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ESG and banking

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ESG and banking

Despite a growing and significant body of thought leadership on Environmental, Social and Governance (ESG), it remains an area many executives are grappling with.

Banks must assess their strategies in the context of ESG and its impact on revenues and risk, to transform themselves and reaffirm their purpose in society

This report intends to resolve that challenge, bridging the gap between high-level ESG thinking and more technical literature. It offers a framework to think through and put in place business initiatives to address ESG and identify growth opportunities.

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Why is ESG important?

The past 18 months have seen increased scrutiny of the impact of banks on the environment and society, as well as the impact of the environment and society on banks. While some underlying drivers are not new (asymmetry, polarisation and declining trust in institutions), the increased awareness and interest in ESG demands a response from the banking community.

Where COVID-19 has posed financial and operational challenges for banks, it has also given them a unique opportunity to support customers and communities when they need it most.

They have had to support thousands of staff working from home and provide payment holidays and lending support to vulnerable consumers and business customers. In doing so, they may be rewarded with enhanced reputations, increased public trust and higher shareholder value. However, the sector is sometimes criticised for its impact on the environment – for example, lending to high-carbon sectors – which risks undermining this progress.

While there are already several purpose-driven banking organisations, like building societies or credit unions, and many large UK banks pursuing initiatives with a positive environmental or social impact, more can be done to set out practical initiatives to embed ESG into business and operating models.

“More can be done to set out practical initiatives to embed ESG into business and operating models.”

The importance of defining ESG

At its simplest, ESG provides an umbrella framework to consider a company's impact and dependencies on the environment and society, as well as the quality of its corporate governance.

Figure 1 – Environmental, Social and Governance (ESG) definition

ESG provides an umbrella framework to consider a **company's impact and dependencies on the environment and society**, as well as the **quality of its corporate governance**

Environmental Impact of a company on the environment or the environment on the company	• Includes controls of: **carbon emissions**, impact on **deforestation and nature loss**, over-consumption of **non-renewable resources**, and production of **waste products** • Also incorporates positive contributions such as the **financing of environmental improvements** (e.g. green finance initiatives)
Social Contributions of a company to fairness in society	• Considers **contributions to equality, trust and welfare in society** (including **improving labour rights** and **diversity and inclusion**) within a firm's workforce, and across its supply chain and distribution • Also includes product safety, respect for privacy and data security for instance in propositions
Governance Processes for decision making, reporting and ethical behaviours	• Focuses on the quality and scope of **reporting**, the nature and type of **accountability**, level of **independent oversight**, and **ethical behaviours** in a firm – on both ESG and non-ESG matters • Considers elements such as **board structure**, director and audit **independence** and **executive compensation**

Source: Strategy& analysis

But there are no official, comprehensive definitions beyond those being developed by the European Commission. What if a significant percentage of what we consider to be compliant with ESG principles today is not 'ESG' tomorrow under country and regional definitions? We detail below the next level down of each element of E, S and G, and have laid out an innovative approach for developing a broad corporate ESG strategy.

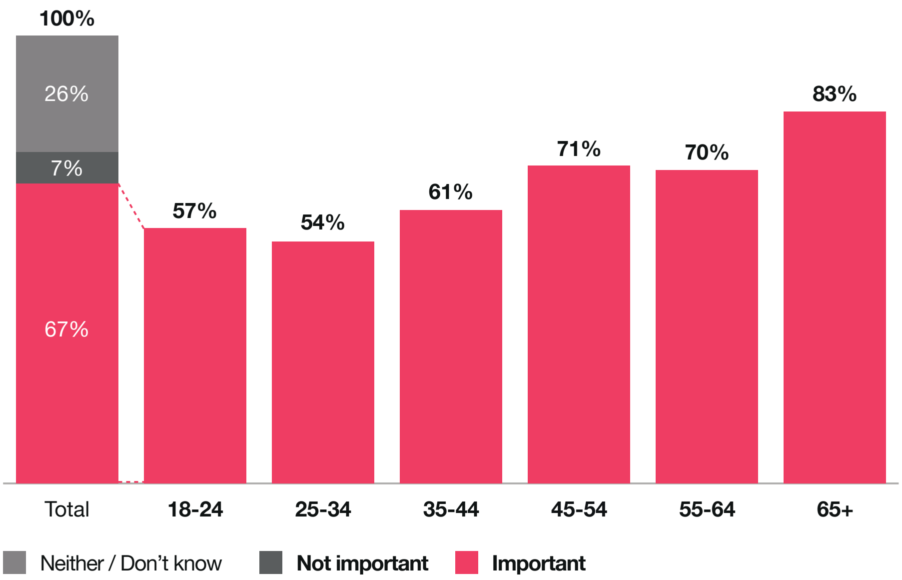
Banks can no longer ignore ESG

Driven by factors such as climate change, social inequality and the impact of COVID-19, and amplified through social media, ESG has become front of mind for all. PwC UK's 24th Annual CEO Survey shows that organisations are increasingly focusing on purpose and sustainability. This year, 70% of CEOs told us they were now concerned about climate change, compared with just 44% in 2019. And there are already positive signs of change, with 60% of UK CEOs increasing their investment in sustainability and other ESG initiatives over the next three years. Around a third also noted that they should be doing more to report on their purpose and values, and their organisation's impact on its wider communities.

These concerns are further reflected in a PwC survey of UK consumers which found that 67% of respondents want businesses to operate sustainably, by minimising their environmental and social impact. Contrary to popular belief, older segments are even more concerned than millennials, demonstrating that ESG worries are not limited to younger generations. This is also supported by a UNDP/University of Oxford survey of 1.2 million people globally, with 81% of UK people saying we faced a climate emergency.

> "This year, 70% of CEOs told us they were now concerned about climate change, compared with just 44% in 2019."
>
> **Source:** PwC UK's 24th Annual CEO Survey

Figure 2 – Views on the importance of business operating in a sustainable way, by age group



Source: Nationally representative survey of UK consumers, PwC UK, February 2021

More stakeholders to manage

Banks are no longer answerable just to shareholders but a new set of stakeholders: customers, employees, suppliers, communities, the press and regulators. These broader and more vocal groups are increasingly interested in how ESG drives corporate performance. Other topics on the corporate agenda, such as Brexit, while complex and important, are focused on narrower stakeholder sets.

Figure 3 – ESG stakeholder environment – Banking example

Customers

- Increasing demand from personal banking customers for **sustainable financing products** (e.g. 'Green' mortgages)
- Corporate customers are showing increasing **demand for green financing products**, including **ESG bonds**

Shareholders / investors

- Institutional investors are **putting pressure on companies to act on climate change** (e.g. shareholder resolutions)
- Investors are increasingly including **ESG** as a **consideration** for **investment decisions** (access to capital)

Communities / press

- Companies are increasingly **held to higher standards** by the public, including pressure from lobbying groups and the press
- As a result of **COVID-19**, there is increasing public demand for **repayment holidays** and interest free loans for **vulnerable customers**

Management

- Executive remuneration is **increasingly linked to ESG outcomes**
- Boards are **requesting executives to incorporate ESG** into firm strategy and decision making

Value chain partners

- Mortgage brokers and other intermediary partners are **increasingly interested in ESG policies**
- Banks that do not respond to ESG adequately risk **narrower partnership opportunities** across the value chain

Government bodies / regulators

- The Government has instructed the BoE to reflect the UK's net zero target in **monetary policy**
- The BoE is conducting **climate stress tests**
- The **PRA** expects banks to embed climate risk management, while the **FCA** and **BEIS** are making climate-related disclosures mandatory

Employees / unions

- ESG will be a **significant lever** for **talent management** given **changing employee attitudes** towards the **purpose of work**
- Research shows that **employee satisfaction** drives **higher productivity** and is positively correlated with **shareholder returns**

Internal stakeholders | External stakeholders

Source: Strategy&

How should banks think about ESG?

Banks can no longer ignore ESG

ESG addresses a broad spectrum of topics and can affect all components of a company's strategy, operating model and execution. To make it easier to tackle, executives should first think through the three elements of ESG separately, and do so at the next level down, with the five or six sub-elements of E, S, and G (for instance, 'E' would include the impact from a bank's buildings and footprint, products and services, and value-chain operations and partners). Below is a framework for breaking down ESG into more structured and manageable sub-elements.

"Leaders should consider their ESG ambitions against the expectations of the stakeholders who matter most to the business."

Figure 4 – ESG framework for banks

Dimensions		Examples
Environmental Impact of a company on the environment or the environment on the company	**Products and services**	• **Lending** to support development of renewable energy assets (e.g. solar and wind farms) and companies reducing emissions • **Origination and distribution** of ESG-compliant bonds • **Project financing** compliant with the Equator principles • **Sustainable linked loans**, e.g. home improvement loans to increase energy efficiency
	Risk management and regulation	• **Identification and quantification of climate risks** through heat mapping, scenario analysis and stress testing • **Integration of climate risks and opportunities** throughout the risk framework • **Regulatory horizon scanning** to maintain compliance in all relevant markets
	Operations and supply chain	• **Carbon emissions** from offices and data centres • **Waste to landfill and incineration**, e.g. non-recycled computers, servers, photocopiers and general office waste • **Business travel** including emissions from flight and train travel and vehicle fleets • **Non-renewable resource** use for electronics and office materials (e.g. minerals used in computer and server production, paper and office consumables)
Social Contributions of a company to fairness in society	**Workforce**	• **Diversity and inclusion** across employee categories (e.g. gender, ethnicity), social mobility, and pay equality • **Health and safety** and **wellbeing** programmes to, including employee mental health support • **Human capital development**, including upskilling of employees and training provided, such as digital analytics training for experienced employees
	Products and services	• Considering **social impacts of borrowers** (e.g. human rights) • Developing **bespoke customer service propositions** (e.g. inclusive banking products) • Financing **affordable housing** and mortgages for the community • Promoting **responsible behaviours around money** (e.g. allowing customers to set spending limits
	Supply chain and Distribution	• **Diverse and inclusive** supply base, such as through office supply and professional services contracts (e.g. catering and events)
Governance Quality of processes for decision making, reporting and ethical behaviours	**Transparency**	• **Providing accurate and timely reporting to stakeholders** vs. recognised standards – on corporate purpose, strategy, financial performance, and ESG tax benefits (e.g. implications from investments in ESG initiatives)
	Accountability	• Ensuring leaders are **accountable for performance** and risk management, across both ESG and other decisions, and pay is aligned to ESG-outcomes within company
	Independence	• **Ensuring appropriate independent oversight**, incl. Board composition, diversity, remuneration, and limiting controlling shareholders and concentrated voting rights
	Ethical behaviour	• **Corporate governance:** undertaking business in an ethical manner (e.g. avoiding bribery and corruption)

Source: Strategy&

Leaders should consider their level of ambition, overall and for each sub-element, against the expectations of those stakeholders who matter most to the long-term viability of their businesses. Should they, for instance, be only minimally compliant with ESG requiring them simply to adapt to a new layer of regulation? Or should they view it as an opportunity to re-align their market-participation strategy with major long-term customer trends, for example supporting the transition to a low carbon economy.

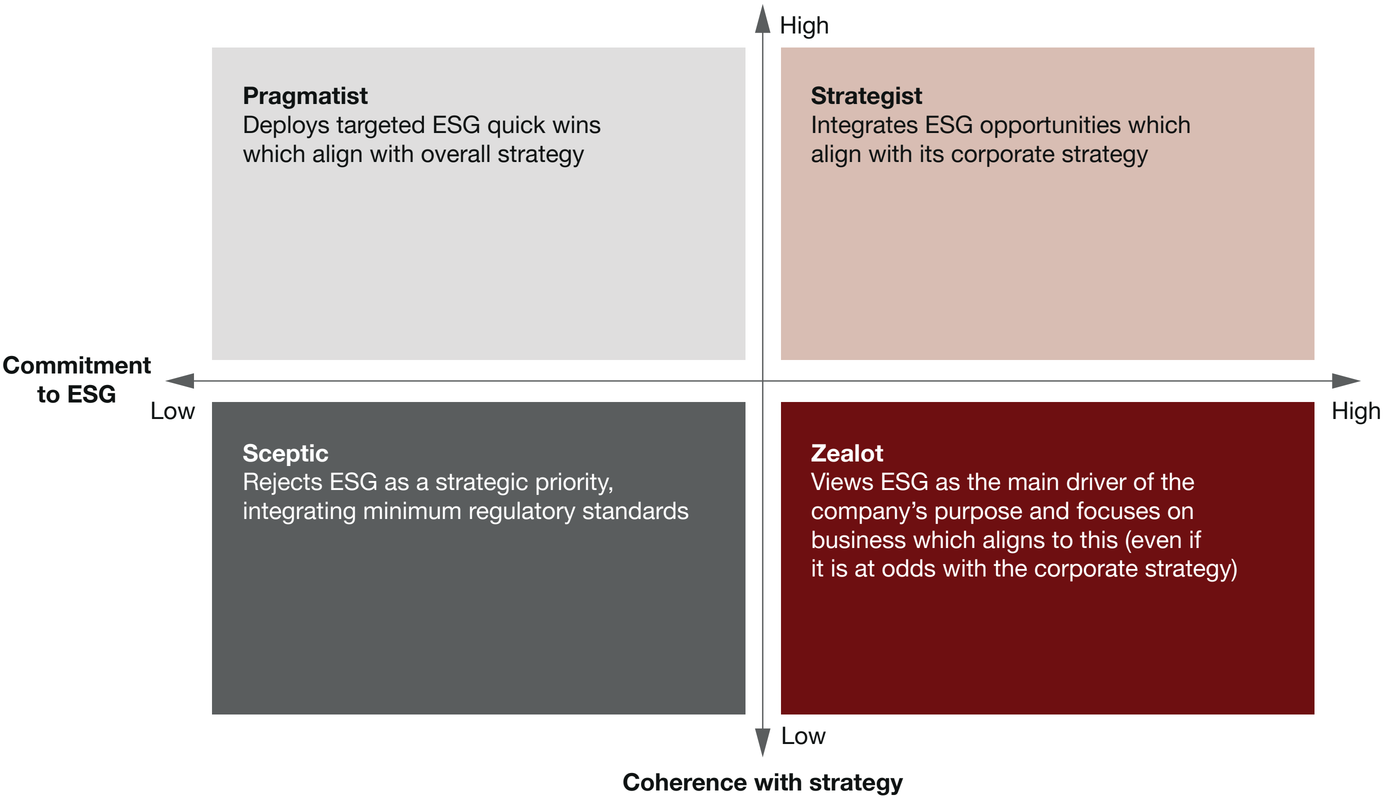
How ambitious a bank is on ESG will determine whether they develop an ESG strategy that complements their existing corporate strategy, on the side, or develop a new, ESG-aligned corporate strategy.

Taking action on ESG

Agree an ESG ambition

Banks should first make decisions based on organisational purpose and values, and set an ESG persona that reflects their ESG beliefs and commitment.

Figure 5 – Spectrum of ESG adoption



Source: Strategy& analysis

Executives with a low level of commitment ('Sceptics') may focus on minimum regulatory requirements, while those with a high level of belief in ESG principles ('Strategists') may incorporate ESG actions fully into strategies and more fundamentally change their organisations.

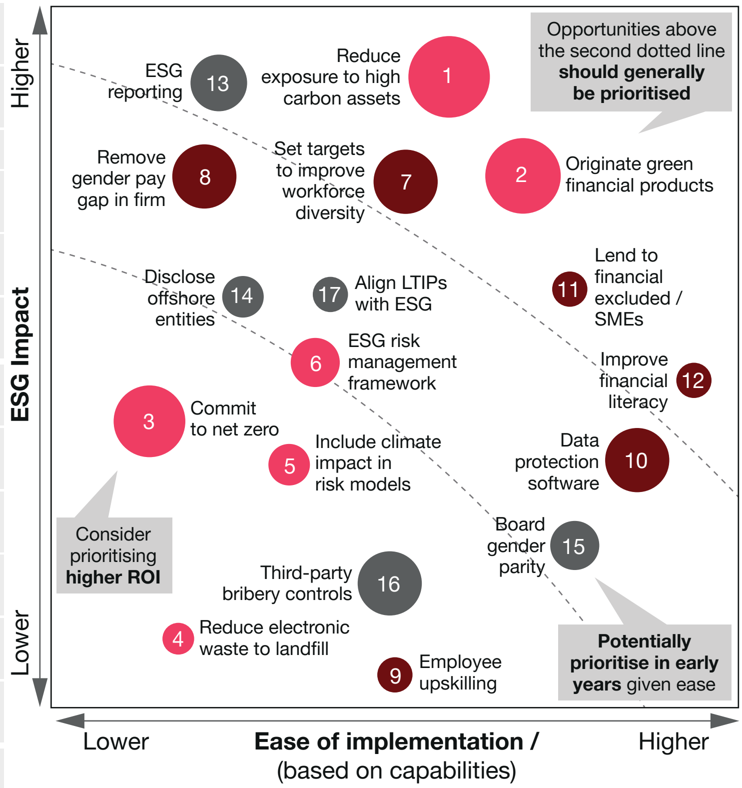
Assess strategic opportunities

Leaders should identify and prioritise business and operating model dimensions to change or redesign.

Figure 6 below provides an example of such a prioritisation exercise. Rather than selecting initiatives at random, ESG actions should be assessed on how impactful they are, how important they are to the stakeholders that matter most and how easy they are to implement. While leaders will naturally want to estimate the return on investment, there remains much to do to narrow the gap between historical performance measurement (e.g. return on investment) and the new, longer-term concepts coming with ESG.

Figure 6 – Strategic ESG opportunities assessment framework

Environmental Impact of a company on the environment or the environment on the company	1 Reduce exposure to high carbon assets over time
	2 Originate green financial products (e.g. green bonds)
	3 Commit to net zero across the business
	4 Reduce environmental footprint in operations and supply chain
	5 Include climate impact in corporate risk models and pricing
	6 Develop and implement ESG risk management framework
Social Contributions of a company to fairness in society	7 Set targets to improve workforce diversity in respect of gender, ethnicity etc.
	8 Remove gender pay gap across company in 5 years
	9 Provide digital analytics upskilling training for employees
	10 Invest in leading personal data protection software
	11 Provide lending to financial excluded people and SMEs
	12 Improve financial literacy and access to finance
Governance Processes for decision making, reporting and ethical behaviours	13 Voluntarily commit to higher-standard ESG reporting, such as SASB Standards
	14 Disclose offshore entities to increase tax transparency
	15 Realise gender parity in Board membership
	16 Implement 3rd party controls, databases and monitoring to reduce potential bribery
	17 Align executive LTIPs with corporate ESG outcomes



● Environmental ● Social ● Governance **Bubble size indicates ROI**

Source: Strategy& analysis

> “More needs to be done to bridge the gap between historical ways of measuring performance and new, longer-term concepts coming with ESG.”

Roll out initiatives, supported by robust ownership, governance and culture

Banks will need to be pragmatic in executing and rolling out initiatives, communicating timely progress and outcomes to stakeholders. While some initiatives will be more short-term focused, often driven by regulatory timelines, others may require a multi-year phased approach. Success will be influenced by the tone at the top of organisations and a ‘critical few’ behaviours that can enable a purpose-orientated culture.

On reporting, more needs to be done to bridge the gap between historical ways of measuring performance and new, longer-term concepts coming with ESG. A practical way to do this is what some refer to as ‘integrated reporting’. This uses the principles of the International Integrated Reporting Framework to integrate the financial and ESG information that is most material to business strategy and value creation. This can help communicate broader performance to stakeholders and show the connectivity between ESG and company financials.

What does this mean for the future of banking?

There is already an ecosystem of purpose-driven banking institutions in the market, from credit unions, building societies to ethical banks. However, this has yet to become mainstream, with incumbents, challengers and neo-banks yet to clearly articulate and act on ‘ESG ambitions’. To see a significant mind-set shift and tangible societal and environmental impact, a purpose-driven ecosystem must become mainstream.

Figure 7 – ESG adoption in banking: example outcomes and approaches

		Sceptic	Pragmatist	Zealot	Strategist
	Example player	**Mid-tier bank**, focused on retail and business banking for target customer segments	**Digital-first neo bank**, focused on deposits, digital mortgages and SME banking	**Specialist lender**, focused on commercial lending and BTL mortgages	**Large-scale wholesale bank**, offering financing solutions for large corporates and investors
ESG approach	**Product and markets**	Focused on reducing costs and makes **minimal change** beyond regulation (e.g. FCA guidance on **vulnerable customers**)	Launches a **digital green mortgages product**, as a quick-win, in line with its strategy to lend more and scale	Launches a **green savings product** in haste, despite being at odds with its current priorities to find lending opportunities	Reduces risk appetite over time **in line with the Paris Agreement / net Zero commitment**
ESG approach	**Operating model**	Does not change operating model beyond what is required to meet regulations, given **higher costs involved**	To enable a rapid launch, “plugs-into” **a third party bank through Open APIs** with minimal op. model change	Driven by social impact reasons, **uses higher-cost SMEs for selected services**, despite the higher costs	**Increases risk limits** and builds its capabilities in the **sustainable financing origination teams**
ESG approach	**Execution**	No exceptional execution approach for ESG outside of **existing change and investment process**	Takes an **agile approach to execution**, with rapid sprint to launch the product and **minimal business cases**	Takes an **adhoc approach** to execution, with **selected projects stood up** and business cases developed	Sets up an **ESG programme** including net Zero commitment and implementation plan, led by a “Head of ESG Banking”
ESG approach	**Communication**	**Reporting to ExCo / Board** as part of existing governance approach (no separate forum or KPIs for ESG)	**Reporting to venture capital investors** as part of BAU updates on business progress (no separate forum for ESG)	Conducts **selected reporting** by the business case sponsor to track benefits of shifting third party services to SMEs	Sets up **ESG governance forums** and **KPI frameworks** to communicate and report back to key stakeholders
ESG approach	**Risk management**	ESG risks **not considered**	ESG risks considered **case-by-case, on reputational grounds**	ESG risks considered in risk policies and approvals **but unaligned to ERM framework**	ESG risks **fully integrated into ERM framework**

Source: Strategy&

While figure 7 outlines examples of how individual banks could respond, we see three areas of impact at a market level.

A shift in focus and behaviours

Base expectations are increasing and these are already permeating across different stakeholder groups. Priorities will change as ESG is promoted to the top of the strategic agenda. There is still room for improvement, even in the widely publicised and important area of climate risk: while 71% of banks state that climate risk is embedded in their corporate strategy, only 29% have set a science-based target or a net-zero strategy. We expect the market to increasingly focus on the social impact of banking particularly as regulators, like the FCA, consult in key areas, such as affordability of unsecured credit and vulnerability of customers.

Changing competition, with winners and losers

ESG could be a point of differentiation or a source of cost, particularly where it is not aligned with a bank's corporate strategy. While some may be able to meet stakeholder needs and achieve attractive returns, others may experience an increase in costs without the impact they expect. Others still may not act on ESG, avoiding the costs but seeing revenues reduce and risks increase over time.

Product and technology innovation

The banking industry has a role both in launching new ESG products, such as compliant savings products, and financing other third parties that spur innovation, like environmental technology start-ups. Incumbent banks may launch new ESG products, while new entrants may enter the market to tap under-served segments. This could occur across the value chain and sub-sectors, including key areas such as Climate Tech and ESG reporting. Open APIs and platform-based models can enable this innovation, allowing banks to plug into third parties to scale capabilities. With near-negative interest rates and board-level pressure to move away from net interest margin-based income, we could see changes to product and market participation choices.

“ESG could be a point of differentiation or a source of cost, particularly where it is not aligned with a bank's corporate strategy.”

As ESG becomes increasingly prominent, banks can no longer hedge their bets by making claims without committing to action.

Executives should make an active choice on what their ambition is and how they are going to deliver on it. They must execute these changes and transform, rolling out chosen strategic initiatives backed by the support of strong leadership. To ensure success, banks should set targets, and track and report these back to stakeholders. Those that perform best will be those that most closely align choices to ESG ambition, as this enables them to meet stakeholder needs while creating value.

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> "Executives should make an active choice on what their ambition is and how they are going to deliver it."

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