Summary Report:
BANKS

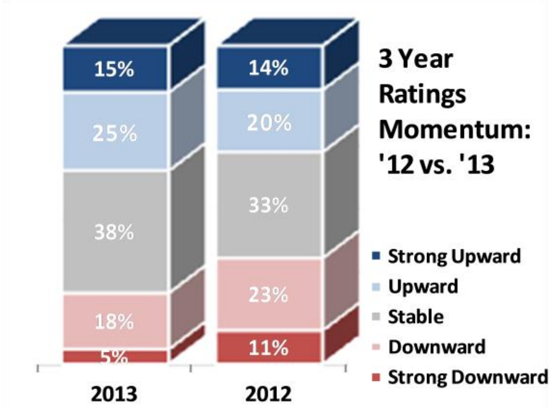
Banks Sector Watch

- **BANKS TAKE MORE ENVIRONMENTAL RISK THAN THE ECONOMIES IN WHICH THEY LEND**
  - *E-risk in lending continues to retract globally, coinciding with growing strength in E-risk management strategies. However, certain banks are making strategic choices to take on broad environmental risk in excess of the economies to which they lend.*
- **DESPITE CREDIT BUBBLE FEARS, SOCIAL RISK LOANS REMAIN UNRESERVED**
  - *Australian banks are grossly under-reserved should interest rates and immigrant migration patterns change, and the debt bubble in Scandinavia is of considerable immediate concern.*
- **NON COMPENSATION BENEFITS CORRELATE TO INCREASED EQUITY GENERATION**
  - *Banks outperforming regional peers for employee engagement, training, and benefits strategies generated more equity per dollar spent and spent less per employee in the last three years.*
- **DISTRIBUTION INNOVATION CORE TO MOVING OUT OF SATURATED MARKETS**
  - *Banks innovating in distribution networks grew SME lending more than 8% YoY, and mobile penetration is a necessity given the entry of technology firms into traditional financial services.*
- **PROVISIONING FOR LEGAL COSTS LIKELY TO INCREASE**
  - *We found a "fine cost curve" to estimate possible legal costs going forward.*

Company Highlights

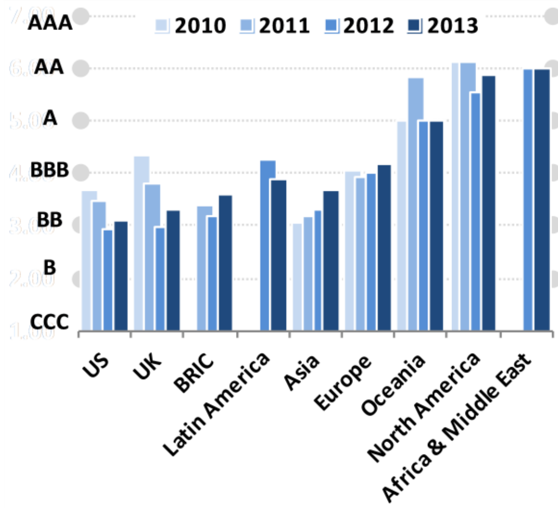
- **DANSKE BANK:** Highest growth in ESG high risk lending since 2011 – 24% of total loans pose ESG risk (includes interest-only loans in Denmark where disposable income to credit has grown 280% since 2008)
- **SBERBANK:** Nearly 50% of loans face environmental risk and the lack of cogent environmental risk management strategies and drops in loan interest rates suggest potentially lost yield to compensate.
- **BANK OF CHINA:** More than 7,000 wealth management products tied to shadow banking issued since 2011 with maturities due in 2014 and 2015 and defaults likely.
- **BARCLAYS AFRICA GROUP:** Strong innovation in distribution networks and higher than average concentration on countries with mobile telecommunication infrastructure.
- **SUNTRUST BANK:** Poorer than peer average human capital programs are likely contributing to slow equity growth despite growing compensation costs.
- **CITIGROUP:** Estimate 4% of 2013 equity in fines outstanding excluding BanaMex, with regulatory scrutiny patterns similar to JPMorgan pre-London Whale.
- **BANCOLOMBIA:** Potential for shareholder targeting with multiple governance concerns and top shareholders are domiciled in nations where the average board is 50% independent to 30% at Bancolombia.

Sector Ratings Momentum



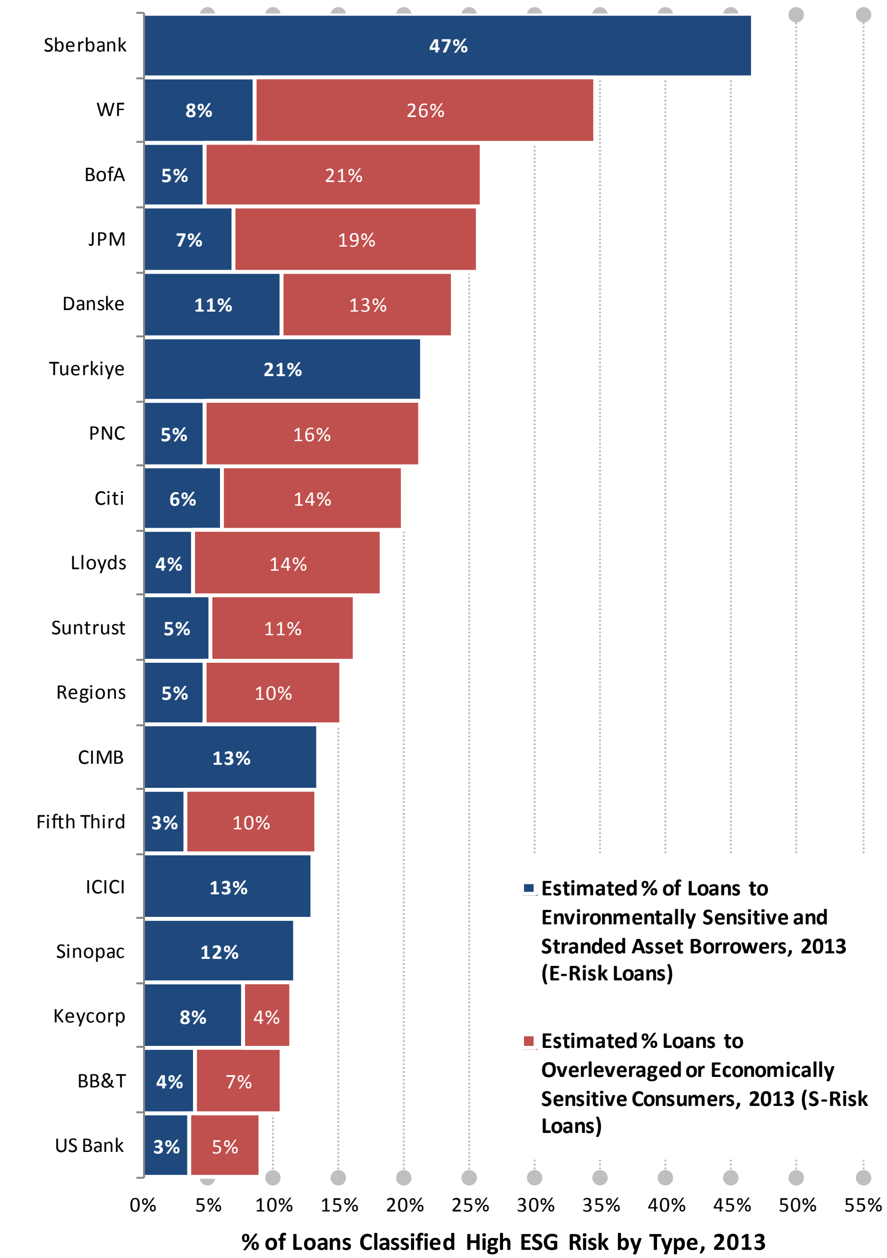
Compared to 2012, sector-wide ratings shifts in 2013 have largely been a squeeze to the middle, as top performers have remained relatively static and bottom performers have steadily made up ground.

Regional Ratings Performance



In 2013, US banks are bottom performers on average. and Canadian and Australian rank at the top.

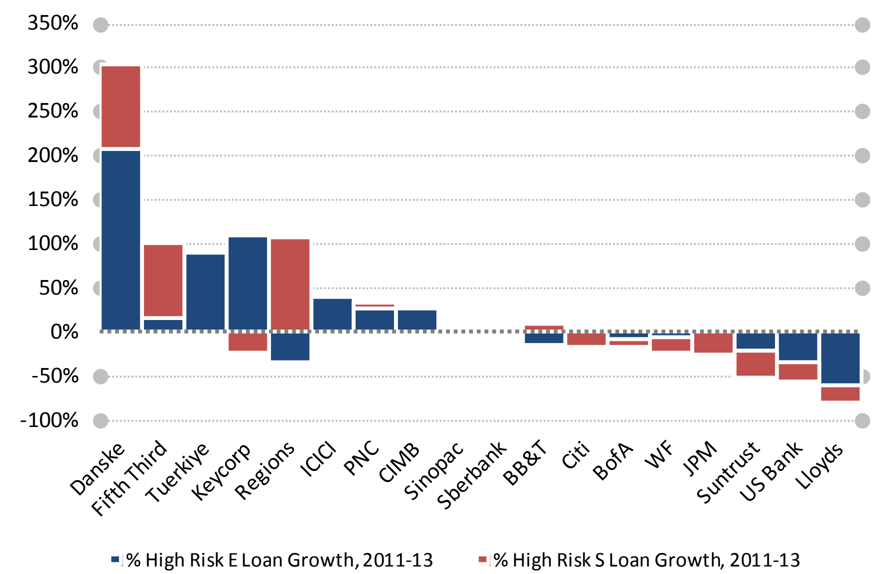
FIGURE 1 **ESG Lending Watch List, 2013**



ESG IN LOAN PORTFOLIOS

By focusing on which banks have high ESG-risk lending growth, loan loss reserve contraction, yield contractions, and poor ESG risk management, we identified banks who are unlikely to be pricing in ESG risk to lending decisions (figure x). We also noted the three year growth rate trends at for banks meeting this criteria, with **Danske Bank** as the group outlier (see figure 2).

FIGURE 2 **ESG Lending Risk 3 Year Growth Rates, 11-13**

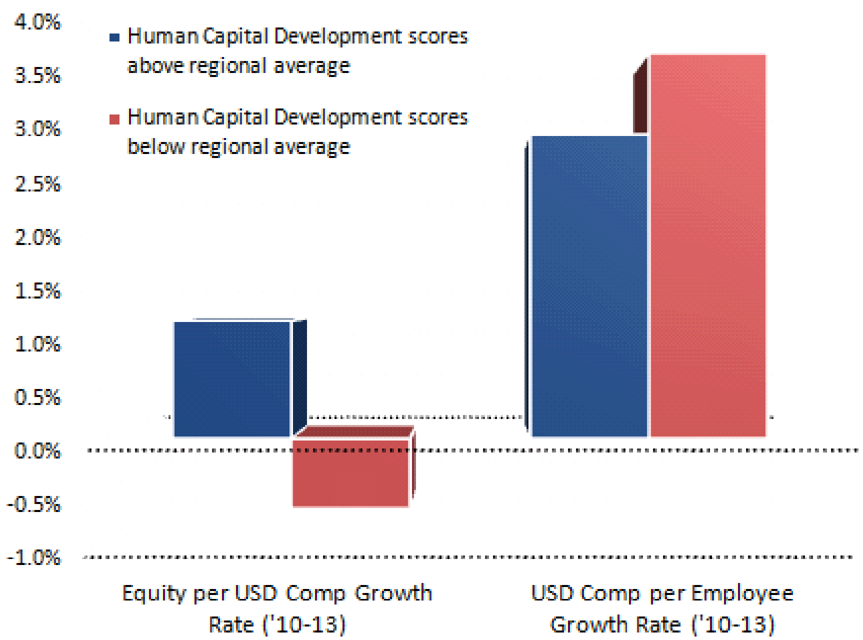


From an environmental perspective, Japanese banks had the highest growth rates in exposure correlating to lending shifts in the post-nuclear Japan. However, **Sberbank** was a large outlier with nearly half of lending estimated to have environmental risk attached. In terms of retail lending, the **US** banks continue to resolve legacy issues, and we noted burgeoning issues in **Australian**, **Swedish**, and **Danish** markets. **Westpac** stands out for Australian banks with the largest proportion of interest-only loans, while **Swedbank** is a clear Scandinavian outlier with more than 75% growth in social risk loans since 2011 coinciding with a 35% drop in loan loss reserves. In China, we reviewed bank issuances of WMPS given burgeoning consumer issues and **Bank of China** and **CITIC Bank** were most exposed to potential consumer issues.

MAXIMIZING EMPLOYEE EFFICIENCY

We found strong cross sub-sector correlations in our data between non-compensation human capital management strategies (including benefits, work/life balance, career development and training, and consistent monitoring of employee engagement captured) and equity generation. Across the Banks, above average performers in our human capital metrics saw higher rates of equity generated per USD compensation growth and lower compensation per employee growth (figure x).

FIGURE 3 **Equity Efficiency and Compensation Growth, Strong Performers vs. Weak Performers, 2010-13**

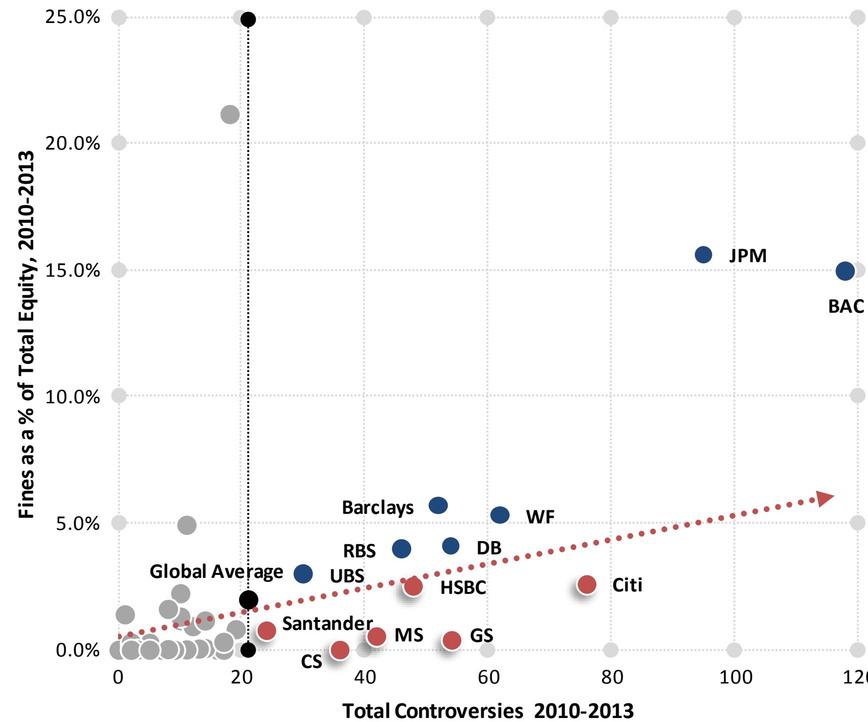


Source: MSCI ESG Research, SNL

REGULATORY MANAGEMENT AND BANK FINES

By using the "expected fine curve," derived from our database of bank fines since 2008 and controversial bank activity, we estimate that **Citigroup** has an "unpaid" balance of more than USD 12 billion, equal to 3.4% of average shareholder equity in the last three years.

FIGURE 4 **Fines Paid in Equity v. Controversy, 2010-13**



Source: MSCI ESG Research

We reviewed board independence for each bank (where data was available, 150 of the 193 banks in the peer group) and compared it to the "home norm" for board independence of the top five shareholders of the bank. The results highlighted banks with a lower percentage of board independence than domicile country average, lower percentage of board independence than the top five shareholders' domicile country averages, and a high concentration of ownership in the top five shareholders (>10% of float). The largest gaps belong to Polish banks, both of which lack independent directors entirely despite country- and top shareholder-level norms, but only **Bancolombia** and **Standard Chartered** stood out with gaps between shareholder expectations and corporate boards as well as multiple governance concerns surrounding shareholder rights, transparency, or audit practices.

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1 As of September 30, 2013, as reported on January 31, 2014 by eVestment, Lipper and Bloomberg *Feb 2014*