



The sleeping giant: Unlocking sustainable finance

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The sleeping giant: Unlocking sustainable finance

Many banks are failing to realise their impact potential, thus missing out on commercial opportunity in the real economy.

- Many analysts believe the pandemic and its impact on society has refocused stakeholders on the role banks can play in supporting customers and society.
- However, not all financial institutions are addressing environmentally and socially impactful financing opportunities in material ways.
- Moreover, the focus of regulators is widening to consider whether banks are financing activities viewed as truly sustainable.

There are few sectors with greater potential to enable real-world, future impact than banking. Banks can contribute to an array of sustainability outcomes by financing economic activity and transformation among enterprises, entrepreneurs, households and governments.

A historic business opportunity in impact may be waiting in the wings

Opportunity	<p>Sustainable finance (SF) may be a sleeping giant of potential future growth</p> <p>The potential for SF to turn into a historic financial opportunity is significant.</p> <p>For example, based on European Commission projections, Morgan Stanley estimates that of the €4.7tn in financing required for the EU Green Investment Plan, €3.4tn is likely to originate from implied private investments¹.</p> <p>The report contends that there may be “a first-mover advantage and estimate \$50bn+ of revenue growth in green investing and financing in the next 5-10 years” at European banks², without considering broader global opportunity.</p>	<p>Progressive investors and customers already keen to do business with purposeful banks</p> <p>Many analysts believe the pandemic and its impact on society has refocused stakeholders on the role banks can play in supporting customers and society³.</p> <p>This significantly altered context is contributing to broader and deeper expectations of a wider range of investors and stakeholders which expect – and potentially invest in or bank with – institutions that positively refocus their purpose and strategies for financing the activity of ‘building back better’.</p>
Risk	<p>Regulators focusing beyond downside risk by asking banks, “what have you done for us lately?”</p> <p>Although the focus for many regulators in 2022 is on understanding risks on balance sheets, particularly for climate change, this is widening to consider whether banks are financing activities viewed as sustainable⁴. The EU’s Platform on Sustainable Finance, and its progression of environmental and social taxonomies, aims to clarify that⁵. We expect that major banking markets will follow suit in the years to come⁶ and believe that proactive preparation on the downside risk exposures – and on scoping appropriate impact opportunities – is warranted immediately.</p>	

Banks have many reasons to explore this historic opportunity, beyond the potential for contributing to SDGs. Although there are countless ‘use cases’ in sustainable finance, we highlight a selection of factors contributing to our outlook for

banks which get their SF strategies right, and possible dangers for those that progress slowly or continue without transparent ambitions and reporting.





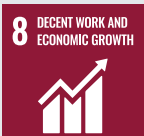



^{1,2,4,6} ‘Banks and Climate: Tides of Change,’ published by Morgan Stanley in 2020.

^{3,5} ‘European Banks: Socially Essential,’ published by Citi Research in 2021.

Our deep-dive comparative approach

The SDG Engagement High Yield strategy seeks to identify future positive, environmental and social impact through the United Nations Sustainable Development Goals (SDGs), including its subgoals and indicators, which can be directly enabled by targeted financing from banks (see Figure 1).

Figure 1: Examples of indicators within many UN Sustainable Development Goals feature measurable outcomes which banks can finance or lend against, including:

	2.3.1: volume of production per labour unit by classes of farming/pastoral/forestry enterprise size [with focus on doubling agricultural productivity and incomes of small-scale food producers]
	7.2.1: Renewable energy share in total final energy consumption
	8.10.2: Proportion of adults with an account at a bank or other financial institution
	9.4.1: [Reductions in] CO ₂ emissions per unit of value added
	10.1.1: Growth rates of household expenditure or income per capita among the bottom 40% of the population
	12.2.1: Material footprint, material footprint per capita, and material footprint per GDP

This approach allows us to invest in banks where we believe there is room to increase impact. We think of this as ‘impact delta’, or additional impact a bank can drive – whether through gigawatts of renewable energy funded, local job-creating SMEs supported, value chain decarbonisation projects financed, and so on.



For banks, the SF strategy and its rigour, ambition and transparency of outcomes, are fundamental to impact analysis. Ideally, SF strategies should offer us an indicative future ‘impact delta’ to evaluate, given the vast amounts of private funding needed to achieve the aims of the SDGs by 2030.

However, we observe that even in 2022, environmentally and socially positive financing opportunities are not being addressed in meaningful or ambitious ways by all financial institutions. We believe more ambitious, creative, better-defined and more transparent commitments in lending and financing are needed in all banks we invest in to a varying degree. Doing so can accelerate the achievement of key SDGs.

In order to better position banking investments in SDG Engagement High Yield and wider fixed income fund strategies, we sought to deepen comparative understanding of our holdings. To do this, we aimed to answer questions which could benchmark how material and strategic each SF plan is, today and in the future, for a selection of 20 banks within portfolios (see Appendix for details on methodology)⁷.

We were taken aback by the wide-ranging insight our research produced – more than we can set out here. **As such, the remainder of this paper focuses on lending; we will explore further implications of our SF strategy analysis in subsequent publications⁸.**

We define a sustainable finance (SF) commitment as one that aims to direct funding into economic activity with genuine, positive impact on environment or society. This implies banks should go above and beyond business as usual to deliver ‘additionality,’ due to the scale and urgency required to close many SDG gaps.

While SF commitments from banks can take many forms (such as eligible lending, underwriting, corporate banking, and asset management activities), our initial analysis in this paper focuses on materiality of commitments within lending.

⁷ Note: This analysis was carried out in the second half of 2021. While some banks within scope have since released more information on SF commitments, our conclusions remain consistent.

⁸ As previously mentioned, SF can mean many things. We sought to focus on key activities of banks which we think are highly material to SDG achievement, and where clarity is poor: lending to businesses and individuals, and asset management on behalf of customers. We have not focused on benchmarking other SF activity, which can include underwriting financial instruments to markets on behalf of borrowers (such as structuring and offering debt or facilitating initial public offerings) and investment banking (such as ESG-focused advisory services on mergers or corporate finance). Future research may include these wider elements, given that some banks are including related commitments in their SF strategies – particularly for ‘universal banks’.

The state of sustainable finance at 20 banks: what did we learn?

The results of our research demonstrate that banks have a great deal of work ahead on articulating, implementing and reporting on SF. Here, we focus on the takeaways central to how we will engage with banks on ensuring SF strategies are both visible and easily accountable in 2022.



Many banks now setting sustainable finance goals, but these are often incomparable and lack sufficient detail

All 20 banks we studied had qualitatively disclosed a SF strategy. Despite this, we could not identify or meaningfully calculate a total SF commitment at five of 20 banks.

Some banks disclosed ambitious numerical commitments yet failed to demonstrate how this would be deployed into activities such as lending, making it impossible for us to understand top-down materiality and bottom-up financing focus areas which contribute to the overall ambition. Bottom-up commitments are helpful to assess specific impact potential (for example, on emissions or employment) but were often presented in ways that are incomparable, overlapping or contradictory.

One bank disclosed its SF approach without any quantification, which is unacceptable, but its historic real-economy lending focus within several decarbonising sectors shows that it has strong promise for greater SDG impact. We continue to engage with this particular issuer on this challenge.



For most banks, it is difficult to compare stated sustainable finance commitments to overall banking activity due to inadequate data

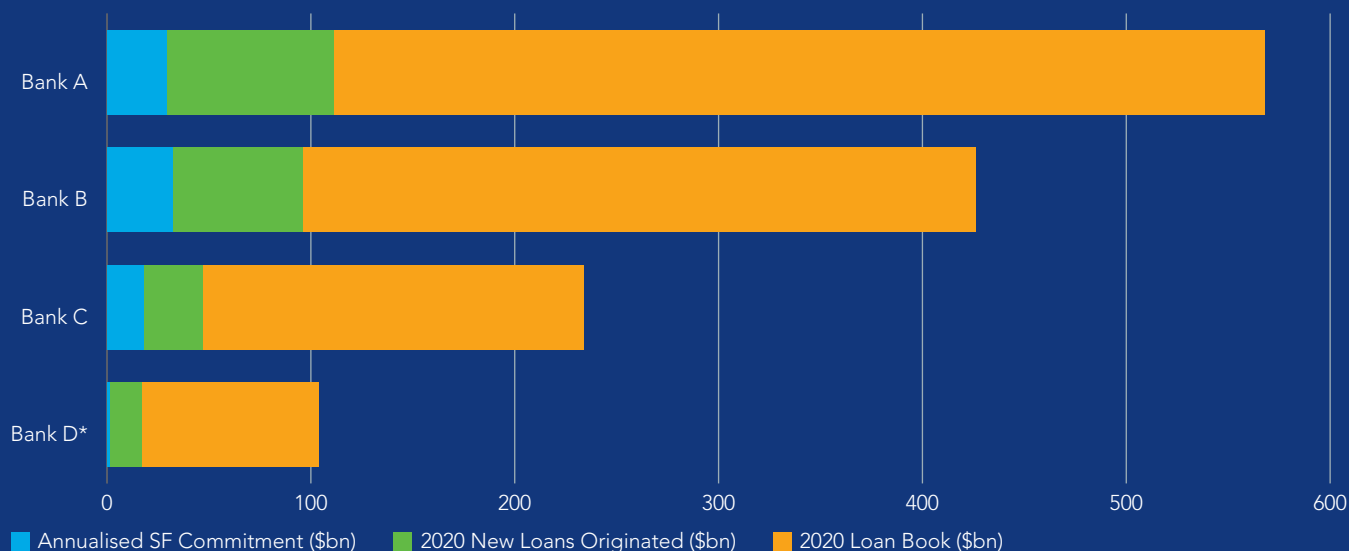
We identified four out of 20 banks (see Figure 2) which had defined SF lending goals precisely enough for us to calculate what this might contribute to overall lending. This is a far cry from 15 banks that provided a headline SF target but little detail on actual lending. As investors, we find this very unhelpful.

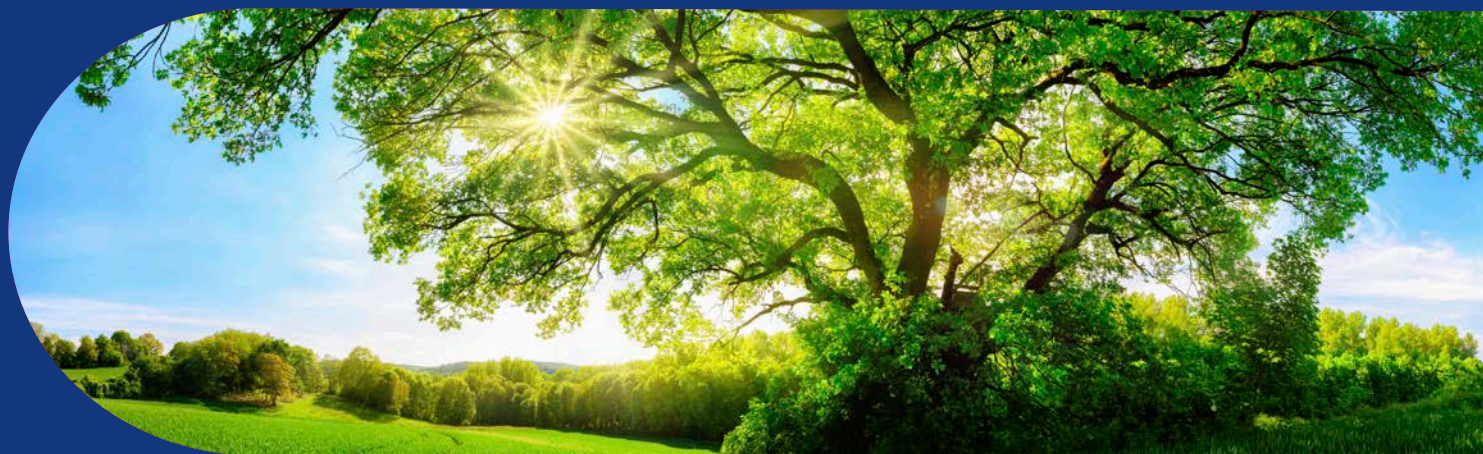
At the four banks in Figure 2, sustainable finance goals are clearly material relative to all lending – but there remains a long way to go to increase the share of total loans. After analysing grandly-stated SF sums, we looked at how banks broke these out in detail. In this area, confusion reigned, because two issues impaired our ability to assess areas of focus within headline SF goals.

The first issue arose from how goals are stated, which often stands in contrast to what banks actually do. Goals seem to conflate or mix together lending, asset management and other commitments. Rather than separating out and reporting sustainable and impact-driven financial activity logically, such as by business unit, banks stick to grand headlines which remain difficult to break apart.

The second issue concerns in how banks report SF activity already undertaken. Existing SF portfolios were reported inconsistently. For example, SF lending amounts were often provided in a vacuum as a single standalone figure, with no relation to total loans or other forms of capital on balance sheets or issued to markets. This left us wondering what 'legacy' SF portfolios consist of, and prevented our analysis of past and future materiality of SF-driven activity.

Figure 2: At the four banks in this sample, SF goals are material relative to all lending – but there remains a long way to go to increase the share of all loans.





We are unable to determine whether investors are choosing 'impact banks' or 'SDG Facades'

As impact-hunting investors, our most important question was: How material are SF commitments, compared to total activity of a bank?⁹ Frustratingly, getting a clear answer was stymied for several reasons.

On lending, we could roughly determine materiality for 12 banks if we created estimates through flawed calculations. We identified the value of SF commitments relative to all activity, or pieced together estimates. Our method was borne in a vacuum of data: we had to compare annualised or cumulative SF commitments (and disclosed previous sums) to all lending, and to the disclosed value of loan books. Many banks provide no annualised SF commitment, so we annualised this if needed.

For 12 banks where data or calculations were available, SF commitments as a proportion of annual lending ranged from 0.4% to 29%. This provided a rough-and-ready idea of how important the SF strategy really is at each bank, but says little about true materiality within each loan book.

We were both pleased and disheartened with this estimate. Several banks under-report highly material SF activity, and are missing a key opportunity to engage investors, stakeholders, and customers on what was accomplished and the journey ahead.

Conversely, several banks are presenting comprehensively marketed approaches which haven't translated into material financial flows yet.

We believe findings for our top 5 banks with material SF commitments (10%-29% of annual lending) are also more accurate, as these banks typically offered greater transparency in quantifying strategies and how they will drive a proportion of all lending activity.

The remaining banks with weak SF materiality (0.4%-9% of annual lending), and the eight banks for which this exercise was impossible, are doing themselves a disservice by not providing understandable quantifications of SF strategies to investors and stakeholders.

We could not self-calculate materiality for banks that do not disclose annual loans written in a year (eight of 20). In some instances, we were able to identify this after asking investor relations teams for data. As such, we used a less accurate calculation to compare total loan books to SF commitments, annually and cumulatively. This does not accurately identify the proportion of loans which are 'SF' on the books. We could not scope impact at five remaining banks which did not provide clear SF commitments (as described earlier). Self-calculations for the final three were too inaccurate to be meaningful.

Conclusion

Banks are failing to realise or communicate their true impact potential, and are missing out on commercial opportunities for SDG impact in the real economy

Large universal banks and national or regional champions have enabling roles to play in facilitating activity with positive environmental and social impact in the real economy. Transparent insight on the genuine materiality of contributions to the SDGs, relative to the volume of everything else a bank does, is required immediately, and is a forthright engagement topic within our banking holdings in 2022.

We will engage banks where we believe SF commitments are insufficient. This starts with banks which may not pass a 10% materiality threshold using our 'blunt force' estimates, and with those whose targets are immaterial relative to all lending or banking. We believe this underserves the opportunity available to providers of capital as a complementary or key avenue of future growth.

⁹ In addition to lending, our research examined materiality in investing and asset management. In general, banks are more transparent on goals for sustainably-managed assets (AUM). This progress will be addressed in a separate publication in the future focusing on asset management within banks.

How we will engage in 2022

1. Ask for full articulation of strategies that explain where banks are going to 'win' in SF, accompanied by frameworks that explain where impact can happen and what outcomes look like for customers.

We conclude from this research that SF strategies and frameworks offered by some banks are unclear and serious improvement is required. We must understand what will be financed, and the nature and impact on sustainable development outcomes. This should, at a minimum, address types of financing being offered, and how it is impacting particular environmental or social outcomes.

Case in point

Credit Suisse's Sustainable Activities Framework, published in August 2021¹⁰, is an example of strong disclosure. It is designed to explain the detail of its CHF 300bn SF commitment. Those who are curious about whether a loan would be included within this framework are presented with a decision tree that outlines Credit Suisse's criteria. It discloses its various exclusion policies, and categorises upside funding opportunities into three buckets – green, transition, and social. It outlines the types of projects that fall within each category. We continue to engage the bank on best practice as it works towards its aim of leading the sector on this agenda.

2. Encourage banks to move faster, regardless of the rapidly evolving regulatory milieu. Crystal-clear clarity is not required for developing needed capabilities, knowledge and strategies.

The regulatory landscape for banks in this arena is ever-changing. We think this is causing some banks to move slowly in preparation and responses. Initial funding and reasonable risk-taking (with the real possibility of course corrections) are needed. A partial lack of established regulations should not prevent banks from internal work on tools, thinking and talent to capitalise on the opportunities in financing sustainable activity in the real economy.

This paper has not touched on how banks can measure outcomes and impact from deploying SF. We believe work on strategy should proceed even as impact investors, regulators and stakeholders deliberate means of measurement and reporting in financial services. Impact measurement remains a challenging medium-term issue for all financial actors to some degree.

Case in point

Intesa Sanpaolo is undertaking an ambitious array of SF initiatives, from inclusive lending geared towards SMEs to a financing facility for circular economy-geared activity developed with the Ellen MacArthur Foundation. However, we believe it can improve its disclosures to highlight how its suite of SF initiatives add up, and how material they are to the bank's activity. We have an objective to improve disclosure on this topic, in order to make its leadership and innovation more visible for the real Italian economy, and to show its progress in increasing the share of SF in its loan book over time.

¹⁰ The Sustainable Activities Framework, October 2021, Credit Suisse.



3. We will request that banks disclose intermediate and cumulative quantitative goals which can be compared to all of a bank's activity.

In 2021, too many banks relied on cumulative end-goals that are not specific about how to get there. We think an intermediate goal 'pipeline' is needed prior to the widely-targeted 2030 end-year. Many banks have geographic, sectoral, financing and transaction specialisms which lead their markets; these are avenues for exploring bespoke strategies with both growth and impact potential. However, management must consider if deeper creativity, resources and capability building is required to succeed in the SF space.

Case in point

Barclays, Bank of Ireland, ABN Amro, and Commerzbank provide shorter-duration SF goals (end dates of 2023-2025) and are relatively clear in how these will be delivered. This is a practical medium-term timeframe on which to assess SF outcomes as investors. We believe that although a long-term vision is needed (and we engage these banks on what that looks like), banks should provide transparency on multiple, accountable timescales.

4. We will ask banks to be transparent in providing performance data and reporting on SF to bring the opportunity and progress to life.

We accept that when some banks show 'the maths', past or future SF activity looks less impressive than in cumulative end goals which may imply a generous future 'impact story'. Regardless of how material the activity was or will be, we must be able to assess:

- Categories of SF activity, such as lending, asset management, or investment banking, comparable to those units' overall activity.
- Whether progress is behind or ahead of intermediate and end goals, with explanation.
- Annual SF activity in terms of value and as a proportion of total annual activity (example: proportion of lending which was SF driven in the year in % or £ terms).
- Cumulative SF activity in terms of value and as a proportion of total loans, assets or other activity (example: proportion of SF loans in a loan book).

Case in point

Commerzbank is among the only banks that we were able to accurately identify or estimate the proportion of all loans or AUM which are considered 'sustainable finance'. However, this still required some assumptions and manual adjustments on our part. In future engagements, we will highlight its leadership status, while supporting it to take further steps to improve transparency. For example, we would like to gain further clarity on the materiality of the bank's sustainable lending in comparison to its total lending activities further into the future.

Appendix

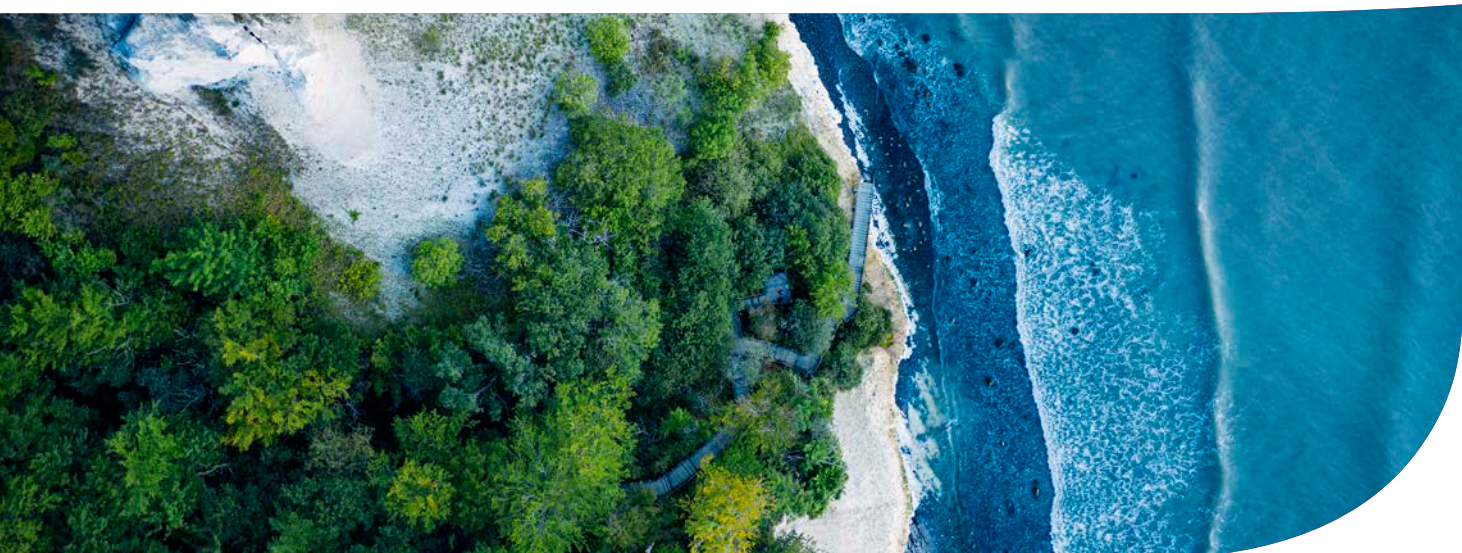
Our research focused on the following questions:

- What SF commitment has the bank disclosed?
- Has the SF commitment been broken into targets for kinds of activity (for example: lending; asset management; bond underwriting)?
- Has the bank described the SF activities, through a framework or meaningful, defined disclosure? Can we identify that a bank is, for example, helping SME job creators with lines of credit, lending to mortgage-holders for energy efficiency, or providing microcredit to entrepreneurs?
- How material are SF commitments, compared to total activity of a bank (for example: total loan book; total assets under management)?
- Has the bank established policies for avoiding activity which potentially cause harm to SDGs (for example: policies to reduce risk in fossil fuel financing)?

We conducted this exercise during Q3-4 2021 for 20 of 22 banks in the strategy; this excluded investments initiated in Q4 2021 due to timing constraints.

Figure 3: Our research aimed for a comparative starting point in 2022 engagement, focus and objective-setting

Inputs	Analyses	Outputs
Sustainable lending commitment, cumulative and annualised (\$ bn)	Size of SF commitment on cumulative and annual basis, relative to total loan book & annual loan origination for reporting year	Sustainable lending commitment as % of loan book
Sustainable asset management commitment (\$ bn)	Breakdown of lending between environmental and social themes	Current sustainable lending as % of loan book
Loan Book 2020 (\$ bn)	Nature of reporting on allocation of proceeds and impact for environmental and social themes	Annualised sustainable lending commitment as % of annual loan origination
Fossil fuel exclusion/phase-out policies	Exclusion and phase-out policies for fossil fuel financing	Sustainable asset management commitment as % of AuM
BankTrack fossil fuels policy scores	Paris-alignment of lending and investment portfolios	Current sustainable asset management as % of AuM
Current sustainable financing (\$ bn)	Collaboration on industry initiatives, e.g. Net Zero Banking Alliance, Equator Principles, Principles for Responsible Banking	Climate and social impact disclosure benchmark and rankings
Current sustainable AuM (\$ bn)		Fossil fuel policies benchmark and rankings
New loan origination 2020 (\$ bn)		
Climate and/or social finance commitments (\$ bn)		
Allocation of proceeds and impact reporting for climate and social finance		



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