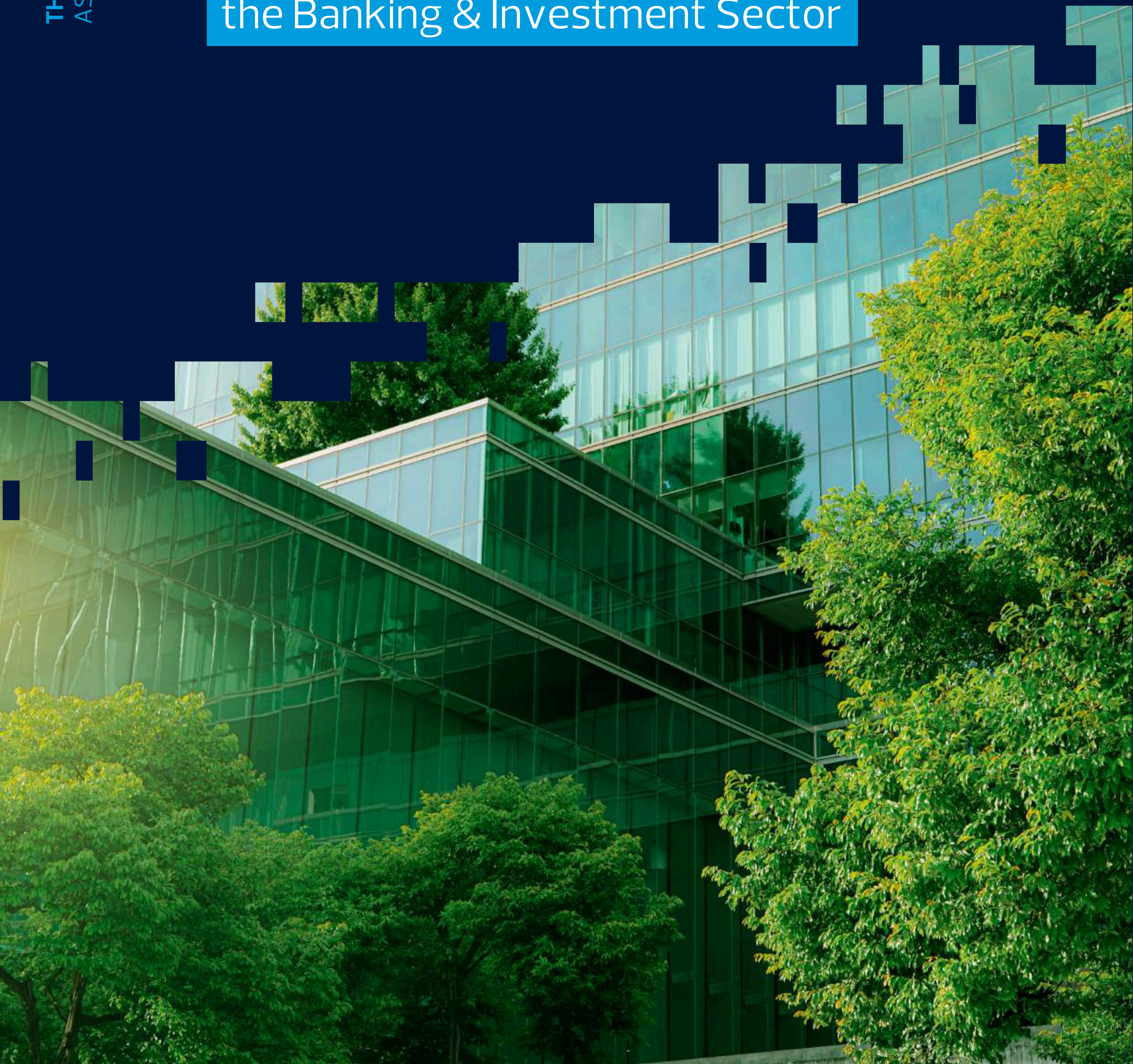
THE POWER OF BEING UNDERSTOOD
ASSURANCE | TAX | CONSULTING

NEWSLETTER

Banking on Sustainability

The Rise and Significance of ESG in the Banking & Investment Sector



Environmental, Social, and Governance (ESG)

A New Era for Banking & Investment Companies in the Middle East

As the world grapples with the urgent need to address climate change, human rights, and governance issues, the financial sector finds itself at the forefront of driving transformative change. The issuance of sustainability reporting standards such as IFRS S1 (General Requirements for Disclosure of Sustainability-related Financial Information) and IFRS S2 (Climate-related Disclosures) marks a pivotal moment, urging banks and investment companies to integrate ESG factors into their strategies and disclosures.

In the realm of sustainable finance, banks are reacting to market changes, and becoming protagonists of an increasingly sustainable future through eco-conscious investments in green bonds, sustainable loans, impact investing, and divestment from fossil fuel. By actively participating in the green economy, banks are not only mitigating climate-related risks but also fostering innovation, creating jobs, and contributing to a more resilient and equitable society.

From Finance to Responsibility: Evolution of ESG in the Banking & Investment Sector

> "The concept of ESG investing traces its roots back to the United Nations Global Compact's "Who Cares Wins" initiative, which highlighted the importance of considering environmental, social, and governance issues for mainstream investors."

PRI | Principles for Responsible Investment

The Principles for Responsible Investment (PRI) was developed by the United Nations (UN) in 2005. The adoption of global agreements like the Paris Agreement on climate change and the UN 2030 Agenda for Sustainable Development in 2015 further catalyzed efforts towards transitioning to low-carbon and circular economies. The Network for Greening the Financial System (NGFS) was launched at the Paris One Planet Summit in 2017.

The establishment of a Taskforce on Climate-related Financial Disclosure (TCFD) in 2015, to develop recommendations, resulted in the four pillars of governance, strategy, risk management, and metrics and targets being incorporated into the two sustainability reporting standards IFRS S1 and S2.

Sustainability reporting frameworks at an industry-specific level, including the Sustainability Accounting Standards Board (SASB) and the Global Reporting Initiative (GRI), along with the GHG Protocol, Integrated Reporting (IR), and Carbon Disclosure Project (CDP), further enhance accountability of ESG-related disclosures, driving the mainstream adoption of sustainable finance practices across the banking and investment sector.

50% **reduction in carbon emissions by 2030 through country-specific pledges**

Recent directives from central banks and capital market authorities signal a commitment to pushing for mandatory ESG reporting in the future, mainly after the climate change COP28 summit in December 2023 in the UAE made country-specific pledges to restrict carbon emissions to 50% by 2030. Furthermore, given the rising importance of these factors in financial investments, stakeholders are increasingly interested in banks' role in the ESG agenda.

The transition to renewable energy, in line with the commitment to honor carbon-neutrality pledges, is progressing at a moderate pace and the introduction of the IFRS S2 framework that tackles climate-change related risks would potentially enable the industry to reach the COP28 target efficiently.

Gulf Cooperation Council (GCC) Nations Spearheading Sustainable Finance Revolution

GCC countries are advancing their sustainable finance ecosystems to bolster GDP contributions. They are prioritizing sustainable investments, and green projects, and fostering sustainable financial institutions through policy implementations. Notable projects that demonstrate these banks' commitment to renewable energy and carbon-neutral urban development include the following:

In May 2023, NEOM Green Hydrogen Company (NGHC) secured **$6.1 billion in non-recourse financing** from 23 local, regional, and international banks for the world's largest green hydrogen production facility in Saudi Arabia for producing green ammonia.

[Source: Note 1 – www.neom.com]

The Saudi Arabian government and Japanese conglomerate **SoftBank signed a MoU to build $200 billion of solar** capacity in the country by 2030.

[Source: Note 2 –www.ijglobal.com]

PIF in Saudi Arabia invested **$1.3 billion in Lucid Motors**, a US-based electric vehicle manufacturer.

[Source: Note 3 – www.reuters.com]

The **UAE invested AED 132.5 billion** (approximately $36 billion) in renewable energy projects in 2022, the highest in the region.

[Source: Note 4 - www.wam.ae Emirates News Agency (WAM)]

The First Abu Dhabi Bank (FAB) provided a **$200 million green loan to Masdar City's Green Real Estate Investment Trust (REIT)** to support the growth of its sustainable real estate portfolio.

[Source: Note 5 - masdar.ae news]

Emirates NBD issued a **$750 million green bond to finance solar and wind projects in the UAE**.

[Source: Note 6 -www.nbd.ae Emirates NBD Investor Presentation Q3 2023]

cont.

There has been a surge in green finance, evidenced by a substantial increase in green and sustainable bonds. For example:

The Kuwait Finance House (KFH) issued the **region's first green sukuk (Islamic bond) in 2018**, raising $250 million to finance renewable energy and energy efficiency projects.

[Source: Note 7 - www.kfh.com]

The Middle East and North Africa (MENA) region saw a **record $15.4 billion in green bond issuance in 2023**, with Saudi Arabia and the UAE leading the way.

[Source: Note 8 - fastcompanyme.com]

Saudi Arabia's Green Financing Framework was announced in March 2024, and is aligned with the Green Bond Principles (GBP) 2021. It has enabled the issuance of green bonds/sukuk, dedicated to advancing cleaner energy sources, economic diversification, and environmental conservation. This framework aligns with Vision 2030 commitments, the Saudi Green Initiative, the Circular Carbon Economy (CCE) national program, and Nationally Determined Contributions (NDC) under the Paris Agreement.

[Source: Note 9 – ndmc.gov.sa]

Spurred on by initiatives like the Saudi Green Initiative and Qatar's National Climate Change Action Plan 2030, other GCC countries are following suit. Voluntary corporate sustainability reporting standards and sovereign sustainable bond programs further illustrate the region's commitment to building the foundations of a thriving sustainable finance ecosystem.

[Source: Note 10 – psa.gov.qa]

Charting the Path to Sustainability

Banking and investment in Kuwait

The Kuwait National Adaptation Plan (KNAP) 2019-2030 underscores Kuwait's commitment to addressing climate change impacts and preserving its natural resources. While focusing on environmental and societal resilience, KNAP also presents opportunities for the banking and investment sector. Financial institutions can support KNAP by investing in sustainable infrastructure projects like renewable energy and water conservation initiatives, thus demonstrating their commitment to sustainability and responsible investment practices.

[Source: Note 11 – www.unfccc.int]

Kuwaiti banks and investment companies can leverage a comprehensive framework for disclosing climate-related risks and opportunities. This framework is built upon the IFRS S1 and S2 standards (which incorporate key elements of the TCFD) and is further supported by disclosure guidance from Boursa Kuwait (regulated by the Capital Market Authority (CMA) and Central Bank of Kuwait (CBK). Both emphasize the importance of board oversight, management assessment, and integration of climate considerations into strategy and risk management. They require banks to identify and assess climate-related risks and opportunities over different time horizons, including their impact on assets and infrastructure.

Additionally, banks must disclose metrics such as GHG emissions and emissions intensity, along with targets for managing climate-related risks and opportunities.

Together with other frameworks like SASB, GRI, and MSCI, the Boursa Guide [Source: Note 12 – www.boursakuwait.com.kw] and TCFD frameworks aim to improve global transparency consistency in reporting climate-related information, and responsible corporate practices to address climate change. By following these guidelines, Kuwaiti banks can enhance governance, management processes, and strategic decision-making to effectively manage climate risks and opportunities in the banking sector.

Sustainability risks in the Middle East banking and investment sector can be classified under:

- Physical Risks arising from extreme weather conditions, water scarcity, and rising sea levels.
- Transitional Risks resulting from carbon-intensive economies, policy and regulatory changes, and reputational risks.

Sustainability opportunities include:

- Green finance due to its growth trajectory and governmental support,
- Renewable energy investments including abundant solar energy and wind energy potential,
- Sustainable infrastructure funding due to climate-resilient buildings and economic diversification due to net zero transition,
- Leadership role in ESG initiatives due to experience in the regional hub.

Recommendations and best practices

Incorporating ESG principles within the banking system's operational and supervisory levels involves multiple steps:

1	Firstly, entities can develop or re-engineer policies to integrate ESG considerations into decision-making processes, which may include fostering the creation of new green products through innovation support.
2	Secondly, the entities can establish methods for tracking the ESG impact of loans and investments.
3	Finally, it is crucial to conduct risk assessments of climate factors on traditional financial risk pillars and enhance reporting and disclosure practices.

In this context, the Basel Committee on Banking Supervision (BCBS) in June 2022 issued principles for managing climate-related financial risks, aiming to improve risk management for banks and supervisors. Principles 1-12 guide banks on managing these risks, while principles 13-18 guide supervisors. Climate-related risk scenario analysis helps identify risk factors and inform risk management. Stress tests incorporating climate change can address financial, systemic, and macroeconomic risks, but institutional constraints must be considered.

[Source: Note 13 - www.bis.org]

UN environment programme | finance initiative

PRI | Principles for Responsible Investment

At a global level, the United Nations Environment Programme Finance Initiative (UNEP FI) and the Principles for Responsible Investment (PRI) have jointly crafted recommendations tailored for investment banks, that also offer a reference point for ESG practices. These guidelines offer a roadmap for integrating ESG considerations into their strategies. By adhering to these recommendations, banks can mitigate risks, seize opportunities, and contribute to sustainable development.

[Source: Note 14 - www.pri.org]

Way Forward

Entities should initially conduct a materiality assessment of sustainability risks, preferably as a double materiality assessment to evaluate both financial as well as environmental and social impacts, and then a reliable process of data collection must be implemented, with clear KPIs to ensure clear and measurable targets that align with the sustainability strategy and risks.

Specific IFRS S1 and S2 Requirements:

- **Sustainability-related Risks and Opportunities:** Disclose how sustainability-related risks and opportunities are identified, assessed, and managed. Describe the potential impact of these risks and opportunities on the company's business model and financial performance.

- **Governance Processes:** Report on the entity's governance processes for overseeing sustainability-related risks and opportunities, including board and management.

- **Strategy and Risk Management:** Explain how sustainability-related risks and opportunities are integrated into the entity's overall strategy and risk management processes.

- **Metrics and Targets:** Disclose relevant sustainability metrics and targets, including those related to climate change, social issues, and governance practices. Ensure the metrics are aligned with industry standards and frameworks.

- **Climate-related Disclosures (IFRS S2):** Provide detailed disclosures on climate-related risks and opportunities, including the entity's governance, strategy, risk management, and metrics and targets related to climate change.

Regulatory Compliance:

- **Local Regulations:** Understand and comply with any local regulations or guidelines related to sustainability reporting, such as those issued by stock exchanges, central banks, and environmental agencies. Such compliance is important as IFRS S1 and S2 standards prescribe a comprehensive global baseline (a minimum level), whereas an entity may have additional disclosure requirements due to country-specific regulations deemed essential based on government policy and to address and disclose relevant ESG risks to stakeholders.

- **GHG Protocol:** Align the entity's GHG emissions reporting with applicable GHG Protocol standards, which provide a comprehensive framework for measuring and managing greenhouse gas emissions.

Additional Considerations:

- **Assurance:** Consider obtaining external assurance for the entity's sustainability report to enhance credibility and transparency.

- **Stakeholder Engagement:** Provide a holistic view of impacts in annual reports by actively engaging with stakeholders and reconciling financial and sustainability information throughout the transition towards integrated accounting.

How we can help

RSM Kuwait is committed to supporting our business community in navigating the complexities of ESG integration. Our team of experts can assist in various services such as, but not limited to:

ESG Strategy Development
Assessing the entity's current ESG performance, setting ambitious targets, and developing a roadmap for implementation.

Sustainability Reporting
Disclosing the non-financial performance based on global reporting guidelines to communicate achievements, engage stakeholders, and enhance transparency internally and externally.

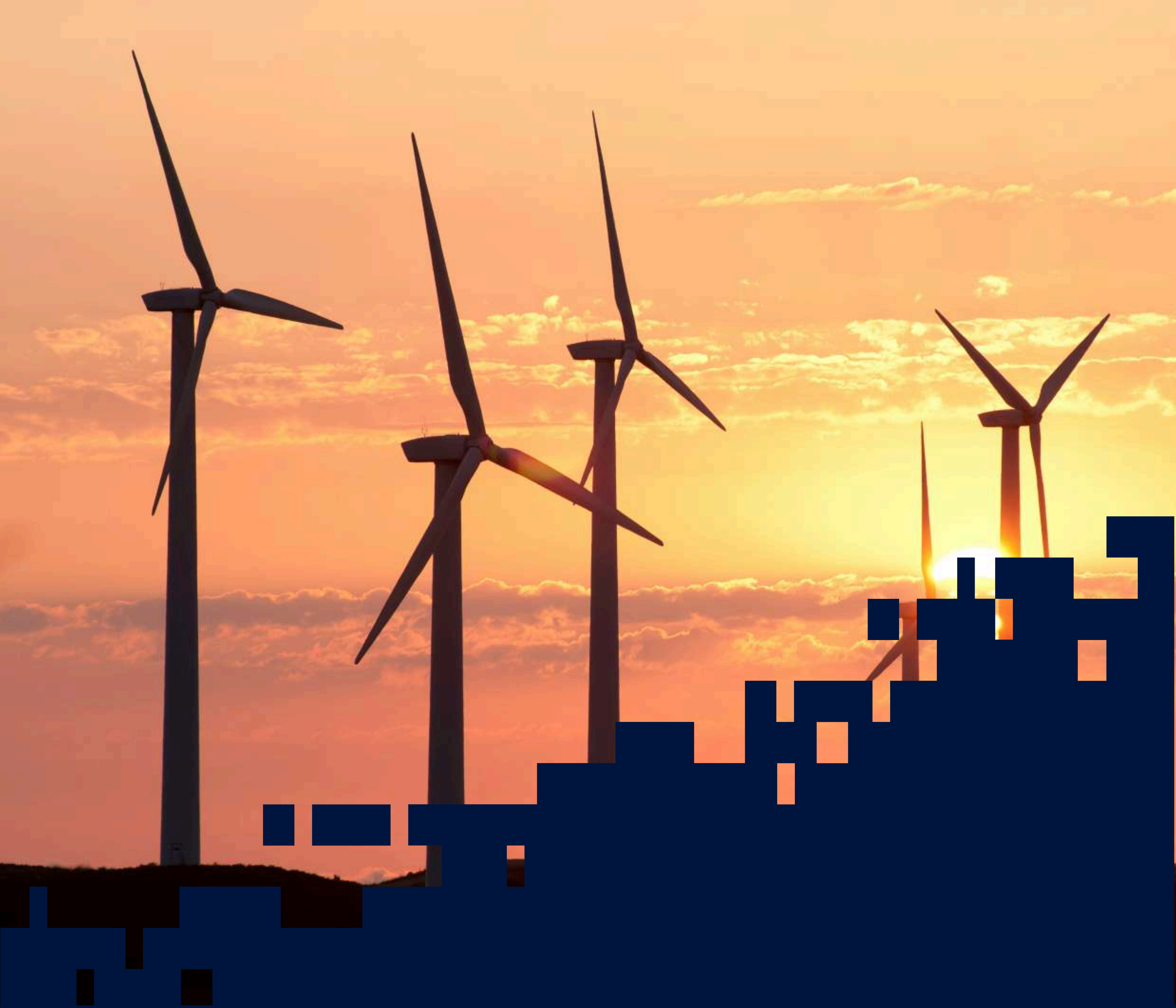
IFRS S1 and S2 Compliance
Ensuring the entity's sustainability reporting disclosures meet the new standards, reducing risk, building investor confidence, and improving accountability and transparency.

Climate Risk Assessment
Identifying and quantifying climate-related risks in a portfolio, and developing strategies to mitigate and adapt to these risks.

Sustainable Finance Solutions
Exploring innovative financial products and investment opportunities that align with ESG principles.

Assurance Services
Performing attest engagements that provide entities with limited or reasonable assurance on adherence to sustainability reporting standards.

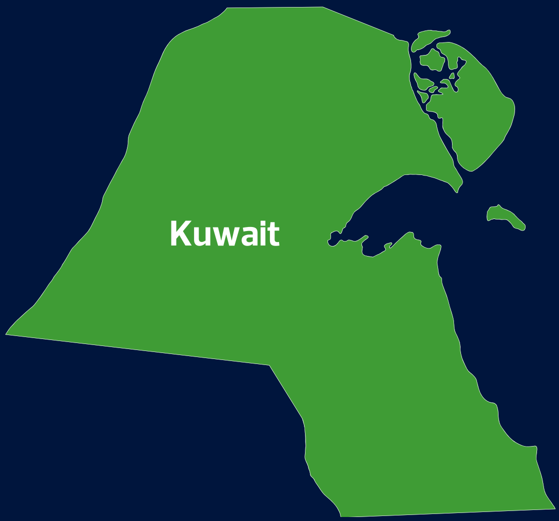
ESG Underwriting Services
Evaluating sustainability performance of entities or projects for investment purposes, such as while issuing green bonds or floating impact investing funds.



Conclusion

Balancing financial goals with ESG objectives is a complex challenge. To quote Inger Andersen, Executive Director of the United Nations Environment Program (UNEP), "Sustainable finance is not just about doing good, it's about doing well. Banks and investors that embrace sustainability are better positioned to manage risks, attract capital, and create long-term value." The transition to a sustainable economy requires collaboration across all sectors. Financial institutions play a crucial role in this ecosystem by partnering with businesses, governments, and civil society organizations to drive systemic change. Through knowledge sharing, capacity building, and collaborative initiatives, they can create a ripple effect that extends far beyond their operations, fostering a more inclusive and sustainable financial system. Adopting ESG principles, fostering transparency, and engaging with stakeholders not only mitigate risks in a rapidly changing world but can also unlock new avenues for growth and innovation, which is a strategic imperative for long-term success.

RSM



RSM Kuwait
Arraya Tower, Floors: 41 & 42, Abdulaziz Hamad Alsaqar Street, Sharq, P. O. Box 2115, Safat 13022, Kuwait
T: +965 22961000
F: +965 22412761
E: connect@rsm.com.kw
W: www.rsm.global/kuwait

Reference source notes:

1. https://www.neom.com/en-us/newsroom/neom-green-hydrogen-investment
2. https://www.ijglobal.com/articles/136677/sakaka-solar-pv-saudi-arabia
3. https://www.reuters.com/business/autos-transportation/lucid-signs-deal-raise-1-bln-saudis-pif-affiliate-2024-03-25/
4. https://wam.ae/en/details/1395303210146
5. https://masdar.ae/en/news/newsroom/masdar-green-reit-signs-green-financing-commit
6. https://www.emiratesnbd.com/-/media/enbd/files/investor-relations/financial-information/presentations/emiratesnbd_investor_presentation_q3_2023.pdf
7. https://www.kfh.com/dam/jcr:42b9d3bd-d33b-4639-ad6a-e18ff0d254d9/KFH Annual Report En 2023.pdf
8. https://fastcompanyme.com/news/uae-saudi-arabia-lead-mena-with-15-4-billion-green-bond-issuance-in-2023/
9. https://ndmc.gov.sa/investorsrelations/Documents/Green-Financing-Framework-KSA-28March2024.pdf
10. https://www.psa.gov.qa/en/qnv1/Pages/default.aspx
11. https://unfccc.int/sites/default/files/resource/Kuwait-NAP-2019-2030.pdf
12. https://www.boursakuwait.com.kw/api/documents/boursa/1701773114617.pdf
13. https://www.bis.org/bcbs/publ/d560.pdf
14. https://www.unpri.org/download?ac=5330