Sustainability in Finance

Banking on the Planet

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Summary

Environment issues and sustainability

Environmental problems can be described effectively by means of the ‘tragedy of the commons’ metaphor. This involves a situation in which little heed is paid to scarcity and so ensues the exhaustion of resources, erosion and, systemic problems like the disturbance of natural cycles and reproductive systems. This metaphor is frequently employed in the fishery sector. Each fisherman can see when overfishing is taking place and when future catches may be adversely affected by this. In terms of the ‘tragedy of the commons’, each fisherman notices the problems developing but has no reason to take action to prevent these problems. After all, his voluntary limitation of his own catch would only increase the catches of his competitors so that the net result in terms of overfishing would be unchanged. The oceans are common property, and this is how overexploitation develops. This overexploitation is a classic example of a market failure in which the most significant causes are the lack of information about scarcity and the victory of short-term self-interest over co-operation. This is sometimes referred to as the ‘prisoner’s dilemma’. This dilemma develops when a person, unable to predict another’s behaviour, works to achieve his own short-term interests to the detriment of mutual long-term interests.

With insufficient appreciation of the scarcity of resources as the underlying cause of environmental problems, the problem is accentuated by a system of property rights from which negative external effects of production and consumption, such as environmental deterioration, derive. If production factors are to be optimised, these external effects should be integrated into market prices. The environmental factor, however, is usually not included in market decisions. Price incentives – and perhaps psychological, legal and social incentives as well – will ultimately ensure that the environmental factor is sufficiently included in production or consumption decisions.

The foundation for today’s environmental policy, and also for sustainable development, can be traced back to the realisation that the environment and the economy are closely interrelated. An economic system cannot exist without an ecological system: the ecological system being the principal system, from which the economic system is derived. After all, it is the ecological system that makes life itself possible and is both a source – in terms of natural resources – as well as a waste pit – the recipient and processing system of waste materials and other emissions – for an economic system. This insight leads to the conclusion that maintaining the environment is a necessary condition for any economic activity and ultimately for mankind’s survival.

It was primarily during the twentieth century that environmental problems changed in terms of scale and magnitude. During this century, the world’s population increased by a factor of five; energy consumption increased by a factor of fifteen due to dramatically increased production, consumption and mobility; agriculture intensified; the exhaustibility of various natural resources became evident; and man’s effect on the climate became ever more clear. Problems first manifested themselves at local level (with such nuisances as stench and local air and water pollution), later at regional and fluvial level (e.g. eutrofication or the use of manure) and continental level (e.g. with acidification) and, finally, even at a global level (e.g. climate change). This means that the necessity to decrease the environmental impact of several forms of pollution has become a matter of global importance: desertification, deforestation, climate changes resulting from the use of fossil fuels, the damage to the ozone layer, and the accumulation of chemical substances in the food chains and in parts of the groundwater. It has become very clear that environmental degradation, economic growth, population growth and poverty are interrelated within an international framework. This insight has led to the introduction of the concept of sustainable development.

This concept received wider attention when the World Commission on Environment and Development published its report entitled *Our Common Future* in 1987. This report (also known as the Brundtland Report) laid the foundation for developing and implementing policy in regard to sustainable development. Its wording has become the most generally accepted definition of sustainable development and has also become the basis for environmental policy in many countries. The definition as expressed by the Brundtland Commission reads as follows: *"Sustainable development is a development that meets the needs of the present without compromising the ability of future generations to meet their own needs."*

What does a bank have to do with sustainable development?

Now that we have a better picture of the development of environmental issues and environmental awareness, another question arises: what does a bank have to do with sustainable development? In an economic system, a bank fulfils an important role: it is an intermediary between borrowers and lenders of money. Banks are the most important intermediaries in an economy. This intermediary function centres on bringing together and co-ordinating savings and investments. As a financial intermediary between entities on the market, a bank has four functions: transforming money by size, duration, place and/or time, and risk.

It is particularly this last function (the distribution and management of risks) that will probably be the most important one for attaining a sustainable society. Between borrowers and lenders of money what develops is information asymmetry, including that which concerns environmental aspects. Banks have extensive and efficient lending operations and have a comparative advantage in information (as a result of the knowledge they have of economic sectors, regulations and market developments). By in principle having a solid view of environmental and financial risks, banks fulfil a key role in reducing information asymmetry between entities in the market. A bank can attach a value or price to reduce that uncertainty. Interest rate differentiation among sustainability aspects is justified from risk perspectives. The scope for interest rate differentiation increases if banks can raise funds more cheaply because they have a relatively 'well qualified' credit portfolio. Banks can go a critical step further by applying interest rate differentiation on the basis of the will to stimulate sustainable development. By means of their financing policy, banks can then take specific measures to contribute to sustainable entrepreneurship. The government could encourage this differentiation in interest rates even further by tax incentives and the Dutch government is, for example, indeed doing so by such means as the green tax ruling (a tax incentive for the investment in 'green' funds and projects).

Examples of sustainability issues and banking

One of the most significant activities of banks is the lending of credit. There are considerable environmental risks involved in the financing of clients. While these usually fail to receive enough attention, there are many methods available to estimate the environmental risks of businesses. An environmental risk associated with a client can become a financial risk for the bank. As an example of this, the continuity of a client can become endangered due to changing government policy or the shifting preferences of consumers or industrial clients, either of which result from attempts to achieve sustainability. Collateral, too, can decline in value or even take on a negative value more rapidly than if there were no environmental risks; this has been shown to happen in the event of serious soil pollution. Furthermore, banks can sometimes even be held directly accountable for the environmental damages caused by the activities of a client. And finally, one can distinguish reputation risks which can arise by investing in activities which are sufficiently disapproved of by society. By now, various banks have drawn up their own methods to determine the environmental risks associated with potential clients. A number of banks are also marketing specific environmental loans for SMEs.

Investing for proprietary trading (in which the same risks as previously described are generally applicable) and investing as commissioned by clients are becoming increasingly more important activities for banks. In cases where clients are interested not only in financial rewards but also in ecological and social rewards, an interesting market develops. The market for funds that invest exclusively in companies demonstrating progressive environmental care, for example, is growing dramatically. Also available are funds specialising in solar energy, wind energy and environmental technology. It is no longer pure idealism, however, that is driving the success of these funds since the financial yields of several of the more 'sustainable' funds are above the market average. This is linked to a sweeping monitoring, sometimes conducted by external agencies, of the financial and environmental aspects of companies that are usually listed on the stock exchange. As the preferences of consumers shift more toward sustainable goods, the companies carrying such products can generate better shareholder value. Obviously, tax incentives can sometimes be necessary or desirable.

The area of insurance and leasing also offers challenges with respect to sustainability. Various bank insurers, for example, introduced an environmental damage insurance in which environmental risk is a key factor in premium differentiation. Several banks have also developed wind turbine leasing products. Advising clients is yet another area involving challenges; several banks have taken this up in the form of brochures, conferences, environmental helpdesks, and specific software applications. Many developments working toward sustainability are extremely creative and are small-scale at present. Financial instruments currently available to meet this need are practically non-existent. Banks striving to achieve sustainable banking could develop special instruments for this such as funds that target innovation.

Internal environmental care means dealing with the environmental factor as carefully as possible in one's own production process. Banks have a relatively limited environmental impact per product unit. Due to the huge volumes with which they work, however, the total environmental impact of banks is not insignificant. Banks occupy huge amounts of office space, devour large amounts of paper, have transport facilities, and consume energy and water. Cost cutting could therefore be considerable. One UK bank, for example, achieved energy savings of approximately 25% over the space of four years; cumulatively, this meant a net cost saving of around fifty million Euro.

Within organisations, working toward sustainability implies the need for changes in behaviour. Although these can come about autonomously, they will usually need to be organised. Communications are then extremely important. An essential element in the success of internal environmental care is that the environmental programme and the environmental policy be communicated to all departments within the organisation. Both internal and external communication can contribute to organisational change. Obviously, external communication can also be accompanied by commercial advantages. These forms of external communication can include PR activities, an environmental annual report, and the signing of international treaties (such as the declaration of the United Nations Environmental Programme regarding banks and the environment). In any form of external communication, however, a bank should consider how well it can be assessed externally: can the bank display results in the area of environmental care or environmental policy, and is it also open to be held accountable for this?

Banking in a sustainable future

Care for the environment has been a major consideration among production companies for several decades. Roughly, banks started devoting attention to this matter only halfway into the 1990s. Within the banking sector, environmental concerns were long considered to be more related to the social sciences, the subject having an image associated with idealistic non-conformist social reformers. By now, many banks are actively involved, however, and are attempting to get the better of one another's green activities. But image is not the only major motivation. Ideas have changed based on such foundations as the pioneer work in 'sustainable investing' done by (smaller) ethical banks. These days, the drive for sustainability is more often seen as a way to generate additional profits.

Sustainable development will go hand in hand with change. This change may be gradual and occur over a long period, similar to the gradual shifts in concepts within the banking sector, or they occur suddenly within a short period of time (usually as the result of a crisis such as a serious environmental catastrophe). From their own perspective, banks usually deal with gradually changing views. Even so, banks can also be confronted with sudden changes. Long-term investments of approximately 20 years or more, for example, are usually considered high risks. It is then necessary to have an idea of what a 'sustainable' society will be like in, say, another 20 years. Banks have to answer several questions. What will be acceptable and unacceptable in another 20 or 30 years from now? Which sectors and kinds of business activities will exist then and which will not? Answers to such questions provide the justification for short-term activities.

Real sustainable banking does not imply that banks should write off clients that are currently not operating as sustainably as they might, but that they assist these clients along the difficult road to more sustainable business practices. At the same time, banks will have to support clients with sustainable investment ambitions (usually ones that are still ahead of their time) with specific financial instruments to help them meet their objectives. Only when clients remain stubbornly opposed to a more sustainable course (i.e. continually unwilling to introduce improvements that would lead to a more sustainable direction) would issues of making choices arise; these can sometimes be sector-related. Even then, it would be advisable to withdraw gradually in consideration of such a client's poor perspectives for the future. Dealing openly with this process of change, both internally and externally, will lay the foundations necessary for sustainable banking. This is not a process than can or will take place overnight. A key factor in this process of change is how a bank sees itself within the global setting.