Sustainable Banking for a Greener Future

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"The largest financial players in the world recognize energy transition represents a vast commercial opportunity as well as a planetary imperative." John Kerry, U.S. Special Presidential Envoy for Climate

The 20th century has seen massive economic progress, more than humankind has seen in the past. However, this has had side effects of biodiversity loss, climate change, and environmental pollution. Social issues like poverty and unequal economic development have been pervasive. The 21st century has seen the problems of sustainability and climate crisis take centre stage. Two factors have led to the climate crisis – producers' unsustainable business practices and consumers' consumption practices (Taneja and Ali 2021).

Mitigating the impact of the climate crisis requires two tools – technology and finance. Given that banking is a significant source of funding for companies to transition to green businesses. At the same time, developing technology is also costly. While the primary funding source for technology development is the government, banks play no less a part. Sustainable banking has emerged from these needs.

This paper discusses the origins and growth of sustainable banking, how it differs from conventional banking, how sustainable banking is operationalised, how they can be structured and concludes with the imperatives of sustainable banking.

The Origin of Sustainable Banking

The origin of sustainable banking can be traced to the temples of Greece and Rome, where money lenders sat to do their trade. Ethical considerations came into play because they were operating from a temple. Gradually, the practice of accepting deposits and changing money developed. It was around the same time that banking developed in India and China.

Modern banking came about in medieval Italy, where banks acted like intermediaries where those who had money and those who needed money to invest came together. In some sense, they operated like credit unions of today. The framework for life and economy came from religious ethics, prevalent environment and community. This had a strong influence on business and banking. Religious ethics set clear rules on money lending and interests. Some banks even put a cap on interest rates for ethical reasons. Over time, some ethical practices and guidelines developed. For example, a bank should lend only to someone who worked hard, behaved responsibly, and took manageable risks. Ethical banking practices became important as many banks were founded with donations and charitable contributions.

The Industrial Revolution led to the growth of cooperative banks and credit unions. The development of the middle class spurred their growth. Credit unions collected the savings as capital and channelled the money into entrepreneurial ventures. While credit unions met the needs of the urban customers, the cooperatives focussed on the rural areas. These credit unions and cooperative banks were set up to fight usury and involved a lot of effort in educating people. While many of these institutions adopted questionable practices, some were early

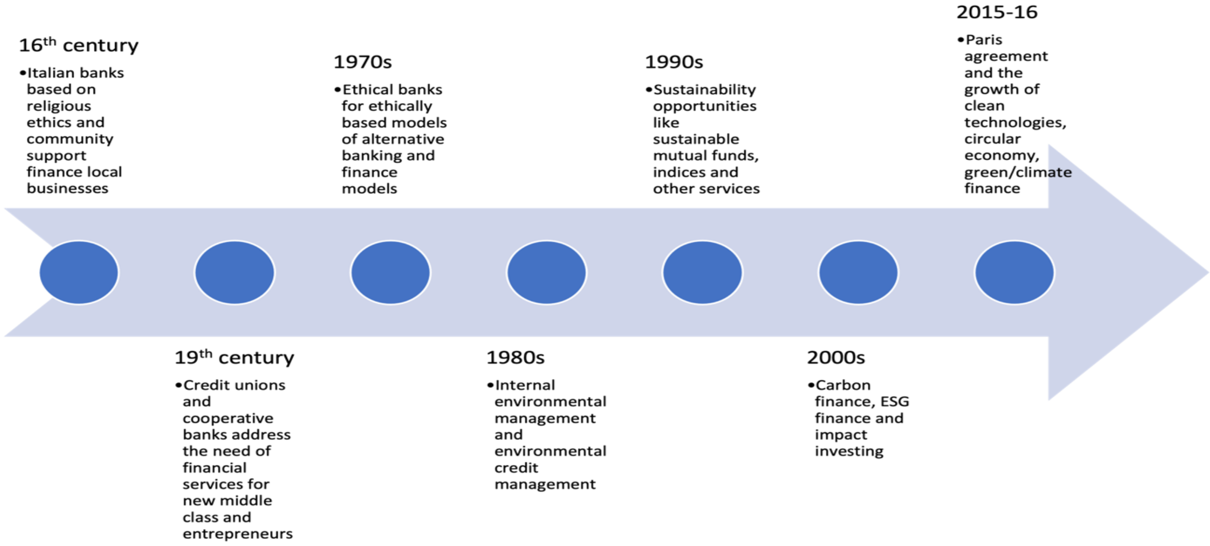
adapters to modern sustainable finance. They promoted sustainable finance initiatives like socially responsible investments, impact investment or clean-tech financing.
Gradually, the banks started becoming transnational and started controlling the financial industry. Banks changed their focus to creating wealth for the individual and the society. Traditional concepts like community finance or supporting local businesses began disappearing. Soon, banks started being criticised for financing dictators or supporting money laundering. This led to the development of ethical banking in the 1970s. However, they did not grow in strength. The Global Alliance for Banking on Values, a network of independent banks using finance to deliver sustainable economic, social and environmental development have only about 70 members in 45 odd countries ("GABV - Global Alliance for Banking on Values" n.d.). The period also saw the emergence of impact investing, which has grown exponentially over the years. Here, banks generate both social and financial returns. The 1980s saw greater consciousness regarding the environment and soil, water and air pollution. Banks became wary of companies' contaminated sites and the resulting credit default risks. Banks started integrating environmental issues into credit risk management to improve their risk predictions.

After managing environmental risk, the next step was to utilise the environmental and social issues to create products and services to promote sustainable development. Indices like the Dow Jones Sustainability Index, FTSE4Good, Stoxx Sustainability Index were developed and the sustainable banking industry grew with sustainable mutual funds and exchange-traded funds.

Sustainable banking has received another boost from IPCC's work highlighting the climate crisis and the Paris Accord requiring governments to act on the climate crisis. The European Union has been at the forefront of developing the taxonomy to streamline sustainable investments. Banks now find it increasingly critical to integrate ESG ratings into their decision-making. Sustainable banking has come of age.

Figure 1 summarises these developments.

Figure 1: Development of Banking and Sustainable Banking



Source: Based on Weber 2012

What is sustainable banking?

Sustainable banking refers to delivering financial products and services developed to meet people's needs and safeguard the environment while generating profit (Yip and Bocken 2018).

Defined in this way, sustainable banking has the following features:

- It enables banks to think from the perspective of the triple bottom line or ESG and how its actions impact people, the planet and profit.

- Sustainable banking is focused on transparency on how the depositors' money is utilised.

- Sustainable banking incorporates the social impact of banking.

How do sustainable banking and conventional banking differ?

Sustainable banking and conventional banking differ on many dimensions:

1. What is the purpose for which the bank exists?
2. Where and how do banks invest their money?
3. How is the project financing decision made?
4. What is the bank's lending policy?
5. What is the level of transparency?
6. How widely distributed are they?

Figure 2 details the comparison between sustainable banking and conventional banking.

Figure 2: Comparison between Sustainable and Conventional banking

Feature	Sustainable Banking	Conventional Banking
Purpose	Stakeholder oriented. Providing social, economic and ecological benefits	Shareholder oriented. Maximising shareholder value
Investment thesis	Invest in projects that satisfy social and environmental benefits.	Invest in projects that maximise the net present value.
Investment selection	Accept projects increase positive externalities; eschew projects with negative externalities	Accept projects that maximise profits/cash flows.
Lending policy	Directed towards social inclusion or environmental protection	Risk based and hence excludes sections of the society
Transparency	Relatively more transparent	Relatively less transparent
Geographical presence	Few branches	Many branches

Source: Based on Cantero Sáiz, Olmo, and Sanfilippo-Azofra 2023; Martínez, Rambaud, and Oller 2020

Sustainable banks create differentiation, attract customers and borrowers who are socially and ecologically aligned, cater to a wider variety of stakeholders, and reduce the risk of stranded assets.

How is sustainable banking operationalised?

Banking can be divided into two major groupings: (a) retail banking and (b) commercial banking. Retail banking includes private banking; the difference between the two is scale. Similarly, commercial banking includes global banking. Again, the difference is only a matter of scale.

Let us look at retail banking and see how it can be sustainable. Banks receive money from depositors, and this money is lent to businesses. For banking to be sustainable, banks should lend money to sustainable companies. Banks adopt different ways of doing this:

1. **Screening**: Here, companies or industries that are unsustainable (e.g. dealing in fossil fuels) or unethical (tobacco or gambling) are excluded from lending. This is called negative screening. Another way to screen is positive screening, where the bank lends to companies and industries whose ESG performance is better than others. Finally, there is norms-based screening, where the bank lends to companies that meet the norms of international like UN treaties, Security Council sanctions, UN Global Compact, UN Human Rights Declaration and OECD guidelines.
2. **Financing mechanisms**: Banks lend to companies through sustainability bonds and sustainability-linked bonds. Sustainability bonds are where the end-use of the proceeds is to make the company greener. On the other hand, sustainability-linked bonds also set targets that the company needs to achieve. For example, a company that achieves predetermined CO_2 emission reduction pays a lower interest rate. Social impact bonds work exactly like sustainability-linked bonds. The only difference is that targets are social indicators (e.g., maternal mortality rates), and proceeds are focused on social impact. Carbon-intensive organisations issue transition bonds with the intention to support decarbonisation. Clean-energy project finance refers to non- or limited-recourse loans to finance clean-energy projects. These projects include low-emission generation, sustainable fuels, and grid-scale storage, among other low-emission technologies.

On the other hand, retail banks have little control over who deposits money. Banks are trying to overcome this by issuing green deposits. For commercial/global banking, the bank can choose its depositors. It can apply ESG rating screens to decide who it wants to onboard as customers.

Let us now look at commercial banking activities. The lending practices are the same as what we have discussed above. Then, there are investment banking activities:

Transactions or M&A: Sustainable M&A are growing fairly rapidly. Here, the bank can promote sustainable M&As by developing criteria for evaluating the sustainability of M&A deals. They can also educate clients on the sustainability implications of M&A deals. Sustainable finance can be employed in M&A deals.

Financing: Helping companies raise debt and equity financing for companies. This requires focusing on green bond issuance, equity issuances for cleantech companies, etc. (McKinsey & Company 2022)

Advisory: This is a consulting business for banks. On sustainability, banks can provide Energy-efficiency education and financing resources for customers that are small and medium-sized enterprises.

There are several other opportunities for banks to support sustainability (Alessio Botta et al. 2022):

Trade finance: Here, for instance, banks may issue letters of credit where the underlying asset contributes to climate change mitigation. The underlying asset could be items like batteries for electric vehicles or fans for windmills. Alternatively, banks can support sustainable trade finance by providing guarantees at improved prices and improving access to finance.

Credit cards: Banks could provide favourable terms for customers purchasing sustainable products or encouraging travel with lower emissions.

Payments: Here, banks may offer favourable terms on where the underlying assets are sustainable or undertake transactions with counterparties that score high on ESG/sustainability.

Buyer-led trade finance: Take the case of reverse factoring. Here, the bank could pay sustainable client suppliers before maturity and at a more favourable financing rate. This will provide benefits over traditional reverse factoring.

Banks need to support the achievement of sustainable development goals (SDGs). Figure 2 lists how banks can finance each of the SDGs.

Figure 2: Financial Products and Services Addressing the SDGs

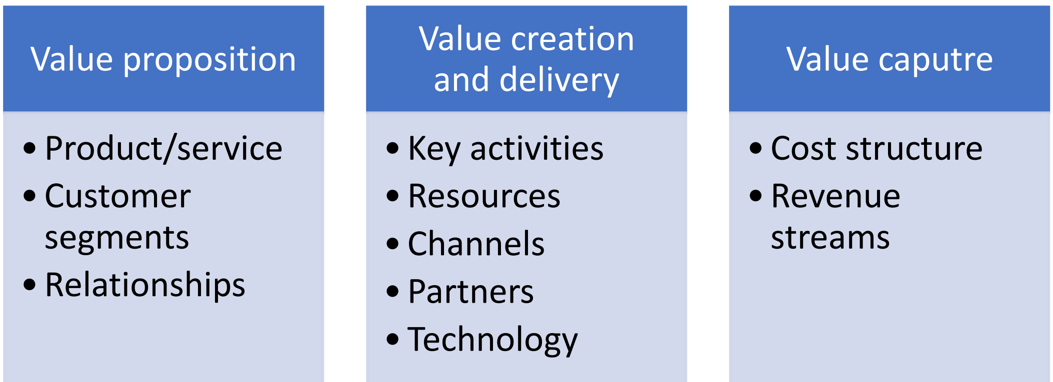
SDG	**Products and Services**		**SDG**	**Products and Services**
1 No poverty	Microfinance; Private international development finance through impact investing		9 Industry innovation and infrastructure	Project finance and commercial lending integrating social and environmental criteria for lending decisions; Public-private partnership
2 Zero hunger	Microfinance for smallholder farmers; Crop insurance; Agricultural loans		10 Reduced inequalities	Fair payment of financial sector employees; Microfinance; Loans for marginalised communities
3 Good health and well-being	Health-care investments; Medical loans		11 Sustainable cities and communities	Green building loans; Sustainable transportation loans; Municipal loans
4 Quality education	Philanthropic donations to schools; Student loans		12 Responsible consumption and production	Socially responsible investing; Green supply chain financing; Circular economy loans
5 Gender equality	Microfinance and lending to women		13 Climate action	Climate finance; Green bonds;

	and female entrepreneurs; Financial education programmes for women		Climate risk insurance; Carbon offset financing
6 Clean water and sanitation	Socially responsible mutual funds investing in water; Water and sanitation loans	14 Life below water	Financing ecological services; Marine conservation loans; Sustainable fisheries financing;
7 Affordable and clean energy	Renewable energy investment; Green bonds	15 Life on land	Financing ecological services; Sustainable forestry financing; Land restoration bonds
8 Decent work and economic growth	General investments into the real economy; Small business loans; Job training programs	16 Peace, justice and strong institutions	Lending to public institutions; Community development loans; Microfinance loans for conflict-affected areas
17 Partnerships for the Goals	Impact investing; Public-private partnerships; Social impact bonds		

Source: Based on Weber 2018; United Nations and KPMG 2017

Structuring Sustainable Banks

The business models of sustainable banking are defined by three elements: (a) the value proposition, (b) value creation, and (c) value delivery.



Source: Based on (Bocken et al. 2014; Nosratabadi et al. 2020)

Sustainable banking business models incorporate a circular economy, the triple bottom line and cover a wide range of stakeholder interests, including the environment and the society. The three areas to look for while configuring the sustainable banking business model are:

a. **Value proposition**: This describes the assortment of a bank's products and services that meet sustainability norms.

b. **Value creation and delivery**: Here, the focus is on activities, resources, partners, and distribution channels. Sustainable banks use their sustainability credentials to exploit new opportunities and address new markets and revenue streams.

c. **Value capture**: Value capture comes from the bank's revenue models and cost structures. Conventional banks focus on maximising the gap between revenue and cost; sustainable banks aim to increase the same while accounting for externalities in the business structure.

Conclusion

Sustainability is increasingly getting integrated with business processes and strategies. Banking needs to align with the new reality. Banks must break up each of the bank's activities and see where the potential for becoming sustainable exists. Banks have long looked at simple solutions like using less paper or electricity. They have believed that sustainability is other people's problem. They can and should contribute to sustainability by looking at their business practices and ensuring that each aspect of their business contributes to sustainability. Banking needs to be sustainable, and sustainable banking is here to stay.

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