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# Sector Report: Banks

## Like a Phoenix from the Ashes?

Hendrik Garz, Thomas Hassl, Sheila Oviedo, Claudia Volk

July 2014



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## Sustainalytics BV

De Entrée 83, Toren A, Amsterdam, 1101 BH  
The Netherlands  
Phone +31 (0)20 205 00 00

[info@sustainalytics.com](mailto:info@sustainalytics.com)

[www.sustainalytics.com](http://www.sustainalytics.com)



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# Executive Summary

## Like a phoenix from the ashes?

### Analysts\*

#### Dr Hendrik Garz

Global Head, Thematic Research  
[Hendrik.garz@sustainalytics.com](mailto:Hendrik.garz@sustainalytics.com)

#### Thomas Hassl

Junior Analyst, Thematic Research  
[Thomas.hassl@sustainalytics.com](mailto:Thomas.hassl@sustainalytics.com)

#### Sheila Oviedo

Senior Analyst, Financials  
[Sheila.oviedo@sustainalytics.com](mailto:Sheila.oviedo@sustainalytics.com)

#### Claudia Volk

Associate Director  
 Industry Lead, Financials  
[Claudia.volk@sustainalytics.com](mailto:Claudia.volk@sustainalytics.com)

\* in alphabetical order

After the drawdown in 2011, investors have been quite pleased with their investments in European and North American bank stocks. At the end of May 2014, their share prices had risen by more than 70% since the beginning of 2012, clearly outperforming market benchmarks. The pendulum of investor sentiment has swung back impressively after seeing the sector standing on the edge of an abyss. Regulatory changes continue to impose high direct costs and constrain banks' profitability. Many investors now fear that price corrections may lie ahead in light of the still significant risk of negative news flow in the coming months.

## Has the pendulum already swung back too far?

The unease of investors going forward is perceptible: How far has the sector really progressed on its path to cultural change? Have the large systemic banks become more resilient? Has the introduction of new regulatory measures really led to a decrease in bailout probabilities? These questions form the background against which we are evaluating the potential sustainability and business impacts of five key ESG issues for the banking sector. The first signs of change can already be spotted. Many banks have acknowledged the business risks posed by loss of public trust in the industry in regulatory filings showing that there is an increased awareness about the materiality of this issue. In addition, anecdotal evidence suggests that the industry as a whole has become more mindful of public opinion and is now more open to engaging with different stakeholders. At the same time, legacy risks remain high and the long list of allegations will probably continue to undermine banks' efforts to regain trust.

## Key Issues - High exposure, significant management gaps

The environmental and social impacts of banks are felt in various ways, ranging from lending and investment, to recruiting and retaining talent. In this report we're focusing on five key ESG issues that have the most significant impact from a sustainability and/or a business perspective for the banking sector.



**Outlook**  
neutral

The litmus test is whether banks are prepared to forego lucrative business opportunities

### Business Ethics – Mind the gap

In the last three years, the industry has faced multiple ethical controversies that have raised significant legal and reputational costs for many banks. Banks responded by implementing disciplinary measures while strengthening ethical codes and compliance measures. The challenge to the industry is a broader one, however, since the issue is not only about misconduct of individuals, but is also rooted more deeply in the system itself. Hence, the effectiveness of stronger policies and compliance measures has its limits. The litmus test for any bank is whether it is prepared to forego lucrative business opportunities if these do not comply with ethical standards.



**Outlook**  
neutral

Stability of banks is also related to “soft factors” that typically are only partly addressed by regulators

### Resilience – Finding the right balance

The recent financial crisis and the subsequent global recession have shown dramatically how delicate and fragile the current financial system actually is and how important its soundness is for keeping the real economy running. Looking ahead, we expect that Resilience will remain a major issue for many years. On a global basis, regulation will continue to be a key driver for reducing the vulnerability of the banking sector. However, while much attention is paid to changes in the regulatory environment and their consequences for banks, one must not forget that the stability of banks is also related to “soft factors” that typically are only partially addressed by regulators (e.g., the mentality of bankers and the systemic risks that are created by misguided behaviours).



**Outlook**  
positive

### Responsible Finance – Acknowledging stewardship

We are convinced that Responsible Finance will continue to gain traction in the banking industry. International standards such as the PRI and the Equator Principles are increasingly recognised as common practice and will determine the way Responsible Finance is understood and practised. To be well prepared, banks have to increase their resources devoted to Responsible Finance. Doing so will enhance prevailing models and standards and set the scene for new innovative strategies and products. Currently, the distribution of companies across score brackets is still quite strongly skewed to the right, indicating significant room for improvement for many companies.



**Outlook**  
positive

General trust in banks has been hit, while customer loyalty remained at a surprisingly high level

### Financial Product Governance – The paradox of trust & loyalty

Banks’ track record with regard to how they manage their client responsibilities is undoubtedly poor. General trust in banks has been hit accordingly, while customer loyalty has remained at a surprisingly high level. Regulatory changes are directed towards consumer protection via increased transparency and better communication. Some banks have improved markedly in this regard, driven either by their new convictions or by regulatory pressures. However, adhering to new regulations comes at a price and banks face the risk of not being able to roll over the additional costs to their clients.



**Outlook**  
negative

### Human Capital – Sea change necessary, but litmus test is yet to come

The management of Human Capital is key for a bank’s profitability and long-term survival in an extremely competitive environment. The way talent is selected and employees are treated, educated, and incentivised, is a major determinant for how a bank generates its business and profits. Are a bank’s employees acting in the best interest of their clients and of the bank’s shareholders, or are they continuing to pursue their self-interests at the expense of these and other stakeholders? This is the challenging question against which the results of changing strategies of Human Capital management will need to be benchmarked going forward. The litmus test is yet to come.

## Industry Leaders (total universe)

Company	Country	Score
National Australia Bank Limited	Australia	83.7
Skandinaviska Enskilda Banken AB	Sweden	83.6
CaixaBank, S.A.	Spain	83.2
Westpac Banking Corporation	Australia	83.0
KfW	Germany	82.9
DNB ASA	Norway	81.7
Banco Santander (Brasil) S.A.	Brazil	79.5
Banco Bilbao Vizcaya Argentaria, S.A.	Spain	78.2
Nedbank Group Ltd.	South Africa	78.2
Inter-American Development Bank	United States	77.7

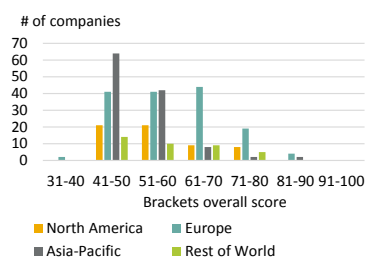
## Selective results of our bottom-up analysis

**Momentum:** Over the last three years the Developed Markets (DM) banks have steadily gained momentum. Most of this advancement is attributable to improved governance standards and practices.

**Industry Leaders:** National Australia Bank (Developed Markets), Banco Santander Brasil (BRICS), BBVA Colombia (Emerging Markets), and KfW (non-listed).

**Size-effect:** Different banking types appear to show different performance characteristics. It is likely that these clusters are the result of a size-effect, meaning that bigger companies (those with a high market cap) are likely to devote more resources towards developing, implementing and communicating sustainability strategies.

## Geographical breakdown

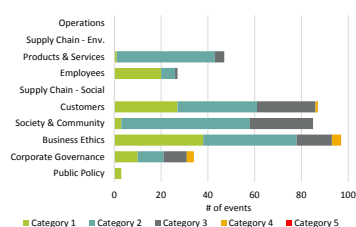


**Geographical particularities:** The distribution of overall ESG scores for the European market is more symmetric than that of its peers from North America and Asia-Pacific, which are significantly more skewed to the right. (i.e., a larger than expected number of companies in the latter two regions still lag behind in their overall sustainability performance). However, Australian banks stand out, with many of them being amongst the top performers.

**BRICS:** The five leading companies in this segment are exclusively domiciled in South Africa and Brazil and show strong connections to the European market, either historically and/or through ownership structures.

**Differences between E, S, and G:** The lower average score for the environmental pillar probably reflects differences in management interest. The attitude still seems to be that financial institutions do not have a significant environmental footprint and that the theme, hence, needs less attention.

## Qualitative Performance



**Qualitative Performance (controversies):** Because banks are primarily service providers, most controversies are clearly attributable to governance and social issues, with the highest frequency in Business Ethics, Customers, and Society & Community.

**Positively skewed distributions:** The skewness of distributions at various levels (overall score, theme scores, single indicator scores) indicates that the banking sector has developed minimum standards to which most companies comply, while only some companies differentiate themselves through voluntary compliance with higher standards.

# Industry Trends

## Like a phoenix from the ashes?

The banking sector stands at a crossroad. Following its strong recovery, the outlook for earnings is mixed. Regulatory changes continue to impose high direct costs and put caps on banks' profitability. After a long period of redundancies, dramatic loss of trust, diminished reputation, less attractive remuneration perspectives, and significantly increased personal liability risks, the pool of talent available to the banking sector appears to be shrinking.

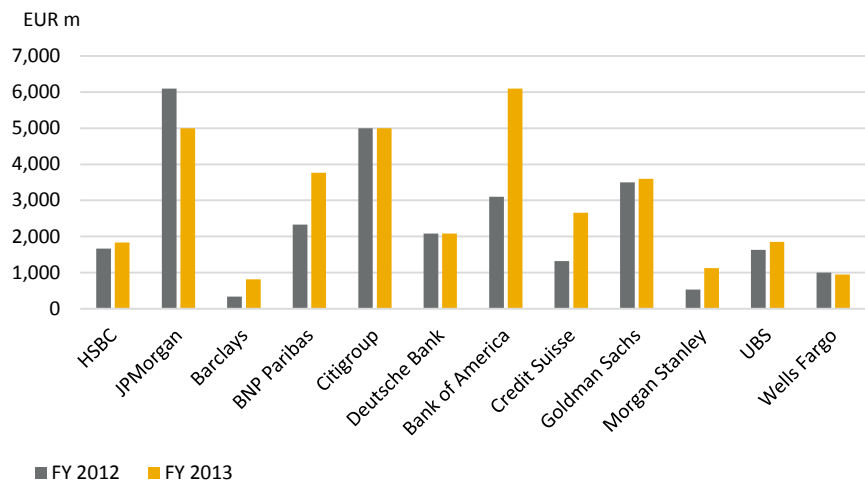
## Legacy risks may bite again this year, before fading away

Has the recovery gone too far already?

Investors were quite happy with their engagement in the sector recently. Globally, banks have clearly outperformed the market over the last two to three years. The pendulum has swung back strongly, and the market has begun to ask whether the recovery has gone too far too quickly (see charts at the end of this chapter). Many investors now fear that price corrections may lie ahead in light of the still significant risk of negative news flow in the next several months triggered by pending litigation cases. We believe that despite the significant number of write ups of litigation reserves, investors may indeed run the risk of being caught on the wrong foot over the short- to medium term. Our expectation is, that positions may have to be bolstered up again this year, until fading away thereafter.

### Litigation reserves and potential losses

Litigation reserves may have to be bolstered up again this year



Source: 10-K annual reports, compiled by Sustainalytics

Mid-term earnings outlook seems to be rather positive

Despite lacklustre earnings by the largest banks in the first quarter of 2014, primarily driven by declining investment banking and trading revenues, the mid- to long-term outlook for earnings seems to be rather positive. Besides the “one-offs” from the litigation side, banks’ P&Ls are likely to be positively impacted by shrinking restructuring costs and a changing interest rate environment. Even though recent efforts of the European Central Bank to fight the low inflation in the euro zone resulted in another cut of short-term interest rates, we expect the phase of record low interest rates to come to an end in 2015/16. Higher rates should then help banks’ revenues as long as the move comes with a reasonable amplitude and does not happen too quickly.

The European Banking Authority’s stress test, the first to be carried out under one pan-European regulator, will shape public perception on its credibility as the lead regulator in the region

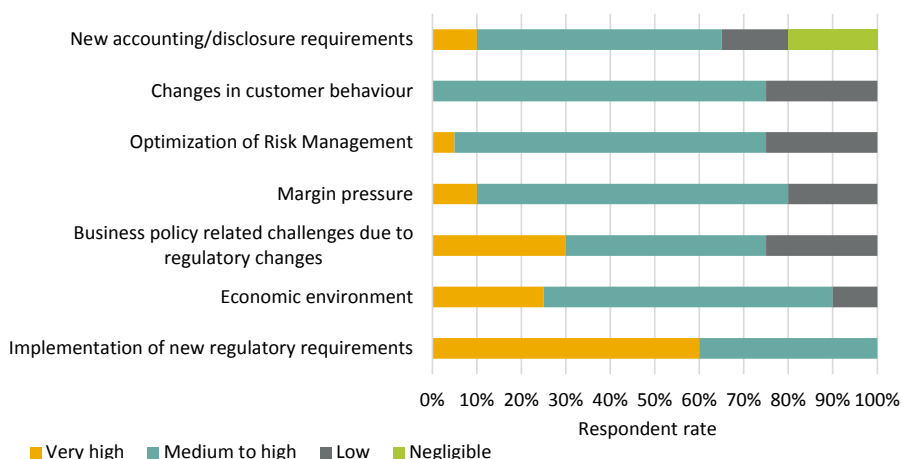
The markets’ focus in the coming months will remain on the effect of changes in regulation (for an overview of international initiatives, see the table at the end of this chapter). In particular, the results of the stress test for European banks, scheduled for October, will have a trend-setting influence on the market. We assume that good test results could trigger increases in M&A activity, share buy-backs or special dividends, all things that shareholders would tend to appreciate. The strongest players in the market seem to be just waiting in the wings.

The “Volcker Rule” has prompted U.S. investment banks to sell off proprietary trading units and forego billions of dollars in revenues. Similarly, Basel III has forced European banks to refocus on retail banking and sell off non-core assets to meet capital and liquidity requirements

### Structural effect of regulatory changes on banks’ ROE

Beyond the event driven investment logic of the regulation topic, there is of course a structural, more long-term component as well. There’s no doubt, regulatory costs, both direct and indirect, have a significant impact on the banking sector’s return on equity. The adjustment of business models, driven by the need to exit lucrative business areas, has started to become visible in banks’ results, as the relatively weak earnings of global investment banks in Q1 2014 have shown. Beyond the anecdotal evidence, more and more studies have been trying to quantify the impact of regulatory change.

#### Challenges for mid-term business success (2013-2015)



Source: KPMG, Dec 2013



Regulatory initiatives seen as restrictive in a number of strategically important growth areas

Estimates based on a survey among German banks (see KPMG, Dec. 2013), for example, show a drop in the ROE of 2.4 percentage points over the period 2010 to 2015, which equals total costs of regulation of around EUR 9bn per annum. The study also found that banks consider the multitude of current regulatory initiatives as restrictive in a number of strategically important growth areas.

Herding to business areas that are attractive from a regulatory standpoint

The response of banks was and is to target businesses that are considered attractive from a regulatory cost point of view. The problem with this is that these moves have tended to be positively correlated. In other words, the herd is again running in the same direction. The effect of this is that the margins in seemingly attractive business areas have been shrinking and will continue to shrink due to increased competition. It remains to be seen if this has already been fully taken into account in the earnings projections of the market. The risk of negative surprises in this regard is by no means negligible.

### Regional implications – Access to lucrative deals more limited for European banks

European banks: Focus on the home front

New liquidity and capital requirements have forced European banks to retreat from auxiliary markets and focus on the home front. A Thomson Reuters survey confirmed that only 15% of EMEA investment banks surveyed cited new market penetration as a top industry goal for 2014, against 45% in the Americas and 60% in Asia and the Pacific. U.S. firms are strengthening their global franchises and growing their assets and portfolios in emerging markets, but are also increasing the complexity of their operations. Banks in Asia are the most aggressive in their global expansion by acquiring assets shed by European and U.S. counterparts, thus increasing their exposure to global volatility risks. European banks will be more resilient than their global peers, but their access to lucrative deals will be limited in comparison.

### Less bonus, less trust, but more liability - Not a formula for success in the fight for talent

A survey by the global public relations firm Edelman showed that as of 2013, banking and financial services continue to be the least trusted of all the industries with a 49% and 46% trust level, respectively, compared to technology (73%) and consumer electronics manufacturing (70%)

Other side effects of changes in regulation have begun to hurt the banking sector. European banks have been hit particularly hard, especially with regards to human capital. Remuneration caps for executives and increased personal liability risks for directors in general have made less regulated areas, such as private equity or hedge funds, increasingly attractive to top bankers. In addition, the redundancy of large numbers of employees in investment banking over the last couple of years has made the industry less attractive for high-potential graduates.

Although scores for major banks remain high in employer rankings, the pool of talent has begun to shrink noticeably, ringing alarm bells of HR managers around the world. And some have certainly understood that this is not only a question of remuneration and a “hire & fire” mentality, but that the issue is more deeply rooted in a general lack of trust in banks and an erosion of the industry’s reputation in general that has been triggered by the recent financial crisis. Those that have proclaimed a basic cultural shift in their houses, hence, seem to be on the right track, but still have to deliver proof that this shift is actually happening.

The industry as a whole has become more mindful of public opinion

First signs of change can already be spotted. Many banks have already acknowledged in regulatory filings the business risks posed by the loss of public trust in the industry, showing that there is an increased awareness about the materiality of this issue. Our perception is that the repercussions of the crisis have also changed the way the banking industry views the public. From being a traditionally closed and arguably elitist culture, anecdotal evidence suggests that the industry as a whole has become more mindful of public opinion and is now more open to engaging with different stakeholders. At the same time, legacy risks are still high and the long list of high-profile allegations will probably continue to undermine banks’ efforts to regain trust.

### Strong link to our key ESG issues

Taking the sustainability and the business impact perspective into account

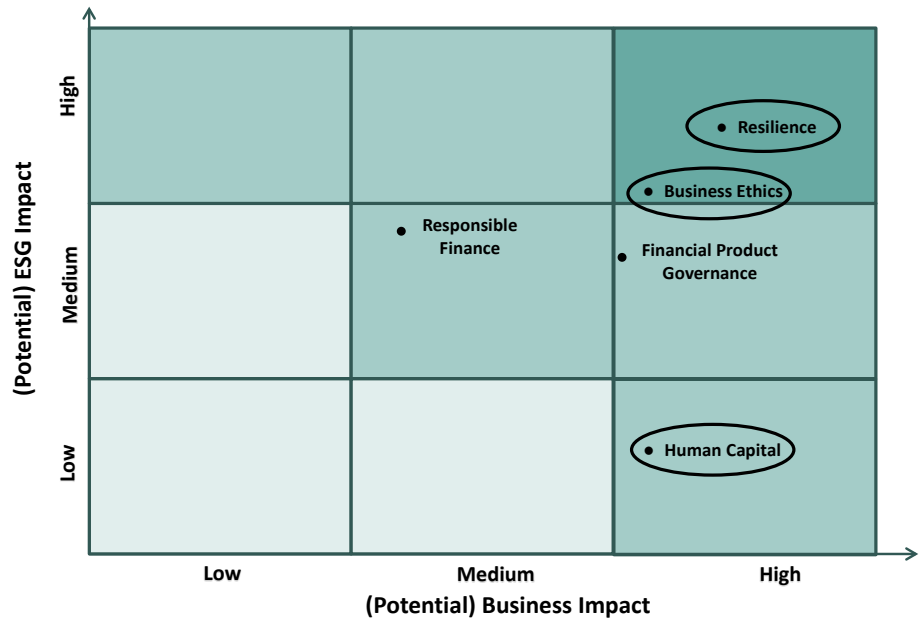
The current business context in which banks are operating is characterised – probably more than ever before – by some of the key ESG issues we use to evaluate companies in the banking sector. Business Ethics (regulation and litigation risks) and Human Capital (hiring capability) do stand out from a business impact perspective. From a social costs point of view (sustainability impact perspective), we also look at the key issue of Resilience, under which we subsume the viability of banks business models. Finally, to complete the picture, we have included two further key issues that are directly linked to a bank’s relationships with customers and to its product offerings: Product Governance and Responsible Finance.

Key ESG issues should not be looked at in isolation

It is of fundamental importance to note at this point that the key ESG issues we have identified should not be looked at in isolation. Rather, they shall be considered as integral, mutually influential parts of a greater system. In the case of Human Capital for example, one major driver for the diminishing attractiveness of banks as employers is the loss of trust in the industry and its poor reputation. The industry’s declining reputation, in turn, was caused to a large extent by a lack of Business Ethics and inappropriate Product Governance, both key ESG issues in our sustainability equation. In the same way, a rigorous implementation of Responsible Finance principles and the underlying commitment to generate long-term sustainable returns helps improve Resilience and accordingly decrease the risk of bank failure.

Business Ethics, Human Capital, and Resilience do stand out from a business impact perspective

**Materiality Matrix - Banks**



Source: Sustainalytics



**Outlook**  
positive

**The true litmus test is yet to come**

Increasing the resilience of the financial system and minimising the future social costs, (i.e., the costs for avoiding systemic failure), is the ultimate goal of the regulatory effort currently dominating the outlook for the sector and the investment case for individual banks. We’re cautiously optimistic that with further increasing visibility the associated portfolio risks for investors will slowly but surely continue to decline going forward.

Will policy makers finally be successful in establishing greater self-sufficiency of the sector?

Having come under public fire for rescuing the banking industry, governments are less likely to become active owners of failed banks than they were in the past. In downgrading a number of large U.S. banks in November 2013, the credit rating agency Moody’s noted that the new regulatory environment will allow the U.S. government to wind down a large, global bank without government assistance, making a taxpayer bailout nonessential. While the aim is coherent and the steps taken by governments point in the right direction, it remains to be seen whether the structures that have been implemented are really sufficient when a new “Lehman case” pops up. This will be the one and only true litmus test for the new world of banking.

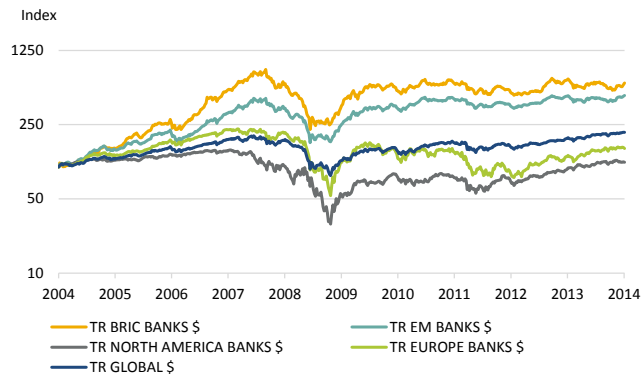
All our key ESG issues will be discussed in detail later on in this report. In the following chapter, we first give an overview of the results of our ESG ratings for the global banking industry. The table below once again summarises our insights with regard to the current investment case for the industry.

**Investment risks for banks – Main drivers**

Positive influence	Negative influence
Restructuring costs are likely to fall going forward	Concerns over valuation after strong recovery
Over the longer run, rising interest rates should help revenues to recover further	Over the short run, the persisting record low interest rate environment puts a cap on banks' earnings growth potential
European stress test should yield no big negative surprises. Publication of results may trigger activities (M&A, share buy-backs....) that will tend to be welcomed by the market	Litigation costs: risk of further negative surprises over the short- to mid-term
Write-ups of litigation reserves will start to fade away and hence stop putting pressure on banks' P&Ls	Human capital: available pool of talent is shrinking; remuneration caps and increased personal liability risks drive senior managers away from the banking industry
	Correlated move in areas which are attractive from a regulatory perspective lead to more competition and margin pressure
	Exiting lucrative business areas bites into banks' revenues

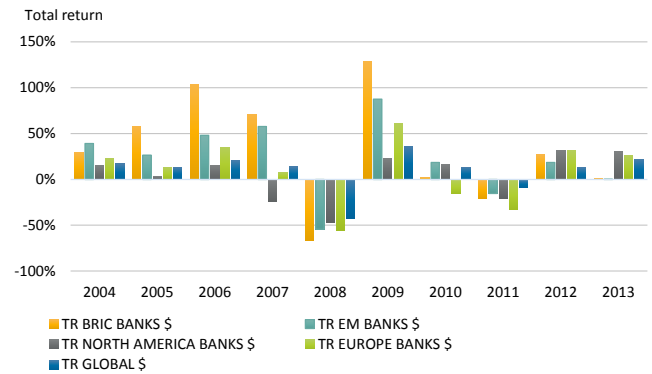
Source: Sustainalytics

**Relative stock market performance of banking sector**



Source: Thomson Reuters Datastream

**Total stock returns (yoy)**



Source: Thomson Reuters Datastream

## Regulatory initiatives – Overview of international initiatives and supervisory authorities\*

Region	Shortcut	Official name	Sphere of influence	Source / link
Global	Basel III	International regulatory framework for banks	Minimum capital and liquidity requirements to strengthen the regulation, supervision and risk management of the banking sector. These measures aim to improve the banking sector's ability to absorb shocks arising from financial and economic stress, to improve risk management and governance, and to strengthen a banks' transparency and disclosures.	<a href="http://www.bis.org">www.bis.org</a>
	IFRS	International Financial Reporting Standards	Globally accepted accounting standards, including IFRS 9: Financial Instruments, IFRS 10: Consolidated Financial Statements, IFRS 12: Disclosure of Interests in Other Entities, IFRS 13: Fair Value Measurement.	<a href="http://www.ifrs.org">www.ifrs.org</a>
	BIS	Bank for International Settlements	The mission of the BIS is to serve central banks in their pursuit of monetary and financial stability, to foster international cooperation in those areas and to act as a bank for central banks.	<a href="http://www.bis.org">www.bis.org</a>
Europe	CRR / CRD	Capital Requirement Directive / Capital Requirement Regulation	Practical implementation of Basel III in the European Union, regulation of the provisions for capital surcharges on systemically important banks, systemic risk buffers and potential limits on bank exposures as well as disclosure requirements.	<a href="http://ec.europa.eu">ec.europa.eu</a>
	MIFID	Markets in Financial Instruments Directive	Regulatory regime for the organised execution of investor transactions by stock markets, other trading systems and investment firms.	<a href="http://europa.eu">europa.eu</a>
	EBA	European Banking Authority	Objectives are to maintain financial stability in the EU and to safeguard the integrity, efficiency and orderly functioning of the banking sector.	<a href="http://www.eba.europa.eu">www.eba.europa.eu</a>
United States	Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act	Includes directives aiming to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end “too big to fail”, to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.	<a href="http://www.sec.gov">www.sec.gov</a>
	FED	Federal Reserve System	The stated goal of the FED is to furnish an elastic currency, to afford means of rediscounting commercial paper, and to establish a more effective supervision of banking in the United States.	<a href="http://www.federalreserve.gov">www.federalreserve.gov</a>

\* bright color: Directive / legal requirements; dark colour: Regulatory authority

Source: Sustainalytics

# Spotlight

## Syndicated loans – A test of banks' ESG attitudes

The credit books of banks are more or less black boxes and associated risks cannot be evaluated effectively from the outside due to the lack of information. Unfortunately, looking at the syndicated loan market, for which quantitative information at the individual bank level is available, does not shed much more light on banks' true risk exposure to key ESG issues. It does, however, tell us something about a bank's attitude towards sustainability risks and the way these risks are taken into account in its daily operating business. The results of our analysis can be matched against any claims by banks that they integrate ESG in their decision making processes. In this respect a bank's syndicated loan deals constitute an excellent starting point for investor engagement.

### Analysing syndicated loan transactions – Merits & limits

The main impact of banks on environmental and social issues is determined via their credit and loan books. Banks can be seen as a part of the value creation/destruction chain depending on whether the money they lend is used for sustainable or non-sustainable purposes or enterprises (with all shades of grey in between). The environmental and social exposure of loan books, however, is not only relevant from a sustainability perspective, but also from a financial/business impact perspective.

The dream is to get full insight into a bank's credit book

"Stranded Assets" hotly debated within RI community

Take, for example, the topic of "Stranded Assets", which is still hotly debated within the Responsible Investment community. In a nutshell, the story assumes that the "2°C target" of climate policy will be enforced at the end of the day, implying that not all fossil fuel reserves will be used going forward. Under this scenario, investments in the infrastructure to exploit reserves and the reserves themselves, which are valued at market prices in oil and gas companies' balance sheets, would become stranded. Hence, banks that have a stake in financing these assets run an increased risk of default that is currently not priced in appropriately, according to the proponents of the Stranded Assets hypothesis.

Banks' credit books are black boxes to a large extent

Examples like this one show that from an analytical perspective it would be of immense value to be able to evaluate the loan portfolios of banks in order to determine their true environmental and social footprints and their associated business risks. However, it is well known that banks' credit books are black boxes to a large extent. There is only scattered publicly available information about single transactions in the field of project financing, for example, or underwriting roles in the syndicated loan markets.

Syndicated loan transactions cannot at all be interpreted in the sense of a portfolio footprint or risk

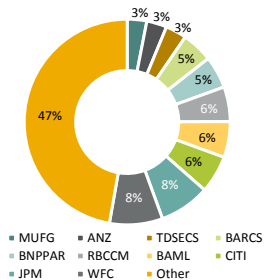
The limitation of the latter is that information about syndicated loan transactions cannot be used at all to assess a loan portfolio’s footprint or risk. This is because the league table information, usually used for calculating market shares in the underwriting business, tells us nothing about whether the underwritten tranches of a loan transaction are still part of the underwriting bank’s portfolio or have already been sold to other market players. On top of this, syndicated loans are just one part of a bank’s overall credit book. Depending on the business model, the portion of bilateral loan agreements, for which no information is available whatsoever, might outweigh syndicated loan tranches manifold.

The results tell us something about the general attitudes of financial institutions and their interpretation of stewardship

In the end, an analysis of the syndicated loan market from a portfolio risk perspective appears almost useless. From our point of view, however, it makes sense to take a look at these numbers from a more generic perspective, since they may tell us something about the general attitudes of financial institutions and their interpretation of stewardship. In this case, we’re not talking about a direct and precise measurement of risk, but rather about indirect evidence that sheds light on whether banks walk their talk and accept that they have a responsibility for what they financing or help to finance. In this spirit we have analysed the global syndicated loan market in 2014 (January to June 23<sup>rd</sup>) as a one-off exercise. Going forward we will consider taking a look at this market over longer periods of time in order to grasp trends or changes in financial institutions’ behaviours and establish this as a key indicator within the Responsible Finance issue.

### Exposure to Stranded Assets

Global syndicated loan market – Deals with issuers from the O&G sector



Source: Sustainalytics, Bloomberg data

Coming back to the idea of Stranded Assets (SA) outlined above, we searched for loans that are issued by companies in the oil and gas and pipelines sectors (O&G sector) – i.e. those sectors that are most exposed to SA risks. Within the time period we looked at, we found 3,010 transactions on the global syndicated loan market based on the league tables provided by Bloomberg. Two hundred and sixty-eight of these deals involved loans to companies from the O&G sector. They had a volume of USD 165.7bn, which is equivalent to 10.4% of total transaction volume.

The chart on the left shows the distribution of market share, with the ten largest underwriters constituting more than 50%. We also inspected the structure of the deal portfolio at the individual underwriter level in order to determine whether there are underwriters in the market with a bias towards this type of transaction. To do this we just looked at those players with a significant overall deal volume of more than USD 5bn. This size filter yielded a list of 51 underwriters with a combined SA deal volume of USD 146.8bn (90.8% of total SA deal volume). We then sorted the results based on the percentage share of O&G deals relative to the total underwritten volume.

### Underwriters with high shares of Stranded Asset deals\*

Top 10 underwriters with regard to their SA portfolio exposure

Underwriter	# O&G deals	O&G deals - participation in %	Volume of O&G deals (USD m)	Total volume of deals (USD m)	O&G deals in % of total
DNBK	9.0	3.4%	2,406	5,762	41.7%
TDSECS	13.0	4.9%	5,338	15,183	35.2%
SCOTIA	18.0	6.7%	4,886	14,222	34.4%
BMO	19.0	7.1%	4,945	18,491	26.7%
WFC	44.0	16.4%	13,493	50,765	26.6%
RBCCM	28.0	10.4%	8,844	35,237	25.1%
BOC	7.0	2.6%	3,170	15,239	20.8%
DBS	9.0	3.4%	1,178	6,038	19.5%
CIBC	11.0	4.1%	2,926	15,135	19.3%
NORDEA	7.0	2.6%	1,186	6,662	17.8%

\* acronyms explained at the end of this chapter

Source: Sustainalytics, based on Bloomberg data

Are there underwriters in the market with an above average SA risk exposure?

The table above shows the list of underwriters that have the largest biases towards issuers from the O&G sector in their syndicated loan transactions. Within this group, the share of SA deals relative to the respective total deal volume ranges from 17.8 to 41.7%, reflecting a level of exposure that is significantly above the overall average of 10.4%.

Wells Fargo alone had 44 deals in this segment with a volume of USD 13.5bn

One remarkable finding is that **Wells Fargo** alone had 44 deals in this segment with a volume of USD 13.5bn, accounting for more than a quarter of all its syndicated loans transactions. Of course these numbers have to be evaluated relative to the overall size of the company. And again, it is also not transparent how Wells Fargo manages its exposure in this area. For example, it is not known how much of this transaction volume the bank retains on its own loan books.

### Exposure to poor ESG quality loans

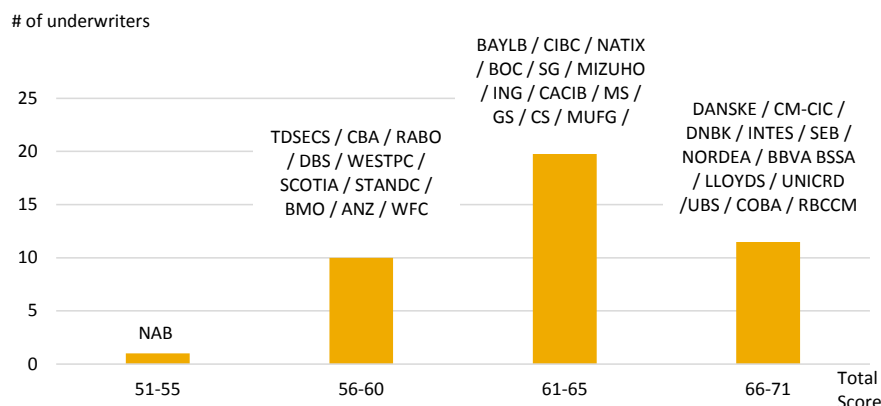
We analysed 352 deals with issuers for which we provide a sustainability rating

Another way to assess the implied risks of syndicated loan transactions for the underwriting institutions is to look at the ESG ratings of the loan issuers. We found 352 deals with issuers for which Sustainalytics provides a sustainability assessment. These deals had a total volume of USD 359.3bn which amounts to 23% of the overall transaction volume. As a first step we looked at underwriters that had a minimum of ten deals with rated companies. This reduced the overall volume analysed to USD 329.6bn, or 93% of all transactions with rated companies. In the following chart we show the distribution of underwriters across four ESG score brackets (for an explanation of our scoring methodology, see Appendix).



The distribution is skewed to the left, which means that there is a tendency of underwriters to engage with issuers that have an above average ESG rating

### Average ESG score of issuers in the deal portfolios of underwriters\*



\* acronyms explained at the end of this chapter

Source: Sustainalytics, based on Bloomberg data

National Australia Bank (NAB) falls into the lowest bracket, for example

Upon examining the graph one can see, for example, that National Australia Bank (NAB) falls into the lowest bracket, as it has underwritten loans to companies with an average score of between 51 and 55 points only, which is below the overall average score of 60. Hence, these underwriters are exposed to deals with companies that have a relatively poor overall ESG rating. In general the distribution is skewed to the left, which means that there is a tendency of underwriters to engage with issuers that have an above average ESG rating. This result, however, might also partly be attributable to the well-known size effect in ESG ratings and hence needs to be interpreted with caution.

The total deal volume with the 10 worst rated companies amounted to USD 13.6bn, 0.8% of the global syndicated loan market

### Deals with worst rated companies

In a final step we analysed the underwriters' commitment to some of the lowest rated companies within the universe we looked at. The table below gives an overview. The total ESG score of these companies is between 41 and 48, and hence significantly below the average of 60. At the individual theme level, scores drop to as low as 34.7 in the Environment pillar or 30 in the Governance pillar. The total deal volume with these ten companies during the period under consideration amounted to USD 13.6bn, which is equivalent to 0.8% of the global syndicated loan market.

### Worst rated issuers in the syndicated loan market\*

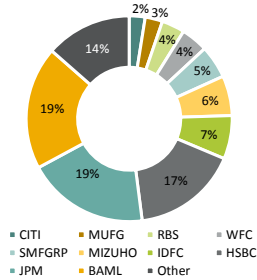
Issuer Name	Industry	Total score	Theme score			Total deal volume (USD m)
			Environment	Social	Governance	
Northern Property REIT	REITS	41.4	38.8	44.2	42.0	46
State Bank of India	Banks	42.8	35.4	61.9	30.0	555
Yamato Kogyo Co. Ltd.	Iron/Steel	43.5	45.9	44.0	39.4	196
Rakuten, Inc.	Internet	44.7	38.4	46.1	51.1	1,118
ARYZTA AG	Food	44.8	44.6	43.6	47.0	2,224
Oversea-Chinese Banking Corporation Ltd.	Banks	46.4	35.8	55.0	46.9	4,991
Anadarko Petroleum Corporation	Oil&Gas	46.4	34.7	52.5	53.1	2,000
Stericycle, Inc.	Environmental Control	47.0	44.3	42.8	57.5	1,200
MICROS Systems, Inc.	Computers	47.3	36.7	45.0	64.0	50
Jaiprakash Power Ventures Ltd.	Electric	47.4	38.9	49.8	60.0	1,181

\* as covered by Sustainalytics, January-June 2014

Source: Sustainalytics, based on Bloomberg data

10 worst rated companies from diverse industries; total deal volume: USD 13.6bn

Market share of underwriters in the “ESG sub-prime” market



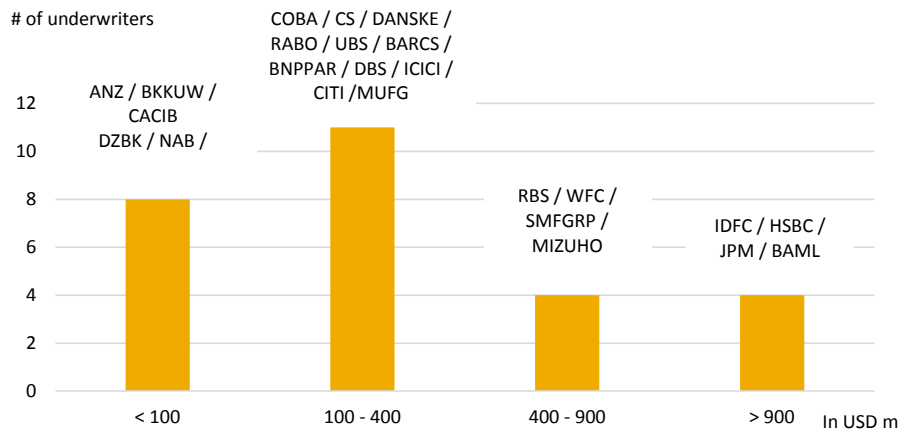
Source: Sustainalytics, Bloomberg data

On the underwriter side, the market is relatively concentrated, with the top ten companies combined accounting for 86.5% of the market. The significance of the individual underwriter’s exposure to “ESG sub-prime” issuers, as we’ve called them here, can be better tracked by looking at the breakdown across volume brackets as presented in chart below. As one can see, there is a huge spread in the size of the individual underwriters’ commitments. By far the highest transaction volumes with lowest-rated companies are displayed for **HSBC, JP Morgan** and **Bank of America Merrill Lynch**, all in the range between USD 2.2bn and 2.6bn (market shares between 16.5 and 19%).

The significant size of these commitments might indicate that there is either no or at least very limited ESG due diligence in underwriting processes. This would be against the notion of financial intermediaries acting as good stewards of their investments or of the deals they are facilitating. Of course one should be careful with overhasty conclusions. In any case, the topic we addressed here and the evidence we found seems to be well suited for investors that actively engage with the companies they invest in.

Significant size of engagements might indicate that there is either no or at least very limited ESG due diligence in underwriting processes

Underwriting volume brackets in the ESG sub-prime market\*



\* acronyms explained at the end of this chapter

Source: Sustainalytics, based on Bloomberg data

Shedding some light on banks’ risk taking attitudes

### Conclusion – Testing if banks walk their talk

Although the analysis of the syndicated loan market does not enable us to assess the exposure of banks’ credit books to relevant ESG issues, the information collected and the results obtained shed some light on banks’ risk taking attitudes and their willingness to take ESG into account at all levels. It certainly also offers an opportunity to test how serious banks are when it comes to walking their talk at an operational level.

Some underwriters pop up under several of the different risk filters we applied – pure coincidence?

Our explorative investigation yielded some interesting insights, which could be used for engagement purposes. For instance, some underwriters pop up under several of the different risk filters we applied. One example is **Wells Fargo (WFC)**: the company is heavily engaged in deals with the O&G sector, and is thus exposed to Stranded Asset risk (among other ESG risks in this industry, of course). Moreover, the issuer WFC dealt with tended to have a below average ESG score. On top of this, the bank's commitment in the ESG sub-prime segment of the market (i.e., deals with the lowest-rated issuers) is relatively high as well (USD 511mn, 4.1% market share). These results are not that surprising, given that the bank has attracted our attention elsewhere in our analysis, showing a comparatively weak qualitative performance track record (see key issue Responsible Finance).

Syndicated loans transactions may become a key indicator in our bottom-up analysis

We will delve more deeply into this topic in forthcoming publications and will consider including loan transaction characteristics as a key indicator in our bottom-up ESG assessment of banks and other financial institutions.

### Acronyms

Acronym	Financial institution	Acronym	Financial institution
NORDEA	Nordea Bank AB	IDFC	IDFC Limited
CIBC	Canadian Imperial Bank of Commerce	ING	ING Bank N.V.
ANZ	Australia & New Zealand Banking Group Limited	INTES	Intesa Sanpaolo S.p.A.
BAML	Bank of America Corporation	JPM	JPMorgan Chase & Co.
BARCS	Barclays PLC	LLOYDS	Lloyds Banking Group plc
BAYLB	Bayerische Landesbank	MIZUHO	Mizuho Financial Group, Inc.
BBVA	Banco Bilbao Vizcaya Argentaria, S.A.	MS	Morgan Stanley
BMO	Bank of Montreal	MUFG	Mitsubishi UFJ Financial Group, Inc.
BNPPAR	BNP Paribas	NAB	National Australia Bank Limited
BOC	Bank of China	NATIX	Natixis
CACIB	Credit Agricole Corporate and Investment Bank	NORDEA	Nordea Bank AB
CBA	Commonwealth Bank of Australia	RABO	Rabobank
CITI	Citigroup, Inc.	RBCCM	Royal Bank of Canada Capital Markets
CM-CIC	Crédit Industriel et Commercial	RBS	The Royal Bank of Scotland Group plc
COBA	Commerzbank AG	SCOTIA	Scotiabank
CS	Credit Suisse Group	SEB	Skandinaviska Enskilda Banken AB
DANSKE	Danske Bank A/S	SG	Societe Generale Group
DB	Deutsche Bank AG	SMFGRP	Sumitomo Mitsui Financial Group Inc.
DBS	DBS Group Holdings Limited	STANDC	Standard Chartered PLC
DNBK	DNB ASA	TDSECS	TD Securities
DZBK	DZ Bank AG	UBS	UBS AG
GS	The Goldman Sachs Group, Inc.	UNICRD	UniCredit S.p.A.
HSBC	HSBC Holdings plc	WESTPC	Westpac Banking Corporation
ICICI	ICICI Bank Ltd.	WFC	Wells Fargo & Company

Source: Sustainalytics, based on Bloomberg data

# Bottom-Up Analysis

## Interpreting the numbers

Universes we look at:  
Developed Markets,  
BRICS, Emerging Markets;  
listed and non-listed companies

On the following pages, we give an overview of company performance within the banking sector as defined by the GICS. However, in order to provide a complete picture, we augmented the resulting universe with a group of companies that are classified under Diversified Financial Services but are considered direct peers in the global banking context (e.g., Deutsche Bank; UBS). We will separately look at listed equities in Developed Markets (DM), BRICS countries and other Emerging Markets (EM), as well as major non-listed banks.

Structure of our evaluation:  
3 themes, and 4 dimensions

Our evaluation is based on the classical three-pillar structure used in responsible investment analysis, consisting of the three main themes: Environment, Social, and Governance. The number of indicators and their respective weights are industry specific (for Banks: 62), reflecting their relevance for stakeholders as well as their materiality for the companies. Furthermore, we evaluate four distinct dimensions: Disclosure, Preparedness (policies, programmes, etc.), Quantitative Performance (employee turnover rates, assets under management, etc.) and Qualitative Performance (controversies).

### Banks – Sector-specific weight matrix\*

Theme	Weight / # Indicators	Dimension			
		Disclosure	Preparedness	Quantitative Performance	Qualitative Performance
Environment	30%	3.3%	31.7%	33.3%	31.7%
	18	2	7	6	3
Social	35%	0.0%	13.0%	5.5%	16.5%
	17	0	8	5	4
Governance	35%	3.5%	19.8%	0.0%	11.8%
	27	5	19	0	3

\* weight for theme within overall rating, for dimension within theme

Source: Sustainalytics

How scores are computed and aggregated

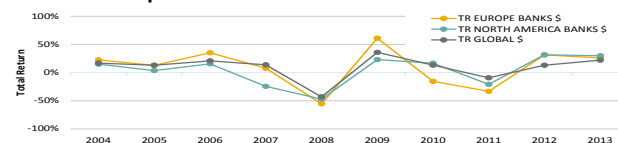
The raw scores we allocate at the indicator level range from 0-100. They are then multiplied by their appropriate weights, summed up and recalibrated to arrive at aggregate level scores, including the three theme scores and the overall ESG score. Based on their scores, companies are allocated to five distinct performance groups (Industry Leader, Outperformer, Average Performer, Underperformer, Industry Laggard) according to their relative position within the industry and assuming a normal distribution of scores. For a more detailed description of our methodology, see the Appendix.

## DM Banks<sup>+</sup>

Universe analysed: **DM Banks & selected peers (DM Banks<sup>+</sup>)**  
 Number of constituents: **138**  
 Total Sustainalytics coverage: **366 (all Banks + 10 DFS\* companies)**  
 Updated: **11 June 2014**

\* DFS: Diversified Financial Services

### Stock market performance



Source: Thomson Reuters Datastream

## Sector Leaders

84

### Overall ESG score

National Australia Bank Limited (NAB)

89

### Environment score

CaixaBank, S.A.

91

### Social score

CaixaBank, S.A.

87

### Governance score

Skandinaviska Enskilda Banken AB (SEB)

As the industry leader in the DM Banks<sup>+</sup> sub-universe, **NAB** exhibits best-in-class ESG policies and management systems, reflecting a strong commitment to mitigating related risks and impacts. While NAB gained its position through a strong balance across sustainability themes, the Spanish **CaixaBank** and the Swedish **SEB** set best practice standards in their respective categories. The fact that both CaixaBank and SEB are also included among the top five banks, speaks to the strong commitment of these companies to lead the sub-sector, not just the sustainability theme. Also noteworthy is the strong performance of **Van Lanschot** which leads the lower MCap bracket with a total score of 73.

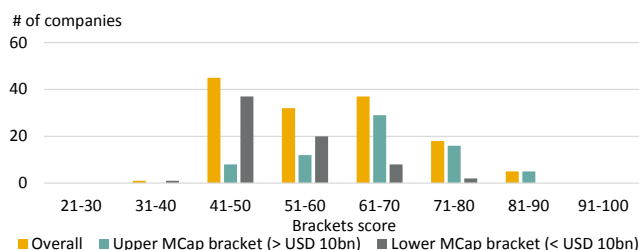
## Overall ESG score & size

Top 5 companies upper MCap bracket (>USD 10bn)	Country	MCap (USD m)	Score
National Australia Bank Limited	Australia	71,817	83.7
Skandinaviska Enskilda Banken AB	Sweden	30,294	83.6
CaixaBank, S.A.	Spain	34,800	83.2
Westpac Banking Corporation	Australia	100,029	83.0
DNB ASA	Norway	31,877	81.7

Top 5 companies lower MCap bracket (<USD 10bn)	Country	MCap (USD m)	Score
Van Lanschot NV	Netherlands	1,037	73.1
Unione di Banche Italiane Scpa	Italy	8,816	70.2
Banco Espirito Santo SA	Portugal	6,683	67.4
Comerica Incorporated	United States	8,913	67.2
Banca Monte dei Paschi di Siena SpA	Italy	3,893	66.4

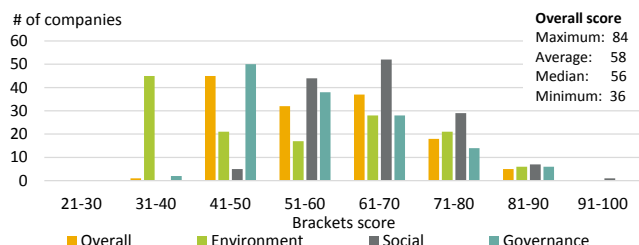
## Distribution of scores

### Distribution by MCap bracket\*



\* MCap as of 11/06/2014 by Thomson Reuters

### Distribution by ESG theme

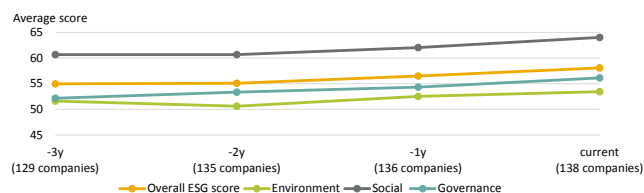


The overall ESG performance of DM Banks<sup>+</sup> ranges from 36 for the Belgian **Dexia** to 84 points for **NAB** with an average value of 58. As the median is slightly below this value, the resulting distribution is positively skewed, meaning lower than average ESG scores are more frequent than higher ones.

The positive skew of the overall ESG score is particularly strong for smaller companies (MCap < USD 10bn) and persists across all themes considered, though it is less pronounced for Social. This distribution of scores indicates that the banking sector has developed minimum standards to which most companies comply, while some companies, particularly the larger ones, differentiate themselves through voluntary compliance with higher standards.

Lastly, banks tend to concentrate most of their sustainability effort on social and governance issues, while environmental performance plays a subordinated role. This may be because financial companies have historically not considered their operations as having a large environmental impact.

## Momentum ESG scores



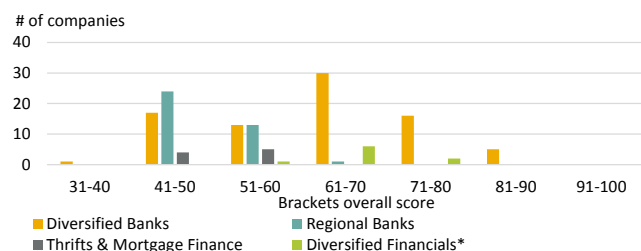
Momentum Leaders (highest yoy performance)	Score: current	-1y	change
Commonwealth Bank of Australia	76.2	65.3	10.9
Skandinaviska Enskilda Banken AB	83.6	72.8	10.7
Wells Fargo & Company	63.8	54.5	9.3
DNB ASA	81.7	72.7	9.0
CaixaBank, S.A.	83.2	74.4	8.8

Momentum Laggards (lowest yoy performance)	Score: current	-1y	change
Dexia SA	36.0	62.9	-26.9
Societe Generale Group	67.4	73.2	-5.8
Raiffeisen Bank International AG	60.3	65.8	-5.5
Banco Comercial Portugues S.A.	60.5	66.0	-5.5
The Royal Bank of Scotland Group plc	61.1	65.9	-4.8

Over the last three years DM Banks\* have consistently gained momentum. Starting with an average score of 55.0 in 2011 the industry has continuously improved, passing 55.1 (2012) and 56.5 (2013) before reaching a score of 58.1 in June 2014. Most of this advancement is attributable to improved governance standards and practices, which rose an average of 2.5%, compared to 1.8% for social and 1.2% for environmental indicators.

Especially noteworthy is the upgrade of **SEB**, which improved its rating within one year by 10.7 points to 83.6 (the second strongest rise yoy), becoming the second best DM bank right before **CaixaBank** (83.2), **Westpac** (83.1) and **DNB** (81.7). The Momentum leader is **Commonwealth Bank of Australia** (+10.9 yoy). **Dexia's** sharp decrease is attributed to its orderly resolution forced by the European Commission.

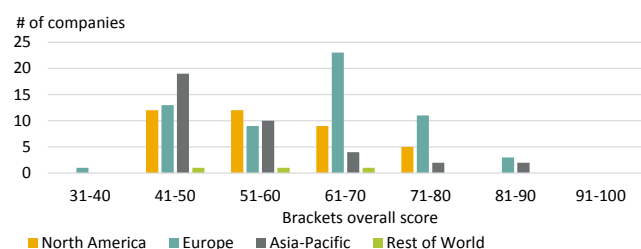
## Rating distribution by sub-industry and region



\* Diversified Financials: 10 selected peers only

Leading company in each sub-industry	MCap (USD m)	Score	
Diversified Banks	National Australia Bank Limited	71,817	83.7
Regional Banks	Resona Holdings, Inc.	11,782	63.0
Thrifts & Mortgage Finance	Aareal Bank AG	2,909	57.0
Diversified Financials*	State Street Corp.	28,838	75.4

\* Diversified Financials: 10 selected peers only



Leading company in each region	MCap (USD m)	Score	
North America	State Street Corp.	28,838	75.4
Europe	Skandinaviska Enskilda Banken AB	30,294	83.6
Asia-Pacific	National Australia Bank Limited	71,817	83.7
Rest of World	Bank Hapoalim B.M.	7,921	64.8

Different types of banks show different performance characteristics. As the largest sub-industry, Diversified Banks have a more bell-shaped distribution of ESG scores. Regional Banks as well as Thrifts & Mortgage Finance Banks are relative underperformers. The comparatively strong performance of Diversified Financials should not be overemphasised, as ten global, well-capitalised companies were chosen as direct peers.

The above-mentioned performance clusters are likely the result of a size-effect, meaning that bigger companies (those having a higher MCap) are apt to devote more resources towards developing and communicating sustainability strategies.

Looking at the geographical particularities, the distribution of scores for the European market is more symmetrical than that of its peers from North America and Asia-Pacific, which are significantly more skewed to the low end. However, when looking at average scores, the European and North American markets achieve similar performance (61.5 vs. 57.3). For the remaining two markets, Asia-Pacific and Rest of World, average scores are significantly lower at 53.8 and 52.5, respectively.

Turning to the industry leaders of the different regions, the picture changes slightly, with Australia (Asia-Pacific) hosting the best-performing bank, **NAB**, right before Europe's **SEB**. The North American leader, **State Street**, falls in the middle, while the leading company from the Rest of World, **Bank Hapoalim**, is lagging far behind.

## Disclosure, Preparedness, Performance - Sector Leaders

98

### Disclosure

Bankinter, S.A.  
National Australia Bank Limited (NAB)

85

### Preparedness

BNP Paribas

78

### Quantitative Performance

CaixaBank, S.A.

In addition to dividing sustainability scores into the three themes (ESG), all indicators used by Sustainalytics can also be attributed to the four dimensions Disclosure, Preparedness, Qualitative and Quantitative Performance. These dimensions assess a company’s ability to address different kinds of ESG-related risks and opportunities.

**Bankinter**, S.A. together with **NAB** proved to be the most transparent companies in the banking sector. **BNP Paribas** has particularly strong policies and management systems in place. Finally, **CaixaBank** stands out for its good quantitative performance that confirms its profound commitment to sustainability.

## Qualitative Performance - Most controversial companies\*

4

### Category 4 - High

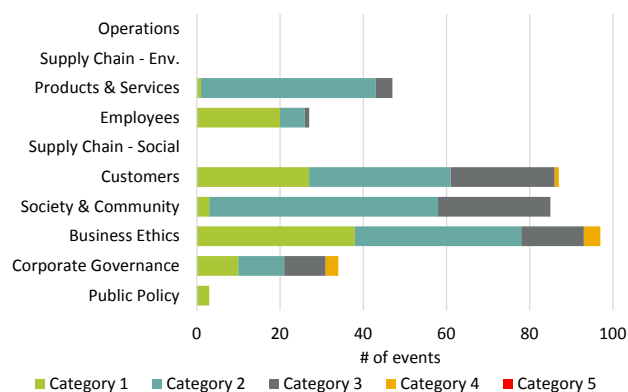
**NEW\*\***: BNP – Society & Community (RF)  
Banca Monte dei Paschi di Siena – Corp. Governance (RES)  
Bankia – Corp. Governance (RES)  
Bank of America – Customers (FPG)  
Credit Suisse Group – Business Ethics (BE)  
Deutsche Bank – Business Ethics (BE)  
Dexia – Corp. Governance (RES)  
HSBC – Business Ethics (BE)  
UBS – Business Ethics (BE)

\* key ESG issues in parentheses - RF: Responsible Finance; BE: Business Ethics; RES: Resilience; FPG: Financial Product Governance

\*\* new BNP Category 4 case not reflected in the data analysis of this report

Qualitative Performance is all about controversies with Category 5 representing the most egregious mismanagement and encompasses controversies that pose significant risks to the company. A Category 4 differs from Category 5 in severity, but also in the way the company deals with the issue (“management”), or what the issue entails for the near future (“outlook”). While still displaying significant breaches, the companies on the left made some progress, managing to tackle underlying issues, which included cases of interest rate manipulations as well as various fraudulent activities. It is worth noting that five out of eight banks with a Category 4 controversy are designated as global systemically important banks by the Financial Stability Board (FSB).

## Qualitative Performance – Distribution of events\*



\* new BNP Category 4 case (see above), not reflected in the data analysis of this report

Because banks are primarily service providers, most controversies occurring in the banking industry are clearly attributable to governance and social issues, with the highest frequency in Business Ethics, Customers, and Society & Community (in that order).

With respect to the severity of events, Business Ethics and Corporate Governance issues are subject to the most intense controversies, and pose the highest risks to the company and investors.

## DM Banks<sup>+</sup> - Company portrait: Westpac Banking Corporation



**Outlook**  
Positive

**83**

**Overall ESG score**  
Industry Leader (4 out of 132)

**2**

**Highest controversy level**  
Environmental Products & Services  
Employees  
Customers  
Society & Community

Domicile: Australia  
Industry: Banks  
Sub-Industry: Diversified Banks  
Ticker: ASX:WBC  
ISIN: AU000000WBC1  
Sedol: 6076146  
Employees (FY 2013): 36,000  
MCap\*: USD 100,029m

\* freefloat market cap as of 11/06/2014 by Datastream

### Analyst view

**With an overall ESG score of 83, Westpac is one of the leading companies in the sub-sample DM Banks<sup>+</sup> demonstrating a sophisticated understanding of sustainability and a broad awareness of environmental and social risks. The bank stands out in all sustainability themes, demonstrating particularly strong policies and management systems. Though Westpac is, like many of its direct peers, involved in a couple of controversies, the level of involvement is considered relatively low with its primary challenge being its close relationship with clients that are engaged in environmentally sensitive projects.**

### Company description

Headquartered in Sydney, Australia, Westpac is the oldest and currently the second largest bank in Australia by market value, providing various banking and financial services, including wealth and insurance products. Westpac's approximately 11.8m customers include retail, corporate, institutional and government clients primarily in Australia, New Zealand, and the near Pacific region.

### ESG performance

Westpac's outstanding overall performance is attributable to its strong programmes and standards, resulting in the company's third place ranking for Preparedness. Examples of these programmes include the bank's comprehensive credit and loan standards, which take ESG risks into consideration and exclude controversial weapons as well as tobacco; its commitment to responsible investment, which is backed by a responsible investment policy; and the explicit promotion of renewable energy and financial inclusion. Additionally, the bank stands out for its commitment to voluntary international initiatives as well as its strong ethical policies and leading workforce and supplier policies, resulting in one of the highest social scores in the industry.

Unlike peers in Europe and North America, Westpac has no significant involvement in ethical and governance issues, indicating adequate enforcement of its ethical policies. However, its social performance has been overshadowed by allegations of excessive fees and misrepresentation of structured products. Also, its lending to the coal and oil and gas industries remains a trigger point for environmental groups and ethical investors.

#### Analyst

Levinia Pantea  
[Levinia.pantea@sustainalytics.com](mailto:Levinia.pantea@sustainalytics.com)

Company characteristics (current & momentum)	Score			Rank curr.
	-3y	-1y	curr.	
Overall ESG score	82	81	83	4
Environment	72	77	81	6
Social	90	83	84	5
Governance	83	82	84	5
Disclosure	56	98	87	6
Preparedness	84	79	84	3
Quantitative Perf.	55	45	64	12
Qualitative Perf.	94	95	89	105



## DM Banks<sup>+</sup> - Company portrait: Skandinaviska Enskilda Banken AB (SEB)



**Outlook**  
Positive

**84**

**Overall ESG score**  
Industry Leader (2 out of 183)

**2**

**Highest controversy level**  
Products & Services (Env.)  
Society & Community

Domicile: Sweden  
Industry: Banks  
Sub-Industry: Diversified Banks  
Ticker: OM:SEB A  
ISIN: SE0000148884  
Sedol: 4813345  
Employees (FY 2013): 16,000  
MCap\*: USD 30,294m

\* freefloat market cap as of 11/06/2014 by Datastream

### Analyst view

With an overall ESG score of 84, Skandinaviska Enskilda Banken (SEB) is one of the leading companies and momentum leaders in the DM Banks<sup>+</sup> universe, reflecting management's recent prioritisation of the bank's long-term sustainability. SEB has integrated best practices across its core business products and services and leads the industry in environmental, social, and governance categories. Furthermore, the company has avoided involvement in major controversies, likely a product of its strong corporate governance oversight and policies governing its lending and investment activities in controversial businesses.

### Company description

Founded in 1856, SEB is one of the largest banks in Sweden, providing retail, corporate and investment banking, including trading, capital markets and global transaction services, as well as pension and asset management, and insurance products to its clients in the Baltics and surrounding area. Through a series of acquisitions in the 1990s, the bank's workforce has grown to 16,000 employees who serve 2,900 large corporates and institutions, 400,000 SMEs, and four million private customers.

### ESG performance

SEB's strong overall performance is a result of its consistent efforts to implement and improve best practices throughout the entire bank. Although SEB already had a strong sustainability track record, its decision in 2009 to address sustainability in a more comprehensive manner eventually propelled the company from an Outperformer to an Industry Leader in all three ESG categories within the last three years.

SEB's marked improvement stems from the bank's commitment to responsible finance. In 2013, SEB launched a microfinance-fund for institutional investors which focused on sustainability. The bank advanced the green bond market by serving as the lead arranger for the issuance of two separate green bonds. It supported the City of Gothenburg as Norway's first issuer of municipal green bonds developed according to World Bank guidelines, and partnered with Vasakronan, a real estate company, to issue its first corporate green bond. The bank incorporates sustainability issues in its general credit and lending programme and has created sector-specific policies on its lending practices for certain industries, such as fossil fuels.

Also in 2013, SEB instituted a human rights policy and expanded its social supplier standards. The bank's new, formal whistleblower programme enhances its already strong corporate governance, which sets SEB apart because of its comprehensive policies and lack of involvement in controversies related to business ethics violations.

Company characteristics (current & momentum)	Score			Rank curr.
	-3y	-1y	curr.	
Overall ESG score	69	73	84	2
Environment	66	65	80	8
Social	69	72	84	6
Governance	73	81	87	1
Disclosure	9	42	83	8
Preparedness	59	65	77	4
Quantitative Perf.	56	46	73	3
Qualitative Perf.	94	97	95	79

### Analyst

Emily Lambert

[Emily.lambert@sustainalytics.com](mailto:Emily.lambert@sustainalytics.com)

## BRICS Banks

Universe analysed: **BRICS - Banks**  
 Number of constituents: **37**  
 Total Sustainalytics coverage: **366 (all Banks + 10 DFS\* companies)**  
 Updated: **11 June 2014**

\* DFS: Diversified Financial Services

## Stock market performance



Source: Thomson Reuters Datastream

## Sector Leaders

79

## Overall ESG score

Banco Santander (Brasil) S.A.

85

## Environment score

Banco Santander (Brasil) S.A.

84

## Social score

Nedbank Group Ltd.

78

## Governance score

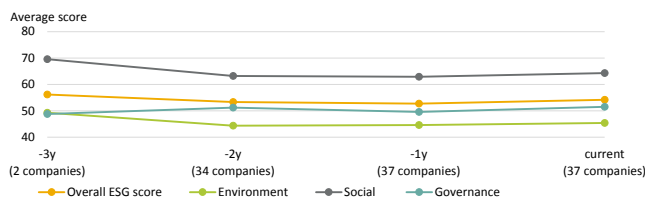
Banco Santander (Brasil) S.A.

The most sustainable bank of the BRICS countries is **Banco Santander Brasil**, which leads the industry in terms of Governance and Environment scores, and ESG performance overall. Only its social performance is surpassed by the South African **Nedbank Group**, which has best-in-class policies and programmes and has not been involved in any social controversies.

Finally, it is noteworthy that the five leading companies within BRICS Banks are exclusively domiciled in South Africa and Brazil and show strong connections to the European market, either historically and/or through ownership structures. However, when compared to best practices in DM, BRICS sustainability leaders still have room to improve.

Top 5 companies BRICS countries	Country	MCap (USD m)	Score
Banco Santander (Brasil) S.A.	Brazil	26,669	79.5
Nedbank Group Ltd.	South Africa	10,003	78.2
Standard Bank Group Limited	South Africa	21,768	70.1
Banco Bradesco S.A.	Brazil	30,331	67.6
Barclays Africa Group Limited	South Africa	12,780	65.6

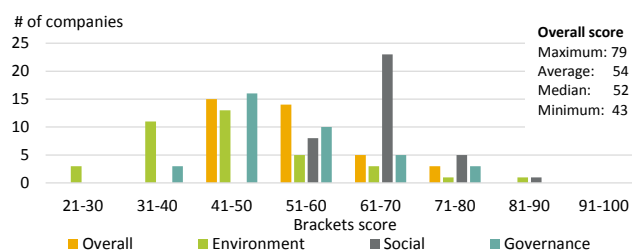
## Momentum



Contrary to DM, the historical scores of BRICS banks shows a slight decrease in average ESG scores over time. However, this performance drift is negatively correlated to Sustainalytics' company coverage of BRICS countries, which has steadily increased in recent years to include more, mainly smaller, companies that negatively influenced average ESG performance. The Momentum leader in BRICS Banks is **Nedbank Group** (+15.6) right before **Barclays Africa Group** (+7.1), with the latter also included in the top five list mentioned above, pointing to its strong commitment to lead the sector.

## Distribution of scores

## Distribution by ESG theme



Like DM Banks, the performance distribution for BRICS countries is positively skewed, with an average score of 54 and a median of 52. The lowest and most populated (41%) performance bracket of the distribution is 41 – 50, and the remaining 59% of companies achieve higher scores. What is special for BRICS Banks is that their average social performance is higher than those of the other sub-universes considered (DM, EM, and Non-listed Banks).

## BRICS - Company portrait: Banco Santander Brasil



**Outlook**  
Positive

**79**

**Overall ESG score**  
Industry Leader (1 out of 36)

**2**

**Highest controversy level**  
Customers

Domicile: Brazil  
Industry: Banks  
Sub-Industry: Diversified Banks  
Ticker: BOVESPA:SANB4  
ISIN: BRSANBACNPRS  
Sedol: 2835578  
Employees (FY 2013): 54,000  
MCap\*: USD 26,669m

\* freefloat market cap as of 11/06/2014 by Datastream

### Analyst view

**With an overall ESG score of 79, Banco Santander Brasil (Santander Brasil) is the industry leader in the sub-universe BRICS Banks, spearheading sustainability by implementing best practices across the organisation. What is most notable is the pace of its improvement; its ESG scores have increased across the three main themes, skyrocketing from Average to Leader in just two years.**

### Company description

The third largest bank in Brazil by assets, Santander Brasil was established in 1982 and has since grown steadily through a combination of acquisitions and organic growth. With 54,000 employees, it operates primarily as a retail bank, but also offers wholesale, third-party assets, management, and insurance products.

### ESG performance

Company characteristics (current & momentum)	Score			Rank curr.
	-2y	-1y	curr.	
Overall ESG score	68	80	79	1
Environment	64	87	85	1
Social	72	76	76	3
Governance	69	77	78	1
Disclosure	61	88	88	4
Preparedness	51	71	69	1
Quantitative Perf.	40	68	64	2
Qualitative Perf.	100	94	97	22

Santander Brasil's strong overall performance reflects the company's conscious effort to improve the sustainability of its operations, which is the influence of its parent company's strong ESG commitments and a corporate culture in Brazil that encourages integration of sustainability into business.

Santander Brasil's strongest performance is in the environment theme with a score of 85, the highest in the sector. This level of performance is driven by its policies to manage the environmental impact of its operations and commercial activities. Its environmental and social lending standards are also strong and address issues as disparate as slave labour and air pollution. It is a signatory to the Equator Principles as well as Brazil's "Protocolo Verde" (Green Protocol), which commits signatories to adopt environmental and social policies to promote sustainable development in Brazil. Its environmental management system meets industry best practice and year over year, its GHG emissions are well below average.

Santander Brasil's governance performance outshines all of its peers in the sub-universe. The bank has signed all the relevant industry initiatives, and its ESG reporting is written according to the GRI A+ level. The bank's social performance is also strong, particularly with respect to human capital programmes. For example, the company has strong support systems in place to encourage diversity.

The bank's Qualitative Performance score is 96.7, just below the median value for the sub-universe. Santander Brasil's performance was primarily affected by national strikes against the financial sector in 2013 and a retroactive investigation into the banks' practices during a period of hyperinflation.

### Analyst

**Sophia Burress**  
[Sophia.burress@sustainalytics.com](mailto:Sophia.burress@sustainalytics.com)

## Emerging Markets (ex BRICS) Banks

Universe analysed: **EM ex BRICS - Banks**  
 Number of constituents: **84**  
 Total Sustainalytics coverage: **366 (all Banks + 10 DFS\* companies)**  
 Updated: **11 June 2014**

\* DFS: Diversified Financial Services

### Stock market performance



Source: Thomson Reuters Datastream

## Sector Leaders

71

### Overall ESG score

Banco Bilbao Vizcaya Argentaria (BBVA) Colombia S.A.

88

### Environment score

Turkiye Garanti Bankasi AS

78

### Social score

BBVA Colombia S.A.

78

### Governance score

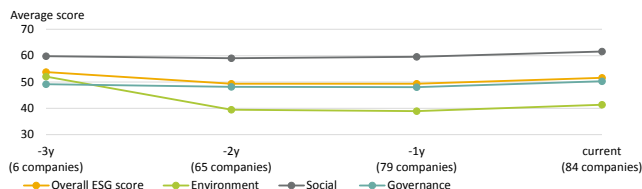
BBVA Colombia S.A.

Within the sample of EM ex BRICS, **BBVA Colombia** shows the strongest commitment to sustainability. Especially for governance and social issues, the bank exhibits exemplary standards compared to its peers. The bank does this with a relatively small MCap of USD 2,288m, contradicting the often stated argument that smaller banks face barriers to achieving competitive ESG scores due to their limited resources.

Even though **Turkiye Garanti Bankasi's** performance in Governance and Social has been assessed to be average (69 and 59 respectively), the company's Environmental performance is remarkable (88), positioning it second among the top five EM banks. Also outstanding is the rocket start of **DGB Financial Group** (founded in 2011) from South Korea, which had been created to integrate several previously independent subsidiaries.

Top 5 companies EM ex BRICS countries	Country	MCap (USD m)	Score
Banco Bilbao Vizcaya Argentaria Colombia S.A.	Colombia	2,288	71.0
Turkiye Garanti Bankasi AS	Turkey	17,475	71.0
DGB Financial Group Co Ltd.	South Korea	2,056	69.4
Bank Polska Kasa Opieki Spolka Akcyjna	Poland	16,484	66.0
Bank Handlowy W Warszawie SA	Poland	5,275	65.8

## Momentum

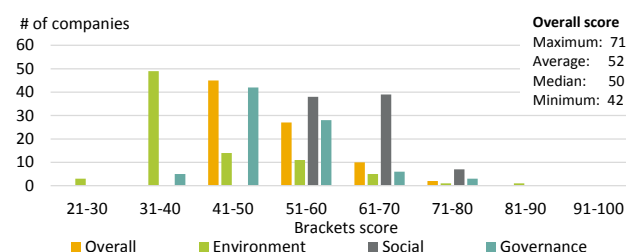


As in the previous case of BRICS countries, the historical overall performance of EM banks is slightly negative, which can be traced back to our recent efforts to enhance sector coverage.

Turning to the momentum leaders in the sub-universe, it is once again **Turkiye Garantie Bankasi** which stands out. In 2013, the company had an overall performance leap of 12.7 points, due to the implementation of a detailed environmental policy as well as an environmental management system following the ISO 14001 standard, both of which are best practices.

## Distribution of scores

### Distribution by ESG theme



Even though all sub-samples considered in the present report (DM, BRICS, EM, and Non-listed Banks) unambiguously reveal that banks put significantly more emphasis on sound social and governance standards than on environmental issues, the discrepancies within the EM sample are particularly pronounced. This is confirmed when taking into account average scores: E=41/S= 62/G=50.

## Non-listed Banks

Universe analysed: **Global Banks (non-listed)**  
 Number of constituents: **72**  
 Total Sustainalytics coverage: **366 (all Banks + 10 DFS\* companies)**  
 Updated: **11 June 2014**

\* DFS: Diversified Financial Services

### Sector Leaders

82

#### Overall ESG score

KfW

84

#### Environment score

KfW

86

#### Social score

Caisse centrale Desjardins

86

#### Governance score

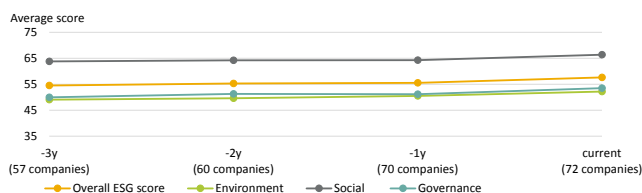
KfW

The strong performance of Non-listed Banks is generally on par with the performance of their listed peers. Especially noteworthy is the consistently strong performance of **KfW**. In the most recent three years KfW has continuously delivered best-in-class results, which brought the development bank a fixed spot among the best five companies of the entire Bank universe (DM, BRICS, EM, and Non-listed Banks).

Compared to the modest sub-sample average score of 52, the Environmental performance of KfW (84) is considered pioneering. Finally, **Caisse centrale Desjardins** shows evidence of best-in-class social standards and programmes. Although most of the non-listed banks are European, it is important to note that two of the top five companies are US banks.

Top 5 Non-listed Banks	Country	Score
KfW	Germany	82.3
Inter-American Development Bank	United States	77.7
Caisse centrale Desjardins	Canada	77.3
ABN AMRO Group N.V.	Netherlands	75.8
IBRD - World Bank	United States	75.3

### Momentum



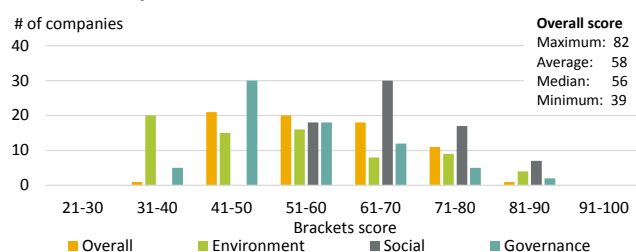
Whereas the number of companies assessed also increased for non-listed banks, contrary to the momentum charts for BRICS and EM banks, the one for non-listed banks (on the left) does not show a decline in score over the years. Instead, one can see a slight increase for the Social and Environment themes.

Momentum Leaders Non-listed Banks	Score: current	-1y	change
Banco Pastor	63.7	49.8	13.8
Caisse centrale Desjardins	77.3	64.6	12.7
Cif Euromortgage SA	52.6	41.1	11.5
Nederlandse Waterschapsbank N.V.	70.7	60.0	10.7
DG HYP - Deutsche Genossenschafts-Hypothekbank	52.9	43.3	9.6

The momentum leaders were primarily poor performers that adapted their sustainability standards to the industry average. All of the top five banks were able to significantly increase their performance in Environment, whereas progress in the other two themes was mixed.

### Distribution of scores

#### Distribution by ESG theme



The performance distribution for Non-listed Banks shows that the industry is characterised by relatively high volatility and extreme outliers in both directions. The latter is reflected also in the fact that the sub-sample includes **Hypo Alpe-Adria-Bank**, the second worst performing bank of the entire universe (overall score=39). Nevertheless, the relatively strong average score of 58, reflects the generally high commitment of non-listed banks to sustainability.

## Non-listed Banks - Company portrait: KfW Group



**Outlook**  
Positive

**82**

**Overall ESG score**  
Industry Leader (1 out of 72)

**2**

**Highest controversy level**  
Product & Services (Env.)  
Society & Community

Domicile: Germany  
Industry: Banks  
Sub-Industry: Diversified Banks  
Ticker: n.a.  
ISIN: n.a.  
Sedol: n.a.  
Employees (FY 2013): 5,347  
MCap\*: n.a.

\* freefloat market cap as of 11/06/2014 by Datastream

### Analyst view

**With an overall ESG rating of 82, KfW is the industry leader in the Non-listed Banks sub-universe, demonstrating best practice in all three ESG themes. KfW's strong ESG standards across all of its of business areas, and its lending and investment business in particular, makes it an industry leader among listed and non-listed banks in mitigating related risks.**

### Company description

Founded in 1984, KfW operates as the promotional bank of Germany, and has since become one of the largest development banks worldwide. KfW engages primarily in domestic promotional activities for retail customers (e.g., student credit or home financing), companies (ranging from SMEs and start-ups to medium-sized enterprises), municipalities and organisations (social and non-profit), export and project finance, and development finance, with a strong focus on sustainable development.

### ESG performance

Company characteristics (current & momentum)	Score			Rank
	-3y	-1y	curr.	
Overall ESG score	77	82	82	1
Environment	81	79	84	1
Social	73	81	78	10
Governance	78	86	86	1
Disclosure	61	64	67	7
Preparedness	60	73	73	2
Quantitative Perf.	77	72	81	1
Qualitative Perf.	98	98	95	59

KfW's outstanding overall performance reflects its commitment to long-term corporate responsibility. The bank integrated ESG standards throughout its business, which is demonstrated by its strong programmes and policies in all three themes. KfW's strongest performance is in the Governance theme with a score of 86, the highest amongst all non-listed peers. Although its board independence is not considered best practice due to the political functions of the directors, KfW's comprehensive policies demonstrate strong compliance and lead the level of preparedness in the industry. With regard to social performance, KfW remains an Outperformer. Noteworthy is its strong performance in diversity management, an increasingly important factor to attract and retain talented employees.

Besides strong environmental programmes and policies addressing its in-house activities, KfW established a large number of sustainable financial products and services (including the recent issuance of green bonds), promoting energy efficiency and renewable energies. In 2012, KfW reported that about one-third of the company's promotional funds flow into climate change mitigation and environmental projects. Furthermore, the company has strong credit and loan standards, has aligned them with international best practice and has implemented, among others, the Performance Standards of the International Finance Corporation (IFC), leading to the strongest performance in Responsible Finance industry wide. Despite its commitment to address climate change, KfW has been repeatedly criticised for playing an important role in global coal financing, posing a moderate risk for the company's reputation.

### Analyst

**Annalisa Werner**  
[Annalisa.werner@sustainalytics.com](mailto:Annalisa.werner@sustainalytics.com)

# Key ESG Issues

## High exposure, significant management gaps

Banks are the (cold) heart of all modern economies – they pump financial means like blood through the system empowering innovation, economic growth and prosperity. Their role as financial intermediaries means that banks are implicated in all kinds of business activities with all kinds of sustainability impacts – though often indirectly. Based on systematic analysis of value chains and business models in the sector, we evaluated the materiality of these impacts and their repercussions on the financial viability of the sector constituents. We have identified five issues that we consider to be key based on the depth, breadth, and duration of potential impacts.

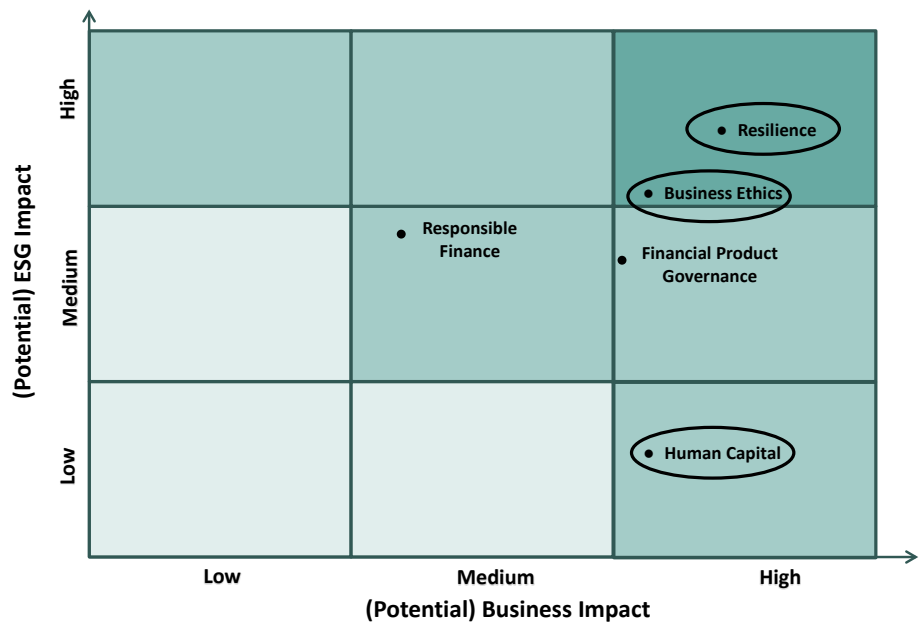
### How material is the exposure vis-à-vis an issue?

We define “key ESG issues” to be those areas of exposure that are most material and, hence, determine the key management areas for a company. Obviously, the areas of exposure differ from industry to industry. Hence, we have generated a list of issues that are potentially relevant for a company based on a detailed and systematic analysis of the business models and the value creation chains within a given sector. The following chart shows the positioning of the five most significant issues we’ve identified for the global banking sector. At the individual bank level, the exposures shown in the chart can be higher or lower based on company-specific factors like involvement in special business areas, location, or size.

Defining the key areas of exposure

### Materiality Matrix Banks

Five key ESG issues have been identified for the sector



Source: Sustainalytics

## Sustainability & Business Impact

Industry-specific selection of key ESG issues based on a “materiality of impact” assessment

In probably no other sector is the link between **Sustainability Impact**, which is defined as the **impact of** a company on its stakeholders, and **Business Impact**, which is defined as an issue’s **impact on** a company, as close as in the banking sector. This is due to the overall systemic relevance of the sector for the economy at large and the well-being of all its actors. An environmental or social issue becomes a key ESG issue within our framework if the magnitude of potential impacts (measured in terms of depth, breadth, and duration) is material. Looking at the Sustainability Impact dimension, for example, the issues of Resilience and Business Ethics stood out in passing our materiality test due to their high significance for customers and the society at large. Looking at Responsible Finance, on the other hand, the range of stakeholder impact is much broader, but mostly indirect in nature.

### Areas of Sustainability Impact

Resilience, Business Ethics, and Financial Product Governance are the issues with the most significant sustainability impacts

Key ESG Issue	Areas of Sustainability Impact													
	GHG Levels	Air Quality	Land	Water Quality	Water Availability	Biodiversity	Animal Welfare	Local Communities	Customers	Employee Health & Safety	Labour Rights & Conditions	Contractors & Supply Chain	Human Rights	Society
Business Ethics														
Resilience														
Responsible Finance	###	###	###	###	###	###	###			###	###	###	###	
Financial Product Governance														
Human Capital														

no major impact   major impact   severe impact   ### mostly indirect impact

Source: Sustainalytics

Striking clusters of impact across four out of the five key issues

Looking at the Business Impact side, it is striking that the exposure of banks is significantly driven by the Regulatory Environment, Litigation Risks, and Reputation Risks. In 12 out of 15 cases across all five key issues, these are considered areas of potentially severe impact. And clearly, there is a lot of overlap and interaction between the issues and the impact areas involved. For example, Business Ethics-related cases of misconduct may trigger regulatory action, which in turn may have an impact on the bank’s business model or product offering, which in turn may have an impact on the bank’s Resilience. Not surprisingly, on the other hand, the areas of most severe impact regarding the Human Capital issue are Employee Motivation and Hiring Capability.

### Areas of Business Impact

Resilience and Responsible Finance both display five areas of severe business impact

Key ESG Issue	Areas of Business Impact							
	Regulatory Environment	Litigation Risks	Reputation Risks	Client Demand	Asset Risks	Operational Risks	Employee Motivation	Hiring Capability
Business Ethics								
Resilience								
Responsible Finance								
Financial Product Governance								
Human Capital								

no major impact   major impact   severe impact

Source: Sustainalytics



## The five key ESG issues

The five key issues we've identified are discussed in detail in the forthcoming sections. For all of them we first analyse the exposure of the sector overall and of the factors that leverage or de-leverage exposure at the individual company level. We then turn to the evaluation of performance and management quality by looking at relevant indicators covering the four dimensions Disclosure, Preparedness, Quantitative Performance, and Qualitative Performance. We conclude each section with an outlook.

The litmus test is whether banks are prepared to forego lucrative business opportunities

**Outlook: Neutral**

The first key issue we're looking at is **Business Ethics (see p. 34)**. In the last three years, the industry has been faced with multiple ethical controversies that have raised significant legal and reputational costs for many banks. Banks responded by implementing disciplinary measures while strengthening ethical codes and compliance measures. The challenge to the industry is a broader one, however, since the issue is not only about misconduct of individuals, but is also rooted more deeply in the system itself.

Stability of banks is also related to "soft factors" that cannot and are typically only partly addressed by regulators

**Outlook: Neutral**

Regarding the key issue of **Resilience (see p. 40)**, we conclude that it is all about finding the right balance. The recent financial crisis and the subsequent global recession have impressively shown how delicate and fragile the current financial system actually is and how important its soundness is for keeping the real economy running. However, while so much attention is paid to changes in the regulatory environment and their consequences for banks, one must not forget, that the stability of banks is also related to "soft factors" that are typically only partly addressed by regulators.

To be well prepared to address Responsible Finance, banks have to increase their resource allocation

**Outlook: Positive**

We continue with discussing the key issue of **Responsible Finance (see p. 44)**. For the coming years we expect the topic to further gain traction in the banking industry. International standards such as the UN PRI, the UNEP FI, and the Equator Principles are increasingly recognised as common practice and will lead the way Responsible Finance is understood and practised. To be well prepared, however, banks have to increase their resource allocation devoted to Responsible Finance in order to enhance prevailing models and standards and to set the scene for new innovative strategies and products.

General trust in banks has been hit, while customer loyalty has remained at a surprisingly high level

**Outlook: Positive**

The key issue **Financial Product Governance (see p. 58)** looks at how banks manage their responsibilities vis-à-vis their clients. The track record of the industry in recent years undoubtedly has been poor. General trust in banks has been hit accordingly, while customer loyalty has remained at a surprisingly high level. Regulatory changes are directed towards consumer protection via increased transparency and better communication.

Is the loss of trust and reputation increasingly biting into the pool of talent available for the industry?

**Outlook: Negative**

The management of **Human Capital (see p. 65)** is key for a bank's profitability and long-term survival in an extremely competitive environment. The way talent is selected and employees are treated, educated, and incentivised, is a major determinant for how a bank generates its business and profits. Is the loss of trust and reputation increasingly biting into the pool of talent available for the industry?

## Business Ethics – Mind the gap

In the last three years, the financial industry has been faced with multiple ethical controversies that have raised significant legal and reputational costs for many banks. Banks responded by implementing disciplinary measures while strengthening ethical codes and compliance measures. The challenge for the industry is a broader one, however, since the issue is not only about misconduct of individuals, but is also rooted more deeply in the system itself. It is the bank as an organisation that is setting the incentives for its employees within a competitive market environment. Hence, the effectiveness of stronger policies and compliance measures has its limits. The litmus test for any bank is whether it is prepared to forego lucrative business opportunities if these do not comply with ethical standards or if they entail incentive structures that provoke misconduct.

## High exposure of the banking industry – Trust is key

The functioning of our economy and of businesses is based on trust and confidence. If trust in the financial system and among its players is lacking, the economic engine very quickly begins to stutter as the corporate world as well as private households start to adopt a wait-and-see attitude. Hence, the issue of Business Ethics goes far beyond the question of impact on the reputation of a bank, on customer relationships and/or legal risks that go along with non-compliant behaviours.

The direct as well as the indirect costs (e.g., adjustment of business models due to regulatory requirements) can certainly be significant and can call the survival of an institution into question. However, more important from a sustainability perspective is the fact that the external (i.e., social) costs of ethical failure can be enormous, as the example of the financial crisis has shown.

### Areas of Sustainability Impact

	Areas of Sustainability Impact													
Key ESG Issue	GHG Levels	Air Quality	Land	Water Quality	Water Availability	Biodiversity	Animal Welfare	Local Communities	Customers	Employee Health & Safety	Labour Rights & Conditions	Contractors & Supply Chain	Human Rights	Society
Business Ethics									Major Impact					Major Impact

no major impact
  major impact
  severe impact

Source: Sustainalytics

Trust is probably the most important capital of a financial institution

Main potential impacts to be felt at the 'Customer' and the 'Societal' levels

The cost of ethical failures have to be borne by many stakeholders of a bank and by society at large

The ramifications have to be borne by the shareholders of a bank via reduced returns on equity and an accordingly weaker share price performance; the customers who lose invested money directly or have to pay higher prices as a consequence of tighter regulation; the tax payers who have to bail out failed institutions and last but not least by society at large which has to digest higher rates of bankruptcies and unemployment (just to name a few of the impacts).

Sustainability Impact and Business Impact are more closely correlated than in any other sector

In probably no other sector is the link between Sustainability Impact, which is defined as the impact of a company on its stakeholders, and Business Impact, which is defined as the impact of an issue on a company, as close as it is in the banking sector. This is due to the overall systemic relevance of the sector to the economy at large and the well-being of all its actors. Thus, policy makers are forced to set a regulatory framework that minimises societal costs in the case of failure. Their inclination to do this properly, of course, changes over time and is conditional on the industry’s recent track record. As the regulatory pendulum is swinging back and forth, changing from under- to overregulation, policy makers are again leaning toward the latter, especially after crisis situations like the one experienced of late.

External costs due to unethical behaviours are internalised via tighter regulation

The consequence: External costs produced by unethical behaviours are likely to be reflected in much tighter regulations with high direct and indirect costs for the banks. These linkages appear in the main impact areas we have identified, finally leading to the very high exposure score of the banking sector in general. On top of this it is clear that conditional on the specific business model (e.g., investment banking in general, commodity trading, etc.), an individual bank’s exposure to the issue might be leveraged additionally (i.e., the respective beta factor would be larger than one).

**Areas of Business Impact**

Broad range of potentially severe business impact

	Areas of Business Impact							
Key ESG Issue	Regulatory Environment	Litigation Risks	Reputation Risks	Client Demand	Asset Risks	Operational Risks	Employee Motivation	Hiring Capability
Business Ethics	Major Impact	Major Impact	Major Impact	Major Impact	Major Impact	Major Impact	Major Impact	Major Impact

no major impact
  major impact
  severe impact

Source: Sustainalytics

**ESG Performance**

The focus is on policies and compliance programmes on the one hand and the track record of controversial events on the other hand

No doubt, the exposure of the banking sector to Business Ethics issues is high. There is a strong consensus about this within the industry and beyond. There is much less agreement, however, on whether banks have managed this exposure appropriately. Banking executives and senior staff have certainly paid some lip service to cultural changes in their institutions. Policies, compliance measures, and operational risk management have been strengthened. However, whether these changes yield the desired results remains to be seen. The fact of the matter is that legacy risks are still overshadowing many banks’ efforts and that the negative news-flow will continue for some time.

Our assessment has two main pillars: (1) Policies and programmes, and (2) Track record of controversies

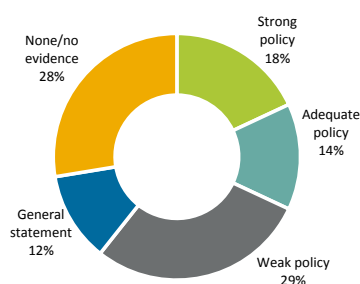
Our assessment of the performance of the industry rests on two main pillars: **(1)** An evaluation of the preparedness of companies within the sector to manage Business Ethics-related challenges. The indicators that have been selected to measure this dimension are policy and programme related ones. The weight of these indicators add up to one-third of our overall Business Ethics assessment.

(2) An assessment of the performance in the narrower sense as it is reflected by companies' track records in the field of Business Ethics-related controversies (two-thirds of our assessment).

## Policies & Programmes

The code of ethics is one cornerstone of a bank's management approach to Business Ethics. Strong codes of ethics should explicitly state a company's requirements on ethical issues that have the most relevance to a bank, such as bribery and corruption, conflict of interest, money laundering, fair dealing, and insider trading, among others. While most banks disclose some form of ethical policy, relevant themes are not always adequately addressed. For example, 144 of 366 banks do not disclose an (anti-) bribery and corruption policy (answer categories "No evidence" or "General statement"). Conversely, 117 have either instituted strong policies (66) by providing nuanced examples of commonplace situations and explicitly referring to international standards, or at least adequate policies (51).

Bribery & Corruption Policy



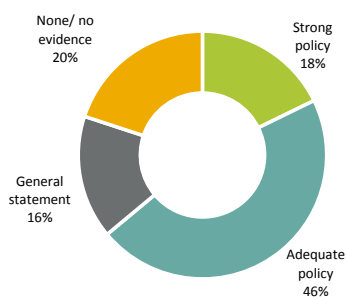
## Business Ethics – Related indicators

Related Indicators	Dimen- sion	Key indicator	# companies with ... score			Weight in issue
			high	medium	low	
G.1.1 Bribery & Corruption Policy	Prep		117	105	144	6%
G.1.2 Whistleblower Programmes	Prep		37	211	118	11%
G.1.4.1 Money Laundering Policy	Prep		65	228	73	17%
G.1.5 Business Ethics Incidents*	QualP	●	308	35	23	67%

\* high: No controversies or level 1 controversies; medium: Level 2 controversies; low: Level 3-5 controversies

Source: Sustainalytics

Money Laundering Policy



With regard to Whistleblower Programmes, which have a weight of 11% in the overall Business Ethics assessment, companies with a low score (118 or 32%) clearly outnumber those with a high score (37 or 10%). This is an obvious weak spot when looking at the banking industry's preparedness to manage Business Ethics-related cases. Examples of banks with the most significant need to catch up include a large number of banks in BRICS countries and other Emerging Markets as well as smaller banks in Developed Markets.

While addressing money laundering has become an integral part of compliance programmes in most developed countries, only 64% of companies in the sector disclose adequate or strong policies. Such policies follow requirements by the Financial Action Task Force as well as national regulations that have become global benchmarks. However, the fact that a bank has a strong policy does not necessarily imply a low rate of reported money laundering violations, as demonstrated by **HSBC** (see below).

### Controversies - Overview

23 companies within the industry are involved in significant controversies

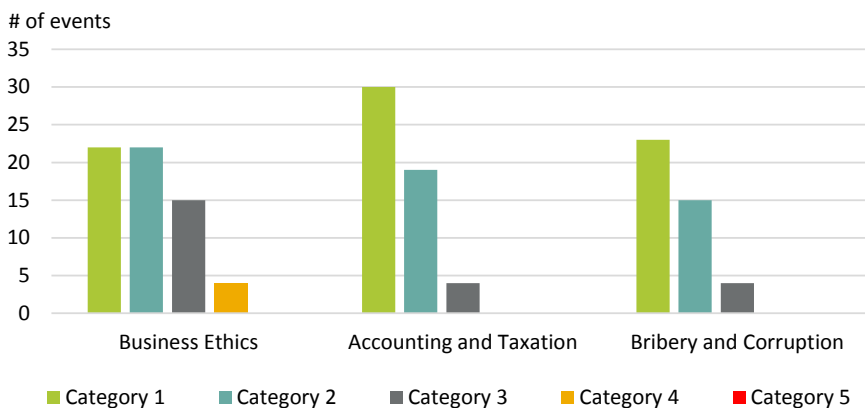
Of the 366 companies in the industry group, 23 had significant Business Ethics-related controversies (Category 3 to 5) over a three-year period. The majority of these companies are global banks with complex operations. The most notable controversies in these category levels include the manipulation of key interest rates, including the London Interbank Offered Rate (Libor), as well as commodity price manipulation, money laundering, tax evasion, conflict of interest, and corruption.

The Libor manipulation controversy was the single most serious ethical allegation that affected the industry in the last three years

The Libor manipulation controversy was the single most serious ethical allegation that affected the industry in the last three years. Relative to the size of the industry, the controversy affected a few players, yet the reputational impact was industry wide. By the end of FY2013, the highest fine was paid by **UBS** (USD 1.5bn), and there are indications that future penalties will be around this figure or higher.

While the actual impact of the attempted manipulation is yet undetermined, regulators believe that it may have skewed the valuation of approximately USD 800trn worth of financial products and services, from mortgage loans and credit card debt, to pension fund returns, illustrating the far-reaching impact of systematic ethical violations in the industry.

#### Business Ethics - Related controversies



Source: Sustainalytics

Controversial issues in Emerging Markets – global banks under increased scrutiny

Additionally, a number of international banks are also increasingly facing scrutiny for their operations in emerging markets. **Goldman Sachs** is under investigation for its dealings with the Libyan Investment Authority, while **JPMorgan Chase** is gaining notoriety for the alleged recruitment of Chinese employees with links to the Chinese Communist Party. These allegations have the potential to erupt into full blown regulator investigations and may also involve other global banks. Also of note are the frequent and recurring bribery and corruption cases among Indian banks.

Credit Suisse agreed to pay record fine of USD 2.8bn to avoid revocation of its banking license in the U.S.

Tighter regulations on tax evasion are changing the face of offshore banking and are threatening the Swiss banking model. **UBS** already paid a fine of USD 780m to U.S. authorities in 2010. This was only recently topped by **Credit Suisse** paying a record sum of USD 2.8bn and pleading guilty to avoid the risk of revocation of its U.S. banking license. One of the triggers of the agreement was a Senate report published in February 2014 that described in detail how Credit Suisse aided its clients' tax evasion and arrived at the conclusion that this type of misconduct seems to be deeply rooted in the culture of the bank.

Large parts of the industry do not have significant Business Ethics-related controversies – this result is strongly correlated with the size of the institutions

Eighty-six companies in our industry universe (23%) were involved in controversies of a low to moderate level (Category 1 & 2), which means that a relatively small number of stakeholders was affected by them and that related business risks are rather small. Two hundred and fifty-seven companies (70%) did not have any relevant Business Ethics-related controversies. This figure may be attributed to a number of factors, most notably size. The majority of the banks without relevant ethical controversies are smaller institutions with regional operations, limiting their exposure to situations that pose ethical dilemmas.

One example of this size effect is seen in money laundering. Large banks with a global reach tend to appeal to those attempting to conceal illegal money in various investments, while a local bank with limited operations is less appealing because frequent deposits of large amounts of money would immediately trigger suspicion.

4

#### Category 4 – High

Credit Suisse Group  
Deutsche Bank  
HSBC  
UBS

#### Most severe controversies

**HSBC's** anti-money laundering violation is one of the most severe controversies recorded in the industry in the last three years. In December 2012, the bank agreed to pay a USD 1.9bn fine (USD 1.25bn forfeiture and USD 665m in civil penalties) to settle a multi-year probe regarding money laundering allegations by U.S. prosecutors. The bank was accused of allowing Latin American drug cartels to launder billions of dollars. The allegations reflected a recurring pattern of violations that was uncorrected despite repeated regulator warnings. This case illustrated the challenge of implementing strong policies across a global and highly complex company.

Strong contrast between preparedness and performance

With a network of over 6,300 offices in 75 jurisdictions, **HSBC** is particularly attractive to those intending to move money across borders. The company continues to face money laundering risks despite having strong policies and sizeable investments aimed at improving compliance. In January 2014, the Office of the Comptroller of the Currency (OCC) reported that it has found continued weaknesses in the way HSBC Holdings tries to prevent money laundering. In particular it criticised the bank's controls of its transaction process business. The bank has responded that it is working to implement global consistent controls and has hired experienced executives to improve compliance.

Huge spread between best and worst performing companies

Deutsche Bank and Credit Suisse are at the bottom of the spectrum

## Leaders & laggards – Non-listed banks stand out

The spread between best and worst performing companies with respect to the key issue of Business Ethics is huge. Looking at listed banks only, **SEB** from Sweden as well as **Bank Handlowy** from Poland have a Business Ethics score of 100. They are at a level playing field with non-listed development banks like **LfA** from Germany or the **Inter-American Development Bank** from the U.S. and the **IBRD - World Bank**. A score of 100 means that these banks have shown no weak spots, neither in terms of being prepared to manage Business Ethics-related challenges, nor in terms of track record (i.e., involvement in Business Ethics-related controversies). At the bottom of the spectrum are **Deutsche Bank** and **Credit Suisse** with a Business Ethics score of just 30, resulting from their involvement in a large number of significant controversies (related to money laundering, insider trading, market manipulation, insufficient due diligence and fraud).

### Leaders & laggards Business Ethics (BE)

Leaders	Country	MCap (USD m)	Score: BE	Overall
Bank Handlowy W Warszawie SA	Poland	5,275	100.0	65.8
Inter-American Development Bank	United States	n.a.	100.0	77.7
IBRD - World Bank	United States	n.a.	100.0	75.3
LfA Forderbank Bayern	Germany	n.a.	100.0	60.4
Skandinaviska Enskilda Banken AB	Sweden	30,294	100.0	83.6
National Australia Bank Limited	Australia	71,817	99.3	83.7
Laggards	Country	MCap (USD m)	Score: BE	Overall
Credit Suisse Group	Switzerland	48,750	30.0	66.6
Deutsche Bank AG	Germany	41,079	30.0	62.0
HSBC Holdings plc	United Kingdom	197,477	36.9	60.9
UBS AG	Switzerland	75,734	39.7	70.2
State Bank of India	India	34,548	41.7	42.8

Source: Sustainalytics



Outlook  
neutral

## High risks are here to stay ... regardless of reforms

Over the next two years, we anticipate an unchanged level of controversial Business Ethics-related events in the industry. First of all, it will take time for internal reforms to show material returns in terms of a reduction in further breaches and new lawsuits. Moreover, new regulations are likely to become operational and integrated, arming regulators with stronger enforcement powers. Parallel to continuing legal risks, compliance costs will continue to rise. Meanwhile, media's attention on new ethical breaches will not alleviate public distrust in the industry. Reputational risks are likely to continue even as the industry implements reforms.

The litmus test will be whether the banking industry will be able to consistently and steadily reduce ethical misconduct over time

Nevertheless, leading banks are using their controversies to strengthen ethical programmes and risk management systems, setting the stage for stronger compliance in the industry overall. Banks are likely to use various indicators to measure progress in this respect. However, the one and only true measure of success is a consistent and steady reduction in ethical misconduct over time. Whether this is going to happen remains to be seen. We will continue to keep a close eye on further developments.

## Resilience – Finding the right balance

The recent financial crisis and the subsequent global recession have impressively exposed the fragility of the global financial and shown how important its soundness is for keeping the real economy running. The failure of just a few players can push the financial system to its limits and force taxpayers to provide billions of dollars to rescue institutions deemed to be “too big to fail”. Ironically, those who instigated the crisis through misguided behaviours and/or inappropriate risk management are the same ones that ultimately had to be bailed out. Hence, Resilience is an issue that is not only of key relevance for banks’ shareholders and their customers, but also for society as a whole.

### Sustainability Impact – Dealing with systemic risk

Early action required to avoid spill-overs

From an ESG perspective, Resilience is all about the ability of financial institutions to withstand negative shocks arising in their economic environment. Due to the tight interconnectedness of the financial system and the real economy, the disease of even a single financial institution must be taken seriously and cured immediately before it spreads to other institutions – and major parts of the real economy – ultimately causing a global pandemic.

Size does matter

Perhaps the most ground-breaking lesson learned from the recent financial crisis is that (bank) size does matter. While successfully conducting their business, merging with other institutions and following aggressive growth strategies, a series of banks managed to clandestinely increase their asset base to a level that made them “too big to fail”. Having this status puts banks in a unique position in which governments, and ultimately the taxpayers, step in as lenders of last resort to protect the institutions from perishing.

Externally enforced stability of the system comes at a high price

Especially after the devastating experience with Lehman Brothers in 2008, governments are most reluctant to let important banks default, in order to maintain the necessary trust in the system and consequently minimise the risk of bank-runs, client-capital losses, and the spill over of a financial crisis to the real economy. Such externally enforced stability, however, comes at a high price: The banks concerned benefit from an implicit state guarantee promoting an increased risk appetite and eventually leading to a system in which profits are privatised (i.e., kept for themselves) and losses are socialised (i.e., have to be covered by tax-payers).

#### Areas of Sustainability Impact

	Areas of Sustainability Impact													
Key ESG Issue	GHG Levels	Air Quality	Land	Water Quality	Water Availability	Biodiversity	Animal Welfare	Local Communities	Customers	Employee Health & Safety	Labour Rights & Conditions	Contractors & Supply Chain	Human Rights	Society
Resilience									Major Impact					Severe Impact

no major impact
  major impact
  severe impact

Source: Sustainalytics



### Business Impact – Regulatory changes as the main catalyst

Tougher regulation – Adapted business models?

To counteract these risks and to ensure that financial losses are borne by shareholders and bondholders going forward, governments and regulators have increasingly stepped in, putting Resilience at the top of their agendas. However, designing appropriate regulatory measures is a complex undertaking and their implementation is anything but simple and straightforward. Regulators have to simultaneously create the right incentives (e.g., reduce moral hazard induced by the “too big to fail” situation), ensure global financial stability, and keep the economic engine running, while taking the interconnectedness of these different targets into consideration.

Multitude of regulatory initiatives – significantly increased requirements for systemically important banks

The result of this complexity is a multitude of regulatory requirements with significant and widespread implications for financial institutions in general, and so-called systemically important banks (SIBs) in particular. For the latter, the requirements regarding capital, liquidity, and risk management have been tightened considerably, both for global SIBs and national SIBs. Furthermore, recent regulatory initiatives attach greater importance to recurring control measures, such as stress tests and so-called “living wills” – the latter representing resolution plans to enable winding-ups without bailouts.

Adaptation of business models may pave the ground for new, currently underestimated risks

Not surprisingly, banks for their part, have responded to the changed regulatory environment with an adaptation of their business strategies, seeking to optimise the emerging risk/return trade off, while simultaneously satisfying the diverging interests of their major stakeholders (regulators, customers, and investors). This adaptation, on the other hand, has resulted in new playing fields, with unknown business and economic risks (e.g., correlated moves towards lending to small and medium-sized enterprises).

#### Areas of Business Impact

Key ESG Issue	Areas of Business Impact							
	Regulatory Environment	Litigation Risks	Reputation Risks	Client Demand	Asset Risks	Operational Risks	Employee Motivation	Hiring Capability
Resilience	no major impact	major impact	major impact	major impact	major impact	major impact	major impact	major impact

no major impact    major impact    severe impact

Source: Sustainalytics

### Controversies – Focus is on risk management

The risk management and control systems are one key element

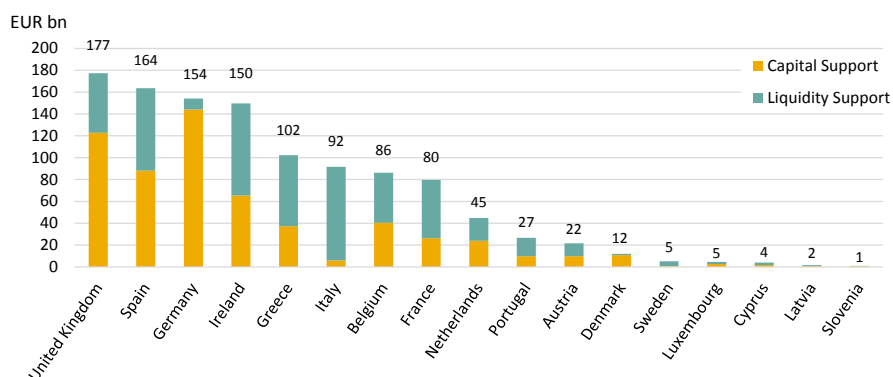
In order to assess banks’ quality of management with respect to Resilience we take a look at their track record of controversial events that are related to this key ESG issue. The most notable ones are associated with weak corporate governance structures, resulting in inappropriate risk management and control systems. In this context an important aspect is, of course, the bailouts in the wake of the financial crisis themselves. In the U.S. alone, 940 institutions received governmental support amounting to USD 611bn, financed by tax-payers’ dollars.

While the situation in the U.S. has cooled down, and 41% of the subsidies have already been returned, in Europe the situation is still characterised by severe vulnerabilities. Recent examples include the USD 5.3bn bailout of the Italian **Banca Monte dei Paschi di Siena** and the Slovenian banking crisis, which devoured USD 6.6bn.

More than USD 6trn in state aid approved by the European Union

In the period between 1 October 2008 and 1 October 2011, the European Union approved more than USD 6trn in state aid (USD 1.2trn capital support and USD 3.8trn liquidity support), of which approximately one-third has already been used.

**European Union – State aid used by member country (2008 – 2012)**



Source: European Commission

Most expensive bailouts

Among the recipients of the most expensive bailouts, one can find names such as **Allied Irish Banks** (USD 20bn), **Banca Monte dei Paschi di Siena** (USD 5.3bn), **Bank of America** (46.4bn), **Bankia** (USD 29.4bn), **Hypo Alpe-Adria-Bank International** (USD 4.8bn), **IKB** (USD 12.5bn), **ING Bank** (USD 13.77bn), **Lloyds** (USD 28.84bn), **Royal Bank of Scotland** (USD 76.2bn), **SNS Reaal** (USD 14bn), **Hypo Real Estate** (USD 50bn), **Commerzbank** (USD 23.4bn), and **Dexia** (USD 14.5bn).

**4**

**Category 4 – High**

- Banca Monte dei Paschi
- Bankia
- Dexia

**Most severe controversies**

The importance of Resilience in the banking sector can best be understood when looking at recent cases that shook the financial system. Most noteworthy are the cases of **Banca Monte dei Paschi**, **Bankia**, and **Dexia**. All three banks experienced significant financial problems and had to be bailed out by their respective governments, in order to prevent bankruptcy and mitigate potential negative effects on the overall financial system.

Dexia case stands out regarding severity and societal impact

The case of Dexia is especially outstanding because of its severity and societal impact. Once Belgium’s largest bank by assets and the world’s biggest lender to municipalities, Dexia is currently under “orderly resolution”. As one of the most severely hit casualties of the financial crisis, Dexia had to be bailed out three times. In 2008, the company received a bailout of EUR 3bn each from France and Belgium, and EUR 376m from Luxembourg. A second bailout followed in 2011, resulting from the European sovereign debt crisis.

The picture gets even more impressive, when numbers are compared to the respective GDPs

Continuing problems led to a third bailout in December 2012, when Belgium and France agreed to recapitalise Dexia with EUR 5.5bn and a funding guarantee of EUR 85bn. The guarantee allocated 51% (i.e., a maximum of EUR 43.7bn) for the Belgian State, 46% (i.e., a maximum of EUR 38.75bn) for the French State and 3% (i.e., a maximum of EUR 2.55bn) for the Luxembourg State. The picture gets even more impressive, when these numbers are compared to the respective Gross Domestic Products (GDPs). Doing so reveals that Belgium guarantees with 9% of its GDP, Luxembourg with 5.7% and France with 1.4%.

Examples of resilient banks do exist – sometimes obviously supported by national regulatory environments

## Best Practice – Conservative business models & strict regulation: The formula for more resilience?

While the number of banks that sought refuge under governmental rescue umbrellas is remarkable, there are several market players that weathered the financial crisis without direct external assistance. **Barclays**, **Credit Suisse**, **HSBC**, and **Standard Chartered** are only a few examples of banks that proved to have sufficiently robust business models and risk management systems to survive under conditions of severe financial distress. Furthermore, it is notable that there were no such bailouts in either Australia or Canada. Both countries are touted to have stricter regulation standards and more conservative business models than their U.S. and European counterparts.



Outlook  
neutral

## Regulatory pressure will remain high

Looking ahead, we expect that Resilience will remain a major issue in the coming years. Globally, regulation will continue to be a key driver for improving the resilience of the banking sector. The international voluntary standards set out by the Basel Committee on Banking Supervision (Basel III) are scheduled to be gradually implemented into national laws by 2019.

Regulatory pipeline is well filled

Recent signs in the market suggest that this implementation process is likely to result in even stricter national requirements, especially for banks that are considered systemically important. Furthermore, governments around the world are anxious to increase best practice standards and develop additional measures, such as the Comprehensive Capital Analysis and Review and the Dodd-Frank Act stress tests by the Federal Reserve or the Comprehensive Assessment by the European Banking Authority and the European Central Bank. Finally, one can notice an increased effort of regulatory authorities to include the widely unregulated shadow banking system under their supervision.

Don't forget the "soft factors" that have an impact on resilience and cannot easily be regulated

While so much attention is paid to changes in the regulatory environment and their consequences for banks, one must not forget, that the stability of banks is also related to "soft factors", which are typically only partially addressed by regulators (e.g., the mentality of bankers and the systemic risks that are created by misguided behaviours). This issue is discussed in more detail in the section addressing the key issue Human Capital.

## Responsible Finance – Acknowledging stewardship

**Banks are implicated in all kinds of business activities with all kinds of sustainability impacts – though often indirectly. They have the power to help shape the way business is done and economies work, including the consideration of environmental and social impacts. But how do banks deal with the special responsibility accruing from this role? This is the central question that underlies the key issue of Responsible Finance. We have defined it as an umbrella term for all practices and strategies employed by banks involving the integration of environmental, social and governance (ESG) criteria and metrics into financial lending and investment decision making. Responsible Finance is all about the integration of ESG into the core business of banks, which makes it particularly interesting from an investor perspective.**

### Exposure – Potential impact is pervasive

Banks as enablers of innovation, growth, and prosperity

Banks are the (cold) heart of all modern economies – they pump financial means like blood through the system, empowering innovation, economic growth and prosperity. In today’s reality, there are different types of institutions with different roles and different impacts. Investment banks provide the funding of the majority of new business ventures, while commercial banks enable individuals and businesses to set up and expand operations. Development banks and global institutions like the World Bank provide funding for various economic endeavours around the world. However, the role of financial institutions often goes beyond their original function as intermediaries. In Japan, for example, they still own major stakes in industrial corporations, resulting in criticism from a Corporate Governance perspective and seen as an obstacle to returning the country to a scenario of economic growth.

Increasing concerns about how banks fulfil their original purpose

Although the core function of banks as enablers of economic growth and prosperity remains undisputed, civil society, particularly in the developed world, are increasingly concerned about how they fulfil this purpose. More and more voices have expressed the need for a more “moral capitalism” that is in line with social and environmental considerations. Banks’ involvement in financing businesses and projects that excessively harm the environment, undermine human rights, and/or are linked to severe negative impact on local communities, have been heavily criticised by civil society groups calling for a comprehensive stewardship commitment.

Distinguishing between direct and indirect impacts

### Areas of Sustainability Impact

Key ESG Issue	Areas of Sustainability Impact													
	GHG Levels	Air Quality	Land	Water Quality	Water Availability	Biodiversity	Animal Welfare	Local Communities	Customers	Employee Health & Safety	Labour Rights & Conditions	Contractors & Supply Chain	Human Rights	Society
Responsible Finance	###	###	###	###	###	###	###	###	###	###	###	###	###	###

no major impact
  major impact
  severe impact
 ### mostly indirect impact

Source: Sustainalytics

Although in all these cases, financial institutions are not directly impacting the environment and/or society, they have the power to do so indirectly via their influence on the businesses they finance.

ESG factors as a part of the due diligence process for lending and investment decision making

### Taking ESG into account – A risk management perspective

Financial institutions increasingly consider environmental and social factors in their lending and investment due diligence process to avoid financing activities that have an unacceptable high negative impact on the environment or on society. In our “Spotlight” on syndicated loan transactions included in this note, we looked at structures and patterns in this market and found indications for a possible lack of sensitivity vis-à-vis ESG issues from some institutions. One specific area of interest is project finance, in which lead managers can play a particularly decisive role. But also in everyday lending and investment, financial institutions are able to set standards, influence borrowers or withdraw from funding. This not only reduces a bank’s credit or investment risk, as a borrower’s inability to manage severe environmental and social issues may also affect its ability to repay its funding, it also reduces the banks reputational risk. **Deutsche Bank**, for example, just recently withdrew from funding a coal harbour in Australia (Abbot Point expansion), located close to the ecologically sensitive Great Barrier Reef.

Positive contribution to development goals

### Promoting sustainable development

The topic of Responsible Finance is not only about managing risk, it’s also about enabling sustainable opportunities. The banking sector and capital markets in general are pivotal elements in the “big plan” to achieve sustainable development. The EU’s climate and energy goals, for example, are estimated to require investments of around 1.5% of GDP per year. It seems clear that the financing of operations of this size has to be carefully managed and spread among a variety of investors. This is where the banking sector becomes actively engaged, taking on the role of a project manager – either acting as an intermediary between borrowers and potential lenders or stepping in with its own resources.

*“The financial sector has the capacity to close the funding gap for sustainable development and support the transition to a green economy.”*

Achim Steiner, UNEP FI (2013)

By setting the right incentives through sustainable Credit & Loan Standards and offering dedicated Sustainable Financial Services – products and services that encourage funding of activities aligned to sustainable development goals – the financial sector is ideally positioned to act as a multiplier for responsible business practices and sustainable development.

Sustainable development goals as a driver for the project finance market

However, sustainable development goals are just one driver for the international project finance market. Naturally, the demand for funding infrastructure in developing countries is immense. But also in the developed world, rising energy demands, demographic change resulting in an increasing need for social infrastructure, and repair-prone transportation infrastructure is feeding the market. S&P estimates that global annual demand is USD 500bn whereas current funding just covers about USD 200bn annually.

Active players in the market, however, face several kinds of risks. For example, there is the political and regulatory environment, which is prone to changes – as seen in the case of renewable energy incentives (e.g., feed-in tariffs). Thus banks have to closely watch the developments here. Also civil society groups are tracking banks’ involvement in controversial projects and tend to pillory the ones they see as involved. Setting meaningful standards to shape these kind of projects in a more sustainable and “fair” way will help to reduce reputational risks.

### Enhancing access to finance for the underserved

Striving for an inclusive financial system

Financial institutions are also expected to be active players in the provision of broad access to financial products and services to the general public, including disadvantaged and low income segments. Globally, it is estimated that every second person does not have access to any formal or semi-formal financial services and that over 2.5bn adults are unbanked. The majority of the people concerned live in Africa, Asia, Latin America and the Middle East. The issue was even added to the list of core responsibilities of the financial sector at the World Economic Forum 2012, when world leaders articulated their expectations vis-à-vis the financial sector. The rationale behind this is that an inclusive financial system can help to reduce income inequalities and enhance economic growth, especially (but not only) in low-income communities. The most common forms of inclusive finance are micro-finance, including micro-insurance and micro-credit, as well as easy access to certain types of consumer loans, such as payday loans.

### Strong growth of Impact Investing

Most popular topics are micro-finance, energy, housing, food and agriculture, and healthcare

Impact investments can be seen as a special type of sustainable financial product that addresses a small but growing niche of investors that value both adequate financial returns as well as direct environmental and/or social impacts. Based on a survey of 125 investors, JPMorgan estimates that in 2014, impact investments will increase by 20% yoy, bringing the industry an additional USD 12.7bn of fresh capital. Total AuM are estimated to hit the USD 4bn mark, whereas about 70% of this capital is invested in emerging markets. The most popular themes among impact investors are micro-finance and other financial services (21% each), energy (11%), housing (8%), food and agriculture (8%), and healthcare (6%). The most dominant asset class is private debt (44%), followed by private equity (24%).

### Areas of Business Impact

	Areas of Business Impact							
Key ESG Issue	Regulatory Environment	Litigation Risks	Reputation Risks	Client Demand	Asset Risks	Operational Risks	Employee Motivation	Hiring Capability
Responsible Finance	Major Impact	Major Impact	Major Impact	Major Impact	Major Impact	No Major Impact	Major Impact	Major Impact

no major impact
  major impact
  severe impact

Source: Sustainalytics

Business risks for impact investors include reputational and legal risks

On the business impact side, impact investments are comparable to venture capital or high yield debt investments, with respect to heightened reputational and legal risks. This is especially the case in emerging markets, where regulatory infrastructure can be onerous and the rule of law is less well defined.

Fiduciary duty more and more understood in a broader sense

### Governance and fiduciary duty

A bank’s social responsibility is not limited to its funding operations. Its asset management activities are at least of equal importance. Institutional investors held approximately USD 64trn in assets globally in 2012 and are estimated to reach USD 100trn by 2020 according to PwC. The debate around a proper interpretation of fiduciary duty impeded a broader application of Responsible Investment considerations for many years and still does. After the ground-breaking “Freshfields Report” in 2005, however, attitudes towards the integration of ESG factors have begun to change. Fiduciary duty is now more and more understood in a broader sense, i.e., it is not limited to the notion of short-term financial return maximisation anymore. One of the main drivers behind this change is the insight that ESG factors can be material, especially over the longer run and from a universal owner perspective.

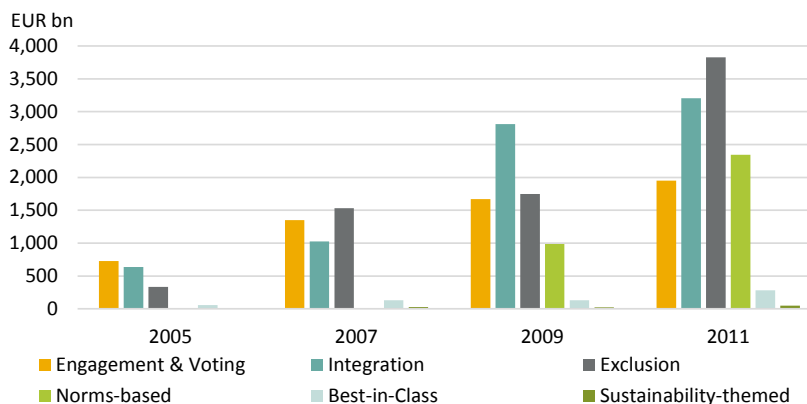
Responsible Investment products as an answer to deal with changed investor expectations

### Responsible Investment

An increasing number of banks are well aware of this broadened understanding of investor interests and serve the rising demand for sustainability by offering a broad range of Responsible Investment (RI) products. These products include all forms of assets, though bond and equity investments still represent the vast majority. For the European market, Eurosif, for example, estimated that in 2011 bonds constituted 51% of RI, equities achieved a share of 33%, money market instruments covered 7% and the remaining 9% were invested in other assets classes. Investment strategies surveyed range from “Norms-based” screening and exclusion of certain holdings to “Sustainability-themed” investments, “Best-in-Class” investments and “Integration” of ESG criteria in financial analysis to “Engagement & Voting” and “Impact Investment” (with the latter not included in the total market size estimate).

“Norms-based” screening was the most strongly growing RI approach

### European RI market development



Source: European SRI Study 2012, Eurosif

The regulatory environment has become a more important driver for the Responsible Investment market

One striking result of the Eurosif survey is that the significance of legislation as a driver of market growth has increased. While in the previous study the topic was ranked fifth, regulation was voted as the second most important factor in the most recent survey. We suspect that this shift is likely related to recent efforts by regulators to tighten regulations on investment activities in general, and to reduce market volatilities caused by short-sighted behaviour in particular.

The “Dutch Market Abuse Decree” is an example recent regulatory intervention

A recent example of stricter regulation is the “Dutch Market Abuse Decree”, which entered into force in January 2013 and prohibits Dutch financial institutions from investing in companies that produce, sell or distribute cluster munitions. Consequently, investment managers that had not reacted with foresight to the debate that started in the Netherlands years before and had not adjusted their investment policies accordingly, were forced to withdraw from related investments.

How well do banks manage their exposure?

### ESG Performance – Moving up the learning curve

The exposure of the sector with respect to Responsible Finance is quite broad, touching more or less every area of impact (though in most cases indirectly), banks’ range of options for action is correspondingly wide. As outlined above, Responsible Finance is an umbrella term for all practices and strategies employed by financial institutions involving the integration of ESG criteria and metrics into financial lending and investment decision making. The assessment is again done according to our four dimensions. Disclosure and Preparedness indicators, examining policies and programmes as well as the company’s transparency, account for 50% of the Responsible Finance rating. The other 50% is equally distributed to Quantitative Performance indicators and Qualitative Performance indicators.

Evaluating the performance of banks in five sub-categories

To evaluate a bank’s performance, we look at five sub-categories that are separately assessed and then summed up to one Responsible Finance rating:

- **Responsible Finance (general):** Refers to all related overarching activities that cannot be assigned explicitly to either lending or investment activities, and demonstrate a bank’s general understanding and recognition of the broader issue. Here, we consider companies’ membership in initiatives like UNEP FI, general activities in sensitive countries like Sudan, and all lending and/or investing related incidents reported in the media that relate to the adverse impacts of banks’ activities on society, communities and/or the environment. The weight of these indicators within Responsible Finance sums up to 32%.
- **Responsible Lending:** Refers to the practice of retail lenders and corporate financiers applying environmental, and/or social criteria to their lending decisions, with special emphasis on project finance. Here, we ask whether, and to what extent, a company has incorporated ESG criteria into its Credit & Loan Standards, and if project financiers have signed the Equator Principles (a risk management framework for determining and managing environmental and social risks in project financing) and to what extent they disclose their due diligence results. Together, these indicators account for 17% of the overall Responsible Finance rating.

Special emphasis on project finance



Integration of ESG factors by asset management arms of banks

Investing and financing projects with positive environmental and/or social impacts

Financial inclusion

- **Responsible Investing (RI):** Refers to the incorporation of environmental, social and governance (ESG) criteria into investment decision making by the asset managing arms of banks. Here, we examine the existence and extent of a Responsible Investment policy; the existence and size of a team dedicated to responsible investment; and the percentage of assets under management regarded as responsible investments. These indicators sum up to 29% within Responsible Finance.
- **Sustainable Products & Services:** Refers to the funding of dedicated businesses related to sustainable development goals (for example renewable energy). It also includes impact investment activities that intend to create a positive impact beyond financial return. Our indicator here assesses a company's initiatives or programmes to promote sustainable products and services and accounts for 11% of the overall Responsible Finance score.
- **Access to Financial Services:** Refers to providing broad access to financial products and services, including to disadvantaged and low income segments. The respective indicator assesses whether a company has a programme that promotes financial inclusion, and if yes, how strong it is. The weight within Responsible Finance is also 11%.

### Responsible Finance – Related indicators

7 Preparedness indicators, 1 Disclosure indicator, 3 Quantitative Performance indicators and 2 Qualitative Performance indicators

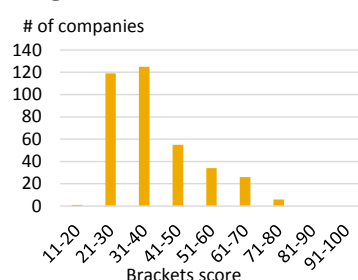
Related Indicators	Key indicator		# companies with ... score			Weight in issue
			high	medium	low	
<b>Responsible Finance (general)</b>						<b>32%</b>
G.1.3.3 UNEPFI Signatory	Prep		67	9	290	3%
S.4.1 Activities in Sensitive Countries	QuantP		357	9	0	3%
S.4.3 Society & Community Incidents*	QualP	●	259	80	27	11%
E.1.5 CDP Participation	Disc		117	12	225	1%
E.3.2 Product & Service Incidents*	QualP		275	85	6	14%
<b>Responsible Lending</b>						<b>17%</b>
G.1.3.5 Equator Principles Signatory	Prep	●	43	17	254	6%
E.3.1.10 Credit & Loan Standards	Prep	●	66	89	204	11%
<b>Responsible Investment</b>						<b>29%</b>
G.1.3.1 PRI Signatory	Prep		37	34	292	4%
G.1.3.2 Responsible Investment Policy	Prep	●	48	50	264	6%
G.2.5.1 Responsible Investment Team	Prep	●	21	50	294	8%
E.3.1.11 Responsible Asset Management	QuantP	●	25	96	241	11%
<b>Sustainable Products &amp; Services</b>						<b>11%</b>
E.3.1.15 Sustainable Financial Services	QuantP	●	11	152	62	11%
<b>Access to Financial Services</b>						<b>11%</b>
S.4.2.3 Financial Inclusion	Prep		139	92	133	11%

\* high: No controversies or level 1 controversies; medium: Level 2 controversies; low: Level 3-5 controversies

Source: Sustainalytics

Positive momentum though overall still lots of room for improvement

Distribution of Responsible Finance rating



European companies leading

## Performance overview

The topic Responsible Finance is receiving more and more attention within the industry. This is reflected in and also fueled by the news about the continued growth of the relevant market segments and the increasingly widespread participation in industry initiatives like UN PRI or UNEP FI. However, as our overall assessment of the topic reveals, there is still much room for improvement in the sector: Even the top performers score only 80 out of 100 achievable points. Besides, the median for the whole universe we have assessed is at a rather low level of 34 points (the mean is at 39) indicating that the majority of the companies do not pay much attention to this issue.

The distribution of the ratings clearly demonstrates a strong positive skewness indicating that Responsible Finance has not yet found its way into the mainstream financial community. Two-thirds of the companies assessed score below 40, which means that they are not really active in the various areas of Responsible Finance, neither in their lending business nor in asset management and investment. On the other side, only 2% of the companies assessed (six companies) score above 70, with 79 being the highest scores achieved overall. Hardly surprising, the average market cap of companies that score below 40 is significantly lower than that of the companies scoring above 40 (USD 12.4bn versus USD 39.9bn), reaffirming the large cap bias already noted in other sections of this study.

## Leaders & laggards Responsible Finance (RF)

Leaders	Country	MCap (USD m)	Score: RF	Overall
KfW	Germany	n.a.	79.0	82.3
Banco Santander (Brasil) S.A.	Brazil	26,669	76.3	79.5
DNB ASA	Norway	31,877	74.9	81.7
Westpac Banking Corporation	Australia	100,029	72.6	83.0
ING Bank N.V.	Netherlands	n.a.	72.3	74.9
Laggards	Country	MCap (USD m)	Score: RF	Overall
Dexia SA	Belgium	101	19.4	36.0
DBS Group Holdings Limited	Singapore	33,368	22.1	45.4
Mizrahi Tefahot Bank, Ltd.	Israel	3,027	22.2	41.6
Industrial and Commercial Bank of China Limited	China	203,293	23.2	50.7
AXIS Bank Limited	India	15,715	24.2	47.6
ICICI Bank Ltd.	India	29,041	24.2	45.7

Source: Sustainalytics

When looking at leading companies, the first observation is that there is a clear predominance of European institutions (14 out of the top 20 banks are European), which can be seen as a confirmation of the usual preconception. However, a comparison of the average Responsible Finance scores by region shows a slightly different picture: Australia clearly outperforms with an average score of 47, followed by Europe with 42, North America with 38 and the Rest of the World with an average score of 34. Notably, the list of the top five industry representatives includes one bank outside the Developed Markets domain (**Banco Santander Brasil**).

Strong position of development banks

Also noteworthy is the number of non-listed banks among the top performers: Six out of the top 20 companies are non-listed, with one development bank being in the group of the top five players: German **KfW**, and another three (**Nederlandse Waterschapsbank**, **Inter-American Development Bank**, and **Caisse des Depots et Consignations**) within the top 20, emphasising their function as a role model for financial institutions promoting sustainable development. For the other 14 companies in the top 20 list, market caps range between USD 10bn and USD 100bn, thus not including the biggest players in the sector, and one company coming from the lower market cap range (< USD 10bn): **Van Lanschot**.

Laggards: bias towards the Asian-Pacific region

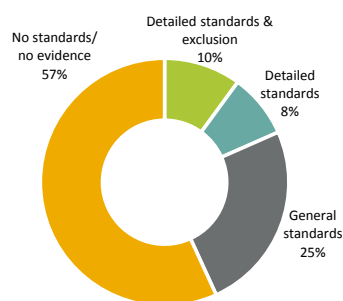
Looking at the bottom 20 companies, it is notable that 15 of these are located in the Asian-Pacific region. Most of them are smaller institutions that often lack business opportunities and resources to promote responsible finance – or just do not disclose their efforts in this domain. In the following sections, we will go through the four sub-categories: Responsible Lending, Responsible Investment, Sustainable Products & Services, and Access to Financial Services.

Best practices on lending standards include a formal environmental and social risk assessment approach

### Responsible Lending – Becoming more commonplace

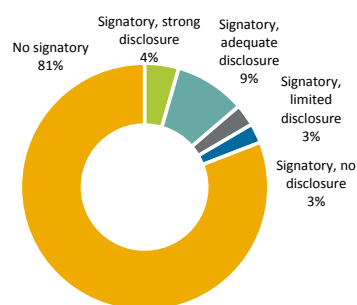
Credit and loan standards that incorporate environmental and social criteria are becoming more common, reflecting the increasing belief that ESG risks can be material. Best practices on lending standards include a formal environmental and social risk assessment approach that covers all types of transactions, from project financing to corporate loans and underwriting services, above a certain dollar threshold. Moreover, some banks conduct additional due diligence on high-risk industries such as extractives and agriculture, perform regular structured engagements with their borrowers on key sustainability risks, and require continuous reporting and disclosure of ESG-relevant developments. The top performers typically exclude certain types of activities from their lending portfolio for sustainability reasons.

#### E.3.1.10 Credit & Loan Standards



Of all banks examined with regard to this indicator, 155 (43%) have ESG lending standards in place. Thirty-six banks (10%) have strong standards that are applied to all sectors and explicitly include lending exclusions based on sustainability criteria. Though 22 of these are European, it is worth mentioning that there are also two Brazilian (**Banco Santander Brasil** and **Itau Unibanco**) and two Turkish banks (**Türkiye Garanti Bankasi** and **Türkiye Halk Bankasi**) that have strong standards. Also remarkable is the fact that 12 of the banks with strong standards are non-listed. Thirty banks (8%) have relatively strong lending standards that do not comprise exclusions. Finally, the remaining 89 banks with Credit & Loan Standards have either only general standards that apply to high-risk industries or do not disclose how specific and detailed their standards are. A majority (57%) of the companies assessed have not disclosed any standards, indicating that these companies are least prepared to mitigate ESG lending risks.

## G.1.3.5 Equator Principles signatories



Three banks have been achieving the highest possible score

The Equator Principles (EP) provide a blueprint for conducting environmental and social due diligence, particularly for project finance but also for general lending activities. Out of all banks assessed in this context, only 60 (19%) have signed the principles. Fourteen of these provide strong reporting on EP implementation, which means that they disclose the category and number of projects reviewed, as well as the projects that received independent review or exceptions, thus opening the black box of project finance. Another 48% of the signatories provide adequate reporting, usually including the category and number of projects reviewed as well as the process by which the EP are implemented. The vast majority, 81% of all banks assessed, have not signed the Principles, including a significant number of emerging market banks that are currently lending to large-scale development projects that have negative environmental and social impacts. Many non-signatories, however, are not significantly involved in project financing activities at all.

Taking into consideration both indicators that assess how well a company is prepared with regard to Responsible Lending, there are only three companies that reach the highest possible score: **Banco Santander Brasil**, **DNB ASA** from Norway and the Dutch **NIBC Holding**.

## Leaders in Responsible Lending

Company	Country	MCap (USD m)	Score: RL	Overall
Banco Santander (Brasil) S.A.	Brazil	26,669	100.0	79.5
DNB ASA	Norway	31,877	100.0	81.7
NIBC Holding N.V.	Netherlands	n.a.	100.0	64.3

Source: Sustainalytics

Biggest project finance houses tend to remain vague in their ESG disclosure

The ten institutions with the biggest market share in project finance, however, remain vague in their ESG disclosure about the deals. Though seven signed the Equator Principles, none of them delivers strong reporting, five have adequate reporting and two don't disclose on their deals. **Deutsche Bank**, **Commonwealth Bank of Australia**, and **State Bank of India** did not sign the Equator Principles at all.

## Top 10 Project Finance (PF) institutions

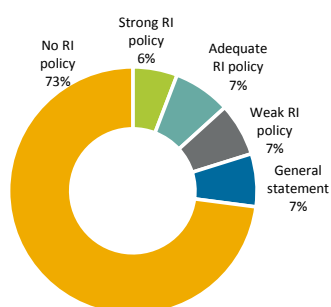
Company	Country	PF market share*	EP Signatory/ disclosure	Credit & Loan standards including ESG criteria	Controversies related to	
					Soc & Com	Env
BNP Paribas	France	7.70%	yes / adequate	detailed & exclusion	Cat. 3	Cat. 2
Credit Agricole S.A.	France	4.50%	yes / adequate	detailed & exclusion	Cat. 3	Cat. 2
Mitsubishi UFJ Financial Group, Inc.	Japan	4.50%	yes / none	no standards	Cat. 3	Cat. 2
State Bank of India	India	4.30%	no signatory	no standards	Cat. 2	Cat. 2
Mizuho Financial Group, Inc.	Japan	4.10%	yes / none	general standards	Cat. 3	Cat. 2
Sumitomo Mitsui Financial Group Inc.	Japan	3.80%	yes / adequate	detailed & exclusion	Cat. 3	Cat. 2
IDFC Limited	India	3.40%	yes/none	general standards	Cat. 0	Cat. 2
Commonwealth Bank of Australia	Australia	3.20%	no signatory	general standards	Cat. 2	Cat. 2
ING Bank N.V.	Netherlands	2.80%	yes / adequate	detailed & exclusion	Cat. 2	Cat. 2
Deutsche Bank AG	Germany	2.40%	no signatory	general standards	Cat. 3	Cat. 2
Barclays PLC	United Kingd	2.30%	yes / adequate	detailed standards	Cat. 3	Cat. 2

\* as of Q1/2014 according to Thomson Reuters

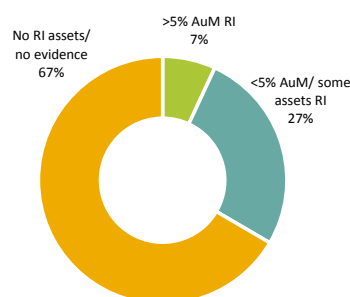
Source: Sustainalytics

Only 22 companies are considered strong in the application of responsible investment approaches

### G.1.3.2 Responsible Investment Policy



### E.3.1.11 Responsible Asset Management



European banks again in the lead

## Responsible Investing – Mainstreaming still not in sight

Despite the tremendous popularity of Responsible Investment, as reported by the various national sustainable investment forums (Eurosif, USSIF etc.), the uptake of RI in the banking industry still leaves a lot to be desired. Of all banks assessed in this context, only 71 (20%) are PRI signatories or have at least a relevant subsidiary that signed the Principles.

On a related note, only 98 banks (27%) have published some kind of Responsible Investment Policy or at least a statement referring to RI. Twenty-one (6%) live up to our highest requirements, which include the application of at least two of the following three RI strategies: Exclusion, best-in-class and engagement. Nearly all of these banks are located in Europe. Only three banks are from North America (the **Inter-American Development Bank**, the International Bank for Reconstruction & Development, known as the **World Bank**, and the **Toronto-Dominion Bank**) and one from Asia-Pacific (**Sumitomo Mitsui**). Again, the vast majority of companies (264, or 73%) do not publish any policy or statement related to Responsible Investment.

When looking at how many of the banks we assessed do actually offer RI products and how many assets under management (AuM) are classified as RI assets, the result is even more notable. Only 25 (7%) report that the share of responsible assets is more than 5% of total AuM. And again, nearly all of these institutions are from Europe, just three from North America (**Caisse central Desjardins**, **Inter-American Development Bank** and **State Street Corp.**), and one from South America (**Banco Santander Brasil**). Another 96 institutions (27%) do have less than 5% AuM dedicated to RI or do not disclose the value of their RI assets, whereas 241 banks (67%) don't provide any evidence of RI assets under management.

The above figures indicate that while a number of banks are engaged in RI, the majority of them are not PRI signatories, do not have RI policies in place and have not disclosed responsibly managed assets.

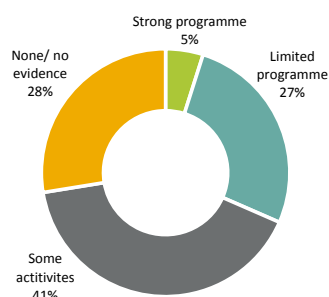
The companies that score highest with regard to Responsible Investment are all European with **Credit Agricole** from France and **UBS** from Switzerland scoring highest, followed by the German development bank **KfW**, and **Swedbank** and **SEB** from Sweden.

### Leaders in Responsible Investment (RI)

Company	Country	MCap (USD m)	Score: RI	Overall
Credit Agricole S.A.	France	40,566	96.2	71.9
UBS AG	Switzerland	75,734	96.2	70.2
KfW	Germany	n.a.	92.9	82.3
Swedbank AB	Sweden	29,303	92.9	70.7
Skandinaviska Enskilda Banken AB	Sweden	30,294	89.0	83.6

Source: Sustainalytics

## E.3.1.15 Sustainable Financial Services



Again, the high number of non-listed companies within the top performers list is notable

## Sustainable Products &amp; Services – Broad spectrum addressed

The range of the banking industry's products and services that support the notion of sustainability spans from green consumer loans, such as lower interest rates or rebates for energy efficient home retrofits, to the financing of large-scale renewable energy projects and green bonds.

Of all banks we assessed on this indicator, 163 institutions (72%) have disclosed programmes or activities to promote sustainability-related products and services, mostly in the form of clean energy financing and "green" consumer loans. While the majority of these report to have some activities, or limited programmes in place, 11 banks (5%) stand out for setting quantitative targets to expand sustainability financing commitments within a specific timeframe, five of them from the U.S., another five from Europe and one from Australia. Once again, the high number of non-listed banks that are represented in the list of top performers is remarkable (six out of 11).

## Leaders in Sustainable Products &amp; Services (SPS)

Company	Country	MCap (USD m)	Score: SPS	Overall
Bank of America Corporation	United States	163,939	100.0	59.3
Caisse des Depots et Consignations	France	n.a.	100.0	68.8
Citigroup, Inc.	United States	148,639	100.0	68.5
Co-operative Banking Group Limited	United Kingdom	n.a.	100.0	72.9
DekaBank Deutsche Girozentrale	Germany	n.a.	100.0	69.7
ING Bank N.V.	Netherlands	n.a.	100.0	74.9
IBRD - World Bank	United States	n.a.	100.0	75.3
KfW	Germany	n.a.	100.0	82.3
The Goldman Sachs Group, Inc.	United States	74,316	100.0	67.9
Wells Fargo & Company	United States	273,782	100.0	63.8
Westpac Banking Corporation	Australia	100,029	100.0	83.0

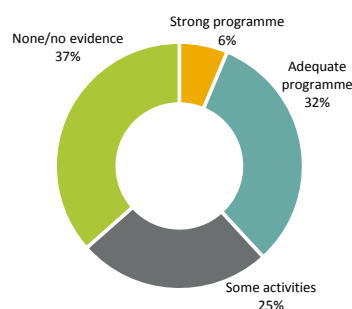
Source: Sustainalytics

Providing financial services at affordable costs to disadvantaged and low-income segments of society

## Access to financial services

Banks are helping to address the access gap through financial inclusion strategies, with the objective of providing financial services at affordable costs to disadvantaged and low-income segments of society. Three elements are considered important to financial inclusion: Affordable prices, face-to-face advice and the facilitation of access to financial products. Inclusive finance is commonly carried out through micro-credit as well as certain types of consumer loans, such as payday loans.

## S.4.2.3 Financial Inclusion



Of the banks assessed, 231 (63%) report having some activities or programmes in place to address this issue. Of these, 23 have strong programmes with quantitative targets at group level and clear deadlines for reaching these targets, five of them coming from the group of non-listed banks. The high proportion of Emerging Markets companies among the top performers is quite remarkable and is a reflection of their responsiveness to local needs. Four companies come from India (**AXIS Banks**, **Bank of Baroda**, **Punjab National Bank**, and **State Bank of India**) and one from Brazil (**Banco Bradesco**), while eight companies are European, five US, and another five Australian.

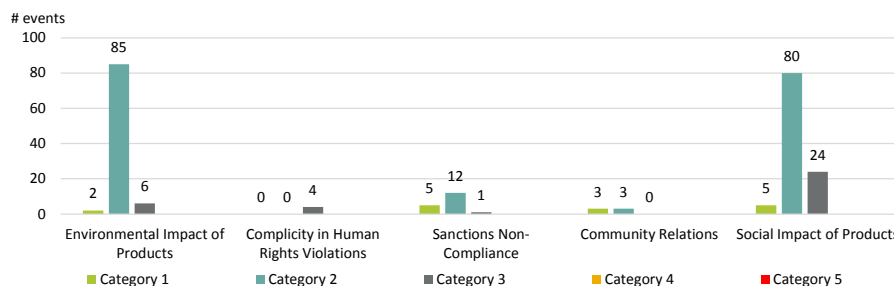
## Controversies - Overview

No Category 4 or 5 controversies with regard to Responsible Finance

The vast majority of the 230 Responsible Finance-related controversial events (88%) that shook the industry in the last three years are clearly attributable to controversial lending practices that have a negative environmental (40%) or social (47%) impact.

Controversies around the negative environmental and social impact of activities financed by banks dominate the picture

### Responsible Finance related controversial events



Source: Sustainalytics

Examples include large-scale (infrastructure) projects, the financing of controversial business activities, but also engagements in sensitive countries like Sudan or Iran, or commodity finance, especially food

On the very top of civil society groups' allegations against banks are their involvement in financing businesses and projects that excessively harm the environment, undermine human rights, and/or are linked to severe negative impact on local communities. Examples include large-scale (infrastructure) projects that are linked to human rights violations, land grabbing or bio-diversity destruction (e.g., huge dams, oil and gas exploration, mining, or palm oil plantations). Also on the radar screen of civil society groups: Banks' engagements in sensitive countries like Sudan or Iran, the financing of controversial business activities, such as large-scale burning of fossil fuels (e.g., coal power plants), controversial weapons production, tobacco production, mountaintop removal or fracking. Furthermore, civil society groups accuse banks of participating in commodity finance and trading and thus being partly responsible for rising prices, especially for soft commodities, in developing countries.

### Gap between policies and performance

Robust lending standards do not guarantee that banks to be free of involvement in controversial finance and, thus, being criticised by NGOs

Banks having a significant exposure to environmentally and socially sensitive industries by way of their diverse financing activities, face significant credit, business and reputational risks that have to be prudently managed. Even though many banks active in project finance are aware of these downside risks and react with robust lending standards, the implementation of these standards is obviously not always as rigorous as necessary. Even those companies showing comprehensive programmes continue to be the target of severe criticism. **BNP Paribas, Credit Agricole, HSBC, Royal Bank of Canada, SocGen, Standard Chartered** and **Sumitomo Mitsui Financial** are banks that, despite having rolled out best-in-class lending standards, have been repeatedly cited by civil society groups for their financial transactions with the coal industry and the weapons producing sector.

Notably, product-related incidents are often related to Sustainable Financial Services and Financial Inclusion

Looking at product-related incidents, it is notable that these are often related to our indicators Sustainable Financial Services and Financial Inclusion. Although both indicators are positive in nature and have been established to acknowledge the sustainability efforts of banks, these activities have not been spared from significant controversies. In particular, banks offering payday lending products have been accused for applying aggressive and misleading lending practices, resulting in interest rates of up to 400% p.a. These usurious interest rates, in turn, cause numerous payday lenders to roll over or renew their loans, triggering a downward spiral that bears the potential to make struggling families even worse off than they were before receiving the loan.

4

#### Category 4 – High

**NEW\***: BNP Paribas

\* not reflected in data analysis of this report

#### Most severe controversies

We recently downgraded **BNP Paribas** from Category 3 to Category 4 as a consequence of its serious breach of U.S. sanctions. The downgrade is based on the severity and scale of the violation, the structural nature of the offences, the accountability of high-level executives, and the reputational, regulatory and operational risks of the U.S. government decision to the company.

On July 1<sup>st</sup>, BNP Paribas announced a comprehensive settlement with U.S. authorities over its transactions with U.S. sanctioned entities in Sudan, Iran and Cuba during 2002 to 2012. In a rare move, the company agreed to plead guilty, pay a total fine of USD 8.97 billion (EUR 6.6 billion), and temporarily suspend its U.S. dollar direct clearing oil and gas finance business for one year in 2015. The bank dismissed 13 staff members, including high-ranking executives, and disciplined a total of 45 employees. U.S. prosecutors found that BNP knowingly and systematically breached U.S. sanctions against the three countries for more than ten years.

The fine was by far the highest applied to a company for sanctions violations, based on the company's prolonged misconduct in combination with its failure to fully cooperate. In comparison, **ING Bank** paid USD 619 million, **Standard Chartered** was fined USD 327 million, while **The Royal Bank of Scotland** settled for USD 100 million for the same violations.

3

#### Category 3 – Significant

ICBC  
Wells Fargo

The two institutions involved in the broadest range of environmentally and socially critical financing, and thus receiving Category 3 ratings for both Environmental Impact of Product & Service Incidents as well as Society & Community Incidents, are **Industrial and Commercial Bank of China (ICBC)** and **Wells Fargo**. ICBC is alleged by civil society groups to have financed coal projects and companies, controversial dam projects like the Gilgel Gibe Dam in Ethiopia, and controversial weapons investments. Allegations for Wells Fargo range from financing companies active in oil sands exploration and coal production, to controversial weapons finance, to payday lending. By and large this picture conveyed by Wells Fargo has also been confirmed by our analysis of the syndicated loan market (see Spotlight section).



Public pressure led to the abandonment of an apparently lucrative product line

In January 2013, the US federal government was reportedly asked to examine a Wells Fargo debt product that was widely believed to be predatory lending. To be more precise, Wells Fargo's Direct Deposit Advance (DDA) was accused for locking customers into a “debt trap” with predatory interest rates, ranging from 91% for a 30-day loan up to 180% p.a. for a 14-day loan. As a response to the increasing public pressure, Wells Fargo decided to abandon its DDA product.



**Outlook**  
positive

### Responsible Finance on the rise

We are convinced that Responsible Finance will continue to gain traction in the banking industry for the coming years. Its recognition as an inherent part of profound financial decision making will become more and more solidly anchored. Furthermore, a variety of pending environmental disasters (Tepco, BP oil spill), social drawbacks (raising income inequality, human rights violations), and governance-related controversies (LIBOR scandal) ensure that sustainability will remain a prominent matter of public concern and that the demand for related products will continue to grow across the globe.

Responsible Finance practices will become the norm rather than the exception

To be well prepared, banks are expected to increase their resources devoted to Responsible Finance in order to enhance prevailing models and standards and to set the scene for new innovative strategies and products. On top of this, international standards such as the UN PRI and the Equator Principles are increasingly recognised as common practice and will shape the way Responsible Finance is understood and practised.

## Financial Product Governance – The paradox of trust & loyalty

The banking industry’s track record with regard to responsible client management is undoubtedly poor. General trust in banks has been hit accordingly. Regulatory changes are directed towards consumer protection via increased transparency and better communication. Some banks have improved markedly in this regard, either driven by their new convictions or by regulatory and market pressures. However, banks face the risk of not being able to roll over the additional costs to their clients.

### Exposure – High potential impacts in both dimensions

Taking a “cradle to grave” perspective

Product Governance focuses on how companies manage responsibilities towards their clients, from identifying targets and target clientele for the products, through sales and marketing practices, to post-sales responsibilities.

Direct impact on individual customers, indirect impact on local communities

### Sustainability Impact

The banking industry’s track record regarding customer relationships has not been very positive in recent years, given the long list of controversial incidents including cases of excessive fees, predatory lending, conflicts of interest and undisclosed product risks. As discussed previously (e.g., in Industry Trends and Business Ethics sections), trust barometers fell dramatically as a consequence of the financial crisis and the numerous client-related issues that came to light in conjunction with it. In many of these cases, the impact of banks’ wrongdoing on individual clients was severe. Many American families lost their homes, for example, as a consequence of banks’ irresponsible reactions to the subprime crisis. The effects of these types of cases (mortgages are only one example), were not only limited to the affected customers, but also had significant impacts on local communities in the form of lost tax revenue, for example.

### Areas of Sustainability Impact

	Areas of Sustainability Impact													
Key ESG Issue	GHG Levels	Air Quality	Land	Water Quality	Water Availability	Biodiversity	Animal Welfare	Local Communities	Customers	Employee Health & Safety	Labour Rights & Conditions	Contractors & Supply Chain	Human Rights	Society
Financial Product Governance									Major	Severe				Major

no major impact   
  major impact   
  severe impact

Source: Sustainalytics

Municipalities had also been directly hit by products they didn't properly understand

Municipalities also suffered the consequences of engagements in complex financial products which they obviously had not properly understood. For example, this includes cases of alleged miscounseling in Germany regarding the pay-off structures of so-called "spread ladder swaps" (see customer-related incidents of Deutsche Bank, for example). The impact of the losses for the municipal treasurer finally had to be paid by private households and local businesses via reduced investment in infrastructure (schools, for example) or higher fees for municipal services and higher taxes. Financial Product Governance, hence, is not only a key issue from a customer relationship perspective, but also from a local community and a societal perspective.

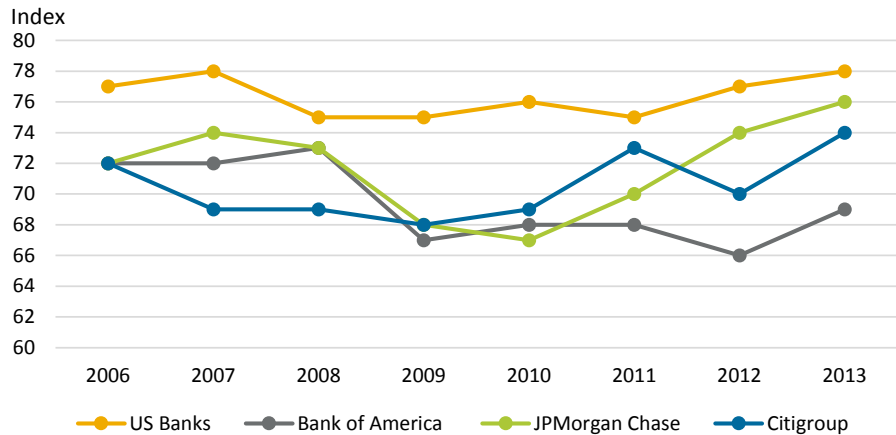
**Business Impact**

Customer satisfaction remained amazingly stable at the industry level

Looking at the business impact side (i.e., the impact of the issue on the banks' business), the story is a little bit different. The mantra of a close link between trust and reputation on the one hand, and client loyalty on the other hand, appears to work only to a limited extent. For example, this can be seen when looking at customer satisfaction indicators on the retail banking side. Paradoxically, these did not really follow the deep drop in trust, but remained amazingly stable at a comparatively high level. At the industry level, the satisfaction of American customers with their main banking provider dropped only slightly as a reaction to the financial crisis and had fully recovered by 2013 already.

**American Customer Satisfaction Index**

Bank of America has not yet recovered from within-crisis lows



Source: ASCI, 2013

Behavioural patterns are changing slowly

Although there is no hard data or full transparency on client attrition, customer loyalty is known to be relatively high in the financial industry. Changing one's main banking services provider can be quite painful, especially if the relationship is more complex, covering not only checking accounts, but also consumer loans and investment products, for example. Behavioural patterns have certainly begun to change, but results won't be seen overnight.

Regional differences in the willingness to change main banking services provider

In a 2012 Ernst & Young survey of nearly 30,000 bank customers around the world, only 34% said they changed their main banking services provider over the last ten years, down from 36% in 2011. There are regional differences, however. In 2012, 45% of customers in the U.S., for example, changed banks. This is up from 38% in the previous year and mainly reflects an increased customer sensitivity to fees or rates on deposits.

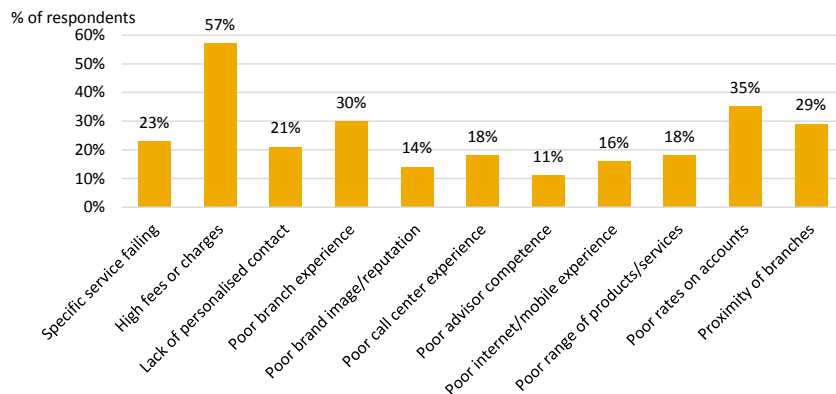
The survey showed that these were the main reasons why customers switch their primary banks (named by 57% and 35% of respondents respectively, see chart below). Poor brand image and reputation also influenced customers’ decision to switch bank, though to a lesser degree (true for only 14%, the second lowest ranked answer category). Obviously, customers distinguish clearly between their general trust in the banking industry and the individual relationship they have with their main providers.

Price sensitivity has increased in recent years

Nevertheless, the fact that price sensitivity has become a more important factor in recent years (mainly due to the increased transparency), has made banks increasingly nervous of late. They fear that the rising costs of regulation can only partly be rolled over to their clients. The rising customer churn risk is reflected in the finding of the survey that U.S. retail banking clients have started to diversify their relationships with banks, and are no longer “putting all eggs in one basket”. Since 2011, the percentage of customers using only one bank has dropped from 41% to 31%, while the share of those with three or more has increased from 21% to 32% since 2011.

Poor brand image/reputation is the second least important factor behind attrition

**Why are U.S. consumers switching?**



Source: Ernst & Young, 2012

Regulatory changes as well as the pressure from the street resulted in banks retreating from controversial business areas - not attrition risk

As the following table shows, we’ve classified litigation, reputation risks, the regulatory environment and direct customer attrition risk (i.e., client demand) as areas of potentially severe business impact. Legal costs resulting from customer-related cases of fraud and wrongdoing are weighing strongly on banks’ P&Ls as the results reported for Q1 have shown (e.g., **Deutsche Bank**). The deterioration of reputation has weakened brand values and has had an impact on policy makers’ and regulators’ actions. Regulatory changes as well as the pressure from the street resulted in banks retreating from controversial business areas like commodity trading and has increased the costs of doing business (e.g., due to higher transparency and documentation requirements driven by consumer protection considerations).

### Areas of Business Impact

Key ESG Issue	Areas of Business Impact							
	Regulatory Environment	Litigation Risks	Reputation Risks	Client Demand	Asset Risks	Operational Risks	Employee Motivation	Hiring Capability
Financial Product Governance	Major Impact	Major Impact	Major Impact	Major Impact	No Major Impact	No Major Impact	Major Impact	Major Impact

■ no major impact   
 ■ major impact   
 ■ severe impact

Source: Sustainalytics

If the distance between individual values and corporate culture gets too large, employee motivation will inevitably decrease and so will the institution's attractiveness as an employer

Furthermore, two areas of major business impact, according to our evaluation, are human capital-related. They relate to the effects of Financial Product Governance on employee motivation and on a bank's hiring capability. If products and the way they are sold are not in alignment with the individual values of employees, i.e. the distance between individual values and corporate culture gets too large, motivation and thus productivity will inevitably decrease and so will the institution's attractiveness as an employer (for a deeper discussion, see section on key issue Human Capital).

### ESG Performance – Legacy cases still pending

Some banks have recovered from 2009 lows in customer satisfaction, others have not

Being aware of the potential risk the financial crisis posed to customer loyalty, banks have allocated resources to repairing frayed customer relationships. Various external surveys show that these investments have begun to pay off. The increases in customer satisfaction for **JPMorgan Chase** and **Citigroup** since 2009 can be seen as examples of successful comebacks (see chart above). Similar examples can be found elsewhere as well. In the UK, noticeable improvements in the ratings for **HSBC** and **Banco Santander** have been recorded (based on the National Customer Satisfaction Index, the sister index to the ACSI). Others, such as **Bank of America**, have not recovered to the same extent during this period, with customer satisfaction scores that are still below pre-crisis levels.

We warn against over-interpreting customer satisfaction surveys

For us there is no doubt: Many banks have improved their Financial Product Governance over the last couple of years. Some of this change was voluntarily, and some was forced by regulatory changes. Survey data only provide limited insight into true customer loyalty, so we would warn against over-interpreting the rebound in customer satisfaction indices. Our key indicator for measuring Financial Product Governance, hence, is looking at a bank's track record for customer-related incidents.

### Financial Product Governance – Performance indicators\*

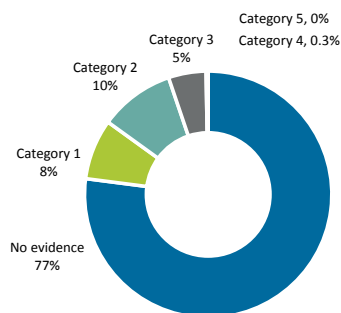
Related Indicators	Dimen- sion	Key indicator	# companies with ... score			Weight in issue
			high	medium	low	
S.3.3 Customer Incidents*	QualP	●	311	36	19	100%

\* high: No controversies or level 1 controversies; medium: Level 2 controversies; low: Level 3-5 controversies

Source: Sustainalytics

19 banks display significant customer-related controversies

S.3.3 Customer Incidents



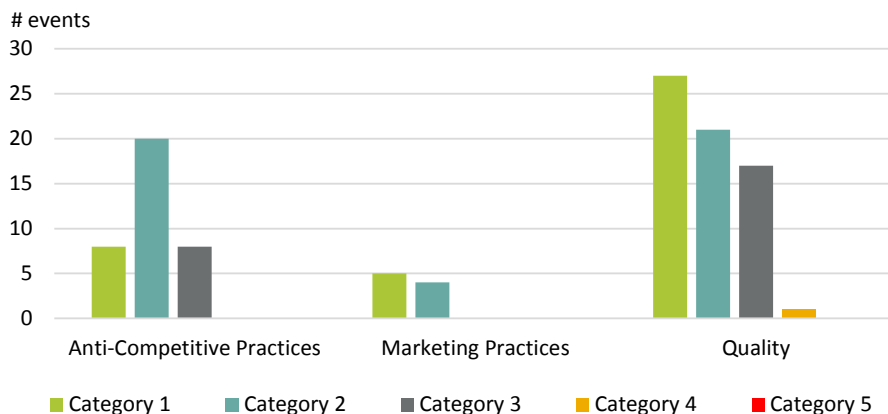
Most significant customer-related events are linked to quality issues

### Controversies – Quality issues dominate

Of the 366 banks evaluated, 19 (5.2%) have significant customer-related controversies (Category levels 3 to 5). Banks with significant controversies tend to have large and complex operations offering diverse products and services. The majority of these controversies relate to the lack of transparency over complicated products, which led to significant financial losses for numerous clients. Nearly all international banks with involvement in the U.S. housing market faced lawsuits seeking compensation for losses from securities backed by risky sub-prime mortgages. Parallel to these lawsuits, banks involved in this market were also accused of improper home foreclosures, which triggered a new set of legal actions by regulators and homeowners. Settlement amounts – USD 25bn by five U.S. banks for fraudulent foreclosures and USD 13bn by **JPMorgan** for mortgage-backed securities claims, for example – are indicative of the severity of the impact of banks’ misconduct.

A number of banks have also been implicated in misconduct relating to retail banking products. European banks that wrongly sold payment protection insurance (PPI) products faced sizeable customer claims. **Lloyds Banking Group** allocated GBP 10bn for customer payouts, the highest among the U.K. banks. Excessive banking fees and overdraft charges are also common in the industry. As the following chart shows, most of the significant customer-related controversies are linked to quality issues.

#### Customer-related events



Source: Sustainalytics

77.3% of the banks in our universe exhibit no controversies

#### Leaders & laggards

Two hundred and eighty-two out of 366 banks (77%) exhibit no controversies and, hence, receive a score of 100. This means that for these companies our rating suggests no specific Financial Product Governance related risk premium or other related investment restriction. On the down side, the list of companies with significant controversies and respectively low scores includes some prominent names, as the following table shows.

**Laggards Financial Product Governance (FPG)**

List of laggards includes some prominent names

Company	Country	MCap (USD m)	Score: FPG	Overall
Bank of America Corporation	United States	163,939	20.0	59.3
Banco Santander, S.A.	Spain	125,949	50.0	65.6
Barclays PLC	United Kingdom	66,890	50.0	59.5
BNP Paribas	France	88,009	50.0	77.3
Citigroup, Inc.	United States	148,639	50.0	68.5
Credit Suisse Group	Switzerland	48,750	50.0	66.6
Deutsche Bank AG	Germany	41,079	50.0	62.0
HSBC Holdings plc	United Kingdom	197,477	50.0	60.9
JPMorgan Chase & Co.	United States	215,615	50.0	66.9
Lloyds Banking Group plc	United Kingdom	96,144	50.0	65.3
Morgan Stanley	United States	62,983	50.0	64.9
Nomura Holdings, Inc.	Japan	25,000	50.0	66.4
Ocwen Financial Corp.	United States	5,032	50.0	44.2
PNC Financial Services Group Inc.	United States	46,640	50.0	49.9
SunTrust Banks, Inc.	United States	21,122	50.0	45.7
The Bank of New York Mellon Corporation	United States	40,130	50.0	63.4
The Goldman Sachs Group, Inc.	United States	74,316	50.0	67.9
The Royal Bank of Scotland Group plc	United Kingdom	64,541	50.0	61.1
Wells Fargo & Company	United States	273,782	50.0	63.8

Source: Sustainalytics

4

**Category 4 – High**

Bank of America Corp.

**Most severe controversy – Continued uncertainty over the depth of the bank's involvement**

**Bank of America's** (BoA) involvement in mortgage-related controversies is exceptional in terms of the value of the claims. The continuing uncertainty over the depth of its involvement led to a Category 4 assessment for Quality. Since 2011, the bank has paid close to USD 50bn in settlements. For 2014, the bank increased its provision for losses to USD 6bn, suggesting that there are more settlements in store.

BoA reviewed its risk management and exited a number of business activities

Many of BoA's woes stemmed from its acquisition of **Countrywide Financial Corporation (CFC)** in 2008, pointing to poor judgemental management qualities. Focusing on CFC, however, would constitute too narrow a view from our perspective. BoA itself was directly involved in the origination and securitisation of faulty loans as well as fraudulent home foreclosures, highlighting weak controls and lack of standards. In response, Bank of America has reviewed its enterprise risk management and exited a number of non-core business activities including mortgage origination. Moreover, it has implemented a new product approval process that considers, among other factors, the suitability of a product or service for customers. It remains to be seen how effective these measures are; thus for the time being, our rating remains unchanged.

**Outlook**  
positive

Banks have begun to reposition themselves

We expect the trend towards improved consumer protection to continue

## The pendulum is still swinging towards more regulation ... and higher costs

Regulatory changes and client pressures have been forcing banks to reposition themselves with regard to Financial Product Governance. The greater emphasis on customer protection has already led banks to let go of products whose benefits are undermined by their complexity. Agencies such as the European Banking Authority and the U.S. Consumer Financial Protection Bureau are stressing the need for banks to be more transparent about their products at all levels, requiring not just increased disclosure of product risks, but also improved communication with customers.

We expect the trend towards improved consumer protection to continue. The higher costs of increased transparency and better communication will have to be absorbed by the banks themselves, at least partly, due to the intense competition in the retail banking market and customers' increasing price sensitivity. The litmus test for banks' Financial Product Governance will be the ability to significantly reduce the frequency of customer-related events. Some banks seem to be moving in the right direction, but whether they will be successful in the end remains to be seen. One key factor to look at in this regard is the willingness of banks to change the incentive structures for their employees.



## Human Capital – Sea change necessary, but litmus test is yet to come

The management of Human Capital is key for a bank’s profitability and long-term survival in an extremely competitive environment. The way talents are selected and employees are treated, educated, and incentivised, is a major determinant for how a bank generates its business and profits. Are bank employees acting in the best interest of their clients and of the bank’s shareholders, or do they (continue to) pursue their self-interest at the expense of these and other stakeholders? This is the challenging question against which updated strategies of Human Capital management will need to be benchmarked going forward. The litmus test is yet to come.

### Exposure – Between redundancy & a shrinking talent pool

The capital of a bank is determined by its employees. It is their intelligence that creates complex products, their relationships that generate business, and their risk appetite that drives leverage and profitability. Banks have long been aware of the significance of the human factor for their business and in the past have done a lot to attract the best talent worldwide. For the young high potentials leaving universities, the investment banking units of the large global banks became the target of their dreams, promising fortune and influence.

Working for a large global bank became the target of many students’ dreams

### Employment in the U.S. Finance & Insurance industry

Employment has not yet recovered to pre-crisis levels



Source: US Bureau of Labor Statistics

Employment in the banking industry: Job cuts have determined the picture since the financial crisis

With the financial crisis and the multitude of banking scandals that have occurred since then, the picture has changed dramatically. In 2013 alone, Europe’s 30 largest banks by market value cut staff by 80,000, as calculations by Reuters based on their year-end statements showed. And there are doubts that the European banking industry’s employment will ever return to what it was in its heyday of 2008. Hence, the industry has changed from being one of the engines of employment growth, to one of the biggest contributors to job losses and unemployment. And the situation is not that different in the U.S. as numbers from the Bureau of Labor Statistics show. Employment levels in the U.S. finance and insurance industry are still well below pre-crisis levels here as well (see chart above). Compared to the employment peak in 2006, around 350,000 jobs have been lost nationwide.

Trading off social costs of the future and the present

Of course one could argue that job losses are a part of or at least an unavoidable consequence of, policy makers’ and regulators’ plan to shrink the industry, making it less systemic and more resilient going forward. The potentially reduced social costs of the future, however, come at a price in the present – namely the increased costs of unemployment. The risk of this trade-off is that reform plans might be diluted, driven by short-term political considerations.

**Areas of Sustainability Impact**

	Areas of Sustainability Impact													
Key ESG Issue	GHG Levels	Air Quality	Land	Water Quality	Water Availability	Biodiversity	Animal Welfare	Local Communities	Customers	Employee Health & Safety	Labour Rights & Conditions	Contractors & Supply Chain	Human Rights	Society
Human Capital											Major Impact		Major Impact	Severe Impact

no major impact
  major impact
  severe impact

Source: Sustainalytics

The redundancy of large numbers of employees and remuneration caps made the industry less attractive for young high potentials

**What makes a bank attractive as an employer?**

While there has obviously been a lot in flux on the demand side of the equation, the picture has changed as well on the supply side. Remuneration caps for executives on the one hand, but also the increased personal liability risks for directors in general have made it increasingly attractive for top bankers to move to less regulated areas, like private equity or hedge funds. In addition, the redundancy of large numbers of employees in investment banking over the last couple of years has made the industry far less attractive for young high potentials.

11 companies out of the Top 50 “World’s most attractive employers” are banks

But how strong is the true impact of the loss of trust and eroded reputation on the attractiveness of banks as employers? The fact of the matter is, that the image of the greedy banker has obviously not significantly impacted employer attractiveness rankings. According to the “World’s most attractive employers” survey, for example, 11 companies out of the Top 50 companies worldwide, are financial institutions/banks. In the 2013 survey, for example, Goldman Sachs came in third after being ranked tenth the year before. The results are based on responses from close to 200,000 business and engineering students from the world’s 12 largest economies.

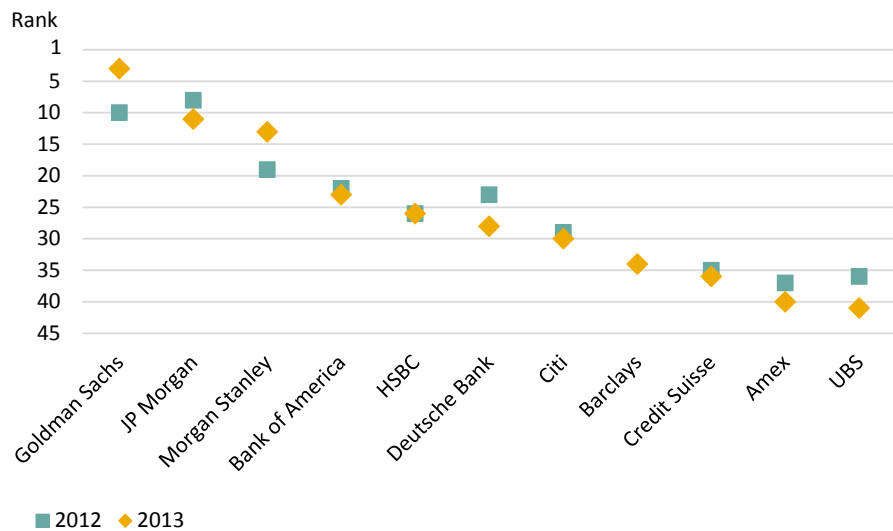
Top attributes of banks: Challenging work environment, high future earnings, ...

The results may seem counter-intuitive at the first glance. For instance, many of the employer attributes most attractive to students are still frequently associated with banks. The top attributes according to the 2012 survey were: Challenging work environment, high future earnings, good reference for future career, and professional training and development. Less important, on the other hand, were attributes such as secure employment or friendly work environment. In other words, many students still believe that banking offers what they are looking for: a competitive environment in which they can excel and become rich.

**World’s most attractive employers**

Goldman Sachs ranked #3 as “World’s most attractive employer”

Deutsche Bank, UBS, and Credit Suisse were among those losing ground in 2013



Source: Universum, 2012/2013

Over decades mechanisms were established, that produced a certain type of banker mentality

And with this we’re getting closer to the core of the problem and the challenge going forward. The systemic risk of the banking sector, is very much linked to the people operating in a highly competitive environment and that have been selected, trained and incentivised to succeed and survive in such an environment. Over many years, if not decades, mechanisms were established that produced a certain type of banker mentality which finally led to the disastrous financial crisis. That mentality still exists as most of the people who built the system are still present.

**Typical banker mentality – What does this mean exactly?**

Bankers are significantly more achievement oriented and focused on measurable external goals

A survey study that looked at systematic differences in attitudes between employees in the financial industry compared to others has produced some empirical evidence that supports the notion of a typical banker mentality. Based on a sample of over 5,000 individuals, the study found that bankers are significantly more achievement-oriented, as they enjoy competition and a focus on measurable external goals. Hence, they would likely be much more motivated by the completion of a project or the attainment of an external reward, such as a bonus. They are also more likely to make sacrifices in their personal lives in order to achieve success at work.

Higher risk of derailment

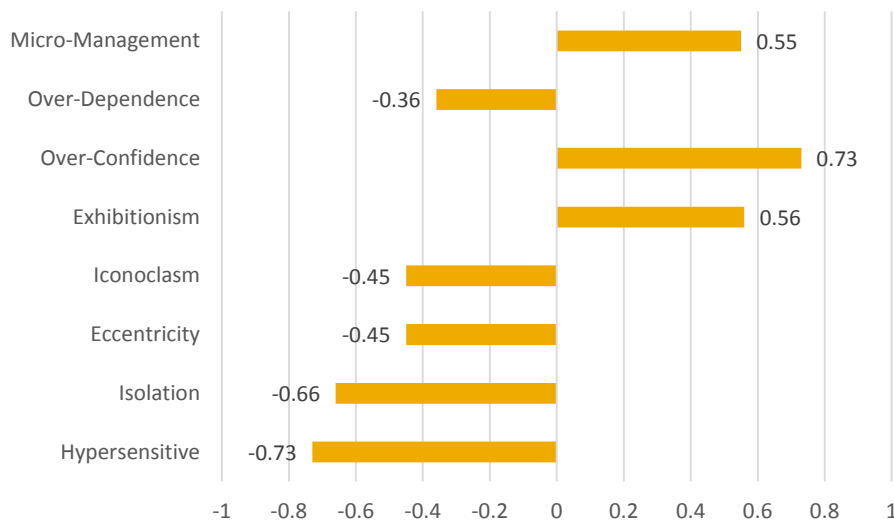
The study also found that bankers as a group exhibit significantly higher risk of what the authors of the study call “derailment”, meaning that these people tend to be more willing to cross boundaries in order to be successful. Three well-known derailment factors are exhibitionism, over-confidence and micro-management. These factors combine with significantly lower levels of sensitivity to others’ opinions of them, to facilitate a working style wherein individuals over-rely on their own judgement and may focus on process and detail at the expense of the bigger picture. The links to the origins of the financial crisis are obvious.

Over-confidence and exhibitionism make people blind to potential downside risks

Exhibitionism and over-confidence make people blind to potential downside risks. The strong desire for success results in bankers trying to outperform each other, while making unsustainable personal sacrifices such as compromising their personal codes of ethics. These two factors also make it very difficult to seek the counsel of more experienced colleagues, or to own up to not fully understanding the detail of the products being sold – one of the root causes of the crisis.

**Dimensions personality assessment: Leadership derailment risks vs global norm**

Based on a sample of over 5,000 individuals



Source: Talent Q, Nov. 2012

Significant changes need to be made to the selection/recruitment process, to training and development programmes, and last but not least to incentive structures

**Banker mentality and systemic risk**

Bringing about cultural change in banking, as promised by some of the most prominent figures in the industry, has been difficult. Many of the people who created the deficient culture are still in place. Those who made the biggest proclamations are the same people who developed in the old system and belonged to the firms that prospered within it. This is surely not the best starting point for a cultural change. It is important to understand that the human capital challenge is not something that can be solved by better risk control measures. These measures are pivotal from an idiosyncratic risk perspective, no doubt, and will help to prevent individual wrongdoing and fraud. From a systemic perspective, however, they will not help to combat the roots of failure.

Changes are necessary in the recruitment process, in training and development, and in incentive structures

The true challenge is to change the “system’s mentality”, which is only possible if significant changes are made to the selection/recruitment process, to training and development programmes, and last but not least to incentive structures. It will take some time to see whether some of the banks that declared cultural change will indeed walk their talk and tackle the issue at these levels.

Human Resources departments need to play a key role in the change process

If cultural change is the final goal, it is clear that Human Resources departments need to play a key role in the change process. First, it is necessary for HR to have a bigger say in recruitment decisions in general, making sure that the criteria applied for selection processes are in line with the new overall strategic requirements. The balance of power has to shift to some degree from line managers, seeking competitive advantages by hiring top ranked employees, to HR managers that ideally have the bigger picture in mind.

In trainings, greater emphasis should be placed on abilities and aptitudes that go beyond the technical knowledge and skills

HR management also needs to take derailment factors more significantly into account not only in the hiring process, but also when it comes to educating and developing employees. Thus, in trainings greater emphasis should be placed on abilities and aptitudes that go beyond the technical knowledge and skills – including business ethical reflections. This type of risk mitigation is probably much more effective than introducing any additional risk controls and compliance measures.

**Areas of Business Impact**

	Areas of Business Impact							
Key ESG Issue	Regulatory Environment	Litigation Risks	Reputation Risks	Client Demand	Asset Risks	Operational Risks	Employee Motivation	Hiring Capability
Human Capital			major impact			major impact	major impact	major impact

no major impact   major impact   severe impact

Source: Sustainalytics

**ESG Performance – Cultural change: True progress unclear**

It is difficult to draw the line between exposure and performance relevant measures

The assessment of the performance of banks with regard to their Human Capital management is extremely challenging. First, it is difficult to draw the line between exposure and performance relevant measures. Secondly, information about the progress of cultural change (i.e., change in the mentality of a bank’s human capital), can hardly be obtained in a timely fashion. Companies do not allow deep insights into the true progress they make in this respect, thus, to analyse performance from the outside, one has to rely on a set of proxy variables that mirror a bank’s preparedness, as well as its qualitative and quantitative performance in human capital-related fields. With regard to the banking industry’s qualitative performance (i.e., the number of companies implicated in human capital-related controversial incidents), the balance looks quite favourable. Only one company ends up in the low score bracket (see table below).

Employee Turnover Rate and  
Top Employer Recognition

Taking a look at the Quantitative Performance dimension, we include two indicators, the Employee Turnover Rate and the Top Employer Recognition. In both cases a relative majority of the banks we look at score low, which means that they have relatively high turnover rates and low employer rankings. The latter points to a large gap between the industry's top representatives (that offer all the opportunities top talent is looking for) and the bulk of banks with less attractive business activities.

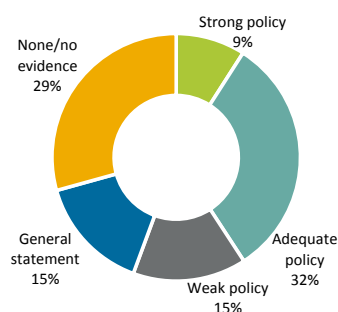
## Human Capital – Related indicators

Related Indicators	Dimen- sion	Key indicator	# companies with ... score			Weight in issue
			high	medium	low	
S.1.2 Discrimination Policy	Prep		149	109	74	15%
S.1.3 Diversity Programmes	Prep		35	168	162	15%
S.1.4 Collective Bargaining Agreements	QuantP		55	76	93	8%
S.1.5 Employee Turnover Rate	QuantP		38	43	143	8%
S.1.6 Top Employer Recognition	QuantP		37	29	158	8%
S.1.7 Employee Incidents*	QualP		355	10	1	38%
S.1.1 Freedom of Association Policy	Prep		105	45	74	8%

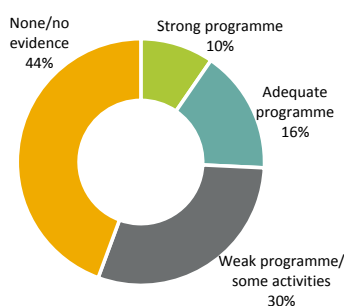
\* high: No controversies or level 1 controversies; medium: Level 2 controversies; low: Level 3-5 controversies

Source: Sustainalytics

## S.1.2 Discrimination Policy



## S.1.3 Diversity Programmes



Looking at the two preparedness indicators, the picture conveyed is somehow split: With regard to Discrimination Policy, significantly more companies receive a high score (41%), which means they have strong or adequate anti-discrimination policies (with more than half of these companies domiciled in developed markets), than a low score (29%). The reverse applies when looking at Diversity Programmes. Here, a relatively high number of companies fall in the low score bracket (44%).

Amidst banks' efforts towards equal opportunity, evidence suggests that disparities continue to exist. A 2013 study by Emolument, a salary data aggregator, showed that in London, the widest pay gap between men and women in investment banking and capital markets is at the vice president level with 27%. The gap narrows at the management director level, where women are paid largely in line with their male counterparts. These findings, however, need to be evaluated against the fact that women are still significantly under-represented at the top management level (and over-represented in administrative and secretarial roles).

In addition, significant salary discrepancies have been reported between top executives and regular employees. Academic studies have found that large pay gaps can hurt employee morale, reduce workplace productivity and lead to increased employee turnover. Disclosure of the pay ratio between the CEO and median employee is voluntary in the industry.

3

## Category 3 – High

Bank of America

## Controversies – Discrimination &amp; Health issues prevail

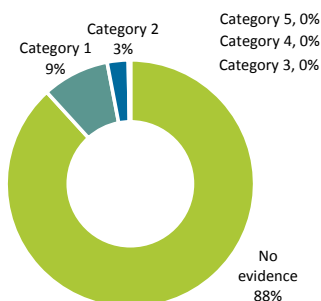
Despite having some of the strongest diversity and anti-discrimination policies, banks continue to face allegations of gender and racial inequality in terms of pay and professional growth. **Bank of America** and **Goldman Sachs** had extraordinary exposure to these issues due to class action and collective lawsuits over alleged unequal treatment of women and racial minorities. In August 2013, **Merrill Lynch** reportedly agreed to pay USD 160m to settle a related lawsuit.

In the last 12 months, the issue of mental health and safety has become a concern following widely-reported deaths of bankers. The death of a 21-year-old intern at the London office of **Bank of America Merrill Lynch** in August 2013 sparked concerns over excessive working hours of junior employees. This incident was followed by the apparent suicides of middle to top-level executives at **JPMorgan** and **Russell Investment Management**, as well as that of a former executive at **Deutsche Bank**. Media reports pointed to the aggressive culture and high stress levels in the financial industry as key factors.

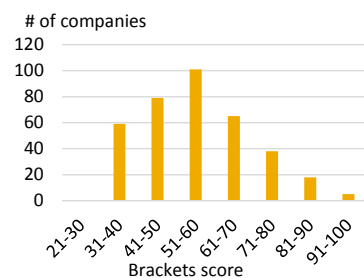
While there has been no concrete evidence linking the deaths to workplace stress, banks appear to have recognised the negative repercussions of long work hours on employee health and have, thus, started to take remedial measures. **Bank of America** and **Goldman Sachs**, for example, recommended that their junior employees take weekend days off. However, these measures only partly address what we consider a systemic and structural workplace issue in the industry.

At the aggregate level, i.e., taking all Human Capital-related indicators into account, our analysis yielded a quite sobering result as the graph on the left-hand side reveals. Of all banks considered in this report, only 228 (62%) received a score higher than 50. In other words, a remarkable share of 38% of banks does not even receive half of the highest possible or “best practice” score. Of these “low performers”, 27 are European, 19 Northern American, 88 Asia Pacific and the remaining banks are located in South America (3) and Africa (1). Notably, none of these banks is headquartered in Australia, pointing to a strong nationwide commitment to human capital development, supported by rigorous national legislation.

S.1.7 Employee related incidents



Human Capital – Distribution of total scores



Significant spread in the Human Capital score of leaders and laggards

## Human Capital – Leaders

Company	Country	MCap (USD m)	Score: HC	Overall
Cif Euromortgage SA	France	n.a.	100.0	52.6
Intesa Sanpaolo S.p.A.	Italy	58,526	97.7	76.5
Caisse centrale Desjardins	Canada	n.a.	96.2	77.3
Skandinaviska Enskilda Banken AB	Sweden	30,294	96.2	83.6
ABN AMRO Group N.V.	Netherlands	n.a.	93.8	75.8

Source: Sustainabilitytics

Laggards come from very different regions, including developed Europe, North America and India

### Human Capital – Laggards

Company	Country	MCap (USD m)	Score: HC	Overall
AXIS Bank Limited	India	15,715	32.0	47.6
Bank of India	India	3,530	32.0	43.6
Punjab National Bank	India	6,247	32.0	47.9
Dexia SA	Belgium	101	38.5	36.0
Dusseldorfer Hypothekenbank AG	Germany	n.a.	38.5	42.0
Hudson City Bancorp, Inc.	United States	5,282	38.5	54.8
Hypo Alpe-Adria-Bank International AG	Austria	n.a.	38.5	39.2
Irish Bank Resolution Corporation Limited	Ireland	n.a.	38.5	46.1
Korea Development Bank	South Korea	n.a.	38.5	49.1
New York Community Bancorp Inc.	United States	6,990	38.5	46.3
Raiffeisenlandesbank Oberosterreich AG	Austria	n.a.	38.5	44.2
Shizuoka Bank Ltd.	Japan	6,098	38.5	43.2

Source: Sustainalytics



**Outlook**  
negative

Banks' focus on more effectively managing human capital is likely to increase further

From a systemic perspective, a shift towards more strategic approaches in HR management appears pivotal

### Too late for the pendulum to swing back again (?)

In the next two years, the banks' focus on more effectively managing human capital is likely to increase further. Banks will have to cope with the challenges of more stringent regulation, which tends to make jobs in the industry financially less attractive and to increase personal liabilities for top personnel.

On the supply side, the appetite to work for banks has suffered due to the deteriorated image of the industry and the attractive alternatives available for young high potentials. Technology companies, for example, are attracting new hires with more generous vacation benefits, flexible working hours, and what appears to be a more enjoyable working environment on top of competitive salaries.

From a systemic perspective, it will be key for the banking industry to switch from the traditionally passive HR management approach, driven by the daily needs of line managers, to a more strategic approach that works against the forces that have led to the selection and retention of people with mentalities that have contributed to many facets of the financial crisis. The time for change is now, but it is clear that the fruit of change will not be harvestable overnight. Our feeling is that some banks have made the first promising steps in the right direction. One can only hope that it is too late for the pendulum to swing back once again.



# Indicator Chartbook (DM Banks<sup>+</sup>)

## Key indicators

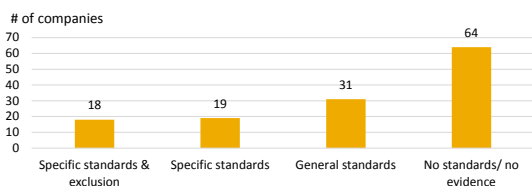
Indicator	Key ESG issue	Dimension	Weight*	Min	Average	Median	Max
<b>Environment</b>							
E.3.1.10 Credit & Loan Standards	Responsible Finance	Preparedness	13.3%	0	35	40	100
E.3.1.11 Responsible Asset Management	Responsible Finance	QuantitativeP	13.3%	0	25	0	100
E.3.1.15 Sustainable Financial Services	Responsible Finance	QuantitativeP	13.3%	0	28	25	100
<b>Social</b>							
S.3.3 Customer Incidents	Customer Responsibility	QualitativeP	17.1%	20	90	100	100
S.4.3 Society & Community Incidents	Responsible Finance	QualitativeP	11.4%	50	85	100	100
<b>Governance</b>							
G.1.3.2 Responsible Investment Policy	Responsible Finance	Preparedness	5.7%	0	25	0	100
G.1.3.5 Equator Principles Signatory	Responsible Finance	Preparedness	5.7%	0	26	0	100
G.1.5 Business Ethics Incidents	Business Ethics	QualitativeP	17.1%	20	90	100	100
G.2.5.1 Responsible Investment Team	Responsible Finance	Preparedness	8.6%	0	18	0	100
G.2.13 Governance Incidents	Resilience	QualitativeP	12.1%	20	93	100	100

\* indicator weight within E, S, G

## Environment

35

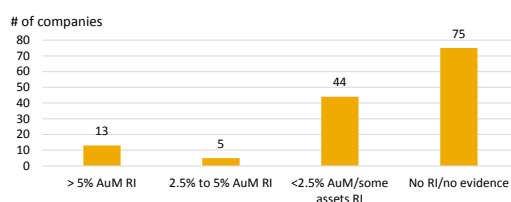
### E.3.1.10 Credit & Loan Standards



While just under half of the companies tracked do not have standards, two companies, **Westpac** in Australia and **Hang Seng Bank** in Hong Kong, are leading the way with strict standards to evaluate the environmental and social implications of their loans. In addition to implementing general standards to track social or environmental risks, the companies exclude entire sectors based on their negative impact. Such policies demonstrate deep commitment to sustainability. The average score is 35 out of 100.

25

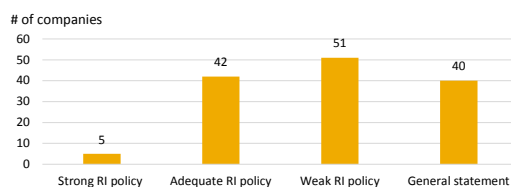
### E.3.1.11 Responsible Asset Management



Responsibly managed assets are dominated by European banks, which were the early adopters of SRI. Asset owners have driven the increase in responsibly managed assets in the past five years. **Danske Bank**, in Denmark, leads the group with 96% of total AuM under its responsible investment policy, while **Nordea**, in Sweden, screens all of its investments for violations of international norms.

28

### E.3.1.15 Sustainable Financial Services

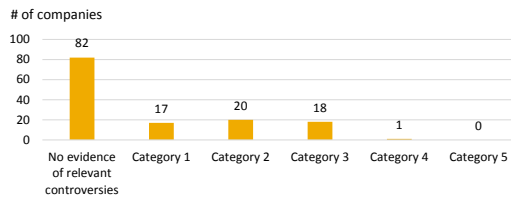


Few companies obtain the highest score in Sustainable Financial Services and demonstrate strong programmes to promote sustainable products and services, including the disclosure of the percentage of revenue these services generate for the business. Four American banks showcase best practices in this indicator: **Wells Fargo**, **Bank of America**, **Citigroup**, and **Goldman Sachs**, accompanied by Australian **Westpac**.

## Social

90

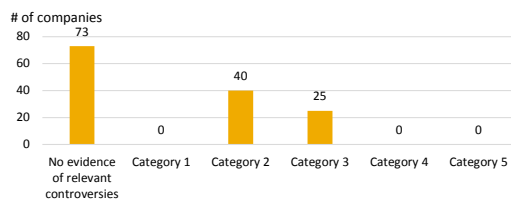
## S.3.3 Customer Incidents



The Category 3 and 4 customer incidents are related primarily to legacy issues from the financial crisis. Poor risk management created an environment where customers, both retail and institutional investors, were improperly sold products. **Bank of America** stands out for its exposure; in 2013 the bank settled with U.S. authorities for USD 9.5bn, and more settlements are expected in 2014. (See the chapter on Financial Product Governance)

85

## S.4.3 Society &amp; Community Incidents

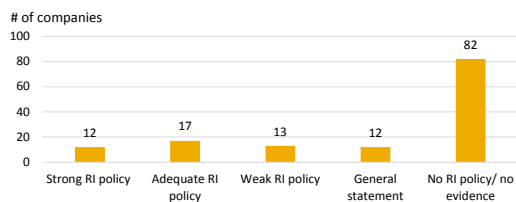


These incidents primarily relate to financing activities that violate human rights or have adverse effects on local communities, causing health issues, for example. Due to their passive role as capital providers, banks are often only indirectly accountable for Society & Community Incidents. The lack of Category 4 and 5 incidents reflects this fact, but might also be attributable to the fact that many banks have implemented management systems like the Equator Principles to mitigate the risk.

## Governance

25

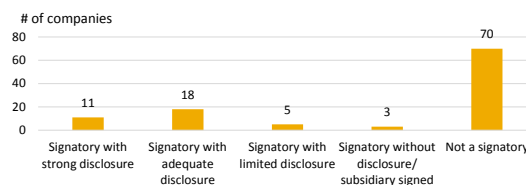
## G.1.3.2 Policy on Responsible Investment



The distribution of companies is indicative of the barriers to entry banks may face when implementing a company-wide responsible investment policy. Although exclusionary standards are relatively easy to implement, including the two other elements of strong policy, positive screening and company engagement, demonstrates significant commitment from the organisation but remains a challenge despite some increases in recent years. Ten of the 12 top performers are European, including industry leaders like **DNB ASA**, and smaller banks like **Van Lanschot**. None of the top performers come from the U.S.

26

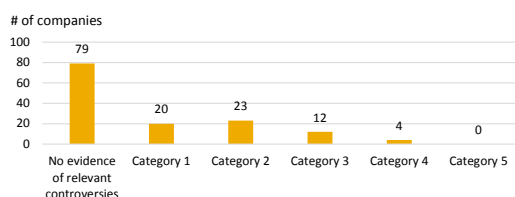
## G.1.3.5 Equator Principles



The adoption of the Equator Principles has been primarily among banks that are most exposed to the risks of project financing. It is important to note that the majority of those that have adopted the standards provide at least adequate disclosure on their implementation. However, to increase the effectiveness of the principles and decrease the “black box” effect, more companies need to disclose their implementation processes. One company that stands out is **Nordea** (Sweden), which reports how many deals were completed and the number that received independent review.

90

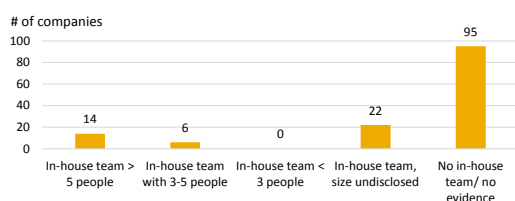
## G.1.5 Business Ethics Incidents



The three most significant business ethics controversies relate to three different kinds of breaches. Money laundering (**HSBC**), tax evasion (**UBS/Credit Suisse**) and interest rate manipulation (**Deutsche Bank/HSBC/UBS**) are all issues within the sector, but the four banks singled out show particularly high exposure to these issues and have faced striking regulatory sanctions.

18

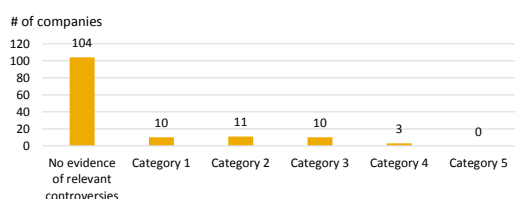
## G.2.5.1 In-house RI Team



The implementation of responsible investment across an organisation requires significant resources, including (especially) people. Companies with developed policies also tend to have an in-house RI team dedicated to implementing RI strategies, although the size is not always clear. Outstanding is the Canadian bank **RBC**, which reports having ten different teams that implement various segments of its responsible investment activities.

93

## G.2.13 Governance Incidents



In recent years, the issue of Governance Incidents was clearly dominated by the multitude of governmental bailouts that saved sinking banks. As the financial crisis recedes into the past, many banks have overcome their problems and appear to be more resilient. However, three European banks, **Banca Monte dei Paschi di Siena**, **Bankia**, and **Dexia** still failed to adequately recapitalise and remain under state control.

## Momentum

Indicator	Average score			
	2011	2012	2013	current
<b>Environment</b>				
E.3.1.10 Credit & Loan Standards	26	26	31	35
E.3.1.11 Responsible Asset Management	23	25	26	25
E.3.1.15 Sustainable Financial Services	20	18	28	28
<b>Social</b>				
S.3.3 Customer Incidents	83	83	85	90
S.4.3 Society & Community Incidents	85	84	85	85
<b>Governance</b>				
G.1.3.2 Responsible Investment Policy	23	24	24	25
G.1.3.5 Equator Principles Signatory	18	18	19	26
G.1.5 Business Ethics Incidents	90	91	88	90
G.2.5.1 Responsible Investment Team	15	16	20	18
G.2.13 Governance Incidents	94	93	91	93

## Disclosure

98

## Industry Leader

Bankinter,  
National Australia Bank

+42

## Momentum Leader

Skandinaviska Enskilda Banken

-59

## Momentum Laggard

Banca Monte dei Paschi di Siena

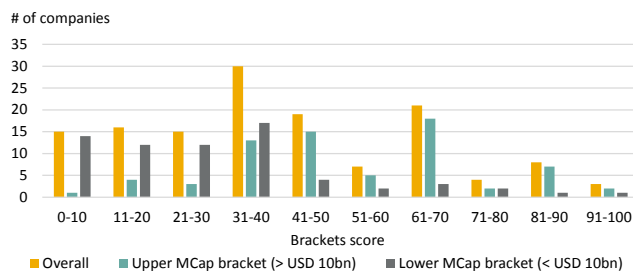
## Overview

Top 5 companies upper MCap bracket (>USD 10bn)	Country	MCap (USD m)	Disc score
National Australia Bank Limited	Australia	71,817	97.8
CaixaBank, S.A.	Spain	34,800	94.9
Banco Popular Espanol S.A.	Spain	13,595	88.9
Australia & New Zealand Banking Group Limited	Australia	86,175	86.7
Westpac Banking Corporation	Australia	100,029	86.7

Top 5 companies lower MCap bracket (<USD 10bn)	Country	MCap (USD m)	Disc score
Bankinter, S.A.	Spain	7,440	97.8
Banco Comercial Portugues S.A.	Portugal	5,434	88.9
Unione di Banche Italiane Scpa	Italy	8,816	75.6
Van Lanschot NV	Netherlands	1,037	72.9
Banco Popolare Societa Cooperativa Scarl	Italy	4,664	62.2

Disclosure reporting mostly focuses on standards around sustainability reporting, but also on specific governance indicators like board remuneration. Looking at the distribution of Disclosure scores once again confirms the assumption that larger companies (those having a MCap bigger than USD 10bn) have an increased ability to devote funds to enhanced reporting and verification. Nevertheless, when looking at the two top-performing small caps, **Bankinter** and **BCP**, it is also shown that market cap is not a basic prerequisite for quality disclosure and that small caps can easily keep up with their bigger competitors.

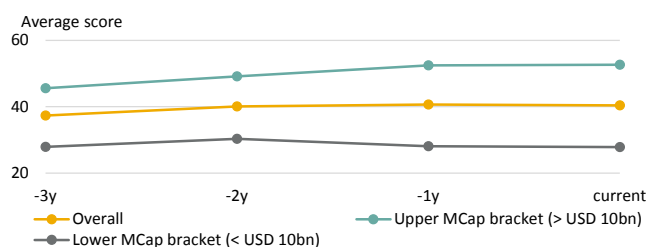
## Distribution of Disclosure scores



## Disclosure indicators

Disclosure	Key	Min	Avg	Med	Stdev	Max	Weight
<b>Environment</b>							
E.1.5 CDP Participation		0	34	0	47	100	11.1%
E.1.6 Scope of GHG Reporting		0	40	0	46	100	11.1%
<b>Social</b>							
n.a.		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>Governance</b>							
G.1.4 Tax Disclosure		0	33	0	45	100	22.2%
G.2.1 ESG Reporting Standards		0	29	0	38	100	22.2%
G.2.2 Verification of ESG Reporting		0	21	0	33	100	22.2%
G.2.3 Board Remuneration Disclosure		0	72	100	35	100	5.6%
G.2.4 Board Biographies Disclosure		0	67	100	47	100	5.6%

## Momentum



Momentum Leaders Disclosure	Score: current	-1y	change
Skandinaviska Enskilda Banken AB	83.3	41.7	41.7
Bank of Queensland Ltd.	38.9	0.0	38.9
BOC Hong Kong Holdings Ltd.	47.8	16.7	31.1
First Republic Bank	31.1	0.0	31.1
National Bank of Canada	64.4	38.9	25.6

Momentum Laggards Disclosure	Score: current	-1y	change
Banca Monte dei Paschi di Siena SpA	38.9	97.8	-58.9
permanent tsb Group Holdings p.l.c.	31.1	70.0	-38.9
Shizuoka Bank Ltd.	1.1	28.4	-27.3
Oberbank AG	3.0	27.9	-25.0
Societe Generale Group	57.1	81.1	-24.0

As the table above shows, disclosure on governance-related indicators (G.2.3 and G.2.4) is broadly accepted, with the vast majority of banks delivering information about board remuneration and biographies. The picture looks different, when it comes to pure ESG issues, for example ESG reports and their verification, but also tax disclosure. In all of these areas, the low average scores suggest room for improvement from the financial sector.

The chart on the left clearly demonstrates that while momentum for larger companies steadily increased over the years, smaller companies recently lost pace, although they were already lagging behind. However, there are a few smaller companies that show quite impressive momentum, for example **Bank of Queensland**, **First Republic Bank**, and **National Bank of Canada**. On the other side of the spectrum, **Banca Monte dei Paschi** reduced its efforts in ESG reporting and verification and thus dropped significantly.

## Preparedness

85

**Industry Leader**  
BNP Paribas

+20

**Momentum Leader**  
Commonwealth Bank of  
Australia

-44

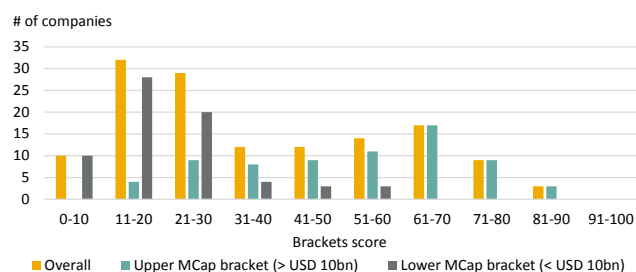
**Momentum Laggard**  
Dexia

## Overview

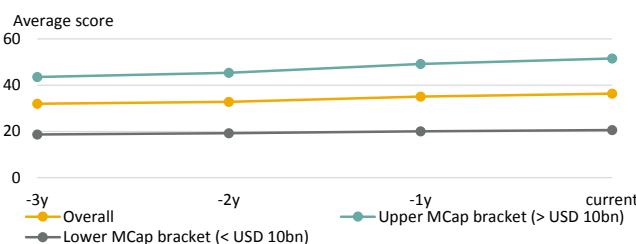
Top 5 companies upper MCap bracket (>USD 10bn)	Country	MCap (USD m)	Prep score
BNP Paribas	France	88,009	85.5
National Australia Bank Limited	Australia	71,817	84.4
Westpac Banking Corporation	Australia	100,029	83.9
Skandinaviska Enskilda Banken AB	Sweden	30,294	77.3
JPMorgan Chase & Co.	United States	215,615	76.2

Top 5 companies lower MCap bracket (<USD 10bn)	Country	MCap (USD m)	Prep score
Van Lanschot NV	Netherlands	1,037	54.5
Banca Monte dei Paschi di Siena SpA	Italy	3,893	50.7
Unione di Banche Italiane Scpa	Italy	8,816	50.6
Banco Espírito Santo SA	Portugal	6,683	49.6
Comerica Incorporated	United States	8,913	48.2

## Distribution of Preparedness scores



## Momentum



Momentum Leaders Preparedness	Score: current	-1y	change
Commonwealth Bank of Australia	72.6	52.5	20.1
Lloyds Banking Group plc	62.9	46.8	16.1
Nomura Holdings, Inc.	58.1	43.0	15.1
National Australia Bank Limited	84.4	70.7	13.8
Banque Cantonale Vaudoise SA	28.2	15.3	12.9

Momentum Laggards Preparedness	Score: current	-1y	change
Dexia SA	9.4	53.4	-44.0
Banco Comercial Portugues S.A.	31.1	42.8	-11.7
Shizuoka Bank Ltd.	5.2	15.4	-10.3
Barclays PLC	56.9	65.4	-8.5
The Royal Bank of Scotland Group plc	60.6	68.9	-8.2

Preparedness indicators combine compliance and management systems, policies, and programmes (e.g., EMS or money laundering policies) with indicators that reflect a deeper commitment to sustainability, such as having an RI team or signing the Equator Principles. In this area, the distinction between large and small caps is stark; the difference between the top performers in the two brackets is around 30 points. **Van Lanschot** stands out for leading the lower market cap companies, while also being substantial smaller than even its peers.

## Preparedness indicators (selection)

Preparedness	Key	Min	Avg	Med	Stdev	Max	Weight
<b>Environment</b>							
E.1.2 Environmental Management System		0	35	20	36	100	2.4%
E.3.1.10 Credit & Loan Standards	●	0	27	0	35	100	9.5%
<b>Social</b>							
S.1.1 Freedom of Association Policy		0	49	25	45	100	2.4%
S.1.3 Diversity Programmes		0	25	25	30	100	4.7%
S.4.2.3 Financial Inclusion		0	29	25	28	100	9.5%
<b>Governance</b>							
G.1.1 Bribery & Corruption Policy		0	46	50	36	100	1.2%
G.1.2 Whistleblower Programmes		0	34	25	30	100	2.4%
G.1.3.2 Responsible Investment Policy	●	0	16	0	31	100	4.7%
G.1.3.5 Equator Principles Signatory	●	0	13	0	30	100	4.7%
G.1.4.1 Money Laundering Policy		0	45	50	32	100	3.6%
G.2.5.1 Responsible Investment Team	●	0	11	0	27	100	7.1%
G.2.9 Board Independence		0	40	25	45	100	2.4%

The lack of momentum in smaller companies is reflective of the depth of commitment required to score highly in these indicators. Some of the momentum leaders' increases in score – such as for **NAB** – come from greater engagement with Sustainability over the past few years, as companies make efforts to publicly disclose proprietary policies.

Conversely, momentum laggards include companies that have been mired in controversies, such as **RBS** and **Barclays**, indicating a focus on core operations that leaves less resources focusing on sustainability measures. However, as investors continue to ask for evidence of sustainability, the importance of preparedness indicators such as responsible investment policies is expected to grow among companies seeking a competitive advantage. Momentum laggard **Dexia's** decrease in score is attributed to its orderly resolution which has distracted the company from its sustainability activities.

## Quantitative Performance

78

Industry Leader  
CaixaBank

+26

Momentum Leader  
Skandinaviska Enskilda Banken

-47

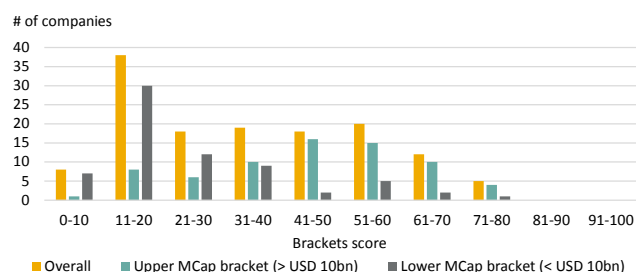
Momentum Laggard  
Dexia

## Overview

Top 5 companies upper MCap bracket (>USD 10bn)	Country	MCap (USD m)	QuantP
CaixaBank, S.A.	Spain	34,800	78.2
UBS AG	Switzerland	75,734	74.2
Skandinaviska Enskilda Banken AB	Sweden	30,294	72.5
DNB ASA	Norway	31,877	70.1
Nordea Bank AB	Sweden	59,882	68.5

Top 5 companies lower MCap bracket (<USD 10bn)	Country	MCap (USD m)	QuantP
Banca Monte dei Paschi di Siena SpA	Italy	3,893	70.9
Banco Popolare Societa Cooperativa Scarl	Italy	4,664	69.0
Unione di Banche Italiane Scpa	Italy	8,816	62.6
Van Lanschot NV	Netherlands	1,037	55.6
Bankinter, S.A.	Spain	7,440	52.1

## Distribution of Quantitative Performance scores

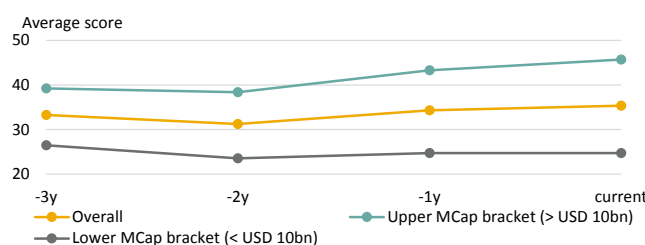


Quantitative indicators are designed to assess a company's actual sustainability performance, including core issues such as carbon footprint, impact of products, and human capital management. For banks, the indicators with the highest impact are those that encompass sustainability focused services. Once again, U.S. companies lag behind their European counterparts, with **CaixaBank** in Spain and **Banca Monte dei Paschi** in Italy leading the two market cap categories.

## Quantitative Performance indicators

Quantitative Performance	Key	Min	Avg	Med	Stdev	Max	Weight
<b>Environment</b>							
E.1.4 Environmental Fines & Penalties		75	100	100	3	100	1.2%
E.1.9 Carbon Intensity		0	23	0	29	100	1.2%
E.1.10 Carbon Intensity Trend		0	24	0	41	100	1.2%
E.1.11 Renewable Energy Use		0	32	0	46	100	1.2%
E.3.1.11 Responsible Asset Management	●	0	19	0	30	100	9.5%
E.3.1.15 Sustainable Financial Services	●	0	28	25	25	100	9.5%
<b>Social</b>							
S.1.4 Collective Bargaining Agreements		0	39	25	41	100	2.4%
S.1.5 Employee Turnover Rate		0	27	0	38	100	2.4%
S.1.6 Top Employer Recognition		0	26	0	41	100	2.4%
S.4.1 Activities in Sensitive Countries		75	99	100	4	100	2.4%
S.5.3 Cash Donations		0	35	25	31	100	3.6%
<b>Governance</b>							
n.a.		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

## Momentum



Momentum Leaders Quantitative Performance	Score: current	-1y	change
Skandinaviska Enskilda Banken AB	72.5	46.1	26.4
DNB ASA	70.1	45.0	25.1
Nordea Bank AB	68.5	45.0	23.5
First Republic Bank	28.8	6.5	22.3
CaixaBank, S.A.	78.2	56.3	21.9

Momentum Laggards Quantitative Performance	Score: current	-1y	change
Dexia SA	9.7	56.5	-46.8
Raiffeisen Bank International AG	24.1	46.9	-22.8
Bank Fuer Tirol & Vorarlberg AG	11.3	33.7	-22.3
The Bank Of Nova Scotia	39.5	57.9	-18.4
Banco de Sabadell, S.A.	48.9	65.5	-16.6

The distribution chart clearly demonstrates that smaller banks score, on average, significantly lower than larger banks with a strong positive skewness.

Furthermore, while larger companies showed, on average, an increase in quantitative performance, the performance of smaller companies more or less stayed the same over the last two years. These scores differ from the more static scores in Preparedness because policies are more likely to remain consistent year-over-year than quantitative indicators like employee turnover and renewable energy use.

For example, in 2014 **The Bank of Nova Scotia** rolled its Global Climate Change fund into a new global fund, which will consider ESG impacts, but does not have ESG in the mandate of the fund. Sometimes smaller banks will close SRI funds because of lack of customers, which is much less likely at larger institutions, with a broader customer base.

## Qualitative Performance

63

**Industry Laggard**  
Bank of America

+10

**Momentum Leader**  
Commerzbank

-8

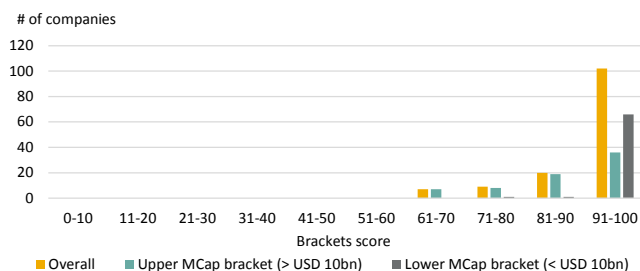
**Momentum Laggard**  
Credit Suisse

### Overview

Bottom 5 companies upper MCap bracket	Country	MCap (USD m)	QualP
Bank of America Corporation	United States	163,939	62.5
Credit Suisse Group	Switzerland	48,750	65.0
HSBC Holdings plc	United Kingdom	197,477	65.6
The Royal Bank of Scotland Group plc	United Kingdom	64,541	67.9
Deutsche Bank AG	Germany	41,079	69.0

Bottom 5 companies lower MCap bracket	Country	MCap (USD m)	QualP
Dexia SA	Belgium	101	79.9
Banca Monte dei Paschi di Siena SpA	Italy	3,893	85.2
Mizrahi Tefahot Bank, Ltd.	Israel	3,027	91.5
Ocwen Financial Corp.	United States	5,032	92.2
Julius Baer Group Ltd.	Switzerland	9,449	94.2

### Distribution of Qualitative Performance scores

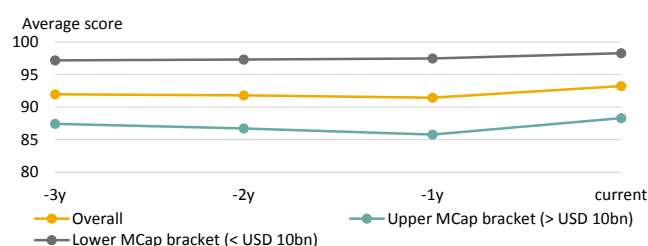


For banks, qualitative performance is rated most heavily on customer and governance-related issues. Most prominent cases include mortgage-related incidents, interest rate manipulations, and governance issues like bailouts. Not surprisingly, large European and U.S. companies lead the field of low performers in this regard, with the bottom five large cap companies (MCap > USD 10bn) scoring significantly worse than the bottom five small caps.

### Qualitative Performance indicators

Qualitative Performance	Key	Min	Avg	Med	Stdev	Max	Weight
<b>Environment</b>							
E.1.12 Operations Incidents		99	100	100	0	100	8.3%
E.2.2 Environmental Supply Chain Incidents		100	100	100	0	100	2.4%
E.3.2 Product & Service Incidents		50	95	100	10	100	11.8%
<b>Social</b>							
S.1.7 Employee Incidents		50	99	100	4	100	11.8%
S.2.3 Social Supply Chain Incidents		100	100	100	0	100	3.6%
S.3.3 Customer Incidents	●	20	95	100	13	100	14.2%
S.4.3 Society & Community Incidents	●	50	92	100	14	100	9.5%
<b>Governance</b>							
G.1.5 Business Ethics Incidents	●	20	94	100	14	100	14.2%
G.2.13 Governance Incidents	●	20	96	100	13	100	10.1%
G.3.4 Public Policy Incidents		99	100	100	0	100	3.6%

### Momentum



Momentum Leaders Qualitative Performance	Score: current	-1y	change
Commerzbank AG	86.3	75.8	10.5
Banco Bilbao Vizcaya Argentaria, S.A.	97.1	86.6	10.4
Intesa Sanpaolo S.p.A.	88.7	78.7	10.1
Regions Financial Corp.	97.7	88.3	9.5
Wells Fargo & Company	79.8	71.3	8.6

Momentum Laggards Qualitative Performance	Score: current	-1y	change
Credit Suisse Group	65.0	73.1	-8.2
Danske Bank A/S	91.9	100.0	-8.1
Zions Bancorp.	94.4	100.0	-5.6
Westpac Banking Corporation	89.2	94.7	-5.5
Unione di Banche Italiane Scpa	94.6	100.0	-5.4

The distribution of scores underpins that larger companies are much more involved in controversies than smaller ones and that the vast majority of companies have few or no controversies.

The dip in performance for larger companies in 2013 is mainly related to the high fines imposed due to LIBOR manipulations, which implicated many major banks. Momentum laggard **Credit Suisse's** recent drop is attributed to that LIBOR fines and tax evasion cases. **Westpac** is indicative of a number of developed market banks with strong policies, but continuing relationships with companies in industries like logging and coal, which are criticised for both their labour practices and environmental effects. This is the main reason for Westpac's downgrade in the past year.

On the other side, **Commerzbank** is one example of a bank that has weathered the financial crisis and made substantial improvements to its business model in order to return to financial health.

### Governance-related events

**4**

**Highest Category**  
Total of 7 companies

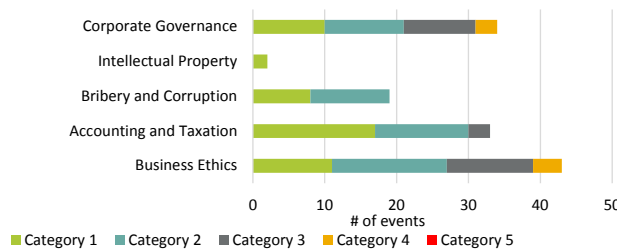
**7**

**Average Impact Score**

**9**

**Average Risk Score**

#### Evaluation of events per indicator



While Governance-related events do not dominate in terms of total number, they do encompass the most egregious breaches in the financial sector. A number of European companies are assessed as Category 4 because of their participation in interest rate manipulations, particularly the LIBOR scandal, which was the most significant controversy to surface since the subprime mortgage scandal.

### Product & Service-related events

**3**

**Highest Category**  
Total of 28 companies

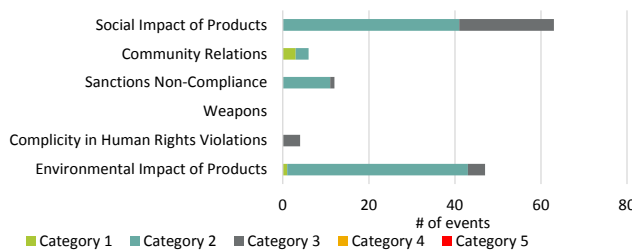
**7**

**Average Impact Score**

**8**

**Average Risk Score**

#### Evaluation of events per indicator



Product & Service-related events have been fairly static over the past three years, especially in the two categories with the highest number of violations: Social and environmental impact of products. Banks have shown reluctance to discontinue lending that is deemed controversial and instead have incrementally increased lending standards, although NGOs continue to criticise the banks. Banks with the highest category level have the highest exposure, and thus the highest reputational risk.

### Customer-related events

**4**

**Highest Category**  
Bank of America

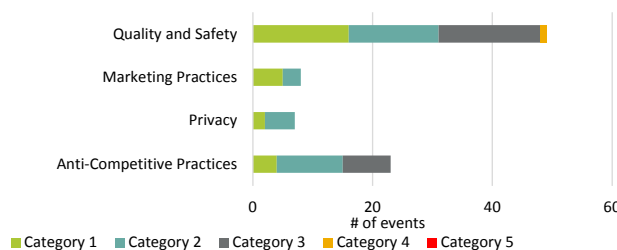
**6**

**Average Impact Score**

**7**

**Average Risk Score**

#### Evaluation of events per indicator



Although Quality and Safety, which includes all mortgage-backed security incidents, has been in the forefront since the 2008 financial collapse, anti-competitive practices is growing in importance. The Category 3s reflect a series of commodity market manipulations, especially in energy and metal, which have grown in notoriety recently. In May 2014, the first lawsuits against **Barclays**, **Scotiabank**, **Deutsche Bank**, **HSBC**, and **Société Générale** were filed by a group of hedge funds, private citizens and public investors.



# Appendix

## Methodology - How we rate companies

### Research process

The annual update of each company rating includes a thorough review of a broad range of generic and sector-specific ESG indicators. Our research is based on information disclosed by the companies themselves (such as annual reports, financial reports, CSR reports, CSR websites, press releases) and independent news sources such as (local) newspapers, relevant websites, and NGO materials. A rigorous internal review process, followed by company contact and feedback, is implemented to ensure consistency and overall high research quality.



This process is complemented by the monitoring of around 20,000 news sources from around the world. Information from these sources is processed on a daily basis, with the aim to identify those news items (so-called *incidents*) that may be significant from an ESG perspective. We monitor individual incidents, such as a lawsuit, an explosion or a strike, and assess them based on their impact on stakeholders and the environment (so-called *sustainability impact*) as well as on the reputational risk they pose for the company. For each incident, the sustainability impact assessment captures the severity of impacts (measured in terms of depth, breadth and duration), taking into consideration accountability and exceptionality; while the reputational risk assessment captures the notoriety and media exposure of incidents.

### Key ESG issues

Our research framework broadly addresses three themes: Environment, Social and Governance (ESG). Within these themes, the focus is placed on a set of key ESG issues that vary by industry.

We define “key ESG issues” as sector-specific areas of exposure that are most material from a sustainability impact and/or business impact perspective and, hence, define the key management areas for a company. The list of issues that are potentially relevant for a company have been determined by us based on a detailed and systematic “materiality of impact” analysis of the business models, and the value creation chains within a given sector. Similar to the incidents assessment, we evaluate sustainability and business impacts in terms of depth, breadth and duration of impacts.

### Indicators, scoring & relative position

The research itself is conducted at the indicator level where a comprehensive set of generic and sector-specific metrics is analysed, scored and weighted to determine a company’s overall ESG performance. For every indicator, our analysts evaluate the degree to which a company meets relevant best practice standards.

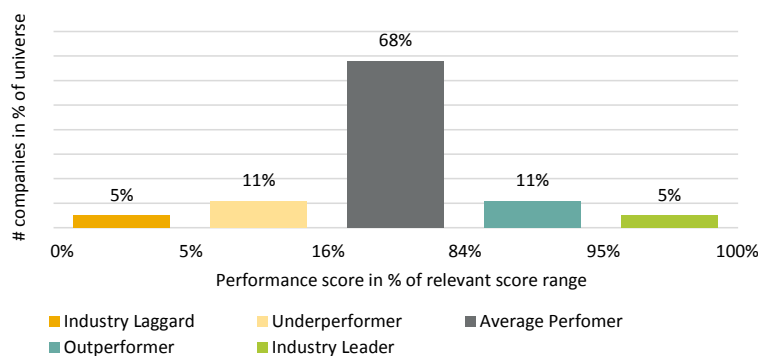
Industry-specific selection of key ESG issues based on a “materiality of impact” assessment

On this basis, a “raw score” out of 100 is assigned to every indicator based on a set of detailed and well documented internal criteria. In turn, these raw scores are aggregated based on an industry-specific weight matrix that reflects the relative importance of an issue and the related indicators.

Companies are allocated to 5 distinct performance groups

Based on their scores, companies are allocated to five distinct performance groups (Industry Leader; Outperformer; Average Performer; Underperformer; Industry Laggard) according to their relative position within the respective reference universe and assuming a normal distribution of scores.

### Relative position within relevant score range



Source: Sustainalytics

### Types of indicators

How well do companies manage areas of exposure?

We differentiate between four types of indicators that focus on different management dimensions: Preparedness, Disclosure, Quantitative Performance, and Qualitative Performance.

Indicators cover 4 different management dimensions

- **Preparedness:** These indicators assess a company’s management systems, policies and programmes designed to manage material ESG risks, e.g., bribery and corruption policies, environmental management systems or diversity programmes. Preparedness also includes a company’s participation in relevant initiatives such as the Equator Principles.
- **Disclosure:** These indicators assess whether a company’s ESG reporting meets international best practice standards and includes, for example, the ESG reporting standard and its verification, but also tax disclosure, board remuneration disclosure or CDP participation.
- **Quantitative Performance:** These indicators assess a company based on quantitative performance metrics such as, for example, carbon intensity or employee turnover rate.
- **Qualitative Performance:** These indicators assess a company’s ESG performance based on an analysis of incidents, events and controversies in which the company has been involved.

## Report parameters






Reference Universe: Banks <sup>+</sup>	Global universe of Banks (according to GICS classification) plus 10 selected peers from Diversified Financial Services (GICS); split into sub-universes DM Banks+, BRICS Banks, EM (ex BRICS) Banks, Non-listed Banks
Weight Matrix	Default Weight Matrix Banks
Update Financial & ESG Data	11 June 2014
Publication Date	24 July 2014

## Contributions

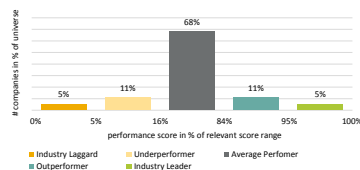
Financials Sector Team	Claudia Volk (Industry Lead), Sheila Oviedo (Senior Analyst), Stefan Klemm (Associate Analyst), Silvana van Schaik (Analyst), Lavinia Pantea (Analyst), Annalisa Werner (Junior Analyst), Sophia Burress (Junior Analyst)
Thematic Research Team	Dr. Hendrik Garz (Global Head, Thematic Research), Thomas Hassl (Junior Analyst), Niamh O'Sullivan (Research Associate)

## Glossary of terms

Business Impact	Assesses the magnitude of the potential impact that an ESG issue may have on the financial performance of a company; business impact is measured on a scale between 0 and 10.
BRICS	Sub-universe including companies from: Brazil, Russia, India, China, South Africa.
Controversy	Collection of observation points reflecting the controversial behaviour of a company regarding environment, social and governance issues; a controversy is measured by the associated controversy indicator which is defined at the <a href="#">sub-theme</a> level; controversies are rated from Category 0 (no controversy) to Category 5 (severe); each controversy indicator consists of a bundle of <a href="#">event</a> indicators.
Default Weight Matrix	<a href="#">Weight Matrix</a> proposed by Sustainalytics
Developed Markets (DM)	Sub-universe including companies from: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, United Kingdom, and United States.
Dimension	To assess a company's ability to address different kinds of ESG-related risks and opportunities, all indicators used by Sustainalytics can also be attributed to the four (management) dimensions <a href="#">disclosure</a> , <a href="#">preparedness</a> , <a href="#">quantitative performance</a> and <a href="#">qualitative performance</a> ; for each dimension we calculate a dimension score, multiplying the relevant indicators with their respective weights and transforming the result so that the highest reachable score is 100 and the lowest 0.
Disclosure	Assesses whether a company's ESG reporting meets international best practice standards; includes, for example the ESG reporting standard and its verification, but also tax disclosure, board remuneration disclosure or CDP participation.
DM Banks <sup>+</sup>	Main reference universe, and basis for the Chartbook section, including <a href="#">Developed Markets</a> Banks plus 10 selected peers from Diversified Financial Services (DFS): Credit Suisse Group, Deutsche Bank AG, IDFC Limited, Julius Baer Group Ltd., Morgan Stanley, Nomura Holdings Inc., State Street Corp, The Bank of New York Mellon Corp., The Goldman Sachs Group Inc., UBS AG.

Emerging Markets (EM) ex BRICS	Sub-universe including companies from: Argentina, Bahrain, Bangladesh, Bulgaria, Chile, Colombia, Croatia, Czech Republic, Egypt, Estonia, Greece, Hungary, Indonesia, Jordan, Kazakhstan, Kenya, Kuwait, Lebanon, Lithuania, Malaysia, Mauritius, Mexico, Morocco, Nigeria, Oman, Pakistan, Peru, Philippines, Poland, Qatar, Romania, Serbia, Slovenia, South Korea, Sri Lanka, Taiwan, Thailand, Tunisia, Turkey, Ukraine, United Arab Emirates, Vietnam.
Event	A series of <a href="#">incidents</a> that refers to the same controversial topic, tracked in one events indicator, for example “labour relations” or “environmental impact of products”; an event assessment is based on the highest <a href="#">impact</a> or <a href="#">risk</a> score assigned to the related incidents, events are rated on a scale from Category 0 (no event) to Category 5 (severe).
Exposure	Defines an area of potential <a href="#">impact</a> a company is facing due to its business activities; exposure to <a href="#">key ESG issues</a> is assessed at a <a href="#">sector</a> level and is further refined at the company level.
Impact	Refers on the one hand to the effects a company’s activities may have on environment and/or society ( <a href="#">sustainability impact</a> ) and on the other hand on the effects ESG issues may have on a company’s bottom-line ( <a href="#">business impact</a> ).
Incident	A single observation point reflecting the controversial behaviour of a company regarding ESG issues; we monitor individual incidents like, for example, a lawsuit, an explosion or a strike, and assess them based on their impact on stakeholders and the environment ( <a href="#">sustainability impact</a> ) as well as on the ( <a href="#">reputational</a> ) <a href="#">risk</a> they pose for the company.
Key ESG Issue	Sector-specific areas of <a href="#">exposure</a> that are most material from a <a href="#">sustainability impact</a> and/or <a href="#">business impact</a> perspective and, hence, define the key management areas for a company; the list of issues that are potentially relevant for a company have been determined by us based on a detailed and systematic “materiality of impact” analysis of the business models and the value creation chains within a given sector.
Key Indicator	A sector-specific ESG indicator that we regard as most important to assess how well a company manages areas of exposure as reflected by the identified <a href="#">key ESG issues</a> .
Momentum	Development of historical scores for -1, -2, and -3 years from the reference date; Note: The industry average calculation is based on the current company universe, defaulted companies are not part of the calculations.
Outlook	A forecast on how a company’s <a href="#">overall ESG score</a> , a <a href="#">controversy</a> rating or a sector’s response on a <a href="#">key ESG issue</a> will change over the next 12 months; for the sector report, we differentiate five different grades:  very positive;  positive;  neutral,  negative, and  very negative.
Overall ESG Score	Evaluates a company’s overall ESG performance on a scale of 0-100, based on generic and sector-specific ESG indicators that are grouped in three ( <a href="#">ESG</a> ) <a href="#">themes</a> and four <a href="#">dimensions</a> ; derived by multiplying the <a href="#">raw scores</a> for the relevant indicators with the respective <a href="#">weight matrix</a> .
Preparedness	Assesses a company’s management systems, policies and programmes designed to manage material ESG risks, such as bribery and corruption policies, environmental management systems or diversity programmes, for example. It also includes a company’s participation in relevant initiatives such as the Equator Principles.
Qualitative Performance	Assesses a company’s ESG performance based on an analysis of <a href="#">incidents</a> , <a href="#">events</a> , and <a href="#">controversies</a> in which the company has been involved.
Quantitative Performance	Assesses a company based on quantitative performance metrics such as, for example, carbon intensity or employee turnover rate.
Raw Score	Score between 0-100 that assesses the performance of a company for a single ESG indicator.

### Relative Position



Classification of companies into five distinct performance groups, based on a company's score ([overall ESG score](#), [theme](#) score or [dimension](#) score), according to its relative position within the reference universe, assuming a normal distribution of the scores:

- Industry Leader: Within the top 5% of the reference universe
- Outperformer: Within the top 5% to 16% of the reference universe
- Average Performer: Within the mid-range 16% to 84% of the reference universe
- Underperformer: Within the bottom 5% and 16% of the reference universe
- Industry Laggard: Within the bottom 5% of the reference universe.

### Risk

Refers mainly to the reputational risk a company is exposed to and forms one part of a company's [incident](#) assessment; the reputational risk assessment captures the [sustainability impact](#), notoriety and media exposure of [incidents](#), and is measured on a scale between 0 and 10.

### Sector

Sustainalytics analyses 42 different sectors, grouped in 14 industries; the sector definitions are by and large aligned with the GICS classification for industry groups (level 3).

### Sub-Theme

Sub-division of the three ESG [themes](#) in:

- Environment: Operations, Contractors & Supply Chain (Env), Products & Services (Env);
- Social: Employees, Contractors & Supply Chain, Customers, Society & Community, Philanthropy;
- Governance: Business Ethics, Corporate Governance, Public Policy

### Sustainability Impact

Assesses the magnitude of potential impact on stakeholders, including environment and society, that may be caused by a company's activities; the sustainability impact assessment captures the severity of impacts (measured in terms of depth, breadth and duration), taking into consideration accountability and exceptionality; sustainability impact is measured on a scale between 0 and 10.

### Theme

The three sustainability areas Environment (E), Social (S) and Governance (G). For each theme we calculate a theme score, multiplying the relevant indicators with their respective weights and transforming the result so that the highest reachable score is 100 and the lowest 0.

### Weight Matrix

A matrix containing the weights with which individual indicators are multiplied to calculate the [overall ESG score](#) for a company; weights are sector-specific reflecting the relative importance of indicators for companies within the respective sector; the weight matrix might be adjusted at the company level if an indicator is disabled due to company-specific reasons (e.g., specifics of the business model). Note: Weight matrices are customisable by our clients. The matrix proposed by Sustainalytics is called the Default Weight Matrix.

