HOW DOES SUSTAINABLE BANKING ADD UP?

A CATALYST REPORT

CATALYST

ABOUT CATALYST

Catalyst is a not for profit policy network established in 2007. We work closely with trade unions, non-Government organisations and academics to promote social and economic equality and improved standards of corporate social responsibility.

Our founding principle is to produce work that promotes good lives, good work and good communities.

In October 2014 Catalyst formally merged with The Australia Institute and now operates as an independent branch

AUTHOR

Martijn Boersma

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Catalyst Australia Incorporated

Level 3, 4 Goulburn Street, Sydney

Tel: +61 (0) 2 8268 9718

www.catalyst.org.au

@CatalystAus

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1. INTRODUCTION

The big four Australian banks have received international accolades for their sustainability efforts. At the 2014 World Economic Forum, Westpac was named the most sustainable company in the world[1], with former chief Gail Kelly being "[…] delighted that Westpac's sustainability performance has been rated so highly on the global stage."[2] ANZ was named as the global banking sector leader in the Dow Jones Sustainability Index, a major reference point for sustainable investors, six times in the last seven years[3], while NAB[4] and the Commonwealth Bank[5] have likewise been recognised for their sustainability performance.

Despite these accolades, a number of recent controversies have stimulated public debate about the social and environmental responsibilities of the banking industry.

Australian banks have suffered public outrage as a result of dubious financial advice costing thousands their life savings, disputed credit card fees, rate-fixing, and insider trading, as well as the funding of unsustainable activities such as coal mining and infrastructure projects along the great barrier reef, nuclear arms manufacturing, and land grabs in emerging economies. As a result, confidence in banks is low: according to a national survey performed by the Australia Institute, 76% of respondents believe that banks put profits before their social and environmental responsibilities.

How can these two conflicting pictures of the banking sector be explained?

This report examines both the sustainability in the Australian and global banking sectors and the assessment indicators. Specifically, it assesses self-regulatory and voluntary measures aimed at producing socially and environmentally responsible banking.

An overview of the social and environmental performance of Australian and international banks using commonly accepted sustainability indicators reveals a schism exists between symbolic and substantive sustainability efforts. Simultaneously scrutinising these indicators by assessing how effectively they measure the performance and commitment of banks makes it apparent that while many Australian and overseas banks perform well according to the indicators, their business strategy and practices may fail to meet three key challenges: misaligned incentives, information asymmetry, and effective management of social and environmental risk.

The report concludes by recommending increased integration of corporate responsibilities in authoritative frameworks, a measure aimed at redressing the unbalanced configuration of public, civil and corporate governance frameworks, which currently favours corporate voluntarism and self-regulation.

Specifically, significant steps towards overcoming the three challenges are:

- reformulating company directors' duties to include social and environmental responsibilities,
- redefining sustainability reporting requirements and enshrining these in corporate governance systems,
- and founding social and environmental risk assessments on the precautionary principle, which shifts the burden of proof towards those parties that potentially cause harm.

THE AUSTRALIAN BANKING SECTOR

The ‘four pillars’ of the Australian banking system are a uniquely dominant part of the Australian economy. The four big Australian banks, Australia and New Zealand Banking Group (ANZ), Commonwealth Bank of Australia (CBA), National Australia Bank (NAB), and Westpac Banking Corporation (WBC) are all featured in the top five of the Australian Securities Exchange (ASX) 200. In the weighting for each sector represented in the index, the **financial sector** dwarfs others industries: the financial sector makes up 46.5% of the total ASX 200 **market capitalisation**, followed at a distance by the materials sector representing 15.4%.[6]

The big banks hold $AUD 522 billion of Australian household deposits, equal to one-third of Australia’s gross domestic product.[7] In the 2013-14 financial year, their pre-tax profit was 87.5% of total bank profits[8] and 2.7% of national income.[9] In the words of David Murray, former CBA-boss and chair of the Financial System Inquiry: “[…] banks fund most of the assets in the economy – whether it’s businesses, governments themselves, homes or projects, whatever else. And because they do that, banks in aggregate are themselves monsters… They have monstrous balance sheets and therefore make a lot of profit.”[10]

According to the chairman of ANZ, David Gonski, Australians ought to “stop bashing the banks” for being large and profitable.[11] This comment should put civil society on guard. The market dominance of banks results in great market power, as well as great responsibility. The impact of banking is measured through operations in offices and branches, as well as through financing, which can lead to involvement in unsustainable practices. As banks provide the majority of external finance to firms and governments, they can influence their practices. Research shows that bank lending potentially has more impact on sustainable enterprise than investment and divestment on the stock market.[12]

Banks can thus wield their enormous market power to support sustainable activities, while their actions can likewise contribute to detrimental behaviour. The global financial crisis has shown that unsustainable banking activities do not only spread through the economic system but also endanger it.[13] This begs the question to what degree banks, apart from posing systemic risks, can contribute to, or alternatively mitigate social and environmental harm, and what are the resulting responsibilities of banks towards the community and the environment?

RESPONSIBILITIES

In 2005, a Parliamentary Joint Committee on Corporations and Financial Services in Australia launched an inquiry into Corporate Responsibility and **Triple Bottom Line** reporting. Specifically, it examined whether companies regard the interests of stakeholders other than shareholders, and the extent to which the Australian legal framework that governs directors' duties encourages or discourages them from considering stakeholder and community interests. The inquiry furthermore examined the desirability of legal revisions, the suitability of voluntary measures, and the appropriateness of reporting requirements.[14]

The Committee found that legal amendments were undesirable, as it deemed it "[…] not appropriate to mandate the consideration of stakeholder interests into directors' duties." Furthermore, the Committee recommended that sustainability reporting should remain voluntary, fearing that "[…] mandatory reporting would lead to a 'tick-the-box' culture of compliance."[15] The Committee made a specific recommendation regarding the inclusion of appropriate guidance in the ASX Corporate Governance Principles and Recommendations, which in 2011 led to guidance pertaining to gender diversity[16], followed by further guidance in 2014 concerning the disclosure and mitigation of environmental and social risks.[17]

The emphasis on voluntary social and environmental efforts is problematic. According to illustrious economists such as Adam Smith and Milton Friedman, economic efficiency through specialisation is vital in wealth creation and market functioning. The question of whether business has duties beyond value creation is thus dismissed: "the social responsibility of business is to increase its profits."[18] Simultaneously, the Parliamentary Joint Committee on Corporations and Financial Services, as well as the advocates of the *let business be business* argument, likewise oppose public policy aimed at keeping business in check.

The outcome is a catch-22: the seemingly inescapable absence of measures to mitigate negative effects of business activities on society and the environment.

For a long time, market mechanisms were thought to provide the solution to the deadlock between the role of government and business. Unconditional trust in the market offered the blueprint for *laissez-faire* capitalism, with the maxim of the invisible hand reigning supreme. Yet the global financial crisis demonstrated that without adequate intervention from non-market forces, the pursuit of self-interest and economic gain does not create desired outcomes for society, but instead has the capacity to devastate it. Hence, markets should not be regarded as forces that miraculously create desired outcomes. Instead, they are man-made, imperfect, and in need of correction and supervision.

SUPERVISION

In the aftermath of the global financial crisis, regulators were pushed to exercise more supervision over financial services providers, and be less trusting of self-regulatory efforts.[19] According to the International Monetary Fund, Australian banks were resilient to the crisis because of sound regulation and supervision: "Prudential rules, often tighter than the minimum international standards [...] together with a proactive approach to supervision, helped maintain a healthy and stable financial sector."[20] In the view of the Australian Prudential Regulation Authority (APRA), responsible for oversight of the financial sector, application of global standards, adapted where needed, formed an important basis of the good international standing of Australian banks.[21]

Despite the fact that the Australian financial sector and the economy survived the global financial crisis relatively unscathed, the Government launched the Financial System Inquiry in 2013. The Inquiry examined how the Australian financial system could be improved to further economic growth and be better equipped to deal with financial crises. The final report, presented in December 2014, featured key recommendations concerning increased banking capital requirements, narrower mortgage risk-weights, minimum leverage ratios, minimum education standards for financial advisors, changes in the law to enhance consumer protection, and the establishment of an assessment board that evaluates the performance of financial sector regulators.[22]

Regrettably, the terms of reference of the Financial System Inquiry did not address social and environmental sustainability and risks in the financial sector.

It seems that the readiness to increase supervision concerning financial conduct, in order to avoid financial risks to the economy and consumers, is not matched by a similar willingness to supervise and regulate the social and environmental impacts of the financial sector. In spite of widespread concerns about climate change, human rights abuses, and political instability, we continue to rely on the self-regulatory efforts of Australian banks regarding funding of the fossil fuel industry, land grabs in developing countries, and nuclear arms production.

A nation-wide survey by The Australia Institute indicates that only 26% of respondents believe banks will behave ethically and responsibly if they regulate themselves, while merely 49% of survey respondents are confident that banks comply with Government regulation. These figures show the Australian public's widespread mistrust of banks, and raise serious doubts about the effectiveness of social and environmental self-regulation by banks. A number of key challenges are discussed below that will need to be overcome in order to establish truly sustainable banking practices.

CHALLENGES

Short-termism, performance rewards, and maximising shareholder value have long been the norm in the financial sector. Yet the focus on immediate returns while neglecting long-term risks is increasingly criticised. While performance rewards and shareholder value creation are not harmful, they become damaging when disproportionally focused on the short-term, which can incite unethical conduct and risk-taking for the sake of instant rewards. Conversely, a sustainable bank would equally consider financial, environmental and social factors, while aligning its own interests with that of the community through long-term financial and non-financial value creation, for shareholders and stakeholders alike.

Information asymmetry is another obstacle that banks will need to overcome. Whenever there is asymmetric knowledge in a transaction, there is a risk that the party with superior knowledge will exploit it for their own benefit, which leads to **moral hazards**. Information asymmetry and moral hazards are not limited to commercial transactions however: absent or incorrect social and environmental information can also misinform stakeholders about the exact impact of activities. It must be noted that this is a two-way street: banks can equally fall victim to moral hazards, for example by being misinformed or misled by firms seeking financing. In order to decrease information asymmetry and the risk of moral hazards, sustainable banks would aim to improve transparency and monitoring.

Lastly, banks need to manage risk more effectively. The global financial crisis demonstrated that financial risk-taking can bring the international financial system to the brink of collapse. This begs the question of what the consequences of excessive social and environmental risk-taking might be, as risk does not merely concern financial elements, but also society and the environment. The main challenge of responsible business and banking enterprise is no longer merely how to mitigate negative externalities, but rather how to find ways to anticipate and prevent negative impacts. This precautionary strategy is a critical step towards corporate responsibility that goes beyond symbolic efforts and implies a major change to the overarching business model.[23]