The role of global banks in collaborative governance

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Outline

Collaborative governance in banking

Since the financial crisis, financial institutions, and in particular, systemically important banks, have been under escalating pressure to take greater responsibility for their impact on society and to influence the behaviors of their clients. That pressure has grown significantly in recent years. Like other large companies, large financial institutions are being asked to define a corporate purpose that goes beyond simply maximizing shareholder value; they are being asked to apply environmental, social and governance (ESG) objectives not only to their own businesses but also to influence their customers through their financing activities. Moral leadership, self-regulation, public-private partnerships and financing a regenerative economy are all now seen as key roles for financial sector leadership. Some governments also increasingly view financial institutions as "transmission mechanisms" for implementing important policy objectives. *"There's a transmission system,"* in some countries according to a director, *"It starts with government and policy. It gets passed to the regulators and then it gets passed down to us. It works because we have to do what we're told."*

Some directors and investors see limited capacity for financial institutions to drive progress without government interventions to standardize requirements and affect behaviors at scale. As one director said, *"We can set our individual climate transition plans, but what is the overall transition plan for society?"* These rising expectations for leadership and responsibility are placing pressure on traditional models of corporate leadership and corporate governance in the financial sector.

This initiative, Collaborative governance in banking, will explore how expectations for banks' roles in addressing challenging environmental, social, and economic issues are evolving and seeks to identify practices for improving governance and policy in response. On May 26, 2022, a select group of bank directors will meet virtually to gather perspectives on changing expectations for financial institutions, the need for effective collaboration between banks and their stakeholders, including investors and between the public and private sectors, and the practical implications for governance structures and processes.

This document synthesizes views gathered from initial discussions with bank directors, investors, and other stakeholders and provides background and context for the conversation. It is organized around three questions:

- **How are expectations for global banks evolving?**

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- **How can or should governance adapt to these changing expectations?**
- **What might effective engagement with public policy entail?**

How are expectations for global banks evolving?

Clarity and consensus around expectations for banks in addressing thorny societal issues remains elusive. One bank director said, *"I get the sense that some of what we're seeing regarding the banks and expectations of the private sector is being approached very haphazardly."* Policymakers, regulators, investors, consumers, activists, and the banks own employees all bring their own concerns and perspectives, complicating bank boards' ability to respond. This work seeks to clarify where perspectives align across stakeholders, where they diverge, and what that means for how financial institution boards respond.

Regulatory policy remains inconsistent globally

Global banks face divergent policy and regulatory regimes that make it difficult to develop a unified approach. Policymakers and regulators in the UK and EU, for example, are pushing for faster action on climate change, through legislation, but also via financial regulatory regimes, including stress testing. In North America, and in the U.S. specifically, no clear federal policy has emerged. And some some state governments want to punish banks that have adopted policies designed to reduce their exposure to oil and gas,[1] further challenging any hope of a consistent approach nationally. A North American regulator said, *"We are very much focused on our existing mandates, the extent to which climate change poses a risk to the existing mandate of safe and sound banking to support the economy. We do not have a mandate to facilitate the transition to a green economy or some of the other goals, like national goals that include the central bank, or include the bank supervisor on climate impacts, in some countries in Europe. I would also be reluctant to see us get into the broader ESG discussion that's really beyond what we have any mandate for."*

Investor pressures remain, but the signals are increasingly mixed

in the absence of coherent public policy, investors—particularly large asset managers like BlackRock, Vanguard, and State Street—have become what some describe as quasi-regulators. They and others are insisting on the need to integrate ESG issues into strategy and operations, pushing for heightened disclosures, and increasingly holding boards accountable for progress through their voting on shareholder proposals and director elections.

Investor views are not monolithic, however, and vary according to the extent to which they balance short-term financial returns with environmental and social goals, and the pace at which they push for change. Some investors are pushing banks to accelerate their climate transition plans. Despite making commitments to reach net zero by 2050, for instance, several leading

banks—including Bank of America, Citi, Morgan Stanley, JPMorgan, Credit Suisse, and Royal Bank of Canada—are facing shareholder proposals in the 2022 proxy season calling on them to cease financing new fossils fuel projects immediately.[2] BlackRock, on the other hand, indicated that it anticipated voting for fewer climate-related shareholder proposals in 2022 than in 2021, due to the changing geopolitical and economic climate and the fact that many proposals are "more prescriptive" and "not consistent with our clients' long-term financial interests."[3]

In addition, the extent to which investors will compromise financial returns, even in the short run, to make progress on environmental and social goals, will no doubt vary. One director said, *"On a like-for-like cost basis people prefer sustainability, but it's another thing if a portfolio based on sustainability will earn less money. If there is a financial sacrifice for ESG concerns, some will make that sacrifice and some will not."*

There is now growing evidence of an emerging backlash against ESG, and not just from conservative state legislatures in the United States. For instance, a group of investors, including Bill Ackman and Peter Thiel, announced in May 2022 the launch of a fund that will urge companies to focus solely on delivering excellent products and services, and maximizing financial returns. They dismiss ESG concerns as "politicizing" corporations and accuse BlackRock, State Street, and Vanguard of putting a political agenda over their clients' interests: "In the name of 'stakeholder capitalism,' they use their clients' funds to exercise decisive influence over nearly every U.S. public company to advance political ideologies that many of their clients disagree with," The group wrote in an announcement about its launch.[4]

Balancing tradeoffs will remain a challenge

Any serious discussion of banks' role in addressing societal issues must account for the challenge of making tradeoffs not just between financial performance and ESG goals, but among various environmental and social goals. For example, many stakeholders emphasize the need for a "just transition"—decarbonizing the economy without imposing undue economic harm on consumers, populations that are economically dependent on the fossil fuel industry, or emerging economies. One bank director said, *"We have a challenge having a balanced discussion, acknowledging some of the costs involved and the economic impact. Or looking for ways to make incremental progress, like moving from coal to natural gas, which would be a net positive, but natural gas is still a fossil fuel, so you cannot have that conversation."* Some investors are indeed open to such a conversation. At a Tapestry Networks event late last year, BlackRock CEO Larry Fink told a group of directors, *"If we could substitute natural gas for coal, we are going from dark brown to medium brown to light brown to very light green. We're not going straight from brown to green unless we want something unfair that destroys the emerging world on that pathway."*[5]

As you prepare for this conversation, you may consider the following questions:

- ? What have you heard from investors (asset owners, e.g., pension funds; asset managers, e.g., large institutional money managers) about how they view the role of banks in helping to address societal challenges? How are those expectations communicated to the board?
- ? Have investors indicated a willingness to accept tradeoffs between financial returns and achieving societal goods?
- ? How do regulators and other policymakers see their role in influencing bank behaviors in regard to climate and other environmental issues and social issues? Where could they provide greater clarity?
- ? How does your board and management team view your institutions' role in addressing environmental and social issues? To what extent is your board willing to take on greater leadership in driving policy or acting independent of policy to address societal challenges? How do you balance values (moral leadership) and value (risk management or revenue opportunities)?
- ? Given the range of views from various stakeholders, what conclusions, if any, can we draw about the role that banks are being asked to play? What role should they be asked to play?

How can or should governance adapt to these changing expectations? ESG issues are requiring significantly more time and attention from bank boards. Given the approach required to tackle long term and systemic issues like combating climate change or tackling racial inequality will likely exceed the tenure of CEOs and management teams, boards must lead the way. A director predicted, *"This is so fundamental to how we do business. It's like a wholesale cultural shift. We're talking about a lot of little discrete things, but it's going to be a significant wholesale change when we get to the end of this journey."*

Bank boards will need to consider a range of strategic and practical changes to governance to facilitate playing this leadership role:

- **Revisiting board structure**: The broad scope of ESG issues means that committee ownership of these issues is correspondingly difficult to establish, and boards are struggling with defining committee responsibilities. Is it important for one committee to own the broad range of ESG issues, such as a sustainability or corporate responsibility committee? Or is it better to let different committees handle relevant aspects?
- **Improving data and metrics.** Bank boards and management teams face basic questions around the metrics and data that allow them to assess an organizations' position and progress relative to climate change, diversity, or corporate culture. While there has been considerable progress toward a more data-driven approach to ESG reporting, there is still a long distance to go toward building greater confidence in that data, and boards still lack a clear sense of the

type of reporting they should expect from management. Setting forward-looking targets, especially around climate change, defining a strategy to reach those targets, and measuring progress is even more challenging.

- **Integrating ESG into incentive compensation.** Boards are facing increasing pressure to tie executive compensation to performance against environmental and social goals. An executive from a leading asset manager said, *"We look for companies to tie executive compensation to greenhouse gas emissions and progress toward net zero. Climate has to be in long term compensation; we need more emphasis on linking compensation to the transition."*
- **Adding new skills and expertise.** Oversight of ESG is demanding new competencies from boards. In response, some boards have begun incorporating sustainability or environmental backgrounds into selection criteria as they recruit new directors to the board. However, many directors are resistant to seeking out such specialist directors, and prefer developing the necessary expertise in other ways, through director education, the use of advisory committees, or third-party consultants.

As you prepare for the conversation, you may want to consider the following questions:

? How do boards determine the appropriate role for their institution in addressing societal challenges and how those fit with their broader strategic objectives? How can boards ensure that management teams are prioritizing the most materially significant ESG risks and opportunities for their companies? How do boards balance potential tradeoffs between financial returns and nonfinancial benefits, especially where long-term transitions could require lower short-term returns?

? How can boards best serve investors with longer-term views on value and those with a near-term focus on returns? How do boards balance potentially competing interests within ESG, for example, where energy transition could create negative socio-economic effects, such as higher energy costs for low-to-moderate income customers, or loss of jobs for those in or reliant upon carbon-intensive sectors?

? How might management and reporting structures evolve to ensure ESG issues are embedded in business decisions?

? How should board structure and composition evolve? Do boards need a corporate responsibility or sustainability committee to ensure sufficient attention is given to these issues? Do boards need more ESG expertise? What kinds of expertise are most needed?

? Do boards need access to additional sources of expertise and advice? Through what mechanisms might this expertise and advice be provided?

- How are boards holding management accountable for long-term objectives? How are incentives and compensation programs evolving?
- Disclosure is an important mechanism for communicating with investors and the public, but company leaders also need to understand what their investors and other stakeholders expect and engage in discussions around what's possible. How should boards and management teams engage with stakeholders?

What might effective engagement with public policy entail?

Most bank leaders still see policymakers as ultimately responsible for setting the trajectory and pace of change in addressing societal issues. Yet, financial institution leaders have a role to play in ensuring policy considers the tradeoffs that financial institutions are being asked to make. A bank executive observed, *"Governments see what the private sector is doing, that we are serious, and they are starting to figure out how they can connect policy to the private sector. The financial sector is there, so governments have to take action. They can't say, 'Finance won't be there,' because we are ready to go."* However, the lobbying activities of individual companies and industry associations is garnering renewed scrutiny as some see a disconnect between what companies espouse publicly and what they lobby for or against privately.

One director noted that in the past, *"when the government regulator said it couldn't and wouldn't do its job of setting policy, they said that you guys [public companies] should do it. I worry that there is going to be a tendency in that direction on the environmental front."* Investors also recognize a critical role for government. Larry Fink said, *"If we don't have good government policy focusing on all of society, we're just asking public companies to shoulder the burden of the transition. That's not going to work."*[6]

To effectively address these challenges, the public and private sectors will need to work together, including through public-private partnerships. One bank director said, *"There could be an opportunity for public-private initiatives, to invest in the infrastructure. For example, utilities will need massive investment in the next ten years if they are going to transition – should they be viewed as municipal bonds? As opposed to government grants, which are subject to misallocation and the like, if we treated that capital as municipal bonds, or tax-free loans, it would reduce the cost. We should be looking at ways to incentivize investment at a scale and cost that can make this a smoother transition. I could see the banks getting behind that and making money in the process. And the government would not have to spend directly and increase the deficit. We need positive incentives rather than clubs to beat people with."*

Governments can help de-risk private investment. If government can provide funding to take the most subordinated position in the capital stack, private enterprise can multiply public investment.

According to Mr. Fink, *"There's just not enough private capital willing to be the junior lender in brownfield investing in the developing world,"* he said, adding, *"If we're going to really try to transform the developing world in a more rapid way, then the owners of the IMF, the major countries of the world, are going to have to be willing to take a first-loss piece."*[7]

As you prepare for this conversation, you may wish to consider the following questions:

- What is the role of "soft policy," i.e., standards set by investors, stock exchanges, and others relative to government policy? When is government policy necessary to make progress?
- When should banks publicly support specific policies? Should bank CEOs make public statements about politically sensitive environmental and social issues? Should they consult the board before doing so?
- How important is industry collaboration when taking positions on social and environmental policy issues e.g Net Zero Banking Alliance?
- How should banks engage with policymakers on these issues? What role should the board play?
- What kinds of policies would be most supportive in achieving shared objectives? When should banking regulations be employed? What kind of policies or regulations should be avoided?

Endnotes

[1] "Texas Spurs Copycats as States Punish Banks That Snub Oil, Gas," *Bloomberg Law*, February 24, 2022.

[2] Manueala Andreoni, "How shareholders are pushing big banks for climate action," *New York Times*, May 10, 2022.

[3] BlackRock Investment Stewardship, "2022 climate-related shareholder proposals more prescriptive than 2021," (memo) BlackRock, May 2022.

[4] "Depoliticizing Corporate America: Strive Asset Management Launches To Advance Excellence Capitalism Over 'Stakeholder Capitalism'," (press release), BusinessWire, May 9, 2022.

[5] Tapestry Networks, "Dialogue with BlackRock chair and CEO Larry Fink," Audit Committee Leadership Summit *ViewPoints*, January 2022.

[6] Tapestry Networks, "Dialogue with BlackRock chair and CEO Larry Fink," Audit Committee Leadership Summit *ViewPoints*, January 2022.

[7] Tapestry Networks, "Dialogue with BlackRock chair and CEO Larry Fink," Audit Committee Leadership Summit *ViewPoints*, January 2022.