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Reconsidering the banks sector

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Overview

Banks have been held widely in the credit side of our sustainable strategies, and selectively on the equity side, for the entirety of their history, reflecting the role that products such as mortgages, current accounts and savings play in society. The global financial crisis of 2008 was the low point for environmental, social and governance (ESG) performance of the sector, but since then it has improved with the most recent development being much better disclosure and policies around loan books and lending.

There is a possibility that the macroeconomic environment is changing compared to recent years, with structurally higher inflation and interest rates. This, alongside more attractive financial characteristics for equity investors, has led us to increase our exposure in line with the changing output from our research process.

The changing macroeconomic paradigm

The macroeconomic outlook for the rest of 2023 and beyond remains distinctly uncertain. Recent data have been more benign than expected, with lower inflation and more resilient growth, albeit with the exception of the UK, where inflation remains very high. This suggests that interest rates are at or close to their peak, but there are still risks that the interest rate increases to date will impact growth and even cause a recession.

Otherwise, there is a credible case to be made that inflation – and therefore interest rates – will be structurally higher than over the last 10 years, something which would benefit the profitability of the banking sector. More expensive energy, labour and capital (debt and equity) mixed in with observable de-globalisation will remove many of the disinflationary forces that have been acting on the global economy for so long. Between 2008 and 2021, each fall in asset prices was met with interest rate reductions and significant amounts of quantitative easing.

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Last year was the first year when this began to feed through to higher inflation – and arguably unsustainable asset prices. It may be that rather than providing a floor to asset prices in the coming years, central banks will be the ceiling, having to increase interest rates in the face of higher inflation, rather than cut them into falling inflation as has been the norm over the last 15 years.

The banks sector today

Our long-established sustainable investment process has two distinct elements. Sustainability always comes first for us, so we need to be convinced of this aspect of anything new that we invest in. In addition, on a financial basis, we want to see value creation and the potential for long-term growth as we think these are the key long-term drivers of investment returns.

From a sustainability perspective, the banking sector has been on an improving path for over a decade following the global financial crisis. Governance improved first, followed by social aspects, with products becoming simpler and somewhat more aligned with societal needs. Finally, environmental performance is improving as better disclosure on financed emissions and clearer policies on future lending are made. We would certainly score this sector higher from a sustainability perspective than at any time in the last decade.

Financially, the low interest rate environment since 2008/9 has been materially detrimental to bank profitability, and most banks have failed to meet their cost of capital in recent years. We think this could change. Equally banks can price their capital more attractively now as other sources of lending, such as bond markets (and, indirectly, central banks), become less favourable. We also think banks have a fundamental role to play in financing the huge amounts of capital investment needed to transition to a more sustainable society, which can provide interesting avenues for growth. Financially, therefore, the sector looks more attractive than for some time.

Ongoing sustainability issues

The widespread unpopularity of banks in the aftermath of the global financial crisis has led to challenges that continue to affect the sector. In particular, the sector is often criticised in the UK for branch closures and the availability of free cashpoints. This was even exploited by mutually-owned building society Nationwide, which very publicly put branch closures on hold for a multi-year period. Although it has closed more

branches since this ended, Nationwide has only closed c. 5% of its branches compared to c. 30% for the industry as a whole (Nationwide boss takes aim at rivals over bank branch closures (cityam.com)).

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Financial inclusion is a very important issue for sustainable investment, whether it relates to the provision of services to elderly or disadvantaged customers in the UK, or underbanked communities in developing economies. And, following the bailouts in 2008/9, it's easy to understand how the public feels that it has a stake in the sector. Nonetheless, while banking is an important service, the banks have made considerable efforts with this, through arrangements with the Post Office or mobile banks that visit small communities each week.

Furthermore, basic banking services in the UK are generally provided free-of-charge, including cash machines. Within reason, given the huge technological shift to online banking and mobile apps – and the commensurate decline in branch footfall (according to NatWest, 88% of retail customer needs are now met digitally and over 60% of retail customers are now digital only), it would be ridiculous to expect banks to maintain in full branch networks that reflect pre-digital customer needs.

Summary

We believe that the prevailing investment environment could be somewhat different over the next few years compared to the previous five to ten years. We could be wrong, but it is prudent to consider the possibility and gently reposition our sustainable equity portfolios accordingly. The changes are relatively modest as we will still be inclined towards areas such as engineering, chemistry, technology and healthcare, but we are diversifying towards other areas of potential investment returns.

In a higher inflation, higher interest rate environment, we believe that banks should deliver better financial returns. We are aware of the perceptions of this sector, which for some years have been somewhat negative from a sustainability perspective. However, with their hard-won sustainability improvements – whether related to governance, social values or the impact of lending on the environment – the sector is more investable for sustainable funds.

Banks are also exposed to the economic cycle, around which there are some understandable concerns. It is our role, however, to assess and think about change and that is what we are currently doing in this area. This this has been and will continue to be done in coordination with our external advisory committee. Ultimately, any investment we make must be through our rigorous process, and the banking sector is no different.

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