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Going Green: financial engagement helps, exclusion hurts

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There are more and more reasons for banks to make sustainability a strategic focus. Paradoxically, perhaps, this is not necessarily beneficial for society and the world at large. Because if investors focus on excluding non-sustainable economic activity, heavy polluters will be forced to rely on lenders who have no eye for sustainability. This could actually cause overall emissions to increase.

The debate about the role that banks have to play in society is back with a vengeance. The biggest question now facing banks is how to refocus their strategy in order to remain relevant in the future. Besides being market players, banks clearly also carry a great responsibility to society. Since 2014, the interests of customers and third parties have been legally enshrined in the General Duty of Care for Banks and Insurers Act. But what exactly does this mean in terms of a bank's sustainability ambitions? How far must the social role of banks go?

Should banks stick to their core activities …

The neoclassical economic theory of Milton Friedman posits that profit maximisation is the sole social responsibility of a business. Within this line of reasoning, the prevention of environmental damage is typically a government matter. CO_2 emissions are perceived as a textbook example of market failure that justifies government intervention as the external effects - in this case global warming of the atmosphere - are not factored into the price. As soon as governments manage to price in the full cost of CO_2 and CO_2 equivalents (e.g. via a CO_2 tax), these external effects become part of the price. To win customers, companies will therefore seek to reduce their prices through lower emissions. This neoclassical reasoning assumes that public goods are more efficiently produced when businesses and governments each continue doing what they do best in their own field. Business owners who want to make a contribution to society can do so by spending a portion of their profit on societal objectives.

… or is sustainability an opportunity?

According to Harvard economists Hart and Zingales, this neoclassical viewpoint is ripe for revision. To start with, full emissions pricing is not yet a reality. So a one-sided focus on profit maximisation is obviously not the solution for environmental pollution. Given this reality, the researchers claim that it is actually inefficient for companies to first maximise their profits through production, and then spending part of their profits on social and environmental improvements. The reason is that profit-generating production and CO_2 emissions are often inextricably connected. Companies can more effectively pursue sustainability by preventing polluting production than by donating a portion of their profit to environmental groups to fight pollution. One key question is: will the prevention of environmental damage impair profits or can companies actually boost profits by embracing sustainability in their strategy?

Sustainability and profit

A sustainable strategy can in theory contribute to a company's profit in various ways: it can create a positive reputation and thus help to attract green-minded customers and recruit talented employees who may prefer to work for a sustainable organisation. Avoidance of the risks attached to unsustainability can also save costs. Finally, companies that participate in the drive towards a more sustainable economy can tap into new revenue-generation opportunities. To what extend do we see these arguments at work in practise?

- **Embracing sustainability for 'reputation effect' is counterproductive**

Contrary to what is often believed, banks generally do not win the favour of the public by playing the sustainability card. A recent survey shows that whilst citizens feel that companies should be good for people, society and the environment, they increasingly mistrust the good intentions of companies.

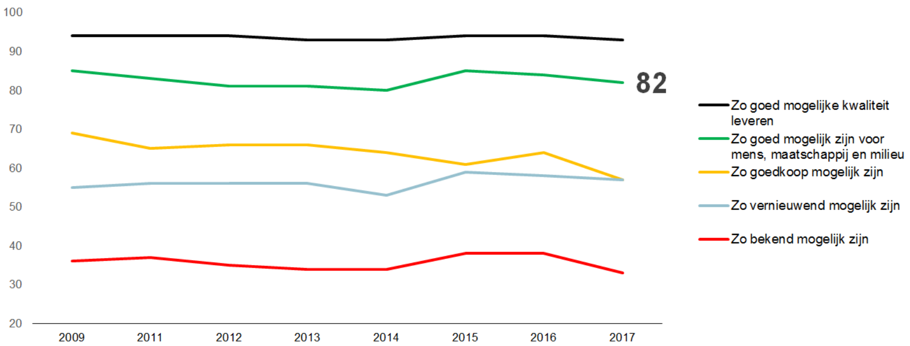
So much so, in fact, that reputation-sensitive companies often deliberately remain silent about their sustainable performance for fear of coming across as insincere to the public.

Dutch people distrust good corporate intentions

One frequently-heard point of criticism concerning sustainability as a strategy is that citizens are not really interested. To find out whether this is true or not, Motivaction put together a representative panel of the Dutch population consisting of 1500 to 4500 respondents aged 18 to 70. Between 2009 and 2017, they were asked every year for their opinion on the social responsibility of companies.

It transpired that the Dutch most definitely see "doing good" for people, society and the environment as important, but almost half of the respondents also distrust the good intentions that companies claim to have. From this perspective, embracing a social objective may even be a risky strategy.

It is (extremely) important to me that firms devote attention in their development to ….., %

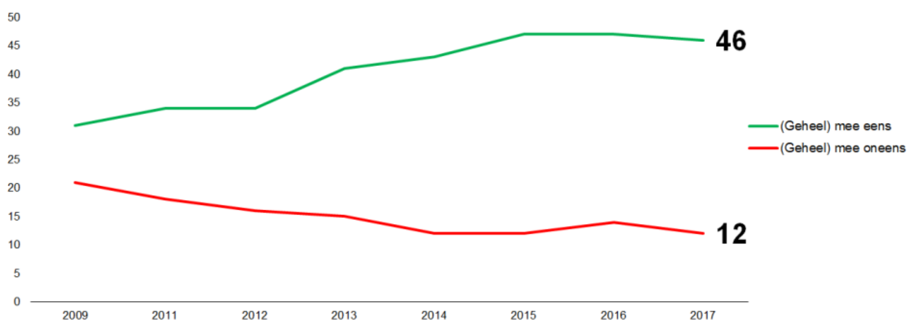


Source: Motivaction

Translation

- Best possible quality
- 'Doing good' to people, society and the environment
- As cheap as possible
- Innovation
- Branding

I distrust the 'doing good' of companies, %



Source: Motivaction

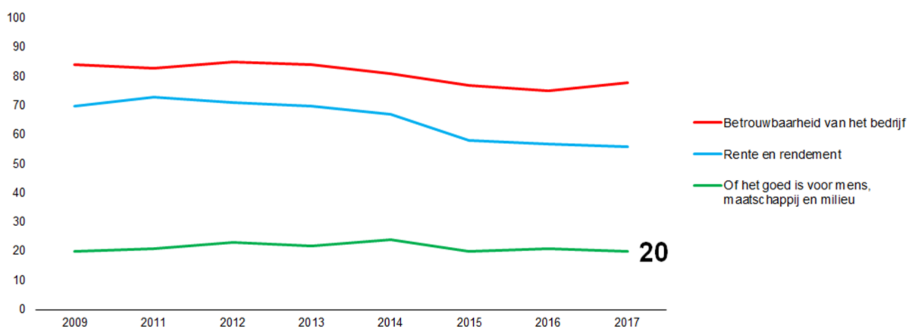
Translation:

- (Completely) agree
- (Completely) disagree

- **Demand for sustainable financial products among investors and companies, but not amongst private consumers**

Though demand for sustainable products in general is rising, sustainable financial products continue to arouse little interest amongst private consumers.

When I buy a financial product, I mainly look at …., %



Source: Motivaction

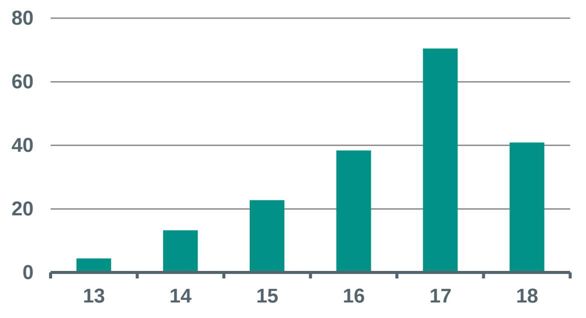
Translation:

- A firm's reliability
- Interest rate and return
- Contributing to people, society and the environment

Investors, by contrast, are warming to sustainable products in a big way. In the annual GfK monitor conducted for ABN AMRO in June 2018, 80% of investors said sustainability was a factor in their investments. Globally, too, investors are eagerly seeking information about the sustainability of their investments. As soon as the rating agency Morningstar launched its Sustainability Rating for Funds, sustainable funds saw their incoming investment flows rise, while non-sustainable funds were confronted with a decrease, so this study shows. The supply side is also accelerating: the global issuance of green corporate bonds has grown spectacularly in a relatively short time from EUR 4 billion to EUR 70 billion in 2017.

Total issuance of green bonds

EUR bn, 2018



Source: Bloomberg, ABN AMRO

Green bonds are bonds that meet the green bonds principle which guarantees the integrity of the investment. Green bonds are issued by companies, banks and, increasingly, also by governments. Clients of ABN AMRO indicate that they issue green bonds as a tangible demonstration of their commitment to sustainability, but also to attract the attention of investors (ABN AMRO/GfK, 2018). Green bonds issued are currently four times oversubscribed on average, which is twice as much as regular bonds.

- **Sustainable mission binds talent**

In the competitive labour market in which banks currently operate, the ability to attract talent at relatively low costs can be a critical competitive advantage. There is increasing evidence that companies with a social mission are able to recruit the top talents at relatively low hourly wages – at least lower than the wage they would have to offer without this social mission. In the annual top employer rankings drawn up by Swedish consultancy Universum, 'green' companies get high scores from young talent.

- **Non-sustainable business model is increasingly risky**

As the costs attached to non-sustainable business models rise, so too does the bank's risk of incurring losses on loans to non-sustainable companies. Think, for instance, of the initial plans to make all new purchases emissions-free by 2030 as put forward by the multi-stakeholder groups on climate change which are tasked in the Netherlands with reaching a Climate Agreement. We should add, however, that the legal feasibility of this proposal is still open to question.

Companies falling within the emissions trading system are already confronted with rapidly rising emissions-related costs. The European Commission's recent decision to remove surplus CO_2 emission rights from the market in connection with the *Market Stability Reserve* of the *Emissions Trading System* (ETS) has already driven the price of these emission rights sharply higher. This policy prompted market parties to 'hoard' emission rights, with the resulting scarcity causing the price of CO_2 emission rights to spiral even further. The price of CO_2 emission rights has increased in eight months' time from EUR 8 per tonne of CO_2 to EUR 21 per tonne in August 2018. A coal-fired power station that emits 3 million tonnes of CO_2 per year has thus seen its emission rights bill soar from EUR 24 million to EUR 63 million.

From the perspective of the three largest Dutch banks - ABN AMRO, ING and Rabobank - the risk of impairment of the underlying assets is still limited according to this DNB report as the loans in question (EUR 40 billion in fossil fuels) have short terms of no more than five years and almost all are secured with collateral. Remarkably, DNB makes no mention in this report of the risks that arise if banks refuse to refinance the polluting assets on maturity. Clearly, the assets will not disappear from the face of the earth and by rejecting this risk, the banks have zero incentive to help borrowers reduce their emissions.

- **Revenue-earning opportunities for sustainable projects still uncertain**

The transition towards a sustainable economy definitely also has upside potential, but there is no convincing evidence as yet that sustainable assets produce an above-average performance. Despite the high expectations in the market, there is still no question of sustainable economic activities delivering higher returns than non-sustainable activities.

For banks, the most important thing to know now is whether more sustainable loans lead to lower default risks. If this is the case, these loans may in due course be eligible for a lower risk weighting. Lower risk means lower capital costs. In other words, banks that help their clients to reduce their CO_2 emissions can benefit from lower capital costs to increase their profit margin.

The search for new energy transition technologies is also fuelling innovation. As yet, however, innovative solutions such as energy storage and tidal energy (marine energy) are still surrounded by too many uncertainties to qualify for bank finance.

The societal importance of a sustainable bank

Efforts by large institutional players such as banks to protect the environment and other public goods can be seen as a positive development. In their capacity as lenders, banks hear of their clients' production plans at an earlier stage than governments or consumers. They also have detailed knowledge of the markets in which these companies operate. This puts banks in an ideal position to rapidly disseminate information on emission-reduction technologies and strategies. And by setting specific green conditions for their loans, banks can also intervene more rapidly in the production process and prevent environmental damage.

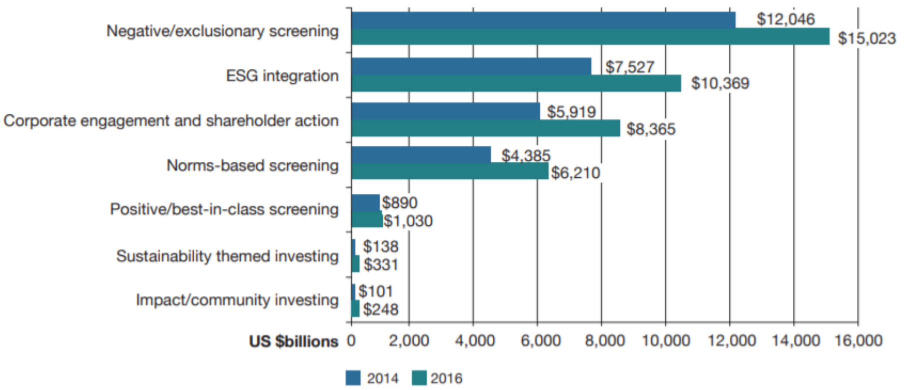
As asset managers, too, banks are able to actively influence the production decisions of the companies in which they invest on behalf of their affluent clients. Asset managers can take the social preferences of investors on board within the frameworks of their fiduciary responsibility to investors. In other words, they can express the social preferences of investors in their voting behaviour during shareholder meetings.

Risk avoidance can exacerbate environmental damage
One potentially large societal risk posed by the growth in sustainable investments is that large emitters of CO_2 are excluded from finance. This could actually make it more difficult to achieve the societal objective of less pollution. Because now that sustainable banks are abandoning non-sustainable activities, these companies and sometimes entire regions are becoming entirely dependent on lenders with no eye for sustainability whatsoever. Once the 'high emitting' firms are financed by unsustainable lenders, total emissions in the overall economy might increase.

Alternatively, banks can actively help achieve emission-reduction in the economy by actively engaging with stakeholders to reduce their CO2 emissions. But this, of course, also depends on whether banks can build coalitions with other investors to nudge the company in the direction of sustainability.

Though still in its infancy, active engagement is attracting growing attention. As things stand, however, exclusion through negative screening remains the most prevalent - and still growing - approach to sustainable investments around the world. Europe is even the leader in this field.

Types of sustainable investment strategies 2014-2016



Source: Global Sustainability Investment Review, 2016

Conclusion
The answer to our initial question - why should a bank want to be sustainable? - turns out to be rather surprising. The strongest arguments for banks to adopt a sustainable strategy are based on self-interest. Whilst there are no clear signs that retail customers are more inclined to opt for a sustainable bank, demand for sustainable products is clearly growing among companies and investors. In addition, a sustainable strategy offers banks a competitive advantage when it comes to recruiting scarce talent. One disadvantage, however, concerns the way in which financial institutions tend to embrace sustainability. In practice, their approach is mainly designed to avoid specific risks such as loan losses and reputation damage. Sustainability-driven investments and loans are usually based on negative screening and exclusion of non-sustainable assets. Besides implying that shareholders must currently sacrifice returns for sustainability reasons - which can be a conscious choice - this may also give rise to high societal costs. Because 'excluded' economic players will turn to non-sustainable lenders for finance, which may result in an increase in overall emissions. Another concern is that producers at risk of 'exclusion' are

typically located in socially and economically vulnerable regions. The conclusion is that a sustainable strategy based exclusively on exclusion actually aggravates the problems that it seeks to address.

All in all, therefore, a strategy where banks do not exclude clients but help them to reduce their emissions seems to be more beneficial for society. Added to this, it is obviously more attractive for banks not to be forced to exclude clients from their lending portfolio. That said, exclusion unfortunately remains the most prevalent strategy among sustainable investors around the world today.