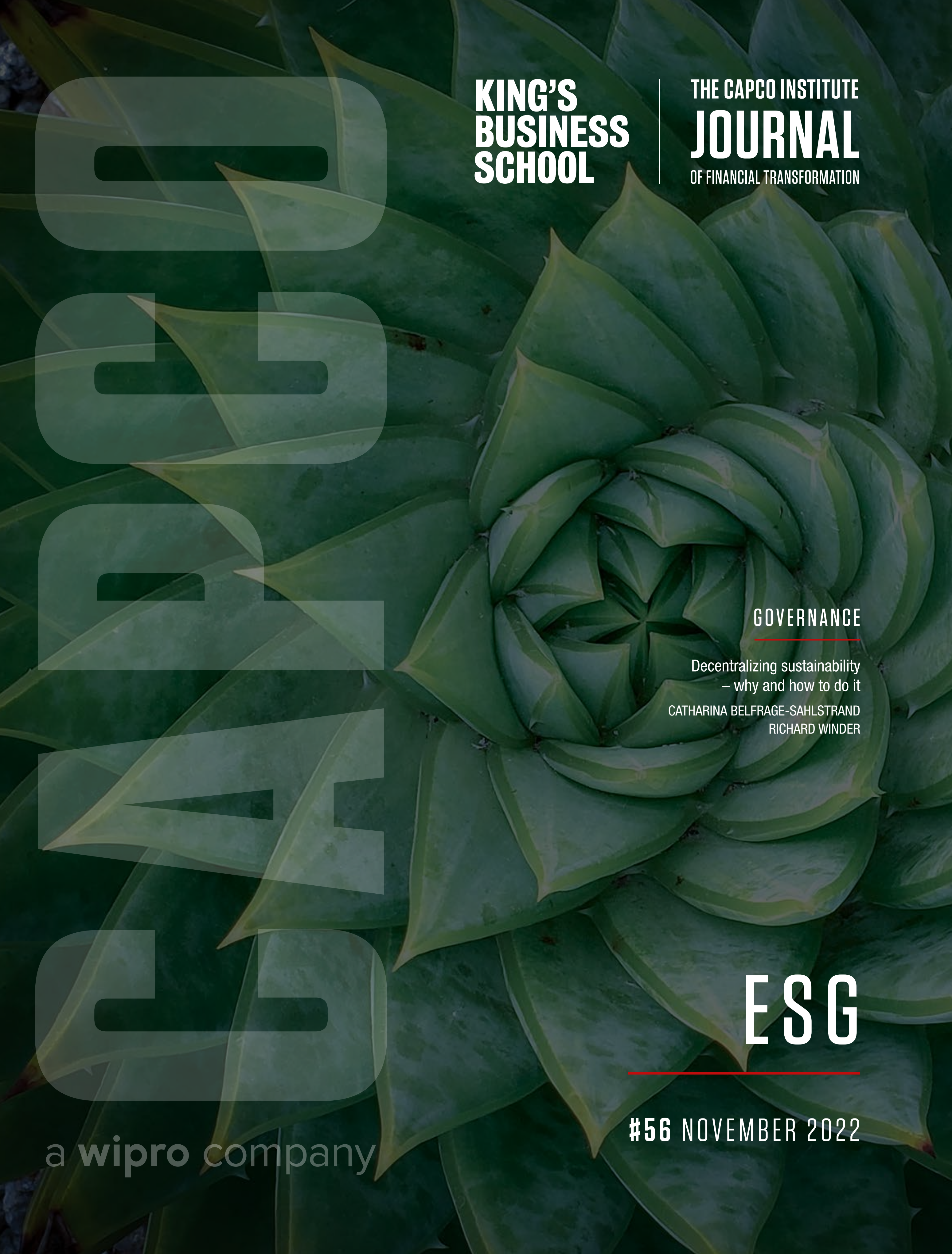

KING'S BUSINESS SCHOOL

THE CAPCO INSTITUTE
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OF FINANCIAL TRANSFORMATION

GOVERNANCE

Decentralizing sustainability – why and how to do it

CATHARINA BELFRAGE-SAHLSTRAND
RICHARD WINDER

ESG

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DEAR READER,

Welcome to edition 56 of the Capco Institute Journal of Financial Transformation, produced in partnership with King's Business School and dedicated to the theme of ESG – environmental, social and governance.

We all recognize that transformation towards a green economic system via sustainable finance is needed, welcome and inevitable. Our clients have a crucial role to play here. Acknowledging the scope and complexity of the evolving ESG landscape, we are perfectly positioned to prepare them for the ESG era.

With climate change accelerating and generating physical events on an unprecedented scale, governments and societies are considering measures to mitigate carbon emissions via net zero initiatives. The focus is firmly on greater sustainability and more equitable policies in response to shifting public attitudes. ESG considerations are reshaping investment risks on the one hand, and opening the way for green financing and sustainable technologies and innovations on the other.

This edition of the Journal examines all three pillars – environmental, social, and governance, highlighting efforts by regulators and practitioners to create a unified approach.

Moving forward, compliance with emerging ESG standards will be a critical differentiator for long-term business success. Data will also play a critical role in delivering the transparency and insights required to validate the ESG credentials of businesses, and investment strategies. Advances in areas such as machine learning, artificial intelligence and cloud technologies will be key to establishing a future model of sustainable finance.

This edition draws upon the knowledge and experience of world-class experts from both industry and academia, covering a host of ESG topics and innovations including the value of tracking Return on Sustainability Investment (ROSI) and the importance of moving away from purely external risks to addressing issues that can have positive commercial and societal impacts.

I hope that that the research and analysis within this edition will prove valuable for you as you shape your own ESG strategies, policies, and innovation.

Thank you to all our contributors and thank you for reading.

Lance Levy, **Capco CEO**

DECENTRALIZING SUSTAINABILITY – WHY AND HOW TO DO IT

CATHARINA BELFRAGE SAHLSTRAND | Group Head of Sustainability and Climate Action, Handelsbanken
RICHARD WINDER | U.K. Head of Sustainability, Handelsbanken

ABSTRACT

Over several decades, banking has evolved into one of the most centralized sectors of the economy. So, what are some of the challenges and benefits of working with climate change and sustainability in a strongly decentralized bank? Catharina Belfrage Sahlstrand and Richard Winder take us behind the scenes at the Swedish-headquartered Handelsbanken.

1. INTRODUCTION

Do you trust your employees? Not a trick question. But do you actually trust them? It may well say so in the chairman's statement or the CEO's foreword to the latest report and accounts. And no doubt instinctively this is how most board directors and senior managers feel about the people who work for them. Some colleagues may wear a passion for their work or organization brightly on their sleeve, while others may display their loyalty and commitment more quietly through their daily efforts and through the results they produce.

However, for the most part, this explicit trust is not fully followed through in large organizations' operating models, steering systems, and, therefore, cultures. In their 2020 book on enlightened corporate leadership, "Humanocracy",[1] Professors Gary Hamel and Michele Zanini highlight the often yawning gap between companies' warm words and the real-world empowerment of their people – or rather the lack of it. This mismatch leads, the authors demonstrate, to disengagement, silo thinking, squandered creativity, and ultimately reduced productivity and profitability. They go on to quantify and illustrate the performance advantage and many co-benefits that can be achieved by distributing power and accountability throughout an organization.

Back in 2002, industrial economist and former bank president Jan Wallander wrote a detailed account of his (successful) mission to radically decentralize Handelsbanken and transform it into one of the strongest performing banks in Europe over several decades. His case for decentralizing was disarmingly simple, although naturally the task of achieving it proved more challenging.

Through his academic observations, Dr. Wallander asserted that, as a general rule, individuals are intrinsically motivated to do a good job. By extension, given extensive decision-making power and accountability, they are both willing and capable of finding good ways forward in their work and pursuing them successfully.

Moreover, in this environment of heightened trust and expectation, people tend to step up and take ownership of challenges and opportunities in their areas of responsibility, taking personal satisfaction in their professional achievements, while striving to remedy any adverse consequences of their actions.

However, this was only one side of Dr. Wallander's argument. During his time as a leading light in Swedish economic research, systems for "extrinsic" individual motivation –

[1] https://bit.ly/3ekaCtF

typically combining top-down instruction and performance management with individual targets and incentives – had risen to prominence across many industrial sectors, spurred on by the early embrace of U.S. corporates and the founding crop of management consultancies. Having studied these systems at close quarters, Dr. Wallander had become convinced they only served to dilute or distort employees' natural feelings of drive, pride, and care for their work.

He saw that this approach to people management – driven by what the late social psychologist Douglas McGregor termed "Theory X thinking"[2] – had the effect of pitting employee against employee, manager against manager, and business area against business area. Sometimes, such internal rivalry sprang up entirely by design in the hope of squeezing out greater ambition, grit, and innovation from employees. Other times, it would occur quite unintentionally through the clash of different parties' priorities based on the targets they had been set. Yet, in all cases, the results would be suboptimal organizational performance, disaffected employees, short-termism, a brittle culture, and – high on Dr. Wallander's own watchlist – dissatisfied customers, leading inevitably to a drag on long-term financial performance. Indeed, this is just as Hamel and Zanini have shown to be the case in today's corporate world.

2. INSTITUTING TRUST-BASED LEADERSHIP WITHIN ORGANIZATIONS

In 1970, Dr. Wallander was appointed managing director (in today's language, chief executive officer) of Handelsbanken, then Sweden's largest bank. The bank had been experiencing a broad set of challenges to its profitability over the preceding decade or so. He took up this post on one condition: that he would have the time, space, and board support to put into practice the full scope of his thinking on trust-based leadership, despite the inevitable resistance his team would face in doing so.

Almost overnight, power for making credit and other business decisions was transferred from directorates in the head office to branch managers on the ground. The middle managers responsible for churning out a steady stream of orders to these branches were told to stop. They were offered roles out in the branch network, which many, though not all, chose to take up. The focus of the organization was to be on long-term profitability, and this would be assured only by higher levels of customer satisfaction and lower costs than the competition. Prudence and relationships would command the premium within his model, while chasing a fast buck at the expense of either would be frowned upon.

To cut a long story short, the approach we work with in Handelsbanken today – when you dig beneath the bank's many significant strategic, digital, and other developments since that time – still takes full account of Dr. Wallander's unshakeable belief in the individual, and their intrinsic motivations and potential. The way of working is decentralized, so that each local branch team forms and follows its own business plan, its own goals, and its P&L and cost-income progression. Individuals, wherever they are in the organization, are empowered to be the decision makers in their areas of responsibility, taking support wherever needed – but not orders – from their management line.

To the uninitiated, this may sound more than a little like anarchy. But we can assure you that it is anything but that in Handelsbanken, a lender long recognized for its strength in managing risks and generating stable returns throughout the economic cycle.

A decentralized way of working requires a solid central framework within which colleagues can carry out their responsibilities the ways they find best, but consistent with the organization's overall strategy, objectives, and obligations. The more decentralized, the stronger this framework needs to be, and Handelsbanken is highly decentralized.

This central framework is made up of the bank's guiding values, its business, operating, and management models, its steering systems, and its policies. These policies cover areas such as credit, risk management, human resources, and, of course, various aspects of sustainability.

Hence, all over our organization, colleagues feel at once free to put their skills, ideas, and networks to best use, while at the same time bound to act in line with the bank's values, goals, and ways of working. In practice, this is less a case of balancing two opposites and more a case of finding the strongest harmony between the individual and the common interest.

[2] McGregor, D., 1960, The human side of enterprise, McGraw-Hill

In any case, half a century of working in the way described above has led to a flat, open organization, where everyday collaboration tends to spawn spontaneously across teams and functions, without the need for a nod or a prod from higher up. It has also cultivated a strong sense of both individual and corporate responsibility – responsibility to each other, the bank, our customers, and the communities we serve.

This culture of responsibility has proven a fertile seedbed for Handelsbanken's work with sustainability over recent decades. However, as the expectations and demands of our stakeholders continue to grow and gather pace, working with sustainability in a decentralized way has not been without its challenges. In this article, we will take a look at some of the challenges we have encountered so far, how we have approached them, and how we would assess the net benefit, or otherwise, of our model in these circumstances.

3. SOME HIGH LEVEL CHALLENGES OF DECENTRALIZING SUSTAINABILITY

3.1 Example 1: Driving focus and ambition

As noted, a strongly decentralized approach requires a robust central framework within which empowered colleagues can work confidently. This is even more the case when the area in question takes in new concepts and requirements well beyond the familiar confines of traditional banking, and more so again when these concepts and requirements are continually evolving.

Like all banks, we need a shared sense of where we are driving towards and when we need to get there. Hence, initially, we worked together at the center to explore our risks and opportunities, our stakeholders' expectations, and how the evolving sustainability agenda connected back to our core values. This led to the bank setting out a number of initial sustainability goals, endorsed by the central board of directors, to guide the focus and efforts of the whole organization (Figure 1).

From this point on, our priority has been to mobilize the organization, initially by communicating the goals in ways that felt relevant to different roles and functions. Through this, we aimed to secure that all-important buy-in from our branches, business support units, and other functions, and to equip them with the direction and context they needed to start considering how best to contribute towards these goals.

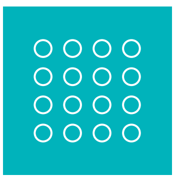
Meanwhile, back at the center, we worked to provide support and challenge, as sustainability subject matter experts, to these developing ideas, connecting workstreams and initiatives wherever this could add value, while identifying potential gaps to be filled. Perhaps a little like the role of an air traffic controller.

What we did not do was to take our corporate-level goals and seek to parcel these up into increasingly granular targets, at business line, district, branch, or individual level, with a view to the sum of these achieving our headline goals. That would be the antithesis of our decentralized approach. For us, leadership

Figure 1: Handelsbanken's goals for a sustainable future

THE CLIMATE GOAL

Handelsbanken's goal is to achieve net zero emissions of greenhouse gases as soon as possible, and by 2040 at the latest. This includes lending, leases and investments as well as the emissions generated by the bank itself from its energy consumption and business travel, for example.



RESPONSIBLE INVESTMENT

The investment portfolios shall be in line with the goals and transition pathway of the Paris Agreement, achieve net zero emissions of greenhouse gases by 2040 at the latest, and increase the funds' contributions to the 2030 Agenda.

RESPONSIBLE FINANCING

By 2025, 20% of the bank's financing volume shall consist of green financing, social financing or financing that contributes to the borrower's measurable, sustainable transition.

ADVISORY SERVICES

By 2023 at the latest, through business development and training initiatives, in a measurable way create conditions for gender-equal savings and thus contribute to reducing the wealth gap between men and women.

needs to emanate from within the organization, just as much as from the top. To achieve this, we cannot simply tell our managers what to do; we need to listen, adapt, explain, and support them. And sometimes we need to sit on our hands.

Looking at, say, our sustainable financing goal, or the overall net zero climate goal, you may be wondering how we can be sure of achieving them working in the way just described. The honest answer is that at this stage we cannot with 100 percent confidence. And neither, in reality, can those who adopt the "command control" model of calibrated targets and close follow up, which has been seen to lead to so much gaming and suboptimization. We can, however, be sure that colleagues throughout the organization know and care about reaching these goals, that they see their roles in doing so, and that they feel responsible to lean in, learn more, and find collaborative ways forward.

That is not to claim for even a moment that progress along this curve is rapid, smooth, or uniform across the bank. If anything, working in a decentralized way takes more time and care to establish critical momentum. But here is the thing: once that point has been passed, the real power of an engaged workforce kicks in and progress tends to go exponential.

3.2 Example 2: Meeting regulatory expectations

Quite understandably, regulation tends to be designed around the norm rather than the exception, not least in banking. Most banks are not strongly decentralized, instead engaging in often sophisticated strategic planning, budgeting and forecasting, portfolio allocation, and activity management from the center. We have, therefore, become accustomed over many years to adapting to rules which assume a centralized point of departure.

The regulatory framework around sustainability is no exception. Thus, ensuring we satisfy an increasingly detailed suite of market, customer, and product disclosure requirements in a way that supports our model takes a great deal of care and thought. In this context, we also think carefully about how best to meet our voluntary commitments, for instance, as a signatory to the U.N.'s Principles for Responsible Banking and their investment equivalents, and to the Net Zero Banking Alliance and Asset Managers Initiative.

As we face these regulations, it can at first seem inevitable for us to centralize this or that element of our response. It appears the simplest, quickest route to compliance, the one we can control and adjust most closely. However, we keep at the front of our minds that such an assumption takes no account of the knock-on effects on our culture of trust, ownership, responsibility, and accountability. Moreover, when you multiply this assumption by all the challenges to which it might be applied, you immediately see how this leads piece by piece to the dismantling of our decentralized advantages. Hence, it pays to take time to consider all the possible solutions and not to come at the question as necessarily an "either or".

Sustainability regulation is evolving rapidly, at the national, European, and international level. Voluntary initiatives continue to be adopted into statutory frameworks, while the outline of convergence across key economies can increasingly be made out.

For us, therefore, it is important to remain adaptable to this changing picture. We cannot simply agree an approach to regulatory compliance, bake it into our decentralized operations, and turn our full focus towards monitoring and follow-up. We will need to iterate and at times substantially rewire this approach as we go, and this requires a shared understanding of the evolving principles, standards, and direction of travel.

Keeping the organization informed and on track is, therefore, a challenge. To achieve this, functions that previously had little to do with one another have established an open dialogue, while regular knowledge sharing forums have sprung up around themes ranging from scenario analysis and data sourcing to sustainable product development and customer engagement.

3.3 Example 3: Seizing customer opportunities

In a command control environment, it is superficially simple to change the business focus of all or parts of an organization. Budget lines, targets, and incentives do the heavy lifting, locked in by hands-on management, and backed up by strategic communications.

To some extent, with a decentralized approach the opposite is true. In Handelsbanken, it is customer demand that determines the business focus of the organization. Branches' business plans are built around an assessment of local market needs more than the bank's requirement to focus on selling this or that product. It has always been customer behavior and expectations that have driven our product and service development, these days picked up as much through our digital platforms and data systems as through face-to-face meetings.

This creates an unusual challenge with regard to climate change. Although our customers are becoming more aware of how their businesses and lifestyles impact the climate, plus the risks a more extreme climate poses to their lives, they are not yet all – by any means – clamoring for our support to take climate-mitigative or -adaptive action. In order to achieve our goal that financed emissions (as well as our investment portfolios and own operations) should be carbon neutral by 2040 at the latest and, therefore, align with the Paris 1.5 degree goal, we need customer action to increase substantially through this decade and beyond.

It is true that, to some extent, the policy environment in our home markets will help accelerate action. For instance, minimum energy efficiency standards and the phasing out of fossil fuel heating or the internal combustion engine. But it is equally apparent that we need – and indeed policymakers expect banks – to take a lead in stimulating market demand.

On one level, this expedient to "push the pace" creates a tension with our demand-led ethos, and thus our decentralized structure. However, we have chosen to come at it from another angle, one which resonates loudly with our core values.

For us, the starting point is the responsibility we feel to our customers. Being decentralized means that our most experienced bankers are embedded in their local communities, out in our branches, making the vast majority of the bank's credit and business decisions day in, day out. They aim to build lasting customer relationships through a focus on their long-term risks and resilience rather than short-term transactions, while the bank focuses on remaining a reliable, responsible counterparty. Together, these factors have led Handelsbanken to be viewed as a trusted partner by very many of our customers.

Through our own wide-ranging analysis and engagement, we can see the shape and scale of the sustainability risks forming around our customers. We can also see the kinds of opportunities that, through informed action, they may be able to seize in what will undoubtedly be the greatest economic transformation of our age.

We, therefore, feel a responsibility to raise these questions with our customers proactively, and to support them as they move from whatever level of awareness they may presently have, through careful assessment and strategic planning, to a plan of action. And we continue to develop our range of resources, partnerships, and incentives to support this journey.

Naturally, in many cases, the customer's action plan will require some kind of financing, and we also need to see that we have the right kinds of sustainable lending products, with the right range of features, flexible to different customers' transition and adaptation needs. In some ways, we have gone through this process already on the sustainable investment side of our business, where Handelsbanken has – through customer engagement – grown into one of Sweden's principal sustainable investment players. However, the road ahead with transition finance is not so well established and banks will need to travel faster along it.

Of course, for customers to prioritize this area, we need our branch teams to decide to do the same. This is not as simple as it might sound, when each branch is used to shaping its business plan around the local demand the team can already see and the discussions they are already having, rather than discussions we need to catalyze and then help to progress through to action.

Add to that the simple fact of life that it is easier to work within one's comfort zone. Sustainability issues are multi-dimensional, complex, and always evolving, while the fear of feeling exposed can be acute when the customer is used to you having all the answers. But as anyone who has worked for any time with these issues knows, the best way to get comfortable with them – beyond an initial grounding in the basics – is to start engaging with others on them and to learn along the way.

This is certainly what we have found through our customer engagement to date, which has really picked up pace over the last year or so. It has also been helped along by the fact that all parts of the bank, from compliance and risk through to our digital teams and branches, take a customer-centric approach. As with our regulatory work, this has led to new dialogue bridges within the organization, as colleagues look to ensure their contributions to the bank's climate change response are aligned around good customer outcomes.

4. CONCLUSION

The challenges sketched out above, along with others encountered when decentralizing sustainability, take patient, careful deliberation, and a shared determination to work through. This, in turn, requires a keen, first-hand appreciation of the benefits of working this way, which far outweigh the headaches and occasional frustrations.

Increasingly, employees in all organizations want to play a fuller role, professionally, in tackling climate change and other societal challenges. In a decentralized approach, they are that much more able to do so. Knowing this, and feeling a strong responsibility to their colleagues, customers, and communities, leads employees to take the initiative, to collaborate openly, and to develop their own knowledge. The level of discretionary effort is understandably higher in an organization characterized by trust, empowerment, and accountability.

It is also true that there are no single “right” answers to the challenges that need to be overcome on the path to a sustainable bank and economy as a whole. Better then to let a thousand flowers bloom – out in our branches, districts, digital platforms and central functions, and across our different markets – and to share what worked and what did not so that we can all learn and improve. Not only will the pool of ideas be deeper and more diverse that way, but the ideas themselves tend to be shaped by practical, on-the-ground realities rather than abstract models.

Nevertheless, not everything can or should be decentralized, and it is important not to be dogmatic, where sometimes we can see that to centralize is the only sensible decision. The measure is whether doing so will add direct value to the bank and its stakeholders, without in any way undermining our successful way of working.

Striking this balance is as much an art as it is a science; the fulcrum point can be found in a different spot from one question to the next and can shift over time. It is also critical to keep in mind the overall tendency of organizations to centralize. Dr. Wallander used the analogy of a stretched rubber band. When the fingers weaken, the band will always contract. Hence, it is important to remain vigilant as well as circumspect in our thinking, so that the fingers stay strong.

Responsible banking has become the hallmark of Handelsbanken since it was founded one and a half centuries ago. Upon these foundations, we have been working actively with decentralization for over 50 years, and with Sustainability (with a ‘big S’) for at least the last dozen of those. Both throw up their occasional challenges amid a rising tide of opportunity. But together, we have found them to be a natural fit – symbiotic even, with each nourishing and feeding off the other.

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