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Managing ESG-Related Crime Risks: The Role of ESG Integrity Assessment for Financial Institutions

The Importance of Responsible ESG Integrity Governance

As global awareness of Environmental, Social, and Governance (ESG) issues increases, so does the pressure on financial institutions. They must adapt, integrating these considerations into their risk assessment protocols. International regulations like the EU's Environmental Crime Directive and the global sustainability push have spotlighted ESG integrity risks, including related crimes. Understanding and mitigating these risks goes beyond compliance; it's a business imperative. Financial institutions need to start making the necessary adjustments throughout the whole organisation in managing and mitigating such risks.

The Kick-off: ESG Integrity Risk Assessment

Every sector of a financial institution plays a role in managing ESG integrity risks. Firms should perform due diligence, identify suppliers' and clients' sustainability statuses, and assess ESG integrity risks in counterparties and transactions. These should be integrated into procurement, KYC, investment, underwriting, and lending decisions. Institutions need to identify, quantify, manage, and respond to latent and emerging ESG integrity risks, integrating ESG capabilities into existing risk frameworks. Additionally, ESG integrity risks should factor into pricing, forecasting, budgeting, financial reporting, and capital allocation. To achieve this, institutions are increasingly using data, ESG scores, and reports to assess clients' environmental practices.

Integrating ESG Integrity Risk Assessment into the Risk Control Framework

The Risk Control Framework protects financial institutions from the perils of serving clients involved in ESG integrity risks, including related crimes. Integrating the results of the ESG Integrity Risk Assessment into the Systematic Integrity Risk Assessment (SIRA) is a crucial first step in doing so. It helps gauge how risks from ESG-related crimes manifest across various dimensions like geographies, client sectors, and transactions. Differentiating between direct and indirect ESG-related crime risks is vital. This differentiation helps assess risk occurrence likelihood and define appropriate mitigating measures. It allows a more informed establishment of the institution's ESG risk strategy and tolerance, aligning taken risks with ethical standards and regulatory obligations. With different teams managing reputational, civil liability, and criminal risks, potential exposure to ESG-related crime risks might not be adequately identified. It's essential to integrate and utilise information from other risk management processes within the institution.

Going Beyond Traditional Due Diligence

The financial sector is beginning to assess how its Know Your Customer (KYC) protocols should evolve to extend beyond traditional due diligence. This enhanced KYC includes scrutinising clients for potential environmental risks and human rights impacts and compliance with ESG benchmarks. This proactive vetting is crucial in managing reputational and regulatory risks tied to ESG-related crimes. By embedding ESG considerations into KYC processes, financial institutions mitigate risks and uphold ethical standards and transparency. This shift is pivotal for maintaining trust and demonstrating a firm commitment to sustainability and integrity in the financial ecosystem.

Examples of Target Operating Model Solutions in Preventing and Detecting ESG-Related Crime Risks

The Target Operating Model for financial institutions requires a robust framework of policies and procedures to effectively mitigate ESG risks, including ESG-related crime. This might include sophisticated transaction monitoring systems or client reviews triggered by specific events. Publications on various types of ESG-related crime risks provide insights for proactive actions. For instance, risks associated with illegal logging and deforestation, or forced labour, as well as the subsequent illicit trade need attention. They often involve shell companies and the movement of proceeds across financial systems, necessitating thorough client reviews and transaction monitoring. Illegal mining, another critical area, offers dual opportunities for scrutiny: the financial gains from mining and the potential to launder proceeds from other crimes. Identifying such risks necessitates robust internal controls to verify client-reported data integrity and proper monitoring of financial transactions.

Getting in Control of ESG-Related Crime Risks

Financial institutions are at the forefront of understanding the role they play in the prevention and detection of ESG-related crime risks. Combatting ESG-related crime risks is not just a regulatory requirement but a strategic opportunity for organisations to demonstrate their commitment to sustainability and earn trust. By proactively conducting an ESG Integrity Risk Assessment and implementing a forward-looking risk management strategy, companies can combat ESG-related crime risks and lead the charge towards a greener, safer future.

ESG Integrity Blog Series

In our next blog, we will focus on relevant ESG challenges for corporates. Additionally, here you will find our solution on managing and mitigating ESG integrity risks.

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