Adding up the numbers

Matthew Arnold considers how sustainable banking has moved from a sideshow, to a risk management issue, to a major business opportunity – and looks at how Citigroup came up with its $50 billiion pledge

In June 2003, 10 banks announced the launch of the Equator Principles in a small auditorium at the International Finance Corporation (IFC), with plenty of extra seats. Getting 10 banks to commit had taken a major recruiting effort.

By May 2007, there were 51 adopters of the Equator Principles, guiding decisions on hundreds of billions in loans and invested capital in project and infrastructure financing globally. That is a remarkable rate of growth.

This month, the *Financial Times*-IFC sustainable banking awards will celebrate the efforts of 100 banks, which have made 151 award applications. The guests will include CEOs, CFOs and captains of industry who will await the results in an atmosphere only a little less intense than the Academy Awards.

These applications describe the efforts of thousands of people inside financial institutions working to protect the environment, safeguard human rights – and make commercial returns on their investments. In four years, the sustainability agenda has lurched from a side-show to the main event.

Walking the walk: Citi puts its money where its mouth is

Over the past half-decade, I have had the opportunity to work with dozens of financial institutions, supporting and participating in the integration of environmental and social thinking into their businesses. These increasingly sustainable banks have top-level support for sustainability, strong teams well educated on the risks and opportunities, are not afraid to have difficult discussions with clients and have capital to invest in the emerging environmental markets.

Most banks initially approach environmental and social issues from a risk management perspective; hence the attraction of the Equator Principles. There is usually resistance because of the fear that risk policies will hurt the business, require deal teams to walk away from clients or ask them to do unreasonable and invasive things. In reality, it usually goes well.

The risks that these policies address are often significant operational or headline issues that can degrade credit quality and lead to public opposition, loss of access to resources or operating permits, government intervention or, in extreme cases, criminal charges. Learning to identify these risks, engage in a dialogue with the client and other stakeholders, and develop solutions is not that difficult. It just takes focus and some will. The policies work best when positioned as a client service offering, rather than a policy compliance requirement. The environmental and social risk managers are trying to make sure a deal gets done, not slowed down and layered with unreasonable requests.

However, once the risk management agenda is under control, many firms see business opportunities in environmental markets. As the first banks were taking steps to develop sustainability commitments, business opportunities received much less attention than risk management. However, since 2004, Citigroup, Goldman Sachs, Wells Fargo, JPMorgan Chase, Morgan Stanley and Bank of America have made increasingly large commitments to investing in sustainable development, carbon markets and climate change. Wells Fargo was the first bank to publicly commit a number: $1 billion. Goldman also committed a billion, and Morgan Stanley $3 billion. In March of this year, Bank of America committed $20 billion. Citi has just committed $50 billion.

The big numbers get a lot of press, but do not really tell the whole story. JPMorgan Chase does not have a public number, but has a broad platform of climate-related products and services, a carbon finance group and an active office of environmental affairs. Goldman Sachs has actually invested far more than its target. Citi and Bank of America both have climate-related activities not included in their big numbers. But for Citi at least, its big number was a big deal.

The bank started work on an investment target in mid February. It had developed a public policy position on climate in January and was going to be a high-profile sponsor of a climate change conference in May. The environmental team had been tracking climate-related initiatives around the bank for several years, and was increasing its internal advocacy for climate investment and advisory services all over the company. With 300,000 employees and hundreds of individual businesses, it is not a simple task. For instance, last year they 'discovered' an energy-efficiency lending programme that had grown to $1 billion quietly and without any corporate support.

The team working on the investment target was originally shooting for $10 billion. Almost no one thought they could get that high. But there was recognition that singling out a number would invite great scrutiny and going out too low would generate negative reactions. On the other hand, the number had to be credible. It had to be a real, bottom-up accounting of individual business commitments, backed by business plans that would deliver.

As crazy as it seems, Citigroup's $50 billion is a conservative and achievable number

The number also had to be measurable. There had to be a line item in the accounting for 'alternative energy', 'renewable energy', 'energy efficiency', or 'carbon finance'. This accounting discipline took several things off the table. Most energy efficiency investments are not listed as such. If Citi invested in GE, which has announced $40 billion in Ecomagination revenue, how could Citi account for that? It couldn't. So the commitment would exclude possibly billions in portfolio investment and underwriting for companies that in turn are investing billions into clean technology. If they found a way to account credibly for those investments, the number would be far higher.

Then, in early March, Bank of America announced its $20 billion goal, initially putting a halt to Citi's effort. Could the bank go public with $10 billion if a competitor had already announced $20 billion? Bank of America did an innovative thing: it extended its investment horizon to 10 years, while Citi had been working on a foreseeable, two- to three-year horizon.

Initially, there was scepticism about a 10-year forecast. But after some haggling, a solution was found. Everyone involved believed that climate change would be a major issue for the foreseeable future. Everyone believed there will be a cap on US greenhouse gas emissions within the investment horizon; in fact, Citi was already on record calling for a cap. So Citi's accounting methodology would include firm commitments over the original investment horizon, and project forward to 2015 at a declining rate, to take uncertainty into account.

By the time of its announcement last month, Citi had counted nearly $10 billion in current commitments, with new commitments of $13 billion over the original investment horizon through 2009. From there, each business made its own growth projections. Those projections total $50 billion. As crazy as it seems, the $50 billion is a conservative and achievable number.

So, are these now sustainable banks? What do these commitments achieve? They direct in excess of $100 billion toward clean energy. On the risk side, they lessen environmental and social impacts. But do they go far enough? Many critics don't think so. The Rainforest Action Network has asked the banks to stop providing financing to new coal-fired power plants. Moderate voices like James Hansen, Al Gore and Senator John Kerry have expressed similar sentiments. However, until there are carbon limits in the US, China or India, it is nearly impossible for a large bank to embargo the power sector. The banks aspiring to sustainability have some rough water ahead.

The good news is that 100 banks applying for sustainability awards are trying to find solutions. It is a slow process, of capacity building, engagement and investment. There is a growing chorus of demand for reporting standards and greater transparency from NGOs, the media and socially responsible investors. Many banks have extensive reports, but there is not an industry standard. The leading banks have an interest in better reporting from everyone. Perhaps the FT could lend a hand, and add an award for reporting.

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A policy development template

Whether starting out fresh, revising an existing policy or creating a climate change initiative, there are some basic dos and don'ts when considering your sustainability commitment.

1) Building the compass

Determine your market positioning: there will be different opinions internally about whether you seek to lead the industry, follow the leaders closely, or take a pass.

Make sure you get buy-in and establish shared ownership:

- Business unit heads are the key internal stakeholders. Their knowledge, judgment and engagement is critical to success. It may help to form an internal advisory group that expects to see drafts and have an opinion.
- External groups – NGOs, clients, universities, etc – also have strong views and can influence the process.

Top management has to sponsor the initiative. You will need clout to overcome the inevitable resistance from powerful business operators who will only take direction from someone senior to them in the business. But once you have written your policy statement, you are just beginning.

2) Risk management – change the culture

In addition to your policy commitment, you may decide to adopt the Equator Principles. If you do not do much project finance, or only operate in one or two OECD countries, the principles may not be that useful to your business. That said, you may receive shareholder resolutions or customer inquiries asking you to adopt them. Consult other Equator banks. It is often not a clear choice.

Regardless of whether you adopt the principles, they are a valid starting point for a risk management framework. Any risk framework will need to focus on the areas of your business which have potential environmental and social impacts, and thus risks. The key issues will emerge from your internal and external consultations. Many banks develop sector-specific policies for oil and gas, forestry, mining, etc.

- Decide how broadly to apply the policy. Equator covers project finance and can be extended to transactions with a single asset. Beyond that, it gets more difficult. Should the risk framework apply to commodities, middle market business, retail? If so, it may need customisation for each business unit and product line.
- Develop client risk assessment processes to evaluate commitment, capacity and track record, particularly in sensitive sectors and where Equator doesn't apply.
- Someone needs to own the policy, and apply it. There will need to be training, tools and support to deal teams entering into difficult transactions.
- Try hard to implement the policy with a focus on deal support and execution rather than policing. Expect strong initial push-back from deal teams. Make sure you explain how this is good for their client, that their transaction is less likely to be opposed and will have less headline risk.

3) Investments and products – create excitement

The core sustainability team usually does not have a client-facing function. It has a vital role to play in exposing business teams to opportunities, bringing in experts and helping them develop products and practices, such as in clean technology and renewable energy.

- Turn the whole agenda into a revenue winner. In the risk management area, make your expertise an advantage to help clients do tough deals with the highest standards.
- Corporate and equity research is a low-cost, high-visibility entry to environmental markets.
- The area of greatest business activity has been in private equity, mostly into clean technology, which accounts for as much as 10% of US venture capital investment. Dedicated teams have been more successful than integrated efforts, because of the complexity of markets in carbon, biofuels and wind.
- Internal networks focused on specific industries or technologies, drawn from different business lines, are a great way to aggregate knowledge on arcane topics such as the Kyoto Protocol project registration process.
- Consumer product development is accelerating. The experience with energy efficient mortgages has been mixed, but there are several carbon credit cards emerging. There is often a strong need for internal education about the issues and opportunities for the retail operation because there are so many employees involved.

4) Public engagement – create learning

To support the commitment to sustainability, it is usually helpful to have external engagement in policy processes, with NGOs, philanthropy and volunteerism. The business case for this type of effort is strongest when the activity is linked to a business purpose. For instance, if you have a strong forestry policy, then forming relationships with conservation groups, campaigners and the illegal logging advocacy community will be useful.

Of course, it is also helpful to have intimate relationships with NGOs and influencers when your colleagues decide to get involved in something controversial. The worst time to get to know outsiders is in the heat of a bad situation.