action exchange

Turning strategy into reality

ESG implementation challenges in Australia's finance sector

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About this report

Turning Strategy to Reality: ESG Implementation Challenges in Australia's finance sector, is a report written by The Action Exchange, a thought leadership and strategic engagement agency. It explores the practical steps Australian financial services firms are taking to embed rigorous ESG management into their organisations, with a focus on the risks and opportunities that implementation of ESG strategy brings.

Based on in-depth interviews with sustainability leaders from across the finance sector, the report finds that while ESG awareness is filtering into commercial banking decisions, managing skills gaps and establishing strong ESG governance remain a challenge.

We acknowledge the Traditional Owners of Country throughout Australia and recognise their continuing connection to land, waters and culture. We pay our respects to their Elders, past and present.

The Action Exchange would like to thank the following people who were interviewed for this research:

- **Kate Bromley,**
  executive director of sustainable finance, **FairSupply**
- **Michael Chen,**
  executive director and head of ESG, **Westpac Institutional Bank**
- **Ivor Gibbons,**
  head of sustainability, **Perpetual Limited**
- **Kristy Graham,**
  chief executive officer, **Australian Sustainable Finance Institute**
- **Darian McBain,**
  chief executive officer, **Outsourced Chief Sustainability Officer Asia;** visiting professor in practice, **London School of Economics and Political Science**
- **Fiona Reynolds,**
  chair, **UN Global Compact Network Australia**
- **Sema Whittle,**
  general manager, corporate governance and sustainability, **Allianz Australia**

Key Findings

The front office is adapting

Once the sole preserve of a dedicated corporate sustainability team and a small group of sustainable finance experts, ESG awareness now permeates banking and investment teams. Financial firms are rushing to upskill banking and investment teams on sustainability as the distinction between "finance" and "sustainable finance" blurs. Teams increasingly comprise staff with specialist sustainability skills and traditional finance experience.

Sustainability-linked KPIs are the new norm

Most finance executives are used to being assessed on ESG-linked key performance indicators (KPIs). This practice is now trickling down to lending and portfolio managers and starting to have a tangible impact on commercial decisions. Industry leaders say the key to managing ESG-related performance is to clarify which individuals and teams are responsible for delivering on specific aspects of the strategy. Defining which accountabilities sit with the core sustainability team and which sit in the front office is critical. Yet embedding genuine responsibility is still a work in progress and many firms need to close the gap between their long-term ESG goals and short-term incentive structures.

An ESG governance gap looms

The fast-moving and complex ESG landscape makes genuine board oversight a challenge. Inadequate sustainability governance is a potential risk for many financial institutions. Skill gaps exist not just among teams but also at the director level, while stakeholder expectations—and regulatory risks—are high and rising. Many boards have only just begun to grapple with climate-related risk and are yet to fully grasp other types of ESG risk. The answer? Invite the tough conversations. Business as usual may no longer be an option.

Specialism rules

As ESG considerations become more complex, financial institutions are recruiting technical and sectoral specialists to sit in core banking and investment teams. People with experience in climate, biodiversity and human rights are in high demand. Yet, as lenders and investors turn their attention to measuring financed emissions as part of scope 3 reporting requirements, they also need data analysts and specialists with sustainability experience in the business sectors or asset classes to which they are most exposed. These specialists will work closely with customers and portfolio companies to reduce their emissions.

Turning ESG strategy to reality: an implementation checklist

01

Curate a mix of traditional finance and sustainability skills within banking teams.

02

Incentivise teams to prioritise long-term ESG-focused returns.

03

Recruit technical and sectoral sustainability specialists—particularly those who have worked in sectors or asset classes to which the organisation is heavily exposed.

04

Embed ESG-focused KPIs across the organisation. Be specific about whether responsibility for aspects of the strategy sits within the core sustainability team or with other corporate or front-office teams.

05

Prioritise experience in organisational transformation among sustainability leadership.

06

Ensure board members are familiar with all aspects of the organisation's ESG performance—not just climate.

07

Upskill all existing staff on ESG policies, with a focus on front-office teams such as lending and investment managers.

08

Clarify board members' specific obligations relating to ESG strategy and implementation, and ensure those obligations are a standing item at board meetings.

09

Recognise that embedding sustainability takes an organisation-wide transformation. This will mean new people, processes and systems.

10

It is the role of sustainability champions to challenge the status quo. Invite them to have tough conversations with the board and executives.

Introduction

In 2015, Mark Carney, then governor of the Bank of England, gave a speech that warned a room full of insurance executives of the severe and impending risk climate change poses to the stability of the world's financial system. "Breaking the Tragedy of the Horizon"—the first of many similar addresses Mr Carney would deliver—pulled no punches and captured the attention of the financial media and executives globally.[1] It also marked the start of an irreversible transformation in how banks and financial services firms incorporate ESG factors into their decision-making processes.

Just as most banks, investors and insurers radically reshaped their operations to stay competitive in the face of digital disruption, they are now thoroughly reimagining their policies, practices and workforces to become sustainability champions. This significant ESG transformation means that sustainability is no longer an imperative to be imposed from the top down, but a set of practices and principles that should be horizontally embedded across an organisation, says Kristy Graham, chief executive of the Australian Sustainable Finance Institute (ASFI).

The practical implications of this shift are clear and far-reaching. Most large financial firms now possess stand-alone ESG functions, have shared comprehensive, board-approved ESG strategies with shareholders and investors, and have proposed processes to transform their organisations and meet ESG targets. Yet many now find that implementation creates new and more complicated sustainability challenges.

Workforce pressures are key among these. Increasingly stringent reporting and regulatory requirements create a need for larger, multi-functional sustainability teams with scientific and technical skills that work under evolving ESG management frameworks. As the line between "finance" and "sustainable finance" becomes increasingly blurred, firms must also create formal accountabilities for front and back-office teams tasked with improving the ESG performance of their organisation and its customers.

This, in turn, delivers new governance challenges. Sustainability leaders and their teams are expected to wield influence over everything that comes under the ESG umbrella, but are not always given the power to make decisions. Inadequate data, particularly about customers' ESG performance, means errors in decision-making are inevitable. Within some financial institutions, a persistent gap in sustainability knowledge at the board level only increases these governance risks.

The shift in focus from strategy to implementation does have an upside. Australian financial firms are finding innovative solutions to these challenges and embracing the need to constantly learn and adapt with optimism. Moreover, their approaches to enabling and embracing change, and to managing the associated risks, offer insight and guidance for companies that may not be as advanced in their ESG journeys.

The front office as an agent of change

It is increasingly common for finance companies to integrate sustainability-related targets and processes throughout their corporate structures. Many also recognise that the most effective path to achieving impact—and the most efficient way to meet their ESG goals—is to weave sustainability considerations throughout lending and investment decisions. Where ESG was once the preserve of dedicated sustainability experts or small groups of sustainable finance specialists, it is now expected that banking, lending and investment teams will not just talk the ESG talk but also apply ESG considerations in their work.

The finance sector can most effectively drive change through their investments, products and services, and supply chains. "The key levers we can pull to influence sustainability are where we invest our money or don't invest our money and who we insure or don't insure, through the design of products and services and of course in our own business operations," explains Sema Whittle, general manager of corporate governance and sustainability at Allianz Australia.

This is about more than just doing good. Banking and investment managers now see ESG investing and financing as a commercial opportunity. Around three-quarters of Asia-Pacific investors and issuers (77% and 75% respectively) surveyed in 2022 said their sustainable investments and or sustainable finance products had performed better than equivalent traditional investments or approaches.[2]

As a result, front-line business bankers and portfolio and investment managers have a strong appetite to develop their knowledge. "ESG for a long time was almost a footnote to client and investment discussions," says Kate Bromley, executive director of sustainable finance at ESG data provider FairSupply. "Now, ESG is often one of the top agenda items, and the time allocated to speak about ESG issues in meetings has increased."

The implication for the Australian finance sector is clear. Where ESG experts once sat in a separate sustainability team, they are now being integrated into investment teams, says Fiona Reynolds, chair of the UN Global Compact Network Australia and former chief executive of the Principles for Responsible Investment. While this is commonplace in European FIs, Ms Reynolds says Australia is now starting to follow suit.

Michael Chen, executive director and head of ESG at Westpac Institutional Bank (WIB), agrees. WIB expects its bankers to handle ever more complex ESG-focused client conversations, a shift that he anticipates will accelerate. "We will still have ESG experts within the bank in the future, but the bankers themselves will be increasingly ESG literate," he says.

Leading for constant change

As sustainability and ESG teams have evolved, their focus and importance has shifted dramatically. Corporate leaders' recognition that climate-change and ESG considerations are core to their companies' success and long-term survival means the sustainability function is now business-critical. Sustainability leaders are still advocates for more ambitious ESG goals but also have complex operational responsibilities.

"As recently as ten years ago, you typically found one ESG person at an institution. They were a generalist, mainly focused on policy," explains Kate Bromley, executive director of sustainable finance at FairSupply. "They were an advocate for this new and emerging ESG space," whose role was to help the business "understand the fundamental business risks that financial institutions need to price and build into our strategies". Responsibility for ESG strategy and implementation resided with various functions, including marketing and communications in some instances, and the role's primary purpose was to educate staff and engage with activist stake-holders and investors.

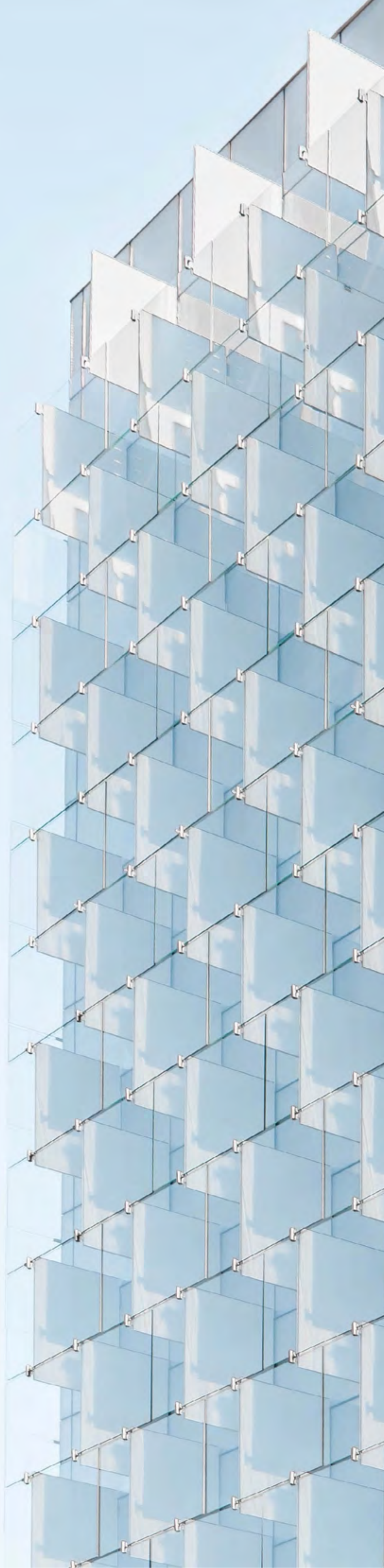
Now that banks and investors are making far-reaching organisational changes to meet their ESG goals, the job description for a sustainability leader has shifted dramatically too. A strong technical background is no longer the most essential attribute for a chief sustainability officer (CSO). Instead, the ability to work across the organisation, engage with external stakeholders and act holistically is the most critical skill, says Kristy Graham, chief executive of the Australian Sustainable Finance Institute.

"Systems thinking is a capability that financial institutions increasingly recognise is needed." Ivor Gibbons, head of sustainability at Perpetual Limited, agrees. Fundamentally, ESG leaders must have the "capability and expertise to coordinate, advocate and drive organisational change," he believes.

It is not just the role of individual ESG leaders that is changing. Sema Whittle, general manager of corporate governance and sustainability at Allianz Australia believes that as financial institutions move from developing ESG strategy into the ongoing implementation phase, those leaders must continually re-evaluate which responsibilities are best held by their corporate sustainability team and which should be assigned to other areas of the business. Ms Whittle is gradually devolving some ESG-related tasks and responsibilities to other parts of the company. "For example, my team still does environmental reporting, but we are now transitioning sustainability reporting to finance," she says. "We keep asking ourselves if the work better sits in another team because that's where the expertise sits."

> The key levers we can pull to influence sustainability are where we invest our money or don't invest our money, and who we insure or don't insure.

– **Sema Whittle,**
general manager, corporate governance and sustainability, **Allianz Australia**



The race for technical and specialist talent

Although financial firms are demanding more general ESG competence from everyone, they are also rushing to hire technical specialists with specific environmental, social or governance expertise. This reflects a global trend: 94% of hiring decision-makers say they lack the necessary talent to implement their ESG goals, while 76% are hiring for one or more E, S or G roles.[3]

Specialists such as climatologists, data and environmental scientists, and even students from climate institutions, are in high demand.[4] "In my experience working as an ESG practitioner, I have hired a climate scientist and a data analyst who had an engineering background. I have hired people with legal backgrounds to develop the governance strategy," explains Ms Bromley. Modern slavery and human rights are also essential focus areas, says Ivor Gibbons, head of sustainability at Perpetual Limited.

Another concurrent trend is for lenders and investors to recruit people with corporate sustainability experience in the sectors they are most heavily exposed to, for example, real estate, mining, infrastructure or agriculture. These industry specialists give firms a much deeper understanding of their clients' ESG risk exposure and are better able to spot commercially attractive sustainable finance opportunities.

At Westpac, hiring sectoral specialists is part of a deliberate and long-term strategy to embed ESG expertise throughout the organisation's banking and investment teams, explains Mr Chen. He says recruiting staff with a deep understanding of their clients' ESG profiles also makes commercial sense. "When they meet with clients, they've got that credibility and understanding."

Asset managers are also hiring sustainability experts who specialise in a particular asset class, says Ms Bromley. Having a sustainability lead in an asset class team with industry experience can be a real advantage, she adds.

This trend is likely to continue and deepen, according to Ms Reynolds, who says it's not just technical advisors that will require specific knowledge, but investment managers as well. In the future, portfolio managers may specialise in specific environmental, social or governance issues, or sustainable investing in a particular asset class. "How you think about ESG investing in infrastructure is not the same as in equities," she says.

Specialism rules in scope 3

As disclosure rules like the European Union's Corporate Sustainability Reporting Directive, and taxonomies governing what qualifies as a green or sustainable investment or asset, become better entrenched in global markets, specialist knowledge will become critically important. It will also help financial firms better understand how they can measure, meet and monitor scope 3 targets, which will require them to disclose and actively work to reduce their clients' carbon emissions.[5]

"Financial institutions who are genuine about their transition plans are going sector by sector, looking much more closely at how each company they finance is transitioning towards net zero," says Darian Mc Bain, chief executive of Outsourced Chief Sustainability Officer Asia and former chief sustainability officer of the Monetary Authority of Singapore.

Applying this scrutiny will become ever more complex as regulators and other stakeholders expect financial firms to probe not just their financed carbon emissions but also their customers' ESG risks, such as those related to nature or human rights.[6] "An investor with a minority stake may not have operational control of portfolio companies, but they could have a responsibility to influence that organisation's sustainability performance," Ms Bromley explains. "To have somebody who can call out when sustainability performance doesn't seem as good as what you're being told, and to be able to interrogate those results, is helpful in being able to guide and influence the implementation of ESG strategy."

> An investor with a minority stake may not have operational control of portfolio companies, but they could have a responsibility to influence that organisation's sustainability performance.

– **Kate Bromley,**
executive director of sustainable finance, **FairSupply**

Toolkit: How leading FIs train staff on ESG

Finding ESG specialists can be challenging. Three-quarters of finance organisations that responded to a survey conducted by the University of Technology Sydney (UTS) Institute for Sustainable Futures said they had had difficulty hiring for climate skills.[7] A further challenge is that many recruits need to gain the basic finance experience that, until recently, was a prerequisite for working in the sector. "There isn't an abundance of climate scientists with financial sector knowledge," says Kate Bromley, executive director of sustainable finance at FairSupply.

Upskilling the existing workforce on ESG is a common response in the UTS survey. Firms will commonly provide a short one to two-hour workshop or online training on a particular aspect of ESG for a large group, then bring together a smaller, specialist group to complete more extensive training, explains Kristy Graham, chief executive of the Australian Sustainable Finance Institute (ASFI).

Yet, while early movers are adapting quickly to retrain staff, a significant skills gap in the finance sector remains. Australian finance, as a whole, has made negligible progress in developing sustainability skills and capabilities.[8] Around two-thirds of survey respondents to the UTS Institute for Sustainable Futures study said they need improved climate skills to do their jobs, and roughly the same proportion said there are significant barriers to upskilling, including time pressure and a lack of available training resources.[9]

How they do it:
Westpac Institutional Bank

- "Lunch and learns" on topics such as net zero, other specific environmental, social and governance issues and risk assessment.
- Regular internal ESG newsletter.
- ESG literacy curriculum, including a nine-month "train the banker" program in partnership with Monash University.
- Information packs, white papers and cheat sheets on ESG topics, which bankers can take to client meetings.

How they do it:
Perpetual

- A 1.5-year process of training, education, and internal communications with teams as the sustainability strategy was developed, which is ongoing during the implementation phase.
- Education around core ESG topics such as modern slavery, reconciliation, and climate risk, tailored to different levels of the business.

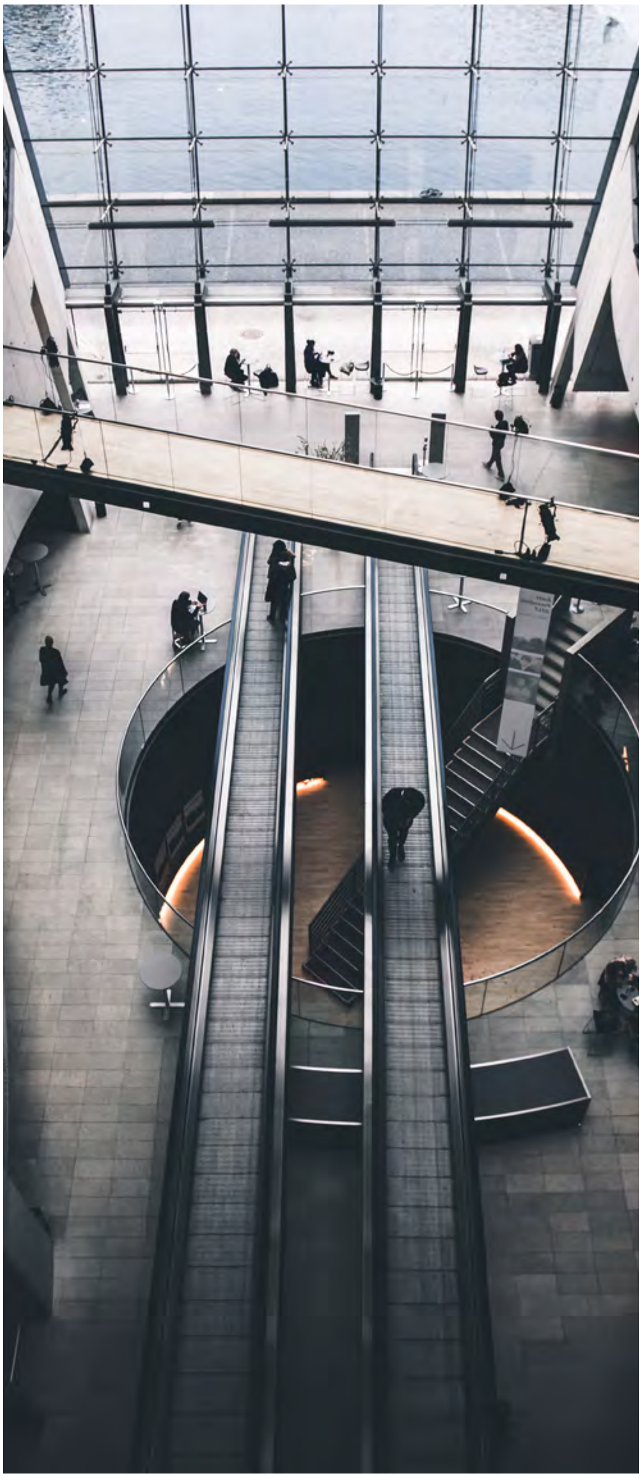
How they do it:
Allianz Australia

- Developed a sustainability capability plan across the organisation.
- A basic online learning module to give all staff base-level knowledge in sustainability and build a common language.
- Leadership offsites and communications featuring sustainability.
- Immersive, experiential ESG-focused training for the board and senior management team.
- Considering how advanced leadership programmes can start to include ESG scenarios to help executives understand sustainability impacts across the enterprise.

> I would fail in my job if the bank just recruited more people with ESG in their titles. We want to make every single banker excellent at ESG.

– **Michael Chen**
Westpac Institutational Bank

Mix and match



Finding and recruiting specialists is only the first step towards building a workforce highly skilled in ESG, and there is no blueprint for integrating people with these ESG-specific skills into a financial firm. ESG data analytics specialists and project managers will likely be spread across different front- and back-office teams, in functions from corporate finance and reporting to investment decision-making.

In financial institutions, ex-NGO activists,[10] agronomists and ecologists now work alongside portfolio managers. Although the global talent shortage's effect on sustainability hiring are well understood,[11] much less is known about how to effectively integrate workers with diverse skillsets, particularly when they lack financial experience. Yet this is critical, says Mr Chen, as across the industry there are examples of experienced climate scientists and experts on natural capital who struggle to apply their expertise in a financial services setting.

To overcome this challenge, WIB deliberately curates a mix of people with traditional finance and specialist ESG skill within its banking and investment groups and its ESG team. "We have purposefully assembled it this way—having people with diverse skill sets," says Mr Chen. "We don't want ESG sitting on the side. We want people that understand portfolio construction, credit analysis, customer relationship management and risk management, working side-by-side with ESG specialists. We're plugging ESG into the existing bank infrastructure."

WIB takes a long-term approach to achieve this integration of diverse expertise, seconding ESG specialists into "traditional" banking teams, and vice versa, on 18-month rotations. Then, "we plug them back into the industry teams," Mr Chen explains. Bankers in effect become sustainability specialists who can hold complex ESG-related discussions with clients. This approach is "working well," he says. "I'm observing that teams feel engaged and enthused because they learn from each other."

Embedding accountability

Upskilling staff and growing their ESG knowledge base is an encouraging first step. Next, financial firms must create formal accountabilities for ESG performance across their teams. This is a two-step process that involves identifying and assigning the right targets to the right people, educating them on what meeting those targets looks like, and implementing structures that incentivise people to meet their KPIs. On this front, the sector has made only modest gains, according to the ASFI's 2022 sustainable finance scorecard.[12]

Yet, while formal accountability for ESG-related targets is still in its infancy in many Australian financial firms, it is becoming increasingly common for companies in the sector to set ESG targets for core banking and investment teams, says Ms Graham. Finance executives increasingly understand they can "deploy more capital, more quickly" to achieve their sustainable finance goals by setting the right KPIs, she says.

To successfully embed accountability for delivering on the sustainability strategy, it is important to clarify who is responsible for specific aspects of it, according to Ms Whittle. "If it's investments, who leads those investment decisions? If it's about product design, who leads that initiative?" she says.

An essential aspect of this is defining the role of the core sustainability team. At Allianz Australia, the sustainability team is responsible for the delivery of the sustainability strategy, coordinating and influencing across the enterprise, being the lead on some projects, Ms Whittle explains.

Executive scorecards at both WIB and Allianz Australia have included ESG-related KPIs for some time now, according to Mr Chen and Ms Whittle. In both organisations, the scorecards have evolved into a tool to advance and cascade accountability more widely. At WIB, they now influence banking and lending decisions and "directly affect how the teams construct their portfolios and the clients they choose to bank," Mr Chen explains.

Scorecards are part of a broader strategy to embed formal accountability for sustainability at Allianz Australia, Ms Whittle says. "Each business division has been assigned a customised sustainability action plan". These collectively feed into a company-wide work plan and every individual employee has at least one sustainability-related KPI. "The targets are ratcheted up year after year, so the bar keeps getting lifted. They're not static," she says.

In it for the long haul

The need to continually adjust KPIs reflects the fact that financial firms must be willing to plan across longer-term horizons if they are to effectively embed accountability for ESG across the organisation. "KPIs need to reflect the relatively protracted nature of ESG investing and sustainability performance," explains Ms Reynolds. She notes that for many FIs, this will necessitate a significant structural shift as investment decisions and portfolio managers' bonuses are typically still calibrated to prioritise short-term returns.

This can cause tensions, as a long-term commitment isn't always consistent with executives' other shorter-term objectives, observes Ms Bromley. Ms Reynolds concurs. "There are changes around the edges happening, and some organisations are a bit more progressive," she says. "But if you incentivise someone to think short-term, they're going to think short-term. We must fix the incentives and pay structures to be more long-term orientated."

The critical importance of data

Accurate and comparable data that is cost-effective to collect and collate at scale is crucial for informed sustainability decision-making in the finance industry. Shareholders, regulators and other stakeholders expect firms to have a clear picture of their ESG exposure—both risks and opportunities—but many presently lack the relevant data.

"Investment professionals need to think differently, and they need to be trained differently, but they need the tools to be able to do that as well. They work in a world where you need information and data," says Fiona Reynolds, chair of the UN Global Compact Network Australia.

A lack of reliable data is the biggest obstacle to Asia-Pacific investors looking to allocate funds to sustainable investments, and for issuers seeking access to sustainable finance, according to a 2022 survey by Economist Impact.[13] Another survey of over 100 British financial services companies, by insurance firm Willis Towers Watson, revealed that this lack of data is the most significant roadblock preventing the finance sector from addressing climate-related risk over the next five years.[14] This challenge will be particularly acute as firms begin to map their scope 3 financed emissions. "We can only accurately quantify [scope 3 emissions] if our customers are reporting in the right way," says Michael Chen, executive director and head of ESG at Westpac Institutional Bank. Yet not all clients are reporting emissions yet.

Moving from ESG strategy to implementation will be even more difficult in areas such as natural capital and human rights, where taxonomies are still being developed, good data is hard to come by and agreement about what needs to be measured and reported is still evolving. Doing this at scale and affordably adds another layer of complexity. And while regulations like those issued by the International Sustainability Standards Board[15] provide a useful framework within which FIs can understand, communicate and improve ESG performance, they don't in themselves facilitate access to the accurate data the frameworks require.

ESG governance: The next big implementation challenge

For financial firms to deliver on their ESG promises, they need leaders at executive and board levels who are well versed on the topic. Without an appropriate level of understanding, oversight is ineffective. While this is true for all material business issues, it is particularly so for ESG concerns, which are not covered by a common framework across all types of companies and activities.

On this critical issue of ESG governance, progress is mixed. Some financial firms have effectively entrenched sustainability into their corporate strategy and risk-management processes. Others still have a long way to go. In 2021, 62% of ASX 200 companies still hadn't published an ESG strategy detailing short-, medium- and long-term goals.[16] Most ESG controversies in financial services have come from governance failures rather than a shortage of action or commitment, notes Ms McBain, who says that the lack of detail in these reports reflects this.

Speaking at the Australian Financial Review's ESG Summit in June 2023, NSW Environment Protection Authority chief executive Tony Chappel bemoaned the number of Australian company boards "fundamentally failing to engage" with ESG risks emerging from the transition to green energy.[17] While his comments were not specifically about the finance sector, they point to a growing challenge: directors must become more conversant with and responsible for ESG matters. "Where I have seen sustainability done well, it comes from the board leadership," says Ms Reynolds. "They understand that it's essential to their mission and part of their investment beliefs. It's not just some tack-on. That's where we need to get to."

Making sure boards can deliver on firms' sustainability strategies will become even more critical as ESG-related obligations for directors—which are currently quite indirect—increase, explains Ms Bromley. "Explicitly, there aren't currently too many board obligations," she says. "There isn't a personal liability like there is in workplace health and safety. If you interpret the Corporations Act, ESG can come under duty of care and not engaging in misleading or deceptive conduct. Greenwashing and appropriate due diligence also fall under the same provisions."

In contrast, expectations of boards are high and rising. For shareholder activists, Australia has one of the world's most friendly regulatory environments.[18] This means that activism is much more common in Australia than in other markets, and activists are increasingly turning their attention to ESG issues. Listed FIs have legal obligations to their shareholders, but shifting consumer expectations mean private companies face increasing pressure to meet the same ESG governance standards.[19]

Beyond climate risk

One challenge for boards is the enormously complicated nature of ESG governance. Financial institutions can hire specialist staff to cover different aspects of sustainability, but boards need the capability—and capacity—to oversee a growing number of issues too. Many are grappling with climate-related risk but have yet to begin considering other ESG issues comprehensively. The Australian Prudential Regulatory Authority surveyed banking, insurance and superannuation firms in 2022 and found that 80% of boards oversee climate risk regularly. Yet when the Australian Institute of Company Directors surveyed its members in 2021, less than half of the respondents had agreed or strongly agreed that their board "has the knowledge and experience to adequately address the climate governance issues facing our organisation".

This discrepancy masks a bigger problem, says Ms McBain, with most Australian boards "only looking at decarbonisation, not at broader environmental issues such as biodiversity, water or the oceans". For many boards, modern slavery (reporting on which is mandatory in Australia for medium and large companies) and diversity, equity and inclusion are the only social aspects of ESG that they oversee. She says these issues are often treated as tick-box exercises and not comprehensively scrutinised. This is a big potential problem: a lack of rigour and breadth in considering board-level ESG issues could leave many Australian financial firms open to significant governance risks, Ms McBain believes.

Time for a tough conversation

To ensure rigorous governance, banks and investors must have a sustainability champion who is empowered to ask difficult questions of the board and executive. Crucially, McBain says that champion needs to outline in black and white why the board needs to address specific ESG issues, and they must be listened to. "They should be there to advocate for change," she says.

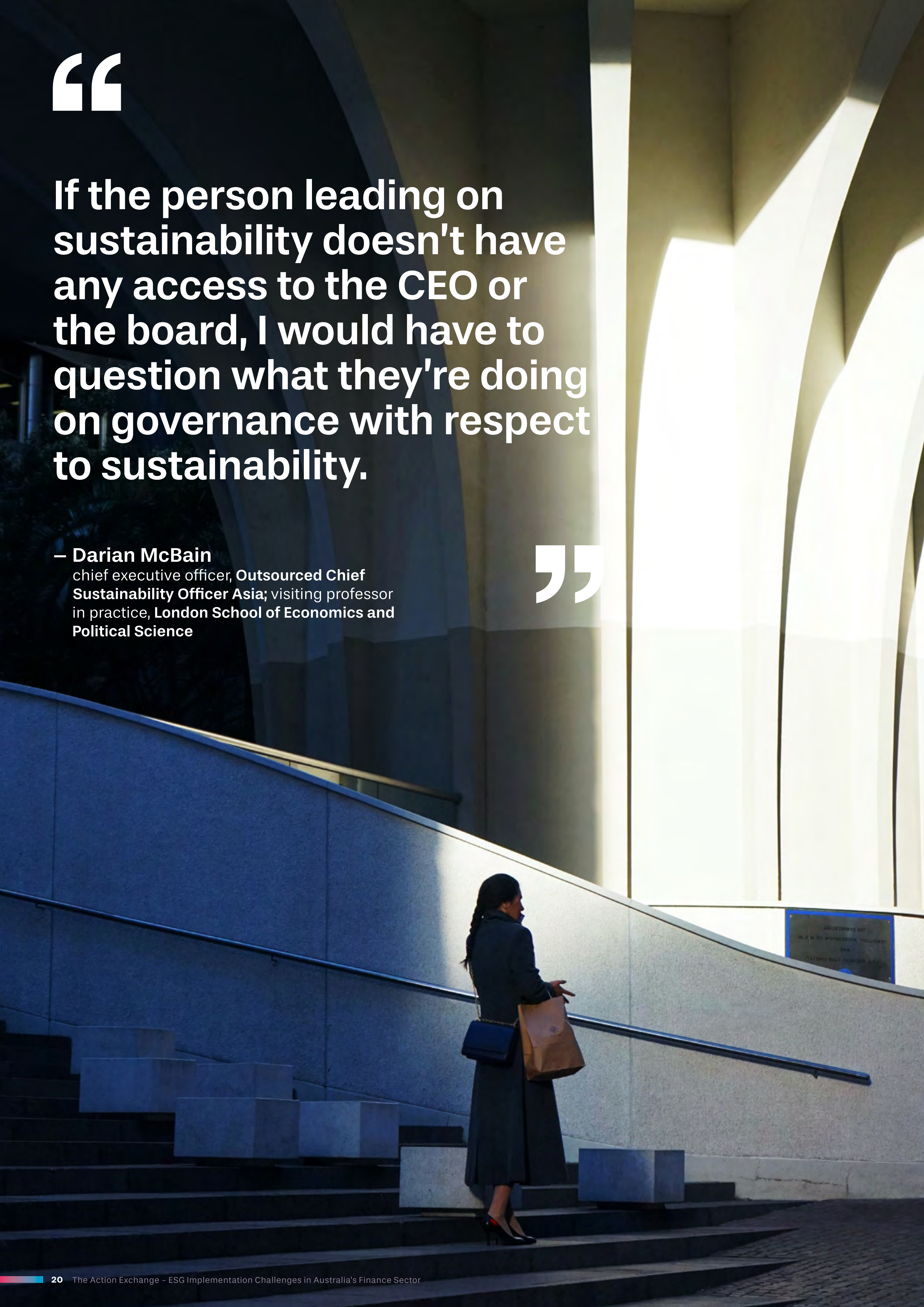
That is often easier said than done, given the nature of the change that's required. As a result, McBain, along with Ms Bromley, worries that sustainability teams instead prefer to give the board positive information about ESG wins rather than have difficult discussions about emerging risks or stalled progress.

"To do ESG right—with integrity and in a genuine way—can be disruptive to some business models," Ms Bromley explains. "Grappling with that is the role of the board and the executive team. It doesn't look good in a sustainability report, but that's the level of conversation we need to evolve to."

One related challenge is that boards and executives often expect CSOs to exert influence across a broad range of business functions, but give them little formal authority to do so, says Ms Bromley. Reporting lines are a giveaway. "If the person leading on sustainability doesn't have any access to the chief executive or the board, I would have to question what they're doing on governance with respect to sustainability," says Ms McBain.

This appears to be a common challenge. Only around one-third of CSOs in the finance sector report to the CEO directly, according to a global survey conducted by Deloitte and the Institute of International Finance.[20] Of the remainder, just under one-sixth (13%) report to the head of marketing or communications.

This can be a governance red flag indicating that "there isn't someone who would be critical and highlight if there is a divergence" between what the organisation sees as a marketing opportunity on one hand and emerging risks and impacts on the other, says Ms McBain. "Until you have board members and C-suite members willing to change the business-as-usual approach, we will continue to have these governance risks."



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– **Darian McBain**
chief executive officer, **Outsourced Chief Sustainability Officer Asia;** visiting professor in practice, **London School of Economics and Political Science**

How to get ESG governance settings right

There are some relatively straightforward ways for financial institutions to better ingrain ESG into their governance structures. A simple first step is to make ESG a standing item on every board meeting agenda. Firms should map out a calendar of dates relevant to their ESG obligations and build a regular cycle of issues the board will consider, Ms Bromley explains.

She adds that it is also critical to engage the board in developing both the ESG strategy and its execution. Ms Whittle of Allianz Australia says her firm refreshed its sustainability strategy in 2022, and the board reviewed several iterations of the draft strategy before they were comfortable signing off on it.

Firms should also clarify what the board's ongoing ESG responsibilities are. This sounds simple, but "having a sustainability strategy that integrates into corporate strategy is quite an advanced step," Ms Bromley says. "ESG is an obligation like any other, and the board needs to have accountability and accept that it comes under its remit," she says.

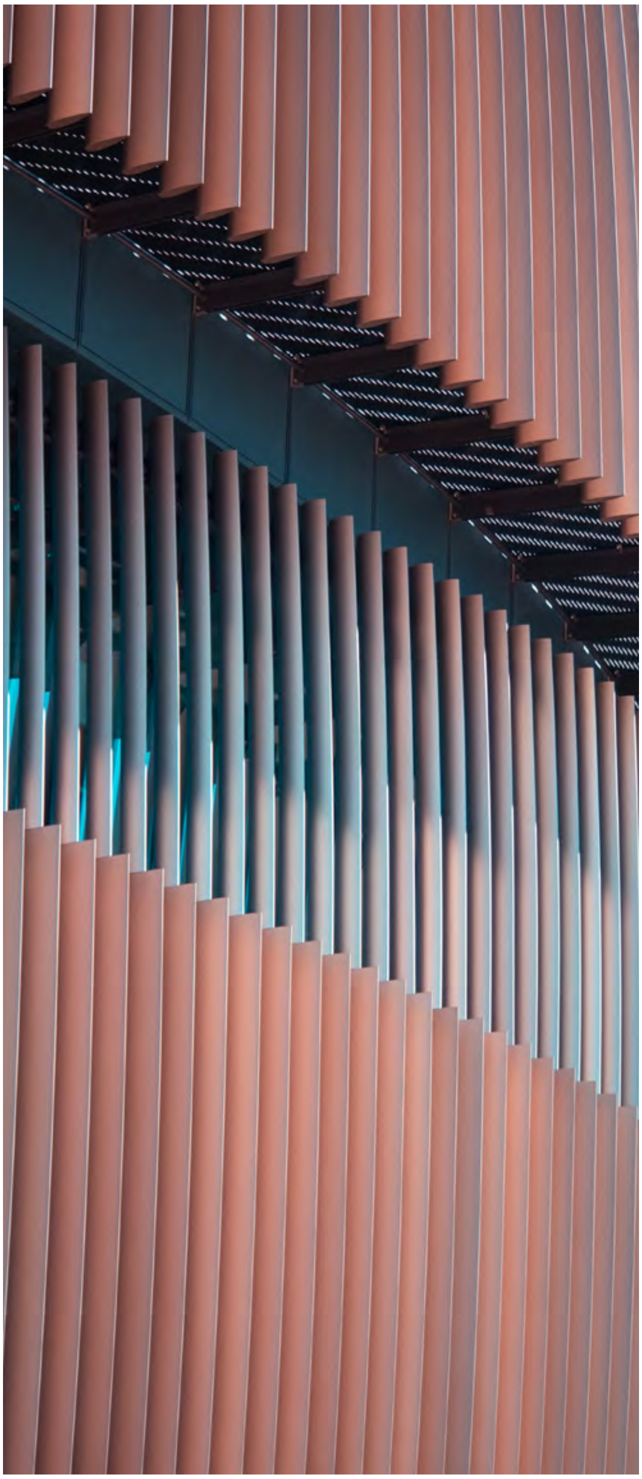
That doesn't have to mean starting from the ground up. Firms can use existing organisational structures to build strong ESG governance, Ms Bromley says. But representation matters, and only around one-third (31%) of ASX 200 boards had a dedicated sustainability committee in 2021.[21] Ms Reynolds predicts this number will grow but notes that stand-alone committees will not be appropriate for every organisation. Many may opt for a different ESG governance framework, says Ms Bromley, but whatever the approach, what is critical is that "accountability is distributed under a clear governance framework".

Reflecting the shortage of ESG understanding among the general workforce, ESG skill gaps are a challenge at board level too. Just 12% of directors on the boards of the world's 100 largest public companies have what are classified as "ESG conscious or competent directors", according to a 2022 report.[22] This is a serious problem, for while skills gaps among employees are a challenge, at a board level they pose a fiduciary risk to a company and its shareholders.

To overcome this, boards of Australian financial firms need to embrace the fact that knowledge is power and, as Ms Reynolds says, more actively recruit board members with sustainability experience. Ms Bromley agrees, and says that even having at least one investment committee member with the knowledge to challenge investment decisions based on sustainability provides a baseline level of ESG governance.

Yet the real problem, says Ms McBain, is that a large pipeline of sustainability specialists exists but these people are presently overlooked for board roles. "Until that changes and until there is genuine demand for people with sustainability skills on boards, not just the veneer of it, I see that governance risk as being quite strong," she warns.

Conclusion



As companies in the Australian finance sector grapple with implementing their approved ESG strategies, there is a growing acceptance that building sustainability into business practices will not be a one-off experience but an ongoing process of transformation. As the ESG discipline itself evolves, and with significant changes like a higher priority for natural capital and a framework from the Taskforce on Nature-related Financial Disclosures on the horizon, many Australian financial firms have recognised the need to adopt long-term, multi-faceted approaches that improve their flexibility to address ESG matters and incorporate more diverse skill sets throughout their organisations.

These changes bode well for the future, but many significant challenges remain. There are ongoing structural tensions between the short-term profit objectives that presently guide most finance sector companies and the long-term nature of ESG issues. These are inherently difficult to navigate and unlikely to be resolved quickly. Shortcomings in governance pose another structural challenge, albeit one that could be overcome relatively quickly with greater board diversity and education, and the appointment of directors with deep ESG credentials.

Regulation has helped drive the adoption of ESG principles, but challenges still accompany implementation across the finance sector. Encouragingly, the interviews conducted for this report have revealed an optimism and drive for success among Australia's sustainability executives, who are finding creative ways to develop their ESG approaches and better serve their clients in the process.

This report also confirms that the push for more ESG consideration in the Australian finance sector is no fad, but a fundamental change that has long-term implications for future operations. As Mr Gibbons notes, a robust approach to managing ESG issues is now mainstream in financial services, not because it looks good, but because embedding sustainability into a company's operations is critical to its fiduciary duty. "If you are not considering material environmental and social and governance factors, then you're not really doing right by your clients," he says. "You're really managing the risk on behalf of your clients. The challenges will change, but ESG issues will always need to be managed."

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