COMMERCIAL BANKS

Research Brief

SASB’s Industry Research Brief provides evidence for the material sustainability issues in the industry. The brief opens with a summary of the industry, including relevant legislative and regulatory trends and sustainability risks and opportunities. Following this, evidence for each material sustainability issue (in the categories of Environment, Social Capital, Human Capital, Business Model and Innovation, and Leadership and Governance) is presented. SASB’s Industry Brief can be used to understand the research and data underlying SASB Sustainability Accounting Standards. For accounting metrics and disclosure guidance, please see SASB’s Sustainability Accounting Standards. For information about the legal basis for SASB and SASB’s standards development process, please see the Conceptual Framework.

SASB identifies the minimum set of sustainability issues likely to be material for companies within a given industry. However, the final determination of materiality is the onus of the company.

Related Documents

- Financials Sustainability Accounting Standards
- Industry Working Group Participants
- SASB Conceptual Framework
- Example of Integrated Disclosure in Form 10-K

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To ensure that investors are able to evaluate these factors, commercial banking companies should report on the material sustainability risks and opportunities that are likely to affect value in the near and long term. Enhanced reporting will provide investors with a more holistic (and comparable) view of performance that includes both positive and negative externalities, and of the non-financial forms of capital that firms in this industry rely on to create long term value.

The sustainability issues that will drive competitiveness within the commercial banking industry include:

- Including underserved customers and developing financial literacy
- Ensuring customer privacy and data security
- Incorporating environmental, social, and governance risk factors in all core products
- Complying with the legal and regulatory environment
- Developing management and mitigation strategies to protect against systemic risk

The extent to which these sustainability issues impact value will become increasingly clear as financial sector regulation continues to evolve and emphasis is placed on ethical business practices, transparency, enhanced risk management, and limiting systemic disruption from interconnected and complex financial institutions.
INDUSTRY SUMMARY

Commercial banks accept deposits and make loans to individuals and corporations. Some commercial banks are also involved in lending for infrastructure, real estate, and other projects. They derive revenues from national banking products such as mortgage banking and credit cards, and from products and services in more fragmented, regional markets, including debit cards, savings and current accounts, and commercial real estate lending. The industry is driven by the volume of deposits, quality of loans made, and interest rate environment. It is further characterized by risk from mismatched assets and liabilities.1

Commercial banks have traditionally depended on a skilled workforce, but are increasingly using technology to expand their product and service offerings, better manage risks, and streamline operations. Some commercial banks also have investment banking or asset management divisions. The industry is highly concentrated with four companies holding 41 percent of U.S. deposits insured by the Federal Deposit Insurance Corporation (FDIC) as of June 2012.2,1

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) continues to present far-reaching implications for the financial sector, and the commercial banking industry. Since the financial crisis in 2008, commercial banks have started to build capital and repair their balance sheets to comply with anticipated and new regulations established under Dodd-Frank, and the implementation of Basel III in the U.S. Uncertainty in this industry stems from continued global macroeconomic and sovereign debt issues. As a result, banks are implementing cost-cutting measures to deal with regulatory compliance costs and lower expected industry revenues.

Wholesale funding has been unreliable as a funding source in times of crisis. Commercial banks that have a strong domestic deposit base and high levels of capital will position themselves well for growth, an increase in market share, and stronger profits.2 Reputation is also an important success factor in this industry, enabling firms to gain market share by attracting and retaining customers.

Although credit and liquidity indicators for banks have improved with support from the Federal Reserve, the low-interest rate environment and flatter yield curves are creating pressure on revenue growth. Furthermore, increased levels of capital adequacy are putting downward pressure on profits and banks continue to face risks from mortgage litigation. Regional banks are outperforming larger, more complex entities in their return on equity.3 There is an opportunity for smaller banks to capitalize on niche local markets and to fill the gap in lending that may be created by larger banks, subject to more stringent regulatory requirements, reducing or withdrawing their lending activities.

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1 A list of five companies representative of this industry and its activities appears in Appendix I.

2 Data as of June 30 2013. Based on annual summary of branch office deposits for all FDIC-insured institutions, including U.S. branches of foreign banks.
LEGISLATIVE & REGULATORY TRENDS IN THE COMMERCIAL BANKS INDUSTRY

The banking industry has faced periods of regulation and deregulation, in response to financial crises or as a result of economic expansions. These shifts in oversight have had significant impacts on business models and profitability. The Glass-Steagall Act of 1933 following the Great Depression forced a separation of commercial and investment banking businesses, and created the Federal Deposit Insurance Corporation, to insure bank deposits. The Gramm-Leach-Bliley Act of 1999 reversed these restrictions on commercial and investment banking activities, and amended the Bank Holding Company Act to allow affiliations among financial services companies, including banks, securities firms, and insurance companies.

Following the financial crisis of 2008, the regulatory environment that governs the commercial banking industry continues to evolve. These regulatory trends have the potential to impact shareholder value and sustainability performance. Commercial banks with global operations have to deal with new regulations in multiple jurisdictions, creating regulatory uncertainty, particularly around consistent application of new rules. The following section provides a brief summary of key legislative efforts that are already impacting, or are likely to impact, value in the industry and the importance of sustainability issues.

Several commercial banks received government support during the financial crisis through the Troubled Asset Relief Program (TARP). The industry has subsequently come under intense pressure from the government, NGOs, and civil society. Commercial banks now face enhanced regulatory scrutiny in the form of proposed regulations as a result of the Dodd-Frank Act. Signed into law in 2010, the Act aims to address the market failures that led to the financial crisis and to ensure market stability.

According to Standard & Poor’s, the Dodd-Frank reforms will lower pre-tax earnings for eight large, complex banks (both commercial and investment banking businesses) by a total of $22 billion and $34 billion per year. This includes additional costs of $2 billion to $2.5 billion per year to meet new reporting and compliance requirements. This impact will be most significant for the largest banks. Some of the more stringent requirements of the Dodd-Frank reforms apply only to the larger banks. For regional banks with assets over $50 billion, Federal agencies may have sliding scale requirements to account for the lower systemic risks they pose compared with the largest companies.

The Dodd-Frank Act includes the Consumer Financial Protection Act of 2010, which focuses on consumer rights and the security of financial information, and may require companies to develop and implement new technologies, increasing compliance costs. Additional rules established under Dodd-Frank include: the Durbin Amendment, which allows the Federal Reserve to limit interchange fees that merchants pay to banks; regulations governing...
over-the-counter (OTC) derivatives markets, including reporting requirements; a new calculation method for deposit insurance by the Federal Deposit Insurance Corporation (FDIC); the Volcker rule, which limits banks’ proprietary trading activities; the Collins amendment, which establishes minimum risk-based capital and leverage requirements; and new rules and enhanced current rules on corporate governance and executive compensation. IV.8,9

In addition, companies are required to submit an annual plan for their rapid and orderly resolution under the Bankruptcy Code. This applies to bank holding companies, including foreign banks with U.S. operations, with $50 billion or more in total assets, and non-bank financial institutions designated for enhanced supervision.10 These rules, along with their counterparts in European and other jurisdictions, and international regulatory standards such as Basel III, focus on capital adequacy and risk management, transparency, fairness in transactions, and removing the “too-big-to-fail” premium on some financial institutions.

In addition to the requirements of the Dodd-Frank Act, implementation of the Basel III capital standards in the U.S. will also influence banks’ profitability and business models. The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the FDIC issued three notices of proposed rulemaking (NPR) in 2012 that introduce strict capital requirements, including additional capital buffers and minimum capital ratios. These new rules will have a significant impact on profitability through the cost of carrying more capital and being limited in terms of leverage. They will also require enhanced data management, stress testing, and risk and capital management from banking institutions. The NPRs also introduce requirements for qualitative and quantitative public disclosures, along with rules around their frequency, timing, and corporate governance; however, these apply only to banking organizations with $50 billion or more in total consolidated assets.11

Non-financial sector legislation may also impact this industry. For example, carbon markets or other environmental regulations that are planned or have already been implemented in some U.S. states such as California and in other countries create both risks and opportunities for commercial banks. Companies in the industry may need to take additional measures to protect their systems and assets from cyber security risks, based on President Obama’s Executive Order on cyber security issued in February 2013.

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8,9 Regulations specific to mortgage lending, and the creation of the Consumer Financial Protection Bureau, are discussed in the Mortgage Finance Industry Brief.
SUSTAINABILITY-RELATED RISKS & OPPORTUNITIES

Recent trends in the regulatory environment indicate a significant shift toward enhanced risk management, increased disclosure, and accountability. Legislation passed in response to the 2008 financial crisis demonstrates the potential for further alignment between the interests of society and those of long-term investors. As policymakers and investors increasingly demand the effective management of sustainability risks and opportunities, firms that are able to address all forms of capital – not just financial – will be better positioned to protect shareholder value.

The following section provides a brief description of how the commercial banking industry depends on each form of capital, as well as the specific sustainability issues that will drive performance, including evidence and value impact. The issues are divided into five categories: Environment, Social Capital, Human Capital, Business Model and Innovation, and Leadership and Governance. A table indicating the nature of the value impact and evidence of interest from stakeholders appears in Appendix IIA. Appendix IIB expands on the channels of financial impacts of each sustainability issue and the recommended disclosure framework appears in Appendix III.

ENVIRONMENT

The environmental dimension of sustainability includes corporate impact on the environment, either through the use of non-renewable natural resources as input to the factors of production (e.g., water, minerals, ecosystems, and biodiversity) or through environmental externalities or other harmful releases in the environment, such as air and water pollution, waste disposal, and greenhouse gas emissions.

As a service industry, commercial banking does not depend directly on natural resources for revenue generation, nor does it engage in activities that have a direct impact on the environment. Although the consumption of energy to operate offices, data centers, and retail facilities contributes to negative externalities, this issue does not meet the threshold of materiality for the commercial banking industry.

Companies in this industry do engage with industries that have a substantial and direct impact on the environment through lending and project financing activities. The importance of integrating environmental considerations into these processes is addressed below in the Business Model and Innovation section below.
SOCIAL CAPITAL

Social capital relates to the perceived role of business in society, or the expectation of business contribution to society in return for its license to operate. It addresses the management of relationships with key outside stakeholders, such as customers, local communities, the public, and the government. It includes issues related to access to products and services, affordability, responsible business practices in marketing, and customer privacy.

Commercial banks rely on a social license to operate, which is at risk when companies create negative externalities and erode confidence and trust on the part of clients, investors, and regulators. Since the financial crisis in 2008, commercial banks have been criticized for their reliance on government funds and for unethical behavior. As a result, the industry has been subject to a regulatory overhaul through the Dodd-Frank Act. Although the sustainability risks and opportunities related to the regulatory environment are addressed in the Leadership and Governance section below, the financial crisis and subsequent loss of confidence indicate a significant need for the industry to rebuild social capital. Specifically, commercial banks must ensure financial inclusion and maintain the privacy and security of customer information. Enhanced disclosure in these areas will allow shareholders to assess performance and determine which commercial banks are better positioned to create long-term value.

Financial Inclusion & Capacity Building

Emerging financing models coupled with legislative incentives provide commercial banks with an opportunity to offer products and services to underserved populations. In addition, the recent financial crisis demonstrated the importance of the diversified and resilient funding sources that these communities can provide.

Although the Community Reinvestment Act (CRA) of 1977 continues to be reexamined for its perceived role in the sub-prime crisis, the intent remains relevant, and important for commercial banks. Further, emerging financing models and technologies provide banks with an opportunity to offer products and services in previously underserved markets and obtain additional sources of revenue. Firms that are able to meet the need to extend credit and financial services to low-income populations and small businesses while avoiding predatory and irresponsible lending practices are likely to create long-term value and enhance social capital. These services should also be complemented by efforts to improve financial literacy, which will ensure that customers make informed decisions.

Commercial banks should disclose how they are enhancing shareholder value through efforts to expand inclusion and build capacity.
Evidence

In the U.S., an estimated 11 percent of consumers are unbanked, meaning they do not have a checking, savings, or money market account, and that their spouses also do not have such an account. An additional 11 percent have a checking, savings, or money market account, but have also used an alternative financial service in the last 12 months, indicating they are underbanked.¹² These findings, coupled with a recent study by the Federal Reserve that found that 63 percent of unbanked consumers and 91 percent of underbanked consumers have a mobile phone, suggest there is significant opportunity for commercial banks to use technology to engage with new customers.

In addition to current levels of underserved customers, numerous studies indicate the need for improved financial literacy. A 2013 survey by the National Foundation for Credit Counseling found that 40 percent of adults gave themselves a grade of C, D, or F on their knowledge of personal finance. In addition, 78 percent agreed that they could benefit from additional advice and answers to everyday financial questions.¹³

Recent statistics suggest that an increasing number of banks are earning negative (“needs to improve” or “substantial non-compliance”) CRA ratings from federal regulators. This number grew from 1.45 percent in 2007 to more than 6 percent in the first quarter of 2011.¹⁴

Value Impact

Commercial banks that have a higher and diversified deposit funding base will be well positioned to protect shareholder value. The expansion of services to new customers will bring new revenue and increased market share. Companies that manage lending risk and improve financial literacy initiatives are also likely to increase interest income, lower credit risks, and reduce the cost of capital.

In the long term, financial inclusion and capacity building through community is likely to have a positive impact on a company’s reputation, increasing the value of intangible assets.

Customer Privacy & Data Security

Ensuring the privacy and security of personal financial data is an essential responsibility of the commercial banking industry. The frequency and magnitude of information security risks continue to increase with the proliferation of new technologies, increased use of the Internet for financial transactions, and sophistication of those who pose threats. Consequently, companies will be required to devote more resources to mitigation and regulatory compliance. Companies that fail to manage performance in this area are susceptible to decreased revenue and consumer confidence.
In the absence of federal legislation relating to cyber security, various regulatory agencies continue to examine this issue and propose new rules and standards. In addition to the potential for increased costs of compliance associated with new rule making, commercial banking companies are currently forced to comply with a patchwork of state laws.

Enhanced disclosure on the number and nature of security breaches, and management strategies to address these risks, will allow shareholders to understand how commercial banks are protecting shareholder value.

Evidence

In 2013 banks (including Bank of America and Goldman Sachs) were among 50 participants in a staged cyber attack. The exercise was designed to determine how bank executives responded to a variety of scenarios. This demonstrates growing concern throughout the financial industry about cyber crime. In fact, cyber attacks are now indicated by many as the biggest threat to the stability of financial institutions.

In May 2013, it was announced that $45 million had been stolen from ATM machines around the world in a single day. In 2012, two security firms indicated that a cyber attack had involved the attempted theft of $78 million from accounts at over 60 financial institutions. Estimates suggest that hackers are stealing upwards of $1 billion per year from small and mid-sized bank accounts. In 2012, commercial bank websites were also targeted in a cyber attack that caused Internet blackouts and delays in online banking for Bank of America, JPMorgan Chase, Citigroup, U.S. Bank, Wells Fargo, and PNC. In addition to companies, individuals are increasingly being victimized by identity theft, which typically targets financial information. A recent estimate suggests that nine million Americans are victims of identity theft each year.

Citigroup reports that “Citi’s operational systems and networks have been, and will continue to be, subject to an increasing risk of continually evolving cyber security or other technological risks, which could result in the disclosure of confidential client or customer information, damage to Citi’s reputation, additional costs to Citi, regulatory penalties, and financial losses.”

Value Impact

Commercial banks that do not adequately address the potential for security breaches and other intrusions will likely be subject to contingent liabilities that may not be covered by insurance. In addition, regulatory actions aimed at addressing the issue of data privacy and security could increase general and administrative expenses, thereby lowering operational efficiency.

Significant disruptions or security breaches are also likely to impair intangible assets through reputational damage and lead to a loss in customer confidence. Consequently, companies could lose market share and revenue as customers switch to competitors. Moreover, companies prone to cyber attacks are perceived as more risky which leads to higher cost of capital.
HUMAN CAPITAL

Human capital addresses the management of a company’s human resources (employees and individual contractors) as a key asset to delivering long-term value. It includes factors that affect the productivity of employees, such as employee engagement, diversity, and incentives and compensation, as well as the attraction and retention of employees in highly competitive or constrained markets for specific talent, skills, or education. It also addresses the management of labor relations in industries that rely on economies of scale and compete on the price of products and services or in industries with legacy pension liabilities associated with vast workforces. Lastly, it includes the management of the health and safety of employees and the ability to create a safety culture for companies that operate in dangerous working environments.

Commercial banks are heavily dependent on human capital to maintain and create value. The industry relies on employees for both customer-facing and highly technical positions. Despite an industry shift towards increased use of technology to reduce costs and enhance efficiency, the industry will remain dependent on strong human capital. However, relative to other industries in the financial sector, these companies do not face specific material risks or opportunities associated with human capital.

BUSINESS MODEL & INNOVATION

This dimension of sustainability is concerned with the impact of environmental and social factors on innovation and business models. It addresses the integration of environmental and social factors in the value creation process of companies, including resource efficiency and other innovation in the production process, as well as product innovation and looking at efficiency and responsibility in the design, use-phase, and disposal of products. It includes management of environmental and social impacts on tangible and financial assets—either a company’s own or those it manages as the fiduciary for others.

The commercial banking industry relies on rapid innovation and growth to meet the demands of clients and changes in technology. The primary opportunities for innovation as they relate to sustainability are associated with the increasing need to address environmental, social, and governance factors that can present indirect and direct risks and opportunities.

Companies in this industry provide loans and project financing to a variety of industries that have substantial impacts on the environment and depend on natural resources and social capital. The industry is subsequently dependent on the continued profitability of these projects and industries. For example, evolving regulatory efforts to address climate change could
limit returns on traditional power generation, thereby increasing credit risk. Similarly, social trends provide opportunities for new products and growth. Enhanced disclosure on how environmental, social, and governance factors are integrated into credit risk analysis with allow shareholders to assess which companies are better positioned to address the associated risks and opportunities.

Integration of Environmental, Social, and Governance Risk Factors in Credit Risk Analysis

Environmental, social, and governance (ESG) factors are increasingly contributing to the financial performance of specific projects and companies at large. Commercial banks that fail to address these risks and opportunities could face diminished returns and reduced value for shareholders.

As financial intermediaries, commercial banks contribute to significant positive and negative environmental and social externalities through their lending practices. In addition, environmental, social, and governance factors can have material implications for the underlying companies, assets, and projects that commercial banks lend to across a range of industries. It is therefore increasingly necessary for companies to examine ESG factors when determining the quality of collateral. This is particularly relevant for loans to industries with high levels of GHG emissions, which could be substantially impacted by certain scenarios of regulatory responses to climate change.

Commercial banks also have the potential to enable positive environmental and social externalities and to generate significant revenue streams through their lending practices. Specifically, companies can capitalize on various tax incentives to support the development of renewable energy and energy efficiency projects.

Companies should subsequently disclose how ESG factors are integrated into lending processes and the current level of portfolio risk associated with specific sustainability trends.

Evidence

Increased investor interest and recognition of the potential for both value creation and destruction associated with the integration of ESG factors have led numerous firms in the commercial banking industry to become signatories to the Equator Principles, the Carbon Principles, and the United Nations Principles for Responsible Investment. Although these initiatives differ in their scope and intent, they demonstrate a growing recognition that firms that consider environmental and social performance across their activities will be best positioned to protect shareholder value.

For example, firms that adopt the Carbon Principles recognize that there is “growing uncertainty around federal climate change policy and potential carbon costs. This lack of clar-
ity has raised concerns in the industry around the economic viability of proposed coal-fired power plants, leading to a growing number of regulatory rejections of new projects. From our perspective as financial institutions, there is a clear need for a consistent approach to assessing these uncertainties.” These considerations coupled with stakeholder concern have led companies in the commercial banking industry to address both the risks and opportunities associated with ESG factors.

Demonstrating the potential for significant risks associated with issues such as financed emissions, Bank of America, the largest financier for the U.S. coal industry, faced protests at its annual shareholder meeting in 2012. Further, since the Rainforest Action Network (RAN) started issuing report cards that provided information on the financing of mountaintop removal mining projects in 2010, banks including JPMorgan Chase, Wells Fargo, PNC, UBS, and Credit Suisse have instituted policies on financing these projects. In addition to reputational or headline risks, regulatory approval of mountaintop mining presents a significant challenge to these projects and their financers. Of the mountaintop removal permits that the U.S. Environmental Protection Agency (EPA) reviewed in 2010, 99 were denied or withdrawn, 84 were still pending as of April 2011, and 18 were approved.

Recent estimates demonstrate the potential opportunities associated with the financing of projects that create positive environmental externalities, such as renewable energy. Bloomberg New Energy Finance indicates that annual spending on clean energy projects may rise to $630 billion at the end of the next decade from $190 billion in 2012. This marks 37 percent more than estimated in November 2011. By these estimates, renewables would account for half of all generation capacity by 2030.

Several leading commercial banks have made significant commitments to capitalize on these opportunities. For example, at the UN Rio+20 Conference in 2012, Bank of America committed $50 billion over a 10-year period for environmental and sustainable energy initiatives, including “lending, equipment finance, capital markets and advisory activity, carbon finance, and advice and investment solutions for clients.”

**Value Impact**

ESG factors have the potential to increase the cost of capital for borrowers through credit downgrades, which impact their discounted cash flow and ability to repay loans. This can have an adverse effect on the financial condition of lenders by decreasing interest income from loans and leases, and devaluing collateral and loans measured at fair value on balance sheets.

In the long term, declined interest income and weakened balance sheets could lower the ability of banks to repay their debt and lead to credit-rating downgrades, higher cost of capital, and diminished shareholder value.

Enabling positive environmental and social impacts through lending can lower reputational risks, enhance intangible assets, and allow banks to capture new market share.
**LEADERSHIP & GOVERNANCE**

As applied to sustainability, governance involves the management of issues that are inherent to the business model or common practice in the industry and that are in potential conflict with the interest of broader stakeholder groups (government, community, customers, and employees) and therefore create a potential liability, or worse, a limitation or removal of license to operate. This includes regulatory compliance, lobbying, and political contributions. It includes risk management, safety management, supply chain and resource management, conflict of interest, anti-competitive behavior, and corruption and bribery. It also includes risk of business complicity with human rights violations.

Strict and evolving regulatory environments coupled with complex and often interconnected lines of business elevate the importance of strong governance in the commercial banking industry. Governance structures must ensure compliance with national and international regulations. In addition, companies must ensure that policies and practices are in place to address the risks and reporting requirements associated with systemic risk. Enhanced disclosure on governance performance is essential for shareholders to assess and benchmark management quality and a company’s ability to protect long-term value.

**Management of the Legal & Regulatory Environment**

The regulatory environment surrounding the commercial banking industry continues to evolve both nationally and internationally. Companies must now adhere to a complex and inconsistent set of rules relating to both performance and disclosure on issues including insider trading, anti-trust, price fixing, and market manipulation. In addition, commercial banks are subject to rules regarding tax evasion, fraud, money laundering, and corrupt practices. Finally, enhanced rewards for whistleblowers established under the Dodd-Frank Act may increase the number of complaints brought to regulators.

In the U.S., provisions of the Dodd-Frank Act continue to be implemented, and companies will also face new capital adequacy, stress testing, and market liquidity risk standards established under Basel III. Although many of these regulations are specific to the issue of “Systemic Risk Management” (see below), it demonstrates the evolving nature of the regulatory landscape and the need to have strong governance practices in place.

Firms that can manage these regulatory concerns and ensure compliance will be better positioned to protect shareholder value and limit future liabilities.
Evidence

The recent fine of $1.9 billion that HSBC paid to U.S. authorities for poor money laundering controls, resulting in misuse of the bank’s accounts by Mexican drug cartels, highlights the financial impact of poor governance for complying with laws and regulations. According to the U.S. Justice Department, bank officials repeatedly ignored internal warnings about the inadequacy of the bank’s monitoring systems and the bank had an understaffed compliance department. HSBC was also charged with violating sanctions laws by doing business with customers in Iran, Libya, Sudan, Burma, and Cuba.

Other U.S. and European banks, including JPMorgan Chase, Wachovia and Citigroup, have been cited for lapses in money-laundering controls or violations of sanctions, and have agreed to total settlements with U.S. regulators of around $5 billion. Although these fines are not a significant proportion of the total book value, banks have had to take additional steps to improve governance; for example, HSBC has launched a global review of its “Know Your Customer” files, which will cost an estimated $700 million over five years.27

In 2012, U.S. and European regulators fined UBS $1.5 billion for manipulating benchmark interest rates in the London Interbank Offered Rate (LIBOR) and Japanese markets.28 UBS posted a quarterly loss of nearly $2 billion during the fourth quarter of 2012, after booking the Libor fine (and including costs related to job cuts).29 The same year, Barclays was fined $451 million for interest rate manipulation, which led to a decrease in share price of 18 percent.30 Additional fines have been levied against Citigroup, JPMorgan Chase, Deutsche Bank, Royal Bank of Scotland, and Société Générale for improperly influencing Libor.31

Value Impact

A failure to comply with the evolving regulatory environment can present material implications for individual companies and for the overall industry. Specifically, non-compliance can lead to significant contingent liabilities, and potential restrictions on specific business activities. In addition, companies could experience an increase in general and administrative expenses, lowering operational efficiency. Poor performance in this area can damage a bank’s reputation and lead to the impairment of intangible assets. These factors combined could present credit rating downgrades, increased cost of capital, and diminished shareholder value.

Systemic Risk Management

Commercial banks provide corporations and individuals with financial security through a combination of fixed debt and flexible assets – clients benefit from fixed terms and interest rates on their loans while they may withdraw...
their deposits, sell their investments or repay their loans at any time. This situation creates inherent liquidity and solvency risks for banks, where their assets (clients’ debt) can fluctuate in value but cannot be adjusted or sold and their debts (clients’ assets) can be called in at any time. Risk management therefore is a key contribution of banks to society and also a major factor in their profitability and survival. At an aggregate level, risk management of commercial banks is a major contributor to economic development and financial stability.

The recent financial crisis articulated the importance of managing risks to capital in the commercial banks industry. Specifically, firms that failed to ensure adequate capital reserves were unable to protect shareholder value and contributed to a significant market disruption. The systemic nature of the risk results from the interconnectedness of financial institutions, and has become a central concern of federal and international regulators.

The capital requirements developed by the Federal Reserve and under Basel III are intended to ensure that firms have adequate capital to withstand a financial stress. In addition, the management of the size, quality, and stability of a company’s capital has been demonstrated to be essential to protecting shareholder value and preventing a systemic market disruption. Subsequently, there is increased recognition of the importance of metrics such as skewness and kurtosis of trading revenue, risk limit management, and exposure to over-the-counter derivative positions as key indicators of stability.

Further, many banks are required to undergo stress tests to evaluate whether the company has the capital to absorb losses, continue operations, and meet obligations in the event of adverse economic and financial conditions.

In an effort to demonstrate how these risks are being managed, commercial banks should enhance disclosure on metrics, including the results of annual stress tests, Basel III liquidity coverage ratios, exposure to over-the-counter derivatives, and management of risk limits.

**Evidence**

The collapse and near failure of several financial institutions, including Washington Mutual, Lehman Brothers, and Bear Stearns, during the 2008 financial crisis provides the most compelling evidence of the importance of systemic risk management, and the extreme impact on value that can arise from both internal and external risk. Although those examples represent an extreme, most commercial banks wrote down significant amounts of capital during the financial crisis due to inadequate risk assessments of sub-prime assets on their books and unsustainable leverage ratios.

In August 2007, at the beginning of the financial crisis, Citigroup, JPMorgan Chase, Bank of America, and the Wachovia Corporation each received $500 million of emergency funding from the Federal Reserve in exchange for collateral totaling $213 billion in asset-backed securities, commercial loans, and residential mortgages, including second liens. In Sep-
September 2007, Citibank withdrew $3.4 billion of cash from the New York Federal Reserve in exchange for $23 billion of assets; despite this, a few weeks later, Citigroup announced a write-off worth $5.9 billion in the third quarter of 2007, leading to a fall in profits by 60 percent from a year earlier.32

Despite increased regulatory scrutiny and stress testing of assets following the financial crisis, commercial banks continue to be exposed to significant risks affecting the value of their assets. According to analysis by the Wall Street Journal, as of September 30, 2010, the top 10 banks had $360.7 billion in “Level 3” securities, which are hard-to-value, illiquid investments. That amounts to 42.6 percent of the banks’ shareholder equity.33

A January 2013 survey of 921 investors, analysts and traders who are Bloomberg subscribers showed that trust in the largest banks has failed to recover and according to the majority, “they lacked or had little confidence that the biggest institutions are taking prudent risks and conforming to laws.”34

In 2013, JPMorgan Chase agreed to pay $13 billion to resolve the U.S. Justice Department’s investigation into the company’s sale of mortgage bonds that contributed to the downturn.35 To date, the six biggest banks in the U.S., including JPMorgan Chase and Bank of America, have incurred more than $100 billion in legal costs since 2008, demonstrating the direct costs associated with actions that contribute to systemic risk.36

Value Impact

The development and implementation of regulations related to systemic risk management are intended to improve the ability of companies to absorb shocks arising from financial and economic stress. The adoption of these requirements and the improvement of capital ratios beyond specified levels are likely to give commercial banks a strong competitive advantage. In addition, increased quality, transparency, and consistency of a firm’s capital base are likely to improve credit rating and lower the cost of capital. Higher liquidity ratios also have a positive impact on operational efficiency and profitability, thereby contributing to shareholder value.

A failure to adapt to new and developing standards could lead to enhanced regulatory oversight and litigation, thereby increasing recurring general and administrative expenses, imposing contingent liabilities, and diminishing the value of intangible assets. Further, this could lead to a lack of trust on the part of clients and a potential loss of market share. Finally, inadequate risk assessment and a failure to accurately price financial assets are likely to have a negative impact on a firm’s balance sheet.

Although regulations relating to systemic risk management continue to evolve and take effect, the potential impact on value is clear, and likely to present material implications in the near and long term.
SASB INDUSTRY WATCH LIST

The following section provides a brief description of sustainability issues that did not meet SASB’s materiality threshold at present, but could have a material impact on the commercial banking industry in the future.

Regulatory Capture and Political Influence

The issue of regulatory capture and political influence continues to be prominent in the commercial banking industry. Specifically, companies are widely seen as having had significant influence on the development of new regulations since the 2008 financial crisis through lobbying, contributions, and direct relationships with regulators.

The material implications of lobbying efforts and campaign contributions remain controversial. Specifically, there is little evidence as to how these actions impact shareholder value, and whether the cost of these activities is outweighed by corporate gains. Additionally, the issue raises questions of the efficacy of lobbying for, or against, a regulation that protects near-term profits but is misaligned with longer-term strategic investments and initiatives.

Although investor interest in the issue appears to be increasing, it is not clear at whether shareholder resolutions requiring such disclosure will receive widespread support.37 Additionally, after indicating it as a priority issue for 2013, the SEC dropped the issue of political spending from its 2014 agenda.38
### APPENDIX I: Five Representative Companies | Commercial Banks

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<th>COMPANY NAME (TICKER SYMBOL)</th>
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<td>Wells Fargo (WFC)</td>
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<td>HSBC Holding (HSBC)</td>
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</tbody>
</table>

*This list includes five companies representative of the Commercial Banks Industry and its activities. Only companies that are US listed and where at least 20 percent of revenue is generated by activities in this industry according to the latest information available on Bloomberg Professional Service were included.*
## APPENDIX IIA:
### Evidence for Material Sustainability Issues

<table>
<thead>
<tr>
<th>MATERIAL SUSTAINABILITY ISSUES</th>
<th>EVIDENCE OF INTEREST</th>
<th>EVIDENCE OF FINANCIAL IMPACT</th>
<th>FORWARD-LOOKING IMPACT</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>HM (1-100)</td>
<td>IWGs</td>
<td>EI</td>
</tr>
<tr>
<td>SOCIAL CAPITAL</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial Inclusion &amp; Capacity Building</td>
<td>50</td>
<td>73</td>
<td>5</td>
</tr>
<tr>
<td>Customer Privacy &amp; Data Security</td>
<td>70</td>
<td>91</td>
<td>4</td>
</tr>
<tr>
<td>BUSINESS MODEL &amp; INNOVATION</td>
<td>58</td>
<td>92</td>
<td>3</td>
</tr>
<tr>
<td>Integration of Environmental, Social, and Governance Risk Factors in Credit Risk Analysis</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LEADERSHIP &amp; GOVERNANCE</td>
<td>53</td>
<td>95</td>
<td>2</td>
</tr>
<tr>
<td>Management of the Legal &amp; Regulatory Environment</td>
<td>62</td>
<td>95</td>
<td>1</td>
</tr>
</tbody>
</table>

**HM:** Heat Map, a score out of 100 indicating the relative importance of the issue among SASB’s initial list of 43 generic sustainability issues. The score is based on the frequency of relevant keywords in documents (i.e., 10-Ks, shareholder resolutions, legal news, news articles, and corporate sustainability reports) that are available on the Bloomberg terminal for the industry’s publicly listed companies.

**IWGs:** SASB Industry Working Groups

**%:** The percentage of IWG participants that found the issue to be material. (-) denotes that the issue was added after the IWG was convened.

**Priority:** Average ranking of the issue in terms of importance. One denotes the most material issue. (N/A) denotes that the issue was added after the IWG was convened.

**EI:** Evidence of Interest, a subjective assessment based on quantitative and qualitative findings.

**EFI:** Evidence of Financial Impact, a subjective assessment based on quantitative and qualitative findings.

**FLI:** Forward Looking Impact, a subjective assessment on the presence of a material forward-looking impact.
## APPENDIX IIB: Evidence of Financial Impact for Material Sustainability Issues

<table>
<thead>
<tr>
<th>EVIDENCE OF FINANCIAL IMPACT</th>
<th>SOCIAL CAPITAL</th>
<th>BUSINESS MODEL &amp; INNOVATION</th>
<th>LEADERSHIP &amp; GOVERNANCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial Inclusion &amp; Capacity Building</td>
<td>Customer Privacy &amp; Data Security</td>
<td>Integration of Environmental, Social, and Governance Factors in Credit Risk Analysis</td>
<td>Management of the Legal &amp; Regulatory Environment</td>
</tr>
<tr>
<td>Risk Premium</td>
<td>Strategic Risk Management</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASSETS &amp; LIABILITIES</th>
<th>Revenue &amp; Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>Non-operating Expenses</td>
</tr>
<tr>
<td>Liabilities</td>
<td>Operating Expenses</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>RISK PROFILE</th>
<th>Cost of Capital</th>
<th>Revenue Operating Expenses</th>
<th>Non-operating Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of Capital</td>
<td>Revenue Operating Expenses</td>
<td>Non-operating Expenses</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>HIGH IMPACT</th>
<th>MEDIUM IMPACT</th>
<th>LOW IMPACT</th>
</tr>
</thead>
<tbody>
<tr>
<td>HIGH IMPACT</td>
<td>MEDIUM IMPACT</td>
<td>LOW IMPACT</td>
</tr>
</tbody>
</table>

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### APPENDIX III: Sustainability Accounting Metrics | Commercial Banks

<table>
<thead>
<tr>
<th>TOPIC</th>
<th>ACCOUNTING METRIC</th>
<th>CATEGORY</th>
<th>UNIT OF MEASURE</th>
<th>CODE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Financial Inclusion &amp; Capacity Building</strong></td>
<td>Percentage of new accounts held by first-time account holders</td>
<td>Quantitative</td>
<td>Percentage (%)</td>
<td>FN0101-01</td>
</tr>
<tr>
<td></td>
<td>Percentage of total domestic loans for underserved and underbanked business segments</td>
<td>Quantitative</td>
<td>Percentage (%) in U.S. dollars ($)</td>
<td>FN0101-02</td>
</tr>
<tr>
<td></td>
<td>Number of participants in financial literacy initiatives for unbanked, underbanked, or underserved customers\textsuperscript{vi}</td>
<td>Quantitative</td>
<td>Number (#)</td>
<td>FN0101-03</td>
</tr>
<tr>
<td></td>
<td>Loan-to-deposit ratio for: (1) Overall domestic lending (2) Underserved and underbanked business segments</td>
<td>Quantitative</td>
<td>Ratio in U.S. dollars ($)</td>
<td>FN0101-04</td>
</tr>
<tr>
<td></td>
<td>Loan default rates for: (1) Overall domestic lending (2) Underserved and underbanked business segments</td>
<td>Quantitative</td>
<td>Rate in U.S. dollars ($)</td>
<td>FN0101-05</td>
</tr>
<tr>
<td><strong>Customer Privacy &amp; Data Security</strong></td>
<td>Number of data security breaches and percentage involving customers’ personally identifiable information\textsuperscript{vii}</td>
<td>Quantitative</td>
<td>Number (#), percentage (%)</td>
<td>FN0101-06</td>
</tr>
<tr>
<td></td>
<td>Discussion of management approach to identifying and addressing vulnerabilities and threats to data security</td>
<td>Discussion and Analysis</td>
<td>n/a</td>
<td>FN0101-07</td>
</tr>
<tr>
<td><strong>Management of the Legal &amp; Regulatory Environment</strong></td>
<td>Amount of legal and regulatory fines and settlements associated with financial industry regulation and percentage that resulted from whistleblowing actions\textsuperscript{viii}</td>
<td>Quantitative</td>
<td>U.S. dollars ($), percentage (%)</td>
<td>FN0101-08</td>
</tr>
<tr>
<td></td>
<td>Number of inquiries, complaints, or issues received by the legal and compliance office through an internal monitoring or reporting system, and percentage that were substantiated\textsuperscript{ix}</td>
<td>Quantitative</td>
<td>Number (#), percentage (%)</td>
<td>FN0101-09</td>
</tr>
</tbody>
</table>

\textsuperscript{vi} Note to **FN0101-03** – Disclosure shall include a description of financial literacy initiatives.

\textsuperscript{vii} Note to **FN0101-06** – Disclosure shall include a description of corrective actions.

\textsuperscript{viii} Note to **FN0101-08** – Disclosure shall include a description of fines and settlements and corrective actions implemented in response to events.

\textsuperscript{ix} Note to **FN0101-09** – Disclosure shall include a description of the nature of the inquiries, complaints, or issues and of any corrective actions taken by registrant in response to information received by its legal and compliance office through an internal monitoring and/or reporting system.
## APPENDIX III: Sustainability Accounting Metrics | Commercial Banks

### (Cont.)

<table>
<thead>
<tr>
<th>TOPIC</th>
<th>ACCOUNTING METRIC</th>
<th>CATEGORY</th>
<th>UNIT OF MEASURE</th>
<th>CODE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Systemic Risk Management</td>
<td>Results of stress tests under adverse economic scenarios, including the following measures (actual and projection): (1) Loan losses (2) Losses, revenue, and net income before taxes (3) Tier 1 common capital ratio (4) Tier 1 capital ratio (5) Total risk-based capital ratio (6) Tier 1 leverage ratio</td>
<td>Quantitative</td>
<td>U.S. dollars ($), ratio in U.S. dollars ($)</td>
<td>FN0101-10</td>
</tr>
<tr>
<td></td>
<td>Basel III Liquidity Coverage Ratio (LCR)</td>
<td>Quantitative</td>
<td>Ratio in U.S. dollars ($)</td>
<td>FN0101-11</td>
</tr>
<tr>
<td></td>
<td>Net exposure to written credit derivatives</td>
<td>Quantitative</td>
<td>U.S. dollars ($)</td>
<td>FN0101-12</td>
</tr>
<tr>
<td></td>
<td>Level 3 assets: (1) total value and (2) percentage of total assets</td>
<td>Quantitative</td>
<td>U.S. dollars ($), percentage (%)</td>
<td>FN0101-13</td>
</tr>
<tr>
<td></td>
<td>Skewness and kurtosis of trading revenue</td>
<td>Quantitative</td>
<td>n/a</td>
<td>FN0101-14</td>
</tr>
<tr>
<td>Integration of Environmental, Social, and Governance Risk Factors in Credit Risk Analysis</td>
<td>Discussion of how environmental, social, and governance (ESG) factors are integrated into the lending process</td>
<td>Discussion and Analysis</td>
<td>n/a</td>
<td>FN0101-15</td>
</tr>
<tr>
<td></td>
<td>Discussion of credit risk to the loan portfolio presented by climate change, natural resource constraints, human rights concerns, or other broad sustainability trends</td>
<td>Discussion and Analysis</td>
<td>n/a</td>
<td>FN0101-16</td>
</tr>
<tr>
<td></td>
<td>Amount and percentage of lending and project finance that employs: (1) Integration of ESG factors (2) Sustainability themed lending or finance (3) Screening (exclusionary, inclusionary, or benchmarked) (4) Impact or community lending or finance</td>
<td>Quantitative</td>
<td>U.S. dollars ($), percentage (%)</td>
<td>FN0101-17</td>
</tr>
<tr>
<td></td>
<td>Total loans to companies in the following sectors/industries: Energy/Oil&amp;Gas, Materials/Basic Materials, Industrials, and Utilities</td>
<td>Quantitative</td>
<td>U.S. dollars ($)</td>
<td>FN0101-18</td>
</tr>
</tbody>
</table>

*Note to FN0101-10: Disclosure shall include a description of the most significant drivers of changes in regulatory capital ratios.*
APPENDIX IV: Analysis of 10-K Disclosures | Commercial Banks

The following graph demonstrates an aggregate assessment of how the top ten U.S. domiciled companies, by revenue in the commercial banks industry are currently reporting on material sustainability issues in the Form 10-K.
References


References (Cont.)