Marsh

How to Integrate ESG Risks into Business Strategy

Growing Need to Manage ESG Risks

The need for environmental, social, and governance (ESG) initiatives has never been higher. These are seen in:

- **The ambitious carbon zero timelines of countries[1]**
- **Corporations' carbon-neutral targets**
- **Announcements of newly appointed ESG leads**
- **Launches of ESG-linked investment products**
- **The evolution of diversity, equity, and inclusion (DE&I) initiatives**

Businesses today are often expected to help advance healthier and more equitable societies through inclusive employee benefits, which at the same time can bring competitive advantages, such as attracting a diverse workforce. This is especially important after the COVID-19 pandemic widened social divides, highlighted as an emerging risk in the World Economic Forum Global Risks Report 2021. Such shifts require focus on the governance aspects of businesses.

Some governments in Asia have begun to make ESG part of national agendas, setting mandatory ESG-related criteria for businesses.

For businesses, requirements have increased for ESG disclosures and compliance with the Task Force on Climate-related Financial Disclosures (TCFD). Companies increasingly need to display their ESG plans or risk losing access to insurance or financing.

Japan

Could end support for overseas coal power projects.[2]

Indonesia

Plans to eventually phase out coal and introduce a carbon tax.[3]

Singapore

Plans to launch Climate Impact X (CIX), a global marketplace for carbon credits.[4]

A large domestic bank will stop financing customers that derive more than 50% of their revenue from thermal coal from January 2026 onwards.[5]

Malaysia

Announced it will stop financing new coal activities as part of a sustainable financing strategy.[6]

South Korea

The insurance arm of a large conglomerate announced it will stop insuring new coal projects.[7]

China

Launched a national emissions trading scheme that covers about 40% of the country's carbon emissions.[8]

ENVIRONMENTAL

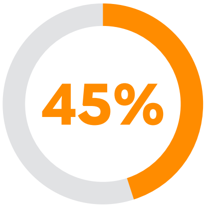
Closing the Climate Protection Gap

In May 2020, a Dutch court ruled that an energy company must intensify its efforts to reduce carbon emissions by 2030[9], while activist groups won a landmark shareholder climate-related vote—making it clear that addressing climate change risks must be high on the corporate agenda.[10]

Recent events involving two large energy companies signaled momentum in ESG issues concerning climate change in particular.

Importance of ESG issues among Asia's Companies

Percentage of companies in Asia that rank climate change and ESG issues as important or most important to their organization, according to the 2021 Marsh Risk Resilience Report.



Taking action against climate/ ESG Risks

Percentage of companies globally that have ineffective or no process for identifying, responding to, and implementing changes based on climate/ESG risks.

Natural Disaster Protection Gap in Asia

Percentage of uninsured economic losses caused by natural disasters in Asia (US$64m out of $67m), whose severity has been exacerbated by climate change.[11]

A significant investment in renewable energy is expected in order for countries to meet obligations agreed under the 2015 Paris agreement; Asia is expected to have 50% of global investments in renewable energy.[12]

SUPPORTING THE TRANSITION TO A LOW CARBON ECONOMY

ESG presents a new opportunity for businesses and investors, but the opportunity comes with challenges:

- New market entrants will increase competition,[13] add cost pressure, and reduce revenue and margins.
- New technologies lack an extensive performance record, and can potentially increase a business's exposure to design risk and performance issues.
- Uncertain regulatory frameworks in emerging markets could cause project delays, potentially making some non-bankable.
- Asia's variety of localization requirements may cause capacity and experience issues along the supply chain.
- Natural catastrophes and site conditions need to be better understood across Asia.[14]

The conventional "insurance-only" approach is insufficient for companies' risk management needs. More robust risk mitigation approaches like risk engineering, estimated maximum loss scenarios, contractual risk allocation and parametric solutions are needed.

COMPLYING WITH TCFD DISCLOSURES: CLIMATE CHANGE RISK MANAGEMENT

Banks are incorporating ESG considerations into their credit reviews, where a defined ESG vision and quantifiable key performance indicators (KPIs) may unlock additional and more competitive financing.

Hence, a clear ESG strategy helps companies understand climate-related risks and creates opportunities to access sustainable financing to support TCFD compliance.

These steps support disclosure and ESG statements in annual reports:

- **Formulate a climate risk strategy to identify and quantify impacts with financial and non-financial KPIs.**
- **Use climate scenario analysis, natural catastrophe modeling and advanced insurance analysis modeling to inform strategic decisions to improve resilience of critical assets.**
- **Determine appropriate reporting standards, identifying and collecting relevant ESG data, and developing board-level ESG risk and performance dashboards.**
- **Act on risk assessment data to enhance climate resilience through measures including engineering solutions and supply chain diversification.**

MANAGING ENVIRONMENTAL IMPACTS

Companies also need to actively manage their environmental impacts across the value chain, such as forestry and agricultural land use, water use, and resource circularity.

This requires quantifying a business's environmental footprint, assessing environmental management policies, and studying the external operating environment for potential regulatory exposures and supply chain risks, among others.

There are also ongoing efforts to elevate biodiversity concerns, including the recent announcement of a **Taskforce for Nature-related Financial Disclosures (TNFD),** based on the successes of the TCFD.

With more than half of the world's economic output moderately or highly dependent on nature[15], taking action to manage nature-related risks is vital and will allow businesses to become more attractive suppliers or business partners.

SOCIAL

Healthier, More Inclusive Workforce for Society

Disparities and inequities for disadvantaged groups—including lack of access to healthcare, education, employment opportunities, and digital technology—have widened the protection gap and posed reputation risks for businesses.

Businesses today are often expected to help advance healthier and more equitable societies through inclusive employee benefits, which at the same time can bring competitive advantages, such as attracting a diverse workforce. As such, many organizations are reviewing their benefit plans through Diversity, Equity and Inclusion (DE&I), ESG, and employee relations lenses.

Effectively managing health risks—in part by taking steps to enhance employee's emotional, physical, financial, and social health—benefits businesses in two ways:

Potential health issues and risks are identified and mitigated early, reducing the effects of presenteeism.

Improved employee well-being drives significant gains in performance and engagement.[16]

According to recent research by Mercer Marsh Benefits, workforce exhaustion and deteriorating mental health are Top 10 risks.[17]

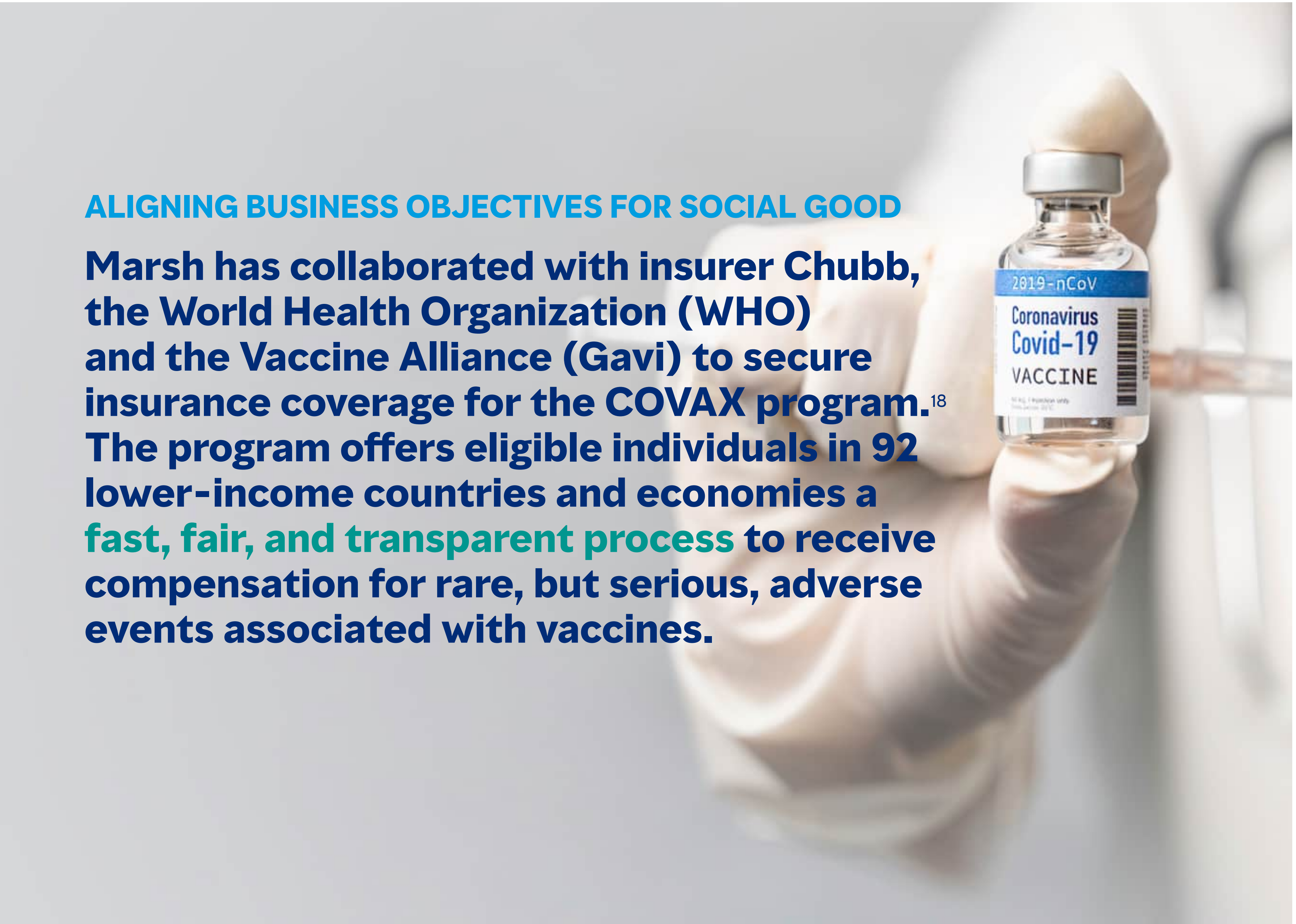
The pandemic's duration exacerbated mental health conditions for many, and helped put people-related risks—as well as their relation to business continuity, employee performance, client experience, reputation and the bottom line—on the boardroom agenda.

BENEFITS FOR ALL

31% Estimated increase in productivity

35% Decrease in turnover

41% Lower healthcare costs



ALIGNING BUSINESS OBJECTIVES FOR SOCIAL GOOD

Marsh has collaborated with insurer Chubb, the World Health Organization (WHO) and the Vaccine Alliance (Gavi) to secure insurance coverage for the COVAX program.[18] The program offers eligible individuals in 92 lower-income countries and economies a fast, fair, and transparent process to receive compensation for rare, but serious, adverse events associated with vaccines.

BEING INCLUSIVE

Many traditional benefit plans assume a linear life pattern, where an "average" employee gets married, buys a home, raises a family, and retires.

Health and well-being benefits often fail to take account of race, ethnicity, sexual orientation, gender identity, income, or country of origin, among other dimensions. Subsequently, health, risk protection, and well-being benefits offered to employees—including provisions for mental health, paid time off, and caregiving—are far behind the reality of a diverse workforce.

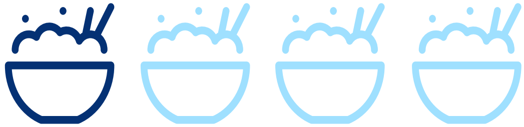
Firms should review their plans and introduce benefits that are designed to support all employees, regardless of race, color, gender, sexual orientation, national origin, and age.

GOVERNANCE

Deciding Sustainably

Governance relates to an organization's decision-making framework and process, such as the distribution of rights and responsibilities among the board, managers, shareholders, and stakeholders.

The pandemic induced stakeholders to scrutinize business continuity planning (BCP) and the cyber risk management of businesses they work with.



1 in 4: Businesses with a comprehensive process to model the impact of emerging risks[19]

BUSINESS CONTINUITY PLANNING (BCP)

Business resilience is critical in ensuring an organization's ability to withstand unexpected aftershocks of an event, such as the lockdown and movement restrictions that came with the pandemic.

The pandemic's impact to supply chains, especially in the food and beverage and retail/wholesale industries, is a reminder to have contingency plans ready and to use BCP to minimize and mitigate further losses. Regular reviews and exercises of business continuity management plans is necessary to ensure they remain effective.

Organizations must identify and prepare for systemic and emerging risks to build resilience and foster competitive advantage.

Business resilience is reflected in the ability to:

- Identify and prepare for systemic and emerging risks
- Anticipate the most important risk issues
- Connect risk management to long-term growth strategy
- Avoid gaps in the perception of preparedness
- Measure relevant data

TECHNOLOGY RISK MANAGEMENT

Organizations with empowered chief information security officers are in pole position to thrive if they can quantify the economic costs of cyber exposures and optimize investments in risk mitigation and transfer. The quantitative framework also enhances preparedness for cyberattacks, as greater sophistication of methodology can lead to innovative risk strategies that potentially reduce costs.

CYBER RISK MANAGEMENT

Cyber threats are pervasive and accelerating, costing global businesses billions every year, creating exposures across almost every aspect of an organization's value chain, and spurring governments to speed up progress around technology governance.

For example, the average business interruption outage from a ransomware attack now exceeds 20 days, with demands for more than US$1 million commonplace.

18%

Percentage of companies who say they are highly prepared for cyber risk, despite the resources organizations are committing to combat it.[20]

Understanding and Managing Your ESG Risks

An overarching framework is necessary to have oversight and management of every aspect of a business's ESG risks.

ESG Assessment

An ESG performance assessment helps develop an understanding of an organization's current ESG maturity, which enables the following:

Better informed risk decision making	**Execution of ESG objectives in line with risk appetite**	**Integration of practices within proven ERM and resilience frameworks**	**Meeting requirements for external reporting**

Recently, a leading manufacturing company in Asia defined ESG as an important business strategy for their long-term operations and used the globally recognized MSCI ESG ratings improvement program.

Marsh Asia undertakes performance gap analyses based on a comprehensive spectrum of relevant ESG criteria, benchmarks the results against industry peers, and provides action plans or implements and monitors improvements at scheduled milestones.

ESG Risk Management

The ESG risk management process entails identifying and quantifying the business's risk aggregation and interdependencies across the value chain to help ascertain the degree of contingent business interruption risk.

Gap analysis assessment against best practice ESG criteria	**Review of governance documentation and data to determine how much stress the business can withstand and at what points in the value chain**	**Identify and codify ESG risks in a robust risk register**	**Evaluate counterparty risk and integrate ESG within enterprise risk management frameworks**

By identifying and codifying ESG risks in a robust risk register, businesses can ensure an alignment of risk and sustainability management, and have a comprehensive view of existing and forward-looking ESG risks and their financial impacts.

Conclusion

Initiatives such as the United Nation's Principles of Sustainable Insurance highlight the need for companies' core ERM assessment framework to be integrated with material ESG risks that can result in significant financial losses.

To this end, businesses need to identify and fully understand the various ESG-related risks and conduct financial impact assessments of ESG exposures and ESG performance by using ratings and indices, before implementing a framework for managing the top risks.

Furthermore, ESG programs can create short- and long-term value. According to a McKinsey survey, a majority of surveyed executives and investment professionals agreed that ESG programs create shareholder value and improve financial performance by maintaining a good corporate reputation, attracting and retaining talent, strengthening the organization's competitive position, and meeting society's expectations for good corporate behavior.[21] An article published in the Finance Research Letters journal also found that high-ESG fund/stock portfolios generally outperform low-ESG portfolios through better financial risk mitigation during a financial crisis.[22]

Given the deep expertise required for a successful ESG program, it is imperative for organizations to have a trusted advisory partner to support them in the alignments, assessments and risk management solutions as they quantify and measure ESG progress.

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