Investing in Stability:
Conflict Risk, Markets and the Bottom-Line

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Summary Report of the Meeting

On September 5, 2003, UNEP FI and IISD hosted a meeting to discuss the relevance of conflict for the financial sector and the role of financial institutions (FIs) in conflict prevention and mitigation. The meeting brought together financial sector actors (banks, asset managers, insurance companies, and export credit agencies (ECAs)), as well as representatives from governments, NGOs, academia and research firms, at the HSBC headquarters in London. The workshop was part of a project sponsored by the German Ministry of the Environment, Nature Conservation and Nuclear Safety (BMU) to better understand the linkages between finance and conflict. With the aim of initiating a multistakeholder dialogue on finance and conflict, participants were asked to engage in an exchange of ideas, experiences and approaches. The meeting was conducted under Chatham House Rules, under which individual views can be expressed confidentially, and are referred to anonymously. Positions and opinions raised at the meeting and cited below do not reflect the collective opinion of the group, nor of the participating organisations.

Background

In accordance with the funding contract with the BMU, UNEP FI and IISD have been working on the development of a background paper on the linkages between finance and conflict. The workshop in London was organised to further inform this paper, the background of which is summarised below:

Over the last couple of years, the economic dimensions of conflict have moved up on the agendas of the international community, and there is a growing understanding of the complex role companies play in relation to pre and post conflict dynamics.. At the same time expectations towards companies to take preventive action or help to resolve conflict are on the rise, underpinned by pressure from NGOs. Furthermore, scenarios are becoming more likely where companies, including FIs, may be blamed or even held to account for association with conflict. One these grounds, some argue that violent conflict within states is of growing concern for FIs, connected to reputational issues, opportunity costs, threats to staff and investments, emerging regulatory and litigation threats, and opportunities for competitive advantage.

Different sectors of the financial industry (project finance, commercial banking, retail banking, asset management) are affected differently by conflict and public pressure and have different tools at their disposal to react. Therefore, a deeper analysis of the linkages between finance and conflict would have to differentiate between the various sectors and actors. However, discussions at the workshop did not progress to such level of detail, but rather reflected the broad scope of the UNEP FI / IISD background paper and the mix of participants.

On a broader level, it was argued that the finance sector can become entangled in or be associated with conflict scenarios, inter alia as a consequence of project finance, or the misuse of financial services by armed groups. On the other hand, the financial sector can help to secure peace and prevent conflict through its core business, its social investments, and its engagement in policy dialogue to promote human rights and other public goods. A conflict risk perspective suggests several opportunities for gaining competitive advantage, including improved risk assessment for mainstream financial institutions; new products, services, and markets, and new identifiers of high performance investments for more specialised companies.

Introduction: The Nature of Modern Conflict, its Economic Dimension and Corporate Costs

A brief introduction was presented covering the characteristics of today's conflicts and their linkages to the business sector: Most of today's conflicts are civil wars, fought by groups competing over access to or control over valuable natural resources within national borders. They emerge primarily in underdeveloped regions amid other governance failures, and are frequently motivated or sustained by trade in commodities, narcotics or people. Increasingly, conflicts are taking place within rather than between states (this was the case for 90% of armed conflicts between 1989 and 2000). Once a country is embroiled in a conflict situation, the risk for further conflict soars.

It was further emphasised that the changing nature of conflict has increasingly drawn attention to its economic dimensions, such as the negative cycle of poverty and conflict. The characteristics of many national economies facilitate the flow of resources into a conflict which has sometimes resulted in further fuelling of violence. Licit and illicit resource extraction, arms and drugs trafficking, organised crime, money laundering, and the diversion of humanitarian aid can provide the necessary resources to sustain conflicts. It was also pointed out that at the same time, the globalisation of trade and investment, as well as the increasing reach of media and civil society who are acting as watchdogs to monitor global business activities, are shaping a new context for global business operations.

On the costs of conflict to business, it was stated that direct and indirect corporate costs could be identified: Direct costs include investment in security and or risk management, material costs, opportunity costs, loss of capital and/or personnel, litigation, and reputational damage. The indirect costs of conflict – i.e. the societal cost to the country or region, which includes the destruction or undermining of human, social, economic, environmental and political capital, would also affect companies and create costs. It was mentioned that International Alert in a report entitled "Business of Peace" had investigated the impact of conflict on business and analysed a range of management strategies and processes.

The Environmental Dimension of Conflict

Dr. Klaus Töpfer, Executive Director of UNEP, was quoted with the statement "Environmental policy on a global level is peace policy", and the importance of integrating environmental dimensions across a range of other policy sectors was highlighted. In this context it was pointed out that the social dimension of environmental change had become obvious with regards to issues like natural resource management and climate change and that an awareness of the security dimension was emerging. Other areas such as transboundary environmental cooperation were mentioned as they point to the suitability of promoting transnational cooperation and peacebuilding. The question was posed how the environmental and social dimension of projects in conflict-prone regions could be geared towards conflict prevention, and to what extent this was an area where public and private investments could be combined. Furthermore, impacts of projects on conflict needed to be taken into account as well as environmental and social impacts. Good examples for such practice could be found in the recommendations of the World Commission on Dams.

Links Between Finance and Conflict

A short presentation was given on the multiple ways in which the activities of FIs could promote, or mitigate and prevent conflict and on the various ways in which FIs could be affected by conflict.

It was argued that the financial sector had a large potential to contribute to conflict prevention through its core business. Arguably the provision of financial services, especially credits to small and medium enterprises (SMEs) and microfinance could stimulate the economy in a way that would create employment, increase resilience and thus contribute to social coherence. In addition it was pointed out that finance also contributes to the public purse and, through its central role in an economic system, could be a lever for positive change, for example by promoting respect for environmental and social standards and human rights.

The mentioning of negative linkages between finance and conflict included the potential contribution to local conflict potential through project finance, the facilitation of conflicts through the provision of financial services to warring parties or oppressive actors, and the contribution to social instability through the exacerbation of macroeconomic downturns caused by large scale financial flows.

Why Should FIs Be Concerned About Conflict

It was highlighted by several participants that the entry into conflict-linked investment creates risk and will be scrutinised very critically.The exposure to conflict varies greatly between companies with operations in the country, investors and asset managers. In general terms, it was stated that for many institutions the risk-reward ratio for conflict-prone / post-conflict regions will not warrant a positive investment decision, even though they might forego entry into markets with high growth potential. However, participants raised several reasons why FIs should take a proactive approach to conflict despite the fact that many institutions will not feel directly involved..

One argument was related to the difficulty of making long-term predictions about social, political and economical stability of countries. Regions that are peaceful and seemingly stable today may erupt in conflict in five or ten years time. It was stated that if banks set up a retail and commercial lending infrastructure in a country, quick entries and exits become costly. Several participants pointed out that it was in the long-term interest of FIs to prevent and mitigate conflict, but that currently the markets did not encourage activities or investments towards this aim.

Furthermore, it was argued that conflict risk is already a factor that is assessed in relation to opportunities and the capacity to manage threats. Companies' capacity to develop effective risk management strategies, their appetite for risk, as well as the perception of reputational risk will, of course, differ greatly across different financial sectors and individual companies. Thus investment may happen despite high risk, if the expected return and the tools to manage potential conflict are adequate. Therefore, evidently, companies with high risk appetites and sophisticated risk management procedures could have an advantage in terms of the range of investment possibilities they can consider and successfully navigate in case violent conflict breaks out.

Several trends in public as well as in the private sector mentioned by participants indicate that the issue of "financing conflict" is climbing agendas. It was pointed out that the rapidly growing importance of corporate social responsibility (CSR) on the agendas of business and stakeholder communities as well as regulators will have notable effects on business and FIs in terms of their approaches towards conflict. In addition, a number of efforts were mentioned, which are underway to curtail resource flows to armed conflict (sanctions, the Kimberly Process on Conflict Diamonds, and the UK government's Extractive Industries Transparency Initiative) and the increasing pressure for the international banking system to monitor and scrutinise transactions ("Know Your Customer" and Wolfsberg Principles). Moreover, various business initiatives, seeking to understand and limit negative corporate-conflict impacts were discussed briefly (UK/USA Voluntary Principles, Extractive Industries Transparency Initiative, UN Global Compact, BP Regional Review of the Southern Caucasus, the IISD/IA Conflict Risk Impact Assessment toolkit, conflict and human rights-sensitive CSR programmes).

The Materiality of Conflict Risk

During the workshop introduction, it was suggested that conflict can pose material risk through underpricing and overexposure, due to an incomplete assessment of the risk and that there were emerging regulatory and litigation risks. In the discussions, participants considered how conflict risk can be assessed and to what extent it already was or could be factored into investment decision.

The materiality of conflict risk was mainly regarded from the asset management perspective. It was stated that the occurrence of conflict on project level was unlikely to result in such a drop in share prices of the operating company that this would have a significant impact on the overall performance of a fund. At the same time, investments that are contestable from a conflict perspective, may be welcomed by other investors as a means to spread the company's risk exposure. Therefore conclusions on the magnitude and direction of the market's response to such investments can be difficult. On the other hand, it was argued that poor management of conflict risk may be an indicator for other forms of mismanagement. Investment in better conflict management would not likely have a negative impact on stock price performance, and may therefore be welcomed by fund managers as indicative of improvement in overall management.

Consensus emerged that risks to the reputation of a company, if they were material, were already included in investment decisions. For banks, reputation is of greater concern than for asset managers, whose connection to concrete operations or projects is indirect, through their equity holdings. Reputation, however, has become an important concern to asset managers, as NGOs are starting to scrutinise them, and participants stated that there exists a scope for them to positively influence their clients.

Institutional investors have so far rarely been targeted by NGO campaigns. However, it was pointed out that (in the UK) the growing recognition of the importance of socially responsible investment (SRI) had resulted in a pushing of boundaries in terms of the responsibility of pension funds.

The Public - Private Interface

A large part of the discussions focused on the important role of governments in creating the right macro-economic framework to address market failures and eliminate perverse incentives for the private sector. A number of participants expressed a sense of failure on the part of governments, the UN and international FIs to understand and constructively engage the private sector beyond mentioning the need for partnerships in policy statements (e.g. the Stability Pact for South Eastern Europe or the UNECE Villars statements).[1] It was stressed that the appropriate incentive structures and disclosure regimes to create a business case for conflict sensitivity on the part of FIs were not in place.

A large part of the discussion focussed on the role of government and multilateral actors in post-conflict situations in redressing post-conflict dysfunctions and, within the post-conflict window of opportunity, putting into place an administrative and legal framework that provides acceptable measures of security for long-term investment. The identified lack of functioning models for public-private collaboration in peacebuilding and the frequent failure to intervene in a timely manner was seen to imply that there might be a significant space for seeking better understanding and pursuing new efforts. From a conflict prevention perspective this applies in particular for investments into public services, like water, energy or infrastructure, which may at the same time have benefits in terms of promoting social stability and coherence. The example of the Chad-Cameroun pipeline was cited several times as an example of a relatively advanced concept on the policy level, which had nonetheless run into problems on the implementational level. Overall, there seemed to be an agreement that a better understanding was desirable on how to make the tandem of public-private work and maximise win-win opportunities. The greatest need in this respect seemed to be a clarification of roles and responsibilities of the public sector and companies/FIs respectively. Furthermore, there may be a role for the UN or other public sector institutions in the formulation of common standards and/or guidelines.

It was mentioned that FIs would prefer to align themselves to third party standards, because this can increase credibility and the potential to create a level playing field. Several policy openings for public-private interaction were suggested:

- review of IFC/MIGA/WB and private sector guidelines (e.g. Equator principles);

[1] Subsequently a participant noted that effective public private partnership instruments did exist that reduce risk and provide positive synergies and linkages to policy adjustment.

- disclosure rules, revenue transparency in the extractive industry and corporate governance requirements
- corporate social responsibility (CSR) and its application to conflict zones;
- supporting the creation of proper governance structures and of functioning partnership platforms in conflict-prone / post-conflict regions;
- export credit and multilateral financial institution guidelines for environmental and social assessment with a conflict-sensitive aspect;
- exploring opportunities to curtail conflict transactions (emerging money laundering regulation);

The Global Reporting Initiative was highlighted as a successful effort to create globally recognised guidelines.

With regards to the relationship with host governments, it was pointed out that FIs with business operations in a country are in a very delicate position vis-à-vis the host government, which limits their ability to make statements of a political nature. However, some participants stated that host-governments often grant very far-reaching guarantees to investors in bilateral investment treaties or project agreements that can become obstacles to public policy making, and the question was raised whether such arrangements are the most adequate to increase investor security. Moreover, in some cases host governments may be illegitimate or oppressive institutions. It was proposed that in such cases a tri-sector partnerships including the local community could be a means to secure some extent of legitimacy, while it was also warned that dialogue with the local and wider stakeholder community required specific conditions to be successful. It was also mentioned, that even though FIs are not 'political beasts', the unavoidable impact of their presence and operations made it impossible to remain politically neutral.

Opportunities to Promote Peace

Several possibilities were mentioned how companies in the financial services sector can promote peace in their own interest. For example with regards to FIs' interest in a functioning public administration, rule of law and security of property rights, the participation in policy dialogues presents an opportunity for some companies. However, participants agreed on the risks and difficulties of private sector engagement in activities that are inherently public. Moreover, gearing social investment programmes of FIs towards conflict prevention could have considerable potential. With regards to investments in conflict-prone regions, it was stated that these investments can be tweaked to reduce conflict potential, but that in most cases the private sector is ill-equipped to identify these opportunities. Existing risk assessment tools fail to comprehensively account for the impact of the project on a latent or manifest conflict and there is a lack of competency to make the most of an investment's preventive potential.

Furthermore, it was argued that there exist opportunities for FIs to make a positive difference through their core business. These include improved risk assessment, conflict sensitivity as a means to identify undervalued investments, and generate ideas for new products, services, and markets.[2] New markets may include those for 'conflict-free' products and SRI funds, like that emerging for diamonds and possibly timber. Further examples included innovative mechanisms for mobilising finance in post-conflict settings, such as through venture capital funds targeting wealthy emigrant communities, if they are linked into wider intersectoral and integrated risk management structures.

[2] An example of this are the Canadian Polar Bear diamonds. A polar bear inscribed in the girdle of diamonds of Canadian origin allows concerned customers to identify them as free from connections with conflict. Reportedly Polar Bear Diamonds were able to command a premium price, and the Canadian Diamond Industry made a headstart since its initiation in 1998. Stueck, W. "Canadian quality adds sparkle to diamonds". In Globe and Mail, 23 November, 2002. www.globeandmail.com .

Recommendations
From the discussions several recommendations emerged, on how to improve the analytical framework of the project:

- To separate further analysis and proposals into banking, insurance, asset management, and public sector finance;
- To distinguish between different phases of conflict: conflict-prone, during conflict, post-conflict. The attempt to capture discussion in such a framework was made with the table below, which lists entry points for positive action by the finance sector at different stages of the conflict cycle:

Conflict-prone	During Conflict	Post-conflict
• Conflict indicators; • Understanding how finance and services can help enhance social stability; • Standards of "appropriate" behaviour (applicable norms, tools, laws and best practice).	• Standards of "appropriate" behaviour (applicable norms, tools, laws and best practice); • Good practice in controlling flows of finance into and out of conflict zones.	• Innovative financing for reconstruction; • Establishing public private frameworks for investment (e.g. export credits/guarantees, tax credits).

- To distinguish between areas where a business case exists (win-wins), where corporate responsibility commitment is warranted, and where market failure implies a need for policy change/government action;
- To identify the finance sector's long-term goals with respect to stability and, from that perspective, assess day-to-day tools and management systems in terms of their adequacy to serve these goals (identify opportunities to extinguish perverse incentives).

Issues for Further Exploration
Furthermore, it was assessed to what extent participants felt that further work was merited and in what areas. Participants stressed the need for practical proposals with tangible outcomes. The following areas were identified for potential further exploration:

- Conflict assessment tools and conflict indicators;[3]
- Case studies on good and bad practice in the finance sector on conflict risk management/post-conflict investment;
- Guidelines for private sector investment (Banking / project finance / asset management) in conflict prone regions. Elements might include: inventory of applicable international norms and laws; factors for consideration in investment/disinvestment decisions; guidance for management of conflict specific multistakeholder processes; managing the unexpected outbreak of conflict;
- Mobilisation of a critical mass of actors in the finance sector in such Initiatives and Partnerships as the Extractive Industries Transparency Initiative in order to overcome the first movers disadvantage
- Innovative financing mechanisms for post-conflict reconstruction, including public-private mechanisms to reduce the risk of such investments; and awareness raising of such models within the private financial sector.

[3] Work in this area has been initiated by IISD and International Alert. More information at http://www.iisd.org/natres/security/cria.asp

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