NEWSLETTER

Legal, Compliance and ESG

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APAC Group is committed to adhere environmental, Social and Governance (ESG) standards in all its activities. APAC has also signed an Investment Code with its investors to adhere ESG norms. As part of this process, we bring this FAQ for the benefit of all employees.

Environmental, Social and Governance (ESG)

What Is ESG?

ESG (Environmental, Social and Governance) is a generic term used in capital markets and used by investors to evaluate corporate behaviour and to determine the future financial performance of companies.

ESG factors are a subset of non-financial performance indicators which include sustainable, ethical and corporate governance issues such as managing the company's carbon footprint and ensuring there are systems in place to ensure accountability.

The integration of ESG factors is used to enhance traditional financial analysis by identifying potential risks and opportunities beyond technical valuations. While there is an overlay of social consciousness, the main objective of ESG evaluation remains financial performance.

The table below lists common ESG factors that are considered. Investments with good ESG scores have the potential to drive returns, while those with poor ESG scores may inhibit returns.

Environmental	Social	Governance
Energy consumption	Human rights	Quality of management
Pollution	Child and forced labor	Board independence
Climate change	Community engagement	Conflicts of interest
Waste production	Health and safety	Executive compensation
Natural resource preservation	Stakeholder relations	Transparency & disclosure
Animal welfare	Employee relations	Shareholder rights

Environmental and Social Risk for Financial Institutions

The operations of a financial institution do not generate significant environmental and social impacts, but the way their clients/borrowers manage impacts of their operations may pose risks to a financial institution.

Client/borrower operations may also represent opportunities for additional financing and growth. All financial institutions are exposed to some level of environmental and social risk through their clients/borrowers. If left unmanaged, these risks can lead to a decline in the financial institution's reputational image, costly litigation, or loss of revenue.

The type, quantity and severity of environmental and social issues that present a risk to a financial institution for any given transaction depend on a variety of factors, including geographic, context, industry sector, and the type of transaction: corporate, housing, insurance, leasing, microfinance, project finance, retail, short-term finance, small and medium enterprise, and trade.

- **Liability risk**. By virtue of taking possession of collateral assets, a financial institution is exposed to liability risk stemming from a client's/borrower's legal obligations. This includes fines, penalties, and costs for addressing third-party claims for damages due to negligence in managingenvironmental and social risksin aclient's/borrower's operationsand clean-up of contamination. If the financial institution is a principal shareholder of a client's/borrower's operations, it may also be directly liable for all environmental and social risks associated with a client's/borrower's operations.

- **Financial risk.** A financial institution is exposed to financial risk stemming from potential disruption of client's/borrower's operations as a result of environmental and social problems. If not managed properly, these problems can affect a client's/borrower's ability to meet its financial obligations to the financial institution and/ or can drive down the value of a client's/borrower's collateral in the context of a transaction. A client's/borrower's failure to effectively address environmental and social considerations can jeopardize its business operations as well as the financial institution that is supporting the transaction. The financial institution will also face liquidity risks from environmental and social problems associated with collateral.

For example, the financial institution will have to use up internal resources to meet government clean-up requirements or to clean the site up before it can be sold if collateral is contaminated.

- **Reputational risk.** A financial institution is exposed to reputational risk due to potentially negative publicity associated with a client's/borrower's poor environmental and social practices. This harms a financial institution's brand value and image in the media, with the public, with the business and financial community, and even with its own staff. For example, if a client/borrower faces strong public opposition against its operations, the financial institution's reputation may be tarnished through its association with this particular client/borrower.

- **Credit risk**. A financial institution is exposed to credit risk when a client/borrower is unwilling and/or unable to fulfill the contractual obligations associated with a transaction as a result of environmental and social issues. For example, if a client/borrower faces increased capital or operating costs of complying with environmental and social standards or if operating and emission/discharge permits are absent or expired resulting in regulatory fines or penalties, there is a risk that the client/borrower cannot meet its financial obligations to the financial institution.

- **Market risk**. A financial institution is exposed to market risk stemming from a reduction in the value of collateral associated with a transaction due to environmental and social problems. For example, if a production site becomes contaminated, the market value of the underlying collateral will fall.

A financial institution's environmental and social risks are those of their clients/borrowers and are inherent in the nature of a client's/borrower's operations. Environmental and social risks can be mitigated through compliance with environmental and social regulations and international environmental and social standards. These risks are not static, but rather are dynamic over time and subject to change.

Some potential environmental and social risks may not seem significant or relevant at the time of approval of a financial transaction, but may become so during execution, for instance as a result of higher regulatory standards and increased levels of enforcement. In other cases, environmental and social risks, such as spills or explosions, may seem unlikely to occur, but when they do, the environmental and social impact is potentially extremely high.

To reduce exposure to risk arising from the environmental and social risks of its clients/borrowers, financial institutions need to ensure that their clients'/borrowers' financial and operational sustainability is not undermined by adverse impacts on the environment and surrounding communities. Financial institutions need to have a clear understanding of potential environmental and social risks and implications for a client's/borrower's operations prior to being linked to the client/borrower in the context of a transaction.

This requires proactive identification, assessment, and management of environmental and social risks before they become significant or result in an adverse outcome on the client/borrower. A financial institution can best achieve this by developing and implementing the Environmental and Social Management System (ESMS), to systematically assess the environmental and social risks and opportunities arising from their clients'/borrowers' operations and manage its exposure to risk.

Responsible Investing

The three concepts of social, environmental and corporate governance are intimately linked to the concept of Responsible Investment (RI). RI began as a niche investment area, serving the needs of those who wished to invest but wanted to do so within ethically defined parameters. In recent years it has become a much larger proportion of the investment market.

Conclusion

ESG is expected to be integral to business today. It has also become the password to not only overcome competition but to ensure sustainable growth. It has been supported by the shareholders and stakeholders, by and large, encompassing the whole community. ESG in reality is the alignment of business operations with social values. It takes into account the interests of stakeholders in the company's business policies and actions. It focuses on the social, environmental, and financial success of a company--the so-called "triple bottom line"--with the aim to achieve social development while achieving business success. More importantly, ESG is the point of convergence of various initiatives aimed at ensuring socio-economic development of the community as a whole in a credible and sustainable manner.

Sources:

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