

# Integrating Environmental and Social Risk Management into a Financial Institution's Overall Operations

Environmental and social (E&S) risk management is often treated as a separate consideration for many organizations, including some financial institutions. Because E&S risks aren't as easily quantified as financial risks (which can be assigned a score), they can be hard to include in a financial institution's models and decision-making. Many E&S risk management approaches are based on project and transaction risks rather than overall client risk, which works for some project and asset-based corporate finance transactions. However, when banks and other companies have multiple transactions and products with the same client, a more integrated and holistic approach can make more sense. Know Your Client (KYC) is often a good approach for integrating E&S risks into an organization's overall decision-making and for dealing with multiple transactions and products for the same client.

## A leasing company in Brazil integrated its E&S risk management framework into its overall KYC screening approach.

The International Finance Corporation (IFC) provided a \$62 million financing package to Brazilian leasing company Société Générale Equipment Finance S.A. (SGEF) to be used for financial leasing of energy-efficient industry and high-tech equipment (climate-smart transactions). A leasing company's exposure to E&S risks depends on the types of assets with which it is involved, often related to transactions involving specialized or heavy equipment and machinery used in certain industry sectors (such as forestry operations, mining, and oil and gas), where liability or reputational risk could be concerns.

Leasing operations don't generate significant E&S impacts directly, but how a leasing company's clients and investees manage their operations could pose E&S risks to a company such as SGEF. Because the company sometimes provides operational leases (it owns and services the leased physical assets and is responsible for installing and operating them), it could be directly responsible for E&S impacts caused by the physical assets' use, such as land contamination or worker safety. However, the company has limited control of the lessee's E&S performance and little leverage over how the lessee uses the fixed asset.

SGEF may also have multiple transactions and operations involving the same customer. As such, having a separate E&S team conduct a review linked to each transaction is highly inefficient.

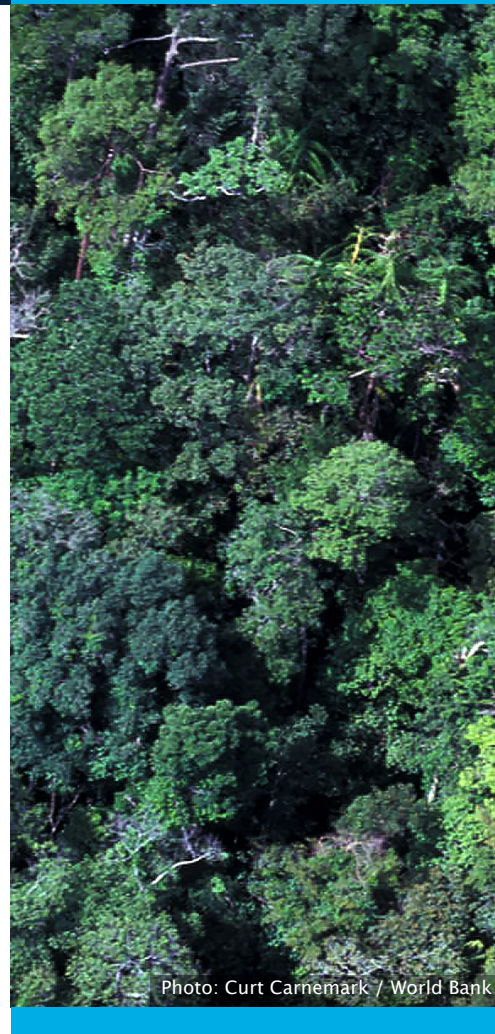


Photo: Curt Carnemark / World Bank

## Know Your Client (KYC): an integrated and technological tool that financial institutions and companies use to assess their customers' profiles and monitor the origin of financial resources

KYC's three main objectives are risk prevention, loss reduction and profit optimization, and customer profile mapping.

KYC requires a process to follow, people who are trained to do it, and information technology support.

Customer due diligence is a process that continues from the start of a customer relationship to the end.

**Leasing companies like SGEF can manage E&S risks more efficiently by integrating E&S risk management procedures into their overall risk management frameworks.**

Leasing companies can develop and implement an internal process or procedure to assess the financial, reputational, and liability risks arising from E&S impacts of their clients' operations. The procedures can be specified based on the types of leases (finance versus operational), the assets being leased, the client's operations, and the lease terms. This can be a stand-alone procedure (which could result in delays and inefficiencies if multiple transactions with the same client are involved), or it can be fully integrated into other risk assessments.

SGEF operates under the Société Générale Group's E&S Policy, and it implemented an environmental and social management system (ESMS). The ESMS, as part of the KYC system, is integrated into the overall risk management framework. The procedures for managing E&S risk need to be applied together with other risk management procedures already in place at each stage of the transaction cycle, which increases the financial institution's compliance with its own requirements and avoids delays. E&S risk is therefore considered throughout the transaction cycle, without needing to involve a separate unit operating somewhat apart from the rest of the risk management team.

Under the approach that SGEF selected, E&S risk management procedures were structured as part of its KYC to assess risks and clients against the applicable E&S laws and regulations. The approach also included screening for excluded activities (against an excluded activities list and restricted companies established by Société Générale Group worldwide), a review of clients' ESG policies, a media alert for publicly available E&S data, and a legal clause. Because the KYC is applied every year at the client level, SGEF doesn't have to conduct an E&S screening for each new transaction, and the E&S monitoring is also incorporated into the company's systems.

Incorporating E&S risk management procedures into a KYC screen approach worked especially well for SGEF. Doing so helped

- Improve the efficiency of E&S assessment and overall risk management, because E&S is not considered separately from other risk processes.
- Monitor existing client risks, including regulatory risks arising from changes in legislation, because it's done annually regardless of whether SGEF has new transactions with the client.
- Increase team productivity, security, and speed while onboarding new clients, because KYC systems incorporate these technologies that also benefit E&S risk management.
- Speed up validation and queries, because all information is centralized in a single risk management system.

**Incorporating E&S risk into a KYC system integrates E&S risk identification and management with other risk procedures, increasing efficiency and making it easier to consider E&S issues in decision-making processes.**

The decision to automate KYC and include E&S risks can be costly, but SGEF's case shows that if expenses related to back-office analysts, team management, and time consumed for queries and training are considered, such a system in the decision-making process can be comparatively cost-effective.

Financial institutions need to clearly understand potential E&S risks and implications for a client's or investee's operations before a transaction occurs, and they can do that by integrating E&S risk management procedures into their overall risk management framework and using procedures such as KYC.

Integrating an ESMS into a KYC system can benefit a financial institution by providing efficiency gains and improving compliance with environmental, social, and governance assessment protocols. But it may not be suited to every type of transaction. Some financing—particularly long-term project and corporate finance—has E&S risks that can be very complex and require technical expertise and more detailed due diligence (for example, on consultation processes, resettlement, biodiversity, and so on) that can't be performed in the context of a KYC system. In those cases, a separate E&S team with appropriate expertise and access to technical experts in specialized fields (such as stakeholder engagement and Indigenous Peoples) can be a better way to manage complex E&S risks.