Searching for the Value of Sustainability in Financial Services

Panos Ch. Vlamis
Andreas C. Soteriou
Stavros A. Zenios

Department of Public and Business Administration
School of Economics and Management
University of Cyprus
Nicosia, CYPRUS

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Outline

- Motivation and Background
  Do Sustainability Practices matter in FIs?
- Theoretical premises
- Sustainability vs Financial Performance
  Empirical Evidence in FIs
  - Portfolio Comparison
- Conceptual Model
- Discussion and Concluding Remarks
Motivation

- Financial services under constant pressure to improve competitiveness
  - stringent market conditions
  - competitive pressures
  - A VERY demanding customer!

- What are the drivers of performance? How can we improve performance?
  - Technology, processes, human-resource management, quality, etc.
  - The focus of our research team’s efforts
Motivation (cont.)

Firm capabilities (resource-based-view of the firm)

- Quality practices
- Operations
  - people
  - technology
  - process/product design and management etc
- Sustainability practices

(Sustainable) Performance outcomes
- customer satisfaction
- loyalty
- delight
- market performance
- profitability/financial performance

Links:
- Link I
- Link II
- Link III
- Link IV
Motivation (cont.)

- **Sustainability**: maintain aggregate stocks of natural and manufactured capital constant over time
- Internal issues (business processes within FIs) – external issues (products)
- An increasing number of FIs are beginning to realise the importance of sustainability
  
  **Witnessed by**
  - Increasing popularity of green products, environmental reporting, ISO 14000 standards
  - UNEP initiative, Equator principles

- **Sustainability indices**
  - FTSE4Good, Dow Jones Sustainability Index
  - Truck the performance of firms with social and environmental criteria

**Limitations**: Mainly non-financial firms
- Cumulative returns only – risk in not taken into consideration
Theoretical underpinnings: sustainability and performance

• Traditionalist hypothesis (Walley and Whitehead, 1994)
  • Environmental Performance improvements are assumed to have decreasing marginal net benefits and increasing marginal costs

• Revisionist hypothesis (Schmidheiny, 1992; Porter, 1991)
  • Any improvement in environmental performance improves economic performance

• Combination of the two (Wagner, 2000)
  • Concave relationship between environmental performance and economic performance
Theoretical underpinnings: sustainability and performance

- **Distinctive nature of services products**
  - Presence of (environmentally sensitive) customer in the system
  - Simultaneity of service production and consumption
  - Value of services
- **Degree of use of environmental management practices** positively related to market performance through the mediating effect of customer satisfaction and loyalty

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**Service Profit Chain (Heskett et al, 1994, 1997)**

- Service Delivery System Operating Strategy
- External service quality satisfaction, and loyalty
- Profitability, Revenue Growth

**Greening the service profit chain (Kassinis and Soteriou, 2003)**

- Hospitality industry

**Environmental Management Practices**

- Internal service quality
- Employee satisfaction
- Employee retention
- Employee productivity
- Service value

**External Service Quality**

- Market Performance
Sustainability and performance – empirical evidence

- Several studies on the link of environmental practices and firm performance
  - Mutual ethical funds were found to underperform the S&P 500 nominally and risk adjusted (White, 1991)
  - Cohen et al (1995) attribute White’s results to poor fund management
  - Numerous studies find negative correlation between performance and poor environmental management (emissions, waste leaks and spills etc)
  - Strong environmental management linked to improved perceived future financial performance (Klassen and McLaughlin, 1996)
  - Firms with formal EMS witness critical positive impact on many dimensions of operations management (Melnyk, Sroufe and Calantone, 2003)

Limitations: Focus on manufacturing firms

Question: Does the market reward sustainability efforts in the financial services industry?
Data Used in Empirical Study

- **Test group:**
  - Financial Institutions that publish environmental reports

- **Control groups:**
  - FTSE 100
  - DAX 30
  - CAC 40
  - Swiss Performance Index

- **Portfolio Comparison**
  - Add institution in the portfolio 5 years prior the first publication of environmental report
Portfolio Performance

Equally Weighted Portfolio

Strategy  FTSE100  DAX 30  SWiSS  CAC 40
Portfolio Comparison

Value Weighted Portfolio

Strategy  FTSE100  DAX 30  SWiSS  CAC 40

EUMOptFin3 - The Drivers of Performance of Financial Institutions

May 17-21 2004
## Portfolio Performance Equally Weighted

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<tr>
<th>Portfolio</th>
<th>Y-6 to Y+3</th>
<th>Y-6 to Y-1</th>
<th>Y0 to Y+3</th>
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<td>Mean Return</td>
<td>Sharpe Ratio</td>
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<td>Portfolio</td>
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## Portfolio Performance Value Weighted

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Financial Performance

Value Weighted Portfolio

- Strategy
- FTSE100
- DAX 30
- SWiSS
- CAC 40

Jan-88 to Jan-04
Financial Performance

Borrowing at the risk free and investing in the portfolio

-20 -10 0 10 20 30 40 50

83 89 90 91 92 93 94 95 96 97 98 99 00 01 02 03 04

Strategy FTSE100 DAC 30 SWISS CAC40
Conceptual Model

- Environmental Management improves financial performance directly and indirectly
  
  **Directly**
  - Minimise /control financial risks
  - Enhance product range
  - Minimise operating costs

- Indirectly
  - Improve corporate image and enhance community role
  - Improve quality of services

- Environmental management encompasses the issues of satisfaction and loyalty
  - Focus on the whole picture
  - Stakeholder satisfaction
Direct Impact on Financial Performance

- Minimise operating costs
  - Energy savings
  - Recycling
  - Use of environmentally sound materials
- Minimise Credit risk arising from environmental issues
- Enhance product range
  - Ethical funds
  - Environmental consulting
  - Sustainable projects
  - Green loans
  - Kyoto protocol
Improving Image

- Increased sensitivity regarding environmental issues
  - Role of banks in project funding
- Banks exhibiting strong commitment in sustainability will gain in terms of image and brand recognition
  - Word of mouth
  - Case of Co-Operative Bank
- Communication practices
  - Seminars, workshops, campaigns etc
  - Environmental reporting
Improving employee satisfaction levels

- Participating in the process
  - Feelings of contribution
  - Employee morale
- Positive effect on employee satisfaction and consequently on employee loyalty
  - Retention rates
  - Willingness to recommend
- Feedback effect
- Internal communication practices (Chinander, 2001)
Improving Customer Satisfaction levels

- Lenders
  - mainly households
    More sensitive to environmental issues
- Borrowers
  - Corporations
  - Ventures
    Trade off between environmental performance and economic performance
Improving External Stakeholder Satisfaction

- External Stakeholders
  - Government
  - Environmental and social groups
- Pressure FIs to contribute in environmental preservation efforts
- Environmental management will
  - Put FIs a step ahead of regulation
  - Enhance relationship with external stakeholders
  - Enhance bank image
  - Create competitive advantage (Delmas, 2001)
- Communication practices
Ongoing Research

- Major data selection effort that focus on Banking Industry in Europe
- Target population
  - UK, Switzerland, Germany, France, Netherlands, Italy, Sweden, Greece, Belgium, Denmark
- Survey instrument
  - Market Performance measures
    - Growth in profits, revenues, and market share
    - Managers asked to rate relative to firm expectations and industry average
  - Environmental Management Practices measures
    - Drawn from SBA and VfU guidelines as well as existing literature
    - Managers asked to rate relative to firm expectations and industry average
  - Stakeholder satisfaction and loyalty measures
    - Drawn from existing literature
- Test conceptual models using Structural Equation Modeling
Concluding remarks

- Evidence on the relationship between sustainability and financial performance in the financial services industry.
- Care must be exercised when investigating this relationship
  - Looking at returns alone may not be enough!
- So sustainability pays...the next step:
  - development of performance frameworks that are specific to the financial services industry.
  - Pan-European study to investigate the impact of quality practices, risk management practices, sustainability and e-banking as well as their synergies on performance