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ESG in CREDIT UNIONS

Framing the Landscape & Getting Started

Osprey ESG Research

The ESG Landscape:

Credit Union Context

Interest in environment, social, and governance issues (ESG) is surging in the business world, and shows no signs of stopping. While regulations do not currently require credit unions to report on ESG, key stakeholders have begun to ask for non-financial disclosures. Successful credit unions need to be 100% member focused, maintain reputational awareness, and listen to the communities they serve. To maintain a social license to operate, credit unions have a responsibility to be aware of and address, the top ESG issues impacting their stakeholders. Many societal, economic, and regulatory factors are already known by the management team, in addition to some that will be discovered with an ESG materiality assessment process. All of these issues need to be understood in a holistic context to address unaccounted for risks and opportunities that impact the long-term performance and sustainability of the credit union.

In the U.S. and abroad, retail investors are pouring trillions of dollars into ESG funds that include, exclude, underweight, or overweight their holdings of companies based on how those companies address sustainability issues. That is, as society places more emphasis on climate change, social equity, and good governance, market demand and investment preferences are shifting in kind.

This is a leading indicator to credit unions that consumers, potential and current members, will be voting with their pocketbooks.

A credit union that acknowledges and addresses ESG concerns will build a competitive advantage.

Governmental regulators are following suit with more rules that require companies to disclose ESG metrics — and that trend toward more regulation and legislation is expected to continue for the foreseeable future. Employees, customers, and the public at large have said in a variety of surveys that they prefer to support businesses, including financial services companies, whose views on ESG issues either align with their own, or at a minimum, are actively cognizant of and addressing sustainability issues.

While investors, creditors, private equity firms, and regulators are large macro drivers contributing to the demand for ESG information, the **primary** drivers for credit unions are the members, employees, and community.

These stakeholders should be valued at the same level, if not higher, than a tech company values a potential venture capital investment. Without members, employees, and a community there is no credit union.

The ESG Landscape:

Credit Union Context

At a high level, credit union ESG stakeholders are demanding information and transparency in a few key areas. These areas include: diversity, employee development, ethics, and equitable access to capital, selling practices, and environmental footprint. Depending on the charter, location, and real estate ownership status of a credit union there will be some variance. Evidence shows that stakeholders are fair. In general, they are looking for a manageable volume of information that's material to your business, that can be incorporated into their consumption, employment, and reputational judgement thought process. Transparency on issues, and assurances that things are moving in the right direction over time, satisfy most stakeholders. It is ill-advised to construct an ESG program to address 'fringe' issues unless those issues are deemed material to your business sustainability.

ESG is something every business must embrace and not simply confront. By embracing your sustainability performance, you'll be able to identify risks that need to be mitigated, opportunities that may lead to competitive advantage or innovation, and value creation for your organization and investors.

The good news is that even in sectors such as financial services some baseline standards for ESG disclosure already exist. Practices and techniques to get started on your ESG journey are ready to use.

Let's consider how to put all that to work.

The ESG Basics:

What It Is, Why It Matters

ESG can encompass many factors. A small sample includes:

ENVIRONMENTAL	SOCIAL	GOVERNANCE
financing environmentally friendly real estate or commercial businesses; greenhouse gas emissions; and clean energy.	pay equity among racial, gender, and other social groups; unionization rates of the workforce; and forced labor concerns in your supply chain.	board diversity; executive compensation; corporate donations; effective financial reporting and compliance with laws and regulations.

ESG FACTORS ARE NOT EQUALLY RELEVANT FOR ALL BUSINESSES.

For example, industrial manufacturers might be more concerned with pollution, energy consumption, and unionization in the workforce. A technology firm might be more concerned with green energy consumption, pay equity, and diversity on the board. A financial services company may be more concerned with selling practices, access to capital, and diversity and inclusion. Every business will need to determine for itself the ESG criteria that matter most to its stakeholders.

The broad point, however, is that ESG reporting offers stakeholders a better sense of the sustainability issues relevant to operational performance and value, that are not addressed by traditional financial accounting and existing compliance processes.

With more fulsome reporting of those sustainability issues, you can manage expectations and align your business with investors, customers, employees, and other important stakeholders. You can also position your business to satisfy regulatory expectations for enhanced ESG disclosure — which are already required in the European Union, and will arrive in the United States quite soon.

The SEC is looking closely at rules for disclosure of greenhouse gas emissions, and based on advocacy originated by the HCMC (Human Capital Management Coalition) has agreed in principle to Fundamental Four Metrics covering number of employees, total workforce cost, turnover, and employee diversity and inclusion.

Once regulatory mandates get started there is no slowing down.

The ESG Basics:

What It Is, Why It Matters

A well-defined ESG program (including ESG reporting) enables your business to **respond** to ESG issues. For example, a credit union that has clarity into business practices and potential risks among its suppliers can address the offending borrowers and vendors, and avoid reputational harm. A credit union that uncovers shortcomings in pay equity or workforce diversity can retool its HR policies, to foster better relations with employees and reap the benefits that a more diverse workforce brings. In short, ESG reporting can drive better business performance and create value.

To realize those benefits, however, businesses need to understand...

- Which ESG issues are material
- What sustainability targets should be
- How to collect ESG performance data

Famously, you can't manage what you don't measure. Credit unions must build robust ESG programs if they are to manage ESG risks and opportunities.

"Materiality" in the ESG world refers to the relevance an issue has on your operational performance. Material ESG metrics can present both risks and opportunities coming from impact on the environment, society, or economy. They go past traditional financial issues that you observe via an income statement, balance sheet, or read about in the Management Discussion & Analysis section of an annual report.

For concept illustration purposes, let's review a straight-forward example, although not specific to credit unions: water usage. If a business uses water as a main element of its production process and derives that water from a water-stressed region, then water consumption is material in two ways. The first is financial: supply issues and price fluctuations will impact the bottom line. The second is societal: overuse of water in a stressed region could affect the people in that region. So, there is a risk to future production for the company, and a risk to the society in which the company operates.

By identifying water as a material issue, a business could then track water usage year over year, normalized by its production capacity; and determine whether the company is becoming more efficient with its water use over time. A strong performance on this issue mitigates risk and societal impact, while a poor performance increases risk and impact.

This concept of dual materiality can be applied to material issues that impact the credit union business, to help you understand the full impact of an issue on operating performance and society, as opposed to understanding an issue only through a financial or compliance lens. In the next section we will explore issues material to credit unions.

Finding the Right Standards:

SASB, GRI, Custom (your own)

One of the most widely recognized organizations publishing ESG disclosure standards today is the Sustainability Accounting Standards Board (SASB). In the same way that the Financial Accounting Standards Board publishes rules for financial reporting, SASB publishes industry-specific standards that can provide input for ESG reporting — all of the standards are evidence-based, decision-useful, and cost-effective.

By using the SASB standards as a baseline, along with other standards from the Global Reporting Initiative (GRI) and custom defined standards as needed, a company can develop a decision-useful ESG reporting program. Stakeholders will gain deeper insight into how your business manages sustainability issues germane to short-, medium-, and long-term sustainability; while you will gain insight into the performance factors driving business operations.

In practice, organizations often leverage multiple standards and frameworks in their ESG programs to develop a disclosure regime that best meets the needs of its stakeholders. The disclosures themselves are typically both quantitative, where the company should report a specific, measured number related to an ESG issue; and more qualitative "discussion & analysis," where the company describes its efforts in a narrative format.

SASB has published sustainability standards applicable to the financial services industry. Utilizing these as a baseline, along with some key GRI standards will provide credit unions a starting point to tell their ESG story. Beyond the standards categories listed below, a credit union will want to add some custom standards that measure high priority impact goals specific to their financial institutions culture. It should be noted that deeper details of these standards are available on the SASB and GRI web portals.

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Finding the Right Standards:

SASB, GRI, Custom (your own)

SASB STANDARDS EXAMPLES FOR FINANCIAL SERVICES

Customer Privacy

- Number of account holders whose information is used for secondary purposes
- Total amount of monetary losses as a result of legal proceedings associated with customer privacy

Data Security

- (1) Number of data breaches, (2) percentage involving personally identifiable information (PII), (3) number of account holders affected
- Card-related fraud losses from (1) card-not present fraud and (2) card-present and other fraud
- Description of approach to identifying and addressing data security risks

Discriminatory Lending

- (1) Number, (2) value, and (3) weighted average Loan-to-Value (LTV) ratio of mortgages issued to (a) minority and (b) all other borrowers, by FICO scores above and below 660
- Total amount of monetary losses as a result of legal proceedings associated with discriminatory mortgage lending
- Description of policies and procedures for ensuring nondiscriminatory mortgage origination

Environmental Risk to Mortgaged Properties

- (1) Number and (2) value of mortgage loans in 100-year flood zones
- (1) Total expected loss and (2) Loss Given Default (LGD) attributable to mortgage loan default and delinquency due to weather related natural catastrophes, by geographic region
- Description of how climate change and other environmental risks are incorporated into mortgage origination and underwriting

Selling Practices

- Percentage of total remuneration for covered employees that is variable and linked to the amount of products and services sold
- Approval rate for (1) credit and (2) pre-paid products for applicants with FICO scores above and below 660
- (1) Average fees from add-on products, (2) average APR, (3) average age of accounts, (4) average number of trade lines, and (5) average annual fees for pre-paid products, for customers with FICO scores above and below 660
- (1) Number of complaints filed with the Consumer Financial Protection Bureau (CFPB), (2) percentage with monetary or nonmonetary relief, (3) percentage disputed by consumer, (4) percentage that resulted in investigation by the CFPB
- Total amount of monetary losses as a result of legal proceedings associated with selling and servicing of products

Lending Practices

- (1) Number and (2) value of residential mortgages of the following types: (a) Hybrid or Option Adjustable-rate Mortgages (ARM), (b) Prepayment Penalty, (c) Higher Rate, (d) Total, by FICO scores above or below 660
- (1) Number and (2) value of (a) residential mortgage modifications, (b) foreclosures, and (c) short sales or deeds in lieu of foreclosure, by FICO scores above and below 660
- Total amount of monetary losses as a result of legal proceedings associated with communications to customers or remuneration of loan originators
- Description of remuneration structure of loan originators

Finding the Right Standards:

SASB, GRI, Custom (your own)

GRI STANDARDS EXAMPLES FOR IMPACT ISSUES

Diversity and Equal Opportunity

- Diversity of Governance bodies and employees
- Ratio of basic salary remuneration of women to men

Non-discrimination

- Incidents of discrimination and corrective actions

Employment

- New employee hires and turnover rates
- Benefits provided to FTE's not provided to part time employees

Energy

- Energy consumption within the organization

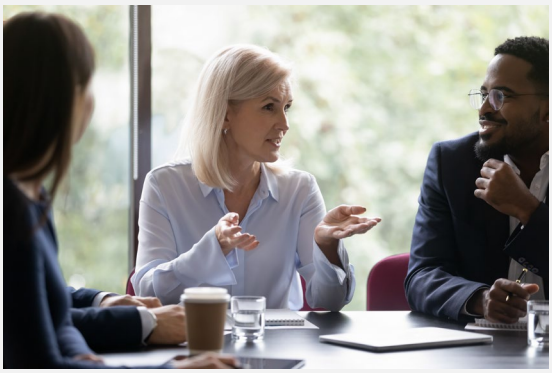
Training and Education

- Average hours of training per employees
- Programs for upgrading employee skills and transition assistance
- Percentage of employees receiving regular performance and development reviews

Local Communities

- Operations with local community engagement
- Operations with potential negative impacts on communities
- Amount of monetary losses as a result of legal proceedings associated with corruption and bribery;
- Description of the code of ethics for dealing with healthcare professionals

The above issues reflect a good starting point for credit unions to begin examining ESG materiality for their specific institution. Above and beyond these issues credit unions should consider their goals, culture, and community composition in an initial materiality assessment.



As one can see, much of the homework to get a baseline of topics to consider is done by SASB, GRI, and others. The next step is to run this initial set of ideas through a materiality assessment process and determine which items are relevant to your business, and uncover any gaps in materiality not covered by the existing standards.

Getting Started:

Goals, Materiality Assessment and buy in

To get started with an ESG program, a company must begin by understanding which ESG criteria are material to their business, and meet the needs of internal and external stakeholders. The company should also consider any ESG compliance obligations that might be on the horizon.

For example, the European Union is already moving ahead with its new Corporate Sustainability Reporting Directive (CSRD). The U.S. Securities and Exchange Commission is planning to unveil its own ESG disclosure proposal soon, with an initial focus on climate change and human capital. This is a clear indication that businesses need to start preparing now. SASB and other ESG standard-setting organizations provide a baseline to determine which issues qualify as material for a business and should be disclosed.

In addition to baseline information from standards organizations, a company would be wise to talk with other stakeholder groups (board members, customers, and employees) to see whether any other ESG issues are material to their analysis or needs. Your credit union might decide to track and disclose metrics for those issues, as well. A business can always go **beyond** any required or demanded ESG disclosures. This is particularly important if your organizational culture rallies around a particular sustainability issue, or if certain sustainability issues support the overall culture of your organization.

Once a credit union has identified the ESG issues material to its business, its ESG framework is effectively defined. The next steps, at a high level, are:

- assigning topic and metrics ownership
- collecting and normalizing data to support those metrics
- auditing and confirming data quality and integrity
- Reviewing results with management and key stakeholders
- Obtaining buy-in on what to disclose
- Preparing and publishing your ESG disclosure
- Implementing policies, procedures to improve your ESG performance,
- Setting the groundwork for year's materiality assessments.

Getting Started:

Goals, Materiality Assessment and buy in

At an abstract level, these steps are not surprising. Financial services companies have taken those same basic steps for years to, say, improve internal control over financial reporting or to strengthen cybersecurity programs. The challenge now is to bring that same discipline to ESG, when your processes to identify and monitor ESG performance might be quite immature. It is recommended that the ESG reporting cycle be in sync with other financial and compliance reporting process cycles.

As an example, the team implementing the ESG program (whether that's the compliance team, risk management, accounting or some combination) will need to work with operating units to understand how to "extract" relevant ESG data from existing business processes — or to modify business processes, to find the relevant data. That may require outside expertise in ESG assessment.

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An ESG program can bring clarity to issues, but it requires knowhow and technology to efficiently achieve success. As an example, the team implementing the ESG program (whether that's the compliance team, risk management, accounting or some combination) will need to work with operating units to understand how to "extract" relevant ESG data from existing business processes — or to modify business processes, to find the relevant data. That may require outside expertise in ESG assessment.

The workflow involved in building ESG processes and generating data for an ESG report can also be formidable. There will be processes to modify, controls to test, policies to amend, and data to gather.

In many instances, the ESG data you need will already exist somewhere in your enterprise; it may, however, be scattered among multiple business functions and perhaps be cumbersome to gather. Workflow technology will be critical to automate ESG processes, assign tasks, escalate concerns about work not done, and gather data in one repository for prompt analysis and reporting. Otherwise, a business will be buried in manual processes and misplaced data, and any number of headaches — from regulatory enforcement to unhappy stakeholders complaining on social media — can follow.

Conclusion

ESG reporting has taken a long time to reach this point, but it is here.

Soon enough, all businesses will need to document and report their ESG-related metrics. Today in the United States this is voluntary, but stakeholders are already asking and regulations are on the horizon. Those that start a program now and get ESG reporting correct first will be more attractive to investors, business partners, customers, and employees. They will also be ahead of the curve when regulations are in place. Effective ESG reporting will be a strategic advantage short-, medium- and long-term.

Credit unions should start this journey today. The standards are there to make disclosures relevant to your business.

Credit unions should start this journey today. The standards are there to make disclosures relevant to your business. In addition, standards-setting groups are looking for the next big issue that will affect your sector. Staying in touch with their research, in addition to your own ongoing monitoring will keep you on track for years to come.

What's needed is executive commitment, knowhow, and technology to implement a robust ESG program.

Once you make the commitment, it is important to understand how to get started. In most cases, using an ESG professional to help you define your materiality framework, and ESG program, as well as assisting you in the transition to a technology solution is the correct approach.

TAKE CONTROL

OF YOUR ESG PROGRAM

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ABOUT OSPREY ESG SOFTWARE

Osprey's technology and processes help organizations turn ESG vision into reality by connecting the entire enterprise into their strategic mission.

Businesses that act responsibly and exercise stewardship over ESG issues deliver long term value creation to investors and benefit all stakeholders. Implementing an ESG Program is mission critical to investors, companies, creditors, employees, and other stakeholders with sustainability specific interests.

A well-constructed sustainability strategy, and the implementation of an ESG program will provide a transparent view, and insight into this value creation process. Organizations adopting ESG principles need a way to organize, track, measure, and report on their ESG goals and plan for substantive
outcomes.

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