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Global Asset Management

ESG divergence unveils banking sector opportunities

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ESG factors have always been present in banking regulation, but never before have they been so influential. Evolving market and regulatory demands are going to create a very differentiated sector, which we believe will generate significant investment opportunities.

With the global shift of ESG considerations from added extra to mainstream influence, their impact on banking regulation is growing. As active bond investors within the sector, we're seeing ESG factors create investment opportunities, and with them comes the potential for alpha generation.

There are multiple factors at play in the growth of ESG considerations. The increased recognition of climate crisis risks and the need to finance decarbonisation efforts are a big part of this trend. So is reputational risk – that being the negative consequences banks face if their actions don't measure up to their ESG pledges.

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But perhaps most importantly, banks are the main conduits of credit into the economy and a key lever that policymakers can use to influence sustainability policies. That's why ESG has always had an impact on banking regulation, and why ESG factors today are a key indicator of good banking practice.

Under pressure

Financial institutions have already made significant strides in response to market pressure, with the majority of banks developing ESG strategies and almost all leading banks having now signed up to achieve net-zero by 2050.

In terms of policymaker leverage – climate stress testing exercises are due to commence this year, with qualitative incorporation of the results into banks' capital requirements. As this pressure builds, we expect to see a system of capital relief develop for 'green' assets and charges for 'brown' ones, with banks being forced to provide more context around their sustainability plans or face regulatory consequences.

The investment opportunity

Pressure from other stakeholders is also increasing exponentially, probably at a faster rate than the demands of the regulator. However, in our view, historic criticism regarding banks' lack of commitment to ESG policies is outdated.

In some cases, criticism is warranted – grand pledges have been made and it is not clear how these will be achieved. However, developing robust policies while continuing to serve clients is a hugely complex task.

In the vast majority of cases, we see clear management commitment to be on the front foot in developing and implementing robust ESG strategies. Not only are investors demanding it, but it's a significant revenue opportunity for the sector that cannot be ignored.

Evolving market and regulatory demands are going to create a very differentiated sector, which in turn should generate significant investment opportunities. A simple approach to harnessing these would be to avoid those banks exposed to certain 'non-ESG' sectors, but we see this as rather blunt and backward-looking.

Direction of travel trumps starting point

We are firm believers in focusing on the trajectory of travel rather than looking in the rear-view mirror. A bank that's fortunate enough not to be exposed to legacy industries and practices will have much less of an impact than one with large exposures, but which is fully committed to helping its customers transition and begin a new journey. We believe that the successful banks will be those that develop thoughtful ESG strategies and that execute on these plans, rather than those with the cleanest starting point.

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Not only are banks poised to benefit from revenue generation by helping their customers transition and from developing ESG products for their clients, they are increasingly, in our view, leading in terms of their own strategies and commitments.

While we expect the sector to broadly benefit from this rising tide, we have long-viewed ESG analysis as adding a valuable layer to our active management approach and our ability to generate alpha. Given the changes we have observed both internally from management and externally from the regulator through 2021, we are confident they will continue to pay dividends and create investable opportunities.

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