

# HOW DOES SUSTAINABLE BANKING ADD UP?

A CATALYST REPORT

**CATALYST** >>

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Catalyst is a not for profit policy network established in 2007. We work closely with trade unions, non-Government organisations and academics to promote social and economic equality and improved standards of corporate social responsibility.

Our founding principle is to produce work that promotes good lives, good work and good communities.

In October 2014 Catalyst formally merged with The Australia Institute and now operates as an independent branch

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# 1. INTRODUCTION

The big four Australian banks have received international accolades for their sustainability efforts. At the 2014 World Economic Forum, Westpac was named the most sustainable company in the world<sup>1</sup>, with former chief Gail Kelly being “[...] delighted that Westpac’s sustainability performance has been rated so highly on the global stage.”<sup>2</sup> ANZ was named as the global banking sector leader in the Dow Jones Sustainability Index, a major reference point for sustainable investors, six times in the last seven years<sup>3</sup>, while NAB<sup>4</sup> and the Commonwealth Bank<sup>5</sup> have likewise been recognised for their sustainability performance.

Despite these accolades, a number of recent controversies have stimulated public debate about the social and environmental responsibilities of the banking industry.

Australian banks have suffered public outrage as a result of dubious financial advice costing thousands their life savings, disputed credit card fees, rate-fixing, and insider trading, as well as the funding of unsustainable activities such as coal mining and infrastructure projects along the great barrier reef, nuclear arms manufacturing, and land grabs in emerging economies. As a result, confidence in banks is low: according to a national survey performed by the Australia Institute, 76% of respondents believe that banks put profits before their social and environmental responsibilities.

How can these two conflicting pictures of the banking sector be explained?

This report examines both the sustainability in the Australian and global banking sectors and the assessment indicators. Specifically, it assesses self-regulatory and voluntary measures aimed at producing socially and environmentally responsible banking.

An overview of the social and environmental performance of Australian and international banks using commonly accepted sustainability indicators reveals a schism exists between symbolic and substantive sustainability efforts. Simultaneously scrutinising these indicators by assessing how effectively they measure the performance and commitment of banks makes it apparent that while many Australian and overseas banks perform well according to the indicators, their business strategy and practices may fail to meet three key challenges: misaligned incentives, information asymmetry, and effective management of social and environmental risk.

The report concludes by recommending increased integration of corporate responsibilities in authoritative frameworks, a measure aimed at redressing the unbalanced configuration of public, civil and corporate governance frameworks, which currently favours corporate voluntarism and self-regulation.

Specifically, significant steps towards overcoming the three challenges are:

- reformulating company directors’ duties to include social and environmental responsibilities,
- redefining sustainability reporting requirements and enshrining these in corporate governance systems,
- and founding social and environmental risk assessments on the precautionary principle, which shifts the burden of proof towards those parties that potentially cause harm.

# THE AUSTRALIAN BANKING SECTOR

The ‘four pillars’ of the Australian banking system are a uniquely dominant part of the Australian economy. The four big Australian banks, Australia and New Zealand Banking Group (ANZ), Commonwealth Bank of Australia (CBA), National Australia Bank (NAB), and Westpac Banking Corporation (WBC) are all featured in the top five of the Australian Securities Exchange (ASX) 200. In the weighting for each sector represented in the index, the **financial sector** dwarfs others industries: the financial sector makes up 46.5% of the total ASX 200 **market capitalisation**, followed at a distance by the materials sector representing 15.4%.<sup>6</sup>

The big banks hold \$AUD 522 billion of Australian household deposits, equal to one-third of Australia’s gross domestic product.<sup>7</sup> In the 2013-14 financial year, their pre-tax profit was 87.5% of total bank profits<sup>8</sup> and 2.7% of national income.<sup>9</sup> In the words of David Murray, former CBA-boss and chair of the Financial System Inquiry: “[...] banks fund most of the assets in the economy – whether it’s businesses, governments themselves, homes or projects, whatever else. And because they do that, banks in aggregate are themselves monsters... They have monstrous balance sheets and therefore make a lot of profit.”<sup>10</sup>

According to the chairman of ANZ, David Gonski, Australians ought to “stop bashing the banks” for being large and profitable.<sup>11</sup> This comment should put civil society on guard. The market dominance of banks results in great market power, as well as great responsibility. The impact of banking is measured through operations in offices and branches, as well as through financing, which can lead to involvement in unsustainable practices. As banks provide the majority of external finance to firms and governments, they can influence their practices. Research shows that bank lending potentially has more impact on sustainable enterprise than investment and divestment on the stock market.<sup>12</sup>

Banks can thus wield their enormous market power to support sustainable activities, while their actions can likewise contribute to detrimental behaviour. The global financial crisis has shown that unsustainable banking activities do not only spread through the economic system but also endanger it.<sup>13</sup> This begs the question to what degree banks, apart from posing systemic risks, can contribute to, or alternatively mitigate social and environmental harm, and what are the resulting responsibilities of banks towards the community and the environment?

# RESPONSIBILITIES

In 2005, a Parliamentary Joint Committee on Corporations and Financial Services in Australia launched an inquiry into Corporate Responsibility and **Triple Bottom Line** reporting. Specifically, it examined whether companies regard the interests of stakeholders other than shareholders, and the extent to which the Australian legal framework that governs directors' duties encourages or discourages them from considering stakeholder and community interests. The inquiry furthermore examined the desirability of legal revisions, the suitability of voluntary measures, and the appropriateness of reporting requirements.<sup>14</sup>

The Committee found that legal amendments were undesirable, as it deemed it "[...] not appropriate to mandate the consideration of stakeholder interests into directors' duties." Furthermore, the Committee recommended that sustainability reporting should remain voluntary, fearing that "[...] mandatory reporting would lead to a 'tick-the-box' culture of compliance."<sup>15</sup> The Committee made a specific recommendation regarding the inclusion of appropriate guidance in the ASX Corporate Governance Principles and Recommendations, which in 2011 led to guidance pertaining to gender diversity<sup>16</sup>, followed by further guidance in 2014 concerning the disclosure and mitigation of environmental and social risks.<sup>17</sup>

The emphasis on voluntary social and environmental efforts is problematic. According to illustrious economists such as Adam Smith and Milton Friedman, economic efficiency through specialisation is vital in wealth creation and market functioning. The question of whether business has duties beyond value creation is thus dismissed: "the social responsibility of business is to increase its profits."<sup>18</sup> Simultaneously, the Parliamentary Joint Committee on Corporations and Financial Services, as well as the advocates of the *let business be business* argument, likewise oppose public policy aimed at keeping business in check.

The outcome is a catch-22: the seemingly inescapable absence of measures to mitigate negative effects of business activities on society and the environment.

For a long time, market mechanisms were thought to provide the solution to the deadlock between the role of government and business. Unconditional trust in the market offered the blueprint for *laissez-faire* capitalism, with the maxim of the invisible hand reigning supreme. Yet the global financial crisis demonstrated that without adequate intervention from non-market forces, the pursuit of self-interest and economic gain does not create desired outcomes for society, but instead has the capacity to devastate it. Hence, markets should not be regarded as forces that miraculously create desired outcomes. Instead, they are man-made, imperfect, and in need of correction and supervision.

# SUPERVISION

In the aftermath of the global financial crisis, regulators were pushed to exercise more supervision over financial services providers, and be less trusting of self-regulatory efforts.<sup>19</sup> According to the International Monetary Fund, Australian banks were resilient to the crisis because of sound regulation and supervision: "Prudential rules, often tighter than the minimum international standards [...] together with a proactive approach to supervision, helped maintain a healthy and stable financial sector."<sup>20</sup> In the view of the Australian Prudential Regulation Authority (APRA), responsible for oversight of the financial sector, application of global standards, adapted where needed, formed an important basis of the good international standing of Australian banks.<sup>21</sup>

Despite the fact that the Australian financial sector and the economy survived the global financial crisis relatively unscathed, the Government launched the Financial System Inquiry in 2013. The Inquiry examined how the Australian financial system could be improved to further economic growth and be better equipped to deal with financial crises. The final report, presented in December 2014, featured key recommendations concerning increased banking capital requirements, narrower mortgage risk-weights, minimum leverage ratios, minimum education standards for financial advisors, changes in the law to enhance consumer protection, and the establishment of an assessment board that evaluates the performance of financial sector regulators.<sup>22</sup>

Regrettably, the terms of reference of the Financial System Inquiry did not address social and environmental sustainability and risks in the financial sector.

It seems that the readiness to increase supervision concerning financial conduct, in order to avoid financial risks to the economy and consumers, is not matched by a similar willingness to supervise and regulate the social and environmental impacts of the financial sector. In spite of widespread

concerns about climate change, human rights abuses, and political instability, we continue to rely on the self-regulatory efforts of Australian banks regarding funding of the fossil fuel industry, land grabs in developing countries, and nuclear arms production.

A nation-wide survey by The Australia Institute indicates that only 26% of respondents believe banks will behave ethically and responsibly if they regulate themselves, while merely 49% of survey respondents are confident that banks comply with Government regulation. These figures show the Australian public's widespread mistrust of banks, and raise serious doubts about the effectiveness of social and environmental self-regulation by banks. A number of key challenges are discussed below that will need to be overcome in order to establish truly sustainable banking practices.

## CHALLENGES

Short-termism, performance rewards, and maximising shareholder value have long been the norm in the financial sector. Yet the focus on immediate returns while neglecting long-term risks is increasingly criticised. While performance rewards and shareholder value creation are not harmful, they become damaging when disproportionately focused on the short-term, which can incite unethical conduct and risk-taking for the sake of instant rewards. Conversely, a sustainable bank would equally consider financial, environmental and social factors, while aligning its own interests with that of the community through long-term financial and non-financial value creation, for shareholders and stakeholders alike.

Information asymmetry is another obstacle that banks will need to overcome. Whenever there is asymmetric knowledge in a transaction, there is a risk that the party with superior knowledge will exploit it for their own benefit, which leads to **moral hazards**. Information asymmetry and moral hazards are not limited to commercial transactions however: absent or incorrect social and environmental information can also misinform stakeholders about the exact impact of activities. It must be noted that this is a two-way street: banks can equally fall victim to moral hazards, for example by being misinformed or misled by firms seeking financing. In order to decrease information asymmetry and the risk of moral hazards, sustainable banks would aim to improve transparency and monitoring.

Lastly, banks need to manage risk more effectively. The global financial crisis demonstrated that financial risk-taking can bring the international financial system to the brink of collapse. This begs the question of what the consequences of excessive social and environmental risk-taking might be, as risk does not merely concern financial elements, but also society and the environment. The main challenge of responsible business and banking enterprise is no longer merely how to mitigate negative externalities, but rather how to find ways to anticipate and prevent negative impacts. This precautionary strategy is a critical step towards corporate responsibility that goes beyond symbolic efforts and implies a major change to the overarching business model.<sup>23</sup>

# PERFORMANCE

The following sections will examine the sustainability performance of banks, which in the context of this report will entail the self-regulatory efforts aimed at environmental, social and governance matters. The performance of the big four Australian banks will be gauged and compared to the 20 largest global banks by market capitalisation<sup>24</sup> and the 20 largest banks measured in assets.<sup>25</sup> Overlap in these lists results in a sample of 29 banks, including ANZ, CBA and WBC. The addition of NAB results in a list of 30 banks (**appendix A**).

The assessment builds on existing research into sustainable banking, which outlines performance by looking at sustainable products, services, and risk management.<sup>26</sup> Supplementary to this research are studies that examine how corporate governance is used to develop and implement corporate responsibility strategies.<sup>27</sup> Combining and updating the indicators from these studies offers an extensive approach to evaluate self-regulatory efforts by banks, using 37 indicators in four categories: (1) voluntary disclosures; (2) responsible finance; (3) stakeholder engagement; and (4) corporate governance (**appendix B**).

The assessment outlined above examines whether a bank addresses a particular sustainability indicator in public disclosures. The report will supplement this quantitative analysis by qualitatively analysing the indicators and the scores to ascertain how accurately sustainability performance is measured. The qualitative analysis will use data obtained from a national survey conducted by The Australia Institute in 2015, as well as academic publications, reports by **civil society organisations**, and media sources.



## 2. VOLUNTARY DISCLOSURES

### Reporting

Every bank in the sample addresses sustainability in public reporting, which suggests that banks seem to acknowledge their non-financial responsibilities towards society. All four Australian banks address sustainability in their Annual Report, while also publishing a separate Sustainability Report. The data shows that most banks publish a separate Sustainability Report, while simultaneously including sustainability information alongside financial information in Annual Reports, which indicates increased **integrated reporting**.

Integrated reporting is defined as “[...] a concise communication about how an organization’s strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value in the short, medium and long term.” Its proponents argue: “[...] the irresistible force of transparency has met the immovable object of an outdated and even dangerous model of reporting,” the example of this outdated model being the near collapse of the global financial system. Integrated reporting, “[...] provides a single version of the truth to all concerned parties, inside and out.”<sup>28</sup>

Indicator	ANZ	CBA	NAB	WBC	Asia	Europe	N. America
Sustainability reporting	✓	✓	✓	✓	8/8	11/11	7/7
Stand-alone report	✓	✓	✓	✓	6/8	11/11	6/7
Integrated report	✓	✓	✓	✓	5/8	10/11	6/7
GRI	✓	✓	✓	✓	6/8	9/11	6/7
Independently checked	✓	✓	✓	✓	5/6*	6/9*	2/6*
GRI application level	✓	✗	✓	✓	1/6*	5/9*	4/6*

\* Banks using the global reporting initiative framework

It is important to note that the spread of environmental and social information between Annual and Sustainability Reports, as identified in the sample of banks, indicates that the move towards fully integrated reporting is still in a transitional stage. This suggests that non-financial performance is not yet considered central to banking operations, and the financial bottom line is still viewed as separate – and superior – to social and environmental issues. Integrated reporting does not offer a panacea that negates conflict between non-financial and financial matters, but rather considers the issues side by side to paint an all-encompassing picture.

### Guidance

The well-known disclosure guidelines of the **Global Reporting Initiative (GRI)** have been widely adopted: all Australian banks and many banks from other regions use the GRI framework to guide their sustainability disclosures. Apart from the Australian banks, not every bank obtains **external assurance** for GRI disclosures, meaning that only a limited number of banks obtain third-party confirmation of the accuracy of their disclosures. Furthermore, not all banks reveal **application levels**, which they can verify using the GRI framework to indicate the scope of their reporting, using a list of required disclosures.

The figures concerning the application levels and external assurance raise doubts about the scope and accuracy of reporting, and confirm research showing that companies often make inconsistent GRI claims.<sup>29</sup> Concerns about information asymmetry in sustainability reporting are amplified by research that shows that increased GRI reporting has not significantly empowered civil society stakeholders.<sup>30</sup> Moreover, there are examples of big accounting firms providing external assurance to banks prior to the occurrence of major scandals, such as Barclay’s<sup>31</sup> connection to \$US 360 trillion interest rate-fixing<sup>32</sup>, or HSBC’s<sup>33</sup> role in money laundering for drug cartels and terrorists.<sup>34</sup>

Despite Australian banks seemingly outperforming their global counterparts on the voluntary reporting indicators, justified doubts exist about how far these indicators effectively gauge sustainable banking. Indeed, the seemingly excellent disclosure performance of Australian banks has not hindered misconduct: the Australian Securities and Investments Commission is conducting an industry-wide investigation into rate fixing in the Australian financial sector<sup>35</sup>, while the financial planning divisions of CBA<sup>36</sup> and NAB<sup>37</sup> have been ridden with scandal due to dodgy financial advice, and Westpac has been linked to global money laundering.<sup>38</sup> Worryingly, none of these transgressions came to light in the banks’ reporting.

## Environmental Transparency

The majority of banks are transparent about environmental performance, in addition to establishing quantifiable performance targets. Banks from Australia, Europe and North America seem to outperform their Asian counterparts. Levels of transparency and the existence of environmental targets are commendable, yet it is important to note that transparency is often mistakenly understood to be a straightforward concept. In reality, transparency has many dimensions, namely *who* discloses to *whom*, and *what* is disclosed to meet *what ends*?<sup>39</sup>

Indicator	ANZ	CBA	NAB	WBC	Asia	Europe	N. America
Transparency	✓	✓	✓	✓	5/8	11/11	7/7
Targets	✓	✓	✓	✓	4/8	10/11	5/7
CDP	✓	✓	✓	✓	5/8	10/11	7/7

Research finds that corporate environmental performance is often pursued and disclosed opportunistically.<sup>40</sup> For example, a decrease in environmental costs positively affects financial performance, in part mediated through enhanced corporate reputation.<sup>41</sup> Opportunistic use of environmental information can be hazardous, as it can potentially erode instead of building corporate legitimacy: feigning or exaggerating environmental performance can backfire and harm a company's image.<sup>42</sup> Reputation incentives can also result in uninspired action, allowing banks to maintain risk levels while meeting stakeholder demands by copying practices of peers, or by applying non-aspirational industry standards.<sup>43</sup>

In the sample, environmental transparency most commonly manifests in carbon emissions disclosures, specifically through participation in the Carbon Disclosure Project (CDP). While participation is high, doubts exist whether CDP disclosures are valuable for investors, civil society, and policy makers, as they are associated with uncertainty about organisational boundaries.<sup>44</sup> For example, a 2013 study found that the Royal Bank of Scotland's fossil fuel deals led to a carbon footprint of up to 1,200 times the reported emissions, 1.6 times as high as the emissions of the UK in 2012.<sup>45</sup> For Australian banks, the scope of emissions reporting does not include the \$AUD 36.7 billion invested in the fossil fuel industry since 2008.<sup>46</sup>

## Social Transparency

An obstacle in assessing social performance is that the bank's functioning in this area can be difficult to quantify. Unlike carbon emissions, water usage, waste production and energy consumption, factors such as human rights, labour issues and community concerns are typically expressed qualitatively. Although banks might feature rich descriptions of case studies in their reports, this information fails to paint a complete picture of the bank's social performance, and does not allow for cross-company or regional comparisons. What is required is a coherent method for banks to measure and disclose their social performance.

Recent changes to the ASX listing requirements involve disclosure of information on social risks.<sup>47</sup> However, compliance is achieved simply by referring to sections of Annual and Sustainability Reports. A globally recognised tool such as **ISO26000** offers guidance on socially responsible enterprise and could structure reporting. It was established after "[...] negotiations between many different stakeholders across the world. Representatives from government, non-governmental organisations (NGOs), industry, consumer groups and labour organisations around the world were involved in its development, which means it represents an international consensus."<sup>48</sup>

Indicator	ANZ	CBA	NAB	WBC	Asia	Europe	N. America
ISO 26000	✗	✗	✗	✗	5/8	2/11	0/7

Yet in the sample none of the Australian banks, and only a limited number of the banks from other regions, expressly mention using ISO26000 guidance regarding their operations. Although WBC does refer to ISO26000, it does so in its supplier code of conduct, requiring providers of goods and services to adhere to practices in line with ISO2600 guidance. While WBC's focus on its supply chain is commendable, resulting in the bank outperforming its Australian counterparts, WBC simultaneously externalises its social responsibilities by shifting obligations towards its suppliers, and misses the opportunity to lead by example.

A recent report by Oxfam Australia showed involvement of the big four banks in improper land acquisition: WBC through its relation with a controversial logging company in Papua New Guinea, CBA and ANZ through relations with companies sourcing sugar cane in Brazil and Cambodia, and NAB

through involvement in the palm oil industry.<sup>49</sup> While NAB and WBC have since changed their policies to reduce the risk of financing land grabs, CBA and ANZ are yet to adopt zero tolerance to land grabs in financial relations.<sup>50</sup> While these actions deserve some credit, they are nonetheless reactive and come into effect after the damage has been done.

While not providing a failsafe, adoption of ISO26000 guidance could have enabled the banks to identify and mitigate the risk of involvement in improper land acquisition, introducing a precautionary strategy in social risk management. Yet, adoption of ISO26000 guidance alone is unlikely to be effective. Successful management of social risks depends on “[...] key areas such as management systems; integration of strategy, operations, technology, CSR (corporate social responsibility) and quality; incorporation of corporate governance; and improvements in third-party certification and internal auditing practices.”<sup>51</sup>

## Summary

Theoretically, voluntary reporting frameworks improve business transparency, and can assist in formulating and achieving social and environmental objectives. However, the preceding analysis demonstrates that voluntary reporting does not offer a silver bullet and has a number of weaknesses. For example, non-financial reporting is not yet fully integrated into financial reporting. This suggests that social and environmental matters are considered a sideshow instead of a core issue, while the economic bottom line of banks continues to reign supreme.

Furthermore, there is a lot of discretion on the part of banks when choosing what reporting guidelines to follow and what information to disclose, which depends on where, when and what non-financial data is considered to be material to business operations. This situation results in discriminatory and opportunistic disclosures, allowing banks to enhance their corporate reputation without addressing all underlying concerns. Consequently, it is unlikely that the current voluntary disclosure regime of banks can help to align incentives, and reduce social and environmental information asymmetry.

### 3. RESPONSIBLE FINANCE

This chapter examines the provision of responsible financial services and products. The indicators consider whether banks offer services and products commonly deemed responsible, such as offering **microcredit** to disadvantaged communities, as well as the provision of **climate products** aimed at improving the environment. The chapter furthermore assesses whether banks practise **socially responsible investing** (SRI), while examining social and environmental risk management and the screening of high-risk sectors in lending practices; and lastly it takes a closer look at the validity of often used **sustainability indices**.

#### Products and Services

Despite financial scandals and crises, there is ongoing belief in financial solutions to social and environmental issues. Reliance on financial solutions to issues that are not exclusively financial is problematic, as market-driven responsibilities do not always equate with responsibilities towards the community.<sup>52</sup> For example, **shareholder primacy**, acting in the interest of your shareholders, may contradict acting in the best interest of wider stakeholders. It is also vital to note that the social or environmental value of a product or service is not intrinsic: instead, the entire range of products and services a bank provides determines the value.

According to John Ruggie, author of the seminal work on business and human rights that bears his name, “[...] there is no equivalent to buying carbon offsets in human rights, philanthropic good deeds do not compensate for infringing on human rights.”<sup>53</sup> Even offsetting of carbon emissions is controversial and often branded as ‘polluting without the guilt’. The fundamental problem with carbon offsetting occurs when the link between the counterbalancing product and the actual reduction of emissions is severed, which can occur due to difficulties in measuring emissions, or fraud. Thus, offering responsible products and services does not simply absolve banks from social and environmental wrongdoing.

Indicator	ANZ	CBA	NAB	WBC	Asia	Europe	N. America
Microcredit	✓	✓	✓	✓	5/8	10/11	7/7
Climate products	✓	✗	✓	✓	5/8	8/11	5/7
SRI	✓	✓	✓	✓	4/8	10/11	6/7

Consequently, although the Australian banks and many peers from other regions offer microcredit, provide climate products and services, and are furthermore involved in socially responsible investing - among which are projects or businesses related to renewable energy, sustainable agriculture and green infrastructure, the material test to determine whether banks truly practise sustainable and responsible financing is to examine their most controversial financial activities. Thus the next section will take a closer look at social and environmental risk management and the screening of high-risk sectors.

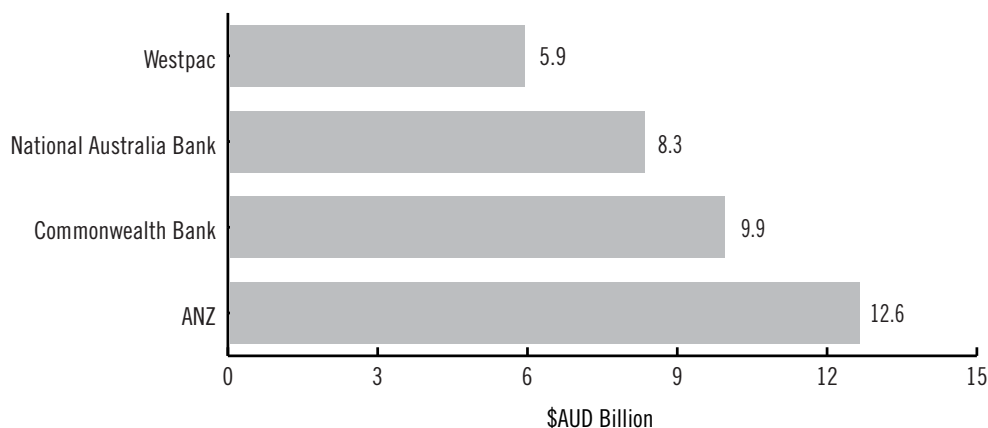
#### Risk Management and Sector Screening

In the Australia Institute survey, only 32% of respondents believe that banks should provide financing for projects even if there are social and environmental risks. The majority of Australian and other banks in the sample state that they evaluate environmental risk. Although this is encouraging, many environmental outcomes will only become evident over time, making it essential to apply a time scale that allows environmental consequences to manifest.<sup>54</sup> This fact illustrates the urgent need for a precautionary turn in risk management. Despite Australian banks stating that they screen high-risk sectors before making lending decisions, they nevertheless continue to fund a wide range of unsustainable activities.

Indicator	ANZ	CBA	NAB	WBC	Asia	Europe	N. America
Environmental Policy	✓	✓	✓	✓	8/8	10/11	7/7
Environmental risk management	✓	✓	✓	✓	5/8	11/11	7/7
Sector Screening	✓	✓	✗	✓	6/8	10/11	7/7
Equator Principles	✓	✓	✓	✓	2/8	8/11	6/7

For example, since 2008, the big Australian banks have provided \$AUD 36.7 billion in funding to the fossil fuel industry in Australia.<sup>55</sup> An example of such a loan is the Maules Creek coalmine in New South Wales, financed by a \$1.2 billion loan, with ANZ contributing \$AUD 325 million, while CBA, NAB and WBC each put in \$100 million. Local communities, including traditional land owners, are opposed to the construction of the mine, which is associated with deforestation, endangering vulnerable species, air pollution, competition for water resources and a billion tonnes of CO<sub>2</sub> emissions over the mine's life span.<sup>56</sup>

### Loans to the Australian Fossil Fuel Industry



In addition, when considering both coal and gas projects, in the period 2008 to 2012 alone the four banks funded \$AUD 3.8 billion worth of projects affecting the Great Barrier Reef, a World Heritage site.<sup>57</sup> In addition to projects already funded, another controversial plan is the development of the Alpha Coal project. The proposed coalmine and associated rail and port infrastructure will produce and transport around 30 million tonnes of coal annually, linking the mine in the Galilee Basin in Queensland to a port 495 km further north via a railway.<sup>58</sup>

The mine would impact over 20,000 hectares of land, threaten endangered species, and emit 65 million tonnes of CO<sub>2</sub> annually. Associated port expansions would result in construction and dredging along the Great Barrier Reef, a World Heritage site, placing this area at risk.<sup>59</sup> Although it has not yet been fully funded, ANZ is advising on the financing of the project, and a funding arrangement similar to the Maules Creek coalmine will likely be finalised.

Apart from endangering the environment, banks also provide financing for other unsustainable activities. For example, from 2011 to March 2014, the banks under examination provided \$AUD 112.2 billion<sup>†</sup> to nuclear arms manufacturers, \$AUD 3.6 billion of which was lent by Australian banks.<sup>60</sup> The report by PAX and the International Campaign to Abolish Nuclear Weapons profiles eight financial institutions that have banned investments in nuclear weapons and another 27 that have taken steps but have not yet fully divested. The Australian banks are not part of these groups.

Banks do apply responsible financial principles to lending activities.<sup>‡</sup> The well-known **Equator Principles** are used as an instrument to determine and control environmental and social risks in project finance, such as infrastructure projects. A common criticism is the distinct focus on project finance, as its share is small compared to the value of global banking assets: \$USD 321.3 billion<sup>61</sup> vs. \$USD 156 trillion.<sup>62</sup> Furthermore, the project component allows for discriminatory application of the principles, and the voluntary nature prevents enforcement.<sup>63</sup>

Despite all four Australian banks applying the Equator Principles, they also continue to finance activities that contradict these commitments. Furthermore, when the Equator Principles are applied, such as in the case of the Alpha Coal project, the far-reaching and adverse project impacts do not seem to discount its realisation. In other cases, such as the Maules Creek coalmine or the Liquefied Natural Gas project in Papua New Guinea<sup>64</sup>, the Equator Principles are simply not considered. This suggests that the guidance provided by the Equator Principles is inadequate, not universally applied, or simply ignored.

<sup>†</sup> Using average US\$ - AUD\$ exchange rate for this period. Excludes banks with <0.5% holdings

<sup>‡</sup> The United Nations Principles for Responsible Investment are not considered, as these principles are more relevant to investment banks than retail banks.

## Sustainability Indices

A growing number of sustainability indices gauge the environmental and social performance of companies. These indices are useful to investors, as research has shown there is a link between the (perceived) environmental and social functioning of a company and its financial performance.<sup>65</sup> Well-known sustainability indices are the FTSE4Good and the Dow Jones Sustainability Index (DJSI). Many banks in the sample are part of both indices, and ANZ was named as the global banking leader in the DJSI six times in the last seven years.

Indicator	ANZ	CBA	NAB	WBC	Asia	Europe	N. America
DJSI	✓	✓	✓	✓	2/8	8/11	6/7
FTSE4Good	✓	✗	✓	✓	2/8	10/11	6/7

Yet, how can ANZ achieve this credit if it is the largest funder of coal mining and related infrastructure projects in Australia? A closer look at the indices reveals a number of other dubious constituents. For example, at the time of writing, food and beverage giant Nestlé is included in the top ten of both the FTSE4Good and the DJSI<sup>66</sup>, despite social and environmental controversies in past<sup>67</sup> and present times.<sup>68</sup> In addition, Apple Inc. leads the FTSE4Good index<sup>69</sup> despite widespread criticisms concerning labour rights violations in its supply chain.<sup>70</sup>

Research into sustainability indices raises additional issues, such as the lack of standardisation and credibility of information, as well as rating bias, and lack of transparency and independence.<sup>71</sup> Furthermore, methodologies and calculation of rankings are of vital importance but frequently opaque.<sup>72</sup> It is also argued that the indices promote a narrow view of corporate responsibility: certain areas of performance are made increasingly visible, leaving others underexposed.<sup>73</sup>

Consequently, it is highly questionable if these sustainability indices truly gauge the social and environmental performance of banks. The high rating of firms with dubious track records can perhaps be explained by research which shows that investors are inclined to reward firms that display overall positive behaviour, rather than to exclude companies based on certain unsustainable products or practices.<sup>74</sup> Thus, from an investor perspective, banks can be absolved from wrongdoing by offsetting their unsustainable activities with sustainable ones.

## Summary

So what are the implications for responsible finance, in the shape of products and services, risk management, sector screening, principles and indices? The evident schism between *regular* finance and ethical variants is difficult - if not plain impossible - to reconcile. Unsustainable products and services cannot simply be 'offset', while risk management and the screening of high-risk sectors falls short and lacks the necessary precautionary approach, as evidenced by ongoing investment in unsustainable activities, while the DJSI and FTSE4Good indices fail to adequately measure the non-financial performance of banks.

A number of questions about responsible finance remain: can financial value creation coexist with the creation of non-financial values, or will it be based on a minimal degree of social and environmental responsibility and a maximum return on investment? Is responsible finance indicative of a sincere commitment to society and the environment, or is it merely market rhetoric? Regrettably, the evidence in this chapter suggests the latter is true. Voluntary responsible finance initiatives fall short in aligning incentives of banks and the community, and also in reducing social and environmental risk.

## 4. STAKEHOLDER ENGAGEMENT

Stakeholder engagement encourages consensus building and avoidance or minimisation of risks to people and the environment.<sup>75</sup> Making stakeholders central to moral corporate discourse also increases the chance of making social progress.<sup>76</sup> Yet, stakeholder engagement does not always have moral motives, and can be aimed at knowledge gathering, human resource management and legitimisation. It should thus not be seen as corporate responsibility in action, but rather as an initiative that can be related to corporate responsibility.<sup>77</sup>

Indicator	ANZ	CBA	NAB	WBC	Asia	Europe	N. America
Identifies stakeholders	✓	✓	✓	✓	6/8	10/11	7/7
Explains engagement	✓	✓	✓	✓	6/8	10/11	7/7

The majority of banks in the sample identify stakeholders and explain methods of engagement. It is crucial to note that, due to the reasons outlined in the preceding paragraphs, present times are characterised by growing stakeholder scepticism. As a result, banks must carefully decide how to convey commitments towards their stakeholders. Recognising this fact will help banks to take greater responsibility for their activities.<sup>78</sup> However, research shows that when companies are faced with increasing pressure to be accountable to a number of stakeholders, decisions to implement standards are frequently made based on cost-benefit calculations, neglecting broadly defined stakeholder interests.<sup>79</sup>

### Internal Stakeholders

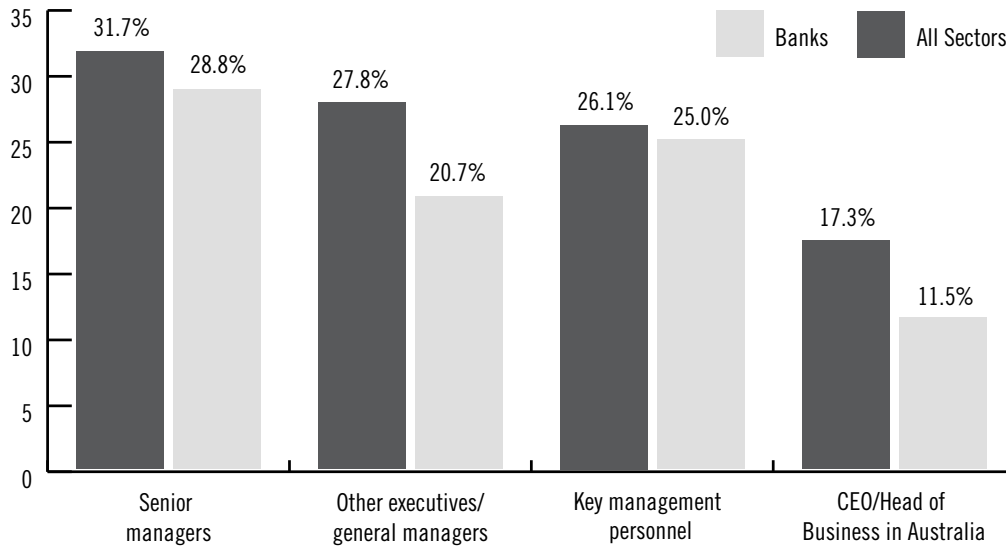
Stakeholder engagement has internal and external dimensions. Moral managing of staff entails considering employees as a resource to be treated with respect. Moral management would seek out fair dealings with employees, and employ a consultative and participative leadership style, focused on harvesting mutual confidence and trust.<sup>80</sup> Concerning the internal social conduct of banks in the sample, the majority report on their employee engagement, providing training and education to staff, diversity initiatives, and actively obtaining staff feedback.

Indicator	ANZ	CBA	NAB	WBC	Asia	Europe	N. America
Training and education	✓	✓	✓	✓	8/8	10/11	7/7
Diversity and opportunities	✓	✓	✓	✓	7/8	11/11	7/7
Staff Feedback	✓	✓	✓	✓	5/8	11/11	5/7

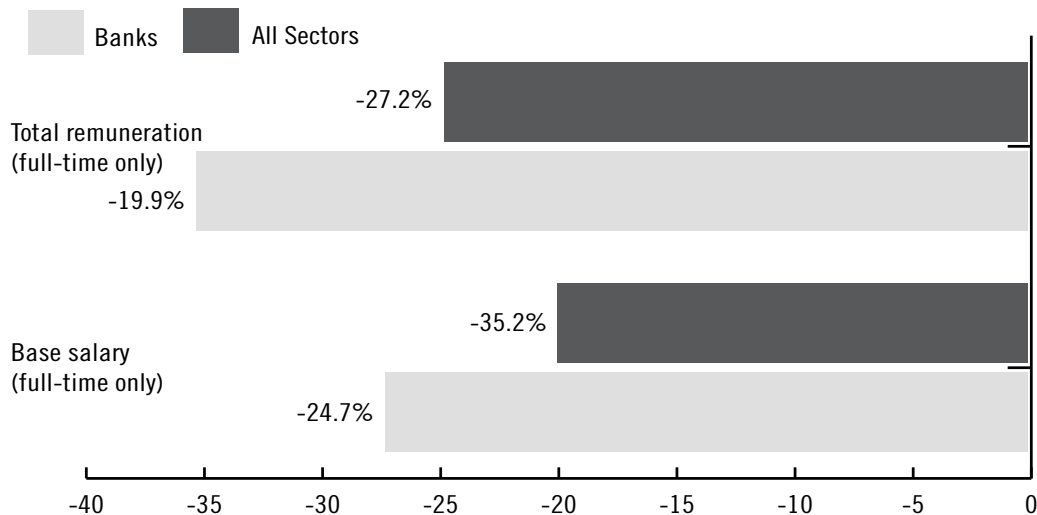
Although the Australian banks report that they manage staff in a moral manner, there are numerous cases that contradict these claims. For example, despite enormous profits, a number of restructures<sup>81</sup> and offshoring<sup>82</sup> of jobs in recent years has resulted in thousands of job losses.<sup>83</sup> Moreover, a look at the representation of women in leadership positions and the remuneration of women compared to men – gives rise to further doubts.<sup>84</sup> In comparison to other industries, banks in Australia have fewer women in management positions, while the base salary and the total pay gap at banks is greater.<sup>§</sup>

<sup>§</sup> Figures are based on 25 banks and 4,329 other organisations in Australia that reported to the Australian Government's Workplace Gender Equality Agency in 2014.

### Percentage of Women in Leadership



### Remuneration of Women vs. Men



## External Stakeholders

When considering external stakeholder engagement, banks frequently devote resources to public outreach and community engagement. Moral management of community stakeholders involves considering a vital community as a business goal that is worth actively pursuing. Leading firms would, for example, focus on environmental issues, education, culture, and volunteerism. Moral management would consider community and company goals as mutually interdependent.<sup>85</sup>

Indicator	ANZ	CBA	NAB	WBC	Asia	Europe	N. America
Community involvement	✓	✓	✓	✓	8/8	11/11	7/7
Sponsoring	✓	✓	✓	✓	7/8	11/11	7/7

All banks in the sample mention that they are in some way engaged in the community. All banks but one report that they sponsor public events. These figures suggest a worthy effort by banks to engage their external stakeholders. Optimism is tempered by research that shows a clear philanthropic strategy is frequently lacking in community investment<sup>86</sup>, as well as by studies showing that “[...] external stakeholders are not integrated on a regular but on a case-by-case basis and most of the time interaction takes place in a situation of crisis”.<sup>87</sup>

Despite the seemingly widespread community involvement of Australian banks, there are some examples where their interests conflict with the interests of the wider community. As mentioned,



thousands of Australians lost their life savings because of inappropriate advice given to them by financial planners. Another conflict between Australian banks and society concerns a class action over disputed late payment fees.<sup>88</sup> In the largest collective legal action in Australia's history, over 185,000 people who claim to have been charged unfair fees are attempting to redeem their money, claiming over \$AUD 240 million.<sup>89</sup> Although the Federal Court over-ruled an earlier decision that branded late payment fees as illegal, the matter will most likely be taken to the High Court.<sup>90</sup> Regardless of the verdict, Australian banks have had to square off against 185,000 citizens.

## Multistakeholder Initiatives

Bringing multiple stakeholders together to participate in dialogue, decision-making and formulating solutions to social and environmental issues encourages transparent and accountable business enterprise. It allows for participation of the stakeholders that are most directly impacted by business enterprise and often have little opportunity to voice their concerns. The **United Nations Global Compact** (UNGC) and the **United Nations Environment Programme Finance Initiative** (UNEP-FI) are two well-known initiatives. All four Australian banks partake in these initiatives, while participation rates are lower in other regions.

Indicator	ANZ	CBA	NAB	WBC	Asia	Europe	N. America
UNGC	✓	✓	✓	✓	4/8	8/11	1/7
UNEP-FI	✓	✓	✓	✓	4/8	7/11	4/7

The UNGC is an international multistakeholder forum that relies on the adoption of ten principles across four areas: human rights, labour standards, environment, and anti-corruption.<sup>91</sup> While the UNGC is often lauded, it has only had modest impact on corporate responsibility.<sup>92</sup> It is criticised for the alleged dominance of corporate interests, vague principles, and a failure to validate fulfilment of the principles.<sup>93</sup> Firms mostly benefit through networking and enhancing corporate reputation.<sup>94</sup> Proponents argue that the UNGC should be seen as an addition to incomplete state and non-state regulation.<sup>95</sup> Yet, companies are less likely to be delisted from the UNGC in countries where institutions function well<sup>96</sup>, which suggests that the initiative does not offer a substitute for weak or absent governance.

The UNEP-FI facilitates dialogue between the community and private sector companies, with the aim of promoting sustainability in business operations.<sup>97</sup> In order to become a signatory, financial companies must adhere to a statement, which dictates that activities are compatible with social and environmental welfare. Signatories express commitment to sustainability, but are not accountable, nor do penalties exist for non-compliance. It follows that criticism of the UNEP-FI is similar to that of the UNGC and mainly concerns the absence of enforcement, while rebuttals likewise state that the initiative should be seen as filling the gap left by incomplete private and public policy.

The fact that the UNGC and the UNEP-FI do not fill the gap caused by weak or absent governance frameworks is best illustrated by the occurrence of land grabs in emerging markets, financed by the big four Australian banks. While bringing together stakeholders to participate in a dialogue about responsible financial enterprise is laudable, it has not served the victims of improper land acquisition well, nor did the UNGC principles or the UNEP-FI statement prevent these land grabs. Without accountability, enforcement and penalties for non-compliance, the UNGC principles or the UNEP-FI statement regrettably are not worth the paper they are written on.

## Summary

At first sight, Australian and overseas banks seem to engage well with internal and external stakeholders. Yet, there is evidence that reveals a different picture. The purported extent of internal and external stakeholder engagement has not solved existing employee and community issues, as shown by the continuing underrepresentation and underpayment of women in leadership, in addition to thousands of layoffs despite enormous profits, as well as banks being faced with the largest class action in Australian history. It appears that stakeholder and community engagement is driven by reputation incentives, given that previous sections show that banks are often motivated to enhance their corporate image.

This supposition is verified by research showing a lack of detailed community investment and engagement strategies, and studies that show companies make decisions based on a cost-benefit basis when faced with pressure from various stakeholder groups, therefore ignoring broadly defined stakeholder interests. In other words, stakeholder engagement is often opportunistic and reactive. This is no different for multistakeholder initiatives, which promote voluntary standards over binding regulation, even though they do not provide a failsafe supplementary governance framework. In sum, these initiatives fall short in aligning actual incentives to stated aims, in countering information asymmetry and reducing social and environmental risk levels.

## 5. CORPORATE GOVERNANCE

Corporate governance provides the system by which companies are directed and controlled, to ensure that duties are exercised according to laws, regulation and codes of conduct.<sup>98</sup> Company leadership, specifically the board of directors and the executive management team, are progressively held responsible for the design, implementation and monitoring of sustainability objectives and performance.<sup>99</sup> This is no different for banks. It is crucially important that the leadership drives social and environmental causes, as they create a precedent for the entire firm. However, the governance of sustainability is still at an early stage, as there are few directors with direct responsibility for sustainability.<sup>100</sup>

Indicator	ANZ	CBA	NAB	WBC	Asia	Europe	N. America
Board	✓	✗	✗	✓	1/8	6/11	6/7
Management	✓	✗	✗	✗	3/8	2/11	1/7

Sustainability committees mark the priority given to sustainable governance mechanisms at the peak of the organisational pyramid. Half of the Australian banks have a board committee, while only one has a management committee that deals with sustainability matters. Yet a closer look reveals little real commitment, as demonstrated by the committee charters: ANZ's Governance Committee merely includes an ambiguous statement that its task is to "[...] review and approve the proposed corporate sustainability objectives for the Company, and review progress in achieving them."<sup>101</sup>

The board committee at WBC that addresses sustainability, called the "Board Risk and Compliance Committee", formulates a similarly general and vague statement by mentioning that the committee will "[...] review and approve other risk management frameworks not specifically referred to in this Charter, and/or review the monitoring of performance under those frameworks (as appropriate)."<sup>102</sup> These are described as including "[...] other risks (including environmental, social and governance risk, equity risk, related entity risk, insurance risk, anti-money laundering, counter terrorism financing, bribery and corruption, and others as identified by the Committee)."<sup>103</sup>

At the executive management level, ANZ's "Corporate Sustainability & Diversity Committee" is somewhat more encouraging. The committee is described as "[...] a strategic leadership body performing an oversight, advisory and advocacy role in achieving the Group's agenda and priorities."<sup>104</sup> Its purpose is to advise management and other governance bodies, set strategies, policies and targets, and ensure leading practice in the management and disclosure of corporate sustainability. Yet the committee's efficiency is questionable, as ANZ is the largest funder of coal mining projects in Australia, and has led the funding efforts of the Maules Creek mine as well as the Alpha Coal Project. Therefore, while a management focus on sustainability issues is laudable and desirable, it does not automatically mean that adverse impacts are avoided.

Overall, the findings suggest that leadership in banks is not commonly focused on, or driving, social and environmental strategy. Indeed, the fact that leadership – management specifically - needs to make significant advances in the area of governance is illustrated by the comments of employees involved in the Australian financial planning scandal, who want to "[...] bring to light senior management as the drivers of much that is wrong in the industry. Until senior managers are named and shamed the bank will continue to chew through the bottom ranks as the body count rises as an accepted cost of doing business."<sup>105</sup>

### Business Ethics

Research shows that "[...] prevailing business culture in the banking industry weakens and undermines the honesty norm."<sup>106</sup> The majority of banks, including all four Australian banks, have formulated and disclosed a code of conduct outlining appropriate behaviour and ethics. It is important to note that some corporate governance regimes, such as the ASX Corporate Governance Principles and Recommendations, require listed companies to establish a code of conduct and to publicly disclose at least a summary of the code. Thus the compliance of Australian banks is not surprising. More remarkable is the considerable divergence in the types of codes, their content, and whom they apply to.

Indicator	ANZ	CBA	NAB	WBC	Asia	Europe	N. America
Code of Conduct	✓	✓	✓	✓	6/8	11/11	7/7

For example, CBA lists eleven codes of conduct on its website, of which only five have been made public.<sup>107</sup> Despite the description in the ASX Corporate Governance Principles and Recommendations, it is unclear which of the codes describes “[...] the practices necessary to maintain confidence in the company’s integrity, to take into account their legal obligations and the reasonable expectations of their stakeholders, and the responsibility and accountability of individuals for reporting and investigating reports of unethical practices.”<sup>108</sup>

WBC’s code “[...] describes the standards of conduct expected of our people, both employees and contractors [...] to help us make the right decision every time.”<sup>109</sup> It is unclear whether the code applies to directors as well. Another document, called the “Principles for Doing Business”, sets out WBC’s “[...] commitment to sustainable business practice.”<sup>110</sup> Similar to the code of conduct, the Principles do not seem to apply to directors: “[...] employees and contractors who breach the Code of Conduct or Our Principles may face disciplinary action including termination of employment or termination of their contracts.”<sup>111</sup>

ANZ has codes of conduct for its staff<sup>112</sup> and its directors.<sup>113</sup> In the codes, the bank states that it “[...] aims to deliver superior long-term total shareholder return, taking proper account of employees, customers and others with whom we do business as well as the communities and environments in which ANZ operates. In striving to achieve these aims, we should not compromise our ethics or principles.”<sup>114</sup> While the codes apply to staff and directors, they suffer from the shareholder primacy paradox: what happens when the focus on maximising shareholder profits conflicts with community and environmental factors?

This paradox is also present in NAB’s code of conduct, in which the bank states it is “[...] committed to achieving sustainable performance and delivering value to our customers and shareholders while maintaining our beliefs, behaviours and trusted reputation.”<sup>115</sup> Yet, the bank does not explicitly mention what sustainable performance means. While the code mentions “community and respects human rights”, it does not mention the environment. Overall, it is unclear which codes of conduct apply to whom, while the principles in the codes are often vaguely formulated and can at times be contradictory.

More importantly, it should be noted that the codes of conduct are accompanied by different accountability mechanisms. For staff members, directors and parties with whom banks are engaged in contractual relationships, the codes of conduct express duties, which means that transgression can result in the termination of employment or the business relationship. Yet, for community stakeholders, the codes of conduct convey social norms, meaning that transgression results in public disapproval. Consequently, societal stakeholders can use the codes of conduct to question a bank’s **social license to operate**.

## Remuneration

In general, firms are increasingly integrating non-financial elements into their remuneration structures, although still to a limited extent and in a narrow manner. Research using data covering 3,512 international companies shows that only ten companies linked staff remuneration to environmental and social performance at the board level, while only 32 firms did so at executive management level.<sup>116</sup> A study covering 600 publicly listed companies demonstrates that 7% explicitly link executive compensation to social and environmental matters, while an additional 9% of companies do so without making reference to targets and weighting of social and environmental issues.<sup>117</sup>

Indicator	ANZ	CBA	NAB	WBC	Asia	Europe	N. America
Non-financial performance	✓	✓	✓	✓	0/8	8/11	2/7
Health & Safety performance	✗	✗	✗	✓	0/0*	0/8*	0/2*
Environmental performance	✗	✗	✗	✗	0/0*	0/8*	0/2*
Customer satisfaction	✓	✓	✓	✗	0/0*	4/8*	1/2*
Employee satisfaction	✓	✗	✓	✗	0/0*	1/8*	1/2*
Community	✗	✗	✓	✗	0/0*	2/8*	0/2*

\* Banks that incorporate non-financial measures in remuneration

This report looks at a number of non-financial performance measures relating to executive management compensation. Sixteen banks mention that they link non-financial measures to remuneration of executive management. Only a few banks further elaborate on specific performance areas. Considering the figures in other studies, banks in the sample seem to perform above average. Yet, a closer look shows that customer and employee satisfaction are mentioned most often, which is unsurprising considering their link to financial performance. Conversely, health and safety, environmental performance and community indicators are linked to remuneration to a lesser extent or not at all.

Remuneration structures that integrate environmental and social performance are often considered a missing piece of the corporate responsibility puzzle.<sup>118</sup> In the survey, 58% of respondents believe that rewards in the banking sector should be linked to social and environmental performance. Yet, several hurdles are associated with linking remuneration to environmental and social goals. Challenges concern balancing of short and long-term objectives, as well as the quantifying and weighting of environmental and social measures.<sup>119</sup> The major concern here is that the percentage of compensation related to environmental and social measures may be small and unlikely to be a significant motivator, especially compared to bonus packages linked to profits.<sup>120</sup>

While all four Australian banks have incorporated non-financial performance in the remuneration schemes of senior management, there are indications that it should be a part of remuneration schemes throughout the entire organisation. For example, remuneration structures in one of the scandal-ridden financial planning divisions in Australia are said to have “[...] a heavy bias to product sales and new clients rather than existing clients.”<sup>121</sup> This suggests that, beyond integrating non-financial indicators in the remuneration of the executive management team, compensation structures throughout the banking sector need to be balanced in order to abolish perverse performance incentives.

## Summary

The figures suggest that social and environmental matters are not commonly prioritised at the board or management levels of banks, nor does the leadership convincingly champion sustainability strategies. Relevant committees either do not exist or inadequately address sustainability issues, as evidenced by the range of banking malpractices outlined in this report. While business ethics are described in codes of conduct, it is not always apparent to whom they apply, nor are social and environmental responsibilities clearly formulated. In addition, banks create a moral conundrum by emphasising shareholder profits together with their social and environment commitments.

Although banks link non-financial measures into executive compensation, social and environmental objectives are inadequately integrated, as shown by the emphasis on customer and employee satisfaction, which suggests profit and reputation motives. Overall, it should be noted that these indicators only reveal a part of corporate governance mechanisms in banks. Yet the earlier discussion of lending policies and risk management, particularly the continued financing of unsustainable activities, suggests environmental and social matters are not generally integrated into corporate governance systems. If those systems are authoritatively regulated – they can achieve increased accountability and the embedding of sustainability principles in banking strategies.

# 6. DISCUSSION

The report examined how two conflicting images of the big four banks can exist side-by-side: that of the banks as lauded sustainable enterprises, and conversely their involvement in a range of financial scandals and unsustainable activities. Furthermore, in the context of the Financial System Inquiry, which failed to address the social and environmental responsibilities of banks, as well as the decade-old parliamentary inquiry into corporate responsibility, which favoured voluntary initiatives over legal amendments and mandatory requirements, the report asked why it is that banks are allowed to continue to self-regulate social and environmental matters, while national and global financial regulation is becoming stricter following financial misconduct and the global financial crisis.

The report then proceeded to examine sustainability in the Australian and global banking sector. Specifically, it assessed self-regulatory and voluntary measures aimed at enabling socially and environmentally responsible banking practices. Extending earlier research into banking and corporate sustainability informed this analysis, while the report also set out to critically assess these indicators to verify whether they form accurate sustainability proxies. The material test was formed by three key challenges: addressing misaligned incentives, information asymmetry, and social and environmental risk levels.

## FINDINGS

The research shows that misaligned incentives are not effectively countered. While banks make some efforts to combine profit with environmental and social goals, they do not do enough. Banking products and services have a two-faced nature, while stakeholder engagement, a tool that can align incentives, is often quoted but is accompanied by many examples where stakeholders have been disadvantaged. Moreover, partaking in multistakeholder initiatives and adopting related principles lacks credibility, due to the absence of serious consequences for non-compliance. Non-financial measures are increasingly included in remuneration, but the focus on customer and employee satisfaction suggests self-interested motives, while the implementation of sustainability in governance was inadequate, suggesting that social and environmental matters are of limited concern to leadership in banks. In sum, the report provides a host of examples where banks do not have community interests at heart.

Doubts also arose regarding how banks address information asymmetry. The report established that there are several levels of commitment to voluntary sustainability reporting among banks, concerning the scope and accuracy of disclosed information. Despite an extensive uptake of reporting tools, as well as external assurance by accounting firms, increased disclosures have not prevented environmental, social and governance controversies from occurring. Doubts likewise exist about the effectiveness of stakeholder engagement, as well as responsible and sustainable finance: in many cases, stakeholders only become aware of unsustainable banking activities following action taken by civil society organisations. This simultaneously verifies that sustainability indices are mostly questionable, providing high ratings despite dubious business practices. In all, the report shows a substantial discrepancy between what banks say and what they do.

The management of environmental and social risks by banks falls short. While risk assessment and the screening of high-risk sectors are frequently mentioned, banks nevertheless continue to finance unsustainable activities. The adoption of voluntary codes and involvement in multistakeholder sustainability initiatives is shown to come at little cost, while the lack of enforcement inhibits increased accountability, allowing for business to resume as usual. Responsible products and services cannot be used to compensate for unsustainable activities. Clearly there would be no need to single out a product or service as 'responsible' if banks would adopt an overarching sustainable business strategy. The voluntary responsible finance initiatives of banks do not represent a strong commitment to reduce social and environmental risk levels, but instead predominantly denote market rhetoric.

Summarising, this report shows that the self-regulatory social and environmental measures of banks have largely resulted in symbolic outcomes. Although the banks have created an image of responsible corporate citizenship, additional probes reveal contradictions and shortcomings that debunk this portrayal. The question that follows is whether self-regulatory efforts should be seen as entirely symbolic: do banks merely try to adhere to societal expectations without truly changing, or is part of their effort genuinely aimed at social and environmental improvement? A balanced view would be that some efforts are symbolic, while others are substantive. Do the symbolic initiatives merely serve as a legitimacy front for banks, obscuring unsustainable activities, or are they a sign of uneven progress and will they eventually develop into substantial activities? Either way, the governance gap created by the present self-regulatory and voluntary sustainability paradigm will need to be overcome.

# BRIDGING THE GOVERNANCE GAP

Business enterprises are subject to three distinct but interrelated governance systems: that of public law and authority; a non-state system revolving around civil society and stakeholders; and the system of corporate governance - where the latter reflects the requirements of the previous two, albeit to varying degrees.<sup>122</sup> The discussed Inquiries demonstrate that the Government foresees a modest role for public law and authority in the governance of social and environmental matters concerning companies, while the system of corporate governance shows promise but has not yet fulfilled its potential. The non-state governance system spurred on by civil society is fulfilling its role as watchdog well, as shown by media and NGO reports on controversies involving banks and other companies.

As mentioned at the beginning of this report, the 2005 Government Inquiry into Corporate Responsibility and Triple Bottom Line Reporting found that legal amendments were undesirable, as it was deemed “[...] not appropriate to mandate the consideration of stakeholder interests into directors’ duties”, while sustainability reporting was to remain voluntary, as “[...] mandatory reporting would lead to a ‘tick-the-box’ culture of compliance.”<sup>123</sup> Ironically, voluntary sustainability reporting has resulted in a similar box ticking exercise, but rather than complying with the law this exercise is instead aimed at societal expectations. The fact that directors’ duties were not reformulated to cover stakeholder interests has, unsurprisingly, resulted in stakeholder issues remaining of relatively minor concern to company boards.

The argument here is not purely to expand the role of public law and authority.

Although additional regulation can potentially decrease risks associated with unsustainable finance, such a measure would also externalise responsibilities to a certain extent: by only embedding social and environmental responsibilities into corporate law, what is required of banks and companies is to be law-abiding. This would embed social and environmental sustainability in legal frameworks, rather than necessarily in business models. Yet, redefining the responsibilities of company directors, to include stakeholder, social and environmental concerns, would anchor responsibilities in the rule of law, while leaving a suitable amount of discretion and incentive on the part of companies to meet this requirement.

Reformulating the duties of company directors is not a new or radical idea: “[...] it may be a breach of **fiduciary duties** to fail to take account of [environmental, social and governance] considerations that are relevant and to give them appropriate weight, bearing in mind that some important economic analysts and leading financial institutions are satisfied that a strong link between good [environmental, social and governance] performance and good financial performance exists.”<sup>124</sup> Indeed, the areas of corporate social responsibility and corporate governance are converging<sup>125</sup>, which suggests that the legal and moral responsibilities of corporate leadership progressively overlap.<sup>126</sup> Thus, narrow views on corporate governance stressing legal and accounting compliance, with a focus on shareholder returns, are gradually supplemented by views that include a social and environmental focus and concern for wider stakeholder groups.<sup>127</sup>

The nature of corporate social responsibility differs from corporate governance in that it is voluntary, while corporate governance is anchored in corporate law and (coercive) stock exchange listing requirements. Increased integration would help make social and environmental matters more enforceable and thus make companies more accountable, diminish the use of sustainability disclosures as a public relations tool, lead to the development of valid performance indicators, streamline disclosures while increasing comparability, and ultimately improve social and environmental performance. Indeed, research shows that instead of establishing obligatory sustainability disclosures, enhancing corporate governance quality is a more effective way to improve disclosures.<sup>128</sup>

Where corporate governance systems are optimally designed and functioning - meaning that they reflect the requirements of the state governance system of the rule of law and authority, as well as the public governance system of civil society - there will be limited need for mandatory regulatory measures and public shaming by civil society organisations. Yet the current configuration of the governance systems is off-kilter and unjustifiably favours self-regulatory and voluntary efforts. To rebalance the governance structures, public law and authority will need to assume a bigger role. If increased convergence between corporate social responsibility and corporate governance takes the shape of additional self-regulation, the same issues that currently inhibit sustainability issues from becoming a core part of corporate bottom lines will undermine it.

## EXTENDED SUPERVISION

The assurance that financial operations are based on sustainable principles requires independent monitoring of compliance and performance, followed by public consultation regarding the findings, as NGOs and the media have been at the forefront of exposing of unethical activities, and naming and shaming is an effective measure.<sup>129</sup> “Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.”<sup>130</sup> Governance, regulation and supervision should thus not be seen as measures that restrain innovation or entrepreneurship, but instead as instruments that can help to restore trust, and ensure that banking activities are conducted openly, fairly and sustainably.

Although the Financial System Inquiry did address the social and environmental responsibilities of banks and the role of corporate governance, regulation and supervision, this does not mean that Australian institutions have no role to play. It should be noted that Australian regulators are not free of controversy. The Australian Securities and Investments Commission (ASIC), which enforces laws to protect consumers, investors and creditors, permitted NAB lawyers into its quarters, and allowed the bank to alter a media release about its failures.<sup>131</sup>

In 2014, a Senate report considering ASIC’s performance recommended a Royal Commission<sup>132</sup>, but the Government adopted the dissenting opinion. The report of the Financial System Inquiry put forward a solution for regulatory capture by corporate interests, which entails establishing a body that assesses ASIC’s and APRA’s performance.<sup>133</sup>In other words, the watchers will need to be watched.

Nation-based regulatory action only forms one part of the governance puzzle, as corporate governance is also rooted in frameworks at the international level. Concerning the financial sector, institutions such as the **International Monetary Fund**, the **Financial Stability Board**, and the **Basel Committee on Banking Supervision** regulate the financial system and assure its proper functioning. Although the plethora of international institutions shows growing global efforts to resolve issues in the financial sector, they focus chiefly on sustaining economic growth and avoiding future financial crises. However, as this report argues, misaligned incentives, information asymmetry, and risk-levels constitute flaws where the effects are not limited to financial crises.

As APRA noted, the diffusion of international governance standards for the financial sector has proven to be economically successful in the Australian context, which suggests that there is an institutional basis to repeat this exercise with social and environmental governance tools. An additional argument in favour of formulating corporate governance in an international context is that financial issues are increasingly global in nature. While defining corporate governance in a global context can result in a more sustainable banking sector, it should be noted that reaching consensus among sovereign stakeholders remains a key task, as national governments and regulatory bodies remain responsible for implementation and enforcement. Good governance begins at home.



# 7. CONCLUSION AND RECOMMENDATIONS

A decade after the Inquiry into Corporate Responsibility and Triple Bottom Line reporting, the time is ripe for the Government to revisit the issue. The present emphasis on self-regulation leaves social and environmental matters peripheral to business and banking strategies. Although banking supervision has become stricter after the global financial crisis, banks are still allowed to take a voluntary approach to social and environmental issues. Consequently, the market power of banks to inspire sustainable enterprise is not fully leveraged, while their actions continue to contribute to social and environmental detriment. Perversely, focus on corporate social and environmental voluntarism has created a governance gap that allows for unsustainable behaviour to be obscured by symbolic efforts.

Yet it should not merely be the existence of mandatory regulation that prompts responsible behaviour by banks and companies, but the dynamics following from the interplay of organisational culture, industry standards, institutional settings, and public scrutiny. The pursuit of self-regulation aimed at aligning incentives, counteracting information asymmetry, and establishing appropriate levels of risk is only fruitful if associated principles or standards are clearly formulated, broadly mandated, actively monitored, and effectively integrated into corporate governance – a system which at all times should reflect the requirements of public law and authority, as well as civil society.

In order for social and environmental responsibilities to become a core part of business and banking operations, some crucial elements need to be considered.

Further aligning the incentives of banks with community interests is greatly served by expanding the duties of directors to take into account social and environmental elements. Defining disclosure requirements and enshrining these in corporate governance systems would help to harmonise standards, increase comparability and enhance transparency, while reducing information asymmetry and the occurrence of moral hazards. Finally, corporate risk assessments should be based on the precautionary principle: if a proposed activity has a suspected risk of causing harm to society or the environment, and there is no consensus that this activity is not harmful, the burden of proof that it is *not* harmful should fall on the prospective financiers of this activity.

Most importantly, the Government should more actively fulfil its duty as the guardian of public interest. The neoliberal doctrine has convinced successive governments that the role of the state in governing business ought to be as small as possible.

The crux of the matter is more complex, as we have seen, and there is good reason to expand the role of the state to rebalance governance responsibilities. This issue is not limited to the topics covered in this report, but is part of a larger contemporary struggle. It is with good reason that the most often voiced unease about the **Trans-Pacific Partnership** agreement concerns the proposed investor–state arbitration, which would enable multinationals to sue governments outside of national legal frameworks to get taxpayer compensation for loss of expected future profits due to government actions.<sup>134</sup> This example illustrates what is at the heart of the issue: unbalanced governance arrangements that unjustly favour the interests of companies over state authority and community welfare.

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## Appendix A

Agricultural Bank of China  
Allied Irish Banks  
Australia & New Zealand Banking Group  
Banco Santander  
Bank of America  
Bank of China  
Barclays PLC  
BNP Paribas  
China Construction Bank Corporation  
Citigroup Inc  
Commonwealth Bank of Australia  
Credit Agricole Group  
Deutsche Bank  
Groupe BPCE  
HSBC Holdings  
Industrial & Commercial Bank of China  
Japan Post Bank  
JPMorgan Chase &Co  
Lloyds Banking Group  
Mitsubishi UFJ Financial Group  
Mizuho Financial Group  
National Australia Bank  
Royal Bank of Canada  
Royal Bank of Scotland Group  
Societe Generale  
Sumitomo Mitsui Financial Group  
Toronto-Dominion Bank  
US Bancorp  
Wells Fargo  
Westpac Banking Corp

## Appendix B

### **Voluntary Disclosures**

Sustainability Report  
Type of Sustainability Report (Stand-alone)  
Type of Sustainability Report (Integrated)  
Global Reporting Initiative  
Independently checked  
Application level  
Transparency of environmental performance  
Quantitative environmental management targets  
Carbon Disclosure Project  
ISO 26000

### **Responsible Finance**

Microcredit  
Climate products  
Socially responsible investing  
Dow Jones Sustainability Group Index  
FTSE4Good  
Environmental policy  
Environmental risk management  
Screening of specific sectors  
Equator Principles

### **Stakeholder Engagement**

Identifies stakeholders  
Explains methods of engagement  
Community involvement  
Sponsoring  
Training and education  
Diversity and opportunities  
Feedback from employees  
Global Compact  
UNEP Finance Initiative

### **Corporate Governance**

Board committee  
Senior management committee  
Code of Conduct  
Remuneration incorporates non-financial measures  
Safety performance (OHS)  
Environmental performance  
Customer satisfaction  
Employee satisfaction  
Community

## Glossary

**Application Levels:** A matrix that outlines the level at which companies have applied the GRI in their performance reporting.

**Basel Committee on Banking Supervision:** A body concerned with the prudential regulation of banks. The membership consists of 28 central banks.

**Climate Products:** Financial products that offer customers the opportunity to invest in organisations and projects that have a neutral or beneficial effect on carbon emissions.

**Equator Principles:** A standard developed by the United Nations for assessing environmental and social risks in projects.

**External Assurance:** A process where an independent organisation reviews and verifies a company's reporting in relation to the GRI.

**Fiduciary Duties:** The responsibility a company director holds to act in the best interests of the company, predominantly defined in corporate law.

**Financial Sector:** Part of the economy that is primarily concerned with the transfer of money and financial products including borrowing and lending.

**Financial Stability Board:** An international body that monitors the stability of the global financial system. Membership consists of countries and organisations.

**Global Reporting Initiative (GRI):** Guidelines and indicators that streamline how to report on a range of matters including environmental, social and governance issues.

**International Monetary Fund:** An international organisation that aims to promote and facilitate international trade. It currently has 188 member nations.

**Information asymmetry:** A situation where one party in a (financial) transaction has superior knowledge to the other party.

**Integrated Reporting:** Incorporating environmental, social, governance, and financial performance disclosures into a single document.

**ISO26000:** Voluntary guidelines on the socially responsible behaviour of companies and other organisations.

**Microcredit:** Small loans typically given to people, organisations or communities experiencing poverty or significant hardship.

**Moral Hazards:** A situation where one party in a (financial) transaction bears an uneven amount of risk compared to another party, which the latter party exploits.

**Market Capitalisation:** The aggregated market value of shares issued by a publicly listed company.

**NGOs:** Non-Government Organisations exist outside government and business sectors. They generally have a social, political or environmental cause.

**Shareholder Primacy:** The practice of giving priority to shareholder interests ahead of other stakeholders of companies.

**Social License to Operate:** Refers to the level of public approval for a company and its operations.

**Socially Responsible Investing (SRI):** Investing in companies or activities that are considered ethical or sustainable.

**Sustainability indices:** Indices that measure the performance of publicly listed companies based on long-term economic, environmental and social criteria.

**Trans-Pacific Partnership:** A proposed trade agreement between the USA, Japan, Malaysia, Singapore, New Zealand, Canada, Chile, Brunei, Mexico, Peru and Vietnam.

**Triple Bottom Line:** A reporting concept where financial, social and environmental aspects are all taken into account when assessing an organisation's performance.

**United Nations Global Compact (UNGC):** A voluntary initiative that organisations can choose to participate in to improve corporate social and environmental performance.

**United Nations Environment Programme Finance Initiative (UNEP-FI):** A body that calls on financial institutions to consider social and environmental impact of operations.

