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Governance of Sustainability in the Largest Global Banks

Posted by Stilpon Nestor, Morrow Sodali, on Wednesday, March 15, 2023

Editor's note: Stilpon Nestor is a Senior Advisor at Morrow Sodali. This post is based on Morrow Sodali memorandum by Mr. Nesto, Catalina Fuentes Benitez, Jacob Nolan and Darya Vinogradov-Wouters. Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance (discussed on the Forum here) and Will Corporations Deliver Value to All Stakeholders? (discussed on the Forum here) both by Lucian A. Bebchuk and Roberto Tallarita; Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy—A Reply to Professor Rock (discussed on the Forum here) by Leo E. Strine, Jr.; and Stakeholder Capitalism in the Time of COVID (discussed on the Forum here) by Lucian Bebchuk, Kobi Kastiel, and Roberto Tallarita.

Introduction

Banks are at the heart of every major national economy — and of the global economy as a whole. By intermediating between savers and companies, they are a prime allocator of capital across all economic sectors. In the process, they make decisions of systemic importance regarding the kind of growth that is supported by the capital they allocate. Their role in promoting sustainability across most sectors of the economy, from the most polluting and socially sensitive to the "green" sectors, is therefore systemic.

Below are the main findings of the Report prepared with my colleagues Catalina Fuentes Benitez, Jacob Nolan and Darya Vinogradov- Wouters which examines the sustainability governance practices of the 30 largest European and North American banks. In preparing the Report, we reviewed publicly available documentation and websites published as of 31 August 2022. We also interviewed representatives from fifteen leading banks – twelve of which were part of this study and eight of which were globally systemic banks ("G-SIBs"). The fifteen banks comprised ten from Europe and five from North America.

We also benchmarked the Report's universe to what we considered the best proxies for the two aspects of "success" relevant to a financial institution: financial soundness and sustainability performance. To this effect, we used two synthetic indexes: one measuring financial performance and one sustainability. Throughout the Report, we use insights from this taxonomy and the resulting categorization of peers. In our benchmarking exercises, we distributed the peer group along three tiers in the two areas covered by our synthetic indexes: financial performance and sustainability performance. We found that there were five banks among the 30 that were included in Tier 1 of both indexes – we call these banks "over-performers"; conversely, there were five banks that were included in Tier 3 of both indexes, which we call the "under-performers".

We are aware that the small peer universe makes this a less-than-robust comparison from a strictly statistical point of view. Nevertheless, we believe that the data does provide valuable insights into best or current practices in the two regions that we cover.

Key findings

Scope and drivers

Investors, some of the firms, and even some capital market (albeit not banking) regulators use the broad category of “ESG” (Environmental, Social, Governance) to discuss sustainability issues. We believe that the ESG scope is not helpful. Its enormous breadth and the fact that it lumps together the strategic “E&S” with the organizational “G” – long the subject of significant regulation and disclosure on a standalone basis among banks — encourages inconsistencies and increases “greenwashing” risk among the resulting “noise”. On the other hand, banking regulators focus on climate and (to a lesser degree) other environmental risks only. We define sustainability as the E&S – the strategic components of ESG,.

In our view, governance is dependent on two key variables: a firm’s strategic aspirations and its capabilities at any given point in time. One of the most important, recurring themes in the Report is that different stages of sustainability “maturity” require different governance solutions and result in different governance outcomes. Firms that are positioned at different points on the “maturity spectrum” do things differently, from strategy development and risk integration to the board’s mandate, structure, and composition. Therefore, directors need to keep a watching brief on where they are in this spectrum and implement change as they “surf along the curve”. Sustainable banking is a journey and its governance is an evolving process.

There are three drivers of the sustainability agenda in banks: institutional investors, regulators, and the firms themselves. Investors push for ESG among their investees and their voices are heard throughout the geographic footprint of our Report but more so in the US and the UK where the large majority of them originate. As discussed above, their scope is typically broad, but the depth of their analysis is rather shallow, albeit supported by the ecosystem of proxy advisors (such as ISS or Glass Lewis) and ESG ratings agencies (such as MSCI or Sustainalytics).

The scope of banking regulation in Europe is limited to climate and environment, but expectations are rapidly getting higher and more granular than those of investors. Moreover, the European Union (EU) is rapidly developing a demanding disclosure regime for E, S, and G. In North America, the supervisors are only starting to include these issues into their supervisory scope, mainly through plans for stress testing and draft disclosure regulations. However, significantly stronger investor pressure and the emergence of global standards, such as the Task Force on Climate-related Financial Disclosures (TCFD), have resulted in comparably strong disclosures in North America despite limited supervisory pressure.

Finally, the firms themselves are pushing for higher sustainability standards in their businesses. This is not only a result of stakeholder pressure; it is also a means to differentiate themselves in the marketplace, to attract and retain (especially younger) talent; and, last but not least, to better manage risks.

Strategy

Ideally, the sustainability strategy is integrated into the firm's overall business strategy at every level: purpose and vision, multi-year business plan, annual objectives of each business and function, and capital allocation. This is also the view of the European supervisors in their recent guidance to banks in which they "expect institutions to integrate climate and environmental risks in their short, medium and long-term strategy". They also seem to suggest that the overall goal should essentially be the institution's alignment with the Paris Agreement Capital Transition Assessment (PACTA) goals of net zero emissions by 2050.

The degree of such integration differs according to the positioning of the bank in the "maturity spectrum", as per above. Early on, banks adopt standalone sustainability strategies which are aspirational in nature and mostly focused on the impact of the institution's own operations; rather than hardwired to business and risk objectives, cascaded to individual businesses, and informing senior management incentives. Boards are usually "pushing the envelope" during this initial period, including through self-standing sustainability committees. Currently, the large majority of banks still have some sort of a standalone sustainability strategy albeit more detailed and objective bound.

As maturity is gained, the "heavy lifting" is assumed by the management while boards tend to distribute the sustainability-related mandates across existing workstreams and committees or assign them to an existing committee.

Risk and materiality

All of the peer banks have or are developing a climate-related risk framework for a "multi-disciplinary company-wide risk management process". In Europe, supervisors expect banks to "integrate climate-related and environmental risks in all relevant stages of the credit granting process and credit processing."[1]

There is a larger proportion of European banks (62%) that assess their entire portfolio from a climate risk perspective than their North American peers (50%) — possibly the result of supervisory pressure. The European peers are also much more likely to disclose their methodology (88%) than the North American ones (38%).

The management of climate-related risks should start with a materiality assessment. However, looking at peer disclosures, materiality analysis is quite generic and very broad. Its utility as a way to identify risk is limited and it comes with a lot of "noise" — information that is irrelevant and makes it hard to focus on what is important. It often lacks prioritization, including the definition of thresholds, especially among Sustainability Tier 3 banks.

This might be partly because there are two tracks for analyzing materiality: the risk track and the stakeholder track. It is in the latter track that one often encounters generality and "noise". The inclusion of G factors further "muddies the waters". Banks include data protection, cybersecurity and digitalization (86% of peers), and ethics and compliance (79% of peers). These are important

[1] ECB, Good practices for climate-related and environmental risk management: Observations from the 2022 thematic review, November 2022, p.41

operational risks but puzzlingly lumped with other ESG factors. We, like regulators, view these factors as being part of the core corporate governance/compliance space and, as such, have excluded them from our analysis.

Few banks have reached the maturity stage where sustainability aspects are fully integrated into their internal credit ratings or market and operational risk frameworks. Many described themselves as still being at the beginning of that journey. Like in the case of strategy, two distinct states of "sustainability-readiness" can be discerned among our population: those dealing with climate risk as a self-standing area with its own metrics and objectives; and those integrating climate risks into the "Basel cannon", i.e., the risk categories that structure risk management in a banking organization such as credit, market, operational, etc. There are a few that still only view sustainability risk through the lens of reputational and/or "macro" strategy risk.

The same variance across the "maturity spectrum" is evident in approaches to risk appetite. In the early stages, this is often confined to reputation with a few sectors of business being gradually introduced in terms of exposure thresholds. The end stage (still an ideal in most cases) would see the banks set risk appetite thresholds in almost all sectors and cascade them across all (material) businesses.

Some banks (mostly in Europe) have adopted exclusions for certain sectors. However, most banks seem to rely on either (a) engagement with obligors in sensitive sectors with the objective of moving them to credible PACTA plans or (b) project-specific exclusions in which certain transactions are excluded from their funding scope.

Only 13% of the peers disclose that they include E&S risks other than climate into their formal risk management framework. The European Central Bank's (ECB) 2022 guidance requires banks to take into account other environmental risks only from a macro perspective;[2] in other words, they are not required to integrate them into their formal risk management framework.

Boards: composition and skills, structure, engagement

While banks are now actively looking for board members with certain E&S experience, candidates must also still have relevant financial or senior leadership experience – they cannot be "one-trick ponies". What best practice boards are really after is "sustainability literacy" embedded in a broader understanding of what the board should and should not be doing. According to our own definition of "sustainability literacy", 24% of peer board members "fit the bill".

While 70% of North American peers include sustainability skills in their skills matrixes, only 40% of European banks do so. It is interesting to note that North American sustainability experts are much more likely to have gained their expertise as businesspeople in sensitive sectors while, in Europe, expertise is rather the result of non-business experience in charitable, NGO, policy, or academic sectors.

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[2] ECB, Walking the Talk: Banks gearing up to manage risks from climate change and environmental degradation, November 2022; ECB, Good practices for climate-related and environmental risk management: Observations from the 2022 thematic review, November 2022

Recognizing that sustainability expertise is rare and sustainability literacy limited among board members, the vast majority of peers hold board workshops on sustainability issues, such as climate change trends, climate risk, sustainable finance and others. In contrast, the use of external board advisors is less common than it seemed to be in the early years of board involvement in sustainability. Only one (UK) bank retains such a senior board consultant.

We identified three approaches to structuring the oversight of sustainability at board level: (A) creation of an ad hoc board committee on sustainability, (B) making sustainability a whole board affair — like strategy, and (C) combination of a broad sustainability mandate within an existing board committee. More than two-thirds of Sustainability Tier 3 peers use option (A), while Sustainability Tier 1 peers mainly use either options (B) or (C), which are also the favorite approaches of 80% of the "over-performers". Four of the five Sustainability Tier 1 peers who follow option (C) combine the general sustainability oversight mandate with nomination and governance responsibilities. One of the banks using option (B) has appointed a "board sustainability champion".

We believe that the establishment of a standalone committee is often the starting (or an early) point in developing a more comprehensive sustainability risk and strategy perspective. As banks move along the "maturity spectrum" the "heavy lifting" is, as noted above, assumed by the management while boards allocate sustainability mandates across existing workstreams and committees.

Whatever the option chosen, the great majority of peer banks have assigned specific responsibilities related to sustainability to the existing committees within the broader mandate for each of these committees. If a sustainability committee exists in a standalone or combined form, the issues discussed there are regularly communicated to and inform the perspective of the risk committee and the remuneration committee, where the final decisions take shape. Audit committees often have the responsibility for the oversight and integrity of non-financial disclosures.

Management organization

If E&S are essentially matters of firm strategy, it follows that management should have the central role in both preparing the strategic approach, materiality assessment, KPIs, and risk appetite framework; and ensuring they are all properly cascaded and embedded in each business and function. The transversality of the issues, their novelty, and a certain conceptual distance from the mainstream banking business – mostly, a transactional affair — dictate an organizational approach that is (a) broad in its reach, transcending organizational pyramids and silos and (b) top-down so that it can convey gravitas and the importance of the whole E&S transformation process.

All peers have adopted specific organizational approaches in addressing sustainability issues. These can be put into three categories: Under option (i) the top executive committee or board ("TEC/B") has full responsibility for these issues (used by 23% of peers). Option (ii) is the establishment of a senior management committee chaired by a TEC/B member, which in more than half of the cases is the CEO (the most common option used by 54% of peers). Option (iii) delegates this responsibility to a lower-level committee of experts that occasionally report to the top committee (used by 23% of peers).

60% of the over-performers have chosen option (ii) for their management structure of sustainability, compared to 40% of our under-performers.

93% of peer banks have appointed a head of sustainability at group level (“ HoS”) or equivalent – and this position is usually standalone. The HoS’s principal task is coordination across businesses and functions in this very transversal area while also having significant input (often the initiative) in the development of sustainability strategy—especially in the early stages of the journey. This coordination role is reflected in the HR footprint of the unit: it is often “light” at the center, often working with “correspondents” in front-line units and some second-line functions.

The HoS reports directly to the CEO in 50% of the peers and to another member of the TEC/B in 42% of the cases. However, in North America only 12% report to the CEO in contrast to 42% among European peers. In 50% of Sustainability Tier 1 peers, the HoS sits on the TEC/B – the numbers decrease with the Tiers.

The stakeholders

Given the importance of stakeholders in the context of sustainability, stakeholder mapping is a common practice, with 87% of all peers disclosing their stakeholder map and engagement plan. North American peers are less keen than their European counterparts to disclose these items. Peers such as UBS and BNP have established specific departments for stakeholder engagement.

The Sustainability Tier 3 peer group is lagging behind on stakeholder mapping, with only 67% of banks disclosing, compared with Tier 1 at 82% and Tier 2 at 90%.

Interestingly, only five of the 30 banks have granted shareholders a “say- on- climate” – an opportunity for a bank’s shareholders to vote in an advisory capacity on the adequacy of the bank’s climate plans and targets (e.g., its net zero pathway).

While “say- on- climate” is on many investors’ best practice lists, it is not widely required. For example, some influential investors, like Blackrock, do not demand it. One should be clear about its potential downsides.

As regards Corporate Social Responsibility (CSR) issues, all 30 of the banks have established foundations or other similar charitable funds whose activities seem to have a significant positive impact in many areas of social action like culture, education, poverty, health, or development.

Concerning supply chain management, there is only one peer that does not disclose a supplier code of conduct.

As regards gender diversity, approximately 40% of peer board members are female, while 10% of banks have a female chair of the board — two of the three are among the “over-performers”.

Three peer banks have a female CEO (10%) while one of the “over-performers” has both a female chair of the board and a female CEO. At the TEC/B, women make up 28% of the average membership – a number that has increased rapidly in the last decade.

In terms of peer participation in the development of norms and standards, sustainability is probably the most important — and resource consuming — area of activity. The average number of sustainability initiatives followed by each peer is 16, with the European peers following significantly more (18) than the North American peer group (12).

Executive compensation

83% of the banks now include sustainability metrics and targets as part of their executive remuneration plans for at least the CEO and the C-suite. European banks are far more likely to include them than North American banks. The banks that do not disclose such KPIs are overwhelmingly situated in the Sustainability Tier 3.

It is interesting to note that 75% of peer banks with sustainability-linked KPIs have set such KPIs in both E&S, even though the banks' risk focus at this stage is almost wholly on climate risk. Our general understanding is that the KPIs relating to S are among those that had been in place for a while but are now becoming less "weighty" than the newer climate objectives.

The use of a synthetic scorecard is the most common measurement tool for variable remuneration purposes. While Scope 3 metrics constitute by far the most impactful area for banks in the sustainability arena, our understanding from interviews is that most banks do not currently set compensation-related targets directly linked to such emissions.

Of the 25 banks that did include sustainability-linked KPIs as part of their variable remuneration policy, 72% disclosed the overall weighting of sustainability components within this plan. The average "weight" among them is 17% of the total variable compensation package, with the over-performers showing a superior weight of 22.5% — almost a quarter of the package.

Short-term incentive plans (STIPs) are the most popular framework for sustainability-linked KPIs. 80% of peers that disclosed this information include the sustainability KPIs in their STIPs. The number in the US was 100%! Conceptually, sustainability targets in STIPs are counter intuitive. Pro-sustainability change (especially on the climate side) should be focused on the long-term.

Reporting

Reporting on ESG and sustainability (other than governance) has reached prodigious volumes in banks over the last few years. The average number of pages in a sustainability report among the peers (including appended materials) is 115. It is interesting to note that Sustainability Tier 3 banks put out the most voluminous reports at an average of 142 pages.

But volume does not necessarily translate in relevance. As noted in discussing materiality, one is distracted by a significant amount of "noise" which in turn makes performance-tracking and compensation arrangements related to sustainability overly complex and non-transparent.

The lack of standardization of regulatory or voluntary reporting systems is a significant problem for all market players which explains the multiple standards employed by the banks in their disclosures, possibly also contributing to their length.

Similarly, each peer discloses approximately six sustainability ratings. The fact that these ratings have at times been found to be at wide variance with each other is probably one factor in this ratings “inflation”. On average, European peers employ seven ratings each; the number for North American peers is four.