Perspectives | Regulation

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Sustainability is becoming Financial Industry' second nature

After over a decade of gradual moves to include environmental and societal variables into existing or new products, the pace is now changing, in line with the increasing global awareness that our model is not sustainable any longer. The entire financial ecosystem is undergoing a profound transformation to embrace Environmental, Social and Governance (ESG) mandates in order to realize the promise of sustainability. In fact, we are on the verge of a vital transformation towards sustainability in the financial industry, which will accelerate other industries' own change. Many forces, ranging from regulatory pressure, business strategy or even branding concerns, are setting sustainability as a second nature.

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Doing business with considerations of Environmental, Social and Governance (ESG) factors goes much further than just having an outstanding Corporate Social Responsibility (CSR) policy. ESG will now become at least a standalone business line, maybe the most important, complete with its own organization, products or services, data, reporting and regulation. ESG will, as such, affect all banking activities from Corporate and Investment Banking (CIB), Asset Management, Wealth Management, Retail Banking and Insurance.

The European Commission's action plan, issued in March 2018, establishes a regulatory framework that will have significant repercussions on the banking value chain; ranging from General management to Human Resources (HR) and impacting Front Office, Operations and Information Technologies (IT) as well.

To take a stance on this changing paradigm, this article aims at presenting the stakes of ESG finance, the regulatory and business pushes and the impacts on the value chain of across financial services.

Mapping the stakes of Sustainable Finance

A new path towards value creation

Looking at a firm through the ESG lens grants the observer a much broader perspective than what traditional financial analysis can bring. ESG data can shine a light on the short to long-term growth perspectives of a potential investment by answering questions of a varying nature touching on organizational, business, regulatory or compliance aspects:

Organizational	Business	Regulatory & compliance
• How will ESG considerations cascade down through my organization? • How will it affect my day-to-day operations? • Will it nurture a positive culture? • Will it make my company more appealing? • Will it help me attract new talent? • Will it increase employees' collaboration?	• What is the environmental and social regulation impact on my sales, operations and cost structure? • Is my production (or delivery) ready? • Can I now better respond to shifting consumer demand?	• What is the legislation? • What are the specifics at National or European level? • Am I compliant? • What are my liability and reputational risks?

In particular, the ESG analysis of a specific investment (or of a whole investment universe) is a way to uncover information that is not yet represented in the investment's price, but which is an integral part of the financial analysis of the potential risks and return.

Complementary ways to become sustainable

For Financial Institutions, an ESG-integrated "architecture" relies on 3 pillars:

ESG Construct: What do Financial Institutions need to do?		
As a firm	As a financial player	As regulated & lobbying party
• Foster brand and reputation • Strengthen corporate sustainability • Enhance employability	• Provide new products and services which are ESG-integrated by design • Be a pioneer in green portfolios • Embed ESG risk indicators into their financial solutions • Promote and facilitate clients' adoption of ESG type of products	• Be an active mediator between private sector and public bodies • Be a role model with trust as a priority • Take an active role in regulatory supervision and in politics.
• As any corporate, financial players need to assess their ESG footprint transversally. • They need to inject an ESG mind-set into the decision-making process. • They should answer to employees concerns about corporate sustainability.	• Financial players have an innovation role: they need to ensure new products and new services that they design and build respond to or anticipate the shifting customer demand (towards positive impact investment and long term profitability improvement). • Financial players also have an educative role in explaining how ESG need to be included in risk assessments; and risk management processes.	• The regulatory frameworks are driving towards harmonization and transparency across the Financial Services Industry. With trust as an imperative, it reinforces the role of trusted third parties within the economic cycle. • Financial players are an ideal catalyst for ESG transformation, where their role is to: 1) Ensure easy application 2) And improve their reputation.

A key role for the regulator

However, several limits to ensure the transparency and harmonization required have been identified by regulators. They are addressing these to facilitate ESG adoption and spread through the market. An action plan has already been set up for each so that everyone is aligned.

Identified limits	What the regulator has planned
No common definition for a "sustainable" investment	Define a EU classification i.e. Taxonomy for sustainable activities
Greenwashing threat for investors	Set standards/labels (or labelize existing ones) and benchmarks for low-carbon/positive impact financial products
Non acceptance of ESG with profitability as priority	Create penalty / incentive on the capital requirements to reflect and limit the exposure to non-ESG impact investing activities
ESG factors underestimation in the investment decision and risk analysis	Enrich the rules and strengthen the roles and duties of investment managers when investing
No harmonization, lack of information on corporates	Review the practices and directive on corporate reporting on sustainability to ensure sufficient standardization
No empowerment within the firms	Enhance corporate governance obligations at board and directors level

Source: EU Commission website, Cognizant Consulting Research
Figure 1. Regulators action plan to overcome ESG limits.

The European Union (EU) regulator, associations and businesses have been working over the past year on establishing an EU common classification system for sustainable activities - the EU Taxonomy[1] - which aims at facilitating sustainable investment. The Technical Expert Group (TEG) also published a report providing recommendations for technical screening criteria for economic activities that can substantially contribute to climate change mitigation or adaptation, while avoiding significant harm to the other environmental objectives.

6 "E" Objectives for Environment Priorities for the next 2 years	
1 Climate Change Mitigation	4 Transition to a circular economy, waste prevention and recycling
2 Climate Change Adaptation	5 Pollution prevention control
3 Sustainable use and protection of water and marine resources	6 Protection of healthy ecosystems

Source: HLEG on Taxonomy, Cognizant Consulting Research
Figure 2. Six Environment objectives included in Sustainable Finance taxonomy wave 1.

[1] More about EU taxonomy for sustainable activities status on https://ec.europa.eu/info/publications/sustainable-finance-teg-taxonomy_en

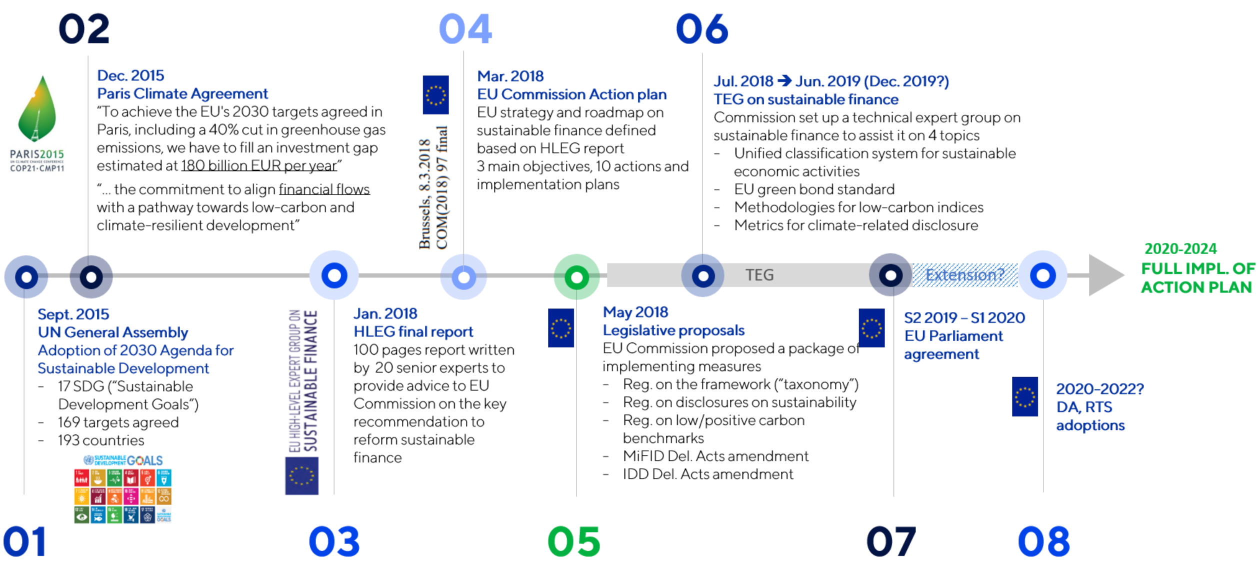
This "Taxonomy" is the cornerstone of the regulatory push, and will require several years to first be defined, then be completely adopted by financial actors, and finally have a rebound effect onto corporates. It is on this basis that regulators will continue to build the future of sustainable finance.

The Drivers of Sustainable Finance

Regulatory push

To comply with the Paris agreement[2] and its overall climate goals, policy makers are targeting the financial industry to leverage their regulatory impact through its direct influence over other industries. In the EU, we expect updates of existing regulations to factor in ESG issues and ESG-specific regulations, even as the regulator works towards unification of the language and methodologies of capturing ESG data as well as defining the type of data to be captured.

The full-implementation of these regulatory changes is still under discussion as the actors are still in the lobbying phase. However working groups are making significant progress and the publication of consultation papers is well underway. We expect implementation will start in 2020, accelerate in 2022 and continue well into the following years.



Source: EU Commission Action Plan, ESMA, Cognizant Consulting Research
Figure 3. ESG implementation calendar.

The European Commission unveiled a sustainable finance action plan in March 2018[3]. This is a major milestone defining the strategy for a financial system that supports the EU's climate and sustainable development agenda. It contains a wide range of legislative and non-legislative measures.

[2] More on https://ec.europa.eu/clima/policies/international/negotiations/paris_en
[3] European Commission press release: https://ec.europa.eu/commission/presscorner/detail/en/IP_18_1404

The plan contains ten "action points" detailing the Commission's Intentions. These actions are more or less subject to controversy; but each point needs to be developed furthermore in order to be applicable for the financial ecosystem [see figure 4].

United Nations Sustainable 17 Goals

A guiding reference for sustainable development initiatives

1. No poverty	2. Zero hunger	3. Good health and well-being	4. Quality education
5. Gender equality	6. Clean water and sanitation	7. Affordable and clean energy	8. Decent work and economic growth
9. Industry, innovation and infrastructure	10. Reduced inequalities	11. Sustainable cities and communities	12. Responsible consumption and production
13. Climate action	14. Life below water	15. Life on land	16. Peace, justice and strong institutions
17. Partnerships			

More on https://www.un.org/sustainabledevelopment/sustainable-development-goals/

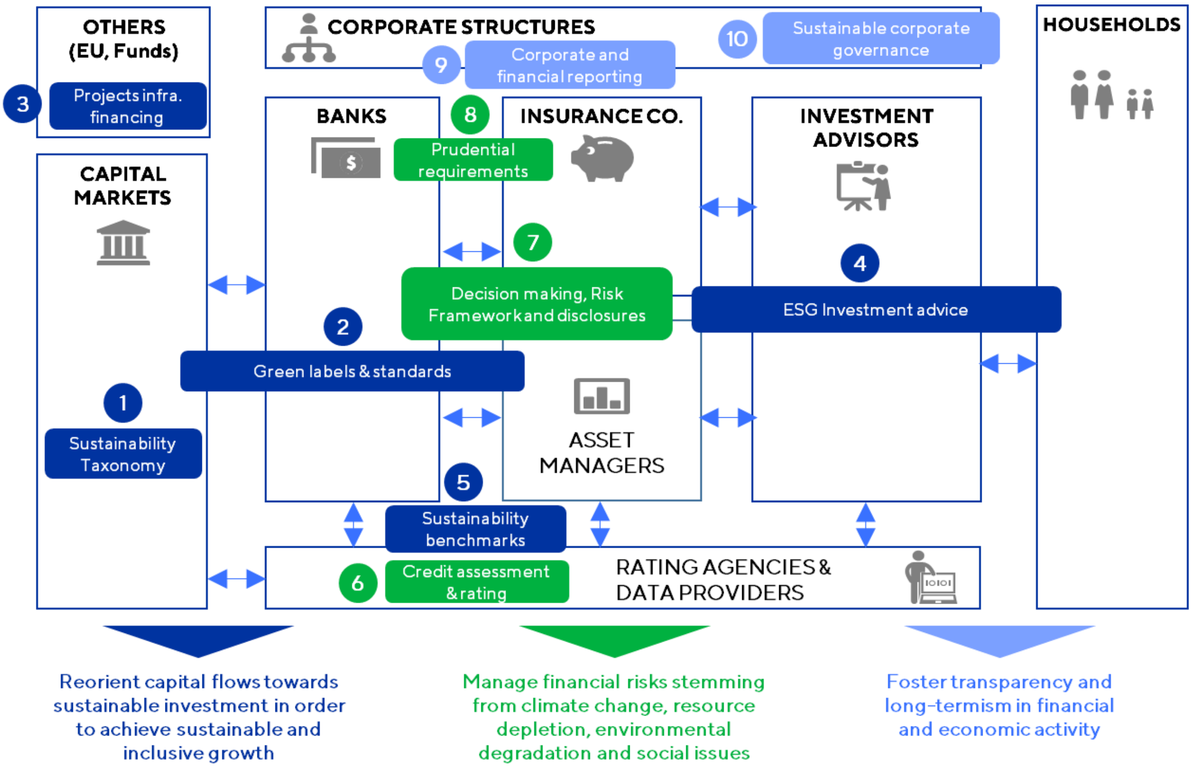
European Commission Sustainable Finance 10 action points*

-1- Establishing an EU classification system for sustainable activities	-2- Creating standards and labels for green financial products	-3- Fostering investment in sustainable projects	-4- Incorporating sustainability when providing financial advice	-5- Developing sustainability benchmarks
-6- Better integrating sustainability in ratings and market research	-7- Clarifying institutional investors' and asset managers' duties	-8- Incorporating sustainability in prudential requirements	-9- Strengthening sustainability disclosure and accounting rule-making	-10- Fostering sustainable corporate governance and attenuating short-termism in capital markets.

*More online https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0097

Figure 4. EU Commission 10 Actions Plan for Sustainable Finance

The entire financial ecosystem will now have to consider impact of Sustainable Finance in their activities. Impacts are already expected to be massive both on the business side (product innovation, capital consumption, services adaptation / creation, client advisory) and on the operational side (qualification of the activities, policies/procedures, reporting, and data) etc. [see figure 5]

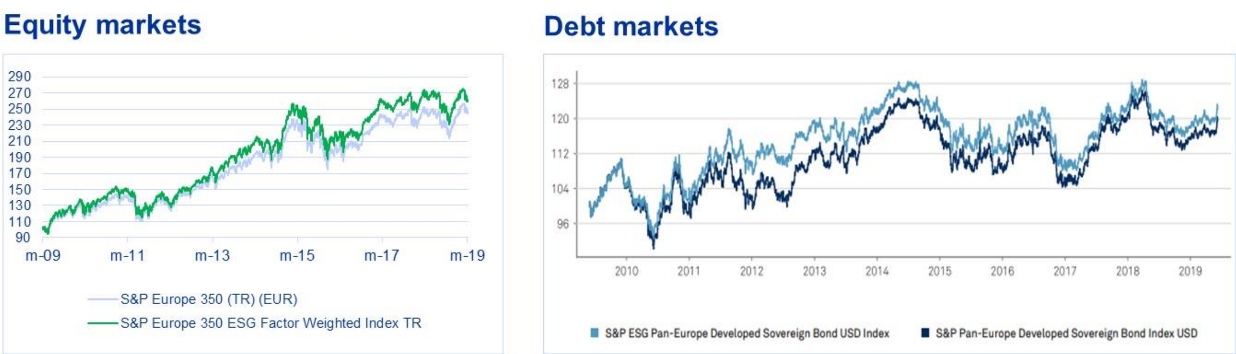


Source: EU Commission Action Plan for Sustainable Finance, Cognizant Consulting Research
Figure 5. ESG Impact analysis on the financial entire ecosystem.

It should be noted that unlike the transformation programs driven by recent regulatory waves, regulation is not the sole driver of sustainable finance.

But before all, a business strategy already engaged

From a pure financial performance point of view, multiple studies show different results. However, there is one common observation: "greening-up" a portfolio does not sacrifice returns, and may even bring better alpha for slightly lower risk on the medium term.



Source: S&P, Cognizant Consulting Research
Figure 6. S&P indices performance

Rather than a unique regulatory-driven change or a pure performance quest, sustainable finance is a more of a demand-driven evolution. Sustainability has indeed become an early market trend, with both retail and institutional clients being more mindful about the sustainability level and the impact on the real world of their investments.

There are two ways of integrating ESG factors into a financial business:

1. as an additional source of financial information
2. or as a key performance indicator (KPI) included in the product targets

In any case, sustainable finance is an early but rising market trend in terms of both branding and performance.

The regulatory push and the shifting of client expectations entail a transformation of the way financial actors conduct their business, but being able to brand its investments as 'sustainable' has far-reaching impacts.

Walking through a Sustainable Transformation

Fueling the organization with the right energy

The most straightforward consequence of a sustainable transformation on a firm is the development of a Corporate Social Responsibility policy, the aim of which is the reduction of the negative externalities of the firm's operations. The CSR policy is not only about removing single use plastic; it can go as far as defining a percentage of women present in the senior management, giving more opportunities for the underprivileged youth, defining a waste management strategy or even focusing on carbon emission reduction (through energy efficiency, travel policy, etc.). It is a useful tool to steer all employees towards a new corporate culture by giving them tangible changes to adapt to.

Sustainability is a message that needs to spread from within a firm to both clients and the internal talent pool, which will in turn bring new business opportunities and delivery capabilities to the company.

A number of key questions however remain.

What is the best way to avoid getting overwhelmed by waves of sustainability initiatives? It starts with preparation: defining an organization and a governance as agile as possible to bring meaning, purpose and concrete results. So far, some financial players have changed their organizational model to integrate ESG principles. For those actors who have just began this work, we suggest leveraging lessons learnt from the recent compliance or data office organizations to set the fundamentals of an ESG strategy.

Why consider a Sustainable Finance Office creation? Based on our experience with enterprise-wide change management, we believe creating a transversal function can tremendously help in accelerating and improving an organization's transformation. A Sustainable Finance Officer with compliance and risk management expertise and a pool of talents can centralize all ESG-related topics and become the internal point of reference on strategy, execution plan to improve CSR and move to ESG, implementation execution and guidelines. The Sustainable Finance Office will have the important task of achieving this transformation with utmost clarity and concrete results. Success depends on a strong understanding of the business, the ecosystems or value chains, regulatory environment, human resources and ways of capturing data with today's technologies and solutions (Artificial Intelligence, machine learning, blockchain etc.).

Guiding Principles

1 **Appoint a Chief Sustainability Officer**
Having a dedicated "lead" is necessary to ensure there is focus in driving sustainability strategy and advancing the company's program—it can also signal the company's commitment

2 **Set up an ESG Committee**
Sustainability oversight by the board of directors is increasingly integrated across several formal board committees, but can also be accomplished through a dedicated committee

3 **Involve General Management & Boards**
General management and boards must be actively involved both in the ESG strategy AND in the monitoring actions

4 **Root ESG in your organization**
ESG resources must be represented within investment / product / service teams BUT also deployed within the whole organisation: Business vs. support, Central vs. local declinations

5 **Consider Specific dedicated functions**
Lobby/external relationships experts, internal coaches, data officers, reporting teams, "as a firm ESG" owner (take-over of RSE teams)

6 **Assess annually**
Integration within yearly assessment processes to reinforce empowerment?

+ Declination in Group structure on all businesses (CIB, AM, WM, Insurance, Retail) with consolidated view provided at Group level

Source: Cognizant Consulting Research

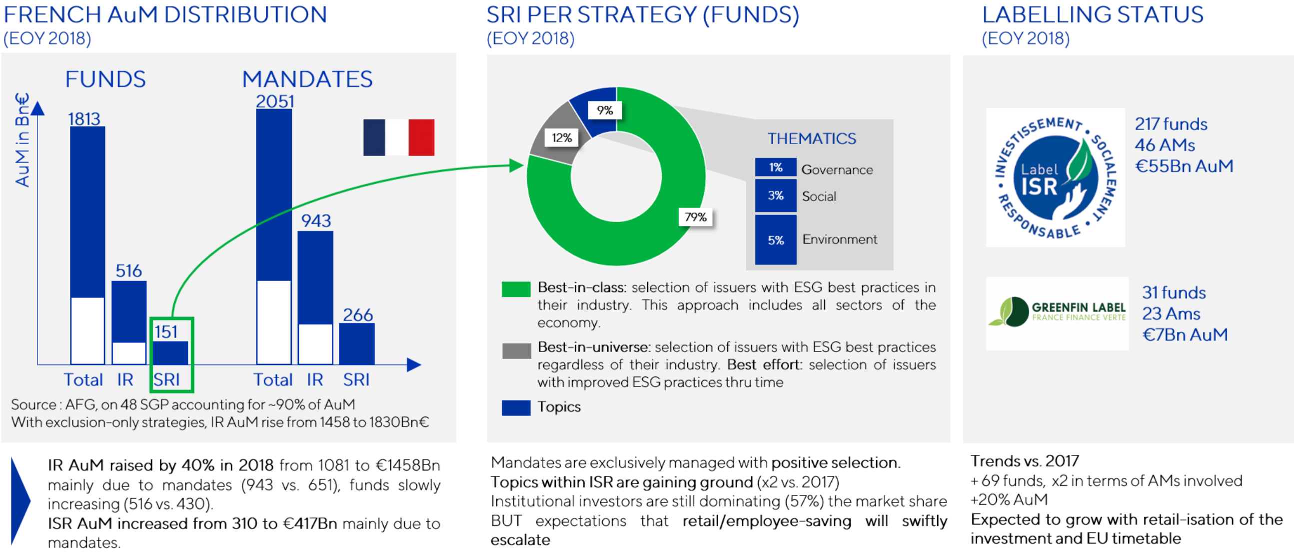
Figure 6. Sustainable Finance guiding principles and governance.

Filling the product and service range with new growth engines

Innovation to the core

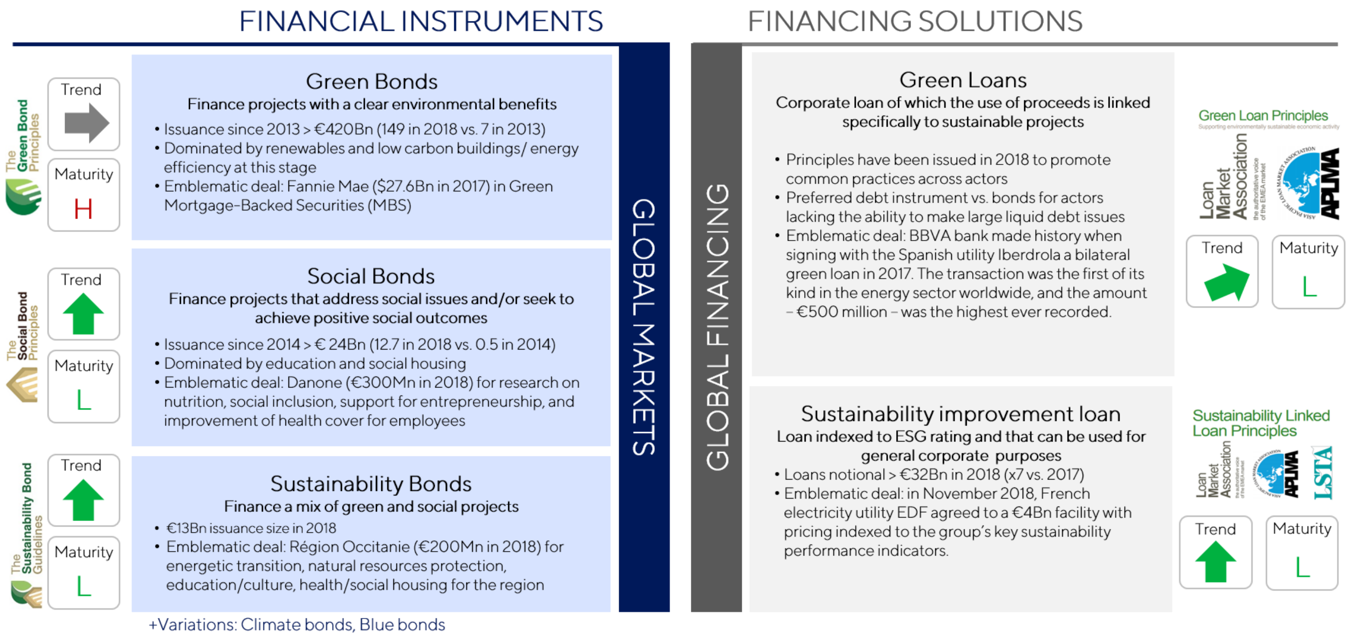
ESG is an invitation not only to improve today's solutions and services but also to innovate! It opens a world of opportunities for any financial player. Be it matching shifting consumer and institutional demand or to compliance with stricter regulatory scrutiny to avoid greenwashing, deploying financial products that can be branded as sustainable is becoming more and more demanding.

Sustainable finance can drive innovation through new asset classes or investment strategies, such as the new impact investing trend whereby the performance of an investment is measured against non-financial indicators, in addition to the traditional financial ones.



Source: AFG

Figure 7. Asset Management French SRI Market is dominated by best-in-class strategies; Best-in-Universe, ESG integration, thematic funds are gaining ground in IR



Sources: Bloomberg, Sustainalytics, BBVA, Crédit Agricole, Novethics

Figure 8. CIBs have developed starring debt solutions to assist clients in meeting their own objectives or mandates on environmental and social impact

Source: Cognizant Research

Figure 9. CIBs still have room to innovate to serve their clients on other products and services

Innovating with new sustainable finance products requires more than a marketing push as this will drive a full-transformation of the operations.

An end-to-end transformation

The complexity of ESG-integrated products lies in measurement, since there is no market consensus about the ESG criteria to monitor, nor is there clarity on related quantification methods. Developing such products first requires designing the ESG indicators that will be used to both assess the product performance and to report to clients.

Capturing data is therefore a critical success factor: both wide data sets across large volumes and in-depth precise data focus with strong granularity. This means a capacity to collect scattered and fragmented data across the value chain involving many different vendors who each have their proprietary systems and data architectures. Core IT Modernization and rethinking information systems is mandatory to be able to process, control, display or visualize data. This encourages rethinking and revamping of reporting processes or communication templates. Data visualization is a key lever for sustainable finance piloting.

But as the below mapping shows the transformation goes far beyond pure data capture, interpretation, use and dissemination.

Transforming the entire banking ecosystem for Sustainable Finance

Strategy, Products, Data, FO, Operations, IT, Risks, Controls, HR, Legal and Compliance… and internal facilities.

GENERAL MANAGEMENT & STRATEGY

CIB: H
AM: H
INS: H
WM: M
SS: M

- Build/reinforce ESG teams, design the suitable governance/organisation
- Determine the strategic guidelines in terms of "as a firm" and "as a financial actor" (priorities, offering, investments)
- Ensure GM/Board is fulfilling its role as responsible for the integration of sustainability risks and factors (governance, reporting, training)

PRODUCTS & MARKETING

CIB: H
AM: H
INS: M
WM: M
SS: M

- Define the right positioning by market segment
- Assess eligibility of products vs. labels
- Update the target product range and the target markets, and the committee's approval process
- Update pre-trade documentation on financial instruments / services and re-paper existing documentation
- Communicate to clients / investors on ESG capabilities

FRONT OFFICE (SALES, INVESTMENT MANAGEMENT, RESEARCH)

CIB: H
AM: H
INS: M
WM: M
SS: L

- Review/document/automate the investment process (new data to be sourced/used, assessment of issuers/instruments to be revised, new scoring methodologies)
- Update the MiFID/IDD processes, review the Risk screening/selection processes
- Review the operating model for research i.e. the benchmarks used to comply with the update BMR regulation (low-carbon, positive impacts indices), and the credit assessments from CRA which will include ESG criteria

DATA

CIB: H
AM: H
INS: H
WM: H
SS: H

- Identify ESG data sources, determine capturing process/repository options, implement feeding flows and use cases (external ESG but also internal)
- Enhance referentials to take into account ESG frameworks (taxonomy, labels etc.)
- Set-up the data governance (owner, manager, users etc.)
- Build the ESG metrics and KPIs

IT & OPERATIONS

CIB: H
AM: H
INS: H
WM: M
SS: H

- Screen all products/services offering to map it to the taxonomy
- Implement disclosures and reporting framework
- Liaise with data to integrate IT evolutions

RISKS & CONTROL FRAMEWORK

CIB: H
AM: M
INS: H
WM: L
SS: L

- Update the credit risk framework to include ESG criteria (ratings by CRA, etc.) and global framework with ESG risks
- Update the RWA framework to take into account the penalty/relief framework
- Update risks policies and procedures to include ESG (framework and monitoring)
- Update control framework is rolling-out the ESG controls

LEGAL & COMPLIANCE

CIB: H
AM: H
INS: M
WM: M
SS: L

- Conduct awareness on the regulations
- Review client documentations from legal & compliance point of views
- Update/Validate the policies (engagement, investment, conflicts of interests, compensation, etc.)
- Review the conflicts of interests framework to take ESG criteria into account

HR

CIB: H
AM: H
INS: M
WM: M
SS: L

- Hire the adapted ESG profiles
- Roll-out training programmes to teams to ramp-up on ESG issues
- Review the internal remuneration policies integrating sustainability investment targets with selected KPIs

\+ General services, Procurement, selection of providers, etc. to meet "as a firm" commitments

Figure 10. Impacts of the new ESG processes on the value chain of Capital markets, Asset & Wealth Management and Insurance

In conclusion, while sustainable finance definitely is a market-driven shift leaving room for product innovation, it also has wide reaching impacts on financial institutions, their organization and their IT set-up. From top management to business, operations and IT to support functions, sustainability must percolate throughout the organization, in sync, and at the pace of the whole ecosystem. And with a strong trend towards it, one should not wait for regulators, even though that may involve re-design at some point.

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About the authors

Thomas Born
Director
Capital markets
Cognizant Consulting

Thomas is Director within Cognizant Consulting, co-heading the Corporate and Investment Banking practice. He has a strong track-record in management consulting particularly in strategic assignments, new activities definition, target operating model design, regulatory expertise matters and large transformation programs in the banking industry, especially in the fields of Investment Banking, Investment Management, Wealth Management and Securities Services. He is executive member of our France's ESG practice. He holds an Engineer's degree from Supélec and a MSc in Metals & Energy Finance from Imperial College London.

Thomas can be reached at thomas.born@cognizant.com
https://www.linkedin/in/thomas-born

Yanina Fedyunina
Senior Manager
Capital Markets
Cognizant Consulting

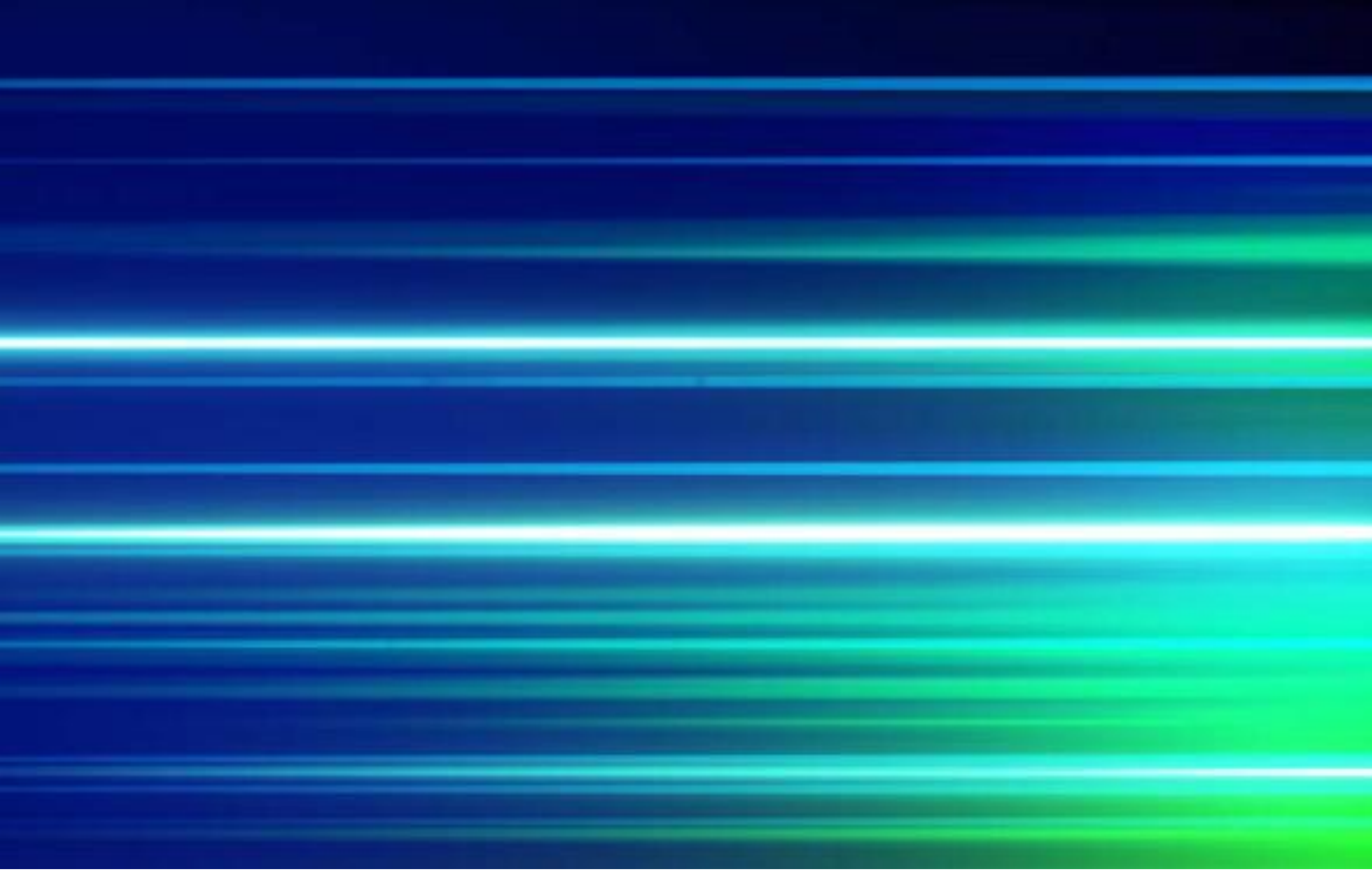
Yanina is a senior manager within Cognizant Consulting France's Capital Market Practice with a strong knowledge across the Asset Management industry gained from working with asset managers and service providers. She is currently leading a sustainable transformation programme for one of the global asset managers. Yanina holds an MS degree in Finance & Strategy from SciencesPo Paris.

Yanina can be reached at yanina.fedyunina@cognizant.com
https://www.linkedin.com/in/yanina-fedyunina-11441264/

Olivier Pate
Senior Consultant
Capital Markets
Cognizant Consulting

Olivier is senior consultant within the Capital Market Practice of Cognizant Consulting France. He has a strong knowledge of the Asset Management industry where he led several projects. He is currently leading a product range reshaping for a global asset manager. He holds Master's degree in European Affairs from Sciences Po Paris and an MSc in Economics and Management from the Bocconi University.

Olivier can be reached at olivier.pate@cognizant.com
https://www.linkedin.com/in/olivierpate



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Cognizant

World Headquarters

500 Frank W. Burr Blvd.
Teaneck, NJ 07666 USA
Phone: +1 201 801 0233
Toll Free: +1 888 937 3277

European Headquarters

1 Kingdom Street
Paddington Central
London W2 6BD England
Phone: +44 (0) 20 7297 7600
Fax: +44 (0) 20 7121 0102

Cognizant France

50-52 boulevard Haussmann
75009 Paris – France
Tel : +33 (0)1 70 36 56 57
Contact-France@cognizant.com