Know Your Customer's ESG Risks

Why ESG should be part of a Financial Institution's Customer Due Diligence process

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Overview

Customer Due Diligence ("CDD") is a crucial element of a company's compliance framework and an essential tool to manage financial crime and money laundering risks within the business operations of a financial institution ("FI"). However, as the regulatory landscape continues to evolve and issues related to climate change, human rights and social responsibility gain materiality, FIs are under pressure to expand their view of the risks posed by Environmental, Social and Governance ("ESG") factors when assessing their current and prospective customer base. This article aims to provide a perspective on how embedding ESG risk factors into existing Know Your Customer ("KYC") procedures can build a more comprehensive customer risk assessment strategy.

Why should a Financial Institution's Compliance and Risk professionals care about ESG?

While the concept of ESG was first coined to inform financial decisions and help companies make more sustainable investments[1], it can be adopted in the context of CDD to support FIs in assessing and adequately managing risks at the customer level. In PwC's view, there are three core arguments for integrating ESG criteria into customer risk management practices:

1. Awareness of ESG risks can support the fight against financial crime

Global estimates[2] suggest that proceeds from criminal activities such as illegal logging, illicit wildlife trade and forced labour could be in the region of hundreds of billions dollars each year, making these activities some of the most lucrative sources of revenue for criminals. The high profitability of ESG crimes, coupled with low levels of awareness of money laundering indicators related to these offences among FIs, present a significant risk of illicit financial flows going undetected in the financial system. As a result, regulators and global supervisory bodies such as the Financial Action Task Force ("FATF") are increasingly focusing on the financial aspects of environmental and social crimes. The link between money laundering and environmental crime was also highlighted in the 2021 typologies report of the Asia-Pacific Group on Money Laundering[3], and several countries in the region have already recognised environmental crime as a predicate offence in their laws and regulations.

Recent enforcement actions highlight the importance of incorporating ESG risks into Anti-Money Laundering efforts. In October 2020, Australia's Anti-Money Laundering and Countering Terrorism Financing ("AML/CTF") regulator AUSTRAC ordered one of the country's 'big four' banks to pay a record AUD1.3 billion penalty over CDD and transaction monitoring deficiencies – including the failure to identify activity potentially indicative of child exploitation.[4]

Moreover, there is a substantial risk that organisations involved in ESG violations are associated with broader criminality, as criminals attempt to exploit weak political and legal systems to facilitate or cover up their crimes. In its 2021 report on Money Laundering from Environmental Crime, FATF further observed that terrorist groups rely on environmental crime like illegal mining to raise revenue and fund their operations – presenting significant terrorism financing risks.[5]

A focus on ESG risks benefits Financial Institutions by:

- Preventing reputational damage, as a result of negative news coverage of financing and business activities
- Contributing to better risk decision-making and thereby enabling sustainable growth, through a holistic understanding of all risks
- Providing better visibility of customer risks, enabling better allocation of time and resources following a risk based approach
- Gaining 'first mover' advantage in the market, by enabling early identification of sustainable customers and investment partners
- Reducing the risk of sanctions and fines, by detecting and preventing relationships with third parties that operate in an unethical way

[1] *The term ESG was first coined in a 2004 United Nations report titled "Who Cares Wins". The United Nations Environment Programme Finance Initiative, "Who Cares Wins", 2004, https://www.unepfi.org/fileadmin/events/2004/stocks/who_cares_wins_global_compact_2004.pdf*

[2] *RHIPTO, INTERPOL and GI, "World Atlas of Illicit Flows", 2018, https://globalinitiative.net/wp-content/uploads/2018/09/Atlas-Illicit-Flows-FINAL-WEB-VERSION-copia-compressed.pdf; ILO, "Profits and Poverty: The Economics of Forced Labour", 2014, https://www.ilo.org/wcmsp5/groups/public/---ed_norm/---declaration/documents/-publication/wcms_243391.pdf*

[3] *Asia-Pacific Group on Money Laundering, "Yearly Typologies Report", 2021, http://www.apgml.org/includes/handlers/get-document.ashx?d=6bfd011b-8edd-40f4-93e4-f219e1c6d73e*

[4] *Statement of agreed facts and admissions – AUSTRAC, file number NSD1914/2019*

[5] *"Money Laundering from Environmental Crime", FATF, 2021, accessible via: https://www.fatf-gafi.org/publications/methodsandtrends/documents/money-laundering-from-environmental-crime.html*

2. Growing regulatory focus on ESG risk management

All economic activities face climate risk. This includes the financial services industry, both through physical impacts of environmental events (e.g. customers in affected sectors being unable to repay loans) and transition risks from moving to a lower carbon economy (e.g. litigation risk relating to financing activities). As a result, the financial services industry and its regulators are becoming increasingly aware of the need to integrate ESG risks into their business strategies and supervisory approaches. The EU continues to be at the forefront of driving ESG regulation, prompting FIs to re-evaluate their risk management processes. Most recently, in March 2021, the European Parliament put forward a draft directive on mandatory corporate due diligence and accountability[6], which would require all European companies, including FIs, to identify and address adverse impacts on human rights, the environment and good governance in their value chain.

While the regulatory shift towards ESG has been slower in the Asia-Pacific region, regulators in the region are also starting to incorporate environmental and social risk in their supervisory expectations towards FIs. The majority of these regulatory guidances currently discuss such risks in the context of sustainable financing and focus on lending and investing activities. There is almost no mention of non-financial risks related to the FI's' supply chain, such as potential compliance or reputational issues resulting from customers' poor business practices.

However, it is expected that non-financial risks stemming from poor ESG practices will become increasingly 'mainstream' in the region and equally important to decision makers as addressing exposure to financial crime. The sharper focus on AML/CTF among regulators and FIs in Asia in recent years already indicates it is likely that ESG risk management will follow a similar path to what can be seen in Europe.[7]

3. Neglecting ESG can result in reputational damage and/or legal exposure

As ESG continues to gain importance in the public eye, the negative perception of a FI's business partnerships and resulting reputational damage is no less important than the risk of regulatory enforcement or legal liability that may arise from perceived or alleged neglect.

Public opinion matters. Past examples have shown that public criticism and negative press coverage are able to sway FIs' financing decisions – as was the case in 2017 when several major bank's withdrew from the financing of the Dakota Access Pipeline over environmental and indigenous rights concerns.[8] The increased consumer focus on responsible business and public pressure to address ESG concerns also present opportunities for FIs. Strong ESG practices can be a competitive advantage in terms of brand reputation, as well as their ability to attract and retain customers and talent. Research carried out as part of PwC's 2021 Global Investor Survey showed that there is an increased interest among investors towards companies' ESG-related commitments and actions, as investors are paying more attention to both ESG risks and opportunities when making investment decisions. The vast majority (75%) of the 325 investors surveyed expressed the opinion that companies should address ESG issues, even if it leads to sacrificing short-term profitability. On the other hand, 50% stated they would divest their investments from companies that failed to take sufficient action on ESG related issues.[9]

[6] *European Parliament, draft legislation "Resolution of 10 March 2021 with recommendations to the Commission on corporate due diligence and corporate accountability", 2021, https://www.europarl.europa.eu/doceo/document/TA-9-2021-0073_EN.html*

[7] *PwC, "Risk & Regulatory Outlook 2021: Key developments in Southeast Asia: Environment, social and governance (ESG)", 2021, https://www.pwc.com/sg/en/insights-/assets/docs/risk-regulatory-outlook-2021-esg.pdf*

[8] *See for example: https://www.ing.com/Sustainability/ING-and-the-Dakota-Access-pipeline.htm, https://www.dnb.no/dnbnyheter/no/samfunn/dnb-has-sold-its-part-of-dakota-access-pipeline-loan, https://www.abnamro.com/clearing/en/news/respecting-land-rights-in-the-energy-sector*

[9] *PwC, "The Economic Realities of ESG", 2021, https://www.pwc.com/gx/en/services/audit-assurance/corporate-reporting/esg-investor-survey.html*

Broadening the scope of Customer Due Diligence

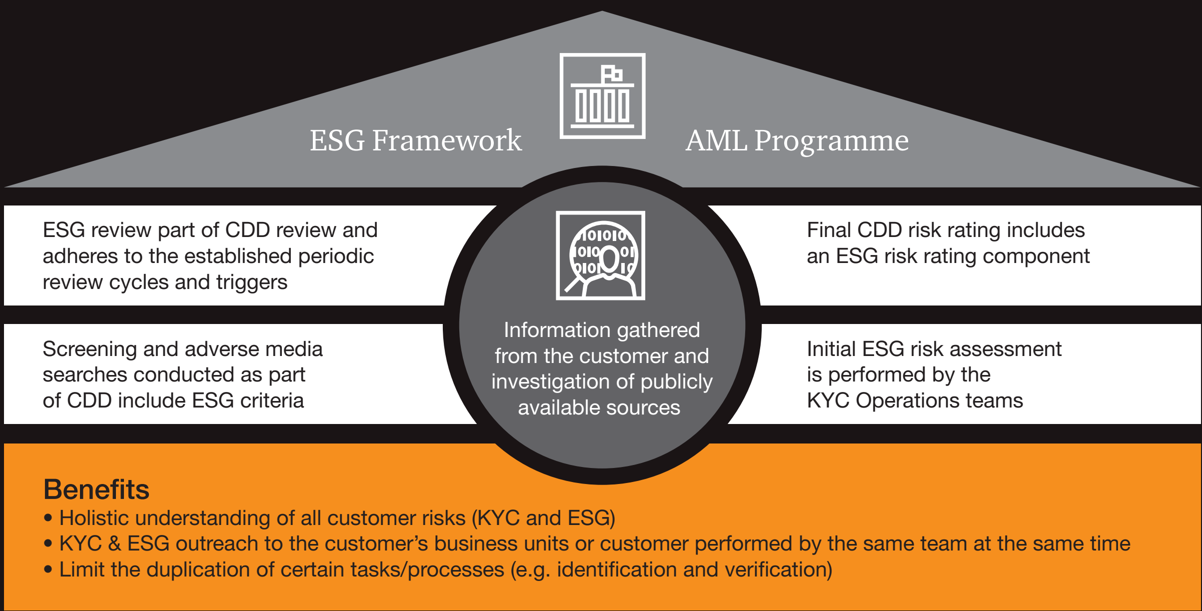
Many of the processes that FIs already have in place as part of their Anti-Money Laundering ("AML") programme, such as KYC procedures and customer screening, can be leveraged to support ESG assessments. The principles that underpin customer onboarding requirements for financial crime can be rapidly adapted to support key risk indicators for ESG, meaning most FIs already have the necessary tools to assess their customers' ESG risks. While some FIs may opt for setting up a dedicated ESG or sustainability department separate from the teams overseeing customer onboarding and reviews, embedding a level of ESG checks into the broader CDD programme presents several benefits:

Information gathering: existing procedures such as the desktop research and customer outreach performed by KYC analysts can be used to collect and process data on ESG. Insight into customers' business activities, geographic footprint and internal policies or controls is valuable for assessing their overall exposure to ESG risks. However, obtaining this information is a manual, resource intensive activity and may require customer contact. FIs can tap into existing document gathering and client communication channels that are already part of customer onboarding and periodic reviews, without risking unnecessary outreach loops. Additional training can be provided to front line staff and KYC analysts to better understand the rationale of ESG data requests, as well as information sources that can be leveraged.

Independent verification: when assessing customers' ESG risks, many FIs rely on selfreported information provided by customers – which may be incomplete due to varying understanding of ESG frameworks, or on ESG scores assigned by external data providers – which may not always include the latest data in their assessments and provide little transparency into their scoring approach. Independent verification that is done as part of the KYC process can also be a resource to independently verify information provided as part of customers' voluntary ESG disclosures. Moreover, FIs can rely on processes like negative news screening to identify recent adverse developments or red flags related to customers.

Risk assessment: a holistic view of a customer's associated risks, including the risk of exposure to ESG issues, allows the FI to assess whether the business relationship falls within its overall risk appetite and ESG strategy, and if necessary – provides the opportunity to take additional measures to mitigate identified risks. FIs can incorporate an ESG component into their existing customer risk rating process – for instance by covering the "E" and "S" aspects under 'industry risk' by classifying business activities that negatively impact the environment, or pose a heightened risk of human rights abuses and including issues relevant to the "G" aspect, such as tax integrity concerns, under 'entity risk'.

Figure 1: The ESG Customer Assessment can be interwoven with existing CDD processes



Key considerations for a successful ESG risk assessment

The methodology used for an ESG review carried out as part of the CDD process necessarily differs from that of professional rating agencies when assigning company ESG scores. The focus is less on assessing the overall performance across a set of ESG criteria, but rather on identifying regulatory and reputational risks that may arise for the FI through its association with companies that are involved in adverse business practices, such as human rights violations or environmental degradation. The following key considerations can support FIs achieve this goal:

■ Understanding the customer's approach to ESG

As part of the customer assessment process FIs should firstly aim to understand their customers ESG practices and how they manage social and environmental risks (e.g. is there an ESG framework in place, is a targeted risk assessment carried out). Implementing a standardised ESG questionnaire to identify any materials risks as part of the CDD process could be an effective solution to record and assess customers' ESG standing, as well as comparing it to other companies in its sector.

■ Including the right risk indicators

Although some overlap with broader money laundering concerns exists, it is important for FIs to recognise that the risk indicators used for financial crime alone may not always be sufficient to identify ESG concerns. For instance, industry sectors generally considered to be more susceptible to money laundering – such as cash intensive businesses or non-profit organisations, do not necessarily pose a heightened risk in the context of social or environmental issues. FIs should therefore adopt a set of ESG specific risk indicators, for instance by assigning risk scores to industry sectors based on their potential exposure to unsustainable environmental practices or forced labour, which are taken into account in the customer risk calculation methodology. The same approach can be taken to evaluate other CDD requirements as well, such as customers' country of operations and source of funds/source of wealth.

■ Adopting a risk-based approach

As with the measures for AML/CTF prevention, the approach towards the review and subsequent monitoring of customers from an ESG point of view should be commensurate to the level of risk they pose.To achieve this, FIs should have a process in place to assign an ESG risk score to their customers, or at a minimum – flag those with identified ESG risk triggers during the course of the CDD review (e.g. customers that operate in high risk industries or have adverse media hits).

■ Looking beyond the focal entity of the customer

Recent cases of forced labour allegations and enforcement actions globally illustrate that ESG issues often do not take place within the focal entity, but in its supply chain. However, FIs' KYC efforts on legal entities usually do not cover such a wide scope and are often limited to the customer and its ultimate beneficial owners. While expanding this scope is not necessary (or feasible) for all customers, enhanced measures should be considered when ESG risk indicators are present. This can include taking into account the business activities of subsidiaries in evaluating customers' industry risks (especially when it concerns a large financial holding company) and including major suppliers in the adverse media screening process.

Good practices and recommendations

1. Conduct Enhanced Due Diligence measures on higher risk customers

This can include adverse media screening, documentary requirements focused on identifying mitigating factors (e.g. relevant industry certifications or internal policies), and approvals from compliance or specialised ESG advisory teams.

2. Embed ESG risk triggers in adverse media screening

Include terms indicative of ESG issues in negative news search strings and / or confirm the screening solution used identifies risk events related to ESG when returning potential hits.

3. Provide ESG training to front line and KYC staff

Raising awareness of ESG issues and sharing case studies as part of regular KYC and / or compliance training helps staff recognise sensitive industry sectors and countries, as well as identify ESG specific red flags in assessing (potential) customers' profiles and documentation.

How can PwC help?

As part of PwC's overall ESG offering, the Financial Crime Unit has established a due diligence service delivery model that can support FIs in managing key aspects of identifying their customers' ESG risk. Our team of delivery professionals and regulatory advisors are experienced in designing policies and procedures for conducting ESG risk assessments, as well as identifying ESG risk as part of the overall customer due diligence offering. PwC's Financial Crime Unit can support FIs in the following ways:

1. **ESG Risk Assessment Methodology**

   We can leverage our established due diligence and risk assessment process to support FIs in identifying ESG risk in their customer portfolios and creating a suitable ESG risk assessment framework.

2. **Access to ESG Data and Training Materials**

   PwC's unprecedented access to ESG news data and training resources will enable our clients to be informed of ESG updates whether locally, regionally or globally to help respond to changing and upcoming regulations.

3. **ESG Experienced Resources**

   We can provide access to our global network of over 1000 ESG practitioners consisting of Subject Matter Experts, trainers, experienced project managers and due diligence and reporting analysts.

4. **Leading Edge Technology**

   We can provide technology solutions – like our ESG Customer Assessment tool – to automate, streamline, and expedite manual and time-consuming ESG based compliance tasks.

Our credentials

In addition to ongoing KYC remediation, PwC has supported multiple leading FIs with their end to end CDD review – covering ESG aspects and considerations of sustainability risk with specific sector requirements. Working together with our clients, PwC has contributed to both the design and execution of the ESG customer risk assessment process by:

- Developing project operational processes, procedures and internal training sessions on sustainability risk assessments, specific ESG requirements and process execution
- Supporting internal ESG advisory teams with the review and escalation of controversial outcomes
- Processing customer ESG risk assessments as part of customer onboarding and periodic reviews, and as a standalone review
- Processing ESG risk as part of the Enhanced Due Diligence review for cases meeting predefined criteria

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