ESG & Risk

How ESG & Financial Risk Interrelates in, and Affects, the Swedish Banking Sector

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Introduction

Considering recent events such as the climate crisis and Covid-19, sustainability and ESG have become an increasingly predominant focus in the world. Furthermore, sustainability is of utmost importance in finance, where investments drive society forward, thus having a large impact on the future. In less than 20 years, ESG went from an initiative launched by the UN where social responsibility was to be taken into consideration when running a corporation, to now a global phenomenon with more than 30 trillion USD in assets under management. (Holder & Michael, 2019)

How does ESG, in reality, affect the risk profile of financial institutions and companies? Plenty of research has been conducted to assess whether ESG-aligned investments are more profitable, but few discuss the interrelation between ESG-initiatives and financial risk. This study first discusses the building blocks of EGS-factors, and thereafter studies how such characterizations can be applied to the banking sector. Furthermore, this study also aims to demonstrate another way of defining financial risk, the credit risk perspective, and how ESG-initiatives affect the risk profile of financial entities. For practical reasons, this is done by exploring how the Swedish bank's SEB risk profile interrelates to its ESG-initiatives and what it actually means.

Sustainable Finance, ESG & the EU Taxonomy

Sustainable finance refers to taking ESG-factors into consideration when making investment decisions in the financial sector. This means that investments are placed where environmental, social, and governance goals are benefited, thus not solely focusing on the effectiveness of an entity's economic growth (KPMG, 2022a). Additionally, sustainable finance encompasses transparency regarding eventual risk when economic activity is performed, i.e., transparency of the ESG-related risks and their potential effect on the financial system (Ibid).

The use case of sustainable finance can be seen regarding the EU's climate and energy targets for 2030 and the objectives of the European Green Deal. Such objectives have led to a focus on both directing and redirecting investments that fall within the lines of being regarded as sustainable efforts. The Green Deal, presented by the EU on 14 January 2020, estimated an assembly of one trillion euros of sustainable investments over the next decade. The implantation of such an investment plan was to aid and stimulate both public and private investments which were deemed imperative in becoming a climate-friendly, effective and inclusive economy. Covid-19 further fortified the need of investing in sustainable finance, where sustainable activities are considered to provide an economic intestinal fortitude when facing environmental and climate shocks. (European Commission, 2022a)

As stated, the requirement in achieving the energy target for 2030, among others, directed investments in the sustainable financial sector were needed. This prompted a need for a shared transparent definition of what is sustainable, thus a common classification system for sustainable economics was formed, named the EU taxonomy. (Ibid)

The EU taxonomy works as a classification system where a list of environmentally sustainable activities is set. The EU taxonomy, therefore, provides appropriate definitions of whether an activity can be considered economically sustainable. When provided with such definitions private investors can be protected from greenwashing, assist corporations in becoming climate-friendly, and aid in shifting investments to more sustainable areas. The EU taxonomy regulation consists of 6 requirements listed below. (KPMG, 2022b)

1. Climate change mitigation
2. Climate change adaptation
3. Sustainable use and protection of marine resources
4. Transition to a circular economy

5. Pollution prevention and control
6. Protection and restoration of biodiversity and ecosystems

(Ibid)

In summary, the EU taxonomy framework provides a comprehensive guide to help the financial sector conform to ESG guidelines.

ESG in the Banking Sector

The emergence and growth of ESG-factors and sustainable finance has seen the implementation of frameworks, to guide and ease the financial sector into conformity regarding ESG-related factors, with frameworks such as the EU taxonomy being utilized. Additionally, ESG frameworks can be used to measure potential risks ranging from financial matters to environmental malpractice. Such measures are furthermore crucial for one of the fundamental functions of the financial markets, pricing of risk (FSB-TCFD, 2022a). Pricing of risk helps ensure informed, efficient capital-allocation decisions. Concerns regarding the misallocation of investments from the providence of inadequate information, led the G20 Finance Minister and Central Bank Governors in requesting the Financial Stability Board to "convene public- and private-sector participants to review how the financial sector can take account of climate-related issues.". This meant that transparency was deemed key when accounting for investment risks, leading to the coined TCFD. (FSB-TCFD, 2022b)

The climate-related financial disclosure recommendations, denoted TCFD, created by the Financial Stability Board, is to provide recommendations on what information companies should disclose to investors and lenders. Such disclosures can therefore lead to appropriate assessment and pricing regarding climate-related risks. The disclosure recommendations are structured around the main building blocks a company's operations rely upon, being: governance, strategy, risk management and metrics and targets. The four stated recommendations are further supported by 11 recommended disclosures to provide additional information regarding how reporting organizations assess climate-related risks and opportunities (Ibid). While the TCFD framework focuses on climate-related risks, other frameworks such as the UN Principles for Responsible Investment, denoted PRI, has a more general approach.

The PRI can be boiled down to two main objectives. Them being.

1. Understanding the investment implications of ESG-factors.
2. to support its international network of investor signatories in incorporating these factors into their investment and ownership decisions.

(PRI, 2022)

The PRI framework can be used by businesses that operate within the EU markets, regarding ESG-related risks.

Proposed and enforced frameworks to regulate sustainable finance are not the only initiatives seen in the financial sector. One such initiative is the EU Green Bond Standard (EUGBS). The EUGBS stemmed from the European Green Deal, further resulting in the European Green Deal Investment Plan of 14 January 2020 announcing the establishment of the EUGBS. The stated standard is a voluntary standard with the aim of raising ambitions with respect to the green bond market. Furthermore, the EU Commission states that such a regulation sets a standard of sorts for how companies can use green bonds to raise funds on capital markets, therefore providing a tool to be used by firms, showing that they are investing in green projects whilst following the EU Taxonomy. (EU Commission, 2022b)

In summary, with the emergence of ESG, the financial sector has seen initiatives in the form of implementations of frameworks and standards to provide a financial corridor of sorts, where investments can be realigned to conform to the frameworks and initiatives provided. To achieve realigned investments, transparency is key, to understand and assess risks following ESG-related factors, which can be seen from the work done by the FSB.

ESG within the banking sector has also been a hot topic of discussion regarding the current Ukraine and Russian war. Discussions on whether investing in the defence industry is to be acceptable, where exclusion of defence stocks has been standard prior to the unfolding events. This is seen where industry executives have become increasingly concerned with the gained trend for sustainability-focused investments incentivised by the ESG investors (Pfiefer Sylvia, 2021), thus leading to institutional investors shunning the defence industry. Exclusion of defence industry-related stocks is criticized by the likes of Robert Stallard, analyst at Vertical Research Partners, where Stallard states how a negative viewpoint to defence industry is based on a lazy view of ESG (Ibid). Arguments like Stallard's propose a valid argument to where the sustainability line should be drawn. One could argue that investing in the defence industry results in countries building resilience to outside attacks and shocks. Adapting one's views regarding the defence industry and ESG investing is further seen by the activities of SEB Investment Management, with a total of 831 billion SEK under management. SEB management is one of few that has loosened its policies on excluding defence stocks. A handful of SEB's funds are now able to invest in the industry. One should however note that only six out of more than 100 SEB funds are to be able to make such investments. (SEB Group, 2022)

Adaptation regarding the viewpoint towards investing in the defence industry has been recognized by other banks as a call for a looser approach towards defence stocks. This however was still a small number of actors that wished to revisit such policies, which surmounted to 8 per cent reviewing the defence industry (Pfiefer Sylvia, 2022). The very essence of the ESG approach is to invest in sustainable products, which further make industries and countries more resilient to shocks. Investing in the defence industry can therefore, as stated,be considered a sustainable investment in making a country, thus the country's economy more resilient to eventual conflicts.

SEB's Sustainability Initiatives

A result of ESG-focused investments, initiated by the mentioned frameworks, is the increased market of green bonds, which is an instrument used to finance green projects. The first-ever issuing of such bonds was made by SEB in 2009, which led to SEB being the frontrunner regarding green bonds (SEB 2022a). From a bank's point of view, the issuance of such bonds have been fundamental in appeasing the increasing interest for sustainable finance, e.g. securities and projects. Furthermore, SEB describes in their sustainability report published November 2021, how the bank's plan focuses on being a financier and leader in a sustainable transition. The report further states, in order to fulfill their role in a sustainable society, the bank plans on transitioning their own business into a more sustainable one. In addition to the ambitions stated in the report, SEB also presents the vast range of sustainable financing solutions provided by the bank such as sustainable bonds, green bonds, and social bonds. (SEB, 2022b)

Additional actions made by SEB regarding sustainable finance can be further seen from the 2021 Annual Report, where the amount of underwritten global sustainable bonds totals 58.5 SEKbn. Furthermore, SEB's total of 357,000 shares of assets financed by green bonds resulted in a reduction of CO_2 equivalent to approximately 357,000 tonnes in 2021. (Ibid)

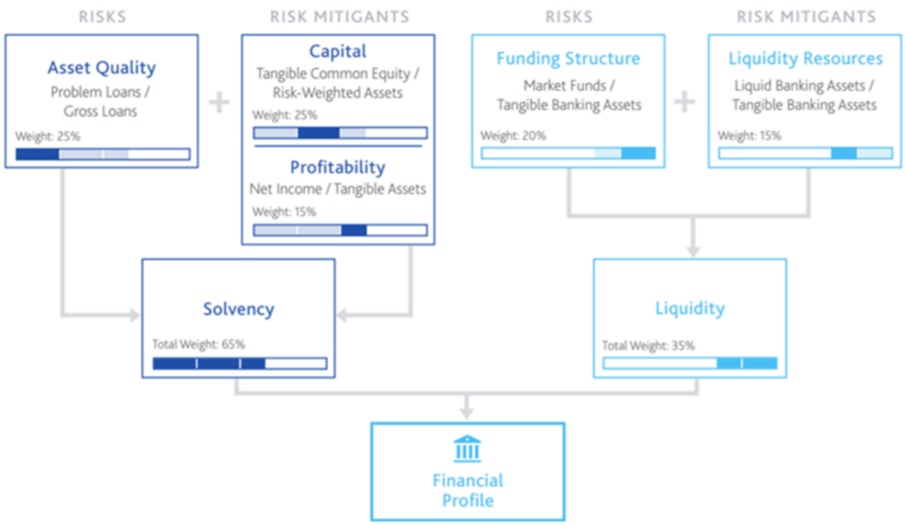
Risk - Credit Ratings and its' Usage and Importance

One way to measure the risk of a company, other than the use of VaR and ES, is to look at the credit rating that credit institutions provide. Moreover, credit rating institutions like Moody do not give ratings to all entities. However, they do provide ratings for almost all banks which is one interesting subsection of financial institutions that are integral to the financial market as a whole. Credit rating institutions exist mainly to assess the inherent financial risk of banks, countries, and other institutions of public interest so the central banks and the public can make informed decisions. Therefore, credit rating providers could, arguably, offer a close approximation of what matters when it comes to inherent financial risk.

To better comprehend the implications of credit ratings, examining the historical effects of banks having their ratings changed is possible. According to a study conducted by Flannery and Nikolova, it is demonstrated that banks with increased rating experience, in the first year, an increase in net loans and profitability. This is likely due to a cutback on costs from wholesale funding and taking a larger size share of the loan market. Furthermore, in the two-year time horizon, the bank continues to experience increased size and profitability, which likely results from a greater risk appetite (Flannery & Nikolova, 2004)

Moody's Framework for Assessing Risk

When Moodys rates different banks' financial profiles, i.e., the financial risk, they assess the banks by breaking down the financial profile into two categories: solvency and liquidity. Here, Moody assesses that the solvency category is more important and makes up 65 percent of the full assessment, whereas liquidity only makes up 35 percent (Hill & Auquier, 2015).



Liquidity and Solvency are subsequently broken down into different subcategories where some of the more interesting ones are:

Tangible Common Equity

Banks are able to utilize more assets to prepare for future potential losses. However, a better proxy for this is tangible common equity. Tangible common equity, often abbreviated as TCE, measures the bank's physical capital, which better reflects how much cash the bank could generate in dire times. The formula for tangible common equity is (Kenton, 2021):

TCE =Total Equity – Intangible Assets – Goodwill – Preferred stock.

Tangible Common Equity / Risk-Weighted Assets

According to a McKinseys' paper on risk, the TCE to risk-weighted assets ratio is one of, if not the best financial ratios to predict the ability to parry financial distress. Risk-weighted assets, abbreviated RWA, are used to determine the lowest amount of capital that must be held by banks and other financial institutions to lessen the risk of insolvency. Thus, the TCE / RWA ratio explains how much potential actual cash the bank has in contrast with how much money it must have. I.e., a higher TCE/RWA ratio would portray that the bank is at a lower risk to falter (Buehler et al., 2009).

Problem Loans / Gross Loans

Problem loans or non-performing loans, as they also are known as, are loans that are either commercial loans 90 days past due or consumer loans that are 180 days past due (Segal, 2021). If the ratio of problem loans to gross loans increases, it means that the bank is at a greater risk of not getting paid a greater amount, making the bank's risk profile worse. Thus, comparing the problem loan to gross loan ratio over time and between different banks could provide a good indicator for the risk profile and which institutions would fall first in particularly poor situations (Kenton, 2021).

Problem Loans / (Tangible Common Equity + Loan Loss Reserve)

The above ratio is also known as the Texas ratio. The Texas ratio became popular after it was used in Texas during the '80s. Multiple banks started to become bankrupt after the bank-financed oil subsided. The ratio was constructed by RBC Capital Markets, and they found that banks with a ratio higher than 100 tend to fail (Heyes, 2021).

A five-year Analysis of SEB's Financial Profile

	2021*	2020	2019	2018	2017
Tangible Common Equity (MSEK)	184 209	164 590	172 084	140 605	145 209
Tangible Common Equity / Risk-Weighted Assets (%)	24,5	22,7	23,1	19,6	23,8
Problem Loans / Gross Loans (%)	0,7	0,9	0,7	0,5	0,6
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	5,8	8,6	6,4	5,6	5,5

**2021 numbers are based on Q3 up until sept. 2021.*

What is particularly interesting in this five-year analysis is the impact of Covid-19 during the years 2019-2020. Two measurements stand out: an increased percentage of problem loans and a slight decrease in tangible common equity.

The increase in problem loans is likely a direct result of people losing their jobs and having their businesses falter or even going bankrupt. However, the problem loans to gross loans ratio only increased from 0,7 to 0,9. This is a minor increase in the larger scheme of things and would not put SEB in financial distress. Historically, anything below one percent is well under the EU and US average. In the EU and US the average peaks at 5 and 7,5 percent, respectively, under the period 2007-2017. Interestingly, Sweden, historically, rarely exceeds one percent, portraying that Sweden has a robust financial system.

Regarding tangible common equity, a decrease from 2019 to 2020 of 4,4 percent is semi-noteworthy, indicating that the bank lost some of its financial stability. However, as the 2021 financials show, this loss was only temporary and SEB's financial situation is back to its former strength, if not stronger.

Analysis

Summa Sumarum, SEB has been and is one of the front runners when it comes to implementing ESG-initiatives, even being the first bank to ever issue a green bond, and SEB from a financial risk standpoint is relatively, if not very, safe. However, for now, SEB's ESG rating (Moody) rests at a

CIS-2, which translates to that SEB's ESG-profile neither affects the overall credit score positively nor negatively. This does not mean, however, that SEBs ESG-initiatives are in vain. It simply means that SEB is currently doing enough for not being in the risk zone of being heavily inflicted by future regulations. This is not the case for all financial institutions as many have had their risk rating degraded as a consequence of sub-standard ESG-practices. This implicitly means that ESG, in the future, can be considered a hygiene factor as having a lower credit rating due to sub-standard ESG-practices could and probably should be considered careless.

Moreover, for a financial institution such as SEB, a pioneer in its field, these challenges might also be considered opportunities. New opportunities as a leading role in the green bond market could give SEB a leading role if they continue developing these solutions and implementing them further.

Concluding thoughts

Even though SEB is a front-runner in its field, Moody still puts SEB on the verge of not being able to keep up with the sustainability shift in the future. This, in reality, means that many institutions are at risk of having their credit rating/financial profile degraded as a result of future, more stringent regulations. This is a strong testament that ESG and specific ESG initiatives, are and will continue to be extremely important to mitigate being at undesired, avoidable risk.

Furthermore, in light of ongoing matters such as the climate crisis, sustainability has become ever more crucial. Sustainability frameworks were set out to provide clearer definitions of what is sustainable and to furthermore ensure transparency regarding an entity's sustainability measure, one could argue that ESG-related investing and risk are rather diffuse. This can be seen from ongoing discussions on whether investing in the defence industry should be considered sustainable or not. Clearly, there are improvements to be made when it comes to the ESG-approach in the finance industry. Although, as seen in the study, ESG has shown its presence in the financial sector, the approach is still rather avant-garde. We therefore believe that as time goes on, more ESG-related frameworks and research will be able to provide the maturity the approach requires. This also applies to the actors in the financial sector, where ESG-related measures and the generality of ESG will be better understood as time goes on. This also applies to ESGs relationship to risk, where a diffusivity of sorts, renders the metrics and conclusions to be made, at this point, rather vague.

Further Readings

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