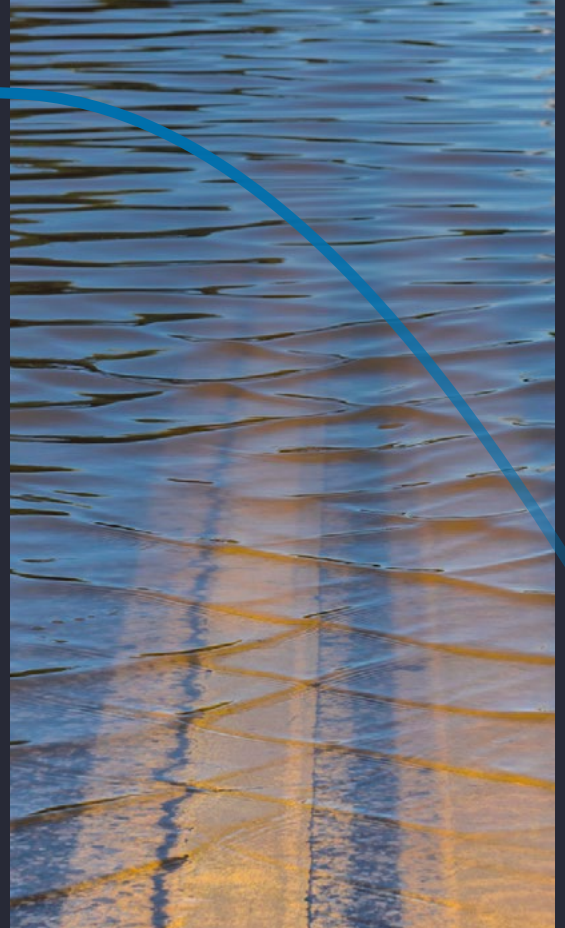




ESG PERFORMANCE

Enabling the sustainable
transformation of financial
institutions

INTRODUCTION



Eighteen of the warmest years on record were registered in the last two decades, and greenhouse gas emissions continue to rise despite the targets set by the Paris Agreement in 2016. Ecosystems are under stress with significant biodiversity loss, while environmental degradation is increasingly felt on multiple fronts, such as air and water pollution. Businesses and communities around the world are already feeling the impact, most evidently with the increasingly frequent natural catastrophes, such as wildfires and flooding.

Today, research shows that we may be reaching a tipping point, emphasizing the urgency for individuals and institutions to take action to protect the environment. While global efforts are still disjointed, momentum has been growing since the Paris Agreement, placing financial institutions at the heart of the transformation towards a more sustainable economy. Through their central role and economic influence, financial institutions are well positioned to be key players in the global sustainability agenda.

ESG Performance - part of an institution's non-financial performance, or more specifically, a measure of its Environmental and Social impact, as well as its Governance practices – is a series of criteria to assess an institution's sustainability positioning. It is a powerful tool for financial institutions to evaluate, measure and monitor where they stand in terms of sustainability, steer decision making, and communicate on progress towards sustainability commitments.

How should financial institutions fully integrate ESG performance considerations into their processes? It is a challenge. But, due to urgent climate considerations, and a growing mobilization of the international community around sustainability, a large number of best practices, standards and regulations are emerging. These are helping to structure the response of financial institutions to the challenge of transformation ahead of them.

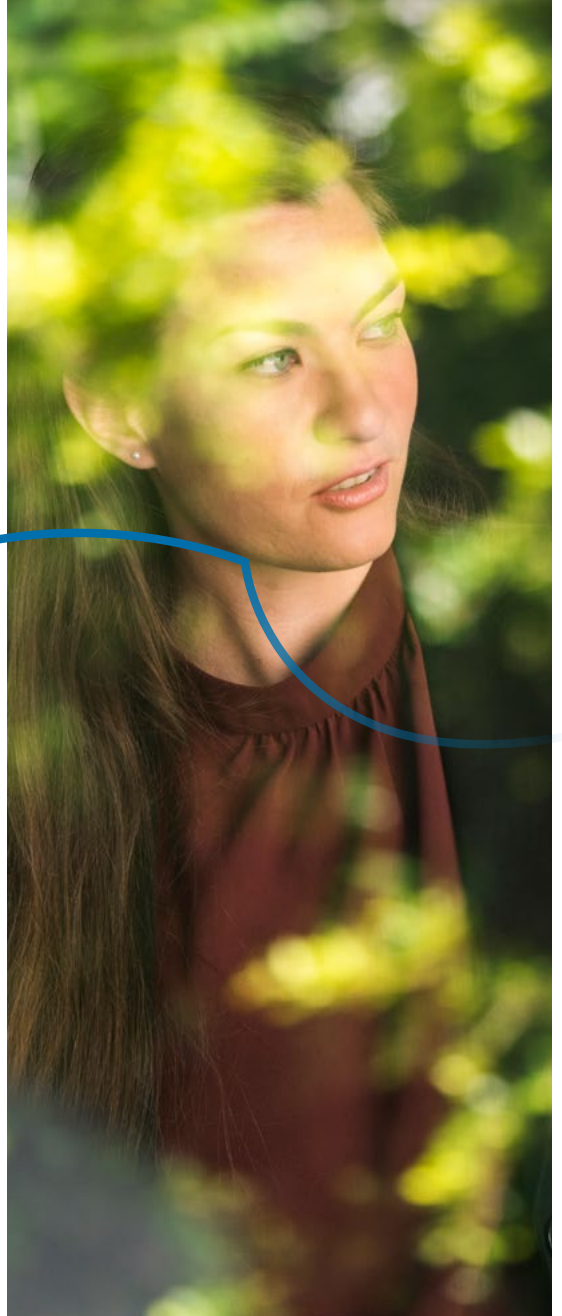
This report aims to address the question of how financial institutions can adjust to the existing and upcoming regulations pushing them to leverage ESG performance as a tool to be active participants in the decarbonization of the economy. It will use concrete and operational examples of how to lead the transition to a sustainable economy.



“As more investors choose to tilt their investments towards sustainability-focused companies, the tectonic shift we are seeing will accelerate further. And because this will have such a dramatic impact on how capital is allocated, every management team and board will need to consider how this will impact their company’s stock”

LARRY FINK
– BLACK ROCK CEO¹

KEY TAKEAWAYS



Financial institutions, key players in the decarbonization of the economy, need to demonstrate agility and pragmatism to accelerate their sustainable transformation:

- Financial institutions are facing an in-depth transformation of their role in the financing of the economy, with a growing focus on directing capital towards projects and companies contributing to the sustainable shift of the economy at large. This change stems from the pressures of the ecosystem (investors, clients, and all stakeholders in general) and of a rapidly evolving landscape of regulations and market norms, combined with the realization of the beneficial nature of this change for their own performance.
- With the transformation presenting a series of open-ended questions in terms of the operational repercussions of these changes, coping and making the most of this still maturing environment will require pragmatism, agility, and flexibility from financial institutions².
- European financial institutions are leading the way when it comes to integrating sustainability in their value chain and defining ESG norms and standards³. The Biden administration in the United States re-engaged in the Paris Agreement in early 2021 and is showcasing a strong ambition to take a leading role on sustainability and in the fight against climate change. This raises some uncertainty around the role the United States will play in the development of existing sustainability standards and norms, whether they will collaborate with the EU on their development and implementation or rather impose their own framework.

A skillful orchestration of the use of data is a prime success factor to ensure the integration of ESG considerations:

- Measurement of the non-financial performance of third parties and transactions is the one core issue to be addressed to make overall non-financial accounting work and provide the necessary input for relevant decision-making.
- Addressing this issue in a still maturing environment, with scarce and often unstructured data of uneven quality, requires a long-running iterative approach to identify and source relevant data and combine it with existing data to gain expected insights. In particular, creating ecosystems of relevant partnerships with external data providers can be a potent lever in a market with fast emerging solutions.
- The experience and best practices gained in the implementation of regulatory-driven transformations over the 2008-2018 decade should be put to good use, particularly the insights on the redefinition of processes to account for the digital transformation, the integration of artificial intelligence and automation, and the leverage of human centric design for reporting.



The magnitude of change will have deep rooted ramifications for financial institutions, and demands the robust development of a specific trajectory, governance and communication plan:

- As with any cultural change, the journey starts with the definition of a corporate-level strategy structured along the growing body of norms and standards. The change needs to be rooted in most functions and embedded into the overall structure of those institutions – new roles, new responsibilities, and a governance structure to lead the efforts around sustainability.
- Beyond the communication that is required around reporting, it will be key for financial institutions to engage in an ongoing internal and external communication to mobilize both employees and clients around those topics.
- In our experience, convergence and industrialization of the accounting, a steering infrastructure, a reporting framework, and a robust communication plan are key levers for success. Their implementation through iterative and agile processes will pave the way and ensure efficiency to avoid later-stage refactoring and remediation.

KEY CLIMATE STAKES IN EUROPE⁴



55%

cuts in greenhouse emission (from 90s levels) targeted in Europe by 2030



UP TO
USD 6.9 tn

required up to **2030** to meet **climate and development objectives**



Climate neutrality

to be achieved before 2050 in Europe, through creating an **economy with net-zero greenhouse gas emissions**



A NEW BOTTOM LINE FOR FINANCIAL INSTITUTIONS:

non-financial performance to lead the path towards the sustainable transformation of the economy

The sustainable transition of the economy is a massive endeavor, requiring substantial funding exceeding the capabilities of states, prompting the need for private funding of the transition. This transition is fueled by:

- The significant appetite of consumers, employees, investors, various stakeholders, and the public at large, to purchase from, invest in and interact with responsible institutions;
- A growing number of regulations and norms aimed at funneling financing towards the most sustainable companies, ventures, and projects.

Europe has led the way in developing a sophisticated framework of regulations to adjust the structure of financial markets through:

- The development of a definition of what it means to be responsible and sustainable (e.g., EU Taxonomy) for all large companies;
- The imposition of disclosure requirements for relevant and legible measurements of the non-financial performance of their activities (e.g., Non-Financial Reporting Directive – NFRD – since 2018, and the much more ambitious upcoming Corporate Sustainability Reporting Directive – CSRD – expected by 2022);
- The development of regulations to ensure transparency on the actual non-financial performance of investments (Sustainable Finance Disclosure Regulation – SFDR) for market participants, or ensure proper performance measurement (Green Benchmark);

- Growing demand for the inclusion of non-financial risk factors (e.g., environmental risks) in traditional risk models.

The direct impact of this transformation means that financial institutions need to adjust internally and to start considering a double bottom line including financial returns and sustainability. The operational consequences are threefold:

- Performance is no longer linked to financial results only: financial institutions' performance is now also related to non-financial objectives, (climate, social, etc.) regulated by external institutions (mainly, as of today, by the European Commission). This criterion heavily relies on the nature, quality, and sustainability of companies and of projects that are supported and funded. To this end, sustainability aspects need to be embedded and evaluated in business decision-making processes to deliver on this new set of non-financial objectives.
- Transparency is key for compliance and recognition: broad and increasing transparency requirements mandate the construction of trustworthy reports addressing expanding regulatory requirements and reporting progress on the company's objectives, commitments, and non-financial performance at large, in a clear and legible way. This involves a transformation of reporting processes that affects a wide range of roles within the bank, from an investment officer to an investor relations or communications team.
- Risk management expands to integrate new risk factors: the implications of new risk factors related to the transformation

of the environment need to be assessed, evaluated, and monitored as part of the financial institution's risk management framework. Financial institutions will have to further adjust internal processes to integrate how to capture risks related to non-financial performance in their risks analysis.

Concretely, we believe such a transformation needs to be played on 4 different levels:

- Strategic, to formulate relevant goals and align the company with its ambitions;
- End-to-end integration of ESG performance and sustainability considerations in business decisions and steering throughout the credit and investment value chains;
- Specific data usages to address the dual issue of third-party non-financial performance measurement and company-wide accounting;
- Fully-fledged data management to handle the sourcing, lifecycle, distribution, and usage of the data.



KEY CONSIDERATIONS

for financial institutions
to move forward in this
transformation

Start small: pragmatism and agility

One of the main challenges of this transformation is its current unstructured and immature nature:

- The regulatory framework overall, and in Europe in particular, is still undergoing rapid developments with major pieces of legislation and regulatory standards still pending finalization (CSRD, SFDR, 4 of the 6 objectives of the EU Taxonomy, etc.).
- Market norms and standards have seen a flurry of recent developments aimed at providing actionable solutions to comply with new requirements (PACTA, PCAF, SBTi-Finance, etc.).
- Solution vendors (rating agencies, data providers, e.g.) are either emerging or gradually maturing their value offerings to match market trends and new requirements as they surface.
- Clients of financial institutions are themselves looking for their path forward within this “new normal”, with their own set of interests, and sector-specific approaches and constraints.
- This general sense of instability is further reinforced by the recent re-entry of the United States in the arena. As the Biden administration has reintroduced sustainability as a priority, an opportunity arises for the EU and the US to co-construct a global framework leveraging the work done by the EU in the past few years. Today, uncertainties around the approach that will be retained by the US Government, its legislators and regulators remain.

The precise structure of this transformation, the exact stipulations of the regulations, and what the financial sector is meant to look like once this process matures are still undefined, fluid and a work in progress. The challenge that financial institutions face today is not one of immediate and massive transformation, but rather one of a gradual long-term journey that will eventually change the face of the financial sector.

Our convictions remain that:

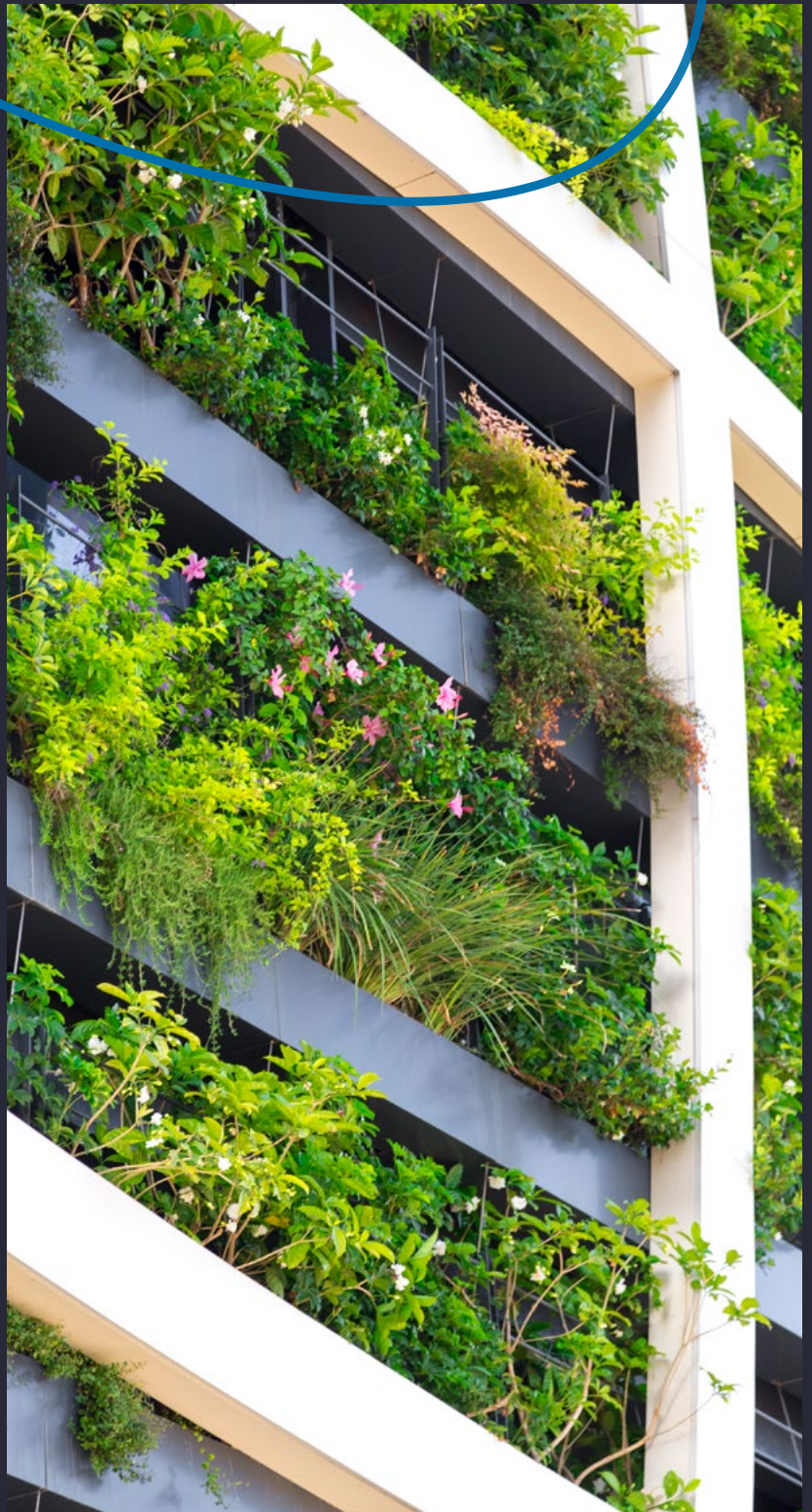
- Financial institutions need to engage in this transformation early, given the time required to handle the far-reaching implications on their business models, asset portfolios, processes or simply staff skillsets and levels of awareness. For example, sustainability related risks and opportunities have multiple touchpoints along the investment and lending process, resulting in the need for top-down coordination and steering.
- Agility, combined with experimentation and a keen market and regulatory watch, will be the key success factors to navigate the fast-moving environment.
- Financial institutions should identify a few projects with perceivable business-oriented results, launch a first iteration, and prepare for subsequent iterations to adapt to the evolving environment and expand the transformational outcome.

In our experience, accessible yet transformational projects could include:

- Initiation and industrialization of a sustainable transformation cockpit to steer the transition and federate entities across strategic initiatives, corporate-level commitments and regulatory requirements as they arise.
- Measurement of asset portfolio ESG performance to enable financial institutions to understand how to relocate capital in a way that actively supports the decarbonization of the global economy.
- Sustainability-oriented customer segmentation, to support opportunities arising as a result of the sustainable transition of the economy (e.g., for sustainable investment appetite qualification or for corporate transition opportunity targeting).
- Non-financial risk integration in asset-centered risk models to integrate risks resulting from climate change and other physical and transition risks into traditional risk models.

“As the EU moves towards climate neutrality and steps up the fight against environmental degradation, the financial and industrial sectors will have to undergo a large-scale transformation, requiring massive investment⁵”.

EU COMMISSION



Embrace the change as an opportunity

With the structuring of financial markets on non-financial dimensions, financial institutions are now in the position to make a significant contribution to the transition of the economy towards more sustainable models by trickling down their objectives to their clients.

Our conviction, for financial institutions is that this development is bound to result in a virtuous circle whereby:

- Direct revenues can be drawn from both transition-related projects carried out by their clients, and from investors' appetite for ESG-aware or ESG-driven investments;
- More ESG-performing clients will result in a more favorable footprint for banks, with both top-line (better reputation drawing and helping retain more clients) and bottom-line effects (lowering funding costs).

To make it work in practice, financial institutions should seek to leverage the new expertise, data, and models they develop or acquire, to adopt a new advisory posture towards their clients on their transition and:

- Combine (i) knowledge of international, national and local incentives and schemes to facilitate and to fund transition-related projects and (ii) financing capabilities to provide more levers for clients to engage in their transition;
- Leverage insights drawn from non-financial risk models to advise clients on significant investment projects;

- Adapt pricing to non-financial performance of clients and counterparties, in line with their own expected lower funding costs;
- Develop data-based value-adding services such as investment analytics, transaction-based ESG analytics (incl. PSD2-enabled opportunities), or benchmarking on non-financial dimensions.

The availability and exploitation of relevant ESG data will be a key success factor to reap the full benefits of these new trends.



INTEGRATION OF ESG STEERING IN DAY TO DAY SUPERVISION OF THE ACTIVITY:

In several financial institutions where CO2 footprint related KPIs were introduced to steer portfolios, we have witnessed that the set targets often clashed with the previously set financial growth targets. For instance, one bank set a sustainability target on its mortgage portfolio to have only the highest energy labels in 10 years' time. This could, by no means, be met with acquisition of new mortgages alone. To meet both targets, the bank introduced an energy transformation program for existing homeowners.

Orchestrate the use of data and leverage the relevant ecosystem

To succeed in this transformation, financial institutions must address the ESG measurement challenge of their counterparties, asset portfolios and trading book. This is relevant both at the level of a single unit and to build a capability to integrate unit measurements at the wider group level.

As the NFRD doesn't propose a data point model, financial institutions have to interpret the regulations and organize for a demonstratable translation towards their own taxonomy and what data elements to collect. Ultimately, what is at stake is the construction of a comprehensive non-financial accounting infrastructure, presenting the same level of quality and reliability as financial accounting.

In pursuing this, financial institutions are currently faced with 2 levels of complexity:

- The scarcity of aggregated, structured, and actionable data to fuel the measurement of sustainable performance of third parties, outside of the large corporate segment (midcap, small cap, professional and retail). As financial institutions rely on client disclosures, it will become key for them to efficiently collect sustainability related information on clients both at onboarding and during the loan monitoring stage. Several Fintechs (RepRisk, RDC, etc) have jumped onto this opportunity, but integration has been limited, or fragmented per business unit;

- The heterogeneity of data, highly sector-, asset- and project-specific, requiring a deeper understanding and modeling of non-financial concepts.

Our conviction is that the solution to these two issues relies on leveraging a combination of several types of data sources, split by segment, sector and geographies, reflecting the specificities of the latter. Examples of relevant data sources include aggregated ratings from specialized sustainability rating agencies (Vigeo Eiris, MSCI, Robeco SAM, etc.), datasets bundled in topical market standard models (e.g., PACTA, SBTi), public and open data sources, issued by NGOs and state actors, etc.

We believe the trajectory to building the comprehensive non-financial accounting mentioned above goes through a series of iterative developments, each contributing to stepping up a lasting infrastructure. Beyond data sourcing, this gradual use-case-driven construction should be guided by clear architecture principles to avoid massive subsequent remediation projects of the same order of magnitude as that demanded by BCBS 239.



Finally, it is also relevant for financial institutions to capitalize on past lessons learnt. The period from 2008 until 2018 was a time of transformation for financial institutions around digital transformation, automation, and integration of artificial intelligence in processes. Today, leveraging best practices from those transformations can fast track and feed some of the processes that need to be put in place to adjust to the new and upcoming regulations. Another of the lessons learnt from that same time is the importance of privileging central data governance and taxonomy, rather than operating under a siloed approach, and putting in place adequate data lineage documentation.



DATA COLLECTION LEVERAGING LESSONS LEARNT FROM THE PAST

In our recent benchmark study on sustainability data management by financial institutions, we identified that almost 40% of participating banks have no data or rely on external data for their sustainability risk assessment. Although banks may start out using external data, fitting the sustainability profile to the actual legal counterparty can be difficult. External ratings are mostly published on a consolidated group level, and the borrower may only be a part of the group. Making the necessary rating adjustments becomes difficult without an internal framework in place. We therefore expect a migration towards internally based ratings, just as we previously witnessed in the credit domain.

Set up a dedicated governance for the transition

The success of such a pervasive transformation of business and operating models also requires:

- Federating all entities around the Group's sustainable transformation and creating the appropriate level of mobilization of staff and management on identified impacts;
- Monitoring and steering achievements against Group strategy to ensure communication on and adherence with commitments made by financial institutions;
- Realize a uniform methodology across portfolios, resulting in a sustainability impact that is measured consistently (preferably LCA based);

- Anticipating and facilitating internal and external communication over posture, performance, and achievements in the sustainability space.

We believe that addressing these points requires the setting up of a dedicated governance, based on the following principles:

- Establish an "ESG Control Tower" aligned with regulations and norms, providing a 360° vision on achievements along the entity's ESG strategy;
- Formalize and promote guidelines across BUs to ensure the right level of consistency on indicators followed and collected throughout the Group;

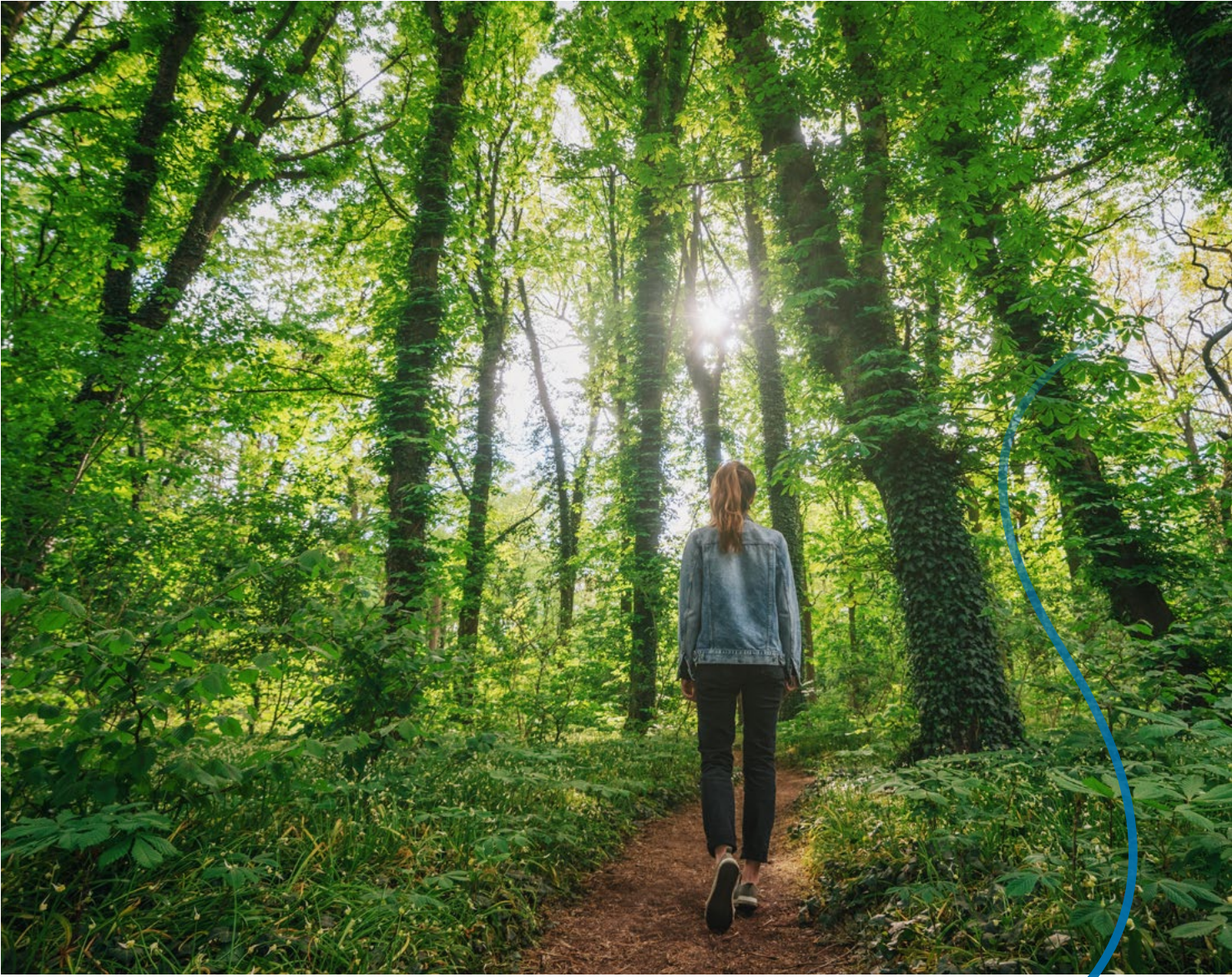
- Deploy an ESG Control Tower and the extra-financial indicators followed at Group level to all business lines, and integrate them in traditional management reporting and control;
- Seek full integration of ESG data into the financial institution's already established data management frameworks, formally aligned with the increasingly stringent requirements of data contributing to soon-to-be-audited disclosures;

- Activate and animate the sustainable community, including the amplification, duplication and cross-fertilization of achievements;
- Organize and drive the awareness and upskilling of employees on these new themes.

A key success factor to the effectiveness of such governance is the establishment of a coalition of key senior-level internal stakeholders, under CXO sponsorship, typically:

- Finance, in charge of the establishment of audited financial (increasingly, of non-financial) reports;
- Corporate Social Responsibility (CSR) or any equivalent in charge of leading the institution's sustainable transformation agenda;
- Data Offices, bringing in the weight of the corporate-wide data management and usage framework.





GET STARTED

Given the trend towards overall company-wide transparency and the increasing importance of demonstrating performance in the sustainability field, we believe an overall centrally steered company-wide ESG initiative is an effective model to drive the establishment of a company-wide non-financial accounting model and to use it as an accelerator of the transformation.

In our experience, such an initiative attains the best results if it:

- Quickly establishes and shares a common vision on group-wide ESG ambitions, concrete goals and key metrics, aligned with overall corporate strategy, embedding commitments to the ecosystem and regulatory requirements;

- Sets and maintains the course in providing transversal solutions as well as guidelines and standards to (I) facilitate local alignment with company-level goals and (II) accelerate creation and reuse of solution building blocks;
- Provides momentum through demonstrating ESG-related and data-enabled business value in a short time.

It is important to translate group-level strategy, different market and ecosystem expectations, and regulatory requirements into a referential of extra-financial indicators. The latter forms the blueprint to the ESG Control Tower under the form of a prioritized repository of extra-financial indicators relevant for the bank (vision & purpose, CSR policies, extra-financial communication, regulation, market...).

Mobilization of the internal community can follow the activation of a company-wide community of sustainability practitioners and local transformation leaders. This community gradually leads the roll-out of the ESG Control Tower locally.

Of particular importance is the initiation of data architecture and technological orientations for ESG integration in the operations and IT systems. The establishment of such principles is instrumental in maximizing subsequent agility through enabling the gradual construction of an industrial-grade data architecture for ESG.

Finally, the construction of a high-value-added / high-visibility minimal viable product (MVP) is a key element in creating and sustaining momentum through demonstrating benefits reaped from the transformation, as well as providing awareness and communication opportunities.



FORMULATE A MEANINGFUL STRATEGY

Corporate level ESG strategy

Define relevant **objectives**, related metrics, **align processes and external communication**



EMBED ESG PERFORMANCE THROUGHOUT THE BUSINESS

Credit value chain

Develop **ESG-specific products**, update policy, implement integration in **operational processes**, etc.

Investment value chain

Develop ESG-specific **products** redesign **investment processes** to integrate ESG control and supervision, etc.



ATTAIN SCALE THROUGH LEVERAGING DATA USE CASES

ESG performance measurement

Orchestrate the implementation of **regulations and standards**

Decision-making and supervision

Leverage **reporting infrastructure** to systematize company-wide **steering of ESG performance**



INDUSTRIALIZE THE DATA INFRASTRUCTURE

Source data

Select and ingest the most **relevant data**

Organize data

Define and implement a **company-wide** data architecture

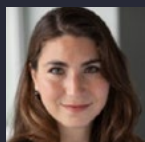
Mix data

Combine **ESG and financial** data

Leverage data

Inject **data modelling** in business processes

AUTHORS AND CONTACTS



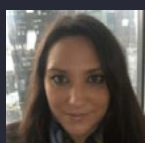
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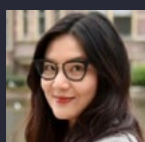
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