Value drivers for green banking

*ESG and sustainable finance move to center stage*
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Executive summary

Not long ago, the attention given to environmental, social, and governance (ESG) issues was of marginal interest to all but a few, little more than an esoteric footnote in an annual report. But thanks to today’s increasing international unease about the impact of climate change on our planet, there’s a growing focus on the environmental and social responsibilities of corporate organizations and their consequent governance. As a result, ESG and sustainable finance have stepped onto center stage, becoming potential game-changers in the financial marketplace.

This new wave of thinking has been enshrined in a series of landmark agreements, including the United Nations Sustainable Development Goals and the Paris Agreement, both coming on the scene in 2015. These established a global framework for limiting global warming.

By 2019, the European Green Deal from the European Commission (EC) added further weight by setting out plans to make Europe the first climate-neutral continent by the middle of this century. As part of this strategy, last year the EC published the European Green Deal Investment Plan. This plan would see the injection of €1 trillion (~US $1.2 trillion) over the next decade to encourage Europe’s transition to a climate-neutral, sustainable, competitive, and inclusive economy.

On top of these recent developments, there is also the EC’s 2030 Climate Target Plan, which increases the EU’s emission-reduction target from at least 40% to 55% over the next decade, along with the EC’s Renewed Sustainable Finance Strategy, published this past July. Moreover – in a move that shows individual countries are toughening their stance against what are seen as unsustainable activities – a recent court order in the Netherlands obligated Shell to cut its emissions, a sign of things to come.

In this Report, we discuss the opportunities from ESG and sustainable finance as well as the strategic implications for financial institutions. Next, we address various ESG and sustainable finance value drivers before moving on to an examination of increasing climate-related risks.
1. ESG and sustainable finance offer growing opportunity

As we transition toward the creation of a low-carbon, climate-resilient, and circular economy, ESG is being recognized not merely as an “extra” but as an integral part of the corporate strategy and business model. While banks and others in the financial services sector can be catalysts for widespread sustainable change, currently few banks have a well-defined or consistent ESG strategy; indeed, only a few have included it in their incentive schemes thus far.

So, while ESG has become a key topic as more and more financial organizations recognize the value-creation potential of an ESG-oriented strategy, there remains in many organizations no real consensus about the right course to take or how best to meet the expectations of different stakeholders.

Plus, the general lack of clarity on what “sustainable” actually means does not help, often leading to confusion about what products classify as sustainable. Moreover, without transparent communication underpinned by accurate and reliable facts, there is the potential for accusations of greenwashing.

Nevertheless, there is an undisputed, fast-growing interest in sustainable finance with more and more banks offering it as an alternative to traditional loans. Assets under management have grown significantly under the last 15 years – with these assets reaching US $120 trillion in 2021, up from about $8 trillion in 2006 with the number of principles of responsible investment (PRI) signatories similarly growing from about 50 to about 3,800 in the same period.¹

This growing “green” interest is similarly reflected in a rapidly rising market for green and social bonds globally, which is particularly strong in the eurozone, where more and more banks are adding these types of bonds to their portfolios.² France, Germany, and the Netherlands, in particular, make up over 50% of this green-centered activity.³

Notably, in the third quarter of 2020, new green bond issuance represented 13% of total euro area bank bond issuance, sharply up from 4% in the first quarter of the same year, according to a report by European Central Bank (ECB). However, volumes remain low with the median share of green investments still just over 1% of total bank securities holdings.⁴

Is “sustainable” always the superior option?

Of course, long-term interest in green and sustainable products will be affected by the results they deliver. If they do not deliver on their promises, this will obviously impact the market.

At face value, you would expect ESG-committed banks and corporates to perform better than their traditional counterparts because they have higher and more stable returns and offer lower costs and risks. Indeed, multiple studies suggest that having a strong ESG proposition correlates with higher-equity returns from both a tilt and momentum perspective. There also seems to be a corresponding reduction in downside risk, evidenced by lower loan and credit default swap spreads and higher credit ratings, among other things.

In addition, a Global Alliance for Banking on Values (GABV) study² shows no conflict in simultaneously pursuing sustainability priorities and strong financial performance; in fact, to do so can be mutually beneficial, with one supporting the other under consistent and strong leadership. An analysis of 100 banks between 2007 and 2017, from that study, found those with consistently high scores on material ESG issues delivered higher risk-adjusted returns compared to those that didn’t. In fact, those with the highest materiality portfolios had, on average, risk-adjusted returns that were 2.65% better than those at the bottom. However, this differential was only evident during the second half of the study; this was probably due to improving ESG data quality and the growing importance of ESG issues.

¹ For expanded details on the numbers, see PRI’s growth chart at https://www.unpri.org/pri/about-the-pri
² For further information, see Deutsche Bundesbank’s chart at https://www.bundesbank.de/resource/blob/862854/82dc040e7f6ad5fa242af04fc9d4b2/ndl/mobi110-data.png
According to an MSCI report last year, high-ESG-scoring companies also enjoy lower costs of equity, which may be due to them being less susceptible to systematic market risks. Companies with a lower cost of capital are likely to have a higher valuation when using a discounted-cashflow model. Besides lower financing costs, high-ESG-scoring companies could also be benefiting from the competitive advantage stemming from better management of resources, human capital, and company-specific operational risks.6

We can see the ESG factor at play when considering the MSCI World Sustainability Index (SRI), which has outperformed the MSCI World Index almost throughout its 12-year existence. Even during the height of the pandemic (year 2020), while the MSCI World lost 9.9% percent, the MSCI World SRI was down just 3.6%.7

And, according to the previously mentioned MSCI report, if we look at the valuation ratio of the MSCI ACWI ESG Leaders Index and MSCI SRI Index, we see that the valuation ratio was greater for high-ESG-scoring stocks than the traditional market-cap-weighted MSCI ACWI Index over an eight-and-half-year period (June 2011–November 2019).

Is there a “greenium” to sustainable bonds?

Do green bonds allow cheaper funding? Though not all academic studies agree, there is a strong body of evidence that indicates a greenium factor does indeed exist. A recent study suggests that yields for green bonds are on average 15-20 basis points (BPS) lower than for conventional bonds, both on the primary and secondary markets.8 However, the ECB report, cited earlier, found that in 2019 and 2020 green bonds were issued in primary markets at lower interest rates and with larger order books than conventional bonds, but that there was little to differentiate the two in the secondary market. This may be because investors are not yet fully pricing in climate-related risks. Or, in the absence of clear standards, they consider that the bonds on offer have been greenwashed.

The fact that a greenium might exist in the primary market is backed up by real-life examples, both for financial institutions and corporates:

- VW issued green bonds at 15 BPS and 17 BPS below fair value.
- Orange issued green bonds at 15.5 BPS below its yield curve.
- In 2019, there was the famous green issuance by E.ON with a negative yield.
- Shell and Enel gained premium prices for sustainability bonds due to strong investor demand. Enel reported that this saved the company 20 BPS compared to a conventional bond.
- In the latest issues of green bonds, a leading banking player in Central and Eastern Europe saved about 15 BPS.

While some suggest that two funding curves – one for traditional bonds and another for ESG and sustainable finance – might possibly arise at some point, currently this seems an unlikely scenario.

Implementing a business model that satisfies immediate needs as well as longer-term ambitions and goals is no easy task given that it requires not just major operational changes, but also a shift in an organization’s overarching cultural mindset that requires every employee to play his or her part in delivering a new corporate purpose.

However, having a clear ESG strategy is not a bad thing, given that diversity and inclusion are now key to attracting young professional talent and reducing the high cost of employee departure, which various studies have shown could be 33% of the departing employee’s annual salary, or perhaps 50%-75%. This helps enhance corporate reputation and feeds into a greater sustainability narrative among a wider group of stakeholders, which is critical since intangibles can make up 70%-80% of market capitalization, as is the case with companies listed on the NASDAQ.

Thus, banks that have decided to become “leaders in green” must understand that committing to becoming net zero is a bold step, as it will require an alignment of the bank’s portfolio with the Paris Agreement, which means that emissions along the full value chain must be accounted for.

Given this, other banks might be tempted to bide their time and be more selective in their opportunities by pursuing green opportunities as they arise, while others may choose to adopt an even lighter minimalist approach.

While this may be an appropriate measured decision in the short term, ESG should not be put on the back burner, or the bank could quickly lose market share and revenue, given the strength of the underpinning forces in the marketplace. Therefore, it may not be so much a case of how much revenue ESG products generate, but rather how much the bank will lose if it doesn’t have such an offering in its portfolio.

What’s driving the sustainability shift?

The general shift to a low-carbon business model is being driven by a range of factors, not least of which is consumer behavior, increasingly being shaped by sustainability factors. ESG and sustainable finance is increasingly a deciding factor for consumers when choosing a bank – with some saying they would leave their current bank if they knew it was investing in coal, oil, or gas. This means that by developing appropriate products and services, banks can safeguard their revenue streams by reducing customer churn.

Some banks are now offering green accounts to retail clients – though the focus is not on funding but rather on attracting ESG-savvy clients. Once consumers become customers, there will be opportunities to cross-sell additional products.

And, even if not yet on the radar of clients, ESG will increasingly become so critical that banks will be expected to discuss their clients’ sustainability preferences – as of October 2022 per EC’s Sustainable Finance package, adopted April 2021. Those that fail to provide the right products are likely to be ever more penalized by both retail and corporate customers – with more positively ESG-aware clients specifically looking for green services, loans, and investment products.

This means that banks will have to look at offering green research and sustainability management services to corporate clients and develop fresh products to add to what is an already-established portfolio of proceeds-based bonds, loans linked to sustainability KPIs, and investment products like ESG exchange traded funds (ETFs). For instance, among those developing new offerings is BBVA, which has executed its first sustainability-linked interest rate swap, where the customer is required to meet sustainability goals. In Germany, UniCredit is offering ESG overdrafts to its SME clients.

The growing market for low-carbon financing opportunities, the potential to achieve stronger ratings, and the resilience of the client base of customers attracted by a range of new products, along with attractive pricing, while reducing capital, funding, and supplier costs. An ESG and sustainable finance strategy also helps mitigate exposure to risk and increase brand equity.

Evaluating the opportunities

The figure below provides some insight into how ESG and sustainable finance can impact organizational revenues, costs, risk exposure, access to capital, and its brand. Those who pursue the right strategy can grow by selling to an ever wider

**Pricing green products**

Unlike non-financial services sectors, such as retail, clients of ESG and sustainable finance products might not willingly pay a premium, so banks need to consider other pricing options. Commerzbank, for instance, aims to attract new customers by offering a 10 BPS lower rate for “green RRE financing” as a short-term incentive.

Green and ESG products can also be priced based on the achievement of specifically defined KPIs. When Philips took out the world’s first corporate Sustainability Linked Loan (SLL) in 2017, interest on the €1 billion (~US $1.2 billion) borrowing was linked to an ESG rating from independent ratings firm Sustainalytics, according to BNP Paribas.12
In another example, Dutch health and nutrition company Royal DSM used a green-labeled €1 billion (~US $1.2 billion) deal with no designated use of proceeds. Rather, the interest rate on its revolving credit facility depends on improving its cumulative greenhouse gas (GHG) efficiency, the Energy Efficiency Index that measures energy intensity, as well as increasing the amount of electricity it uses sourced from renewables. Annually, an auditor will assess how well the company meets these targets. This means it is more like an ESG-linked or an SLL than a green loan in its structure.

There are many KPIs that could be used for ESG products, as reported by BNP Paribas. Green and ESG lending to companies covers a wide range of sectors:

- **Chemicals.** Belgian chemical company Solvay’s €2 billion (~US $2.4 billion) SLL was first to link to an ambitious GHG reduction target (1 million tons of CO₂ by 2025).
- **Utilities.** In a £1.4 billion (~US $1.9 billion) SLL that was the first of its kind, UK utility company Thames Water linked its borrowing to the GRESB Infrastructure Score.
- **Hotels and hospitality.** AccorHotels has completed a €1.2 billion (~US $1.4 billion) SLL tied to sustainability performance by Sustainalytics.
- **Education.** UK-owned Pearson became the first education company to tie its SLL to educational targets (e.g., number passing through its learning programs).
- **Housing.** L&Q was the first UK housing association to borrow through an SLL linked to employment targets; it was soon followed by Optivo.

As yet, there is uncertainty about whether corporate clients will pay banks for ESG services – but the answer is probably yes, if there is a clear value proposition. This means banks become true partners in helping a company become net zero.

ING, for instance, has helped Xylem in determining ambitious performance targets to guide loan pricing with interest margins based on independent social and corporate governance ratings. This was initially set at 110 BPS over the London Interbank Offered Rate (LIBOR) and then adjusted 5 BPS up or down depending on whether predetermined sustainability targets were met.  

### How ESG cuts costs

Certainly, there are additional costs for banks in moving to a more ESG-oriented strategy, but there are clear offsetting benefits:

- **Lower funding cost.** We have already touched upon a probable greenium, since companies with high ESG scores tend to have comparative lower costs of capital. This is true in both developed and emerging markets and also holds true for the cost of equity and debt. Perhaps this relationship is to be expected as one of the pillars of ESG is the corporate governance standard, a factor that goes into reducing a firm’s default risk and thus directly impacts its cost of debt.
- **Lower capital cost.** Having effective ESG risk management in place can lessen unexpected loss, which in turn feeds through into a lower cost of capital.
- **Lower cost of risk.** Though ESG-linked loans and bonds may involve higher reporting and diligence costs, many banks find these are offset by a lower cost of risk. European members of the GABV, for instance, had a five-year average cost of risk at 25 BPS, or 32% lower than the top 25 European banks by assets in 2019.  

- **Lower supplier costs.** Creating an ESG-oriented supply chain may mean having to use specialist vendors that come at a higher cost. However, this may only be a short-term problem, as the number of appropriate suppliers increases and as non-ESG-oriented suppliers are pushed out of the market. Moreover, as sustainability measures cut energy, water, fuel consumption, and material use, operational costs will also be reduced.

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3. Increasing climate-related risks

Ultimately, banks and the wider economy need to embrace ESG thinking simply because there is no alternative, given that climate-related risk is a major potential cause of financial instability.

And although ESG is not yet fully considered as a material risk by all banks, funds, and insurers, this might well change as the impact of global warming becomes more significant and extensive.

Extreme weather events have already resulted in significant economic loss. The ECB put this at 1% of GDP in the eurozone in 2019, a figure that is likely only to rise. And since about 30% of the eurozone’s banking system has credit exposure to NFCs (non-financial corporations) that are threatened by at least one physical risk factor, the implications of this are serious – especially as much of this risk is concentrated within just 25 banks.16

Globally in 2020, natural catastrophes caused an estimated $76 billion of insured losses, up 40% from in 2019.17 These were mostly the result of secondary peril events, such as severe thunderstorms and wildfires in the US.

One sector particularly at risk from extreme weather is real estate. Hurricanes like Harvey and Maria, and storms in Europe, all contributed to insurers having to pay out a record $135 billion globally in 2017. This has a consequent effect on property prices. In several US states, for example, homes vulnerable to flooding lost $7.4 billion in value between 2005 and 2017. The New York metropolitan area also experienced a devaluation of $6.7 billion due to flooding from sea-level rises.18 And, according to data shown on the NOAA’s Office for Coastal Management website, up to $106 billion worth of coastal property is likely to be below sea level by 2050.

When asset values fall, so too does the quality of the collateral held by banks which, in turn, impacts loan-to-value-based risk steering. These losses both directly and indirectly harm portfolio growth and returns. So, from a private sector investor’s perspective, global warming of around 4°C could result in a present value loss of $4.2 trillion of financial assets globally, which would triple to $13.8 trillion if there were a 6°C rise, according to a report by the Network for Greening the Financial System (NGFS).19

A “hot house world” would present a major source of systemic risk, particularly for banks with portfolios concentrated in certain economic sectors and more particularly in those regions most vulnerable to severe events, such as heatwaves, wildfires, and other extreme weather events. This substantially increases the probability of default with the impact of climate risks unevenly spread.20

The risks of transition

While few would argue the importance of taking major rapid steps to a more sustainable future, there are risks and costs associated with such a transition.

As reported in the NGFS report, a climate stress test of the financial system found that for the top 20 listed banks in Europe, the value at risk is about 1% of their regulatory capital, while under “severe” scenarios losses could actually be between 8%-30% of capital. Indeed, studies on the transition risks of climate change have estimated the potential for losses as ranging from $1 trillion to $4 trillion when considering the energy sector alone or up to $20 trillion when looking at the economy more broadly.

The NGFS report goes on to highlight various studies worth noting. For example, if we look at the energy sector, a study by HSBC Global Research suggests that unburnable fossil fuels could result in a decrease in valuations of up to 60%. This will be compounded by an expected fall in clean energy costs, putting downward pressure on coal-fired power prices, an overall decline in demand, and increased funding costs for polluting and carbon-intensive companies. Given all these factors, a study by Tsinghua University estimates that this could lead to a non-performing loan ratio that could exceed 20% by 2030 for coal-fired power companies, up from less than 3% today.

17 Source: “Swiss Re Institute estimates USD 83 billion global insured catastrophe losses in 2020, the fifth-costliest on record.” Swiss Re Group, 15 December 2020.
Mitigating transition risks

Since investors in ESG bond and equity funds appear less sensitive to past poor performance, they could provide some financial stability during the transition.

So, while the returns of ESG and non-ESG funds are statistically similar, the sensitivity of flows to negative performance in ESG funds, including those with a green focus, has not been statistically significantly different from zero over the last four years. This is in contrast with non-ESG funds, which exhibit a clear flow-performance relationship following negative returns, consistent with the wider literature.21

This may signal either that investors have started pricing in transition risks and may now expect better risk-adjusted performance from ESG funds, or that ESG investors are more committed and have a longer-term investment horizon.

Of course, whether supervisors, banks, or investors, it’s only possible to accurately assess risk exposure to climate-related events when there is sufficient disclosure about transition strategies and GHG emissions, which EU-wide research by the EBA shows is currently lacking.22 And without this, banks can’t make the most appropriate decisions about reducing assets or cutting future lending in areas of perceived risk.

This same study also highlights the importance of banks expanding their knowledge and understanding of their clients’ activities. Since over half of the banks reviewed had non-SME corporate clients in sectors that could be sensitive to transition risk with better knowledge, financial services providers would be able to introduce exclusion criteria (negative screening) and best-in-class approaches (positive screening) to ensure activity in these areas is focused and properly monitored.

Conclusion

Moving forward

There is undoubtedly huge interest in ESG whether in the form of sustainable finance or how corporate organizations are embracing their wider social responsibilities in a new, fast-changing environmental landscape. However, while there have been some disproportionate financial inflows into certain areas, such as renewable energy, this has not led to any sort of “green bubble” as of now.

Though still relatively in the early days, if the potential of green and sustainable finance is to be maximized, then there needs to be some adjustments in the interest of investors in order to take advantage of opportunities arising from the transition to a low-carbon economy.

There is as of yet, for instance, no standardized methodology or approach to accurately establishing an ESG rating. As a result, unlike with well-established credit ratings agencies, there is widespread disparity between even the larger providers, which is probably even more pronounced among midsized ESG-rating companies.

Of course, as reported by NGFS, it’s crucial that ESG ratings are underpinned by accurate and reliable climate-related data in order to make a confident assessment of financial stability risks and for the proper pricing and management of climate-related risks. Unfortunately, persistent gaps in climate-related data hinder the achievement of these objectives.

According to NGFS, stakeholders express the need for more forward-looking data about targets and emissions pathways, as well as more granular data generally. This means that new verification and audit mechanisms must be developed to ensure trust in the quality of climate-related data through improved access to it.

This will require a mix of policy interventions that move us toward a common and consistent set of global disclosure standards, a globally accepted core taxonomy, plus the development and transparent use of well-defined and decision-useful metrics, certification labels, and methodological standards. When we have all these in place, banks and other financial institutions will be able to move to a much greener place.

Notes
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