Decode ESG Risk. Unlock Opportunity

Environmental, social and governance (ESG) is a huge and emerging risk area for financial institutions. A common taxonomy and level of understanding around risk areas are essential for an effective enterprise-wide risk control and reporting framework. Implementing ESG-specific learning pathways across your organization will ensure that your workforce has the knowledge and skills to support your ESG strategy.

ESG is top of mind

ESG is at the top of minds and the tips of tongues. It should be. ESG issues are all around us, every day – floods, rising sea levels, melting glaciers, excessive heat, drought, and wildfires. Events considered to be once-in-a-century are now occurring annually. Societies are strained with inequalities that are exacerbated by a global pandemic and rising inflation, with ineffective governance at many levels.

ESG is not new

In the lending business, credit risk analysis has always incorporated ESG considerations. In private credit, ESG issues were often thought of as either macro considerations, as contributors to financial risks, or in the context of management. But these risks were frequently hard to quantify even when identified.

Financial institutions are feeling the pressure

Now, with the rising importance of climate change and ESG considerations, financial institutions are under increasing pressure to consider ESG risks as an independent risk class. They are therefore focusing a massive amount of attention on ESG, especially on climate-related risk.

In June 2022, the Basel Committee on Banking Supervision (architects of the global banking regulatory framework) issued their principles for the effective management and supervision of climate-related financial risks.

Principal #6 reads

Banks should identify, monitor, and manage all climate-related financial risks that could materially impact their financial condition, including their capital resources and liquidity positions. Banks should ensure that their risk appetite and risk management frameworks consider all material climate-related financial risks to which they are exposed and establish a reliable approach to identifying, measuring, monitoring, and managing those risks.

In the U.S., the FDIC and OCC have issued virtually identical guidance in the past twelve months.

Ultimately, financial institutions and their clients must address both the urgent need to transition to a low carbon economy and the inherent risks of that transition. In doing so, they will also be able to unlock opportunities within the new economy.
Measuring ESG risk

Among efforts to address ESG risk, financial institutions must assess their own and their portfolios’ greenhouse gas emissions, and face a range of new considerations:

» Do our lending operations align with public emissions reduction commitments?
» How to account and report financed emissions?
» What are the forward-looking emission trajectories of our clients?
» How viable are our loans in the face of transition risk?

The transition to a low carbon economy depends, in part, on reliable, standardized methods to assess an organisation’s greenhouse gas emissions. By measuring emissions, we can employ metrics to identify, monitor, and manage them, as we do other risks.

In short, transition risk can be addressed the same way as traditional financial risks. This way, it will be incorporated as a mainstream risk managed by financial institutions and monitored and compared by stakeholders.

And, as we develop new or better ways of measuring other ESG risks, we will see increased focus and attention of a wider range of ESG risks.

Invest in employees; prioritize knowledge and skills

Developing and executing a strategy to address these types of considerations may seem as daunting as ESG itself. However, there are clear lessons to be learned from the history of risk management that can guide us.

Experience in risk management shows that for enterprise-wide risk control and reporting, it is essential to establish a common level of understanding around any new risk.

At minimum, all employees, at every level of the organization, should have a common understanding of ESG as a risk class and of its business impacts.

Pathway 1: All Employees

The Principles of ESG
Online (1.5 hours)

Climate Change Fundamentals
Online (1.5 hours)

Specific teams and businesses will require additional knowledge and skills around transition risk and ESG risk assessment and measurement.
Outside of risk, client-facing teams will need learning and reinforcement that helps them actively engage with clients around ESG risks and opportunities.

Moody's is an expert in partnering with institutions to deliver valuable learning experiences with real business impact. Implementing ESG-specific learning pathways across your organization is an essential step in ensuring that your workforce has the knowledge and skills to support your ESG strategy. Reach out to us to find out more.
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