POSITION PAPER #1

ESG – how the Boardroom can structure banks' approach

> *Not everything that can be counted counts, and not everything that counts can be counted.*
>
> **William Bruce Cameron**

In short

- Financial institutions play a vital role in a country's economic development by financing businesses in every sector and providing financial services to consumers. In doing so, they enable job creation, foster innovation and can help build better societies.
- Today, citizens, consumers, employees, and even capital providers expect the corporate world not only to be profitable, but also to have a clear purpose that enables them to create value that benefits shareholders and stakeholders alike. Furthermore, regulators across the world are enacting regulations that will transform how banks and the capital market should assess their risks and deploy capital to support and enable a transition towards greener and more inclusive societies.
- Banks are at the forefront of this movement, and their Boards should carefully enhance the way they consider, integrate, and monitor ESG components in their core business. They should define their strategy, focus on material issues, and monitor how the executive team implements its actions to deliver sound and sustainable performance.
- If risks related to the environment, society and governance (ESG) are becoming more material for financial institutions, those associated with climate change and nature-related risks are crucial. The extraction of natural resources, data, etc., is the fulcrum of most business models. Today, planetary boundaries, science-based targets used to set goals, and the fact that access to a healthy and living planet is becoming a human right and are redefining how businesses in general and banks, in particular, should approach ESG risks to deliver sustainable performance and value.
- Myanmar banks should carefully consider ESG risks, especially those related to climate change, as the country is among the most vulnerable to the consequences of global warming. According to reports published by Germanwatch, more than 7 million people died, and 1.5 billion USD were lost between 2010 and 2019 because of the consequences of climate change in the country. Likewise, building inclusive and respectful workplaces or fostering good corporate governance practices are critical not only to sustaining their own operations but also to mitigating the risks of their financing activities. When financial institutions integrate climate- and nature-related risks into their models, this has a positive impact, as it fosters the rise of a greener economy and enables more resilient societies.

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Why should ESG matter for Myanmar banks?

> **Banks and financial institutions must carefully manage social and environmental risks. Unchecked, they can destroy asset value, limit development, and impact people's lives. Central banks are also starting to incorporate ESG factors into their management. Banks' long-term sustainability depends on their ability to (i) structure their ESG strategies to comply with new regulations while enabling meaningful stakeholder engagement and (ii) integrate ESG into their core operations to assess risks across their value chain, especially in their portfolios.**

Financial institutions and banks enable economic development by financing projects and businesses. However, to sustain their operations, banks must ensure that the businesses and projects they finance are well managed and that their risks are properly identified and mitigated.

If focusing on financial risks makes sense, focusing only on them can itself be risky, and even costly. Numerous examples are now well known and illustrate the magnitude of the financial consequences of a lack of social and environmental risk management: in 2010, BP recorded a 53.8 billion USD pre-tax charge for the Deepwater oil spill in the Gulf of Mexico, while in 2015, Volkswagen's misconduct cost the company 27.4 billion EUR when it manipulated 11 million diesel vehicles to pass emissions tests.

Furthermore, according to the Global Risks Reports published yearly by the World Economic Forum, the most important risk factors are environmental and social. But are they also relevant for Myanmar? What are the costs of this kind of risk for the country?

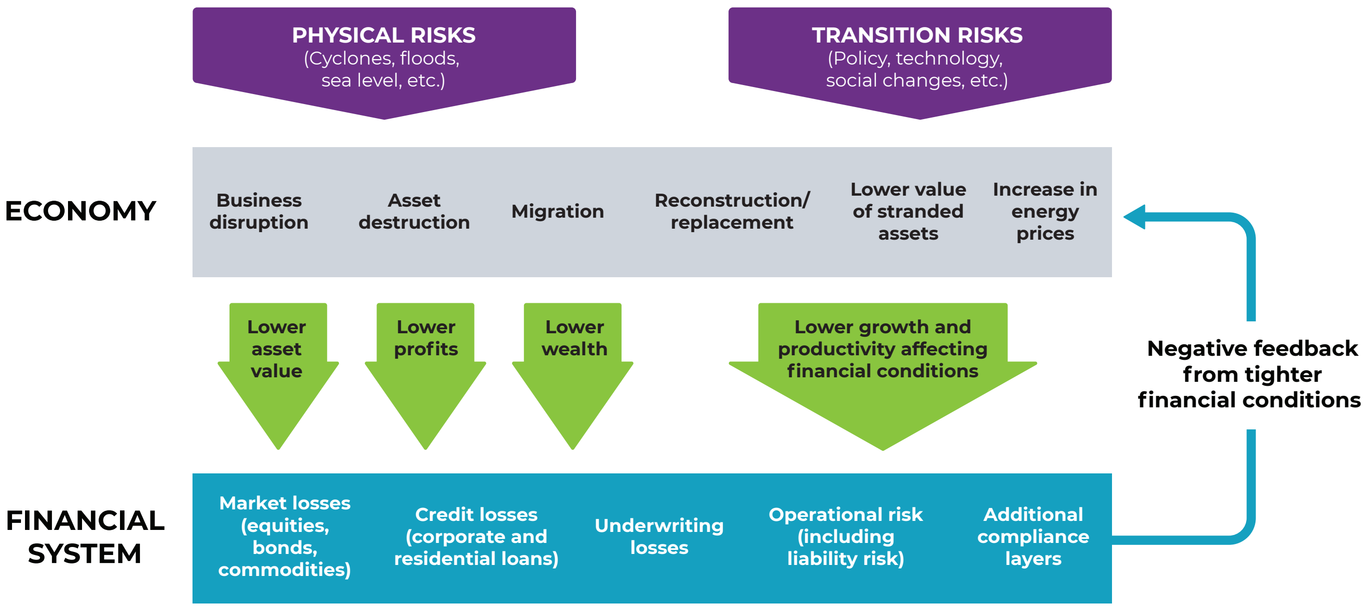
Sound management of social and environmental risks is essential for ensuring sustainable businesses in Myanmar.

- Environmental risks – Germanwatch published a series of reports identifying the countries most affected by the consequences of climate change. Between 2000 and 2019, according to these reports, Myanmar was the second most affected country in the world, just after Puerto Rico. While Cyclone Nargis in 2008 had terrible consequences, the frequency and severity of regular climate change-related events such as exceptional floods, landslides, cyclones, etc. have, over the last twenty years, been enormous and have had a terrible compounding effect: more than 7 million people died, and 1.5 billion USD were lost. But what about tomorrow?

  The Asian Development Bank (ADB) estimates that unchecked, climate change could wipe out 11 per cent of the region's GDP by the end of the century, as it will generate and reinforce two types of risks, as shown in the graphic below:

  - *Physical risks* arising from property damage such as damage to land and infrastructure from catastrophic weather events. For example, Climate Central provides various datasets and tools that reveal the areas threatened by sea-level rise and coastal flooding: this can help assess the vulnerability and fragility of various projects over time.

- *Transition risks* that result from changes in the price of products and services, and economic disruption as the result of evolving climate policy and climate events. For example, the IMF estimates that, to reduce carbon emissions to a level consistent with a 2°C target, the price of each tonne of carbon dioxide should be 75 USD, which would affect the return on investment of projects and the value of assets. Reducing carbon emissions and combating deforestation are two areas that are essential to safeguarding Myanmar's future, and Myanmar banks can play a key role in these.



Adapted from IMF, *The economics of climate*, December 2019

- *Social risks* – Unequal opportunities between men and women, for example, negatively impact the economy and the development of society. A report published by the World Bank in 2018 estimates that wealth could increase by 14% if gender equality in earnings were achieved. In Myanmar, the Business Coalition for Gender Equality aims to help organisations structure their approach to gender equality and inclusivity in order to build better workplaces. Two banks were among its founding businesses: AYA Bank and KBZ Bank. Likewise, financiers can enable adverse consequences for people, such as human trafficking, if they do not carefully assess the impacts of the projects they finance.

Developing a meaningful ESG strategy can help banks manage one of the most critical assets: their stakeholders' trust. Defining a clear purpose helps to retain talents, attract new customers, and foster collaborative innovation in which stakeholders are seen as allies and not just resources. Stakeholder engagement is critical to identifying the most material topics for the sustainability of financial institutions and society's prosperity. Banks should prioritise projects and organisations aiming to develop activities that create social, economic and environmental value.

Finally, governments and regulators are issuing ESG-related policies to guide companies, especially those in the financial sector. One example of a supportive, authoritative body is the Monetary Authority of Singapore, which supported green bond issuance and the Green & Sustainability-Linked Loan Grant Scheme (GSLS) in 2020. The ASEAN Capital Markets Forum (ACMF) has set up a dedicated working group to foster sustainable finance in the region; it has published several guidelines and toolkits:

- The ASEAN taxonomy aims to offer capital providers a credible classification system to identify and support sustainable activities in the region;
- The working group has also published specific guidance to promote and encourage a new sustainable asset class in ASEAN.

Another example of climate-related and environmental risks is the European Central Bank's (ECB) issuing of a climate risk stress test for significant institutions in 2022 to be carried out annually.

However, financial institutions need to ensure that their management practices are solid. Indeed, regulators are now monitoring more closely how asset managers engage with investors on green finance. In 2021, German and US authorities started an investigation into DWS, a German asset manager, after receiving allegations from a whistleblower that DWS was misrepresenting how it used ESG metrics to analyse companies' performance.

How can Boards act to integrate ESG?

The Board is ultimately responsible for ensuring that the company's business model is future-proof and sustainable. As discussed previously, sound management of ESG factors is essential to mitigating risks and safeguarding the value of assets.

To integrate ESG into banks' operations and activities, the WWF has identified six pillars. To assess the current maturity of Myanmar banks for each, we used the data collected by Yever, a Myanmar consultancy, based on the information publicly disclosed by the banks as of December 2021. The results are detailed in the table below.

#	Pillars	Data
1	Purpose	▪ 70% of the banks surveyed state their mission clearly. ▪ However, only 10% of bank Boards have reviewed the mission statement during the last 5 years, and only 13% disclose their goals.
2	Policies	▪ Only 17% of banks explain the role and responsibilities of their Board. ▪ 10% of banks have a diversity policy describing its scope and monitoring system. ▪ 10% of banks include ESG factors when they screen customers and projects.
3	Process	▪ Only 20% of banks disclose how they manage their risks, and only 3% consider environmental, social or governance issues as potential risks. ▪ 7% of banks detail their approach to sustainability and ESG.
4	People	▪ 10% of banks disclose sufficient information about the training of their staff. ▪ 10% of banks disclose sufficient data on diversity and inclusion. ▪ No banks have an expert sitting on their Board with ESG/sustainability expertise.
5	Products	▪ Only 7% of banks disclose information regarding the impact of their products on ESG components: for instance, loans provided to microfinance institutions, SMEs, etc.
6	Portfolio	▪ No banks have set a target to have, for instance, a carbon-neutral portfolio. Likewise, little information is provided on banks' portfolios.

Myanmar banks do not seem to prioritise ESG components for the time being. However, enhancing their performance on these topics is crucial for their sustainability and ensuring the continuity of their operations.

The very first step for Myanmar banks is ensuring that they have qualified Board members. For example, they can work with the Myanmar Institute of Directors, which organizes regular training sessions to develop the skills and expertise of Board members, with an occasional specific focus on banks. This will help them develop their capabilities and benefit from MIoD's support and expertise.

As part of their evaluation process, Board members should consider the following questions to structure the Board's approach to sustainability/ESG:

Pillar	Questions to ask	Actions to consider
Purpose	Can we articulate simply why our company exists and how we create value?	▪ Help to formulate the company's purpose (or its mission and vision) ▪ Consider the materiality and meaningfulness of corporate values and culture
	What are we doing to ensure that our purpose and approach to sustainability are supported by everyone inside the company and by our stakeholders?	▪ Engage with your stakeholders, including investors and owners: the purpose of your company should be part of the discussion with them ▪ Oversee how purpose is communicated across the organisation, and be part of the conversation
Strategy	Do we have a sustainability strategy?	▪ After defining the purpose, develop a strategy for the bank to prioritise its efforts on ESG for its own operations and for all the projects it enables financially.

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Policies	How bold are we with sustainability? Could we be held responsible for not considering it?	▪ Embrace the [Principles for Responsible Banking] and join UNEP-FI ▪ Commit to considering ESG factors when making any decision ▪ Add a point to the agenda dedicated to sustainability
	Do we have a Board committee responsible for sustainability?	▪ Establish a Committee, or ▪ Refine the current roles and responsibilities of the Board and its committees
	What are the policies on ESG risks developed by the company?	▪ Review ESG policies, and ensure that they are based on appropriate standards ▪ Ensure that the policies are aligned and coherent with the company's purpose and conducive to delivering its strategy and creating long-term value responsibly
Process	Do we receive sufficient material information to assess the risks from ESG trends?	▪ Review the materiality, quality and frequency of non-financial data and reports ▪ Ensure the comparability of the information provided with relevant standards and frameworks
	How well do we consider ESG risks?	▪ Ensure that ESG factors are integrated into the risk management framework ▪ Ask your auditor to cover ESG information as well
	Do we have a common under-standing of our stakeholders' expectations andhow we meet them when creating value?	▪ Oversee how the different functions of the organisation manage the relationships with their main stakeholders ▪ Ensure that the company's stakeholders are identified ▪ Review and approve the Stakeholder Engagement policy and ensure that grievance mechanisms are well defined and implemented
	Which sustainability standards do we use, and how confident are we that our information is relevant, reliable, and accurate?	▪ Review the materiality analysis conducted by the Management ▪ Ensure that the non-financial reporting system can be audited by a third-party ▪ Task the internal audit to assess the soundness of your management system

People	Who has sustainability competence on the Board?	▪ Identify at least one Director with relevant skills to support the Board on sustainability, and hold the Management accountable on this topic ▪ Train the Board and top management in ESG ▪ Appoint a Board Member with sustainability expertise
	Do we have a clear message regarding how our strategy is aligned with sustainability risks and opportunities?	▪ Define a communication strategy based on the stakeholders' needs ▪ Prioritise meaningful and useful disclosure: less can be more, especially in building trusting relationships
	How do we reward performance related to ESG factors?	▪ Develop a remuneration scheme for the Management which embrace financial and ESG components
Products	How well do we use ESG criteria to understand and screen our clients' projects?	▪ Review and optimise your KYC process ▪ Use the National Green Finance Guideline ▪ Develop new loans to foster the transition towards more carbon-efficient products and solutions
Portfolio	Is the bank's portfolio aligned with the targets to maintain climate change below 2°C?	▪ Consider using the guidelines from the Science-Based Targets Initiative for the financial sector and the Task Force on Climate-related Financial Disclosures to explain how the Bank is contributing to delivering a sustainable world through its financing activities

Tools

- ASEAN Corporate Governance Scorecard
- ASEAN Green Taxonomy
- Coastal Risk Screening Tool
- Fair Finance Methodology
- IFC - FIRST
- Taskforce on Nature-related Financial Disclosures
- IFC Toolkit for disclosure
- Science Based Targets Initiative
- SUSBA
- Task Force on Climate-related Financial Disclosures
- Workplace Gender Equality Agency

Resources

- ASEAN, Sustainable Finance.
- Catalyst, Why Diversity and Inclusion Matter, 2020
- FT, Climate capital series.
- Germanwatch, Global Climate Risk Index, 2021
- IFC, Myanmar Corporate Governance Scorecard, 2019
- IMF, The Economics of Climate, 2019
- MCRB and Yever, Pwint Thit Sa report, 2020
- World Bank, Unrealised potential: the high cost of gender inequality, 2018
- World Economic Forum, Global Risks Report, 2022
- WWF, Reports focused on the banking sector in the ASEAN region.
- WWF, Seeing the forest for the trees - a practical guide for financial institutions to take action against deforestation and conversion risks, 2022
- Bain & Company, Temasek and Microsoft, Southeast Asia's Green Economy 2022 Report