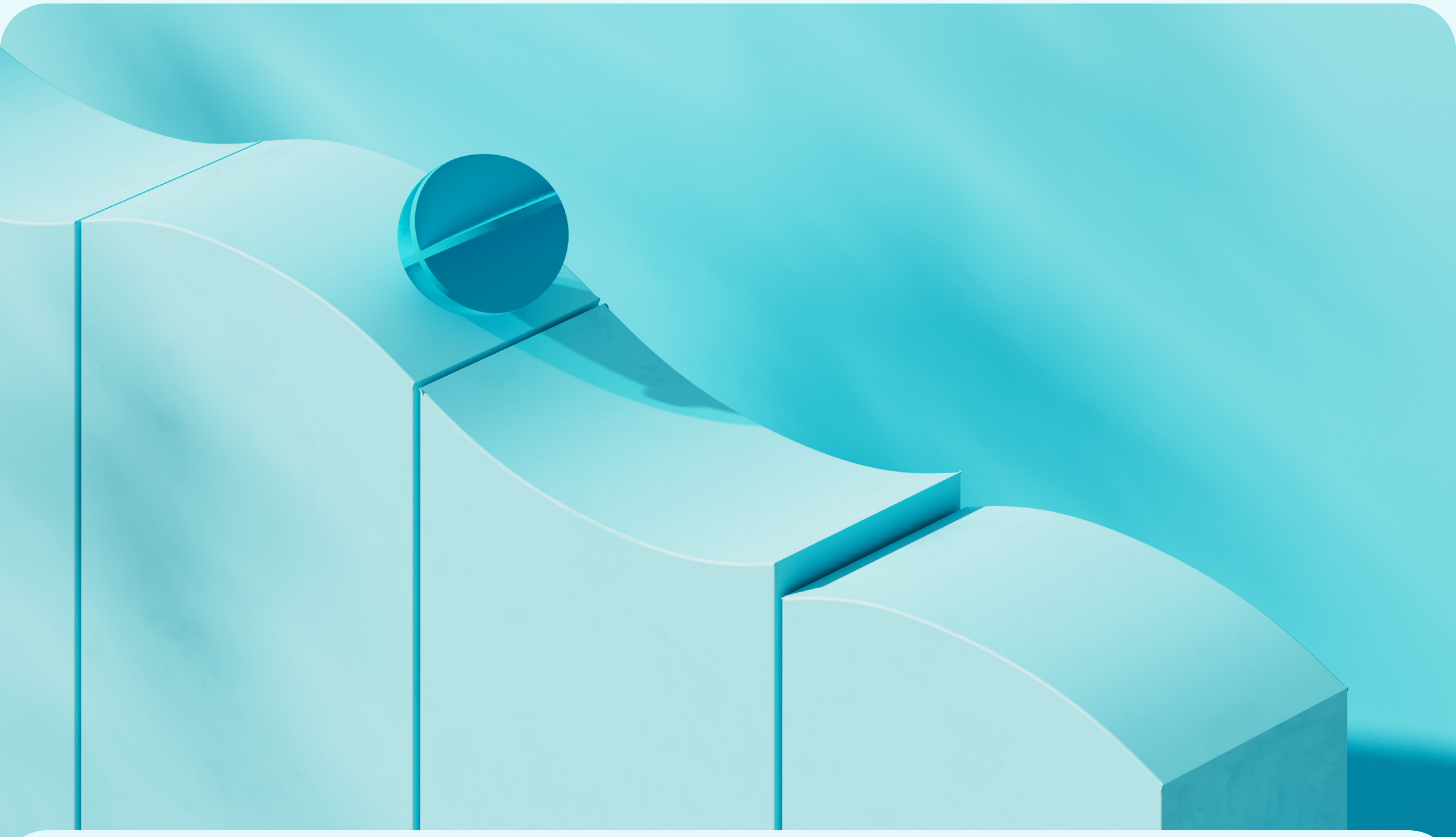


E-BOOK

Environment, social and governance.

A comprehensive practical guide to incorporating environmental, social and governance best practice into your enterprise risk management framework

PROTECHT

Contents

Introduction.

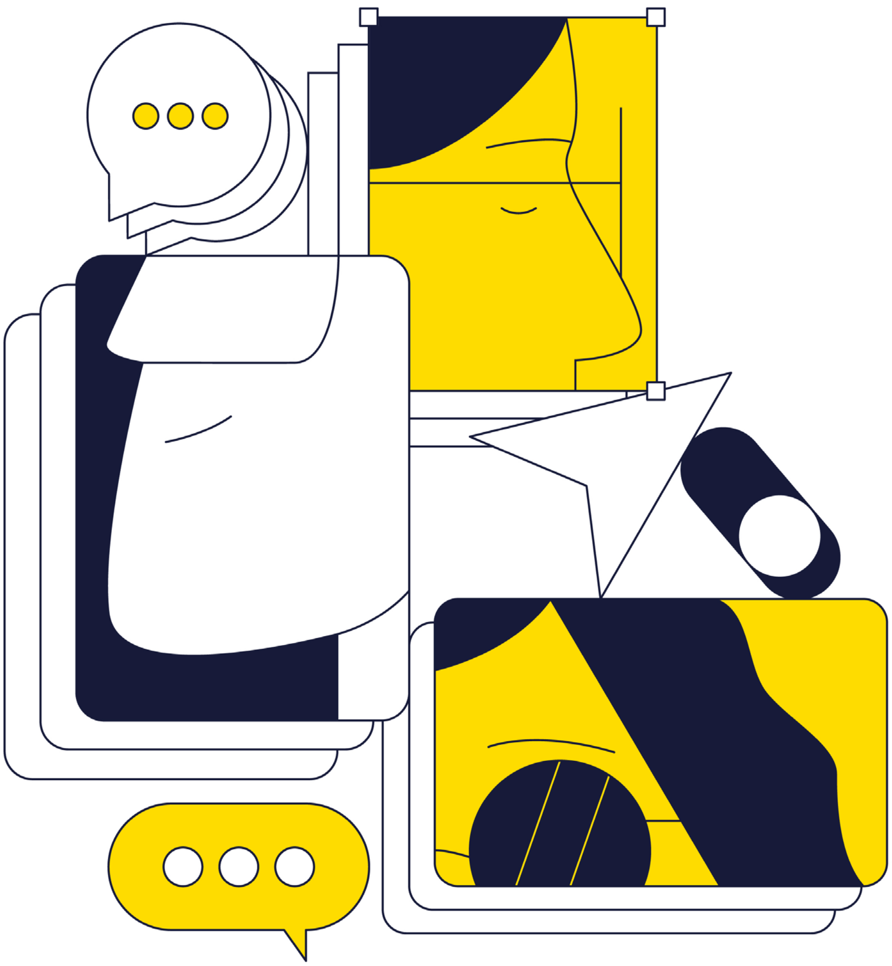
Environment, Social and Governance – ESG – is being talked about everywhere. It is the latest key focus for management, especially for risk management. But is it something new, or should it just be part and parcel of a mature enterprise risk management capability?

What is clear, whether you are a director, an investor, an employee, a supplier, a consumer or of course a risk manager, is that ESG has important implications for you and every other stakeholder.

This eBook is aimed at deciphering ESG and providing a practical framework for its management as an integral part of your existing risk management framework.

The eBook covers:

1. What is ESG?
2. Drivers of ESG
3. ESG risk
4. Analyzing and understanding ESG with Risk Bow Tie Analysis
5. ESG reporting
6. Fitting ESG into your ERM framework
7. Where to next?



01

What is ESG?

ESG stands for Environment, Social and Governance. Collectively they represent overarching themes that organizations must consider when delivering their services or products.

As we enter an age of stakeholder capitalizm, it's not enough just to be aware of them or consider them a 'nice to do'. Increasingly, pressure from investors and the public create both opportunities for creating value, as well as potential for poor performance and stakeholder backlash if not handled well.
Let's look at each in turn.

1.1 Environment.

Environment can be broadly considered as how we interact with, and impact, the planet. This is the most tangible and directly observable of the three letters. This may include the effects of pollution, emissions, and more broadly the effects on biodiversity. There is an increasing expectation for organizations to be responsible stewards of our natural resources. This has led to organizations to look at their practices and reduce reliance on non-renewable resources, move to recyclable or sustainable products, and reduce emissions.

Organizations must consider not only the impact they have on the environment when they create or deliver their products and services, but also need to consider how changes in the environment might impact or disrupt them. Changing climate conditions might make productive land arid. The decline of natural pollinators may impact on food production and supply chains. Facilities on coastlines may need to be relocated due to rising sea levels or erosion. Property insurers need to assess the changing nature of flood, bushfire and other climate-related risk in the regions that they operate.

1.2 Social.

Social can be broadly considered as how we interact with and impact upon people. Social expectations consider the collective behaviors we expect to ensure people are treated fairly, equitably and with dignity.

These social expectations are changing at an increasing pace, and can evolve into a social license

to operate. This includes issues related to human rights, minimum working conditions, community engagement, and diversity. In some cases, these expectations become enshrined in law.

There is a growing expectation for organizations to take an interest in, or state their position on, social issues not directly related to financial performance. Social issues are less tangible, can evolve quickly and are less predictable. The nature of the internet and the ability for topics to go viral can create swift expectations for companies to adapt to. What is acceptable today may not be acceptable tomorrow.

Organizations must consider the needs and expectations of all of their stakeholders across the extended enterprise, which can include complex supply chains and stakeholder interest groups. It's not enough to treat your employees well; a number of countries and jurisdictions have implemented modern slavery laws to hold organizations to account for assessing whether slave labor may exist in their supply chains.

1.3 Governance.

Governance considers how organizations are run and how their resources are directed in pursuit of their purpose and value creation. It considers accountability for how decisions are made ethically and align with that purpose. Issues of governance can include board diversity, how boards and executives are remunerated and being transparent and open with stakeholders.

Also included within governance are the factors that might unduly influence decision making. These include issues of conflicts of interest and independence, whether there is an appropriate mix of skills and experience in board and executive positions, and unethical or deceptive practices such as price fixing.

Governance also considers complying with legislation and adhering to principles of good conduct. Consider the findings of Australia's Financial Services Royal Commission1 , where the

CEO of a major bank was questioned about the dubious value to consumers of one of their products. His response? "Temper your sense of justice".

1.4 Bringing them together.

While the 3-letter acronym implies separation, E,S & G are considered collectively because they are interwoven not just with each other, but with all aspects of an organization:

- Good governance drives policies and resource allocation to address social and environmental issues.
- Failure to manage your impact on the environment might result in loss of customer, reputation, brand and shareholder value, and so on.
- While they may not be as directly obvious, failures of governance can have flow on, indirect effects. For example, a board and executive team that has limited diversity is much less likely to be considerate of the range of social issues that can affect their stakeholders.

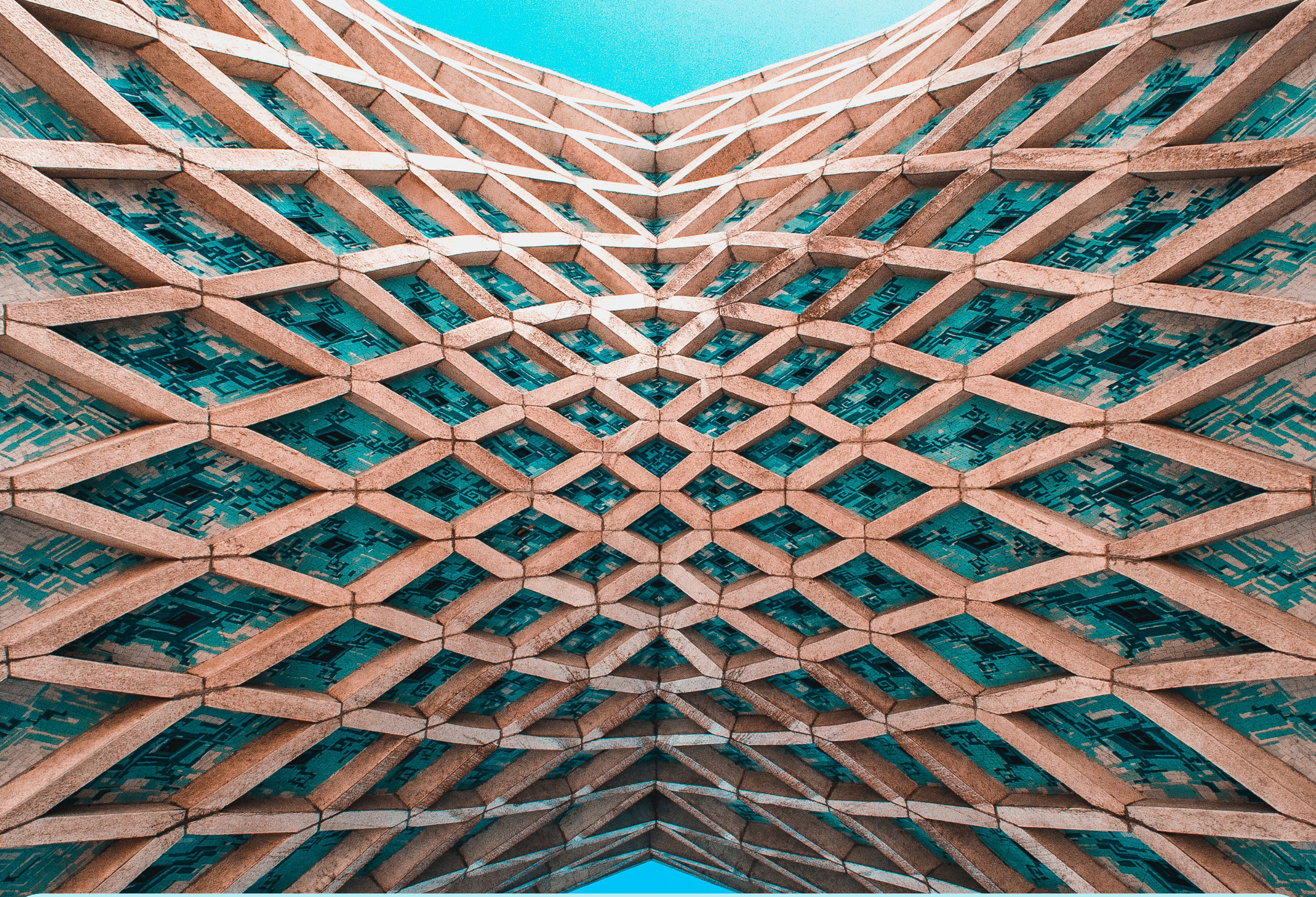
At a wider level, environment and social are stakeholders we need to consider but so are employees, customers, shareholders etc. Let's consider them all as part of our overall stakeholder management.
Your environment and social objectives should be considered together with all of the objectives of the organization, not separately. The same goes for your environmental and social risks: consider them as part of your overall suite of risks and an integral part of your ERM framework.

1 1 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, February 2019.

With the use of yet another acronym we run the risk of ESG being the latest trend. It should not be a trend but a permanent long-term focus of any organization. Over the years we have seen, to name but a few:

CSR – Corporate Social Responsibility
HSE – Health Safety and Environment
EHS – Environmental Health and Safety

The extraction of E and S from these adds no specific value other than potential confusion, other than perhaps to raise the profile of E and S. This may help raise the practices, standards and regulations around these two areas, and that can only be a good thing.[1]



02

Drivers of ESG. Why are we talking about it?

ESG is not a new concept. Most organizations have had these three elements on their radars for years, admittedly some more than others! However, ESG-related awareness and pressures are increasing, at least in part due to the following factors:

- Investors consider a strong ESG strategy as an indicator for sustainable performance, which has in turn created an ESG reporting economy
- Individuals are choosing the organizations they spend money with based on their ethical practices and position on ESG-related matters. Price and quality are important, but value alignment informs consumer choice
- Employees are becoming more selective in working for organizations that align with their personal values, including on environmental and social issues
- Increased awareness of climate change in the public eye, made tangible by the increasing frequency of more extreme weather events in recent years
- Organizations further up the ESG maturity scale are reviewing the ESG credentials of their third parties, creating pressure to follow their lead
- The speed and reach of communication driven by the internet and social media platforms mean that low-key or dormant issues can quickly become high profile, particularly on social issues. Consider the #MeToo movement and the public response to the death of George Floyd. This can be driven by the 'halo effect', where influencers make a statement to a trusted or captive audience that go viral
- Increased transparency into how organizations operate, reducing the ability for poor corporate practices to be overlooked and organizations (and their decision makers) being held to account
- Children are becoming more aware of the planet they live on and the social factors that affect them. Our children care about litter, child labor and social injustice

All these trends are supported by a huge increase in ESG related regulatory developments. A range of reporting standards on ESG-related matters have been introduced across the globe, and in some cases as a regulatory requirement in some jurisdictions and sectors. Even if they aren't regulated, the rise of stakeholder capitalism and interest from investors and other stakeholders means that voluntary reporting can still create value.

Evolving stakeholder expectations in relation to consultation and participation, protection of people and planet, and transparency and disclosure, are likely to continue the emerging emphasis on best practice rather than lawfulness.

03

ESG risk.

Enterprise Risk Management (ERM) considers and manages how uncertainty affects the achievement of organizational objectives. For ESG, this manifests in two primary ways:

- Where your organization has defined specific ESG objectives
- The effect that ESG factors have on your other objectives

For the first, ESG risks are any operational, financial or strategic risks you face which could lead to an impact on any of your ESG related objectives. ESG risk and risk management then naturally becomes an integral part of your ERM framework.

For the second, ESG becomes causes or drivers of many of your other risks. Again, ESG becomes an integral part of your overall ERM framework.

To identify the ESG related aspects of your risk universe, you need to first consider your ESG objectives back to the risks, and secondly from your ESG-related causes forwards to the risks.

3.1 Identifying ESG risks from objectives.

The first step is to identify your stakeholders that have an interest in and/or are affected by ESG. Consider what each stakeholders objectives are through an environmental, social and governance lens.

From an environmental perspective, what do end consumers expect from how your products and services are sourced or delivered? If you are a supplier, what standards of ethical sourcing will your customers expect if they deal with you? Are there other special interest groups, such as native land title holders? If you produce waste, where does it go and who might be impacted? Are there environmental regulators with specific requirements regarding your operations?

From a social perspective, what are the values of your employees? How do they expect to be treated, and what is the environment they want to work

in? If there are consumer advocate groups in your industry, what issues are they focused on? Who are your third parties and what are their values?

From a governance perspective, directors and executives need to ensure there are systems and processes in place to drive stakeholder engagement, ensure that their needs are understood, and integrated into decision making. A typical list of stakeholder groups, together with their ESG focus, might read as follows:

STAKEHOLDER GROUP	ESG OBJECTIVES
Environment	Enhance and protect the environment
Society	Enhance and protect society and social values
Customers	Interest in the E and S practices of suppliers they buy from
Employees	Interest in the E, S and G practices of the employer they work for
Suppliers and third parties	Interest in the E and S practices of the organizations they supply and associate with and the risk of contagion.
Regulators	Compliance with ESG related regulations
Shareholders	Impact on shareholder wealth through mismanagement of E, S and G related matters.

The second step is to identify the specific objectives that are ESG related. These may include such things as:

- To enhance and protect the environment
- To enhance and protect society and social values
- To satisfy customers in relation to their ESG values
- To have a satisfied and motivated workforce in relation to their ESG values.
- To comply with ESG-related regulations and reporting requirements

Risks are then identified that could impact these objectives. These risks will cover a wide range of financial, operational and strategic risks across the business. These risks, due to their ability to impact ESG related objectives, are ESG risks.

3.2 Identifying ESG risks from causes.

The ultimate cause of all risks is commonly considered to be at least one of the following:

- People
- Process
- Systems
- External events

Social "S" risks exist within the "People" category. Environment "E" risks can arise from within the "External Events" category and Governance "G" risks would be included within the "Process" category.

These causes can then lead to a wide range of risk events which then lead to potential impact on every objective. Those risks driven by ESG-related causes can then also be considered ESG risks.

This leads to the natural conclusion that the concept of ESG risks is spurious. ESG is a component of many of our overall risks and should be considered as an integral part of ERM, not as a standalone concept.

3.3 Balancing stakeholder priorities with ESG objectives.

To allocate resources to achieving your ESG objectives and managing the risks that have an ESG component, you need to balance the needs of your stakeholders. That includes an assessment of:

- Your stated organizational purpose, strategy and objectives
- The nature of your operations and the products or services you provide
- The needs and values of each stakeholder group
- The potential conflicts or synergies between those groups, including sub-groups
- The relative size and influence of those stakeholders
- The context you operate in, including location and regulatory requirements

It's not just the intersection of these factors that will drive your approach to managing ESG-related objectives, but also how you anticipate and respond to changes over time.

Consider a hypothetical provider of consumer goods whose age demographics of their consumer is trending downwards to younger generations. Simultaneously those younger generations may increasingly demand more transparency about where those goods are produced and the local working conditions. Failure to adapt to these changing trends might not only lead to lost revenue, but also reputational impacts.

What do you want to stand for? Which ESG-related objectives do you want to pursue? Where will you create the most value for your communities? Understanding and prioritizing the different expectations of your stakeholders will require a careful balance.

Risk appetite and ESG.

If your existing risk appetite statement doesn't already do so, consider including ESG related statements. Ideally these should be supported by measurable tolerances. This makes it clear to decision makers and employees on the types of risks they are encouraged to take in pursuit of objectives (ESG related or otherwise).

04

Analyzing and understanding ESG with risk bow tie analysis.

At Protecht we recommend the risk bow tie methodology to visualize how risks unfold, including understanding the different causes and eventual impacts on your stated objectives. Let's use a case study of a transport company that currently has a fleet of combustion vehicles, with warehouses across its country of operation. As part of strategic planning, the executive team define an environmental objective, identify critical success factors to achieve it, and identify risks that may affect those critical success factors.

Objective: Reduce long term carbon dioxide emissions (with a measurable timeframe and target).

They define the following critical success factors to achieve their objective:

- Replace combustion fleet vehicles with electric vehicles.
- Install solar panels on all warehouses.
- Install energy management software

For each of those they define the risks that will prevent this from being achieved. For replacing the fleet, one of the risks defined is that the full fleet will not be replaced within the timeframe. If the fleet is not replaced in full or early enough, the emissions targets will not be met, contributing to ongoing impact to the environment.

As we breakdown the causes and impacts of the risk, the visualization highlights the concept of ESG components being both causes and impacts. This is often called "double materiality". This means not only understanding which environmental and social factors will have a material effect on the organization's performance, but also how the organization has environmental and social impact on wider stakeholders.

While there are environmental impacts if we don't achieve the objective (we don't reduce emissions as expected), the effects of climate change on the natural environment might also cause disruption to the supply chain, reducing the likelihood we can achieve our objective.

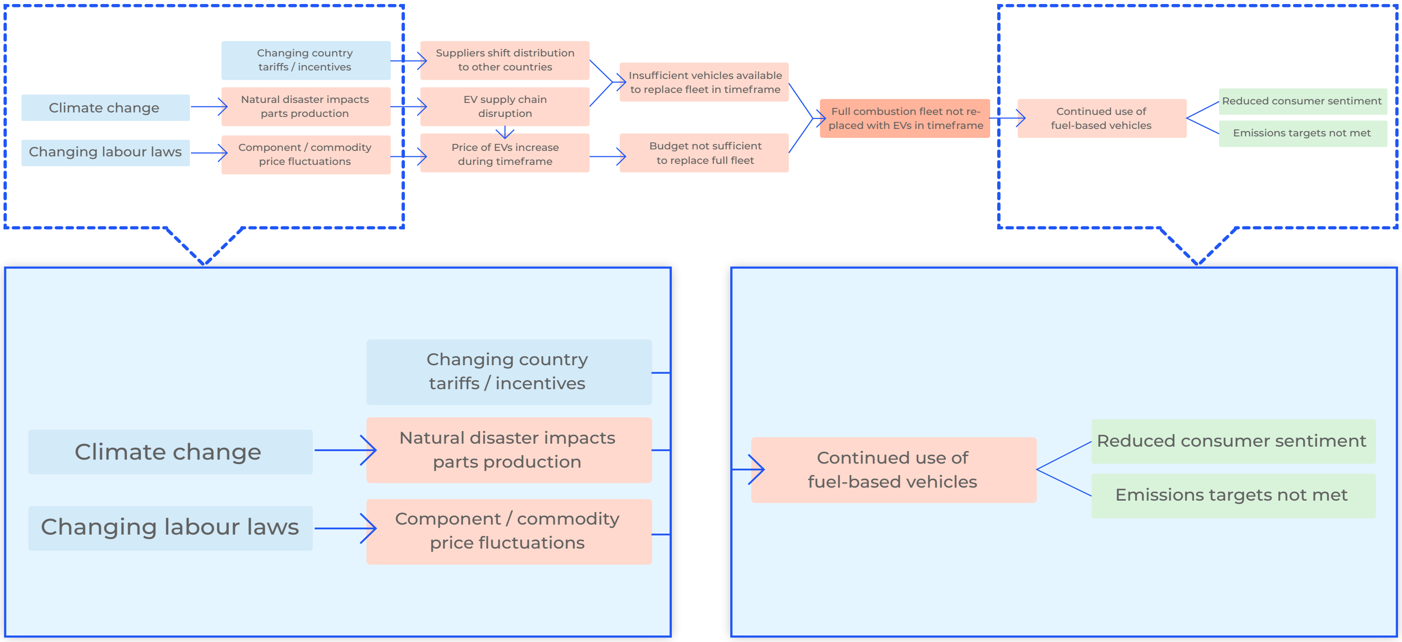


Figure 1: Environmental risk bow tie analysis in Protecht.ERM

The livestock industry also provides a visceral example of 'double materiality' in relation to climate change. Changes to the environment, such as increased drought, flooding and other extremes, have a material impact on the industry's ability to produce milk and other goods. Concurrently, livestock produce methane gas and contribute to global warming. Not only do they need to take action to withstand potential shocks driven by climate change, they are also taking action to reduce their own impact on the environment, such as promising studies where introducing seaweed diets reduces livestock emissions.

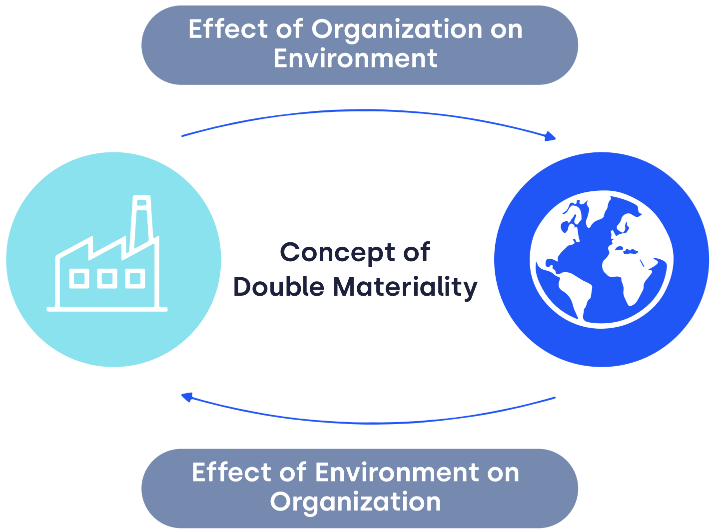


Figure 2: The concept of Double Materiality

05

ESG reporting.

Given that ESG is a broad umbrella that covers a range of topics, developing reporting can be complex. When developing your reporting, you need to consider:

- What internal reporting is required to Executive and the Board related to ESG objectives?
- What reporting or disclosures do regulators require, if any?
- What external reporting do stakeholders (such as investors and third parties) expect?

The data required for each of these may be the same or overlap. In certain jurisdictions or sectors, some ESG related issues may require disclosure to regulators or in public statements. Examples might include:

- Modern slavery disclosures
- Greenhouse gas emissions
- Gender composition of employees and boards

The expectations or needs of stakeholders usually come first before they are codified as a regulatory requirement. You may benefit from voluntarily following one of the reporting standards. If you wait, you may need to make unplanned investment to react to changing rules.

Given the importance of ESG and sustainable performance to investors, there have been several frameworks and standards across the globe developed to allow for more consistent comparison of investments. The overarching intent of these frameworks is to provide a picture of future performance, rather than simply past performance.

Some of the more well-known frameworks or standards around the globe include:

- The Task Force on Climate-related Financial Disclosures
- Greenhouse Gas Protocol
- Global Reporting Initiative
- Sustainability Accounting Standards Board
- The International Integrated Reporting Framework
- International Sustainability Standard Board

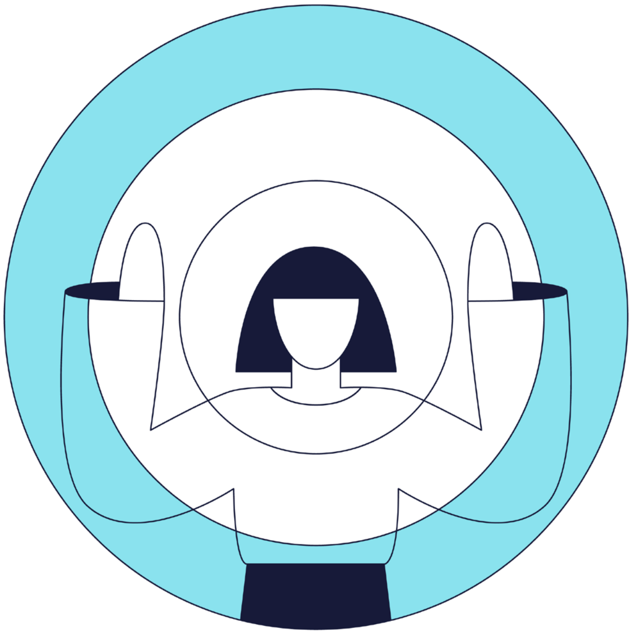
Some of the standards overlap, and meeting the standards of one may meet another. Reporting regimes and standards continue to evolve, with some effort to align them across jurisdictions[2]. Another focus for development is assurance; it may not be enough to report on your ESG or sustainability, but also have those reports or statements assured by an independent assurance provider.

Consider which stakeholders matter, what they need to know, and then determine what data you need to collect.

Collecting the data.

Once you've determined what reporting you need to produce, the next step is to consider the data that you need to collect, and who you need to collect it from. Usually this is going to be from a broad range of people or stakeholders. The different topics within ESG are often going to be handled by different departments or specialist teams. You may also need to aggregate information that is required to be collected from different geographical locations or different processes.

While the data needs to come from various sources, someone needs to be responsible for aggregation and pulling it all together. Ideally a system will manage this for you by automating notification to individual stakeholders and aggregating information that already exists, thereby allowing the responsible person to manage by exception.



2 PwC, ESG Trends in 2022.

06

Fitting ESG into your ERM.

Based on the above analysis, it makes most sense to amalgamate ESG into your existing ERM framework. This can be achieved by:

1. Incorporating your ESG objectives into your risk impact types
2. Incorporating ESG causes into your risk cause taxonomy and link these causes to your risks
3. Mapping your risks to your ESG objectives / impacts, including controls you may have in place to ensure they are achieved
4. Identifying the metrics you want to measure, the frequency that you want to capture them, defining metric tolerances and reporting on those metrics
5. Automating workflows to stakeholders across your organization to collect those metrics
6. Using reporting dashboards to track progress against your defined objectives, targets and risk levels.
7. Incorporate third party ESG or sustainability assessments into third party engagement or monitoring tools
8. Link existing compliance obligations (such as Modern Slavery) to your ESG reporting metrics
9. Incorporate ESG related obligations into your compliance management.

6.1 Third Party Risk Management.

ESG will have implications for your third-party risk management program. Most prominent is the reputational impact of using a third party who conducts their operations unethically, which may include unfair treatment of workers, false statements about waste disposal, or being involved in bribery. This has led to an increased focus on due diligence of the supply chain in an effort to reduce the likelihood of these scandals.

The fashion and clothing industry has a history of child labor and exploitation. In 2021, eight former child laborers from Mali filed a lawsuit against several major chocolate companies, alleging they knowingly engaged in forced labor[3].

Consider whether you need to improve your due diligence or ask for additional assurance from your third parties. On the other side of the fence, consider whether you should provide information on your own practices to your third parties.

3 The Guardian, Feb 2021.

Even if not asked, providing this information proactively as part of your third-party engagement practices demonstrates transparency and generates goodwill. Where practical, leverage technology to make this as seamless as possible, particularly where you or the third party may require ongoing assurance.

6.2 Strategic Decision Risk: Do you need to transform?

Some environmental or social issues may require some organizations or sectors to not only adapt but transform. If your operations are highly reliant on fossil fuels or produce significant emissions, how will you change your processes to reduce or eliminate that reliance or production? These transformations, which may take years, also need to consider your human capital.

Using a hypothetical transport company with a large fleet of petrol-based vehicles, we will assume that they employ a team of mechanics traditionally trained to service and maintain combustion engines. If you replace those vehicles with electric vehicles, what is your plan for those people? Will you invest in training them to maintain the electronic vehicles? If the need for maintenance is lower on the new vehicles, will you be able to redeploy them elsewhere?

While that is a simple example, the key is to understand what roles or job functions will become less relevant over time. Organizations who take a proactive and consultative approach to helping their people demonstrate a commitment to nurturing their human capital. Similarly, you may need to consider not only your own transformation, but those in your supply chain. Sometimes you transform; sometimes transformation happens to you. This highlights the importance of monitoring industry trends and having open dialogue with your stakeholders.

07

Where to next?

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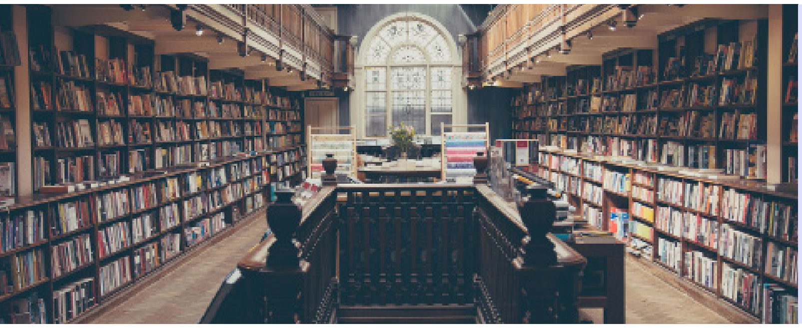
As ESG is not a standalone siloed concept, your approach needs to be carefully considered as to how it touches many aspects of your management processes, systems and governance.

Enterprise Risk Management is an ideal place to consolidate the many aspects of ESG and particularly manage all ESG risk related matters as well as compliance, metric monitoring and reporting.

We recommend your next step be the creation of a blueprint for how ESG fits into your management processes and once that is understood, the mapping of the steps needed to make it happen. This blueprint needs to take into account the objectives and stance of your organization with respect to ESG as well as your current management processes and systems, especially your current ERM capability.



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David Tattam is the Chief Research and Content Officer and co-founder of the Protecht Group. David's vision is to redefine the way the world thinks about risk and to pioneer the development of risk management to its rightful place as a key driver of value creation in each of Protecht's clients. David is the driving force behind Protecht's risk thinking, pushing risk management to the frontiers of what is possible. He is also focused on driving the uplift of people risk capability through training and content.

David is passionate about risk and risk management and in reaping the value that risk and good risk management can create for any organization willing to embrace it. He is particularly passionate about risk management research and is prolific in creating a wide range of content delivered in blogs, eBooks, webinars and training courses. He has developed Protecht's comprehensive suite of risk management training courses and has, and continues, to train many thousands of risk practitioners across the globe. David also manages Protecht's consulting business offering a range of risk consulting capabilities from Risk Management Framework to Risk Appetite Statement development.

He is also the author of "A Short Guide to Operational Risk".

Prior to co-founding Protecht, David was the Chief Risk Officer and Head of Operations for the Australian operations of two global banks. He started his career as a Chartered Accountant and Auditor with Grant Thornton and PwC. David is an Associate of the Institute of Chartered Accountants in Australia and New Zealand and a Senior Fellow of the Financial Services Institute of Australia.

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Michael Howell is the Protecht Group's Research and Content Lead. He is passionate about the field of risk management and related disciplines, with a focus on helping organisations succeed using a 'decisions eyes wide open' approach.

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Michael's industry experience includes managing risk functions, assurance programs, policy management, corporate insurance, and compliance.

ABOUT PROTECHT

Redefining the way the world thinks about risk.

For over 20 years, Protecht has redefined the way people think about risk management. We help companies increase performance and achieve strategic objectives through better understanding, monitoring and management of risk.

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