OBSERVATÓRIO PORTUGUÊS DE BOAS PRÁTICAS LABORAIS | PORTUGUESE OBSERVATORY OF GOOD LABOR PRACTICES

OPBPL Electronic Papers

OPBPL e-Working Papers (ISSN 2182-8393)
Av. das Forças Armadas, Edifício ISCTE, 1649-026 LISBOA, PORTUGAL

Objectives

The Electronic Papers published by the Portuguese Observatory for Good Labour Practices (OPBPL) main goals are to confer the accessibility and high-speed readability of essential information and good practices in regards to work organisation, collective bargaining, human resources management, labour relations, inclusion and sustainability, corporate social responsibility, and labour market statistics.

Editoral Board

OPBPL Electronic Paper|2011/05

Banks' responsibility to the Environment and Society: an utopia, a need or a reality?

Author: Sofia Santos

Abstract

When sustainability issues are linked to business, they focus on how organisations impact the environment and the surrounding community and their management practices. These factors, commonly referred to as ESG (environmental, social and governance), have gained increasing importance over the past 20 years. Society in general, as well as international bodies, has been urging companies to implement actions aimed at gradually reducing their negative environmental impacts and fostering the social inclusion of populations. As banks provide finance and allocate investment, they have the power to direct the way money is used in investments, and can therefore also indirectly allocate the exploitation of natural resources and the well-being of populations.

This article aims to give an overview of how good environmental practices are being implemented in banking, indicating potential future paths, resulting from the 2008-2009 financial crisis that emphasised the banking sector's responsibility in society as a whole.

1 | The Bank's true environmental impact

Financial institutions' main impact is the indirect impact of its core business - loans - that can encourage or discourage the development of economic sectors, products and specific services (Barannik, p. 247 quoted in Bouma et al., 2001). Their influence on economic development is not only quantitative but also qualitative since they can induce the direction in which economic growth takes place (Jeucken, 1999). Through their loans to companies, banks also allocate the use of natural resources that are required to produce the goods and services the company will sell. On the other hand, the loans banks make to consumers also indirectly promote specific industries by stimulating the consumption of these goods. This means that the banks' environmental impact is much deeper than one might initially think; as banks have so called structural power over other sectors, they can induce these sectors to develop in a certain direction.

2 | The Banks' structural power

"The handling of money is intrinsically linked to the movement of raw materials, finished goods, labour and, ultimately, to the quality of the environment... if we are to achieve sustainable development we must be willing to finance it." Sarokin and Schulkin (1991).

It is even more important to incorporate environmental aspects in the banking sector than in other sectors as banks have a central role in the economic system (Levine, 2004). The financial sector can be said to induce other stakeholders' activities that depend on their financial support to develop their activities; this means that funding affects the size and evolution of the economic system (Schaper, 2008).

According to Levine (2004) *"financial systems produce information ex ante about possible investments and allocate capital; they monitor investments and exert a level of corporate governance after funding; they facilitate trade, diversification and risk management; they mobilise and aggregate savings and facilitate the exchange of goods and services."* Thus, money and financial system are key instruments for the optimal allocation of physical assets (Soppe, 2004). The banking sector plays a key role in promoting good environmental practices among other sectors, since it has structural power and a specific efficiency associated with this (Diamond, 1984, Boyd and Prescott, 1985, Diamond 1991). When a bank uses unusual criteria at market level, such as environmental concerns for example, they are *using "... their structural power to make projects more environmentally friendly"* (Schaper, 2008, p. 2).

Despite the lack of consensus among economists as to role of the financial sector in economic growth, Levine (2004) assumes that there is *"a growing body of evidence (...) that financial development exerts a major impact on economic growth"* (Levine, 2004). The existence of this impact has been evident with the current financial crisis and its consequences in the real economy.

Banks are also one of the major stakeholders with the power to promote and induce investment by offering financial services to savers and potential investers. In fact, in the 1970's, companies in OECD countries increased their reliance on banks' funding so they could continue developing their business (Richardson, 2005). According to Jeucken (1999) *"In many countries, banks are the most important financial intermediary in the economy."* This means that the banks' responsibility should not be viewed as solely maximising the shareholders' dividends; it must also include an analysis of its potential positive and negative impacts on the real economy.

3 | What can banks do?

Banks can develop three different approaches (Thompson, 1998) that involve risk management or product creation so as to use their structural power in support of good environmental (and social) practices:

• They can analyse “how” and “if” the recipients of funding are complying with environmental standards and they may also deny loans to those who do not comply with these standards;

• They can encourage creditors to adopt environmental practices by providing them with information about these issues and about potential environmental risks that affect various sectors.

• They may develop financial products that foster the reduction of the environmental impact of economic agents’ activities. For example, banks can have funding lines for specific sectors based on clean technologies, or even offer loans with lower interest rates to those sectors that positively impact the environment.

It is interesting to note that examples of these three possibilities can be found today, though it is harder to find banks that have applied the environmental analysis criteria in their various business areas. This may mean that banks are still not aware of the implications that environmental risks can have on their business; we may therefore wonder to what extent the risk analysis models are upgraded in response to emerging risks that companies face.

However, this topic is not the aim of this paper but will be the subject of a later reflection.

4 | Some examples

As identified in the study "Benchmarking Credit Policies of International Banks" [1], published in 2008 by Bank Track[2], some banks can already be considered examples of good practices due to the inclusion of environmental risks analysis when granting credit.

A study[3] by Sustentare[4] in 2009 made a detailed analysis of the practices of eight banks that are referenced by Bank Track as having good practices in risk analysis, with the aim of identifying what measures they apply to assess the environmental credit risk. The following Banks were analysed: ANZ, Barclays, Westpac, Citi, HSBC, Santander, Triodos and Co-operative.

This study therefore examined the practices of the so-called mainstream banks, as well as of those called "Ethical" Banks (Co-operative and Triodos).

The main conclusions from the analysis of mainstream banks were as follows:

• All banks state that they include environmental criteria in their risk analysis of credit. However, different approaches are used and with distinct degrees of depth and scope.
• All claim to perform environmental risk assessments; however, this is done only for sectors considered as a risk.
• Although all the major Banks already include environmental criteria in their risk analysis for Project Finance transactions involving amounts up to USD 10 million (the result of their adherence to the Equator Principles), in practice only a few have begun extending this type of analysis to all types of loans granted to companies.

---

[1] Study Available at:: http://ec.europa.eu/enterprise/policies/sustainable-business/corporate-social-responsibility/reporting-disclosure/swedish-presidency/files/surveys_and_reports/mind_the_gap_benchmarking_credit_policies_of_international_banks_en.pdf.
[2] Bank Track is an NGO that looks at how the banks invest their depositors' money: www.banktrack.org
[3] The study is available at: http://www.bancaeambiente.org/pdf/doc.Inclusao.pdf
[4] Sustentare is a Sustainability consulting firm (www.sustentare.pt) with projects developed in sustainable banking in conjunction with the United Nations (www.bancaeambiente.org)

The main conclusions on the “Ethical” Banks were:

Triodos and Co-operative give utmost importance to issues related to biodiversity and energy production, distribution and consumption. In addition, agriculture, energy and fisheries are the activity sectors for which they show greatest care. For these topics and these sectors, the Ethical Banks not only possess well-defined environmental risk evaluation criteria, they also have policies that define the non-concession of credit to enterprises in sectors that harm the environment.

These banks go for these policies because they consider that environmental aspects deteriorate the quality of their loan portfolio, but also because they believe it is their mission:
- Triodos adopts this stance as its mission is to fund projects that contribute positively to cultural value and benefit people and the environment, thus contributing to sustainable development.
- The Co-operative Bank claims that it is accountable to its customers and members, as it was founded on a set of principles and values of justice and social responsibility associated with the impact of money.

Another major difference between Ethical Banks and the Mainstream Banks is that the former do not grant loans to companies that undertake activities in sectors considered harmful to biodiversity and which have a strong impact on climate change. On the other hand, Triodos and the Co-operative also refused to grant credit to companies working in: some types of intensive agriculture and/or using methods of genetic manipulation; production and distribution of energy produced from nuclear or fossil fuels; and unsustainable fishing.

Our analysis indicates that two distinct types of bank are emerging and their activities are related to the specific Mission of each. Mainstream Banks usually have a large number of customers; their approach to sustainability is mostly associated with reputation and the need to be perceived as a company with environmental and social concerns. Ethical Banks are considerably smaller and they have a more demanding credit analysis based on a set of ethical values associated with how they intend to contribute to the development of society. In most cases, the mission of mainstream banks is to maximise returns for investors whereas that of ethical banks is linked with maximising the social and economic well-being of society.

5 | After the 2008-2009 financial crisis

According to a study by Edelman Trust Barometer made in the first quarter of 2011 and released in 23 countries[5], the banking industry is ranked 15 out of 16 sectors for the confidence consumers attribute to them. Given that trust is the bank's main asset, we can induce that banks generally are confronted with fundamental problems in relation to the perception of how they fulfil their duty as trustees.

The results of a survey by Mori and Euris[6] shed further light on this lack of trust. Conducted in the United Kingdom in November 2010, the purpose of the survey was to examine society's perception of banks. The results showed that:

- 66% of respondents believe that banks and other financial institutions have not learned the necessary lessons even after the financial crisis and that their way of doing business has remained unchanged;

- 82% say it is important for financial institutions to pay greater attention to environmental, social and governance risks when deciding on their investments and loans in order to ensure a good financial return;

- 77% of the respondents argue that financial institutions should disclose information about "how" and "where" the savings of their customers are being invested, via loans that they provide;

- 38% said they would be more willing to switch banks if there were more information on ethical financial products or green products;

[5] To see other indicators in this study see: http://www.grupogci.net/pt/knowledge/edelman-trust-barometer/
[6] http://www.eiris.org/media.html#CharitySurv2011

- 37% also say they would be more willing to change if there were more information about how these green and ethical financial products make a difference in the world's economic, social and environmental development.

These results show a growing trend in society's demands and expectations about what is, ultimately, the banks' role in the economy. These new demands could result in future changes in the way banks view their business and relate to their customers.

These themes are not mere utopias; they are important issues with real impacts in the bank business. In 2008[7] the European Savings Banks Group published a charter of principles on good business practices in banks. It recognised that:

> "… *environmental issues are becoming one of the main collective hazards ever experienced worldwide*" ...

and that banks need to:

> "*consider the impact of their business on the environment, both direct … and indirect in terms of clients and suppliers; …; promote products and services that respect social, environmental and sustainable development criteria*" .

All these developments point to the need to create new ways of financing the economy and society. It is necessary to anticipate the legal requirements that will emerge and understand that the society, from which the bank obtains its customers, are changing their expectations.

[7] This "Charter for Responsible Business" in banks can be obtained in: http://www.esbg.eu/uploadedFiles/ESBG/charter%20screen%20view.pdf

6 | Further reading

SITES: http://opbpl.cies.iscte.pt; http://www.sustentare.pt/parcerias.html

BOOKS:

BankTrack, 2008. Mind the GAP. Bank Track

Bossone, B., 2001. Do banks have a future? A study on banking and finance as we move into the third millennium. Journal of Banking & Finance. Vol. 25, pp. 2239-2276.

Bouma, J. Jeucken, M. & Klinkers, L., 2001. Sustainable Banking. Greenleaf Publishing Limited.

Boyd, J., Prescott, E., 1985. Financial Intermediary-Coalitions. Federal Reserve Bank of Minnneapolis, July 1985, Report 87.

Case, P., 1999. Environmental risk management and corporate lending - a global Perspective.Woodhead Publishing Limited.

Coulson, A. Monks, V., 1999. Corporate environmental performance considerations within banking lending decisions. Eco-Management and Auditing Review 6, 1-10

Decker, O., 2004. Corporate Social Responsibility and Structural Change in financial services. Managerial Auditing Journal, Vol.19, N.16, pp.712-738.

Diamond, D., 1984. Financial Intermediation and Delegated Monitoring. Review of Economic Studies. LI, pp. 393-414.

Diamond, D., 1991. Monitoring and reputation: the choice between bank loans and directly placed debt. Journal of Political Economy. Vol. 99, pp. 689-720.

Freshfields, 2005. The world bank is not enough: Equator Principles Survey. Freshfields.

Jeucken, M. Bouma, J. 1999. The changing environment of banks.

Jeuken, B., 2001. Sustainable Banking, the greening of finance. Greenleaf

McKenzie, G. Wolfe, S., 2004. The impact of environmental risk on the UK banking sector. Applied Financial Economics, Vol. 14, pp. 1005-1016.

Richardson B., 2005. The Equator Principles: The Voluntary approach to environmentally sustainable finance. European Environmental Law Review, November 2005, pp. 280-290.

Sarokin, D. Schulkin, J., 1991. Environmentalism and the right to know, expanding the practice of democracy. Ecological Economics, Volume 4, 1991.

Schaper, M., 2008. Leveraging green power: environmental rules for project finance. Berkeley Electronic Press.

Scholtens, B., Dam, L., 2007. Banking on the Equator: are banks adopted the Equator Principles different from nonadopters? World Development, vol. 35, no. 8, 2007

Soppe A., 2004. Sustainable Corporate Finance. Journal of Business Ethics 53, pp. 213-224

Thompson, P., 1998 b. Assessing the environmental risk exposure of UK banks. International Journal of Bank Marketing, 16/3, pp. 129-139.

Weber, O., Fenchel, M. & Scholz, R., 2006. Empirical Analysis of the Integration of Environmental Risks into the credit risk management process of European Banks. Bussiness Strategy and the Environment. DOI: 10.1002/bse.507olicy:

Environmental Policy

The Electronic Papers published by the Portuguese Observatory for Good Labour Practices (OPBPL) are CO_2 free; all the OPBPL labour practices respect the environment and go towards sustainability

offsete • apague a sua marca | www.off7.pt