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A LOOK AT ESG POLICIES FROM AN AML PERSPECTIVE

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With the wind-down of events in Glasgow last week, governments around the world re-stated commitments to target net-zero global emissions by 2050. As representatives of their citizens at the United Nations' 26th Climate Change Conference of the Parties (COP26), governments have acknowledged the want of their peoples: climate action must be made a priority.

Investors make up an influential portion of a nation's citizenry. This affluent population has also expressed concerns about the threats posed by climate change to the global economy. Where, at one time, many investors wouldn't think twice about investing in a high-performing resource stock, they are increasingly evaluating the sustainability of the products in which they invest.

Whether governments are being spurned into action by the cries of the people or by the loud shuffle of investment dollars being withdrawn from companies with vague or poor environmental, social and governance (ESG) records, a renewed focus on sustainable investment is on its way.

Certainly socially responsible investment (SRI) is not a new concept, but in recent years there's been a particular focus on ESG investments[1]:

> *The pressure to make positive changes to the way businesses operate is not just coming from COP26. Consumers and supply chain partners are increasingly demanding better sustainability from the companies with whom they engage. Institutions now regularly evaluate businesses against [ESG] performance criteria before making investment decisions.*

Seeing investing as more than just a profitable undertaking, an increasing number of investors are signalling their approval (or disapproval) of companies and industries with their investment dollars. But where do investors even begin to find, let alone evaluate, ESG factors related to organisations in which they wish to invest?

SEEING INVESTING AS MORE THAN JUST A PROFITABLE UNDERTAKING, AN INCREASING NUMBER OF INVESTORS ARE SIGNALLING THEIR APPROVAL (OR DISAPPROVAL) OF COMPANIES AND INDUSTRIES WITH THEIR INVESTMENT DOLLARS.

Companies, thirsty for new investors, will publish annual reports and other slick public relations (PR) collateral wherein they purport to have strong ESG commitments. But how can an investor really evaluate a company's ESG performance under these conditions? Can these craftily-worded claims be trusted?

There's no convenient repository where measurement of ESG performance is quantified. When investors look at the Nasdaq Composite or the Dow Jones Industrial Average, there's no metrics there to indicate how responsible, well-managed or sustainable a company is. There are no indices signifying an organisation's track record on environmental or social practices.

While perhaps these stock market indexes are not the place for such information to be readily accessible, in the lead up to COP26, the World Economic Forum (WEF) acknowledged that[2]

> *confusion and fragmentation have grown on how to evaluate ESG policies, how to compare them and even what constitutes a sustainable investment in the first place.*

Thus, the WEF suggests that governments develop and specify reliable ESG reporting standards for companies and banks so they can measure, report and set targets on ESG goals. There do appear to be governing bodies already attempting to track ESG factors and make companies – including financial institutions – accountable. Introduced in November 2019, the European Union (EU) Regulation 2019/2088[3]

> *aims to reduce information asymmetries in principal-agent relationships with regard to the integration of sustainability risks, the consideration of adverse sustainability impacts, the promotion of environmental or social characteristics, and sustainable investment, by requiring financial market participants and financial advisers to make pre-contractual and ongoing disclosures to end investors when they act as agents of those end investors*[.]

Reporting entities in the EU have had to comply with this regulation since March 10th 2021.

Meanwhile, the United States (US) Securities and Exchange Commission (SEC) chair, Gary Gensler, has[4]

> *asked SEC staff to develop a mandatory climate risk disclosure rule proposal for the Commission's consideration by the end of* [2021].

Gensler says he expects climate risk disclosures to be consistent and comparable so investors can evaluate companies against each other.

And so, if investors are looking to educate themselves on a company's ESG stance before they invest, there may soon be more sources with reliable data from which to draw their information. The trick, so far, has been to find these reliable sources.

INVESTORS CONCERNED ABOUT ESG PERFORMANCE WILL BE ATTENTIVE TO THE POLICIES AND PRACTICES OF THE FINANCIAL INSTITUTIONS WITH WHICH THEY DEAL.

Investors concerned about ESG performance will also be attentive to the policies and practices of the financial institutions with which they deal. To date, financial institutions that offer "green investments" have attracted many morally-sensitive investors. But these investors may take umbrage if they find out that the same banks offering green investment products are the primary lenders to some of the world's most polluting companies. Thus, this growing interest in ESG investments will have significant impact on financial institutions in more ways than one.

From this vantage point, banks may see themselves as being in a precarious spot. On one side, they are uniquely positioned to monitor and capitalise on investment trends. On the other side, banks that finance companies that greenwash their business practices, may be looking at higher incidents of client risk, reputational risk and regulatory risk. As one KPMG asset manager observes, "[i]nvestor demand remains the key driver of change, worldwide, but regulators are catching up[5]." In this instance at least, investor demand and government regulation are starting to come into alignment. Still, new regulatory demands will require an uncomfortable shift from business as usual.

While regulators gain a firmer understanding of risks associated with poor ESG performance to the global financial system, they will expect that financial institutions also be aware of and mitigate these risks within their own organisations[6].

The already vast expectations of financial regulators will likely continue to expand well beyond the new reporting requirements from the EU and the SEC. For instance, COP26 finance goals are pressuring "[b]anks, insurers, investors and other financial firms [...] to commit to ensuring their investments and lending is aligned with net zero[7]." Financial institutions are being required to factor ESG considerations into their organisational practices one way or the other. But where to begin?

A change in perspective may be an appropriate starting point. Financial institutions already have practices and procedures to integrate or strengthen ESG considerations. For instance, concerns related to ESG criteria are already examined by the anti-money laundering (AML) compliance side of the business. Though their aim is to identify and interrupt illicit financial flows, financial crime compliance professionals are required to flag suspicious transactions related to environmental crime, social issues and weak governance.

ENVIRONMENTAL CRIME

Exploiting confusion and ignorance, companies with poor ESG standards may seek legally questionable, hazardous waste disposal channels. Businesses linked to criminal networks can sustain illegal supply chains in exotic forestry and wildlife by-products and commingle them with legally obtained items[8]. AML compliance professionals may be able to spot transactions related to these practices and alert the authorities. After suspicious transactions are flagged, regulators will expect that these clients be subjected to enhanced due diligence protocols. But it will not look good to investors if the financial institution continues to finance companies with poor environmental practices over the long haul.

SOCIAL ISSUES

The conditions that make it possible for human trafficking to exist and thrive involve trafficker greed, victim desperation and victim shame. Poverty, food insecurity and joblessness can all be factors that lead to victims being exploited. Traffickers who amass wealth at the expense of others may attempt to use the financial system to launder the proceeds. With proper training, bank staff can employ financial metrics and data to link victims, their captors and financial institutions. These links can form key components of a law enforcement investigation and the recovery of exploited victims.

> ON ONE SIDE, BANKS ARE UNIQUELY POSITIONED TO MONITOR AND CAPITALISE ON INVESTMENT TRENDS. ON THE OTHER SIDE, THOSE THAT FINANCE COMPANIES THAT GREENWASH THEIR BUSINESS PRACTICES, MAY BE LOOKING AT HIGHER INCIDENTS OF CLIENT RISK, REPUTATIONAL RISK AND REGULATORY RISK.

Regulators will expect that a financial institution has trained compliance analysts to spot the red flags and interrupt this cycle so that the illicit funds do not make their way through the global financial system. Investors will want assurances that their investments aren't inadvertently supporting human trafficking networks.

WEAK GOVERNANCE

Corruption's vast social and political impact can make it seem like an insurmountable problem to tackle. However, since much to do with corruption is associated with financial gain, looking at corruption as it relates to financial crime may be the best way to detect and convict perpetrators. It is under these circumstances that know your customer (KYC) protocols are particularly useful to gain a clear picture of those individuals and organisations that obfuscate the origins of the funds they are looking to place into the financial system.

A financial institution's inability to maintain anti-corruption defences can lead to regulatory failures and even criminal prosecution. Socially-responsible investors will be quick to extricate themselves from banks unable or unwilling to address corruption scandals.

ESG AND TONE FROM THE TOP

If the sentiments expressed at COP26 last week are accurate indicators, in the near future financial institutions will be required to adhere to ESG reporting standards that measure, report and set targets on ESG goals. However, there are practical steps they can take starting with the G in ESG. Senior management sets the tone for a financial institution's corporate culture. A reluctant or lax attitude towards regulatory demands sets a permissive tone at the top and can lead to under-reporting of suspicious transactions or wilful blindness of bad behaviour on the part of clients. Should the financial institution be embroiled in a financial-crime scandal, the regulator will ask if senior managers had implemented appropriate AML policies and procedures[9]. In other words, the regulator will be asking if the bank's leaders were following good governance practices.

Offering employee training on environmental, social and governance concerns, beyond just the mandatory AML fundamentals, will not only address regulator concerns but can also show investors that their priorities are top of mind.

Caught between investors and regulators, going forward financial institutions will have little choice but to up their own ESG performance. Adapting regulatory compliance requirements and disseminating these considerations across the entire organisation can only have positive long-term ESG outcomes and will signal to investors and regulators that they are being heard.

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[1] https://www.sgs.com/en/news/2021/11/cop26-meeting-cop26-finance-goals-with-sgs-esg-certified
[2] https://www.weforum.org/agenda/2021/10/as-the-world-gathers-for-cop26-here-s-how-leaders-can-dispel-esg-confusion-ac418a72bc/
[3] https://eur-lex.europa.eu/eli/reg/2019/2088/oj
[4] https://www.sec.gov/news/speech/gensler-pri-2021-07-28
[5] https://home.kpmg/xx/en/home/insights/2020/11/more-regulators-pick-up-the-esg-baton.html
[6] https://www.refinitiv.com/perspectives/regulation-risk-compliance/regulators-focus-on-esg-criteria-in-the-fight-against-financial-crime/
[7] https://ukcop26.org/cop26-goals/finance/
[8] https://www.moneylaunderingnews.com/2021/10/esg-aml-compliance-and-the-convergence-of-social-concerns/
[9] Ibid.