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LAW AND ECONOMICS YEARLY REVIEW

ISSUES ON FINANCIAL MARKET REGULATION, BUSINESS DEVELOPMENT AND GOVERNMENT'S POLICIES ON GLOBALIZATION

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The "Law and Economics Yearly Review" is a an academic forum to promote a legal and economic debate. The Review is published twice annually (Part I and Part II), by the "Fondazione Gerardo Capriglione Onlus", an organization aimed to promote and develop the research activity on financial regulation. The Review faces questions about development issues and other several matters related to the international context, originated by globalization. Delays in political actions, limits of certain Government's policies, business development constraints and the "sovereign debt crisis" are some aims of our studies. The global financial and economic crisis is analysed in its controversial perspectives; the same approach qualifies the research of possible remedies to override this period of progressive capitalism's turbulences and to promote a sustainable retrieval.

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CONTENTS

WHAT MAKES A BANK A "SUSTAINABLE BANK"?

Roger McCormick*

"Events over the past couple of years have raised profound questions about the ways in which banks and businesses contribute to society. For both to play their full part, they must restore trust and become better citizens in a publicly demonstrable way…. Our focus on Citizenship is not for the short term; in fact, it is how we expect to make our business sustainable over the long term."[1]

"….our work towards becoming the UK's most Helpful and Sustainable bank has…been recognised….."[2]

"Stephen Cecchetti, chief economist of the BIS….said five years after the financial crisis engulfed the global economy, the world appears no closer to finding a sustainable economic model. Not until regulators get to grips with the banking system's woes by forcing banks to recognise losses, take write-offs and raise capital can the path to sustainable growth begin, he said"[3]

ABSTRACT: *The notion of sustainability has been used in several contexts in order to denote, in general terms, a reconciliation between the needs of the present and the needs of the future. In the specific context of banks and financial markets this concept needs do be further analysed, looking at possible solutions and criticalities (like those linked to the eurozone crisis and to politicians' short term interests). In the specific case of banks, an honest recognition of losses is key, as well as the search for clear and publicly available infor-*

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[1] Statements taken from the Barclays PLC 2011 *"Citizenship Report"*.

[2] From the RBS Group 2011 *"Sustainability Report"*.

[3] From a report in the *Financial Times* of June 25th (Global economy stuck in "vicious cycle" of debt reduction, says BIS", by NORMA COHEN). The comment accompanied the publication of the *BIS' 2012 annual report*.

mation on balance sheets. This latter would help understand to which extent banks have changed their "bad habits". Suggestions for improvements are then provided, aiming at information that enable verification, and include proper indicators of sustainability, for banks' own business and for the overall financial system. The use of "soft-low" pressure may be an appropriate choice to bring about changes.

1. This article is about banks, the financial markets and sustainability. In particular, it is concerned with how the modern notion of sustainability fits in with what banks do, what society wants them to do (to the extent society is capable of expressing a view) what activities are financed by banks and how banks and financial markets are organised. It suggests that although sustainability has, perhaps inevitably, become an elastic and over-used term, there is now a strong case for being more precise about what it encompasses (and does not encompass), particularly in relation to reporting requirements….and particularly in relation to reporting requirements for banks. At the centre of the debate is the question: what do we mean when we refer to "sustainable banks" and "sustainable banking"?

The Brundtland Commission of the United Nations[4] famously defined sustainable development in 1987 as development that meets "the needs of the present without compromising the ability of future generations to meet their own needs". The concept of sustainability thus involves striking a bal-

[4] The formal title of the Commission's report is *"The Report of the World Commission on Environment and Development: Our Common Future"*

ance between the needs of the present and the needs of the future. Examples abound. Timber production should be managed in a way that does not result in the rainforests being stripped bare, with potentially appalling consequences for the environment as a whole (not merely a shortage of timber for future generations). Fishing policy should not allow over-fishing that could result in endangering entire species of fish. Energy policy should recognise that the supply of carbon-based fuel is not infinite and that alternative sources of energy need to be developed for the future. And so on. The idea of balancing the needs of successive generations fairly is sometimes referred to as "intergenerational equity".

Against this background, it comes as no surprise that awareness of the need for "sustainability" is generally regarded as highly desirable. Politicians and businesses alike give the impression that they make common cause with environmentalist campaigners on the subject. Policies of any kind (whether or not directly concerned with the environment) are, if disliked, often criticised for having "unsustainable" aspects and, conversely, if liked, regarded as having "sustainable" qualities. It is hard to get through the day (if you are at all exposed to the modern media) without hearing "sustainability" and "sustainable" being mentioned many, many times. (Unfortunately, not always in a way that suggests that the word is being used for purposes that go beyond the decoration of an otherwise anodyne sentence).

Sustainability is thus a contender for "word of the decade" – perhaps several decades. As such, it merits close attention as to its use and meaning. In what follows, particular concerns are explored in connection with its meaning in the context of financial markets and institutions. How has the idea of "sustainable finance" (or "banking") been developed as at 2012? The question is a pressing one, as the financial turmoil engulfing the eurozone and other parts of the world shows no signs of abating. As Patrick Jenkins (writing in the Financial Times "Sustainable Banking & Finance"[5] supplement of 14th June) put it:

"At a time when several eurozone governments are battling to restructure their budgets and make their debt burdens more manageable, the topic of sustainable finance could hardly be more pertinent."

But what is "sustainable banking"? Is it the same as "responsible banking" --- the title of a Times newspaper lead editorial on 29th June?[6] Is it related to the "culture" of banks themselves (whatever that may be), or is it more concerned with how banks use their financial power, the role they play in the "allocation of capital" in a global market? Are these, in reality, two distinct areas of concern or are they so closely linked that they should be considered together? Whatever may be the answer to such questions (which we will consider below) they clearly share the same practical difficulties insofar as they raise issues that are both inter-national and inter-generational. As a result, traditional (national) legislative measures --- which emanate from legislative bodies populated by politicians whose agendas are dominated by national, and usually short-term, interests are unlikely to be the source of a complete solution.

2. June 2012 (the time of writing) raised environmental concerns in the public consciousness in the most direct and fundamental way as it brought with it (in Europe) a truly appalling spell of stormy weather that made many of us wonder whether climate change was bringing a "rainy season" to replace what we had previously thought of as "summer". It also brought (following hard on the heels of a G20 Summit in Mexico) the second Rio "Earth Summit" (formally entitled the "United Nations Conference on Sustainable Develop-

[5] *The International Finance Corporation/Financial Times "Sustainable Banking Awards"* were presented at a gala dinner in London on June 14th.
[6] This editorial was a comment on the *"LIBOR rigging" scandal*, referred to in footnote 18 below.

ment" or "Rio+20"). In a speech given on 12th June, Christine Lagarde, the Managing Director of the International Monetary Fund, said, in relation to the Rio conference, that "we will be journeying back to Rio to affirm our commitment to sustainable development – the idea that we should strive for economic growth, environmental protection and social progress at the same time".

Europe continued to endure further chapters in the ongoing eurozone crisis, with new bail-out measures (of the order of 100bn euros) being tabled for Spain (following the collapse of its biggest bank (in terms of domestic business), Bankia), a request for a bail-out by Cyprus and a return of "unsustainable" borrowing costs for certain eurozone countries. Commentators digested remarks from Mario Draghi, the President of the European Central Bank, in an interview published on the last day of May, that indicated he thought the euro system had become "unsustainable" unless national governments took further (unspecified) action), and there was a knife-edge re-run of Greece's General Election that resulted in the party that had roundly rejected the terms of the country's bail-out coming a close second (and, eventually, a coalition government being formed that then pledged to renegotiate a bail-out deal signed only a few months earlier).

In the UK, in the first part of the month[7], the government published a White Paper[8] on important bank reforms (mainly on the topic of "ring-fencing" retail banking from investment banking (or "utilities" from "casinos") that was sub-titled "delivering stability and supporting a sustainable economy" and, in the first of his Reith Lectures for the BBC[9], the historian, Professor

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[7] The last week of the month was dominated by the *LIBOR rigging scandal* – see further below.

[8] Cm 8356. The White Paper does not refer to the "sustainability" of banks as such – but it does refer to the need for UK banks to be "more robust" and "resilient, stable and competitive".

[9] Delivered at the London School of Economics and broadcast on 19th June 2012.

Niall Ferguson, appealed for greater inter-generational equity and asserted that current practices in government accounting are "fraudulent":

"There are no regularly published and accurate official balance sheets. Huge liabilities are simply hidden from view. Not even the current income and expenditure statements can be relied upon. No legitimate business could possible carry on in this fashion".

The essence of Professor Ferguson's complaint, however, was not merely the dubious accounting practices but also the fact that modern representative government, especially when accumulating debt, does not look beyond the interests of the current generation of voters:

"The heart of the matter is the way public debt allows the current generation of voters to live at the expense of those as yet too young to vote or as yet unborn".

Those suffering as a result of extreme "austerity programmes" introduced around the eurozone in order to allow governments to gain access to bail out funds to refinance unsustainable debt might be inclined to nod in agreement. Campaigners for "sustainable development" (see below) likewise. However, although Ferguson suggested that ordinary businesses could not be as unreliable in accounting practices as governments, he should perhaps have made an exception for banks, since his remarks carried echoes of an article published earlier in the month (5th June, in *Economia* magazine) by Andrew Haldane (executive director of bank stability at the Bank of England) when, calling for reforms to bank accounting, he said that accounting rules should "properly recognise the special characteristics of banks' assets and liabilities" and that: *"to provide point valuations of banks' assets, as at present, is to ask auditors to pin the tail on a boisterous donkey".*

Various recent statements from regulators and others about banks' balance sheets and solvency, particularly in the eurozone, could lead, were it not for depositor guarantee schemes, to a sharp loss of confidence on the part of the average citizen as to just whom you can believe any more. In his Mansion House speech (14th June), Mervyn King (the Governor of the Bank of England) remarked that, in the euro zone:

"…liquidity is not the issue, because after a few months [following the ECB's one trillion euro liquidity programme (known as LTRO –long term refinancing operation] we are back to where we were. The problem is one of solvency.

Where there are debtors who cannot afford to repay, there are creditors who will not be repaid. Until losses are recognised, and reflected in balance sheets, the current problems will drag on. An honest recognition of those losses would require a major recapitalisation of the European banking system."

The appeal for an "honest recognition" implies that what we have at the moment is, shall we say, not entirely honest. Could it be perhaps that many banks hold large quantities of eurozone sovereign debt on their balance sheets? And that these "assets" (along with others, such as property loans that have become subject to excessive "forbearance" on the part of a lender that does not want to face reality) are perhaps valued rather optimistically? Is there, furthermore, an unhealthy commonality of interest between regulators who are subject to political pressure and the banks themselves to continue viewing such "assets" as though the euro crisis had never happened? The absence of clear, publicly available, information leaves us with no choice but to speculate[10]. But the sweeping downgrading of 15 major bank credit ratings carried out by Moody's on 21st June suggests that speculation of this kind may not be very wide of the mark[11]. As the calls for the use of public money to buy

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[10] The apparently chronic difficulty in coming up with clear numbers is reflected in a comment about the Spanish banks made by the economist, Nicholas Spiros, and reported in the Daily Telegraph on 22nd June: "In the space of a fortnight we have gone from a euro 37bn forecast for Spain's capital needs in a stressed scenario to a euro 52bn, to a euro 52bn one. This begs the question – what will the more detailed audit in September reveal?"

[11] The report in the Independent newspaper said that: "Moody's downgrades came amid fears that the euro crisis will prompt another credit crunch by making banks afraid of lending to each other, or anyone else." The UK government had apparently already anticipated such

eurozone government bonds continued[12] – with the purported aim of lowering borrowing costs – the risk of such assets continuing to be given an inflated value only seemed to increase.

It looks like a vicious circle (or, perhaps, cycle)[13]. Some have called it the "bank-sovereign-bank doom loop" and suggested that many sovereign states are now becoming "aid junkies" as the number of bail-outs (for states or for banks), actual and predicted, keeps increasing. Has the financial system got hooked on bad habits?[14] Does our approach to bank supervision work at all without the use of subterfuge and obfuscation? To take one example, the vast majority of European banks have now passed the European Banking Authority's stress tests for two years running (including, infamously, the Irish banks

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developments when arranging for the Bank of England to make available £100bn of cheap credit lines to UK banks for the express purpose of on-lending to UK borrowers (announced in the Chancellor's Mansion House speech, 14th June).

[12] See, for example, the remarks of Christine Lagarde reported in the *Financial Times*, 22nd June: "Christine Lagarde, the IMF chief, said eurozone leaders needed to prevent the single currency from deteriorating further by considering the resumption of bond buying by the European Central Bank and pumping bailout money directly into teetering banks."

[13] The *Euro Area Summit Statement* issued on 29th June began by saying: "We affirm that it is imperative to break the vicious circle between banks and sovereigns".

[14] The business of banking, the selling of securities issued by banks (or governments) and the potential for political interference makes for a dangerous cocktail. Various episodes in the creation and downfall of the Spanish bank, Bankia, reported in a damning article in the Financial Times of 22nd June ("The bank that broke Spain" (Mallet and Johnson)) provide an illustrative case study. "Bankia was floated on the basis of unaudited accounts – "due to the recent creation of the Bankia Group", the prospectus said – and it was eventually Deloitte's refusal to sign the 2011 accounts that prompted the government's intervention…" Although the risks were explained in the prospectus, the "euro 19bn hole" evidently took everyone by surprise. There was also, according to the authors, a shortage of "experienced top executives" – at least initially, until some of the investment banks involved in the IPO threatened to withdraw. "And when foreigners shunned the share offer, senior members of the government called the heads of Spanish banks and corporations and strong-armed them into buying 40 per cent of the euro 3bn worth of shares "in the national interest". Retail clients across Spain –some 35,000 of them—were persuaded to buy the rest."
Further, the regional savings institutions ("cajas") that were grouped together to form Bankia "began as regional businesses and were in most cases closely connected to politicians in the areas where they operated." The article suggests that the cajas generally were ill-equipped at managerial level to deal with the financial crisis that resulted from the collapse in Spanish property values. ""Fifty per cent of the banking sector in Spain –which was the cajas—did not have the corporate governance or the management skills to withstand a crisis" says one of the many investment bankers involved in the July 2011 public offering of Bankia". On 4th July 2012, the Spanish High Court announced a fraud investigation into matters related to the Bankia flotation.

that collapsed with a few months later). If Mervyn King is right, one might wonder just what the point of those tests actually is. They are hardly a persuasive advertisement for the latest[15] proposed "solution" to the euro crisis; a European "banking union" with centralised supervision[16]. More importantly, as one looks at the current position, when a political leader tells us (as such leaders are wont to do) that his country's banks are "strong" and do not need rescuing, should this now be taken as an early warning sign that they are on the point of collapse and in urgent need of yet more bail-out funds from the public purse (whether provided directly or indirectly)?

All this tells us that we have to be sceptical about what we are told about the financial position of banks. But even if we could trust "the numbers" that banks and regulators present to us, we know that they do not tell us anything like the whole story. Whatever new laws, regulations and codes of practice are passed, will the banks try to find ways round them and "game the system"? Will they honour the spirit as well as the letter of the law? How can we know if banks have changed since the crisis? Have they started to take ethics and morality more seriously? Do they look at their long term sustainability or are they still blinded by a desire for short term profit at any cost? Do the remuneration packages of senior executives still provide all the wrong incentives? These issues go to behaviour and attitude. If these have not changed, we can expect the "bad habits" that brought us the financial crisis in 2007 to give us a re-run before too long. If banks continue to operate within amoral or immoral culture zones, the lack of responsibility that ensues will infect the financial system itself, as graphically demonstrated by the LIBOR

[15] Having been trailed for some weeks beforehand the idea seemed to take hold at the EU Summit meeting at the end of June, with commitments being announced to have some kind of cross-border, eurozone supervisory authority to be given to the European Central Bank by the end of the year (thus paving the way for bail-outs to be given to banks directly rather than via government balance sheets).

[16] King was reported to have made the rather dry comment on this proposal: "Having one overall [eurozone] supervisory authority that didn't have political commitments to individual banks might be an advantage from our point of view" (*Financial Times*, 30th June 2012)

rigging scandal that surfaced in late June 2012[17], which succeeded in shocking an already sceptical public and resulted in calls for resignations, police investigations and public enquiries. The question of bank culture[18], and how to correct it, has now become urgent for any financial market centre that values its reputation.

We can, of course, find any number of statements by senior bankers that tell us they have learnt their lesson and "turned the page". We can see the growth of new committees and changes to organisational structures that suggest that changes are happening. But how can we verify that all this is not just window-dressing? After all, they have fooled us before…

3. As the eurozone continued to struggle with its apparently intractable problems, many of the world's politicians and environmentalists, concerned about sustainability, were converging on Rio. Of course, the agenda was dominated by traditional "ESG"[19] issues but the financial sector was able to make its voice heard (although not by saying very much about the financial sector itself). The United Nations Environment Programme Finance Initiative (UNEP

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[17] See *FSA Final Notice*, FSA ref:122702, regarding a fine imposed on Barclays "for significant failings in relation to LIBOR and EURIBOR". The fine of £59.5m was the largest ever imposed by the FSA and related to apparent attempts to "rig" the LIBOR rate during the period 2006-8. Other penalties were imposed at the same time by US regulators. The day after the fine was announced, there was a significant fall in Barclays' (and other banks') share price (Barclays falling nearly 16%) and many calls (including from the Financial Times) for the resignation of Barclays' Chief Executive and/or Chairman. (The Chairman eventually announced his resignation on 2nd July but the following day the Chief Executive and another senior officer resigned and the Chairman said he would stay on to help find a new Chief Executive). Many commentators speculated that the "rigging" practice complained of was not confined to Barclays and this seemed to be confirmed by the FSA saying that it was still investigating other institutions. The Chairman of the House of Commons Treasury Select Committee said that the committee would be looking into the matter, commenting, "the corporate governance of Barclays needs scrutiny. We intend to provide it…." The front page headline of the Financial Times for the day after the scandal broke (29th June) was "Barclays firestorm rages".

[18] Space considerations do not permit any consideration in this article about the deeper implications of the "culture" question or, indeed, what is really meant by "culture". For consideration of some of the historical perspectives, see the author's article referred to in footnote 21 below.

[19] Environment, Social and Governance.

FI) describes itself (in a "Position Paper presented at the 2012 Rio conference) as "a global partnership between UNEP and the financial sector" which is "member-driven" and "voluntary" (with over 200 members). The initiative is based on the UNEP Statement of Commitment by Financial Institutions on Sustainable Development. The "commitments" in question (set out in the UNEP Statement) include a number of statements of belief and opinion rather than undertakings to do (or not do) anything in particular. For example, the first "commitment" is:

"We regard sustainable development – defined as development that meets the needs of the present without compromising the ability of future generations to meet their own needs – as a fundamental aspect of sound business management".

Any "commitment" in the above statement is, at best, implicit and, as a result, somewhat imprecise. The second "commitment" states that the UNEP FI members "believe that sustainable development is best achieved by allowing markets to work within an appropriate framework of cost efficient regulations and economic institutions" and that "Governments have a leadership role in establishing and enforcing long-term priorities and values". No "commitment" in the ordinary sense is contained in this statement, which, at least in part, seems to reflect the bankers' desire for free markets. In fact, the only clear commitment – such as would be recognised as involving a promise of some kind– is a commitment to comply with the law. The members state (in paragraph 2.2 of the Statement) that they "will comply with all applicable local, national and international regulations on environmental and social issues…" When it comes to going "beyond compliance", however, the Statement simply says that the members will "work towards" integrating environmental and social considerations into operations and business decisions. (For the sake of completeness, one should add that there is a promise to "endeavour to pursue best practice in environmental management" and to "seek to form" relationships with counterparties that have high environmental standards - although not to the exclusion of relationships with counterparties that do not).

Perhaps one should not expect too much. At least the banks that have committed to the Statement recognised that "sustainable development is an institutional commitment and an integral part of our pursuit of both good corporate citizenship and fundamentals of sound business practice." We will look into "good corporate citizenship" in more detail below.

The "common vision" shared by UNEP FI members is (they say) that sustainable development can only be achieved with "a stable and sustainable financial sector" as the "backbone" of a "more balanced, inclusive and green economy". So the Position Paper for Rio 2012 should, one would think, be very aware of the decidedly unstable conditions prevailing in the financial sector as at June 2012. One might expect that any paper or "commitment" on sustainability by or on behalf of the financial sector would evidence such awareness. This, however, does not appear to be the case. The Position Paper consists of six short paragraphs, mainly exhortatory in nature and encouraging the "governments of the world" to do various things (including, it would seem, providing unspecified encouragement and incentives for the financial sector), and a summary of what the authors regard as desirable "key outcomes" for the Rio conference. These outcomes (which "governments" are asked to consider) are:

Highlighting the role of the financial sector, having regard to "its ability to promote the allocation of capital to those businesses and market players operating more sustainably";

incentivising financial institutions to "integrate sustainability issues into their risk management policies and overall decision-making procedures";

promoting "the availability and accessibility of relevant and comparable sustainability information";

committing to “work closely with the financial sector in building markets for long-term sustainable lending, investment and insurance services…”; and

calling for “all UN-embedded and UN-backed partnerships with the financial sector and the broader private sector to work closely in order to enhance their efforts in making sustainable finance a reality”.

Of the above, the most interesting is 3). The text describing the detail of the “outcome” is unusually specific. It tells us that the objectives are to include:

“Facilitating access to information on relevant sustainability-related norms and regulations, as well as on their enforcement”;

“Developing a convention that provides a global policy framework requiring the integration of material sustainability issues within the corporate reporting cycle on a “report or explain” basis”; and

“Encouraging the regular evaluation of the sustainability impacts of commercial and residential properties….”

If the objective of improving access to information on sustainability-related norms could be achieved and the result was the availability of information about “ESG performance” that was both accessible and “comparable” (enabling one to compare one institution with another) we would have taken a major step forward. The public would be able to compare companies (including banks) with one another in a way that does not require the filtering out of the inevitable value judgements that tend to come with data and assessments produced by NGOs currently. The difficulties caused by the absence of objective indicators in this area have been commented on in an article published by the author earlier this year.[20] However, the main focus of UNEP FI, it seems, is looking at potential investee companies of all kinds from the point of

[20] “*Towards a more sustainable financial system* – part 2: Creating an effective civil society response to the Crisis”. (2012) 6 LFMR (at 200).

view of a financial sector investor (e.g. an investment manager or analyst). It is not directly concerned with the sustainability issues that are peculiar to banks.

It would seem that the "outcome" referred to above is reflected in part in paragraph 47 of the joint government statement ("The Future We Want") issued at the end of Rio+20:

"We acknowledge the importance of corporate sustainability reporting and encourage companies, where appropriate, especially publicly listed and large companies, to consider integrating sustainability information into their reporting cycle. We encourage industry, interested governments as well as relevant stakeholders with the support of the UN system, as appropriate, to develop models for best practice and facilitate action for the integration of sustainability reporting, taking into account the experiences of already existing frameworks, and paying particular attention to the needs of developing countries, including for capacity building".

This, in turn, was accompanied by a press release by a group of governments (Brazil, France, South Africa and Denmark) calling themselves the "friends of paragraph 47", that committed to "advance corporate sustainability reporting". It would seem that these governments are looking to promote a "report or explain" approach, as currently applied in Denmark and South Africa – although, at the time of writing, the precise scope of their work remains unclear. What does seem to be clear, however, is that Rio+20 has not resulted in any initiatives that are specific to the sustainability of banks or the financial markets – or the sustainability reports of banks. This suggests that the meaning given to "sustainability" at ESG fora such as those gathered at Rio is narrower than one might have hoped.

But notwithstanding the lack of interest at Rio + 20, perhaps the time has now come for such matters to be looked at more closely? Do sustainability reports of banks, for example, serve a useful purpose? Could they be made more useful if they provided, for example, more material that enabled the reader to make a judgement about the culture of the bank and how it compares with its peers?

4. To study a bank's sustainability report is to study what a bank says about itself. It is not, to any material extent, a study of objective, and verified, data save to extent that certain data in the report may, in somewhat obscure language, be the subject of a limited form of assurance by an independent third party set out at the end of the report. Still less can it be considered a study of a bank's culture, although a comparison of a report with known facts about a bank's behaviour can be instructive.

No one could criticise the banks for shrinking from the task of presenting material about how sustainable they consider themselves to be. The difficulty arises when one tries to analyse the large amount of material made available, separate the hard facts from the statements of opinion, acknowledgements of room for improvement (which tend to be scarce) from self-acclaim (which tends to be plentiful) and find any kind of data that enables one bank to be compared with another. There is also, in the post-financial crisis world, a serious shortcoming that such material needs to address: the absence of any significant information that enables one to assess the sustainability of the bank in question as a viable, long term financial market participant and contributor to society and its stakeholders -- and form a view about its culture and its approach to ethical questions (evidenced by practice rather than stated policy). According to the Financial Services Sector Supplement ("FSS") of the Global Reporting Initiative ("GRI"), "Sustainability reporting is the practice of measuring, disclosing, and being accountable to internal and external stakeholders for organisational performance towards the goal of sustainable development." However, in practice, sustainability reports of banks are far from consistent about how the latter part of that phrase (which is, admittedly, somewhat imprecise) should be interpreted and this lack of consistency makes analysis of the reports, and the comparison of one bank with another, difficult.

To illustrate the extent of the difficulty, it is instructive to compare the 2011 Reports of two of the UK's largest banks, RBS Group and Barclays (both of whom signed up for the UNEP FI statement of commitment referred to above). Although they cover similar ground, the two reports have different names: the RBS report is called a "Sustainability Report" whilst the Barclays report is called a "Citizenship Report". RBS focuses its document around "five sustainability themes": "fair banking"; "employee engagement"; citizenship and environment"; "supporting enterprise"; and "safety and security". Barclays' "citizenship commitment" is based on "three pillars": "contributing to growth"; "the way we do business"; and "supporting our communities". Many of the predictable themes can be found in both documents. These include, for example: "stakeholder engagement", combating financial crime, the bank's carbon footprint and general impact on the environment, governance structure, lending to small and medium-sized businesses, inclusiveness, diversity, the ever-widening range of "corporate social responsibility" and so on. Much of this material appears to seek approval for the bank doing little more than what the law requires anyway or for simply following sound business practice in its choice of borrowers or treatment of retail branch customers. It's not that treatment of retail customers is unimportant, it's just that at times these reports stray too far into "customer relations" (or just plain "PR") territory and, a result, leave the reader feeling somewhat sceptical as he reads lengthy accounts of how wonderful the bank thinks its service is[21]. RBS, for example, tells us that it is working towards "becoming the UK's most Helpful and Sustainable Bank" and that its progress on this has "been recognised externally

[21] Admittedly anecdotal evidence arising from the author's conversations with bankers, journalists, academics and "sustainability professionals" suggests that there is a widespread (but rarely openly expressed) view that documents of this kind are "just PR" and not to be taken seriously. Of course, if a bank regarded its own sustainability report as "just PR" that would itself seem to be prima facie evidence of a dubious culture.

through the awards we have won for our branch network, our call centres, our new mobile apps, our online service and our products." Barclays tells us that it goes "beyond regulatory requirements to ensure the best experience for our customers" and even uses its document to advertise what are essentially investment banking services when, under the heading "Supporting the Eurozone", it tells us:

"We continued to help government borrowers during the difficult conditions experienced in 2011. We also provided strategic advice, including advising the French state on the restructuring of the Dexia Group, the Spanish government on the valuation of its domestic savings banks, and the Bank of Ireland on a restructuring programme for the banking system".

There are also references to the bank managing bond issues for eurozone governments. One begins to wonder if there are any aspects of the bank's business that would not qualify for a mention in the report.

RBS, however, is prepared to address some business model issues in its document and provides a table of "key financial targets" for the bank, which includes statements such as:

"We want to put our balance sheet on a more secure footing by lending only as much as we have in deposits";

"We want to reduce our reliance on short-term money market funding to make our balance sheet less volatile"[22]; and

"We want to hold strong liquidity buffers to guard against unexpected funding difficulties"

These statements, and others in the document, tell us that RBS sees its own business model as a sustainability issue. This is to be welcomed. It is not clear that this is the case with Barclays. One would think that a bank (or any-

[22] The *Banking Reform White Paper* (see fn 8 above) suggests that, in future, retail banks should not be dependent on wholesale funding: "Reducing reliance on wholesale funding is a way of ensuring that ring-fenced banks run less risk of funding and liquidity shocks, such as those experienced in the recent crisis".

one else) that is serious about sustainable development would recognise that a sustainable financial system is needed if it is to be achieved and that a sustainable financial system depends, amongst other things, on banks learning the lessons of the global financial crisis and adopting sustainable business models themselves and converting to a more responsible culture than the one that dominated in the pre-crisis period. You might therefore expect a bank's report that deals with "sustainability" (whatever its title) would say something about the sustainability of its business model and ability continue in business without needing more taxpayer support than is implicit in depositor protection schemes and "lender of last resort" functions at the central bank. But such matters (which, as indicated above, are outside the scope of ESG, as traditionally understood) seem to slip under the radar of the traditional sustainability community and no pressure seems to be exerted on banks to develop such matters in "sustainability reporting".

Neither bank has anything to say in the document about its regulatory disciplinary track record (for example, how much it has been paying out in fines to its regulators) but both banks tell us about how they are getting on in dealing with customer complaints. In each case, the data about complaints are not presented in a way that enables progress (or the lack of it) against previous periods easy to assess (although Barclays produces a table for its UK bank that shows an improvement over 2010) and the information is unhelpfully laced with an excess of self-congratulatory prose. A statement of the bald facts followed by reasonably objective comment would have been better.

In both cases, complaints about mis-selling payment protection insurance (PPI) – a major, and expensive scandal for all the large UK banks --- loom large (although neither bank informs us in the document of the massive provision it has had to make for claims). In the case of RBS (which owns NatWest as well as other UK high street banks), the next report will no doubt have to comment on the severe problems encountered during week following 19th

June 2012, when a computer upgrade problem (widely referred to as a “technical glitch”) caused severe payment difficulties for its customers over a period of several days. This caused the Times newspaper to reflect on what society expects from banks in an Editorial on 25th June:

“For their customers, all banks are too big to fail. The systems meltdown at NatWest…was not just a commercial failure.

It left up to 16.9 million people surviving a weekend without cash, holidaymakers stranded, and account holders finding that payments were not made and paychecks did not arrive. In a handful of cases, families have been left living out of hotels as actual house purchases have stalled….

Just as the first duty of the state is to defend its people, the first duty of a bank is to provide a means whereby customers can get hold of their own money. All else is secondary….When a bank’s computers grind to a halt, rendering it an institution into which money can neither go in, nor come out, the blame can go nowhere else. This is rank incompetence”.

A serious operational failure, such as that which afflicted RBS can inflict serious reputational damage. Since banks depend on their reputation as a safe home for our money (whatever we may think of “bankers” these days) even a major bank like RBS can only afford a limited number of “technical glitches” of this kind before its business (and its viability and sustainability) is threatened. RBS will no doubt survive this incident but it will have to spend a great deal of time and money dealing with the ensuing avalanche of complaints and claims. UK banks may also find that they have to report next year on how they have handled claims regarding the mis-selling of derivatives to small and medium-sized businesses (SMEs), the subject of an FSA “update” statement at the end of June 2012[23]. Are these sustainability issues? If “fair banking” and “good corporate citizenship” are, one would think so.

[23] This was entitled “Interest Rate Hedging Products, Information about our work and findings” and stated that the FSA investigation into the alleged mis-sellings had found “serious failings” in the methods used to sell the products to SMEs. The failures included: poor disclo-

The interesting, wider point is that issues such as how a bank handles complaints from its customers (and how many complaints it gets) are seen as a sustainability (or citizenship) issue by banks themselves. If that is the case, then surely data on fines for regulatory breaches (or sums paid in settlement of regulatory proceedings) in relation to matters such as insider dealing and other kinds of market abuse[24], lax controls to discourage rogue traders or other operational risks (including computer failure), poor anti-money-laundering procedures, failure to protect client money etc., should also be fed into the mix and an appropriate section be included in the Sustainability Report (in addition to anything reported elsewhere)?[25] Disciplinary action by regulators, after all, could be regarded as a form of "complaint" but made on behalf of the public as a whole. Further, many may feel that a bank's disciplinary record (particularly if it is out of line with its peers) tells us more about a bank's "culture" and ethical behaviour than any number of organisational charts, grand-sounding "sustainability committees" or statements of pious intent from the Chief Executive or Chairman[26]. Let's bring these things out into the open. (In many countries the raw data are in the public domain anyway). To paraphrase

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sure of exit costs, failure to ascertain customer's understanding of risk and "non-advised sales straying into advice". There was evidence that financial incentives for the sales people were a driver of the poor practices.

[24] Again, the *LIBOR rigging scandal* provides an example. On 27th June 2012, it was reported that (according to the BBC News website) Barclays was fined £290m for "trying to rig" the LIBOR interest rate over a period of several years. The statement from the US Commodity Futures Trading Commission said: "Barclays…. attempted to manipulate and made false reports concerning both benchmark interest rates to benefit the bank's derivatives trading positions by either increasing its profits or minimising its losses. The conduct occurred regularly and was pervasive".

[25] *The FSSS of GRI* requires (at PR9) disclosure of the "monetary value of significant fines for non-compliance with laws and regulations concerning the provision and use of products and services". In relation to this item, both Barclays RBS simply state "NR" (not reported). No explanation is offered.

[26] In order to provide a reasonably comprehensive picture, it is suggested that the figures include sums paid in settlement of regulatory proceedings (a very common occurrence) and sums paid to third parties on the instruction of a regulator. Arguably, egregious losses due to poor risk management or controls and sums paid to tax authorities in recognition of a breach of undertakings relating to tax avoidance should also feature. The figures should be presented on a five year rolling basis so that the reader can judge more easily progress (or deterioration) over a representative period.

Barclays, a good "corporate citizen" should be aware of, and prepared to publish its history on such matters and ensure that its governance and controls result in a record that does not cause embarrassment.

In other areas, the contents of the Barclays and RBS documents tend to reflect different emphases and experiences of the two banks. Barclays, for example, has a great deal to say about tax avoidance – a subject that has given rise to some concerns for it in 2012 (and which, in June, received much attention in the UK media, thanks to a campaign by the Times newspaper that "exposed" the tax avoidance schemes entered into by various celebrities and induced the Prime Minister himself to pass judgement on the morality of the schemes). Barclays make some reasonable points about tax avoidance and there is at least a suggestion that they are changing their ways[27]. It is a pity, however, that they insist on referring to tax paid by their employees (through the PAYE system) as though it was a contribution to society by the bank itself. RBS, on the other hand, provides a separate document on its financing of the energy sector which incorporates environmental data on "the activities and impacts of large companies worldwide" obtained from Trucost and enables RBS to boast, for example, that "we estimate that our top 25 power clients and top 25 oil & gas clients are less carbon intensive than the industry average". Both banks state that they comply with the Equator Principles and both break down their EP (i.e. project finance) deals by risk category, but without any indication of the amount involved or any information that would enable a given project to be identified. Barclays gives us data on all its energy, mining and comparably environmentally sensitive finance deals that have been sub-

[27] For an article suggesting the links between the "celebrity tax avoidance" story and Barclays see Philip Johnson "A penitent comic offers lessons to shameless bankers" in the *Financial Times*, 26th June 2012. Stephens notes that Barclays, and its CEO, Bob Diamond, were annoyed that the UK tax authorities had named it as being involved in a tax avoidance scheme to which it objected and "as a result, the bank suffered reputational damage. This was especially galling as it had just started marketing itself as a good corporate citizen. Given the controversies of the recent past, including a shareholder revolt against Mr. Diamond's £20m-plus pay and benefits package, it is moot whether Barclays has anything much of a reputation to be tarnished".

ject to its internal screening process but nothing that would enable the reader to carry out any kind of verification.

5. A comparison of the Independent Assurance statements in the two reports raises some interesting points of comparison. According to the FSSS of GRI, such a statement should (inter alia) "assess whether the report provides a reasonable and balanced presentation of performance, taking into consideration the veracity of data in a report as well the overall selection of content". The statement for the RBS document (made by Deloitte LLP) says, in the relevant part that:

"RBS have implemented processes and procedures, as described on page 39, that adhere with (sic) the principles of inclusivity, materiality and responsiveness as set out in the AA1000 Accountability Principles Standard 2008 ("AA1000APS")"; and

"Nothing has come to our attention that causes us to believe that the selected key performance data which we were engaged to provide assurance on are materially misstated."

To understand the above statements, one does of course have to read page 39 of the report and also look at the key performance data on which the "limited assurance" is given. Page 39 simply describes the AAA1000 Account-Ability Principles Standard and the three principles (of inclusivity, materiality and responsiveness) that "an organisation should adopt as a framework for sustainability management and reporting". "Inclusivity" is expressed to mean "Identifying and engaging with stakeholders to gain a full understanding of issues". "Materiality" means "Determining what issues are important to RBS and our stakeholders". And "Responsiveness" means "Responding to material issues and being transparent about our performance". So, one can conclude, Deloittes were happy with RBS's approach as regards these procedures. But what about the content of the document? It is here that one has to study the second of the above statements. What were the key performance data that Deloittes looked at? Sixteen different categories are listed. These range from the "number of mortgages provided to first -time buyers in 2011" to the "number of voluntary and compulsory redundancies"; the "employee diversity gender, age and ethnic profile" and the "number of project finance deals per Equator Principle category and industry sector"; "total community spend" and "total air travel"; and so on. They do not cover the data about the bank's business model. How many of these headings should one regard as providing objective indicators of a bank's sustainability? Can they be scored, with different values (as to sustainability relevance) being ascribed to each? For example, should a bank be regarded as scoring more "sustainability points" for an admirable record on, say, air travel than on first-time buyer mortgages? How are such judgements to be reached? There seems to be no attempt in the reports of either bank to distinguish core issues from the more peripheral issues.

The equivalent statement for the Barclays document is made by Ernst & Young LLP. This is laid out quite differently to the Deloittes statement, with the "meat" of the assurances taking the form of questions and answers. For example:

"Inclusivity

Has Barclays been engaging with stakeholders across the business to develop its approach to citizenship?

We are not aware of any key stakeholder groups that have been excluded from dialogue

We are not aware of any matters that would lead us to conclude that Barclays has not applied the inclusivity principle in developing its approach to citizenship"

"Completeness and accuracy

How plausible are the statements and claims within the Report?

We are not aware of any inconsistencies in the assertions made with regard to performance and achievement"

Such statements do not exactly fill one with confidence. How much simpler life would be for the reader if the reports clearly separated facts from opinion and the assurance statement just told us that the factual statements were accurate! No doubt, accountants have their reasons for the tortured style of English that they employ (not least, a fear of being sued) but perhaps a renewed appeal for the use of plain English and, as far as possible, the presentation of a self-contained statement with minimal cross-referencing may be made? To make the necessary investigations needed to support more assuring "assurances" would cost more money perhaps….but are we to take these reports seriously or not?

6. The documents of the two banks raise a range of issues and suggest there is room for improvement in (at least) the following areas:

Reducing the amount of material that relates to what the bank would have to do to comply with the law anyway or that is simply good customer relations (eg reducing queues in branches);

Presenting information that, as far as possible, enables verification and/or is accompanied by a statement from a third party that is confirmatory in nature.

Presenting information in a way that reflects a consensus (which, admittedly, may still need to be established) as to which are the more important issues and which are relatively peripheral;

Increasing the amount of material that is related to the bank's own business model and culture and its sustainability;

Increasing the amount of material on the bank's disciplinary record;

As far as possible, present material in a way that (i) makes comparison with previous years *and* with other banks easy (ii) distinguishes clearly fact from subjective commentary[28];

Improving the navigability of internet based documents so that, for example, (i) the indices of the Global Reporting Initiative are (where relevant) easily found (not the case, for example, with the RBS document) and (ii) one can easily follow a link to *any* cross-referenced item (either in the same document or elsewhere, such as the Annual Report) with appropriate page and paragraph references; and

Ensuring, as far as possible, that all banks present the same kind of information under the same headings (bearing in mind the widespread use of imprecise terminology such as "engagement") and omit information and "PR material" that is not relevant to those headings.

In order to make progress in these areas, it is suggested that organisations that have an influential role in the content of sustainability reports (such as GRI or the "friends of paragraph 47") take a fresh look at what the principal indicators of sustainability are *in the context of banks* and give more emphasis to issues that relate to a bank's own business model, its culture and approach to ethical issues as opposed to the more "traditional" ESG issues. At present the focus at organisations like UNEP FI remains on how financial sector investment specialists could do a better, more "ESG-aware," job if reporting on sustainability was better and more widespread. That is a worthy objective. But it should not be pursued to the exclusion of looking more closely at what sustainability means for the banks' own business and for the financial system.

[28] According to the *FSSS of GRI*, "Comparability is necessary for evaluation performance. Stakeholders using the report should be able to compare information reported on economic, environmental, and social performance against the organisation's past performance, its objectives, and, to the degree possible, against the performance of other organisations." Clear and unambiguous language would seem to be an implicit requirement if this objective is to be met.

Through the lens of sustainability indicators, properly adapted for the peculiarities of banks, we could, if we wanted, start to learn a great deal more about bank behaviour and attitude than currently comes into the public domain. The sustainability reports, instead of being “just PR”, could become engines of change for the better. It seems inconceivable, after all, that a bank that had participated in something like the LIBOR rigging scandal could be considered a candidate for “Sustainable Bank of the Year”.

The use of “soft law” pressure, through the organisations mentioned in this article (and possibly others) is more likely to bring about change in an arena that looks both across jurisdictional boundaries and down to generations as yet unborn. Traditional law-making is ill-suited to dealing with the difficulties that the differing time and space dimensions present. But a greater level of consensus needs to be developed on what the objective indicators actually are of good and bad sustainable behaviour for a bank. Such indicators then need to be regularly updated rather than set in stone. The reporting requirements need to reflect that consensus. And banks should not feel free to pick and choose which ones they report on, entering “NR” if they find the matter too embarrassing or inconvenient. The reports should then be backed up by clear and unambiguous assessment statements from independent third parties. These would, as a result, carry some weight, rather than merely “perform a function of ritualistic comfort”[29] -- as now seems to be the case.

“Soft law” is not necessarily all that soft in its effect. The moral pressure that can be exerted by it can result, ultimately, in (to borrow from the Financial Times’ lead editorial of 29th June 2012, commenting on the LIBOR rigging scandal) “shaming the banks into better ways”. According to that editorial, the LIBOR rigging scandal shone an “unsparing light on the rotten heart of the financial system.” If we can get the senior officers of banks to understand that

[29] See CHIU *“Standardization in Corporate Social Responsibility Statements” Florida International Journal of Law* Vol. 22 No. 3 (December 2010) at 361 and 390.

society expects sustainability reports to provide both information on, and commitments relating to, a bank's culture, and that egregious incidents showing that such commitments have failed would generally be expected to lead to a resignation at the highest level, we can start to believe that some worthwhile change has at last been achieved. Making changes to reporting practices involves relatively small steps, and relatively easily achievable objectives. But small steps – if in the right direction – can have a big effect. If we can, through better reporting, insist that light is shone on what happens inside banks on a more regular basis and get out of the habit of taking bankers at their word when they tell us how good their "culture" is, we will start to make progress on meaningful reform. Such reforms would also have a positive effect on our collective efforts on the ESG agenda. To the extent that events like Rio+20 can look uncomfortably like "the West" lecturing the developing world whilst overlooking the catastrophes taking place in its own backyard, it would do no harm at all if the West (including the ESG community) took more positive steps to set its own house in order in relation to the sustainability of its banks and its financial system.[30] This must now be seen as a priority for all stakeholders, not just for governments and regulators.

[30] In an interview published on the *Times* on 2nd July, the President of the World Bank, Robert Zoellick, reflecting on Rio+20 – and the eurozone crisis – said, "The rest of the world is saying, who do these people think they are? We are worried they are going to bring down the world economy, and they are trying to tell us how to run our economies?"