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Seamlessly integrating ESG considerations into the business strategy: Balancing short - term financial objectives with long term ESG objectives and addressing ESG concerns of different stakeholders.

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ABSTRACT:

In an era marked by escalating population growth, unsustainable resource consumption, global climate change, pollution, biodiversity loss, among other issues, sustainability has never been more relevant. The Worldwide Fund (WWF) predicts that if the current trajectory persists, we will require the resources of at least three planets by 2050. Therefore, Environmental, Social, and Governance (ESG) emerges as crucial to ensure the protection of the environment and organisational sustainability.

While many organisations are cognizant of these challenges, integrating ESG aspects into their planning while balancing short-term and long-term goals is a daunting task. This paper aims to explore mechanisms that financial institutions can employ to seamlessly integrate ESG considerations into their overall business strategy in light of internal financial objectives and ESG pressures, balanced against ESG interest of their stakeholders. This paper draws from a review of published literature on the subject matter coupled with ESG industry experience of the authors.

The findings presented herein underscores the imperative for financial institutions to embrace ESG principles. Doing so not only aligns with customer expectations and enhances competitiveness but also helps mitigate against ESG risks and ensures compliance with existing legal and regulatory frameworks. Failure to embed ESG in financial institution's strategies may lead to erosion of shareholder value, loss of clientele, loss of investment, reputational damage, and other adverse outcomes. Additionally, the paper notes that financial institutions can shape the ESG agenda, by playing the role of ESG change agents, considering that they have an advantage of being perceived as trusted partners by their clients.

Another important aspect that is addressed is the need for balancing ESG interests as part of the integration of ESG into business strategy. Of specific importance are the short-term financial objectives and long-term ESG Objectives. In doing this, financial institutions need to pay attention to three factors, including materiality, transparency, and regulation. Whereas all the three aforementioned factors are important and should be addressed simultaneously, the issue of materiality is most critical if financial institutions are to realize their sustainability ambitions. ESG issues are pertinent to both its internal and external stakeholders and are in tandem with the concept of "stakeholder capitalism" which emphasizes paying attention to interests of all stakeholders in order to drive shareholder value.

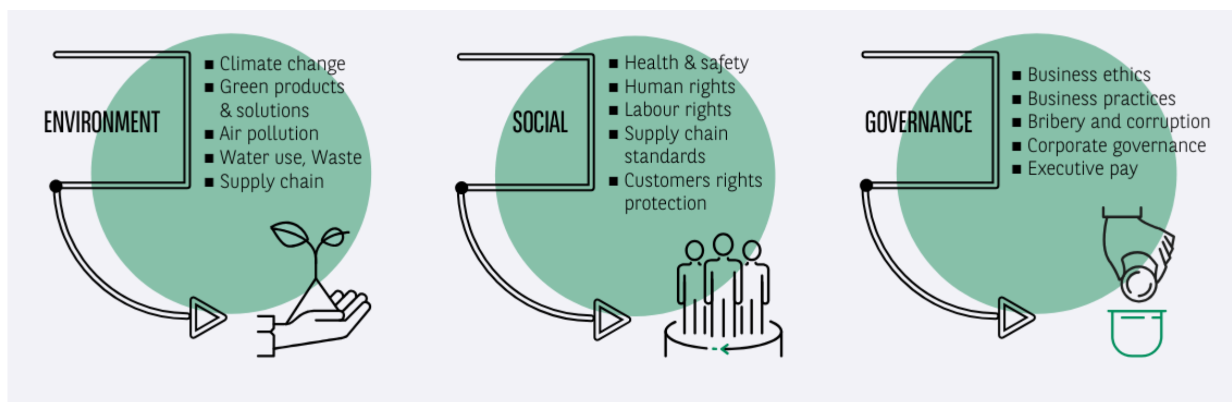
Lastly, the paper explores some of the ESG risks that financial institutions are exposed to and notes that they are mainly associated with the projects or transactions they finance rather than within the organisation. A number of proactive measures for integrating ESG into the business strategies of financial institutions are then proposed with the ESG policy of the financial institution being the overarching component and the driver of the process.

Keywords: Materiality, Transaction ESG Screening, Global Climate Change, Financial Institutions, ESG Policy.

1.0 INTRODUCTION

There is an increasing realization that the current rate of population growth and the associated resource consumption are not sustainable. It has been predicted by the Worldwide Fund (WWF) that if the current trend continues, then we will at least need to have three planets by 2050. Therefore, there is need to rethink our consumption and production patterns if sustainable development is to be realised and in particular the need to decouple economic growth from environmental degradation.

ESG is a tool that is increasingly taking center stage as far as addressing sustainable development aspects is concerned. The term ESG first came into use in 2005 and its roots can be traced to the Quakers in the 17th Century England, who were a group that invested in companies that turned profit while minimizing harm to society (Assent, 2024). Although there are a number of definitions of ESG depending on the E, S and G leaning of a particular constituency, for purposes of this paper we have considered the definition of the Corporate Finance Institute (CFI) that defines ESG as ***a framework to assess how a company manages risks and opportunities that shifting market and non-market conditions create (CFI, 2021).*** These conditions may include changes to environmental, social, and economic systems.



Source: *BNP Paribas Asset Management.*

Therefore, ESG is used as a framework for assessing how organisations manage risks and opportunities in their respective operating environments.

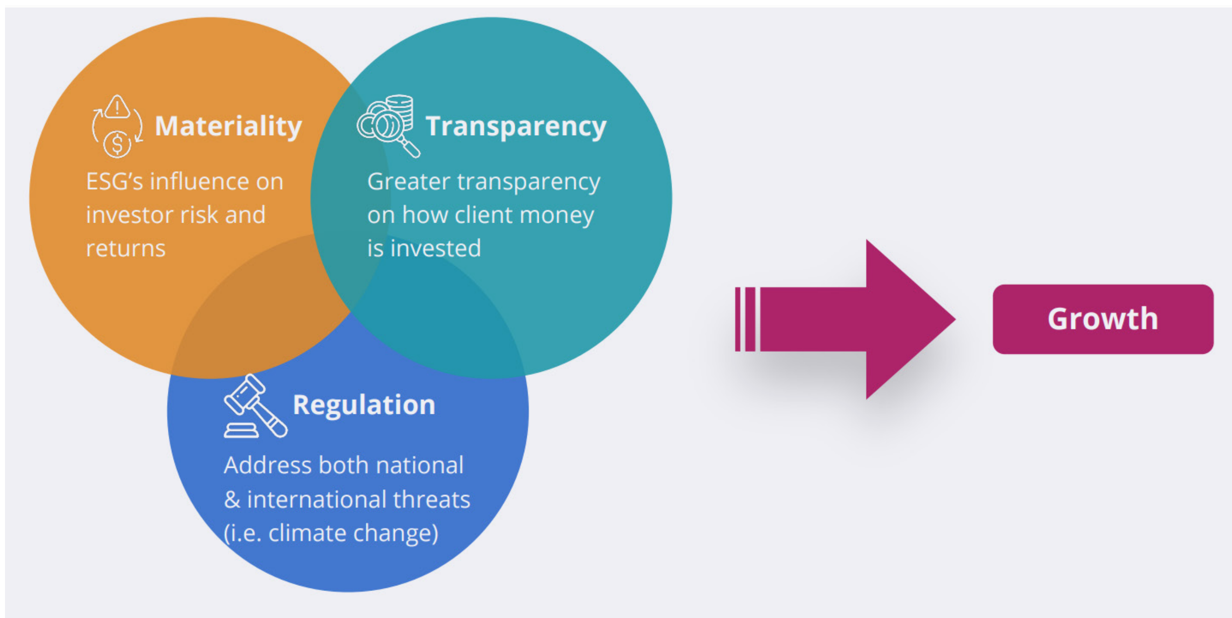
2.0 FINANCIAL INSTITUTIONS AS ESG CHANGE AGENTS

Financial institutions continue to be exposed to various environmental and social risks based on the activities of their respective clients which have ESG implications. Therefore, financial institutions have a critical role to play in shaping the ESG agenda as agents of change. They can do this by navigating the sustainability journey with their clients and providing the requisite products and services needed to enable the change. Financial institutions have the added advantage of being trusted partners by the clients. They thus can effect the change through the provision of ESG technical assistance, business development as well as green financing instruments, including the associated monitoring and evaluation of such portfolios. This provides a sound platform for a sustainable financial institution-client relationship.

The above is not without its challenges given the stakeholder pressures and conflicting interests of investors, shareholders, regulators, funders, competitors, Non-Governmental Organisations (NGOs), customers, suppliers, service providers such as banking agents, and project host communities that financial institutions have to contend with in light of the level of transparency and accountability that tends to be associated with ESG. For example, investors are increasingly pivoting towards investments that are prioritising ESG and a Bloomberg report has estimated that ESG assets will exceed $53 trillion by 2025. Therefore, this calls for a balancing act so as to ensure that the needs of the different stakeholders are spoken to as part of the financial institutions' business activities. The question is, how the diverse interests identified are aligned, including the balance between short-term and long-term goals as the financial institutions integrate ESG in their respective business ecosystems.

3.0 THE BALANCING OF ESG INTERESTS

For a balance to be struck between short-term financial objectives and long-term ESG objectives as well as ESG concerns of different stakeholders, it is important to consider some of the factors that have led to ESG morphing into a mainstream agenda item. These include materiality, transparency, and regulation.

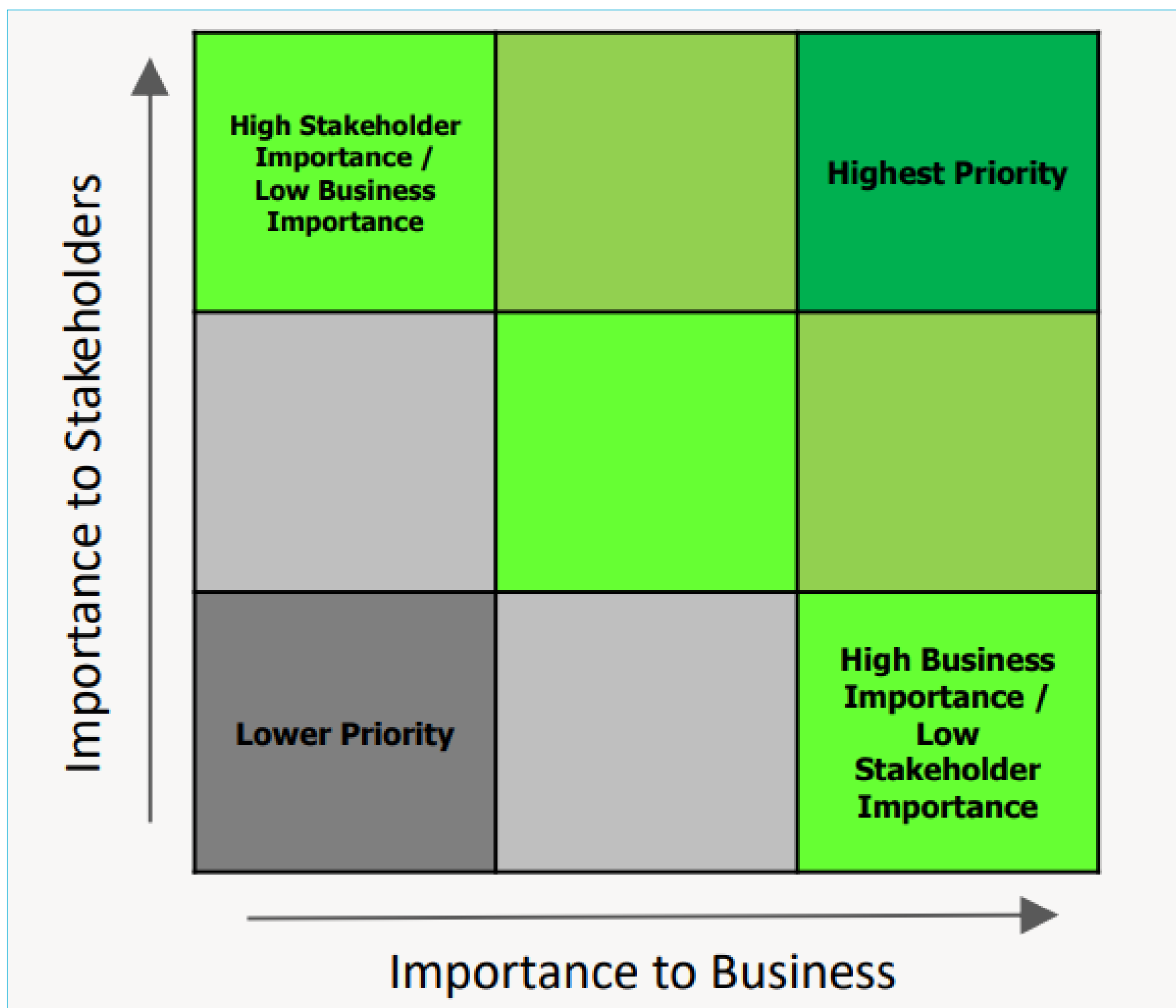


Source: *Corporate Finance Institute*

The advancement in technology has increased the degree of transparency with which information related to actual or potential ESG risks and impacts can be disseminated, thus placing organisations such as financial institutions under a wider spotlight. This implies that corporations need to proactively provide information to their stakeholders on the focus ESG factors, such as resource efficiency, pollution prevention, labour management, community engagement, among others, as a differentiating factor from the competition. For example, according to the Global Reporting Initiative (GRI), over 10,000 organisations from more than 100 countries use the GRI Standards for sustainability reporting as a means of proactively sharing their ESG performance.

Regulation, on the other hand, has made what used to be voluntary disclosure of information by corporation's mandatory. This shift in the regulatory landscape stems from ongoing challenges related to ESG, hence bringing a surge of new regulations and standards. For example, the European Union's Corporate Sustainability Reporting Directive (CSRD), which took effect in January 2023, requires EU and non-EU companies operating in the region to file annual sustainability reports alongside their financial statements.

For the purposes of this paper, we shall focus on materiality. Materiality considers issues that are most important for the long-term success of the business and its stakeholders – *a stakeholder being anyone that can be affected by or affect a business* (CFI). This can then be used to shape the financial institution's sustainability strategy or road map based on the level of priority of the respective issues, as seen in the figure below.

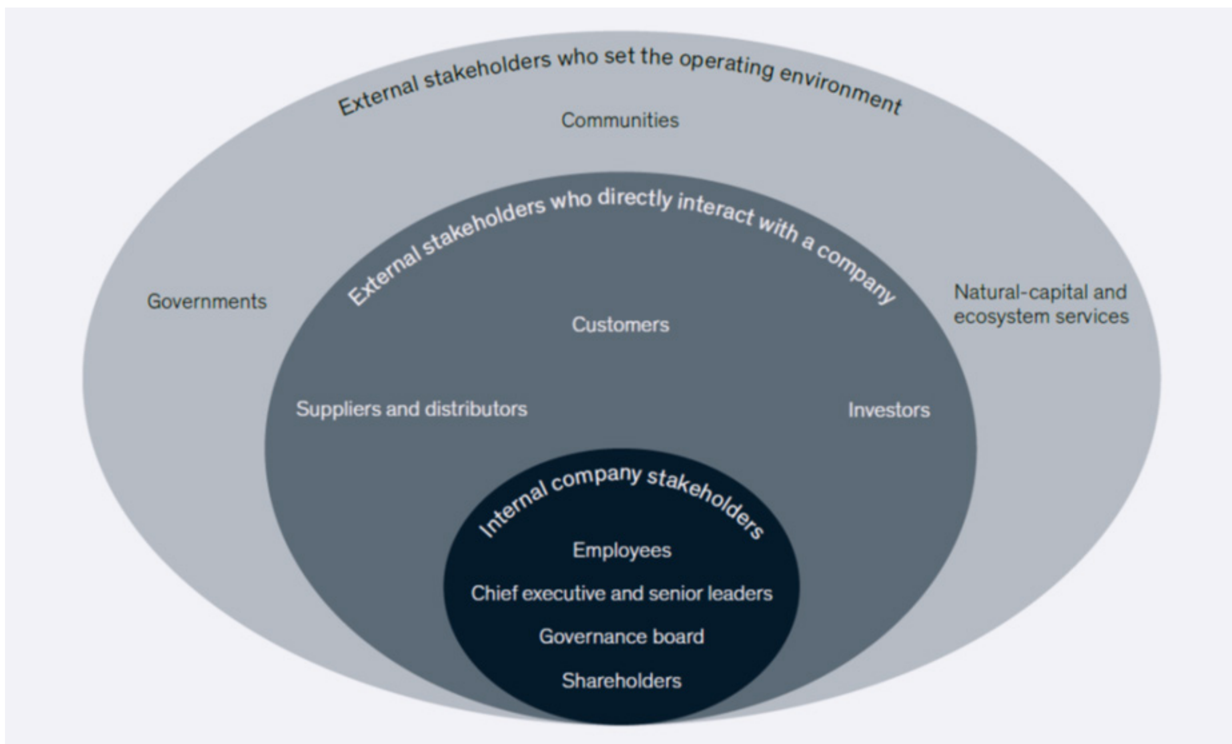


ESG Materiality matrix

Source: *British Standards Institute (BSI)*

From a short-term financial objectives' point of view, financial institutions have to contend with aspects such as increasing shareholder returns through annual dividends, expanding the customer base, reducing loan processing time, and growing the loan portfolio etc. Long-term objectives may include business survival, and implementing innovative banking solutions, among others. On the other hand, they also have to address long term ESG objectives, which might involve investing in the energy transition through green finance, achieving net zero emissions by 2050 and establishing a net zero transition plan, decarbonizing the bank's processes, ensuring transparency and disclosure, labour management, among others.

In order to ascertain the ESG concerns of the different financial institution stakeholders, stakeholder identification and engagement are very important. It's worth noting that stakeholders can be classified per activity, project, product, or service. Some of the typical stakeholder groups for a financial institution are highlighted in the figure below, and these may typically have a range of concerns that span the E, S and G spectrum. These may include, but not be limited to, Diversity, Equity, and Inclusion (DEI), energy use and carbon emissions, biodiversity and energy conservation, social and environmental impact on communities, pollution prevention, board oversight, and supply chain responsibility.



Identification of Stakeholders.

Source: *McKinsey & Company*

4.0 STAKEHOLDER CAPITALISM AND ESG VALUE CREATION

Value is perceived to be created for all parties in line with the tenets of ''stakeholder capitalism'. ESG Value Creation refers to the process by which a company integrates ESG considerations into its business strategy and operations to generate long-term value for both shareholders and stakeholders (Eccles, 2012).

According to a 2019 McKinsey quarterly report, ESG creates value in several keyways. It drives top-line growth by enabling corporations to easily obtain a social license to operate and access new markets and clientele through their sustainability credentials. Additionally, it reduces costs by optimising resource use. Companies can also benefit from regulatory and legal interventions, such as earning government subsidies and support. ESG practices lead to a productivity uplift by attracting talented staff and keeping them motivated due to the company's social credibility. Finally, it optimizes investment and assets by promoting investments in more sustainable, long-lasting solutions.

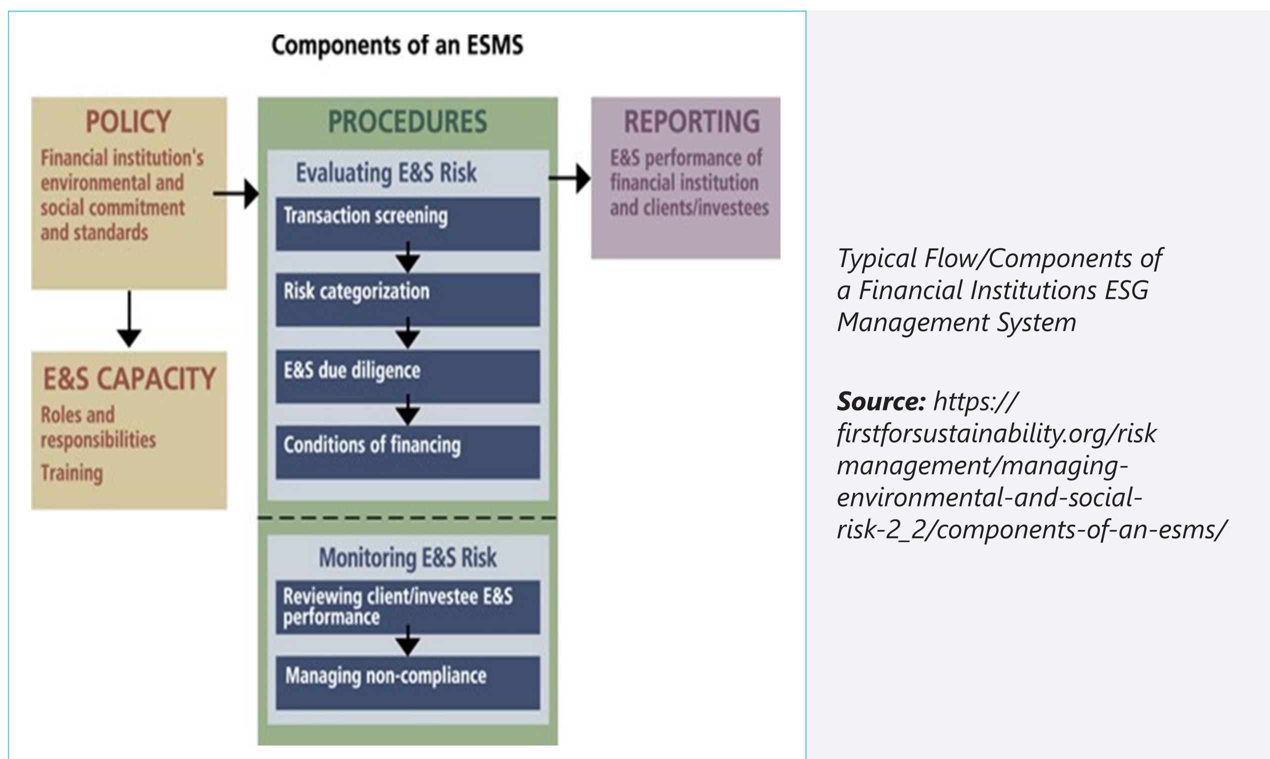
All the aforementioned ESG value propositions are hinged on proper stakeholder involvement. A recent study on stakeholder capitalism concluded that interests of all stakeholders can actually help maximize returns to shareholders, because how a company treats its non-shareholder stakeholders can affect shareholder value (Paine, 2023). The study further recommended that investing in other stakeholders may reduce shareholder value today but pay off for shareholders in the future. On the flip side, it was found that shortchanging other stakeholders may benefit shareholders for a time but will be detrimental to them over a longer period. The study then concluded that corporate leaders whose only objective is maximizing value for shareholders should consider the interests of other stakeholders. Therefore, there is indeed needed to balance short-term financial objectives with long-term ESG objectives and address ESG concerns of different stakeholders.

Larry Fink, the Chairman and CEO of BlackRock (one of the big three Asset Management Companies in the United States of America), echoed the benefits of stakeholder capitalism in his letter for fellow CEOs in 2021 by stating that: *"The more your company can show its purpose in delivering value to its customers, its employees, and its communities, the better able you will be to compete and deliver long-term, durable profits for shareholders."* According to (Turzo, 2021), stakeholders require information on non-financial activities as considerations for decision-making in funding companies. ESG is considered the most dominant sustainability standard indicator used in current practices to measure companies' non-financial performance (Howard-Grenville, 2021). Therefore, keeping stakeholders abreast of the organisations activities is key in obtaining a social license to operate but also in ensuring broad ownership of the process. Relatedly, financial institutions should communicate ESG requirements across their organisations and bring all employees on board with an intentional change management approach (McKinsey, 2024).

In the context of Uganda, other than concerns of shareholders and communities, financial institutions need to ensure that concerns of regulators such as the Bank of Uganda (BoU), National Environment Management Authority (NEMA), Financial Intelligence Authority, Industry Associations, Development Partners, among others are factored in their sustainability roadmaps. For example, a statement from the BoU Deputy Governor at the launch of BoU's new Strategic Plan (2022 – 2027) on 15th July 2022 highlighted the plans to attain sustainability credentials such as the need to focus on emerging issues such as climatic risk, and integrated reporting. This implies that all financial institutions in Uganda have to initiate strategies to combat climate risk. Additionally, section 49 of the Uganda's National Environment Act, 2019, makes it mandatory to establish, maintain and implement an environmental management system. An environmental management system can proactively address environmental and social risks and impacts such as pollution, biodiversity loss, community uprisings, reputational risks, share devaluation, leadership commitment, corporate social responsibility, and care for employees, which are usually concerns by stakeholders. Other stakeholder ESG related requirements include the World Bank's Environmental and Social Standard 9 that provides for all Financial Intermediaries to have Environmental and Social Management Systems commensurate to their E&S risks associated with their portfolio, among others.

5.0 INTEGRATION OF ESG INTO BUSINESS STRATEGY

To seamlessly integrate ESG considerations into the financial institutions business strategy, it is important for financial institutions to have a functional ESG management system in place and the associate procedures to proactively manage material environmental, social and governance risks that are specific to them. The figure below illustrates a typical flow of a financial institution's ESG management system and some of its key components:



Typical Flow/Components of a Financial Institutions ESG Management System

Source: *https://firstforsustainability.org/risk management/managing-environmental-and-social-risk-2_2/components-of-an-esms/*

Considering the ESG management system components highlighted in the figure above, the ESG Policy is the driving factor of the ESG management system and should be endorsed by top management as a sign of total commitment. The policy is a statement of intent and sets the short-term, medium term and long-term ESG objectives based on the results from the materiality assessment. The ESG policy enables organisations to differentiate themselves from the competition and should also be well communicated to all stakeholders including the financial institutions shareholders and non-shareholders.

The commitment of top management is critical to the success of ESG taking root in any organisation and this should be reflected in ESG policy commitments. The change in business philosophy in response environmental, social, and economic demands and threats resulted in

corporate governance based on the ESG agenda. ESG should be well anchored at board level and the board of directors should proactively adopt the best practices recommended in their oversight role of the organisation's planning, performance, and long-term strategy to ensure the company remains resilient, with the ability to deliver durable and sustainable value as well as to maintain stakeholders' confidence (Kamaludin et al., 2022; Bolourian et al., 2021; Pucheta & Gallego,2019). Organisational leaders, from CEOs to department heads, play a vital role in ensuring their companies effectively embrace ESG principles. The leaders act as catalysts for change and set the pace for the entire organisation. Leadership shapes ESG integration in many ways such as determining the vision and strategy, shaping the organisational culture and values, driving stakeholder engagement, ensuring risk mitigation, innovation, and adaptation, and reporting and accountability. This implies that organisations should identify the best suited leadership models and ensure that the leaders and staff are well informed and trained to drive ESG integration throughout the entire organisation.

There is a need to allocate resources for ESG for it to take root within the organisation. Resource-based strategy theory suggests that a firm's competitive advantage and long-term success stem from its unique and valuable resources and capabilities (Powell, 1993). In addition, this theory applies to ESG implementation, where a company's ability to effectively manage environmental and social challenges, as well as demonstrate strong governance, can create a competitive advantage in the market. Furthermore, companies that place importance on ESG factors have the potential to attract investors who seek to align their investments with personal values while mitigating the risks of negative external impacts that could harm the company's reputation and financial well-being.

Financial institutions seeking to integrate ESG into their business strategy should ensure training of their personnel on all ESG matters. The organisations need to develop mechanisms to foster internal and external knowledge sharing in line with the organisation's ESG strategy. Organisations can choose to undertake internal training that requires less resources and is less specialised, which will enable the organisation to achieve the short-term ESG objectives whilst remaining aligned to the financial goals. More specialised training can be taken on as more resources are made available through improved sustainability practices.

The ESG Procedures provide a good entry point for the incorporation of ESG factors in the financial institutions' processes. For example, during transaction screening, ESG aspects can be incorporated through updating the financial institutions exclusions list to include ESG related exclusions. Additionally, the ESG can be factored in transaction screening process should seeking answers to key questions related to ESG risks associated with the transaction applicant as well as the project for which a transaction application is being made. Some of these questions could include the applicants ESG compliance history, their human resourcing, impact of their activities on the community, among others. It is at the transaction screening stage that all transactions would be screened against the ESG exclusions list and preliminary ESG risks identified as illustrated in the figure above. This saves time and resources considering that the transaction process would not go so far before any potential ESG red flags are identified.

The Transaction ESG Screening process should not be seen as a barrier to doing business but rather an enabling tool in ensuring that the financial institution's ESG long-term objectives as well as those of its stakeholders are realised. In terms of achieving the short-term financial objectives, the process of transaction screening should be well understood by those at the forefront of undertaking the screening exercise to ensure that it is done seamlessly. Secondly, the Transaction ESG Screening process should be explained to clients, and they should be guided or supported on how to prepare the requisite documentation. Borrowing experience from BNP Paribas Asset Management, Séverine Mateo its Head of the Low-Carbon Transition Group stated that: *"the company provides its clients with technical support around key topics that include clean energy, sustainable mobility and new technologies useful for decarbonization, and that this was one of the reasons for their success in ESG integration"* implying that there is need to support clients to comply with financial institutions ESG related requirements.

ESG Risk Categorization allows a financial institution to understand the ESG risks associated with the transaction and grade the transaction's based on its level of ESG risks level as guided by the ESG risk rating criteria. ESG Due Diligence further serves to enable financial institutions to understand the on-ground ESG risks associated with a potential transaction. Similarly, conditions of financing provide a platform for a financial institution to agree with the applicant on the identified ESG issues and how they will be addressed prior or during the financing period. The monitoring function of the ESG management system provides a proactive approach to review the client's ESG performance and manage non-compliance.

ESG Reporting then brings to life a financial institution's commitment to Transparency on ESG matters and obligations to report the material issues to their stakeholders. Stakeholders can then act on the information they have received. Some of the reporting avenues could include sustainability reports, financial reports, among others.

Overall, the ESG Management System ensures a holistic approach that ensures that ESG criteria are embedded in all processes within the organisation. An ESG management system would enable the financial institution to identify entry points for integrating ESG in other additional processes such as planning, ESG organisational competence, grievance management, internal audit, and management review, among others. Once an ESG management system is in place, the personnel of the financial institutions are cushioned from ad hoc planning considering that the system would keep all processes in check.

6.0 CONCLUSION

Based on the ideas presented, it can be concluded that ESG considerations should be embedded into the core business processes of financial institutions in order to drive value. It is important to note that the ESG risks faced by financial institutions lie in the activities they finance (i.e., clients' projects) as well as in their internal activities. Therefore, robust systems are needed to enable financial institutions to change their ESG perspective internally and in turn become ESG change agents for the clients they serve. Additionally, financial institutions must ensure that all their stakeholders are identified, and their interests catered for as financial institutions shape their ESG and financial objectives. The involvement of all stakeholders results in increased value for the financial institution in the long run.

At the heart of implementing ESG and balancing different ESG interests by stakeholders is the need to be transparent, be cognizant of existing regulation, and undertake materiality assessments. The materiality assessment is the most important step as it will enable the financial institution to identify ESG factors pertinent to its stakeholders and fast track achieving the "low hanging fruits" before aiming for the longer term and complex ESG goals. Of importance is the need to keep all stakeholders informed of both the financial and non-financial activities of the organisation as this affects shareholder value. This way, the organisation will not lose sight of its financial goals while on its sustainability journey.

Achieving sustainability relies on an organisation's ability to continuously innovate and collaborate with other industry players to identify new opportunities for sustainable growth and mitigate ESG-related risks. Collaborative initiatives with industry peers, NGOs, and government agencies can drive collective action towards addressing systemic ESG challenges. Lastly, having an ESG Policy and an ESG management system in place will enable financial institutions to embed ESG in all their activities i.e., financial, and non-financial. The ESG Policy and the ESG management system are a proactive way to manage ESG risks and a means to balance a financial institution's ESG short term interests with long term financial objectives.

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