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Banks, Banking, and the New Sustainability Paradigm – Opportunities and Risks

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Until recently, banks, like many public facing businesses, could focus on satisfying customers; hiring, training, rewarding, and retaining high performing employees; improving company performance; and building shareholder value.

The Emergence of the Sustainability Paradigm

Now, additional challenges for Boards and management have arisen as a "**Sustainability Paradigm**" has emerged encompassing certain elements: "**ESG**" (Environment, Social, & Governance), "**CSR**" (Corporate Social Responsibility), "**DE&I**" (Diversity, Equity & Inclusion), "**ROL**" (Rule of Law), "**Social Justice**" and "**Human Rights**." The elements of this new Paradigm have become an important factor influencing (i) regulators' oversight, (ii) regulations and laws under consideration, (iii) decisions of investors and customers about their choices of banks with which to do business, (iv) decisions of banks about which companies to do business with based on Sustainability risks and a company's long term performance and value, and (v) financial, social, and issue-oriented activists who select companies whose policies and practices, or the lack thereof, draw their attention.

Understanding the Elements of the Sustainability Paradigm

In considering the implications of this Paradigm, it is important to understand the Paradigm's several elements. With respect to ESG, the "E" represents Environment and refers to an organization's environmental impact (e.g., its use of natural resources, its carbon footprint, and its emissions and waste) and the initiatives it takes to mitigate its negative environmental impact. The "S" represents Social and focuses on how an organization makes the society in which it operates and society at large better places to live and work. Many community banks emphasize this arena and are very successful in it. The "G" emphasizes Governance and the importance of the roles of management and the Board of Directors in incorporating the elements of the Paradigm in the organization's plans and strategies, as well as in their oversight and assessment of the effectiveness, or lack thereof, of the organization's

Sustainability initiatives.

CSR represents Corporate Social Responsibility. The “S” is very much related to the S in ESG and further emphasizes the responsibility of banks and other organizations to be responsible citizens of their communities and the Planet and to act in a manner which respects all of the elements of the Sustainability Paradigm (e.g., mitigate negative environmental impact, respect laws and regulations, and treat citizens of their communities and their employees in accordance with the best standards of human rights and social justice).

From an S perspective, many community banks are well known for a devotion to making their communities better places for all to live and work through loans they make, activities they sponsor, organizations and events they support, and volunteer efforts of their employees. These activities are a prime example of CSR. Certain bank activities, to the extent they focus on making the community a better place for all elements of the community, also speak to elements of DE&I.

DE&I is an especially strong Sustainability focus in our society at this time. DE&I’s primary focus is on human capital management and includes the social justice and human rights elements of the Paradigm. “D” references Diversity. There are many lenses through which to view Diversity, e.g., the Society for Human Resources Management. In the context of an organization’s workforce, Diversity means that the organization’s workforce is made up of people who merit their positions without regard to their race, color, ethnicity, religion, gender, sexual orientation, etc. Further, these elements of Diversity are explicitly, in policy and practice, not considered as a basis for decisions pertaining to recruiting, hiring, training, promoting, or terminating employees. “E” represents Equity, which addresses fair, just, impartial, nondiscriminatory treatment of those seeking workforce positions, as well as those experiencing evaluations, training, promotions, and opportunities which become available within a workforce. “I” represents Inclusion. We all recognize that it’s one thing to be a member of a workforce, team, or group, and another to feel included, i. e., that one’s voice is heard, considered, and respected equally, and that the group does not condone discriminatory behavior.

Rigorous Assessment: Beginning /Accelerating a Sustainability Journey

As banks begin or accelerate their Sustainability journeys, it is critical that they rigorously assess their (i) corporate values, policies, strategies, development, and growth plans, (ii) enterprise risk mitigation and oversight capabilities and practices, and (iii) compliance systems and processes to ensure ethical business practices and compliance with applicable laws and regulations - all in light of the elements of the Sustainability Paradigm. To the extent a bank has personnel knowledgeable about, and experienced with, the elements of the Paradigm, the suggested assessment can be conducted using internal resources. Supplementing those internal resources as needed with experienced external resources must be considered to obtain an independent view of the bank's key Sustainability initiatives, capabilities, strengths, weaknesses, and risks. For example, there are firms which may be engaged to determine a company's carbon footprint and recommend means to reduce it. This assessment should result in a "gap analysis" illustrating the bank's strengths, weaknesses, and vulnerabilities regarding the Paradigm elements, which will assist management and the Board in developing the bank's Sustainability plans and strategies.

Board involvement represents the "G" in the ESG element of the Sustainability Paradigm, and the Board should be an integral part of the assessment and the resulting plans and strategies. As discussed below, the G element is critical to the credibility of an assessment and follow through on recommendations.

The Emergence of Sustainability Ratings

Another factor that underscores the importance of banks' accelerating their Sustainability journeys is the rapid emergence of ratings organizations that rate banks and other businesses, public and private, on their progress addressing the Sustainability elements of the Paradigm. These organizations assign Sustainability scores to companies based on information gathered from a variety of publicly available sources, including online commentators (such as customers and competitors), company websites, press releases, reports and advertisements, news articles, and published reports of social and financial activists. Ratings and the information and judgments which inform them will increasingly be used by regulators, competitors, investors, media, financing parties, debt raters such as Moody's and Standard & Poor's, suppliers, actual and potential customers, valuation experts, buyers and sellers in M&A transactions, and others.

Vendors and the Paradigm

Lastly, banks must also consider the Sustainability values and policies of their vendors and ensure that their vendors' Sustainability policies and practices align with those of the bank and the Paradigm. Gone are the days when a bank or other business bears no responsibility for the egregious conduct of its vendors. Ratings organizations will rate a bank or other business on some or all of the elements of the Sustainability Paradigm, including the Sustainability practices, policies, and performance of an organization's vendors.

Competitive Edge

Those banks which excel in adapting to the new Sustainability Paradigm and navigating their Sustainability journeys will be increasingly more successful than those who are slower to understand the competitive implications of this Paradigm shift. The ratings discussed previously also present a tremendous opportunity for banks to embrace the various elements of the Sustainability Paradigm, enhance their enterprise value, and become leaders among their peers and within industry associations.

Back to the "G": Governance

It is essential that management and Boards collaborate on addressing the implications of the Sustainability Paradigm. Does the management team have the background and experience needed to effectively address the various elements of the Paradigm? Is there a Chief Sustainability Officer or Chief Diversity/Inclusion Officer? Similar questions must be asked about the Board. Does the Board composition address gender, ethnicity, and other diversity issues? This is a very significant DE&I issue which is receiving the attention of regulators, legislatures, Sustainability and governance activists, and investors. Does the Board have one or more directors experienced with Sustainability matters? Has the Board addressed the Paradigm in its Governing Principles or in its committee structure? Is Sustainability risk delegated to one or more of the Board's standing committees, or has the Board created a Sustainability Committee to address the many governance and other aspects of the Sustainability Paradigm?

Clearly the Paradigm impacts many aspects of organizational governance: strategy, annual plans and budgets, human resources, compensation, enterprise risk identification, assessment, mitigation, and all matters germane to the Board's Governance Committee itself.