As of September 2012

How to integrate ESG risks into financial sector's operational risk management methods?

Executive Summary of the Practical Guide

While operational risks are clearly identified and managed by Risks Departments within banks through regulatory mechanisms such as Basel II[1], Environmental, Social and Governance (ESG) risks are left aside so far. With the rise of Corporate Social Responsibility (CSR), a new type of risk is emerging: ESG risks whose main characteristic is to focus on the potential impact that stakeholders (customers, employees, suppliers, environment ...) may have on the company and in reverse, the risks that the company - due to its activity - may cause on its stakeholders and its environment. Therefore the Finance Club of ORSE initiated a collective reflection which led to the publication of a practical guide which is presented here.

Risk is intrinsic to banking, and risk management is a key priority for the sector and its sustainability.
The banks traditionally manage three major categories of risk:

- **Credit and counterparty risks** found in potential losses due to counterparty default.
- **Market and balance sheet risks** caused by interest rate fluctuations, a drop in share prices, etc.
- And **operational risk**, which is the risk of direct or indirect losses resulting from inadequate or failed internal processes, people and systems, or from external events.

The common thread running through these three risk categories is that they all concern the impacts of the risk on the company itself.
With the development of CSR, we are seeing ***the emergence of a new risk category, called ESG (Environmental, Social and Governance) risks***. The main characteristic of these risks is the **potential impact of stakeholders** (customers, staff, suppliers, natural environment, etc.) **on the company and, conversely, the risks to which the company exposes its stakeholders and environment due to its business**.

The Finance Club at the French Study Centre for Corporate Social Responsibility (ORSE) set up a think tank with its members – including representatives of sustainable development departments and risk management departments (banks, insurance and asset management) – to consider how environmental, social and governance (ESG) risks can improve our understanding of operational risks.

Our working group compared Basel II standards with the ESG risks identified by the chosen standards (ISO 26000, GRI and EFFAS). Its work has culminated in this guide[2] presenting the interactions between these two risk categories and where they converge and diverge. This guide also shows good practices. It is designed to help factor in new CSR-related risks and understand how CSR practices can improve on current operational risk management methods and their associated decision-making processes.

Our work is especially dedicated to banking sector's social and environmental responsibility and sustainable development practitioners, risk management departments, and non-financial analysts and non-financial rating agencies.

[1] The Basel II standards are described later in this document. For more information, see the Banque de France Prudential Supervision Authority (ACP) website: **http://www.acp.banque-france.fr/international/les-grands- enjeux/les-accords-de-bale/bale-ii.html**
[2] Available from ORSE' website : **www.orse.org**

This guide makes two important contributions. First, it builds on the standards used by risk management departments by shedding new light on ESG considerations. Second, it improves upon the approach taken by non-financial rating agencies and analysts, which do not systematically cover operational risk issues.

Note on the standards chosen:

1. The **Basel II** standards are the benchmark standards for operational risks in banks[3].
2. The **ISO 26000** "standard" identifies major CSR action levels and has achieved international consensus[4].
3. The **GRI and EFFAS guidelines**[5] provide a list of indicators to monitor the effectiveness of ESG risk management actions.

Main conclusions of the comparison of the Basel II standards for operational risks and the ISO 26000 standards for ESG risks

There are three major conclusions to be drawn from the comparison of operational risks and ESG risks:

1. A better understanding of the risks already addressed by Basel II

- Categories 1 (**internal fraud**) and 2 (**external fraud**), as defined by Basel II, might seem vague to certain professional managers (*the causes and aggravating factors of fraudulent behaviour are hard to explain*). → **The CSR standards identify these categories more clearly. They place greater emphasis on anti-corruption and fair practices** and go further than purely the financial risks and the legal concept of fraud. Codes of conduct on governance and business ethics have grown in keeping with this development.

- Category 5 (**damage to physical assets**) already took into account notions associated with natural disasters and their impacts on business premises and computer centres, etc. → The ESG standards clarify these notions. They focus corporate attention more particularly on climate change considerations and provide a broader reading of the **natural disaster risks that have stepped up the need for ad-hoc adaptation plans to deal with these factors**. The notion of corporate community investment also comes within this category.

2. Broader scope and greater weight for the risks already addressed by Basel II

Operational risks are classically found essentially in the organisation's processes and operational risk analysis seeks mainly to identify impacts on this organisation. The inclusion of "ESG risks" places operational risk management in a system that transcends the organisation itself with the notion of impact on others.

- Category 3 (**employment practices and workplace safety**) concerns mainly compliance with labour laws and regulations and related litigation. → **The ESG angle covers issues connected with the promotion of diversity, gender equality at work and, more generally, compliance with international standards** (*human rights, International Labour Organization, etc.*), which takes operational shape in "human rights" policies, diversity promotion approaches, commitments to respect ILO conventions, etc.

[3] The Solvency II standards are the insurance sector's equivalent of Basel II. The think tank that produced this guide made some preliminary comparisons between these standards and the ESG risks to which insurers are exposed. These comparisons revealed certain similarities with the banking sector observations. For more information on the Solvency II standards, see the Financial Services Authority (FSA) website: **http://www.fsa.gov.uk/solvency2**

[4] For more information on GRI: **www.globalreporting.org**

[5] For more information on the EFFAS/DVFA standards and the guideline for the integration of ESG into corporate reporting, see: **http://www.reportingrse.org/force_document.php?fichier=document_513.pdf&fichier_old=KPIs_ESG_FINAL[1].pdf Financials chapter.**

- Category 4 (**clients and business practices**) addresses the notions of fair practices (aggressive sales, information provided to customers, etc.) and product quality. → **The CSR standards support this interpretation by stepping up the importance of customer information, voice and protection as seen, for example, in service commitment charters, ombudsman systems, and closer co-operation with consumer associations**.
  Also concerned in this category is **financing for sectors considered to be sensitive** (*armaments, energy, etc.*). → The granting of this financing is increasingly conditioned by compliance with a certain number of social and environmental impact criteria. The Equator Principles[6] form one such example in project financing.

- Category 6 (**business disruption and system failures**) takes an exclusively technical approach to these issues under Basel II. → The **ESG approach establishes the "essential services" notion**, which concerns the capacity to ensure the continuity of this service over time (e.g. 24/7 ATM availability) and the supply of basic banking services and their accessibility for all.

- In Category 7 (**execution, delivery and process management**), the ESG approach enhances interactions between the company and its external stakeholders (*counterparties, suppliers, etc.*). → **Dissemination of the CSR principles in the value chain** guards against unsuitable practices by certain suppliers that could ricochet back on the company. It also compels companies to adopt responsible purchasing practices (*responsibility in the customer/supplier relationship*). In this regard, the banks propose purchasing charters to their suppliers and conduct audit processes. Some even rate their suppliers on their non-financial performance.

3. A broader view of image and reputational risk

The ESG approach ultimately makes for **a broader picture of the potential image risk to the reputation of the banking institutions. It extends the scope of their responsibility beyond their core business**, sometimes as far as their licence to operate.

The image risk has expanded considerably, due to civil society pressure in particular, and now cuts across all the "Basel" risk categories. Reputation and customer confidence have become major assets for banking institutions. This means that the banking institutions have to protect their reputation like a strategic tool. The somewhat subjective notion of image makes it complicated to understand and quantify the associated risks.

[6] The Equator Principles are a financial industry benchmark for determining, assessing and managing social and environmental risk in project financing. For more information, see: **http://www.equator-principles.com/resources/equator_principles_english.pdf**

Conclusion

The exercise of Corporate Social and Environmental Responsibility builds on and extends the foundations of operational risk management, such as it is practiced by banking institutions in keeping with the Basel II standards.

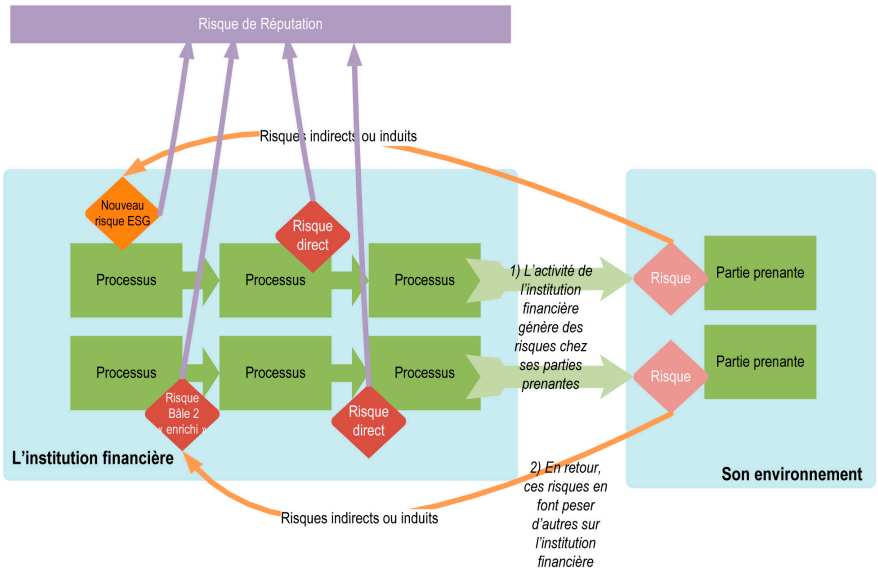
The introduction of Environmental, Social and Governance (ESG) criteria into operational risk management scales up this risk management with the addition of two strands:

- First, it brings into the equation new risks to the financial institutions, especially the impact of (indirect or induced) risks on other stakeholders and their effect on the organization's overall performance, using dedicated measurement indicators;
- Second, it sheds new light on the risks defined in the traditional standards.

Managing the "ESG" risk to the company should not be a separate issue to operational risk management dealt with by a service other than the operational risk department, since it is ultimately the financial institution that stands to suffer the losses.

The ways of managing these risks, prudential capital requirements aside, are definitely to be found in the operational processes that the operational risk management departments supervise and audit. This increases these departments' credibility.

The inclusion of ESG criteria in risk management takes us a step further on the road to integrating CSR into organization management assistance approaches, and better image and reputational risk management.



The figure above is about analysis of ESG risks: Consideration of ESG risks induced by the financial institution's business places the institution in a "retroactive" system where the stakeholders expose the institution to a risk on the scale of that which the institution induces.

This guide was issued with the support of La Banque Postale.

ORSE – the French Study Group on Corporate Social Responsibility (Observatoire sur la Responsabilité Sociétale des Entreprises), conducts a permanent overview of corporate social and environmental responsibility, sustainable developmentand socially responsible investment in France, Europe and globally, on behalf of its members (large companies, fund management companies and social and professional organisations).
25 rue du Charolais - 75012 PARIS - Tél. : 01 43 46 02 22 - Fax : 01 43 46 86 99 - Site : www.orse.org - contact@orse.org