global alliance for banking on values

Real Economy – Real Returns: The Business Case for Values-based Banking

Research on Performance through Yearend 2017

4 February 2019

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More than ten years have passed since the collapse of Lehman Brothers signified the start of the financial crisis. The impact of that crisis and the real and/or perceived lack of consequences for those responsible for the crisis continue to reverberate through our society. Increased consequences from climate change as well as financial inequality and exclusion make even more compelling the need for a financial system that supports individuals and enterprises addressing core issues facing society.

Since the financial crisis, a group of values-based banks and banking cooperatives (VBBs) have demonstrated that a holistic focus on the real economy[1] with a dedication to supporting economic, social and environmental impact delivers steady financial returns. These entities, all members of the Global Alliance for Banking on Values (GABV) operate in numerous markets, serve diverse needs, use distinct business models but share a common strategic foundation: the Principles of Values-based Banking (Appendix 1).

The call for change is echoed in a variety of initiatives as well as analysis that highlight the need to move beyond a narrow shareholder focus to a holistic stakeholder approach for our economy. Academic research[2] highlighted in The Economist[3] last November shows that corporations with a focus beyond accounting profits often deliver higher returns and have lower costs of capital. The need for radical rethinking of our economic models is supported by a variety of other studies well summarised in recent commentaries by Martin Wolf in the Financial Times[4] and David Brooks in the New York Times[5].

The recent launch of the Principles of Responsible Banking by UNEP FI[6] indicates growing interest in values-based banking by a broader group of banks. This initiative is a positive development, especially with the commitment to identify, assess and improve the impact on people and environment resulting from their activities, products and services[7]. However, greater focus on the real economy would be an improvement in these principles.

There is also increased evidence of the support for values-based banking by regulators in developing markets such as Nigeria, Malaysia, Peru and elsewhere.[8] Of specific interest is the Value-based Intermediation strategy paper by Bank Negara, the central bank of Malaysia[9].

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[1] The real economy relates to economic activities that generate goods and services as opposed to a financial economy that is concerned exclusively with activities in the financial markets.

[2] "Corporate Sustainability: First Evidence on Materiality" by Mozaffar Khan, George Serafeim, and Aaron Yoon in *The Accounting Review* 91 (6): 1697-1724. An earlier version of the paper is available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2575912; Luigi Zingales, Does Finance Benefit Society (faculty.chicagobooth.edu/luigi.zingales/papers/research/Finance.pdf).

[3] "Working for purpose", Bartleby, The Economist, 18 November 2018.

[4] "We must rethink the purpose of the corporation," Martin Wolf, Financial Times, 11 December 2018

[5] "The Remoralization of the Market," David Brooks, The New York Times, 10 January 2019.

[6] The draft Principles of Responsible Banking were released in November 2018 and are open for comment until 29 March 2019.

[7] Details on the approach can be found in the Implementation Manual for the Principles of Responsible Banking relative to Principle 2.

[8] International Finance Corporation Sustainable Banking Guidance (http://www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/IFC+Sustainability/Partnerships/Sustainable+Banking+Network/SB+Guidance+from+SBN+Members/). Central Bank of Nigeria Principles of Sustainable Banking (www.cenbank.org/out/2012/ccd/circular-nsbp.pdf)

[9] "Value-based Intermediation: Strengthening the Roles and Impact of Islamic Finance," Bank Negara, 12 March 2018.

VBBs have constantly shown that serving the real economy delivers better and more stable financial returns than those shown by the largest banks in the world. These VBBs address the very real banking needs, especially access to credit, of enterprises and individuals within their communities. The success of this banking approach is verified by independent research[10].

Since 2012 the GABV has published research comparing the results of VBBs with the largest banks in the world, the Global Systemically Important Banks (GSIBs)[11,12]. This research originally looked at financial results through year-end 2010 and is now updated through year-end 2017. It is striking that with the crisis now several years behind us, the conclusions fundamentally remain the same.

Why isn't all banking done this way?

The data are clear: the business case for values-based banking is compelling. So why aren't all banks and banking cooperatives adopting this model? The reasons are many, ranging from: inertia and the power of the *status quo*, including existing personal incentive structures; a lack of courage and innovation by banking executives and shareholders in changing course; and limited awareness of the data provided by this and the other reports cited.

However, there is growing recognition of the need for change in how banks and banking cooperatives behave and operate.[13] Over time this recognition should result in the growth of VBBs as well as increased focus on this approach by other banks and banking cooperatives within the overall financial ecosystem. There are early signs that investors are beginning to seek more stable returns from their investments in banks and banking cooperatives, where they can also verify that their capital is being used to support real economy activity creating value for society.

Research Approach

The GABV research comparing the results of VBBs with GSIBs focuses on the following key questions:

→ What support does a bank provide to the real economy?
→ How resilient is a bank in the face of economic challenges?
→ What returns does a bank provide to society, clients and investors?
→ What growth does a bank achieve to expand its impact?

This report provides the eighth update of that research and incorporates financial results through the end of 2017. The GABV research is based on publicly available financial information.

What is most striking is the consistency of conclusions over the years strongly supporting the business case for investing in and banking with VBBs that serve the real economy, and the business case for banking institutions that operate in accordance with the Principles of Values-based Banking.

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[10] How Banks Profit by Rethinking Their Business published by FSG (http://www.fsg.org/publications/banking-shared-value?srpush=true). The Effect of Ethics on Banks' Financial Results, Radek Halamka and Petr Teply (https://www.vse.cz/pep/609).

[11] Learn more at the Financial Stability website (www.financialstabilityboard.org)

[12] Listing of VBBs and GSIB Peer Groups can be found in Appendix 2.

[13] John Kay (2015), *Other People's Money: The Real Business of Finance*, Public Affairs, New York.

Results – Financial Perspective

What support does a bank provide to the real economy?

Publicly available financial information does not currently provide a fully clear distinction between bank activities in the real economy in contrast to the financial economy. Furthermore, there is limited disclosure of non-balance sheet activities that are relevant. Therefore, this research uses lending and deposit information as a proxy for the distinction between the real and the financial economy activities of banking institutions. This assumption is believed to be appropriate but one where further research would be helpful although limited by publicly available data.

The degree to which a banking institution finances the real economy is evident from the portion of assets on its balance sheet devoted to lending (Table 1). As a group, the difference between VBBs and GSIBs is striking. For VBBs the level of lending is nearly double that of GSIBs. Moreover, it remains core to their activity with over 75% of their balance sheets devoted to lending compared to just over 40% of the balance sheets of GSIBs in 2017. Even after the financial crisis of 2008, the GSIBs continued to have a substantial portion of their balance sheets focused on the financial economy, considered by many external observers to be a cause of the financial crisis.

Table 1 – Loans to Total Assets

Loans / Total Assets	2017	2012	2007
VBBs	71,8%	71,6%	70,5%
GSIBs	41,5%	38,3%	40,7%

In addition to the focus on lending, VBBs rely much more on client deposits to fund their balance sheets in comparison with GSIBs (Table 2). This reliance on deposit taking is another example of their focus on real needs of individuals and enterprises and the real economy. Furthermore, this reliance by VBBs on customer deposits reduces the liquidity risk of their funding strategies while returning to the roots of banking that intermediates between clients with excess money and those in need of money for productive investments. The research does show that GSIBs are beginning to use deposits to fund more of their balance sheet in 2017 but that funding continues to be deployed primarily in the financial economy.

Table 2 – Deposits to Total Assets

Deposits/Assets	2017	2012	2007
VBBs	73,9%	79,4%	68,5%
GSIBs	54,8%	49,2%	46,2%

How resilient is a bank in the face of economic challenges?

The capital comparisons (Chart 1) between VBBs and GSIBs over the years have reflected growing regulatory pressure on all banks and banking cooperatives but especially GSIBs to increase capital. The shifts in capital comparisons since 2008 provide evidence that this regulatory pressure has improved the resiliency of the overall banking system in case of another financial crisis.

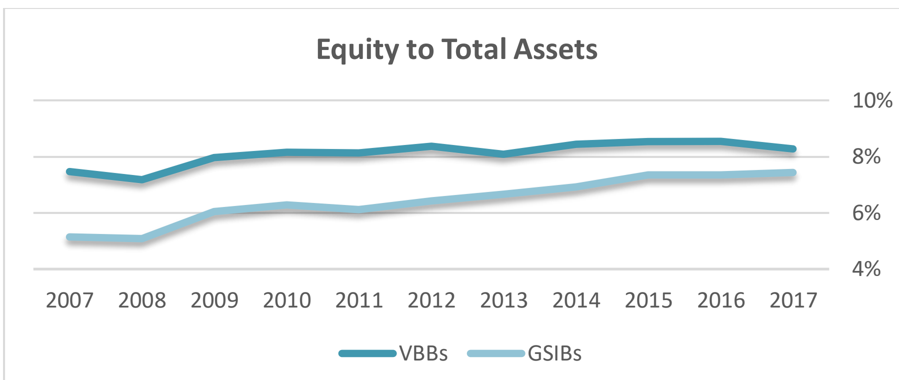
When measured by Equity/Total Assets VBBs have stronger capital positions although the gap with the GSIBs has reduced significantly from 2007 from more than 2% to under 1%. As noted in prior research, higher levels of equity held by VBBs did not reduce their appetite to lend, challenging claims by some larger banking institutions that higher equity requirements lead to less lending.

Risk-based capital measures show significantly stronger levels of capital by GSIBs since 2007.[14] One driver of this change is likely to be pressure from regulators to increase capitalisation to reduce systemic risk[15]. The GSIBs have nearly doubled this ratio whilst the VBBs have remained consistently above 12%.

In looking at Tier 1 Capital Ratios it is important to consider the impact of Risk Weighted Assets (RWA) which are used in the denominator of the ratio. The Tier 1 Capital ratios for GSIBs are significantly impacted by the relatively low level of RWAs compared to total assets, as calculated by their internal risk models. There is an ongoing discussion, led by regulators and supported by regulatory research, as to whether these calculated levels of RWAs fully capture the risks for which capital is required[16]. Therefore, the strength of the Equity/Total Assets ratios of VBBs positions them well for challenging economic conditions in contrast to GSIBs with lower levels of equity to total assets.

It should be noted that the capital positions for both GSIBs and VBBs as well as other measures of resiliency are an area for which focused research could provide further insights. Better understanding of the drivers of the changes in these ratios over time as well as sources of differences across banks would provide useful insight into the overall resiliency of the banking system.

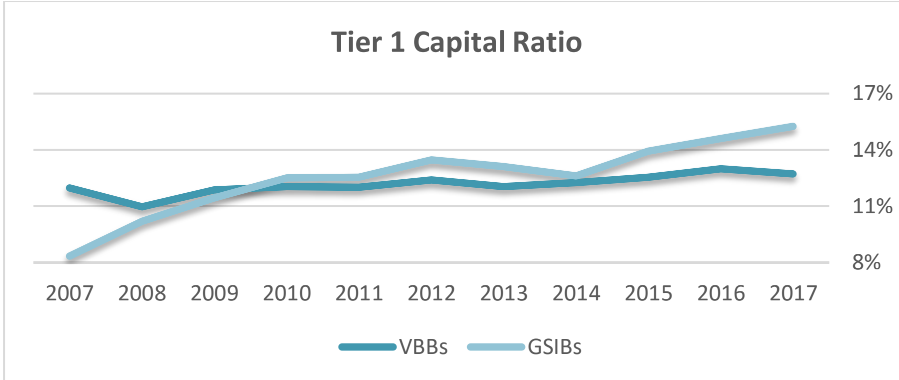
CHART 1 – Capital Comparisons



[14] Due to changes in capital regulation over the full time period, Tier 1 Ratios and RWAs/Total Assets Ratios are not fully comparable for the period of analysis.

[15] Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement, Basel Committee on Banking Supervision, July 2013. (https://www.bis.org/publ/bcbs255.pdf)

[16] The Dog and the Frisbee; Andrew Haldane, Executive Director Financial Stability, Bank of England, delivered to the Federal Reserve Bank of Kansas City Economic Policy Symposium; Jackson Hole, Wyoming, 31 August 2012 (http://www.bankofengland.co.uk/publications/Pages/speeches/2012/596.aspx). Back to Basics: A Better Alternative to Basel Capital Rules; Thomas M. Hoenig, Director, Federal Deposit Insurance Corporation, delivered to The American Banker Regulatory Symposium; Washington, D.C., 14 September 2012 (https://www.fdic.gov/news/news/speeches/chairman/spsep1412_2.html).



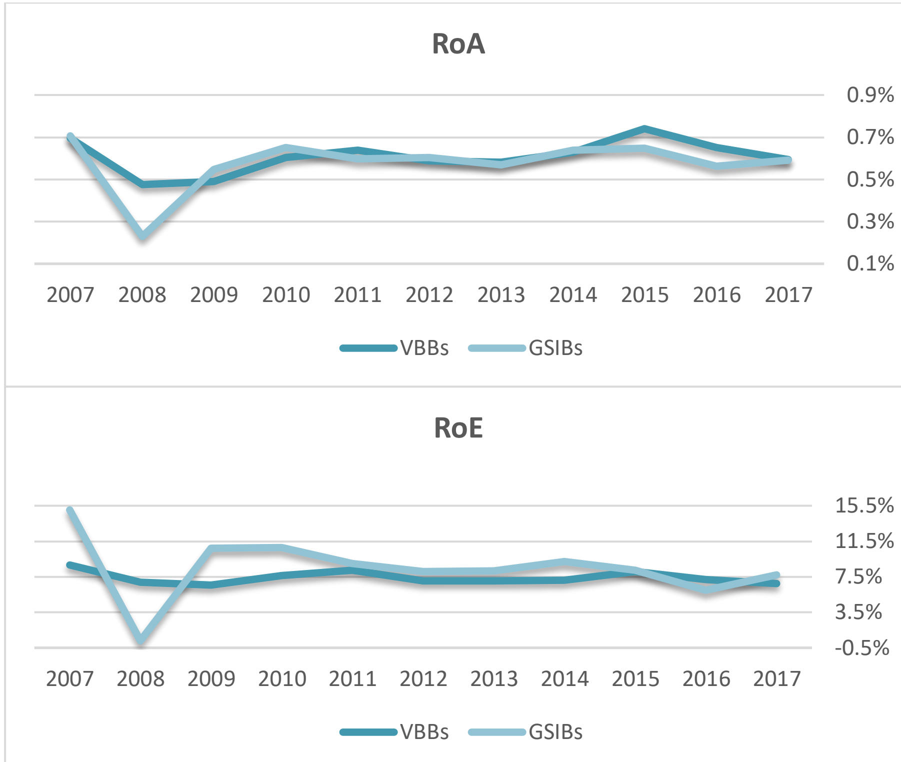
Equity / Total Assets	**2017**	**2012**	**2007**
VBBs	8,3%	8,4%	7,5%
GSIBs	7,4%	6,4%	5,2%
Tier 1 Ratio			
VBBs	12,7%	12,4%	12,0%
GSIBs	15,3%	13,5%	8,3%
RWA / Total Assets			
VBBs	57,6%	61,8%	64,4%
GSIBs	42,4%	39,3%	47,1%

What returns does a bank provide to society, clients and investors?

VBBs have historically stable Returns on Assets (ROA) with limited volatility as measured by the standard deviation of these returns (Chart 2). This volatility is greater over the 10-year period reflecting the impact on returns in the period immediately after the financial crisis. Nearly all banks and banking cooperatives faced challenges to their results increasing the volatility of their returns in the years immediately after the start of the crisis. Of interest is that VBBs continued to have higher ROAs than GSIBs over the last five years showing that returns are not negatively impacted by a focus on values-based banking rather than on maximising financial returns.

Relative to Returns on Equity (ROE) VBBs have comparable or slightly better performance over both time periods analysed. VBBs have lower volatility in both the 5-year and 10-year analyses. ROE is impacted by the level of equity capital, which is lower at the GSIBs thus implying greater risk. The combination of higher ROE and equity provides evidence that banking focused on meeting societal needs can be advantageous to investors.

CHART 2 – ROA and ROE Comparisons



Return on Assets

5y (2013-2017)	Average	St. Dev.
VBBs	0,61%	0,18%
GSIBs	0,61%	0,22%

10y (2008-2017)	Average	St. Dev.
VBBs	0,59%	0,23%
GSIBs	0,57%	0,30%

Return on Equity

5y (2013-2017)	Average	St. Dev.
VBBs	6,9%	2,0%
GSIBs	7,9%	3,1%

10y (2008-2017)	Average	St. Dev.
VBBs	7,1%	2.7%
GSIBs	7,8%	5,8%

What growth does a bank achieve to expand its impact?

The issue of growth (Chart 3) further demonstrates marked differences between the two groups. VBBs have had much higher growth in Loans, Deposits, Assets, Equity and Total Income compared to GSIBs over the periods analysed. One element driving higher growth for VBBs is their relatively smaller scale. Another element is that VBBs with a strong and long term client focus tend to have higher client loyalty and lower client attrition supporting growth. Another element is that in some markets clients are consciously choosing to move banking activities to VBBs. Further research on the sources of growth for both groups could be informative.

CHART 3 – Growth

Loans	5 years (2013-2017)	10 Years (2008-2017)
VBBs	9,9%	13,1%
GSIBs	4,1%	4,3%
Deposits		
VBBs	8,1%	12,3%
GSIBs	4,0%	5,6%
Assets		
VBBs	8,5%	11.6%
GSIBs	0,9%	2.9%
Equity		
VBBs	8,9%	12,8%
GSIBs	4,4%	8,2%
Total Income		
VBBs	6,3%	7,1%
GSIBs	0,4%	1,8%

European Challenges

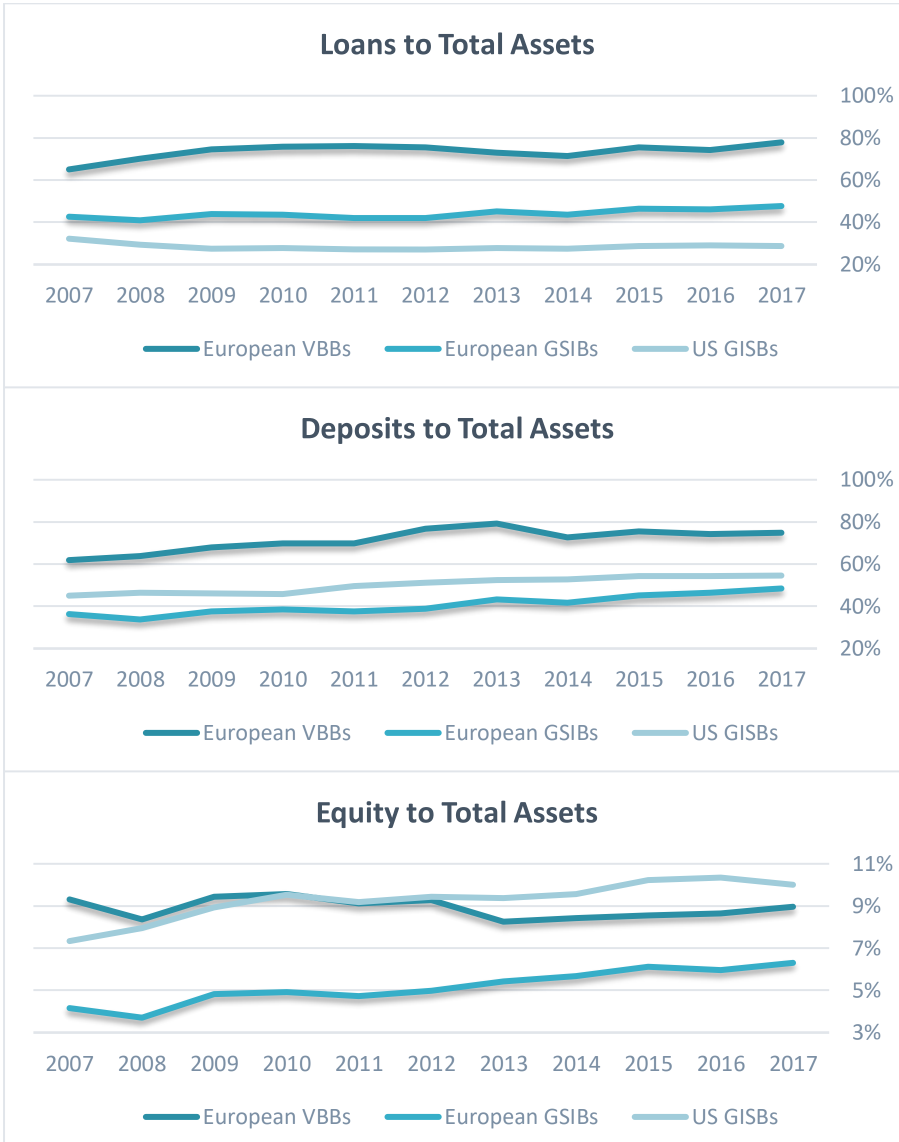
Over the past few years our research has looked in more depth at the European market (Chart 4 and Appendix 4). There are 12 VBBs and 12 GSIBs based in Europe[17]. Comparing these two groups operating with similar market conditions further highlights the strength of the values-based banking model. As shown in Chart 4, VBBs in Europe registered significantly higher levels of finance for the real economy, stronger levels of equity capital, and better levels of Return on Assets with lower volatility. They also delivered significantly stronger levels of growth over the period of analysis especially post-2008 when the crisis became evident.

The challenges facing European GSIBs and their ability to meet the needs of the European real economy is further illustrated by comparison with US GSIBs. Such comparisons are complicated by differences in accounting rules, especially relating to the balance sheet impact of derivative portfolios as detailed in the Federal Deposit Insurance Corporation Global Capital Index calculated as of yearend 2017[18]. This analysis showed that on a comparable IFRS basis, US GSIBs would have just over 17% higher assets than reported under US GAAP. Nevertheless, the US GSIBs show both strong capital and earnings making them formidable competitors for the European GSIBs as well as potential sources of strength to the US economy.

[17] Full comparison details of European VBBs and European and US GSIBs (Appendix 3).

[18] "Global Capital Index: Capitalization Ratios for Globally Systemically Important Bans (GSIBs)," Federal Deposit Insurance Corporation.

Chart 4 – European Comparison Graphs



Research Opportunities

The GABV research has over the years shown that financial returns have not been reduced through a focus on the real economy and banking models driven by supporting individuals and enterprises creating societal value. As noted above, the overall positive returns of sustainability focused enterprises have been demonstrated in a recently published study.[19] That study covers a variety of sectors but more than 25% of the entities covered are in financial services.

A more detailed review of the banks and banking cooperatives within the financial services sector of that study would provide further insight into the impact of a values-based approach on financial returns. This research could assess if Environmental, Social and Governance (ESG) factors identified as material by the Sustainability Accounting Standards Board (SASB) are associated with banks' financial performance and valuation multiples. The GABV is sponsoring this study with other thought leaders in improving the financial system to further build the business case for values-based banking with the results anticipated to be released in 2019.

As noted above additional research into capital and resiliency as well as sources of growth would further understanding of the differences between VBBs and GSIBs. These topics are beyond the current research resources but provide areas for future expansion of this research.

Conclusions

VBBs continue to demonstrate steady financial returns and growth with a strong focus on the real economy built on solid capital positions. These entities support the intermediation of money to individuals and enterprises that deliver economic, social and environmental impact. They operate in numerous markets, serving diverse needs, using distinct business models but are united by a set of common guidelines, the Principles of Values-based Banking. Detailed information on their work can be found here.

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[19] "Corporate Sustainability: First Evidence on Materiality" by Mozaffar Khan, George Serafeim, and Aaron Yoon in *The Accounting Review* 91 (6): 1697-1724. An earlier version of the paper is available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2575912.

Appendix 1 Principles of Values-based Banking

Principle 1. Triple bottom line approach at the heart of the business model.

Values-based banks integrate this approach by focusing simultaneously on people, planet and prosperity. Products and services are designed and developed to meet the needs of people and safeguard the environment. Generating reasonable profit is recognized as an essential requirement of values-based banking but is not a stand-alone objective. Importantly, values-based banks embrace an intentional approach to triple-bottom-line business – they don't just avoid doing harm, they actively use finance to do good.

Principle 2. Grounded in communities, serving the real economy and enabling new business models to meet the needs of both.

Values-based banks serve the communities in which they work. They meet the financial needs of these geographic and sector-based communities by financing enterprises and individuals in productive and sustainable economies.

Principle 3. Long-term relationships with clients and a direct understanding of their economic activities and the risks involved.

Values-based banks establish strong relationships with their clients and are directly involved in understanding and analysing their economic activities and assisting them to become more values-based themselves. Proper risk analysis is used at product origination so that indirect risk management tools are neither adopted as a substitute for fundamental analysis nor traded for their own sake.

Principle 4. Long-term, self-sustaining, and resilient to outside disruptions.

Values-based banks adopt a long-term perspective to make sure they can maintain their operations and be resilient in the face of external disruptions. At the same time, they recognize that no bank, or its clients, is entirely immune to such disruptions.

Principle 5. Transparent and inclusive governance.

Values-based banks maintain a high degree of transparency and inclusiveness in governance and reporting. In this context, inclusiveness means an active relationship with a bank's extended stakeholder community, and not only its shareholders or management.

Principle 6. All of these principles embedded in the culture of the bank.

Values-based banks seek to embed these principles in the culture of their institutions so that they are routinely used in decision-making at all levels. Recognizing that the process of embedding these values requires deliberate effort, these banks develop human resources policies that reflect their values-based approach (including innovative incentive and evaluation systems for staff), and develop stakeholder-oriented practices to encourage values-based business models. These banks also have specific reporting frameworks to demonstrate their financial and non- financial impact.

Appendix 2 Listing of Peer Groups as of 31 December 2016

Global Systemically Important Banks (GSIBs)

1. Agricultural Bank of China
2. Bank of America`
3. Bank of China
4. Bank of New York Mellon`
5. Barclays^
6. BNP Paribas^
7. China Construction Bank
8. Citigroup`
9. Credit Suisse^
10. Deutsche Bank^
11. Goldman Sachs`
12. Group Crédit Agricole^
13. HSBC^
14. Industrial and Commercial Bank of China
15. ING Bank^
16. JP Morgan Chase`
17. Mitsubishi UFJ FG
18. Mizuho FG
19. Morgan Stanley`
20. Nordea^
21. Royal Bank of Scotland^
22. Royal Bank of Canada
23. Santander^
24. Société Générale^
25. Standard Chartered`
26. State Street`
27. Sumitomo Mitsui FG
28. UBS^
29. Unicredit Group^
30. Wells Fargo`

Royal Bank of Canada was included for 2017 and Group BPCE was removed for 2017 in comparison with the list for 2016 yearend.

Values-based Banks and Banking Cooperatives (VBBs)

1. Alternative Bank Schweiz^
2. Amalgamated Bank New York
3. Banca Popolare Etica^
4. Banco Ademi
5. Banco Solidario*
6. BancoFie
7. BancoSol
8. Banfondesa*
9. Bank Australia
10. Bank Muamalat
11. Bank of Palestine
12. Beneficial State Bank
13. BRAC Bank
14. Caisse d'Économie Solidaire Desjardins
15. Caja Arequipa*
16. Centenary Bank*
17. City First Bank
18. Cooperativa Abaco
19. Cultura Bank^
20. Ecology Building Society^
21. Ekobanken^
22. First Green Bank*
23. First Microfinance Bank Afghanistan
24. First Microfinance Bank Tajikistan
25. Freie Gemeinschaft Bank Schweiz^
26. GLS Bank^
27. Group Crédit Coopératif^
28. Kindred Credit Union
29. Lapo Microfinance Bank*
30. Magnet Bank*^
31. Merkur Cooperative Bank^
32. Missoula Federal Credit Union
33. New Resource Bank*
34. NMB Bank Limited
35. Opportunity Bank Serbia^
36. SAC Apoyo Integral
37. Southern Bancorp
38. Sunrise Community Banks
39. Triodos Bank^
40. Vancity
41. Verity Credit Union
42. Vermont State Employees Credit Union
43. Vision Banco*
44. XacBank

* These banks and banking cooperatives did not have financial history for the full period covered for a variety of reasons including conversion to banks from micro-finance organisations as well as being *de novo* banks. The data for these banks was included in the analysis for all available years.

^Banks included in in the European analysis

` Banks part of the US subset in the European analysis

Appendix 3 Financial Comparisons

All Peer Groups

	2017		2012		2007	
Real Economy	VBBs	GSIBs	VBBs	GSIBs	VBBs	GSIBs

Loans/Assets	71,8%	41,5%	71,6%	38,3%	70,5%	40,7%
Deposits/Assets	73,9%	54,8%	79,4%	49,2%	68,5%	46,2%
Capital strength						
Equity/Assets	8,3%	7,4%	8,4%	6,4%	7,5%	5,2%
Tier1 Ratio	12,7%	15,3%	12,4%	13,5%	12,0%	8,3%
RWAs/Total Assets	57,6%	42,4%	61,8%	39,3%	64,4%	47,1%

Financial Returns and Volatility	**5y (2013-2017)**		**10y (2008-2017)**	
	VBBs	GSIBs	VBBs	GSIBs
Return on Assets	0,63%	0,61%	0,64%	0,57%
Return on Assets - Standard Deviation	0,23%	0,22%	0,76%	0,30%
Return on Equity	7,1%	7,9%	7,4%	7,8%
Return on Equity - Standard Deviation	2,5%	3,1%	12,1%	5,8%

Compound Annual Growth Rates	**5y (2013-2017)**		**10y (2008-2017)**	
	VBBs	GSIBs	VBBs	GSIBs
Loans	9,9%	4,1%	13,1%	4,3%
Deposits	8,1%	4,0%	12,3%	5,6%
Assets	8,5%	0,9%	11,6%	2,9%
Equity	8,9%	4,4%	12,8%	8,2%
Total Income	6,3%	0,4%	7,1%	1,8%

Appendix 4 European Comparison

European Peers Comparison

	2017			2012			2007		
	European VBBs	European GSIBs	US GSIBs	European VBBs	European GSIBs	US GSIBs	European VBBs	European GSIBs	US GSIBs
Real Economy									
Loans/Assets	77,9%	47,7%	28,8%	75,4%	42,0%	27,1%	65,1%	42,8%	32,2%
Deposits/Assets	75,0%	48,5%	54,6%	76,7%	38,9%	51,2%	61,9%	36,3%	45,1%
Capital Strength									
Equity/Assets	9,0%	6,3%	10,0%	9,3%	5,0%	9,4%	9,3%	4,2%	7,3%
Tier 1 Ratio	14,5%	16,7%	14,7%	12,0%	13,9%	14,6%	12,1%	8,1%	6,6%
RWAs/Total Assets	59,6%	33,2%	53,9%	70,1%	31,4%	47,7%	85,6%	37,5%	49,0%

Financial Returns and Volatility	5y (2013-2017)			10y (2008-2017)		
	European VBBs	European GSIBs	US GSIBs	European VBBs	European GSIBs	US GSIBs
Return on Assets	0,31%	0,34%	0,77%	0,29%	0,33%	0,69%
Return on Assets - Standard Deviation	0,09%	0,30%	0,20%	0,10%	0,32%	0,34%
Return on Equity	3,6%	3,9%	8,4%	3,3%	3,6%	7,9%
Return on Equity - Standard Deviation	1,2%	4,0%	2,0%	1,2%	7,3%	4,0%

Compound Annual Growth Rates	5y (2013-2017)			10y (2008-2017)		
	European VBBs	European GSIBs	US GSIBs	European VBBs	European GSIBs	US GSIBs
Loans	9,5%	-0,3%	7,6%	14,8%	0,8%	5,5%
Deposits	7,7%	2,1%	3,9%	13,6%	2,4%	7,5%
Assets	8,5%	-3,3%	1,4%	12,7%	-1,4%	3,8%
Equity	8,5%	1,7%	2,6%	13,7%	3,6%	8,0%
Total Revenues	5,2%	-2,0%	0,9%	10,2%	-1,5%	2,5%

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#bankingonvalues
The Global Alliance for Banking on Values is an independent network of banks and banking cooperatives with a shared mission to use finance to deliver sustainable economic, social and environmental development.