Sustainability in Financial Services Is Not About Being Green

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The next time we hear about a bank or insurance company's "green program" — like using energy efficient light bulbs or operating out of a LEED Platinum building — we'll either scream or throw up. Don't get us wrong. We aren't "climate change deniers" and we believe that every individual and organization should use energy and other natural resources responsibly.

Our problem with banks, insurance companies, and other financial institutions that tout their commitment to sustainability by focusing on energy and water in their sustainability reporting is that these issues are simply not material to the sustainability of the institution itself. Thus this focus is not material to shareholders and a vast range of other stakeholders including employees, customers, counterparties, and society itself which depend upon a stable financial services sector to create jobs and responsible economic growth.

What, then, is material to these institutions' sustainability? Their performance on social and governance issues.

Unfortunately, the financial services sector hasn't been doing a very good job in these realms as they lurch from one major financial crisis to another. Not surprisingly, as Jean Rogers, the Executive Director of the Sustainability Accounting Standards Board (SASB), points out in a Greenbiz blog, "It's no surprise that banks and financial sectors are the institutions least trusted by U.S. society. Trust reached an all-time low of 24 percent in 2011, down from 69 percent in 2008."

As a result, institutions in the financial services sector risk losing their license to operate — the permission to conduct business granted by customers, partners, and government. These institutions are already feeling their license come under threat from increasing regulations as the government attempts to address the causes of the latest crisis. This is like closing the barn door after the horses have fled. Since no one can know what the source of the next systemic financial crisis will be, regulation can only do so much.

What these institutions' stakeholders need is transparent information about their true source of sustainability: their social and governance performance, and how it relates to financial performance. Examples of social performance include talent recruitment, employee compensation, customer security and privacy, customer transparency, responsible products, and financial inclusion. Examples of governance performance include management of the legal and regulatory environment, systemic risk management, and managing conflicts.

In our recent HBR article "The Performance Frontier: Innovating for a Sustainable Strategy," we argue that typically there are tradeoffs between financial and nonfinancial (e.g., environmental, social, and governance — or ESG) performance. These tradeoffs can be particularly consequential in large financial institutions, such as huge employee incentives for financial performance combined with poor risk management practices. The result is a "heads the bank wins, tails society loses" set of outcomes. Taxpayers are getting tired of bailing out financial institutions considered "too big to fail." No wonder the public has lost trust in them and is questioning their license to operate when the institution captures the majority of the upside of financial performance with the rest of us bearing the brunt of the downside.

With better information, shareholders and other stakeholders will have a clearer understanding of exactly how a financial institution is trying to deliver on financial performance and the potential negative effects it is creating in doing so. This will put pressure on financial institutions to better manage nonfinancial ESG performance through innovation in new products, processes, and business models that will enable them to do this and improve on financial performance at the same time. This is in direct contrast to "financial innovation" that focuses on only one dimension of performance, putting the others at risk.

Here is where the work of SASB becomes important. The mission of this non-profit organization (for which Bob is the Chairman and George is on the Standards Council) is to identify the material ESG issues by sector and the key performance indicators for reporting on them. SASB recently released the results of its Industry Working Group on Financial Institutions comprised of the Asset Management & Custody Activities, Investment Banking & Brokerage, Commercial Banking, Consumer Finance, Mortgage Finance, Security & Commodity Exchanges, and Insurance industries. The draft standards are now open for a 45-day period of public comment period until June 14 and we encourage you to weigh in.

We should emphasize that we don't think environmental issues are irrelevant to financial institutions. We actually they think they can play an important role in environmental stewardship but with a focus on enabling more environmentally responsible practices on the part of their customers — rather than the institution itself — such as creating products like green credit cards (which encourage customers to buy environmentally-friendly products), green securitization products (such as climate bonds), and energy efficient mortgages (which create incentives to reduce energy consumption in buildings, which alone account for 40% of energy consumed in the U.S.).

Yes, financial institutions should be environmentally responsible in their own operations. But they and we shouldn't be confused that this is the key to sustainability in the financial services sector. Mistaking financial institutions' green gestures for a true commitment to sustainability will be costly. Investors and other stakeholders should be a lot less concerned about the energy efficiency of some banker's building than the irresponsible products the company is developing that create great returns at unacceptable risk.