greenhouse gas emissions, waste, pollution, and other nature-related considerations
- **Social:** the company's working conditions, power and influence in the local community, and employee relations/diversity, as these imperatives become critical to a vibrant society
- **Governance:** the overall position of the company and its board with respect to business ethics, the interests of various stakeholders – employees, suppliers, shareholders, customers – and financial transparency.

[1] The author would like to thank the following for their contribution to this paper: Amandeep Sehgal, Bronwyn Vaisey, Jason Wang, James Musgrave, Andrew Yates, and Ian Lee.

3. DIVESTITURE AND ENGAGEMENT EXPLAINED

Divestiture is the process of selling assets held by financial institutions to maximize the value they retain. Given the rise of ESG initiatives, the definition of value has been reshaped, such that decisions pertaining to asset ownership must give some consideration to the societal impact of the position. As such, advocacy groups have been lobbying institutions to divest from industries that deplete non-renewable resources. Despite these efforts, there are many implications to divestiture, including, but not limited to, the transferal of emission concerns to institutions that are less distressed by the high-emissions, and perhaps worse – the invested company takes no action to improve or reduce their emissions and research goals. For example, British Petroleum (BP) sold its petrochemical business to INEOS, effectively wiping off related emissions from its books; however, little is known about what INEOS has done with the business after purchase.

Engagement, or active ownership, serves as an alternative to divestment, whereby institutions with a controlling position in an underlying company exercise their influence to ensure changes are made in terms of operating model and governance, thus pushing companies with higher net-negative social costs to reduce their footprint. Engagement requires a well-rounded understanding of the underlying's business practices and requires a long-term mindset to ensure entrenched practices can be re-evaluated and restructured.

At present, both ESG-related divestment and engagement have not been widely practiced among financial institutions. This is largely due to the financial outcomes that are met and remain unchallenged by regulatory bodies. In addition, challenges with governance and oversight serve as a disincentive to financial institutions, as measuring improvements in the components of ESG is novel and presents challenges with qualifying impacts.

4. DIVESTMENT FOR FINANCIAL INSTITUTIONS MAY BE A FORGONE CONCLUSION

For several reasons, financial institutions have been resistant to divestment in the near-term. Within Canada alone, the Office of the Superintendent of Financial Institutions (OSFI), a regulatory body for over 400 financial institutions in Canada, asserts that a primary objective is to prioritize the stability of the economy over other pursuits. Given the scale of investment into socially costly assets, a large short-term pullback could result in price disruptions that are not favorable to the general wellbeing of the economy. Other regulatory authorities are also getting engaged in applying guidance leading to more enhanced reporting requirements; IFRS through the Task Force on Climate Related Disclosures (TCFD) and the SEC on securities filings of publicly traded companies. All these initiatives will provide a framework for planning, monitoring, and reporting on ESG-related matters.

In case financial institutions were willing to divest from ESG offenders, underlying firms would scarcely be starved of capital. These companies routinely raise capital to fund their initiatives and the onus of ESG considerations would, therefore, shift from socially conscious institutions as funding sources to their less concerned counterparts. As a result, consequences for operating companies with high emissions would likely remain minimal in the longer term, and new shareholders may not take the necessary strides to enact lasting change.

This notion is summarized by The Economist: "The Western world's dirty assets are heading into the shadows. Public firms, including European oil majors such as Shell, and large listed mining outfits, are selling their most polluting assets in order to please ESG investors and meet their carbon-reduction targets. But those oil wells and coal mines are not being shut down. Instead, they are being bought by private companies and funds that have alternative sources of capital and stay out of the limelight. Little wonder: owning dirty assets may require a thick skin, but it is likely to be profitable. Private-equity firms have snapped up $60bn-worth of fossil-fuel-linked assets in the past two years alone, from shale fields to pipelines."[2]

For institutions that claim to be committed to generating net positive ESG changes, divestment is largely an act of wiping one's hands clean of the responsibility the institution is claiming to have to society, while potentially inducing short-term market volatility in the process. As stated by the global head of sustainability research at Morningstar, "managers who allow their engagement strategies to drag on for much longer than two years have some explaining to do". Financial institutions have another path of "active ownership engagement" to ensure long-term emission reduction: by exercising their authority as shareholders, corporate behavior can be influenced.

[2] Economist, 2022, "The truth about dirty assets," February 12, https://econ.st/3LR1IFU

> *"Once financial institutions successfully institute ESG practices within a company, it is vital to ensure the success of these measures is tracked."*

5. REGULATORY TRENDS INSPIRING NEW APPROACHES TO ENGAGEMENT

Engagement is becoming a more frequently used method to tackle ESG concerns for institutions. In tandem, regulatory bodies are becoming more sensitive to climate-based concerns and have come up with various methods to help model the risk scenarios. In May of this year, OSFI issued a draft framework to highlight beneficial strategies to manage climate risk. This included governance and risk management practices to identify climate related risks, as well as a set of financial disclosures on the same topic. Given this movement, it is reasonable to assume that regulatory bodies are trending towards ESG-based mandates, for which financial institutions need to be aptly prepared. At the same time, this guidance is useful to construct assessment and engagement frameworks for active ownership. Some institutions are leading the charge in this regard, both through carefully considered sustainable investment frameworks and engagement with governance teams of their underlying investments.

One such institution that is actively shaping the near-term landscape for other financial institutions is the Canadian Pension Plan Investment Board (CPPIB). This institution is actively developing a framework aimed at benchmarking and reducing the emissions profiles of their portfolio investments. The CPPIB uses an abatement capacity assessment to understand which emissions can and cannot be reduced in the short and long term. This concept will be further discussed when assessing the implications of measuring engagement.

Given that CPPIB is federally regulated, and they operate on a comparable scale to many large financial institutions, this serves as an indicator of potential change in regulatory mandates – keeping a close eye on how CPPIB builds out an abatement capacity plan and resulting emission reduction strategy provides early indicators on how other financial institutions can adapt to upcoming Canadian regulatory changes. CPPIB's efforts indicate the plausibility of a standardized financial institution ESG framework applied to investment evaluation and management.

6. PRACTICAL APPROACHES TO ENGAGEMENT

Frameworks, such as that proposed by CPPIB serve to narrow the lens for engagement to a tangible, goal-oriented outcome. For such frameworks to be truly effective, financial institutions need to take measures to actively engage with constituents and must carefully monitor such engagement practices. When institutions invest with the intent to actively engage with the underlying company, several covenants need to be understood by both parties. This expectation-setting needs to be carried out with regards to the reasons and objectives of the engagement. By outlining the rationale for engagement, financial institutions can paint a better picture of what will be reported and aim to ensure the relevant performance objectives and measurements are in place. In addition, if the underlying company has a complete understanding of the goals of the engagement undertaking, they can communicate more clearly, and allocate resources to support with the engagement activities more effectively.

One of the most direct engagement approaches entails working with corporate governance teams to instill and advise on practices. Beyond bringing ESG concerns to the attention of company representatives, financial institutions can urge them to conduct additional due diligence and push for standardized monitoring processes. If the financial institution utilizes the same engagement practices across various firms, these standardized monitoring processes will allow for more simplified ESG benchmarking across investments and industries. In addition, with a direct line of communication established, financial institutions can advise on the engagement activities. For example, using CPPIB's economic abatement capacity framework, an institution may seek to discern the most productive emission abatement avenue as a priority.

Despite the benefit of direct engagement with governance, publicly traded companies traditionally cannot ratify major changes without seeking a majority shareholder vote. As a result, institutions need to ensure they have enough influence to push their social agenda in a timely manner. One avenue

FACTOR	CORPORATE PERSPECTIVE	
	ENABLERS	BARRIERS
RELATIONAL	• Presence of a two-way dialogue. • Being honest and transparent in the dialogue and having an open and objective discussion.	• Language barriers and communication issues. • Lack of continuity in interactions.
CORPORATE	• Responsiveness (e.g., speed of response) and willingness to act on investor requests. • Selecting appropriate internal experts. • Knowing who your investor(s) is(are) and having access to all prior dialogues/discussions to tailor your conversation. • Keeping a systematic record of the interactions with investors.	• Bureaucracy inside the company preventing changes in internal practices and/or external reporting on (new) practices. • Lack of resources and/or insufficient knowledge or expertise to meet specific investor demands. • Lack of ESG policies, practices, and/or reliable internal results that can be reported externally.
INVESTOR	• Listening capacity. • Making the effort to communicate in different languages. • Providing a list of questions in advance so accurate information can be prepared for the dialogue. • Prior knowledge of corporate ESG performance and preparations to ensure a sophisticated dialogue. • Genuine interest in (improving) the management of ESG issues at the corporation. • Patience and understanding regarding corporate ability to address ESG challenges.	• Lack of preparation and posing questions/requests that are too generic. • Lack of investor knowledge about the corporation, its business model, ESG policy, and/or track record compared to peers. • Lack of tracking process to determine whether engagement requests have been met. • Changing engagement objectives and targets over time.

financial institutions can take to enhance their general influence with their portfolio companies is by temporarily increasing voting rights through "share lending". This pertains to a temporary share transfer by a lender, giving the borrower the voting rights associated with the additional shares. Consequently, a financial institution can establish a share lending program whereby shares are lent during times where the need for voting power is low and subsequently recalled when major ESG-related voting is set to occur. In the latter case, financial institutions can also opt to borrow additional shares from other lenders should they need to exercise additional influence over major voting.

In order to ensure engagement is successful, financial institutions can lean on research conducted by the Principles for Responsible Investment (PRI), a U.N.-supported network of investors. PRI has conducted studies into methods of engagement, and their evidence suggests that engagement quality is significantly more important that quantity. Improper relational, corporate, and investor practices can inhibit the success of engagement efforts. Table 1 outlines various factors and associated perspectives.[3]

Once financial institutions successfully institute ESG practices within a company, it is vital to ensure the success of these measures is tracked. This presents a unique challenge, given the juvenescence of the ESG reporting landscape and a present lack of mandates surrounding ESG disclosure. Active ownership with regards to ESG will require a plan to tackle any challenges associated with collecting, processing, and utilizing data. It is often best to leverage third-party ESG data providers who collect ESG metrics from corporations. They try to apply standardized data approaches, but often more than one provider is needed, and additional logic and modeling may be required.

[3] https://bit.ly/3y3c4r1

7. CONCLUSION

Though both divestiture and engagement can reduce the ecological footprint supported by financial institutions, engagement is more likely to result in measurable changes beyond just abatement levels of portfolios. While divestiture transfers emission-based responsibilities to less concerned parties, engagement allows institutions to target each of the facets of ESG. A financial institution that becomes aware of poor treatment of workers can exercise influence with corporate governance teams and lead shareholder voting to institute ESG policies, such as anonymous whistleblower systems. An institution that finds a noticeable gap in skillset at a portfolio company's executive level can follow the same approach to establish change management action plans. Such changes can result in net-positive outcomes for firms, economies, and ecosystems. Given the surge in active ownership, necessitated by depleting natural resource reserves and major climate agreements, it seems likely that governing regulatory bodies will begin to mandate and perhaps regulate active ownership policies; taking such actions in advance of these mandates serves to better position financial institutions for the socially and environmentally equitable future envisioned for the generations to come.

Despite engagement being the favorable and likely path forward for financial institutions, these organizations must enhance the basis upon which investment decisions are made to ensure synergies exist between the ESG goals across portfolio companies. Evaluation methods such as positive and exclusionary screening, or abatement capacity frameworks, provide a fundamental platform to ensure meaningful engagement can be conducted, and transferable methodologies can be applied. The path forward to a sustainable future is being shaped by many organizations and financial institutions have a major role to play in helping to solve these challenging problems.

ABOUT CAPCO

Capco, a Wipro company, is a global technology and management consultancy specializing in driving digital transformation in the financial services industry. With a growing client portfolio comprising of over 100 global organizations, Capco operates at the intersection of business and technology by combining innovative thinking with unrivalled industry knowledge to deliver end-to-end data-driven solutions and fast-track digital initiatives for banking and payments, capital markets, wealth and asset management, insurance, and the energy sector. Capco's cutting-edge ingenuity is brought to life through its Innovation Labs and award-winning Be Yourself At Work culture and diverse talent.

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ABOUT KING'S BUSINESS SCHOOL

King's Business School, the ninth and newest faculty at King's College London, opened in 2017. It is accredited by AACSB and EQUIS and was rated one of the top 10 business schools for research in the U.K. based on the Research Excellence Framework 2021. It is rated fifth in the U.K. for Business Studies by the Times and Sunday Times Good University Guide. Based in the heart of London, the School is part of an internationally renowned research-intensive university with a track-record of pioneering thinking and the limitless energies of the city's businesses, policy-makers, entrepreneurs and change-makers to draw on. The School's commitment to drive positive change is at the heart of its research and education.

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