European banking: social factors material for credit analysis as regulatory pressure mounts

We have previously highlighted the increasing importance of environmental factors in bank credit analysis. Here, we do the same for social factors. Regardless of one's views on the appropriateness of incorporating ESG factors in credit and investment decisions, we argue that once regulators take a stance on these matters, it becomes highly relevant.

Indeed, regulatory proposals aimed at increasing diversity, ensuring customers have access to cash, and improving sustainability-related disclosures all point to the growing importance of the "S" in ESG when evaluating the creditworthiness of banks. We look at key initiatives affecting UK and EU banks and provide a snapshot of where the sector currently stands.

UK: diversity and inclusion a part of threshold conditions to operate

The Bank of England and the UK Financial Conduct Authority (FCA) are currently holding a consultation on improving diversity and inclusion in the financial sector. The regulators have jointly issued a discussion paper backed by a literature review providing evidence of the impact of diversity and inclusion in the workplace. They intend to propose rules and guidance based on the paper. In addition, they highlight their willingness to use regulatory powers where firms fail to meet minimum expectations.

For the FCA, these issues will become part of how they regulate conduct in the UK financial sector, with a focus on the treatment of customers. The premise is that firms need to be sufficiently diverse and inclusive to understand and meet the needs of retail customers. For the Bank of England, the focus will be on threats to the soundness of firms stemming from groupthink related to a lack of diversity and inclusion.

The discussion paper includes a section on incorporating diversity amongst the threshold conditions that firms must meet to be allowed to continue operating. More specifically, board and senior-management diversity could become part of the assessment when determining whether a firm has sufficient non-financial resources. As well, the non-financial misconduct of individuals and discriminatory market practices could have a bearing on the assessment of suitability.

The UK regulators have also proposed diversity and inclusion metrics for diagnosing, tracking progress and measuring return on investment. The suggested metrics are broad and wide ranging, covering recruitment, retention, advancement, representation and pay (Figure 1). They are not, however, prescriptive, in line with the regulators' intention to avoid a "one size fits all" approach to diversity and inclusion.

The disclosures of the UK's six largest banks suggest that diversity and inclusion is improving. However, the information provided varies in content and quality from bank to bank and falls short of the levels that the regulators would now like to see. Tracking progress made by each bank and making comparisons across banks remains a challenge.

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Figure 1: UK regulators up the "social factor" ante: proposed metrics for measuring diversity and inclusion

Recruitment	Retention	Advancement	Representation	Pay
Number of applications, interviews, hires, etc. by demographic. Employee perception – whether the firm is a good place for diverse talent to work. Cultivating sources of diverse talent – e.g., scholarships, career returners, internships.	Retention numbers, accounting for voluntary and involuntary departures by diversity characteristic. Engagement survey results on employee morale and intent to stay at the firm. Engagement survey results on employee wellbeing and personal resilience, including psychological safety.	Promotions tracked by diversity characteristics by level. Parity of performance reviews. Diversity in succession plans. Participation in acting up, secondment or project opportunities.	Percentage by level and business (including the board and senior managers). Employees' perception of inclusion (e.g., Do you believe your opinion matters? Do you have role models at work?)	By role and tenure – base pay, discretionary and bonus pay, pay gaps.

Source: Bank of England, Scope Ratings.

EU: ECB becomes more forceful in ensuring diversity

Focus of efforts are at the board and senior management level

The EU authorities are also making efforts to improve diversity within banks. In June, the ECB held a public consultation on a revised and more comprehensive guide to fit and proper assessments. The revised guide introduces additional considerations for assessing the suitability of bank boards, including one meant to foster gender diversity.

As impetus for the revised guide, the ECB points to various findings: only 8% of the CEOs of European credit and investment institutions are women; only around a fifth of the positions in the management bodies of Europe's largest banks are held by women; women on the management boards of most institutions are paid less; and two-thirds of banks do not have a diversity policy relating to their management bodies despite the requirements under European law[1]. Diversity policies are meant to cover not only gender, but age, professional and educational background, and geographical provenance.

ECB to increase enforcement when targets exist

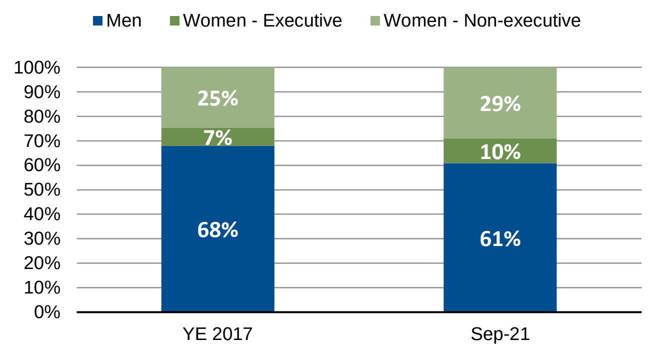
In its supervisory work, the ECB notifies banks of failures to meet self-imposed gender targets. In addition, diversity shortcomings identified as part of fit and proper assessments are included in the governance assessments of the annual Supervisory Review and Evaluation Process (SREP). In the future, where targets exist and are not met, the ECB will issue recommendations to remedy them. Further, when there are manifest breaches of diversity strategies the ECB may require banks to comply.

Diversity within European banks is still work in progress

Our analysis based on a sample of 25 large European banks shows that while progress has been made over the last few years there is room to improve (Figures 2 and 3). We believe that the breadth of experience and views provided by a diverse management team supports a robust risk culture and ensures that a bank is better prepared to adapt to changing operating dynamics.

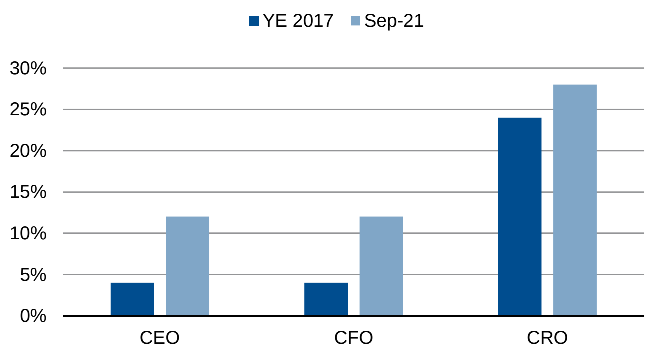
[1] European Banking Authority (2020), Benchmarking report on diversity practices in credit institutions and investment firms.

Figure 2: Board composition by gender



Source: 25 European banks, Scope Ratings.

Figure 3: Proportion of women in senior executive roles in European banks



Source: 25 European banks, Scope Ratings.

Access to cash: a core social challenge for banks

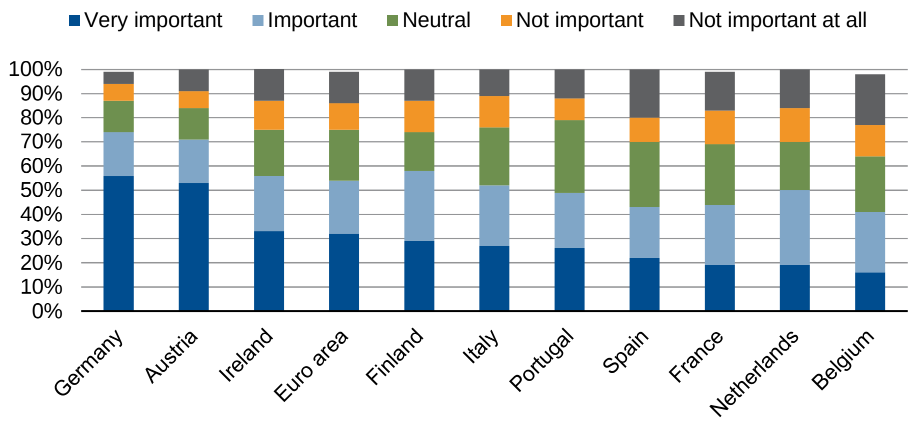
In the past, we have highlighted the costs, including the potential social and reputational risks of closing bank branches. We now see a further risk as governments move to protect access to cash, meaning that banks are likely to face more challenges in reducing their branch networks.

Despite declining usage over the years, cash remains an important payment method for many, including small businesses. In 2009, cash accounted for 58% of all payments in the UK, falling to 23% in 2019. The pandemic accelerated this decline to 17% last year, but cash was still the second most popular payment method, after debit cards[2].

Option to pay with cash still important for consumers

And while there are differences by country, more than 50% of consumers in the euro area still consider it to be very important or important to have the option to pay with cash.

Figure 4: Importance of having the option to pay with cash, by country



Note: Where the percentages do not add up to 100%, the remainder is classified as "do not know".
Source: ECB Study on the payment attitudes of consumers in the euro area (SPACE), December 2020; Scope Ratings.

The UK government is currently consulting on legislative proposals to protect access to cash. In September 2020, the FCA had already introduced guidance for regulated firms considering whether and how to reduce branches or the number of free-to-use ATMs. These aim to ensure fair outcomes for consumers when banks make these decisions.

[2] UK Finance, UK payments markets summary 2021.

Legislation based on geographic distance to cash access…

Currently, around 90% of neighbourhoods in the UK are within one kilometre of a free cash access point. The government considers this an appropriate basis for setting initial geographic requirements to ensure reasonable access to withdrawal and deposit facilities. Under the proposal, the FCA would also be given new powers to monitor and enforce cash access requirements, including directing designated firms to refrain from closing branches if necessary.

In response, large UK banks have started piloting shared bank hubs. These branches provide counter services operated by the post office alongside face-to-face access to community bankers from the largest lenders in an area. Further, the start-up OneBanks is testing shared branch kiosks using open banking technology to offer services from different banks.

The discussions regarding access to cash in the UK follow developments in Sweden. Since January, legislation requires the six largest banks in Sweden to provide cash withdrawal and deposit services throughout the country[3]. This is notable as the country stands out in terms of declining cash use. According to the 2021 Worldpay Global Payments Report, Swedes used cash for just 9% of transactions last year.

…and ensuring resilience of payments in the economy

As cash is considered legal tender, the Swedish government concluded that it has a duty to ensure that people have reasonable access to cash. This conclusion stems from a broader review conducted by the Swedish central bank covering responsibility for cash management, cash provision and contingency planning in the payments system.

Other factors supporting the new legislation included concerns that a completely cashless society would be extremely vulnerable in the event of an internet or power grid failure. As well, there were observations that the move away from cash has been problematic for those living in rural areas, the elderly, and those with mental disabilities.

Tightening ESG reporting requirements include social disclosure

Many larger European banks are already subject to the EU's Non-Financial Reporting Directive (NFRD), which requires disclosures on non-financial matters such as environmental protection, social responsibility and the treatment of employees, respect for human rights, and anti-corruption. In addition to widening the range of companies required to make sustainability disclosures, the EC's proposed Corporate Sustainability Reporting Directive (CSRD) will toughen up rules some more.

Multiple reporting requirements are in place

Another key plank of the EU's initiatives on sustainable finance is the Sustainable Finance Disclosure Regulation (SFDR) which has been in place since March. The SFDR requires financial market participants and financial advisors to report on how they account for sustainability risks and how their financial products are affected by such risks.

In their roles as providers and advisors of financial products, banks are subject to the SFDR. Disclosure requirements apply at both entity and product level. At entity level, the disclosures cover the integration of sustainability risks into the investment decision-making or investment advice process, the consideration of adverse sustainability impact in investment decisions or advice, and how remuneration policies are consistent with the integration of sustainability risks.

Work on social taxonomy elevates importance of social factors

Growing recognition that social factors must also be addressed

With the entry in force of the EU Taxonomy Regulation in July 2020, the focus has been largely on environmental issues. The Taxonomy Regulation establishes a classification system for environmentally sustainable activities to which companies subject to the

[3] No more than 0.3% of population will be more than 25km from a place for cash withdrawal and no more than 1.22% of the population will be more than 25km from making daily cash deposits into their bank account.

NFRD and the proposed CSRD must report. However, policy makers are recognising that work must also be done to support the social aspects of the EU's sustainable finance strategy.

In July, the European Commission published a draft for a social taxonomy, acknowledging the need for investment in social sustainability and a just transition as well as investor demand for socially oriented investments. The suggested structure is based on two dimensions: (a) promoting adequate living standards, including improving access to products and services for basic human needs and (b) promoting positive impacts and avoiding and addressing negative impacts on affected stakeholders.

The proposal also covers sustainable corporate governance and transparent and non-aggressive tax planning. More specifically, good sustainable corporate governance includes diversity (gender, skillset, experience, background), including employee participation as well as executive remuneration linked to environmental and social factors in line with company targets.

Social washing may be greater issue than green washing

In a similar manner to the Taxonomy Regulation, the social taxonomy would identify socially sustainable sectors and activities. Widely accepted definitions or measurements of social sustainability in the context of investments currently do not exist. Social washing may be an even greater issue than green washing, as social issues are often considered qualitatively and are based on international norms, principles and goals.

The draft contains two options – expanding the existing green taxonomy into a broader sustainability taxonomy covering both social and environmental factors or developing a complementary social taxonomy connected to the environmental one through minimum safeguards. Once finalised, the social taxonomy is expected to be incorporated into legislative texts such the NFRD and CSRD. In comparison to the NFRD and CSRD which are directives requiring transposition into national law, the SFDR and the Taxonomy Regulation are immediately enforceable.

International sustainability standards are in the works

Momentum for global sustainability standards

At the global level, the IFRS Foundation earlier this year held a consultation on the demand for global sustainability standards. Considering the responses, the IFRS Foundation now intends to produce a definitive proposal and to potentially announce the establishment of a sustainability standards board at the UN Climate Change Conference COP 26 in November. While there is currently no global standard for how sustainability risks and impacts should be accounted for and reported on, there appears to be a demand and willingness for this to change.

In this report we have focused on regulatory initiatives. However, other stakeholders (e.g., investors, customers, employees) are also increasingly interested in how banks are positioned on social factors. These concerns influence a bank's reputation and its social "license" to operate, ultimately with implications for a bank's business franchise and funding costs.

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