



ESG Issues as Strategic Components of Long-term Success of Financial Institutions: Are There Differences in Financial Performance and Firm Value?

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1 INTRODUCTION

This chapter will discuss ESG (Environmental, Social, and Governance) issues as strategic success factors of financial institutions. However, we will mainly focus on banks as major financial institutions. In addition, we will use the terms ESG, corporate sustainability, and corporate social responsibility (CSR) in similar ways, since they all address environmental, social, and governance aspects.

The chapter starts with a historical overview about ESG in the banking industry. Then, we will discuss theoretical explanations for the ESG issues as strategic components of long-term success. This discussion will be followed by an analysis of financial aspects of ESG integration in different banking products and services, such as credit risk assessment,

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green lending, and others. Finally, we will focus on some general principles of sustainable banking and how they could be used as a strategic business approach.

2 HISTORICAL OVERVIEW

The consideration of ESG and sustainability has a relatively long tradition in the banking industry. Modern approaches go back to Italian banks in the sixteenth century. They were founded as an intermediate for those who could save money and those who needed funding for starting or running a business that were needed in the region, such as construction-related trades.

At this time, the lending business often was conducted by loan sharks using usury (Milano, 2011). In contrast, the Italian banks founded at this time were connected to the Catholic Church and therefore judged usury as unethical. Because some of these banks still exist, these were early examples of how ESG criteria positively influenced the business of banks. In addition, these banks also included basic assessment criteria, such as the work ethics of the business owners, their responsibility and efficiency, and their risk-taking (Weber & Feltmate, 2016). Again, we see early approaches of addressing ESG criteria in credit risk assessment that are used by modern banks as well (Weber et al., 2010).

Also, credit unions and cooperatives that were founded in the 1850s in Germany were based on ethical principles. Today, it would be called stakeholder management (Berman et al., 1999). Stakeholder management is often associated with higher firm financial performance (Berman et al., 1999; Freeman, 1984; Scholtens & Zhou, 2008). Their clients were also their members and owners, providing them with democratic participation and financial benefits coming from the revenues of the credit unions. In cities, their members were mainly small and middle-sized company owners while on the country, they mainly served farmers and connected industries. Another difference to other banks with regard to ESG is that credit unions and financial cooperatives have been non-profit organizations. Profits either go to their membership, being lenders, savers, or political units such as municipalities or counties. They addressed the new middle class as well as entrepreneurs and farmers. Credit Unions are still strong in many countries, such as Canada (Desjardins) and Germany. Also, agricultural cooperatives such as Raiffeisen are still very popular

in rural regions in Europe. They mainly follow the same ethical principles of their founders. According to the World Council of Credit Unions (https://www.woccu.org/documents/2020_Statistical_Report), they served nearly 400 million members in 2020. Because of their ethical principles, such as focusing on regional activities, and the focus on internalizing the business benefits credit unions suffered much less from the 2008 financial crisis (Li & van Rijn, 2022). Again, the example demonstrates a positive impact of an ESG-oriented business approach, since the cooperative and regional principles avoid credit losses.

Ethical banks founded in the 1960s did not just add ESG indicators to their business but they made them the centre of it. Because of political changes in the 1960s, including social movements and increasing strengths of unions, social criteria, such as financed projects and businesses having a positive societal impact have been considered an essential part of all banking activities of social banks. Furthermore, the E component of ESG, has been emphasized since and the beginning of the discussions around business and the environment caused, among others, by Rachel Carson's book "Silent Spring" (Carson, 2002). Social banks implemented environmental approaches at the core of their business and want to contribute to environmental and societal change. Consequently, they exclusively finance organic farming or the processing of organic products. Hence, the Global Alliance for Banking on Values, an association of 72 ethical banks in 2022, described this ESF-type of approach as "We put finance at the service of people and the planet" (www.gabv.org). Though social banks are still small and responsible only for a small part of global banking, their number, and assets under management are increasing. Also, their growth is stronger than that of conventional banks and they suffered less under the 2008 financial crisis (Weber & Felzmate, 2016).

Assessment of ESG Risks in Lending

Lending has been one of the first conventional banking businesses that considered ESG aspects. It has been introduced to assess mainly environmentally induced credit risks and leads to a decrease in credit defaults (Weber et al., 2010, 2015). It has been introduced because of the implementation of environmental regulations in Europe and North America that follow the polluter pays principle. This led to financial risks for lenders of polluters as well (Weber, Fenchel et al., 2008). Later, the

approach has been used in other parts of the world as well (Weber et al., 2015). ESG risk assessment is used to manage risks of contaminated sites, used as collateral, costs for borrowers because of environmental regulations, and market changes because of changes in environmental and social attitudes of clients. These risks led to the development of ESG- and sustainability-related credit risk assessment tools that the contribution of environmental, social, and governance factors of the credit risk of commercial loans (Weber, Fenchel et al., 2008; Weber et al., 2010).

ESG-Related Investment

Since the 1990s, ESG criteria also have been used for selecting green, social, and sustainable investments. ESG criteria are used to conduct (socially) responsible investments (RI). Also indexes, such as the Dow Jones Sustainability Indexes, use ESG criteria to select their constituents (Weber & Feltmate, 2016).

The literature on the financial performance of RI compared to conventional investments is vast. Most of the studies found an overperformance or at least the same performance for RI products as the review study by Friede et al. (2015) demonstrates. They also found that the positive ESG impact on the financial performance of companies and consequently for RI products and services is stable. In addition, Weber et al. (2011) found that ESG-based mutual funds outperform their conventional peers in times of turmoil, such as financial crises.

Banks and Climate Risks

At least since the COP21 meeting in Paris in 2015, climate change is on the radar of banks as both, a main financial risk and opportunity. However, historically, climate finance has already been introduced in 1997 with the Kyoto Protocol. The Clean Development Mechanism (CDM) allowed countries to fund projects that reduce GHGs in developing countries abroad to earn carbon credits (Pfaff et al., 2000). Consequently, many banks were lender to the projects. However, in 2012 the CDM mechanism has been out-phased. Since then no UN based official climate-finance mechanisms exist. However, climate finance is still a major part of green finance, including climate bonds.

In 2021, \$500 billion have been issued in green bonds. Financially, these bonds are attractive because they usually offer the same financial

return as a comparable conventional bond, but in addition they offer a green premium. Many investors ask for the green premium because they want to reduce the climate exposure of their portfolio to reduce climate-related financial risks (Battiston et al., 2021). These risks are increasing for lenders as well (Battiston et al., 2017). Consequently, banks use ESG criteria in their credit assessment processes to reduce these risks. Again, ESG is related to the financial performance of banks and consequently to their firm value.

3 ESG CRITERIA IN COMMERCIAL LENDING—FINANCIAL ASPECTS

Academic research as well as other reports have demonstrated that ESG performance and financial performance correlate positively (Friede et al., 2015; Klassen & McLaughlin, 1996; Nakao et al., 2007; Weber, 2017). Theoretically, there are a number of explanations for this phenomenon. Some of the prominent theories are institutional theory, slack theory, and good management theory.

Theoretical Background

The relationship between ESG and financial performance is the subject of many studies (Chollet & Sandwidi, 2018; Clark & Viehs, 2014; de Bakker et al., 2005; El Ghouli & Karoui, 2017; Flammer, 2015; Goss & Roberts, 2011; Yannan et al., 2021) and in meta studies (Friede et al., 2015). Though the majority of the studies found a positive correlation between ESG performance and financial performance, it is still open how the connection can be explained theoretically. Often used theories are the slack resources theory, good management theory, stakeholder theory, and institutional theory.

The slack resources theory (Daniel et al., 2004) states that a part of slack resources from financial revenues are used to invest into ESG performance reactively. Consequently, better financial performance leads to better ESG performance. Income is the driver of ESG performance.

In contrast, good management theory (McGuire et al., 1988) claims that ESG management is a part of good management. Therefore, ESG increases financial performance. In this case, ESG is the driver for financial

performance. However, often both directions can be found in the literature. Therefore, (Waddock & Graves, 1997) used institutional theory to explain the bi-directional causation.

Also, the resource based view (Wernerfelt, 1984) is closely related to the good management theory. It claims that CSR can have a positive influence on the financial performance because it helps to reduce environmental and social costs, to address stakeholder needs, and to increase a firm's reputation (Deephouse et al., 2016; Lankoski, 2008). Consequently, firms use resources proactively to achieve a competitive advantage through ESG performance (Sharma & Vredenburg, 1998).

Both slack resources and good management theory can also influence each other. Waddock and Graves (1997) call this a bi-directional causality or a virtuous circle. Slack resources in the form of financial assets might be a reason for improved ESG performance. In turn, improved ESG performance might create better financial performance through reputational, costs, and stakeholder effects.

Also, Institutional theory (DiMaggio & Powell, 1983) has been used to explain the bi-directional causality between corporate sustainability and financial performance that is often found in the literature and cannot be explained by both slack resources theory and good management theory (Ameer & Othman, 2012). Institutional theory considers the processes by which structures, including schemas, rules, norms, and routines, become established as authoritative guidelines for social behavior. Furthermore, it explains how these elements are created, diffused, adopted, and adapted (Scott, 1987). Consequently, also firms are influenced by coercive (regulative), normative (social norms), or mimetic (mimicking competitors) pressure. This pressure might also cause an increase in ESG performance. An example for coercive pressure is the introduction of environmental regulations, such as the Chinese Green Credit Guidelines. These regulations increased the ESG and the financial performance of Chinese banks (Cui et al., 2018). Voluntary codes of conduct are an example for normative pressure. If a firm becomes a member of such a voluntary code, for instance, the Equator Principles for Project Finance. A study by Weber (2016) showed that the ESG reporting quality increases if financial institutions are members of the Equator Principles. Mimetic pressure appears if competitors increase their ESG activities successfully and others will imitate this successful behavior.

To summarize, there is a number of theories that explain the connection between ESG performance and financial performance. The explanations, however, are manifold and it needs detailed research to explain the connection for a specific firm or industry. Also, the quality of the ESG performance data is rather low compared to financial data because it is not mandatory and is often incomplete. This makes it harder to analyze and to explain the connection between ESG and financial performance.

4 ESG INTEGRATION IN FINANCIAL PRODUCTS AND SERVICES

ESG Investing

ESG Investing also called Responsible Investing (RI) and Socially Responsible Investing (SRI), has left its niche and became mainstream. The Global Sustainable Investment Alliance estimates that ESG-based assets under management reached USD35.3 trillion in 2020, with a growth of 15% in two years (Global Sustainable Investment Alliance, 2021). Overall, they state that ESG Investing counts for 35% of all investments.

To stay consistent, we use the term ESG Investing to describe the following type of investing “...the integration of environmental, social and governance (ESG) factors in the selection and management of investments” (Bragg & Smeh, 2013). Major socially responsible investing (SRI) strategies that can be identified are positive and negative screening, the integration of ESG factors in investment decisions, sustainability themed investing, and corporate engagement and shareholder action. We address Impact Investing in a separate section outside of ESG screening since it follows a different goal than ESG investing.

Generally, ESG Investing has two main goals. First, ESG wants to guarantee attractive financial returns by investing in securities that take long-term sustainability concerns into account. Second, ESG Investing wants to shift capital toward activities that have a positive social, environmental, or sustainability benefit (or a less negative sustainability impact), and therefore support a sustainable development (Weber & Felzmate, 2016). The rationale behind the first goal is that firms and other investments that address ESG criteria perform better financially. This logic and the theories that explain it are described above in this chapter. The rationale behind the second goal is that sometimes investors do not only

strive for profit maximization but for positive environmental and societal impacts as well. However, ESG Investing does not guarantee that the investments and consequently the investment portfolio becomes greener or more social.

ESG Investment basically means that ESG criteria are considered in investment decisions. Nevertheless, considering does not mean that investment will be made or not made based on ESG criteria. Investors might acknowledge the good or bad ESG performance of an investment but make or do not make the investment anyway. This approach of “integrating” ESG criteria is also one of the reasons that ESG Investments are estimated that high (see above). Many portfolios that are based on an ESG approach are not really different from conventional portfolios. This issue has even led to regulatory action against investors claiming that their funds follow an ESG approach. Some investors are accused for greenwashing with regard to their sustainable investment products (Heitzner, 2022).

With regard to the financial success of ESG Investments, studies and meta-studies found that ESG Investments perform similar as conventional investments, and that many ESG Investments even outperform their conventional counterparts (Busch & Friede, 2018; Friede et al., 2015; Weber & Ang, 2016; Weber, Koellner, et al., 2008). Often, it is found that these investments outperform their conventional counterparts in times of crises (Weber et al., 2011). Some studies, however, could not find this characteristic during the COVID pandemic (Folger-Laronde et al., 2020). Additional factors, such as the general portfolio management and the investment decision-making, regional and sectoral factors, and the type of ESG indicators used, might be variables that explain the variance in the performance of ESG Investment.

Impact Investing

Impact investment is a form of investment that addresses social or environmental challenges and generates financial returns. In contrast to ESG Investing, the creation of positive impacts is a necessity in Impact Investing. Usually, societal impacts have a higher priority than financial returns. However, the spectrum of financial returns as well as impact vary. Therefore, some impact investments may create financial returns that are comparable to conventional investments. For instance, Porter and Kramer (2011) describe such an approach in his article about the shared value

approach. They claim that investments addressing societal needs are also more successful from a financial point of view. However, Impact Investing is similar to ESG Investing as its principles are diluted.

Busch et al. (2021) claim that impact investing originally focused on achieving transformational changes. Nowadays, however, the term is used interchangeably for any investments that consider ESG criteria. Consequently, they ask for metrics that can be used to measure the impact of the investment. Such metrics could be, GHG emissions reduced by \$X of investment, or number of schools built by \$X of investment. Often, however, these metrics are not measured though systems, such as IRIS by the Global Impact Investing Network provides a system of indicators to track the social and environmental impact of Impact Investments.

Financially, Impact Investments might outperform other types of investments or not. Often, this depends on the choice of the investors and on the type of investment. Because, the creation of a societal transformation is the first goal of an Impact Investor, the financial return might be less important. There might be cases, such as investments in social enterprises that create high returns, but other cases might not create such a win-win situation. In some cases, Impact Investors even abstain from a financial return at all or even provide their investment as a grant.

The attitude toward the ratio between impact and financial return might also depend on the type of impact investors. Specialized impact investors might strive for more societal impact. The same might be true for foundations that focus on specific impact investment topics. The ratio might be different for investors that conduct impact investment as a small part of their financial activities. Some banks, for instance, conduct impact investment with a small part of their assets and consequently might strive to returns comparable to conventional investments. However, even specialized impact investors often achieve financial returns comparable to conventional investments.

Fossil Fuel Divestment and Engagement

Analyses of the Intergovernmental Panel on Climate Change (IPCC) state that only a small part of the fossil fuel reserves that are still in the ground can be burned if the world wants to stay below a 2 °C warming (IPCC, 2021). Among others, this has serious consequences for investments in the fossil fuel industry. Hence, there are both moral and financial reasons to rethink investments in the fossil fuel industry.

Firstly, the fossil fuel industry may be tagged as “immoral” because fossil fuel production and consumption contributes to two-thirds of the CO₂ emissions that cause climate change (Ekwurzel et al., 2017; Heede & Oreskes, 2016). Consequently, some investors might divest from the industry because they do not want to support firms that cause climate change. Financially, even announcement for such decisions have a negative effect on the share price of firms in the fossil fuel industry (Dordi & Weber, 2019) as well as a positive effect on the share price of the divesting investor (Bassen et al., 2020). Furthermore, studies demonstrated that portfolios that are less exposed to climate change perform better financially (Henriques & Sadorsky, 2018; Hunt & Weber, 2019; Trinks et al., 2018). This leads to the second reasons to divest from or to engage with the fossil fuel industry, the financial motivation.

Secondly, a number of studies even found that investments in the fossil-fuel sector create financial risks for investors (Battiston et al., 2017; Monasterolo & De Angelis, 2019; Monasterolo et al., 2017) because of stranded assets (Ansar et al., 2014; Green & Newman, 2017) caused by the limited opportunities to burn fossil fuel reserves (Campiglio et al., 2018, 2019), and because of political decisions to transition to a low-carbon economy might have negative financial impacts on the fossil fuel industry (Linnenluecke et al., 2015; Strauch et al., 2020).

Consequently, investors might reduce their investments in the industry or engage with their investees to make their business in-line with climate needs (O’Rourke, 2003; Othman & Ameer, 2010; Schaltegger & Burritt, 2015). Such investment strategies might have a strong impact on the fossil fuel industry and climate change because only a small number of investors own a significant portion of the fossil fuel industry, and consequently, are able to apply pressure on their investees (Dordi et al., 2022).

Green Lending

Green lending exists until the 1990s (Weber & Feltmate, 2016). The rationale is that lending to green borrowers including Greentech is a good business opportunity because these borrowers address a market demand. Consequently, green loans have a lower default probability than non-green borrowers. The same approach has been used for mortgages Green housed might have lower energy costs, have a higher value and—according to the good management theory (Waddock & Graves, 1997)—their owner conduct a better financial management.

Recently, green lending increased again because of government policies and incentives. For instance, the European Union and the European Banking Federation have issued green and sustainable finance guidelines (Cui et al., 2018). Furthermore, members of the Sustainable Banking Network hosted by the International Finance Corporation (IFC), have introduced green and sustainable financial regulations. Out of these, the Chinese Green Credit Guidelines are probably the most prominent green credit guidelines (Aizawa & Chaofei, 2010; Cheng et al., 2021; China Banking Regulatory Commission, 2012, 2014; Zhang et al., 2011; C. Zhao, 2015; N. Zhao & Xu, 2012). They ask for a shift of the lending portfolios away from polluting industries to green industries. Consequently, the Chinese financial regulators have developed indicators that measure the progress of lenders with regard to green lending. Banks have to demonstrate that they increase the ratio of green loans in the credit portfolio. Overall, it seems that green lending in China is also successful from a financial point of view (Cui et al., 2018).

Bangladesh Bank uses an incentive-based approach to channel loans to green or less polluting industries. They provide lenders with lower interest loans if they apply an environmental credit risk assessment scheme and consequently prefer greener borrower (Bangladesh Bank, 2011). Again, it looks like using an environmental risk management tool in commercial lending decreases the probability of default of loans (Weber et al., 2015). However, banks need to follow a more proactive approach with regard to green lending to increase the benefit of green lending (Weber & Chowdury, 2020).

ESG-Related Credit Risk Assessment

Similar to ESG Investing, ESG-related credit risk management uses ESG criteria in addition to financial criteria to manage credit risks. The risks might be environmental, societal, and climate-related. With an increasing climate emergency and the introduction of GHG emission pricing, the need to address climate-related credit risks increases.

Battiston et al. (2017), for instance, analyzed the influence of climate exposure on portfolio risks. They found higher risks for lending portfolios that are more exposed to climate risk. Other studies analyzed the connection between GHG emissions and the credit default probability of commercial borrowers. Monnin (2018) showed increased probability of default for borrowers from the Utilities and the Material sectors. Bouchet

and Le Guenedal (2020) also found significant EBITDA losses and consequently an increase in the probability of default for firms in the Energy, Materials, and Utilities sectors. Also, Capasso et al. (2020) found a negative effect of carbon emissions on the creditworthiness that is amplified by climate-related events, such as the Paris agreement. Finally, Oyegunle et al. (2022) found a negative impact of a price on carbon emissions on the credit default probability.

Also, studies that used a broader sustainability approach found a connection between ESG performance and creditworthiness (Bauer & Hann, 2010; Höck et al., 2020; Weber, 2012; Weber et al., 2010). They all state that it makes financial sense to consider ESG criteria in lending decisions to avoid ESG-related default risks.

Green Bonds

To date, green bonds are the single biggest source of capital with a higher amount than equity (Weber & Saravade, 2019). Green bonds are issued to raise long-term debt capital from various domestic and international investors to either finance or refinance green assets and projects (Saravade & Weber, 2020). Hence, their use of proceeds goes toward green projects and assets. They are issued by national and regional governments, financial institutions, such as banks and multilateral development banks (MDB), and by firms that want to finance ESG activities. Since its inception in 2007, the frequency of issuances and the financial value of green and climate bond issuances have increased significantly. In 2021, the global market reached \$1.2 trillion of cumulative issuances (Climate Bonds Initiative, 2022). Consequently, green bonds are an important financial product that helps to meet the 1.5 °C target.

Similar to conventional bonds, eight types of green bonds exist (Weber et al., 2018). Corporate bonds, usually use-of-proceeds bond, are backed by the issuing corporation's balance sheet. Secondly, project bonds are backed by earnings of a single project or multiple projects. To disburse the proceeds of these projects special purpose vehicles (SPV) that are independent subsidiaries of the issuer, are established. They disconnect the risk of the project bond from the issuing corporation. Thirdly, multiple projects, such as windfarms or photovoltaic projects, might be grouped and collateralized to create an asset-backed security (ABS). Fourthly, covered bonds are secured with underlying assets to cover the bond if the issuer defaults.

Fifthly, financial sector bonds are used by the financial industry for “on-balance sheet” lending. Often, the use of proceed is defined broadly to provide the financial institution with the opportunity to use them for a variety of projects and corporations. Sixthly, multilateral institutions, such as the World Bank and other MDBs issue supranational, sub-sovereign and agency bonds. Seventhly, municipal bonds are issued by regional governments, municipalities, and cities. Finally, sovereign green bonds are issued by national governments. Their proceeds go toward green public sector projects, for instance, green infrastructure projects.

Because the interest of green bonds is based on the risk of the issuer, they offer the same financial returns as conventional bonds, but offer an additional green premium (Saravade & Weber, 2020). This makes them attractive for institutional investors, such as pension funds, insurance companies, hedge funds, mutual funds, sovereign wealth funds, and endowments that often need to achieve certain financial returns because of their fiduciary duty but want to have more green investments that decrease the climate risk exposure and increase the environmental performance of their portfolios.

To summarize, the proceeds of green bonds go toward green projects and assets. Financially, green bonds are attractive because they offer fixed returns that depend on the risk of the issuer. In addition to the financial attractiveness, green bonds offer a green premium, also called greenium.

5 CONCLUSION

This section presented the effect of ESG criteria in financial decision-making. We could show that considering ESG criteria has not only had an environmental and societal effect, but a financial effect as well. Nearly all academic studies agree that considering ESG criteria has a positive effect on financial risk. Furthermore, introducing ESG-related products and services might create additional income as it meets market demands.

Consequently, ESG issues should become strategic components of firms inside and outside the financial sector to guarantee long-term success. Both, investors and lenders use ESG criteria to price their investments and loans. Hence, a borrower with a good ESG performance is more likely to achieve credit and then interest rate of the loan might be lower than that for a low ESG performer. Hence, the investment in ESG will pay off. It is a so-called sustainability case—better sustainability increases the financial performance (Weber & Feltmate, 2016).

Furthermore, there is a stronger demand that firms prove their positive contribution to society. They need to show that they do not contribute to climate change and other societal challenges, such as discrimination of minorities, including indigenous people. Banks and other investors, for instance, are criticized because they still finance fossil fuel companies and consequently contribute to climate change (Dordi et al., 2022). This has a negative effect on their reputation and might lead to long-term financial underperformance. Integrating ESG into the long-term business strategy might help to avoid this problem.

Integrating ESG into the corporate business strategy, however, is not without difficulties. Currently, ESG criteria are still not standardized, and the quality of the indicators is often hard to evaluate. This might also be one of the reasons that studies about the correlation between ESG and financial performance deliver mixed results. Furthermore, ESG expertise is needed that is often not available in corporations. Here, the need to integrate ESG knowledge into business school education is obvious. However, with an increase of environmental and societal challenges, the benefits of addressing ESG issues strategically are obvious.

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