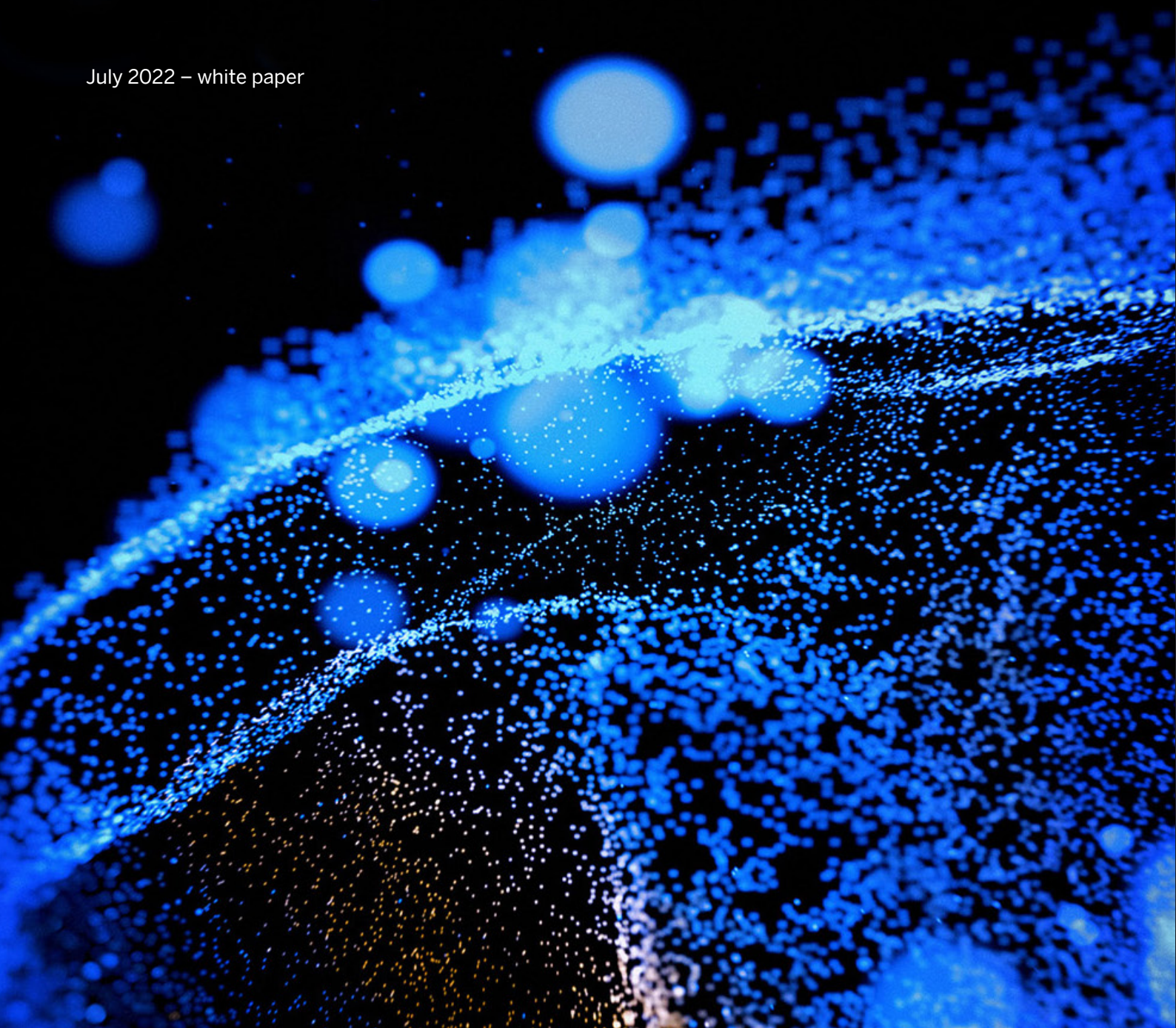
SAP Fioneer

The challenge of sustainable sustainability

Accelerating the ESG transformation in banking

July 2022 – white paper



ESG is the acronym for Environmental, Social, and (Corporate) Governance, the three broad categories defining socially responsible behavior of businesses.

Introduction

Over the last few years, ESG (environmental, social, and governance) has become an important theme for banks across the world. Europe is at the forefront of this development, fueled by a rapidly-evolving regulatory framework.

Banks also face pressure to embrace ESG principles from other stakeholders. Investors are attracted by the growth opportunities of ESG as a way for banks to preserve their long-term value, while customers and employees increasingly demand higher standards of their company's operations.

Some banks have demonstrated their commitment to ESG by signing up to ambitious net-zero emissions targets. More than 100 institutions have joined the UN-convened Net-Zero Banking Alliance (NZBA), pledging to align their lending and investment portfolios with net-zero emissions by 2050.[i]

However, meeting the rising - and sometimes conflicting - expectations of stakeholders is quickly becoming a major challenge. While banks are increasingly successful at measuring and managing their own emissions, many firms struggle to measure the emissions produced by portfolio assets and operate efficiently in accordance with clearly defined sustainability goals. This white paper explores the ESG requirements that banks need to meet, and the main challenges they experience when integrating ESG principles into various business areas. It concludes by giving an assessment of what it will take to tackle these challenges, and how SAP Fioneer can help banks to accelerate their ESG transformation.

ESG challenges for banks

Over the course of numerous interviews with banks and ESG experts globally, three overarching challenges emerged that made it most difficult to adopt ESG principles: regulatory, business, and implementation. Each one is considered in turn here.

The regulatory challenge

Banks face complex and constantly evolving regulatory ESG requirements, particularly in Europe.

While regulation of the social and governance components of ESG are still at a very early stage, sustainability reporting is well established. Banks have been required to report on policies implemented in response to ESG factors since 2018 under the Non-Financial Reporting Directive (NFRD),[ii] but the extent and rigor required of such reporting is increasing.

In 2020, the EU Taxonomy Regulation was introduced to support the EU economy to meet its green objectives.[iii] In 2022, the European Central Bank conducted a first climate stress test to assess how prepared banks are for dealing with financial and economic shocks caused by climate change.[iv] European banks must now also publish their initial taxonomy KPIs, with full disclosure required from 2026. From 2024, banks will have to calculate and disclose their so-called Green Asset Ratio (GAR) KPI for a substantial part of their portfolios.[v] This represents major difficulty as it requires banks to specify which assets in their portfolio do and don't comply with the requirements in the Taxonomy Regulation.

In addition, a new Corporate Sustainability Reporting Directive (CSRD) is expected to replace the NFRD regulation in order to standardize sustainability-related disclosures, which must be externally audited to ensure full compliance.[vi] Banks will need to start publishing their sustainability reports for the previous year in a format dictated by the CSRD from 2024 onwards.

These are only some examples of the ESG requirements that banks need to fulfill, now and in the near future. Uncertainty about ESG regulation remains, as most of them are still evolving, but it is clear that regulatory oversight will increase over the next few years.

These changes will impact risk and finance departments the hardest, because they will affect the entire risk framework of banks. New data will need to be collected and analyzed, which will require adjustments to internal processes, models, and disclosures. Some of that data is not currently available, but is sorely needed, as banks learnt during the ECB's first climate risk stress test in 2022.

The business challenge

ESG challenges go beyond the risk and finance department. Every bank business function will be confronted with unique, but interrelated, problems that are expected to grow in the coming years.

For example, strategy and business development units will need to set an overall ESG strategy laying out their path to net-zero emissions by 2050, in accordance with the Paris Agreement and - if they are a signatory - the NZBA. This requires measuring the emissions of their entire portfolio. The NZBA also demands clear guidelines on approach and timeline.

To achieve this, banks must not only collect and analyze entirely new types of data, but also steer their portfolio and adjust their sales and pricing mechanisms to achieve their net-zero goals. Yet today, most banks still struggle to obtain satisfactory transparency over financed emissions.

Separately, business teams face the challenge of developing a competitive and robust green product offering, and building ESG advisory capabilities in order to take advantage of what is seen by many as a major growth opportunity in banking.

The numbers speak for themselves: achieving net zero is estimated to require $9.2 trillion in capital expenditure (capex) per year until 2050 globally.[vii] This amounts to a total capex requirement of $275 trillion. Demand for green financing products such as green or sustainability-linked loans is also expected to keep surging, resulting in an even more dramatic rise in green lending volumes. The sustainability-linked lending market has already

grown from $5 billion in 2017 to $120 billion in 2020.

These products also have a knock-on effect, accelerating the sustainable transformation of the customers who buy them. By providing green financing, banks can play a major role in responding to the climate emergency. Though many would argue that helping companies in the value chain to reduce their carbon emissions falls under corporate social responsibility obligations, there is also a clear financial benefit to banks of participating in the race to net zero.

The implementation challenge

For banks, implementing ESG principles is clearly more than a one-off effort. It requires a wholesale transformation that will impact many processes, from risk to sales steering and pricing.

While ESG use cases differ across various bank units, all of them share a common basis: obtaining data not currently held (and not easily obtained in the market), and processing this data efficiently to build ESG applications and integrate the results in both upstream and downstream systems.

At the moment, banks are struggling to build a solid ESG foundation. Four common challenges emerge:

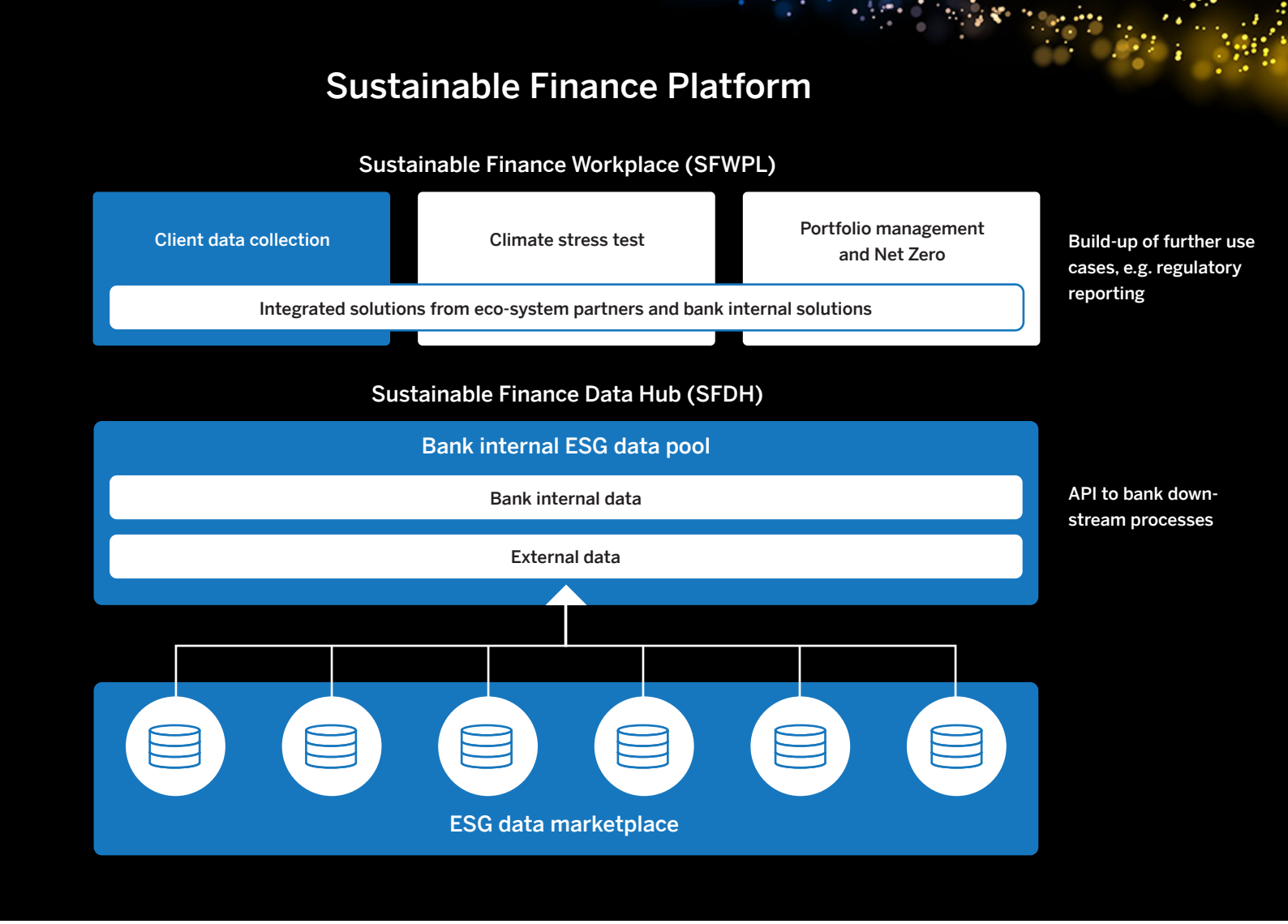
1. Solutions must work across the bank. ESG affects different parts of banks in interrelated ways. For example, the risk department must perform the climate risk stress test and report the result to the ECB, as well as applying the results to adjust risk frameworks and upstream and downstream systems in order to incorporate climate risk into the bank's risk steering mechanisms. Other departments will also need to consume and process ESG risk metrics and integrate with their own ESG metrics in partially overlapping upstream and downstream systems. The number of adjustments needed and the number of affected systems challenges makes it difficult for banks to introduce efficient ESG processes. A solution is needed to accommodate use cases across the board.

2. Data and analytics are currently being developed in silos. ESG data is required at different areas of the bank for their specific use cases. Currently, firms are building up several ESG data repositories, often using highly manual methods, that are not easily accessible across the bank. More importantly, this poses a reputational and compliance risk as efficient reproduction and trail of ESG metrics becomes tedious.

3. High-quality market data is not widely available. ESG data, such as emissions levels or climate risk exposure, is typically obtained from public sources, directly from corporate clients, or from ESG data providers. While clients are starting to report on ESG data, and data providers are emerging and evolving quickly, ESG data remains scarce, particularly for small- and medium-sized companies (SMEs). In the EU, more data may soon be a legal requirement. The European Banking Authority's proposal for additional ESG disclosures includes a duty for small counterparties to produce this data from 2024 in order to calculate the KPI Banking Book Taxonomy Alignment Ratio. Currently, banks must also match external data to bank internal counterparty records and/or asset-level records and harmonize conflicting data points, which requires a lot of time-intensive manual work.

4. ESG requirements for banks are constantly evolving. Regulatory requirements, as well as expectations from other stakeholder groups such as customers, employees, or investors, change frequently. As a result, banks need their ESG solutions to be flexible, especially given the growing regulatory demands, and be able to accommodate future use cases. At the moment, these requirements make it particularly challenging for banks to implement an efficient, standardized ESG process across the bank.

To sum up, ESG affects different bank departments in interrelated ways, and those challenges will only increase in the coming years. This means that banks urgently need to develop flexible, efficient, future-proof, and scalable solutions to integrate ESG principles. They need sustainability software that is truly sustainable.



Developing a sustainable sustainability solution for banks

SAP Fioneer is developing the *Sustainable Finance Platform* - the ESG platform enabling banks to tackle their end-to-end ESG challenges centrally across all bank units.
The platform is built around a *Sustainable Finance Workplace*, consolidating holistic, bank-integrated ESG applications, such as climate risk stress testing, ESG advisory, and emission management and steering. Together with banks, we will jointly develop applications to serve their priorities, while also allowing banks and partners to integrate custom solutions on the platform.

The *Sustainable Finance Workplace* builds on a central *Sustainable Finance Data Hub*, a reliable, regulation-compliant single source of ESG truth within the bank. It consists of two core elements: the *bank integrated data pool* that connects and harmonizes external data with a bank's internal ESG data. That external data is sourced through the *ESG data marketplace*, where bank can choose from contracted prominent ESG data providers and prioritize data fields based on a central data model.

Our standardized ESG software solution produces a data foundation with a clear audit trail that is integrated into all existing banking processes.

We are building an initial use case within the *Sustainable Finance Workplace*: a holistic ESG client data collection solution that helps banks to collect and verify ESG data from clients in a structured and efficient manner. This choice of prioritization is based on the realization that no matter how well the *Sustainable Data Hub* is designed, in the current stage ESG data availability from public and proprietary sources alone is insufficient in coverage and reliability in order to fulfill a bank's ESG requirements. Therefore, we see the *client data collection* solution as a pressing use case at the moment for banks.

The *Client data collection solution* consists of an easy to navigate frontend, pre-filled with existing internal and external ESG client data. Hence, the solution minimizes manual effort and time spent in particular for a bank or corporate customer that might have to provide this type of ESG data to a number of banks.

Our solution also leverages these ESG-triggered additional customer touchpoints to create valuable ESG advisory dialogue, helping banks and their customers to accelerate their ESG business transformation and create business value for banks coming from, what was initially thought to be a purely administrative process.

The *ESG Data collection & Advisory Workbench* analyzes client data to alert bank relationship managers to potential advisory needs of corporate clients, which allows bank sales teams to identify opportunities for targeted ESG advisory.

SAP Fioneer is strongly committed to building the *Sustainable Finance Platform* solution. We understand the pressure banks are facing to act and aim to deliver a solution as fast as possible. We are currently finalizing our IT architecture and are building a strong eco-system of co-development partners consisting of both banks and solution specialists to join us on this ESG transformation journey.

As is clear, ESG will only play a more central role in the financial services industry. This brings many challenges, but also creates incredible potential, both commercial and societal. Banks need suitable software in order to unlock this potential, and SAP Fioneer aims to provide that solution.

SAP Fioneer

Founded in 2021 as a joint venture between the global technology leader SAP and private equity firm DEDIQ, SAP Fioneer's vision is to build the next generation of financial services software and platforms.

By combining proven world-class technology with development expertise and a broad ecosystem of partners, SAP Fioneer enables banks and insurance companies to transform, grow and differentiate their business while meeting their needs for speed, scalability, and cost-efficiency through digital business innovation, cloud technology, and solutions that cover banking and insurance processes end-to-end.

SAP Fioneer has operations in 13 countries in Europe, North and Latin America, Asia-Pacific and the Middle East.

For more information, visit www.sapfioneer.com. Follow SAP Fioneer on Twitter and on LinkedIn.

Authors

SAP Fioneer is currently building a strong ecosystem of partners – banks, ESG data providers, and solutions providers to jointly develop further use cases. Reach out to us if you have questions or wish to discuss opportunities to collaborate.

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[i] The Net-Zero Banking Alliance brings together banks committed to aligning their portfolio (lending and investment) with net-zero emissions by 2050 latest. To date more than 100 banks globally have joined the alliance, providing clear timelines and steps to take by banks over the next years in order to reach their net-zero goals.

[ii] The Non-financial reporting directive (NFRD) is a mandated reporting on policy implemented in response to environmental protection, social responsibility, human rights, anti-corruption and bribery, and diversity on corporate boards. It applies to public companies with over >500 FTEs, or companies designed as "public-interest entities" and is effective as of December 2014, reviewed December 2019.

[iii] The EU Taxonomy Regulation (July 2020) provides the overall structure to identify 'green' activities. The first delegated Act (June 2021) provides the Technical Screening Criteria for companies' substantial contribution to climate mitigation and adaptation. The Commission will later issue (i) another delegated act detailing technical standards for additional sectors on climate mitigation and adaptation and (ii) other delegated acts to cover the remaining objectives and any further sectors. The Taxonomy provides a list of eligible economic activities which can make a substantial contribution toward at least one of six environmental objectives: climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control, as well as protection and restoration of biodiversity and ecosystems. It also sets the technical screening criteria (TSC) to assess alignment of economic activities that directly contribute or enable environmental objectives as: (a) substantial contribution to at least one environmental objective, (b) do no significant harm to any of the other five objectives, (c) compliance with minimum safeguards. The EU taxonomy was published in the Official Journal of the European Union on 22 June 2020 and was effective from January 2022. It applies to Entities aiming to classify activities as 'sustainable' or 'green', and entities subject to NFRD and SFDR regulations.

[iv] The climate risk stress test was first launched in 2022 by the European Central Bank (ECB) to assess "how prepared banks are for dealing with financial and economic shocks stemming from climate risk. (...) It aims to identify vulnerabilities, best practices and challenges banks face when managing climate-related risk". The climate risk stress test is performed in addition to the regular stress test, which banks are required to conduct on a regular basis. It is expected that banks will need to perform the climate risk stress test on a yearly basis from 2022 onwards.

[v] The GAR KPI measures the proportion of the credit institutions' assets invested in taxonomy-aligned economic activities (i.e. loans and advances, debt securities, equities, repossessed collaterals financing taxonomy-aligned activities) as a share of total covered assets (total covered assets = all on-balance sheet exposures excl. sovereign and trading portfolio).

[vi] The CSRD (Proposal for Corporate Sustainability Reporting Directive) describes sustainability reporting standards which specify the reporting structure of sustainability information and resolve challenges of the NFRD, e.g. insufficient or omitted information, impaired comparability between companies and accountability. It amends the existing reporting requirements of the NFRD and applies to all listed and non-listed large companies (without the NFRD 500-employee threshold), and listed SMEs (except listed micro-enterprises) thus extending the scope of the NFRD.

[vii] Capital expenditure on physical assets for energy and land-use systems. This represents an increase of spending by $3.5 trillion per year from today's level, plus $1 trillion re-allocated capital spending from high to low emission assets.

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