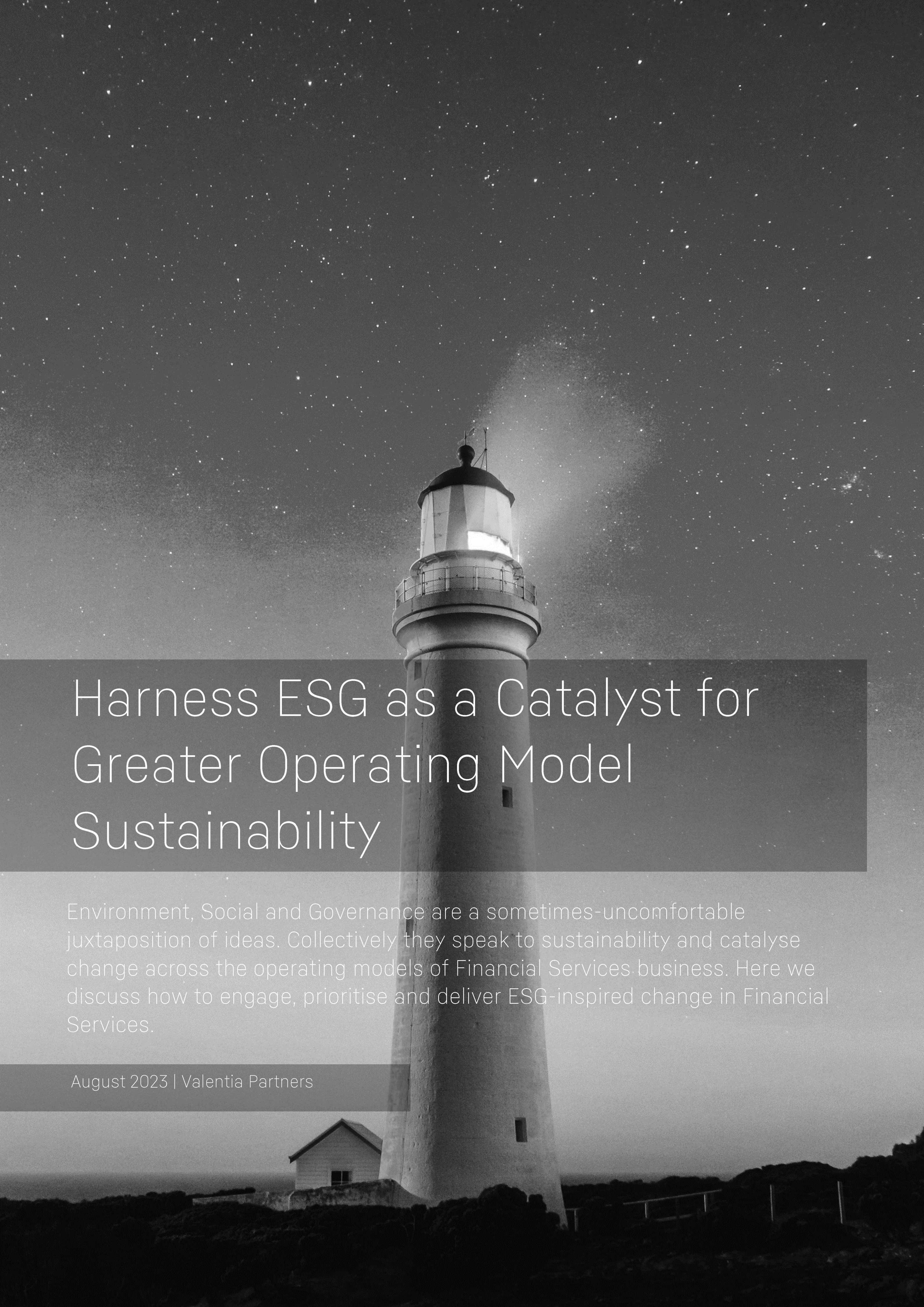

Harness ESG as a Catalyst for Greater Operating Model Sustainability

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The Transformative Impact of ESG on the Operating Model

Environment, Social and Governance are a sometimes-uncomfortable juxtaposition of ideas. Collectively they speak to sustainability and catalyse change across the operating models of Financial Services business. Here we discuss how to engage, prioritise and deliver ESG-inspired change in Financial Services.

Environmental, Social and Governance (ESG) considerations have gained significant traction in in recent years. Organisations are recognising the need to address sustainability across all aspects of their businesses. The challenge is becoming one of coordination, harmonization and strategic integrity.

Financial Services businesses are often complex and multi-facetted. Changing one aspect of the operating model to address ESG requirements and/or constraints creates a ripple effect across other areas of the business. Implementation of shared services, outsourced operations and widespread automation have created challenging conditions for operating model change on the scale required.

There is a powerful need for change. It's driven by customers, regulators and the market. But the risks of change are also high, inconsistency in standards, the increased costs of working in sustainable ways and the risk of alienating customers are all very real. Whilst some organisations are setting out to blaze a sustainable trail, others are, understandably, more cautious.

Whether organisations set out to be on the vanguard of ESG or wait to 'fast-follow' the successful models, strategic clarity and disciplined delivery will be instrumental in avoiding operational disarray, runaway costs and regulatory challenges.

In this article we'll review the forces that are driving change and propose a model for defining a coherent ESG strategy and working out how to realise it.

ESG creates new requirements for Financial Services businesses

All Financial Services organisations are being forced to adapt by the increase of ESG pressures, from changing customer expectations to new regulatory requirements. There are 4 main drivers of this change.

[Figure 1] Sources of ESG Change

Stakeholder expectations and preferences

There is increased demand from internal and external stakeholders in relation to ESG. Both the institutional and retail investment spaces have seen investors actively seeking sustainable investments. Sustainable assets grew by 15% from 2018 to 2020 amounting to $35.3tn. [1]

As investors look to long-term strategies for growth, *ESG has emerged as an excellent way to manage risk* and seek out Alpha. However, there are costs involved in evaluating ESG options and providing investors with the options and insights they are looking for. This also has to be balanced against markets where ESG is regarded more suspiciously and held against a historically long run of low interest rates with some critics suggesting that a return to a more 'normal' interest rate environment may erode interest in ESG options.

Retail banking customers are also increasingly conscious of the impact they have on the environment and society. They are placing greater demands on firms to be transparent in their ESG performance. For many this means working with a Bank that reflects their values but for some the expectations go further. Retail customers are increasingly looking for innovations that allow them to manage their own sustainability concerns and Banks are moving to meet these. Tools that enable carbon footprint tracking based on transaction history and mortgage products that focus on 'green' housing are becoming more commonplace.

Finally, a firm's own staff have a vested interest in strong ESG performance. It's been widely publicised that firms with greater diversity of senior management and stronger governance outperform firms that neglect these factors. Employees building a career are increasingly motivated by ESG performance and place a greater weight on social impact, good governance, employee wellbeing, D&I and transparency. Financial Services exists in a constant battle for top talent and ESG may be one way to compete for the next generation of staff.

Regulatory and Compliance Requirements

Early attempts to mandate and standardise practices around ESG have been made globally. The landscape remains uneven as the UK and EU in particular outpace other regions in issuing and enforcing ESG related regulation.

ESG regulation is naturally complex and diverse. Regulators and industry bodies have focussed on enhancing disclosures from issuers, industry and the FS businesses themselves. Rules such as those contained within the TCFD, SASB and GRI focus on reporting data related to the externalities concerning business activities. These regulations point to a change in how Financial Services businesses need to handle and report on data related to their own activities.

A further wave of regulation, specifically in the Financial Services space, focusses on the externalities of activities carried out by other organisations to whom FS businesses provide financing or financial services. The EBA's Pillar 3 disclosures are an example of regulation that will impact Bank's risk models as they push to include greater appreciation of climate change related risk in assessing the financial health of the Bank.

[1] https://www.reuters.com/business/sustainable-business/sustainable-investments-account-more-than-third-global-assets-2021-07-18/

Finally, both EU and UK regulators have placed responsibility firmly at the feet of FS organisations when it comes to labelling and promoting 'green' products. The mechanisms are different but both the UK SDR and the SFDR restrict what's allowed to be labelled and sold as 'green' and aim to eliminate green-washing. Raising the bar in this way means that FS businesses have more strategic choices to make when it comes to creating and marketing a 'green' product set.

Digital Transformation and Data

Fundamentally the shift to ESG is one that forces the Financial Services industry to factor in externalities that have previously been neglected. In practice this means finding ways to absorb and analyse information (data) that has not previously been part of how those businesses made their decisions. To achieve this without adding unmanageable levels of cost to the business requires that digital and data capabilities are able to handle the change.

ESG demands improved reporting and risk assessment. Regulation is driving organisations to report ESG metrics. To do this, good quality data is essential to comply and to mitigate risk. Although this could be achieved by human analysts the costs would be prohibitive. To successfully drive this change through existing systems requires that they are well integrated and sufficiently flexible. Legacy technologies will struggle.

ESG Investment decisions rely on sound data. The decision making, execution and tracking aspects of a given investment produce and consume data. Although ESG requires that more data is produced and consumed, it does not increase the timeframes in which decisions need to be made, nor does it reduce the existing regulatory requirements to understand and report on performance, liquidity or leverage. As such organisations need to be capable of processing more data, at higher speeds than ever before.

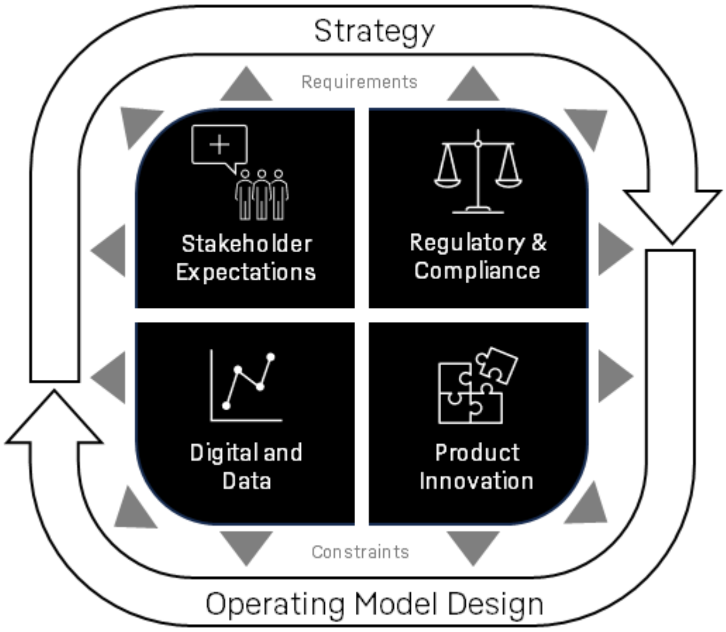
Finally, there is the human element. Future regulation notwithstanding 'ESG' will not necessarily mean the same thing to any two customers. Whilst some will be motivated by climate change, others will prioritise governance. Accurate data is needed to understand stakeholder expectations and preferences. With this, firms can tailor their ESG initiatives. But firms can't risk putting barriers between their customers and their jobs-to-be-done. As such, responsive, flexible digital journeys are needed to get on top of what individual customers actually want.

Product Innovation

As organisations adapt to this wave of new requirements there are two ways to go with their products. Either they could modify existing products to make them 'more-ESG' or they could add new products to the line-up that meet ESG requirements.

Encumbered by existing client relationships, uneven global regulation and inconsistent data, only the second option makes sense.

For firms setting out to integrate ESG into their product set introducing new 'ESG' products and gradually phasing out legacy options is both the fastest route to market and the best way to de-risk. Examples are already coming through. Green mortgages, ESG linked loans and ESG index funds have all emerged over the past few years. Indeed, A 2020 Harvard Business School study found that firms with strong ESG performance had greater profitability when compared to non-ESG focused organisations.[2]



[Figure 2] Relationship between ESG and Strategy & Op Model Design

We expect that ESG will become commonplace. However, as FS businesses manage the

[2] https://corpgov.law.harvard.edu/2020/01/14/esg-matters/

introduction of these external considerations to their businesses these early products will drive change and make ESG capabilities available to help to 'green' the legacy product set.

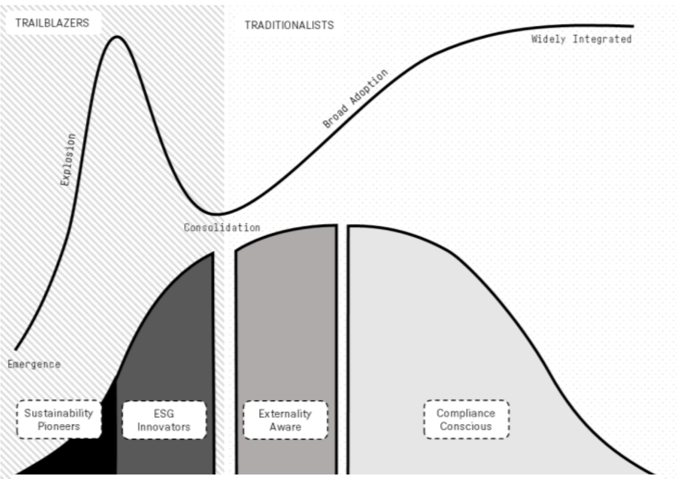
These emerging demands need to be synchronised by alignment to organisation-wide strategy

In order to avoid these four impact areas being delivered tactically, in isolation, creating a disjointed. outcome, it is the role of organisation-wide strategy and operating model design to ensure that change is delivered in sync.

Placing ESG at the centre of the organisation-wide strategy and operating model design allows each element to inter-connect. For example, delivering new products requires input from regulatory and compliance teams as well as digital transformation. Whilst delivering against regulatory requirements will demand new data feeds, enhanced processing and greater reporting transparency.

ESG driven change will touch multiple areas of the operating model. However not all organisations will want or need to change to the same extent. Financial Services businesses evaluating the changes required to incorporate ESG into their operating model will first need to set their ESG strategy.

Where does your organisation sit on the ESG Scale ?



[Figure 3] ESG Adoption Curve

Identifying the relationship your organisation wants to have with ESG can help to focus on specific impact areas.

As with any area of rapid change or innovation there will be sliding scale that determines the rate and depth of engagement that individual organisations will adopt. Some will trailblaze, others will follow, hot on their heels, and the majority will take a more cautious approach.

Determining where a firm sits on the scale is a strategic decision and ESG is forcing organisations to start with 'why?'.

Sustainability Pioneers

Sustainability is at the heart these organisations' vision and strategy, enhancing their brand and driving revenue. Organisations that aspire to be first movers are unlikely to think much about 'ESG' and tend to focus on a single issue, integrating the requirements and constraints resulting from that issue into all areas of their business.

Although 'sustainability' is used as a differentiator from a marketing perspective and to position the business as a trailblazer the underlying mission is not a commercial one. Organisations taking this level of risk in the ESG space are unlikely to be driven by capital returns.

ESG Innovators

Organisations that see a commercial opportunity in ESG recognise that there is a market of conscious consumers who are looking for sustainable financial services. By adopting a fast-follower strategy these businesses are able to benefit from the insights that pioneers achieve whilst limiting the risk they expose themselves to.

Financial Services organisations that want to innovate their proposition around ESG are able to do so without eliminating their legacy product set. Although they have to acknowledge that significant investment and some tolerance for failure will be needed to crack some of the thornier challenges of creating authentically 'ESG' products.

Operating model change should revolve around segmenting and serving ESG products with a view to bringing ESG capabilities into the mainstream for the long-run. There should be a desire to understand customers' ESG preferences and build a set of products and capabilities around them.

Externality Aware

Legacy financial services business are exposed to risks that are potentially intensified by the impact of climate change and other factors covered by ESG. Although these businesses are not focussed on serving the ESG market they acknowledge that prudent risk management needs to integrate aspects of ESG data and analytics.

Operating model changes should be driven by the desire to leverage new data sources and analytics techniques in support of the legacy business. Regulation will drive change across the organisation and these businesses will choose to invest a little more in ESG to drive risk, and therefore cost, reduction in the long-term.

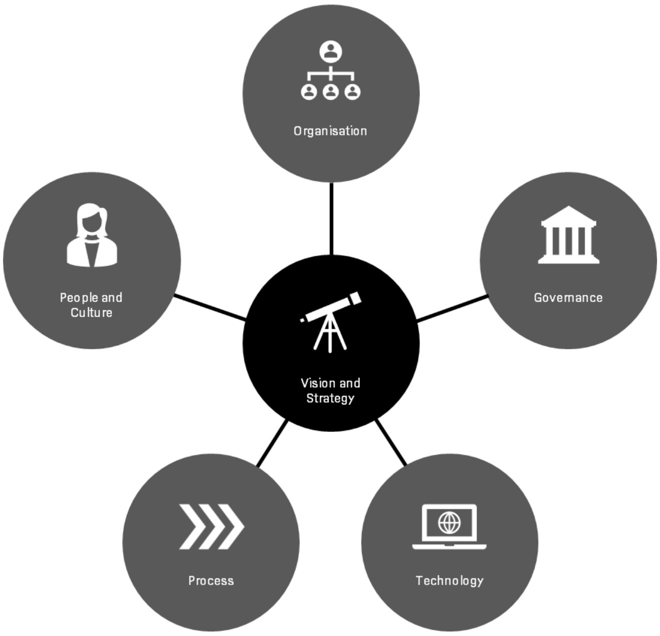
Compliance Conscious

All regulated financial services businesses in the UK and Europe are bound by ESG regulation. This regulation may not, in and of itself produce any need for operating model change. But it will introduce markets, products and practices that firms are unable to participate in without delivering support through their operating model.

Businesses that sit in this category do so, not for wont of ethics or desire to participate in the ESG movement, but for the fact that they are guided by existing relationships and regulation. As regulation changes these organisations will have to change with it. But at this, early stage most are able to absorb change by 'bolting-on' relatively basic services.

Of course, acting in this way does diminish the benefits attainable by implementing ESG later down the line.

Achieving Operating Model Change



[Figure 4] Operating Model Dimensions

The role of the enterprise operating model is to integrate the many and varied business requirements and constraints and synthesise them into a coherent plan. From an ESG perspective, once an organisation has established the level at which they wish to engage with ESG it is to bring together the four ESG impact areas into a cohesive, enterprise-level ESG approach.

The six operating model dimensions above should be referred to in order to:

- Assess the current state of organisation (or specific function) against this requirement
- Define the end state (i.e. what does success look like) and establish business requirements
- Understand the gap between current organisation and the end state
- Create an action plan to close the gap

Our Approach

Valentia Partners' 'Thought to Execution' approach helps Financial Services organisations to take a structured approach to their strategy and operating model design. Our approach focuses on evaluating the forces impacting an organisation, establishing a reference set of requirements and systematising the design and implementation of solutions that deliver the desired outcomes.

As an emergent force in the Financial Services industry ESG is creating new requirements for businesses, imposing new constraints and changing the prioritisation of historic requirements. Following our 'Thought to Execution' approach enables businesses to find a way through this turbulence.

Assess

Businesses looking to change need to start with an objective assessment of where they are to begin with. Understanding the existing forces acting upon a business, the requirements currently served by the operating model and the operational reality that has resulted.

Creating this baseline enables organisations to look objectively at the changes they want to make and clearly understand the prioritisation between maintaining the status-quo and driving change through.

Define

With reference to the engagement model discussed earlier in this paper organisations need to establish what they want to be doing differently. Where ESG is concerned this is likely to relate to new practices, products, data, reporting and risk management capabilities. All businesses will be subject to mandatory change and selecting which voluntary changes to make is the first step in understanding where the business is going.

With the new set of requirements understood the business can better discuss strategy and direction. The organisation can also formulate a view of target state, which is key for step 3.

Gap Analysis

With a view of current and target state established the business can begin to plot the changes that need to happen.

Gap analysis should be conducted at the most abstracted level first, before drilling into specific capabilities, processes and technologies. The goal of gap analysis is not to point out where the legacy state is 'wrong' but where change needs to happen to bring about the target state.

Design

Identified gaps enable businesses to identify solutions. The design process will vary between different challenges. For those businesses at the cutting edge of ESG it may be necessary to innovate from first principles, designing solutions that meet the most granular of business or user requirements. For most the avoidance of first principles innovation will be sensible instead preferring to partner, contract or acquire solutions from the market.

Operating model assumptions and technical constraints will have a significant part to play in designing solutions that meet newly established ESG requirements. Many FS organisations have pursued a de-centralised model over the past decade and as such will need to work closely with partners and suppliers to design effective solutions.

Implement

The danger with large-scale implementation is losing sight of why it's happening. When implementing operating model changes to address ESG changes will touch risk, operational effectiveness & compliance, not to mention organisational strategy.

Perhaps uniquely, ESG change requires widespread change in individual attitudes and standards. Encourage a culture of ESG awareness and accountability throughout the organisation (e.g., training, communications, and incentives) to achieve purity of mission and coherency of strategy. This alignment will act as a defence against mission drift.

To assure delivery organisations should develop strategies to effectively communicate ESG practices and performance to internal and external stakeholders. By creating both internally and externally reported KPIs relating to ESG performance and change delivery businesses incentivise themselves to deliver change at every level.

ESG is a catalyst for change

ESG remains relatively new in Financial Services. As an analytical framework it's flawed, as a regulatory framework it's inconsistent and as a marketing tool it's been disingenuous applied. But, as an idea, it is sound.

Sustainable business is good business.

Financial Services is used to boom-and-bust cycles. The industry is numb to large scale failures, bail-outs and crises. We're all very good at dealing with them. But ESG offers a catalyst for change, and one which stands a chance of increasing stability in the long-run.

By focusing on ESG and sustainability throughout the Operating Model, financial services organisations can meet regulatory obligations, align ESG considerations with their overall business objectives and meet stakeholder objectives.

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James' background in Financial Services has taken in operating model challenges in both buy- and sell-side organisations. Throughout his career he's dealt with digital and data transformations alongside supporting clients with strategic advisory and long-term change.

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