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Communications Technology

Iron and Steel

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Railways

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# *Industry as a partner for sustainable development*

## Finance and Insurance

UNEP's Finance Industry Initiatives

*Developed through a multi-stakeholder process  
facilitated by:*



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# *Industry as a partner for sustainable development*

## Finance and Insurance

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In a multi-stakeholder consultation facilitated by the United Nations Environment Programme, a number of groups (including representatives from non-governmental organisations, labour unions, research institutes and national governments) provided comments on a preliminary draft of this report prepared by UNEP's Finance Industry Initiatives. The report was then revised, benefiting from stakeholder perspectives and input. The views expressed in the report remain those of the authors, and do not necessarily reflect the views of the United Nations Environment Programme or the individuals and organisations that participated in the consultation.



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## Foreword

The UNEP Finance Initiatives (UNEP FI) is a unique public-private sector partnership between the United Nations and companies from the banking, insurance and asset management sectors worldwide.

After a decade of partnership, exploration and learning, UNEP FI arrives at the year of the World Summit for Sustainable Development (WSSD) with a keen appreciation of the formidable tasks ahead if our common goal of sustainability is to be realised.

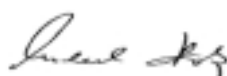
The finance sector is and will continue to be part of sustainable solutions. In the spirit of Kofi Annan's Global Compact, we look forward to working with our partners in government and civil society – in its broadest sense. But this also means that governments must step up to their responsibility to enact legislation that encourages the proper attendance to environmental and social issues in insurance, banking and investment management.

The UNEP FI partnership seeks to develop the awareness and the financial instruments that will channel capital to environmentally and socially sound businesses while securing profitability for financiers and those businesses. The only solutions that will last and prove sustainable are those that create value for all involved parties, including shareholders, customers, employees, and civil society.

Many members of the UNEP FI have contributed generously and diligently to the development of this report in an effort to further build understanding of the role the finance sector has to play in the realization of sustainable development. This excellent collaboration has resulted in a more thorough understanding of the path we must take. We thank all our colleagues throughout the industry who have worked so hard and so well in the making of this report and we

welcome and invite further comments and insights from others interested in this important issue.

Yours sincerely,



Michael Hoelz, Deutsche Bank AG, Chair  
UNEP Financial Institutions Initiative



Carlos Joly, Storebrand, Chair, UNEP Insurance  
Industry Initiative

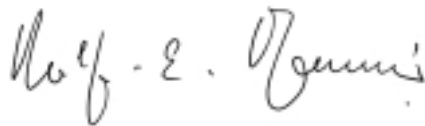
Chairs, UNEP Finance Initiatives

### Deutsche Bank

In 1992, the Rio Earth Summit outlined the guiding principles for sustainable development. Today – in light of the perspective gained from the advances of globalisation – these are of ever-greater importance. For future-oriented businesses, and especially active members of UNEP, it is clear that a singular focus on economic success is no longer sufficient to ensure long-term, enduring development.

Since Rio, approximately 170 banks have committed themselves to the 'UNEP Statement by Banks on the Environment and Sustainable Development'. Today, an ever-increasing number of sustainability-relevant criteria have become part of the evaluation process in a variety of financial transactions – be it in investment management or project finance. Moreover, many corporations have recognised their responsibility to the community in this area and have begun to recognise sustainable development as a fundamental part of corporate citizenship.

Globalisation requires, however, an increasing willingness within the financial industry to actively encourage sustainable development. The challenge is spelled out in the preamble of Agenda 21, which calls for 'the elimination of abject poverty and the long-term preservation of our ecosystems'. This challenge can only be met together, through solution-oriented dialogue and the co-operation between businesses, governments and every part of society.



Dr Rolf E. Breuer, spokesman, board of managing directors, Deutsche Bank

### Lloyds TSB

I am very pleased to have the opportunity to add Lloyds TSB's support to this UNEP finance sector report to the World Summit for Sustainable Development 2002. Lloyds TSB has a proud history of active support for the UNEP Financial Institutions Initiative and is committed to supporting the principles of the UNEP statement on the environment and sustainable development, which was first signed by Lloyds Bank in 1992.

The UNEP statement grew out of the Rio Summit and, ten years on, the World Summit for Sustainable Development in Johannesburg will, I believe, be another milestone in the history of the sustainable development movement. Since Rio, there have been many successes across the finance sector. In the United Kingdom, environmental risk assessment is firmly established in the credit appraisal process, banks are taking the lead on employee issues such as work-life balance and diversity, and London continues to be at the heart of world finance.

As we approach the World Summit, there are further great challenges ahead. Over the next ten years, the financial sector will continue to have an important role in stimulating economic growth, while protecting the environment and helping to improve the quality of life of billions of people worldwide – especially those in developing countries. I believe we are capable of meeting those challenges and I look forward to the World Summit providing a platform for major advances in the years to come.



Maarten A. van den Bergh  
Chairman, Lloyds TSB Group plc

## Gerling Group

At Gerling, the UNEP Insurance Industry Initiative has been a cornerstone of our public commitment to sustainable development and the environment. It has been, and will continue to be, helpful in raising awareness among both the public and the financial community. Gerling is proud to be a founding member of this unique partnership between an intergovernmental organisation and the private sector.

We were honoured to host the annual conference in 1998 at our headquarters in Cologne, Germany and also to have had the opportunity to chair the Initiative's steering committee over recent years.

The UNEP Initiative needs, however, to continue to evolve. The recent developments in an increasingly interlinked global financial market, as well as the rise of complex and potentially devastating natural disasters, call for universally responsible and future-oriented risk managers. It is our firm belief that sustainable development is the only long-term process to-date able to address global concerns in terms of social equity, environmental justice and economic development. Ignoring any of those factors will be contributing to conflicts and may trigger frustration, as well as aggression.

The Johannesburg Summit 2002 has to be a turning point in our understanding of multilateral action on global challenges. We need a ratified Kyoto Protocol, a renewal of the commitments made in Rio and concrete action. It is unacceptable that the official development assistance has shrunk over recent years, falling short of the goal of 0.7% of industrialised nations' gross domestic product (GDP).

A sustainable 21st century only seems possible if we leave behind our traditional ways of thinking. We need to get out of our boxes, with 'evil' multinational companies on one side and 'good' multi-governmental regulatory

bodies on the other. I am convinced that a new world order will need a new multi-stakeholder dialogue, plus a mechanism to unleash creative thinking and trust-building steps towards a better future.

We stand prepared to work with customers, governments, the UN, our competitors and non-governmental organisations to help shape a more robust, and economically, socially as well as environmentally responsible and just society. As risk managers, we at Gerling have begun to work towards this end. We take our mission statement seriously that our ultimate aim is 'to work in harmony with creation, for the good of man and nature'. In my opinion we cannot afford to fail.



Dr. Juergen Zech, former chairman of the board and CEO, Gerling Group

## Storebrand

All of us engaged in asset management, banking, and insurance want a better life for the people we care about – our family, our colleagues, our clients, and our business communities. Less obvious, perhaps, is that we also care about many other constituencies and we take their interests into consideration in how we conduct business. As business leaders, we all want a strong economy, safety and peace, widespread prosperity, and to conserve the natural world as we know it.

That is what corporate social responsibility (CSR) is all about – seeking to promote these values in our day-to-day business. That is what we mean by sustainable development. We recognise the importance of conducting business in ways that foster environmental protection and social well-being in its largest sense, in addition to creating competitive returns for our shareholders.

We are agreed on the aspiration, but we also know that achieving this is certainly not easy and there are no automatic answers. Like everything else in business, objectives have to be clearly defined, targets must be set, and activities have to be managed in the midst of unexpected events and constrained resources. In financial terms, this translates into reducing risk, securing stable returns over time, developing new forms of insurance and portfolio management, searching for opportunities, being creative, and learning how to integrate environmental and social criteria into financial management, while earning satisfactory returns on investment.

The purpose of the UNEP Insurance Industry Initiative (UNEP III), which Storebrand is proud to chair, is to create a forum for banks, insurance and asset management companies to learn from each other and stimulate each other in pursuing these goals.

Our many working groups (including asset management, climate change, and

environmental reporting) seek to develop best practices in these areas. We believe there is much to be done in developing pragmatic and effective co-operation between the private sector and the public sector. UNEP III seeks to help make that happen. Our initiative is purely voluntary, but we are not opposed to intelligent regulations that promote sustainable development. This report, in setting forth experiences from representative companies in our initiative, seeks to share with you what we are doing and hope to achieve.



Idar Kreutzer, president and chief executive officer, Storebrand Group

## United Nations Environment Programme (UNEP)

### **A decade of transition, challenge and opportunity for the finance and insurance sectors**

The scale, pace and depth of events affecting the finance and insurance sector since 1992 have been staggering. The decade witnessed the globalisation of financial markets, the emergence of giant 'one-stop-shop' bank-assurance institutions, and system rattling crises in Asia Pacific and Russia.

But, it was not just regions and countries creating unimaginable shocks for the financial system. The fall, in 1998, of Long-Term Capital Management, a United States-based hedge fund which leveraged its way to USD 1 trillion of exposure, sent a powerful warning highlighting the age-old unpredictability of risk to investing institutions.

The global IT revolution gave us online banking, e-banks, and provided access to the type of instant market and corporate information that turned small time investors into 'day traders'. The 'most rewarding bull market in history' ended as hubris turned to nemesis for many dotcom investors. Questions concerning the role and responsibilities of the financial community with respect to the Enron scandal in the United States remain to be answered.

Many of the largest banking and insurance institutions, serving saturated and highly competitive markets in the industrialised countries where profit margins were tightening, explored the new opportunities in the emerging economies. Mergers, acquisitions and joint ventures were all the rage as Australasian, European, North American and Japanese financial institutions jostled to establish brand and market presence in industrialising Asia Pacific, the economies in transition, Latin America and, to a lesser extent, Africa.

Through all of this upheaval in the first post cold war decade, the finance sector woke up to, and started acting on, its environmental and broader sustainability responsibilities. This report, looking at the asset management, insurance and lending components of the global financial community, aims to examine how leading institutions have internalised sustainability challenges. It also considers how, increasingly, they are developing policies and practices to ensure financial institutions are playing their part in the development of responsible capitalism which respects the ideals behind the 'people, planet, prosperity' concept.

## Acknowledgements

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## Executive summary

The finance and insurance sector has taken great strides to improve its environmental and sustainability performance since the 1992 Rio Earth Summit. Banking, insurance and asset management companies, however, acknowledge that the task of establishing the sector as a key driver of a new 21st century global sustainability ethic is formidable. The sector stresses that it is not only willing to – but also realises that it must – take on the diverse and complex sustainability challenges if it is to flourish in a global economy.

Within the finance sector, corporate policies and practices that contribute effectively to the realisation of a balanced 'people, planet and prosperity' development process are emerging amongst the most progressive companies.

Across all elements of the sector, the development of standardised, internationally recognised sustainability metrics, accounting, and reporting protocols is a priority if the measuring, monitoring and reporting transaction costs associated with the sectoral move to sustainability are to be reduced. The Global Reporting Initiative (GRI), through its firm links with initiatives such as the UNEP FI environmental management and reporting guidelines and the Sustainability Performance Indicators (SPI) Initiative, is a significant sectoral development in this regard.

Sectoral voluntary initiatives, effective codes of conduct, and a collaborative approach with government and civil society for the development of innovative regulations, offer a powerful way forward to realise specific sustainability goals. Fiduciary authorities, capital markets, rating agencies, and those regulating the financial sector have an important role to play to reward sustainability leaders and nudge along laggards in the sector.

### Asset management

In mainstream asset management, integration of social, environmental and ethical concerns into investment analysis and portfolio construction, are embryonic at best. Since 1992, however, the socially responsible investment (SRI) movement has witnessed a coming of age and has become a critical driver, demonstrating to the mainstream the correlation between good governance, sound sustainability practice and positive investment performance. The arrival of sustainability indices heralds the start of a process by which SRI will be mainstreamed. Governance, transparency, and disclosure will be a significant driver of future sustainability oriented asset management.

### Insurance

The insurance sector will have to go 'back to basics' and work within a multi-stakeholder dynamic if it is to develop new products and strategies to enable society to cope with emerging sustainability challenges. Risks associated with climate change are the foremost example of the new challenging environment in which insurers and reinsurers are operating. The vast majority of global economic losses associated with natural disasters remain uncovered by either public or private insurance and the burden inevitably falls on the poorest members of society.

Government and the private insurance industry will be required to co-operate innovatively to underwrite or propose coping strategies for new societal risks stemming from excessive inequality, resource depletion, pollution of global commons and emerging technology risks. Increasingly, the insurance sector's historical expertise in risk assessment and management and its development of tools to mitigate and manage risk effectively, is being recognised by civil society activists as a powerful force to promote sustainability.

## Lending

The lending sector, which historically regarded itself as a 'clean industry' with a limited ecological footprint, was slow to adjust to environmental and sustainability concerns. During the 1980s and 1990s, however, the leading lending institutions moved swiftly to deal with internal environmental management issues and, increasingly, are exploring how the sustainability risks linked to the external dimensions of their business can be managed and turned into new commercial opportunities.

Once environmental liability became financial liability – driven by developments in the United States in the 1970s and 1980s – the lending sector awoke to the new challenges. As the sustainability agenda has shifted during the 1990s, to incorporate more social and poverty alleviation concerns, so have the leading lending sector companies adjusted to these issues.

Development of new environmentally focused lending products, micro-finance, and the emergence of private equity businesses to feed capital to sustainability-oriented companies and technologies, are all signs that the lending sector now appreciates the growing commercial opportunities associated with sustainable development.

Further development of credit and project screening processes that fully account for the sustainability upside and downside of debt and equity investment is required. Lending of money – debt financing – today is dominated by speed, security and liquidity. But in future, success will also depend more heavily on trust.

## Introduction

Looking to the future, it is worth remembering The Rio Resolution<sup>(1)</sup> submitted to the Rio Earth Summit in 1992 from the international social investment community describing the role of investment in achieving sustainable development. The covering letter to Maurice Strong, secretary general to the 1992 Earth Summit, stated: 'Financiers are the pump primers of the global economy – they can withdraw funds or give their full support to any enterprise. They can therefore uniquely and powerfully influence the course of industrial development so that it is compatible with the sustainable development agenda'.

The sentiments captured in the two sentences above, written some ten years ago, remain relevant for the diverse global finance sector in 2002.

In this report, prepared for the World Summit for Sustainable Development (WSSD), the environmental and sustainability achievements, the ongoing issues, and the future goals and challenges of the finance sector – the asset management sector, the insurance sector and the lending sector – will be explored.

This report does not present itself as the definitive viewpoint of the finance sector worldwide, covering all aspects of the complex subject of sustainability. However, leading figures from the finance community, many at the forefront of cutting edge environmental and sustainable development initiatives, provide a wide-ranging overview of the finance sector's achievements and, most importantly, cast forward to explore what critical steps financial institutions must take to play their part in the realisation of sustainability.

The remainder of the introduction aims to capture the key broad challenges that the finance sector and the capital markets, along with other major groups in society, face as we

see markets globalise and we come to understand the full scope of our joint sustainability challenges.

### Globalisation, sustainable development and financial institutions

The questions that arise for those financial institutions considering sustainability are complex and manifold. This finance and insurance sector report for the WSSD aims to explore some of the critical questions framed below by Carlos Joly of Storebrand:

- How can world financial institutions, international capital markets, and supporting national and regional components of the world's financial architecture, be motivated to find workable sustainability solutions?
- How can the process to globalise capital markets be harnessed to the cause of sustainable development?
- Will international capital demand and pay for eco-efficient factories and better living wages, as well as better corporate governance?
- How can environmental concerns be addressed and balanced against the priority to alleviate poverty and create jobs with better wages?
- What role will progressive financial institutions play in framing, promoting and fostering solutions to the aforementioned challenges?

The world faces a tremendous dilemma. Will we be able to evolve from underdevelopment to sustainable development, avoiding the evolutionary pattern and mistakes that have historically taken place during centuries in developed countries? In the Organisation for Economic Co-operation and Development (OECD) it is has taken us 30 or 40 years of attitudinal and institutional change to get where we are today. From grassroots public

(1) Full details of the Rio Resolution may be obtained from the United Kingdom Social Investment Forum Web site, <http://www.uksif.org/publications/archive-rio-1992-05/frameaset.shtml>

awareness in the 1970s, to environmental legislation, environmental liability, and, finally, the beginnings of socially and environmentally responsible investing, in the past decade. Can the world afford another century of the same stepwise evolution and the same pace of change to apply in the developing world? Or is the pace of deforestation, water pollution, megalopolis expansion, air pollution and general resource degradation such that the balance of risks pushes us to accelerate the process and find ways of leapfrogging evolutionary stages?

Mass poverty, corruption by public officials, tax evasion by corporations and individuals are both root causes and effects of underdevelopment. Overcoming these problems are huge global tasks that require working co-operation between the public and private sectors, between multinationals and NGOs, between international and local communities.

In developed countries, private rather than public sector financial institutions have led the way towards sustainable finance. In the developing world, the situation is the mirror image – public sector multilateral financial institutions have been the leaders. The World Bank, the European Bank for Reconstruction and Development (EBRD), the Inter American Development Bank (IADB), the Nordic Investment Bank (NIB), and the International Finance Corporation (IFC) are all implementing environmental criteria in their loans or investment projects in the developing world.

They have also established in-house environmental competence and require expert environmental evaluations when and where environmental risk is considered high. The private sector financial institutions are laggards when it comes to the developing world. The process of awareness, recognition, understanding, and response has not yet reached into Latin America, the Middle East, most of Asia, or Africa.

The stock and bond market's volatile attention to emerging markets has been fixated on economic growth, but has not been accompanied by concurrent attention to growing environmental problems. Let us note the challenge presented by the following interconnected trends:

- the globalisation of financial markets and the evolution of market economies in the developing world and economies in transition (such as in eastern Europe, China and Latin America);
- the steady fall of official development assistance (foreign aid) which makes the issue of private foreign investment acute and the most important focus in regard to developing world finance as it relates to development, environment and sustainability considerations;
- the enormous amount of capital needed for developing economies to obtain the growth rates required to alleviate poverty and generate sustained growth;
- the exacerbation of inequality in the developing world and in some regions, notably Africa, the re-emergence of diseases of poverty;
- the catastrophic global consequences were growth in the developing world to be conducted in accordance with the unsustainable pattern of industrialisation pursued by the northern countries.

Most of the foreign capital needed for the continued economic expansion of developing economies will have to come from the private sector and, naturally, financial institutions will play a fundamental role in this process. Since the 1980s, the amount of official development assistance (ODA) has fallen steadily to the present level, where it constitutes less than 0.3% of the gross national product of OECD member countries, under half of the global target of 0.7% set by the UN in 1970 [Kaul, 1995].

Since foreign aid is dropping, we must ensure that private sector capital is not invested in ways that increase pollution, eradicate biodiversity, destroy irreplaceable resources, or undermine the local ability to produce sustainably [Eatwell, 1997]. Financial institutions will have an increasingly significant role to play in ensuring investment streams and capital flows respect sustainability.



## Part I: Asset management

Globalisation, the wiring together of international capital markets, and the creation of new commercial and industrial opportunities in emerging economies demanded a 'step change' from the asset management community during the 1990s. By 1999, according to the United States Treasury, some USD1.3 trillion in private capital had flowed to emerging market economies compared with just USD170 billion during the 1980s. This exponential increase in capital for developing economies created new, often untested, investment opportunities for which the asset management community competed to create investment products.

At the same time, the information technology (IT) revolution – which encouraged the so-called 'democratisation of finance' – worked to break down the traditional mystique of the asset management sector:

In effect, a series of converging economic, societal and technological developments forced the asset management community to be increasingly competitive and creative to secure individual and institutional funds to manage.

As a result, the decade saw a proliferation of investment products serving the needs of a new breed of share-owning investors, mainly in the industrialised world. Traditional stocks, bonds, foreign exchange and commodities investment vehicles, were joined by hedge funds, derivatives, and other offerings that marked a drive by the asset management community to securities.

These developments in asset management followed a period of an unprecedented rise in share prices since the early 1980s. *'At the start of 1982, the Dow Jones Industrial Average stood at 875; the index for the exuberant and then newish Nasdaq stockmarket was 196. Eighteen*

*years later, at the start of 2000, after the longest and strongest bull market in history, the two indices stood at 11,497 and 4,069, respectively. That meant they had run up average annual real increases over that period of 11.7% and 14.6%, respectively. And this included, among several other dips, the great crash of 19 October 1987, when the Dow fell by 23% in a single day,' explained The Economist, 3 May 2001.*

The end of the long bull market came with the collapse of the 'tech bubble' which dominated the headlines in the late-1990s. Since January 2000, the world's markets have lost as much as USD7 trillion. Equity markets fell 63% from Q1 2000 to Q1 2001.

After a decade of dramatic change, innovation, and the spread of 'equity culture', the asset management community now faces the challenges associated with a stubborn bear market. The question to be asked is: do asset management companies have the appetite to tackle the challenges of sustainability during such a downturn?

### What has been achieved by the asset management sector?

**By Tessa Tennant, ASrIA (Association for Sustainable and Responsible Investment in Asia)**

The global asset management industry has taken a roller coaster ride over the last ten years – from the boom times of the IT expansion, to the Asia melt-down, to the burst of the dotcom bubble. Yet, throughout this turbulence socially responsible investment (SRI) has continued to grow substantially.

SRI has grown rapidly in both Europe and North America, and the Japanese market is now emerging. The United Kingdom ethical

investment market grew by 47.7% between 1998 and 1999 and fund managers have developed guidelines for reporting on social, environmental and ethical matters. PricewaterhouseCoopers predicted the SRI market in the United Kingdom would exceed £300 billion by the end of 2001. As an indication of market penetration, in the United States alone - the world's largest SRI market - of the total investment market with an estimated USD 16.3 trillion funds under management, 13% is deemed socially responsible [Social Investment Forum, 2000].

The growth of the United States market has been driven strongly by the introduction of 401k pension plans that give individuals the opportunity to make investment choices in their personal retirement plans. With the opening up of investment choice in pensions planning in other markets such as Japan, the United Kingdom and Australia, the prospects for continued SRI growth remain strong.

One major obstacle to sustainability issues being addressed by asset managers has been the lack of awareness and skills of investment professionals. Brokers, analysts, financial advisers, actuaries, pension trustees and investment managers are all 'gatekeepers' to the allocation of finance. Ten years ago, few investment advisers were prepared to consider recommending an SRI fund. Today, up to 60% are recommending them to their clients according to a recent survey in the United Kingdom. However, the figure is much smaller in markets where SRI is less developed.

In some instances the SRI specialisation has triggered a much wider corporate awareness as in the case of AMP, which now has a sustainability unit covering its entire investment operations. In the case of insurance giant CGNU, which has been active on insurance and climate change, as well as overall environmental management issues, it was a logical next step to set up an SRI capability.

SRI has become the leading light for sustainable development in the asset management industry. No other field of investment has been as active in making sense of sustainability for investment purposes. In the ten years since the Earth Summit, it has shifted from being the specialisation of a few niche players, to a standard offering from many investment houses.

### Evolution of environmental and social analysis

The last decade has seen a convergence of corporate governance interests with SRI. Only last year, America's leading corporate governance activist, Robert Monks wrote: *'Nothing is external to a global shareowner. Institutions having investments in all countries have virtually no incentive to permit environmental and hiring practices in the poorest countries that can only have the impact of competing with their own investments elsewhere. Why lower third-world production costs through pollution only to compete with your own products manufactured elsewhere when you own all of the comparable enterprises?'* [Monks, 2001].

Consequently, greater focus is being placed on reliable metrics for company performance. The decade has seen the first attempt at a universal accounting standard for carbon disclosure<sup>(2)</sup> and one of the primary objectives of the GRI is to develop accounting standards for other environmental and social metrics.

The number of research groups supporting the industry has grown and become more global. The traditional corporate governance research groups such as IRRC in the United States and Manifest in the United Kingdom are reaching out to SRI, while the early SRI research companies such as EIRIS, CEP and KLD have been joined by Innovest, Okom, SAM, Global Risk Management, ARESE, Caring Company, Good Bankers, SIRIS, Japan Research Institute, Unibanco and others. The challenge now facing the industry is to reduce the costs of core SRI data provision and increase the quality of SRI analysis supplied to investment

(2) Produced by the World Resources Institute and The World Business Council for Sustainable Development in collaboration with the United Nations Environment Programme.

managers. 'Raw data provision is a commodity business...it's the analysis of that data which counts and where the value-added can be found,' says Mark Bytheway of SIRIS.

While the number of specialist SRI research groups has grown, larger securities houses have also begun to provide coverage for SRI funds. CLSA's Emerging Market survey of Corporate Governance standards now includes a number of SRI factors and Dresdner Kleinwort Wasserstein publishes a daily SRI report for the European market.

### Shareholder engagement

Shareholders have also become more vocal over the last decade, especially in the United States and United Kingdom, and increasingly in other European countries. Australia too has seen its fair share of disrupted AGMs where shareholders have joined with non-governmental organisations to raise issues of concern. The Asian market meltdown in 1997 has also prompted many institutional investors

to become more active in demanding equal rights as minority shareholders, calling for an end to cronyism and greater independence of board directors.

Corporate governance organisations have emerged in many countries with working groups established by the OECD and the World Bank. A network of active institutional investors is working together under the Bank's auspices.

In the United States, environmental and social resolutions have been championed for many years by the Interfaith Centre for Corporate Responsibility, a powerful alliance of social investors, church groups, academic institutions, municipalities and other shareholding NGOs who submit a wide range of resolutions to companies every year.

This example of collective shareholder action is spreading to Europe and Australia. In the United Kingdom, it began with shareholder

**Table 1: Types of analysis in SRI stock selection with examples**

Type of screening	Examples
<b>Ethical screening</b> Factors driven initially by religious communities but important to many atheists too.	Avoiding manufacturers of armaments, alcohol, gambling, tobacco, pornography.
<b>Environmental risk due diligence</b> Part of regular due diligence by non-SRI firms in mergers and acquisitions, IPOs etc. Also considered by SRI community.	Contaminated land, sick buildings, out-dated technology.
<b>Social responsibility</b> Concerns about justice and human rights and the impact of globalisation drive this agenda.	Workplace issues such as profit-sharing, family benefits, women, minority and union rights and community issues such as sourcing, volunteering and giving.
<b>Sustainable strategy</b> Driven by concerns about pollution and resource depletion arising from population growth, global industrialisation and increasing material consumption.	Eco-efficiency and re-engineering to eliminate toxics and emissions. Industries of the future.
<b>Corporate governance</b> Application across asset management industry and standards rising.	Voting rights, independent directors, minority shareholder rights, democratic and accountable management.

outcry at Cedric Brown's pay at British Gas, followed by the Shell campaign that urged shareholders to vote for clearer policies and fuller reporting on environmental issues and human rights. In 2000, 13% of shareholders voted for BP to redirect its capital expenditure programme away from the ecologically sensitive Alaskan fields towards solar power. In Asia, a number of shareholder initiatives have been created, such as HAMS, the Hong Kong Association for Minority Shareholders, and the shareholder network established in South Korea to support reforms of companies in that country.

### Backing for community investments and venture finance

Social investment is not just about the stock markets. Just as crucially, and at the other end of the capital market spectrum, social investors have pioneered new mechanisms for micro-finance. The South Shore Bank (United States), Grameen Bank (Bangladesh) and Triodos Bank (Europe) are notable in this regard, and Calvert's pioneering work in this field is now available to other investors through the Calvert Foundation.

One notable micro-finance initiative is mutual funds (unit trusts) that devote a portion of their assets to high social impact and social venture finance products. These innovative funds offered by Calvert Funds and Australian Ethical Investment are fully supported by their

### Deutsche Bank – A big hand in making small loans

The Deutsche Bank Micro-credit Development Fund provides loans to micro-credit programmes throughout the world that, in turn, extend small loans to poor people for self-employment. These small loans enable families to improve their lives through their own initiatives, and they are exceptionally effective in enabling families to rise from poverty. Micro-credit loans currently reach nearly 30 million borrowers, and the field is growing rapidly, as it maintains high repayment rates.

In January 2001, the Micro-credit Development Working Group was launched by Deutsche Bank. Professional banking experience can offer much needed assistance to the micro-finance sector, and the main goal of the working group is to supply interested bank employees with information about micro-finance and to provide opportunities for interested volunteers. Recent projects have included:

- a project in Bolivia involving Empreder, a private sector micro-credit institution that targets poor regions outside Santa Cruz and other cities;
- a credit memorandum for Milamdec Foundation on Mindanao in the Philippines. This micro-credit institution lends only to women, mostly in Muslim agricultural communities.

Volunteers use their expertise to prepare credit memoranda, applying quantitative and qualitative analyses. The fund is a non-profit venture with minimal expenses. As Asad Mahmood, a director in the Community Development Group explains: 'Our hope is to continue to engage more bank employees in this work as we expand the Fund to reach more organisations serving the poor throughout the world.'

This extract was taken from Deutsche Bank's Community Focus newsletter - Autumn/Winter 2001

investors as the funds provide them with a simple, low risk route to an inspiring area of investment. It is an innovation which funds elsewhere have yet to adopt.

The provision of affordable housing and mixed-use developments is a key feature of many community finance projects. Yet, community finance remains a small proportion of property investment overall. There is considerable scope for further innovation in property finance for affordable housing, and more environmentally sound and low energy construction. As an asset class, property investments have shown least progress in the last decade.

There also remains considerable scope for start-up financing of sustainable enterprises such as renewable energy, water management, recycling, organic food production, mass transit systems and alternative health therapies, and these areas must be a focus for governments to leverage private finance in the decade to come.

### Measuring the markets

In 1990, KLD launched The Domini Index, the first social index tracking the United States market. The index substantially raised the visibility of SRI on Wall Street and has fostered greater confidence in SRI through its good performance. In 1999, Dow Jones and Sustainable Asset Management (SAM) of Switzerland<sup>(3)</sup> launched the first world series of sustainability indexes, the Dow Jones Sustainability Indexes (DJSI).

The DJSI index policy is driven by the view that corporate sustainability is an investable concept. Superior performance is directly related to a company's commitment to SAM's five corporate sustainability principles: technology; governance; shareholders; industry leadership; and society. This concept, they state, is 'crucial in driving interest and investments in sustainability to the mutual benefit of companies and investors. As this benefit circle

strengthens, it will have a positive effect on the societies and economies of both the developed and developing world' [Dow Jones Indexes, 1999]. The launch of the series triggered new interest in financial benchmarks for SRI and was followed, in 2000, by the launch of the FTSE4Good Series that takes corporate social responsibility as its core theme.

### The Rio resolution and collective action

One important trend since the 1992 Rio Earth Summit has been the development of a collective voice for SRI. Social investment organisations now exist in several European countries, Canada, the United States, Australia, New Zealand, and one is planned for Japan. Pan-regional associations are also now appearing. ASrIA, the Association for Sustainable and Responsible Investment in Asia and EuroSIF, the European Social Investment Forum, the United Kingdom Social Investor Forum, and Observatoire Responsabilite Social Enterprise (ORSE) in France provide forums for SRI dialogue, education, and communication to investors and asset managers. Further, at America's largest SRI conference 'SRI in the Rockies' last year, the international working group began to examine the creation of a global capability to represent SRI interests at intergovernmental fora and other global gatherings.

### Looking ahead

Looking ahead, it is worth remembering The Rio Resolution<sup>(4)</sup> submitted to the Earth Summit in 1992 from the international social investment community, describing the role of investment in achieving sustainable development. The covering letter to Maurice Strong, secretary general to the Earth Summit, stated: *'Social investors are at the forefront of developing methodologies for the assessment of corporate performance from an environmental and social perspective. This analysis is the bedrock from which companies can evaluate and adjust their activities in relation to environmental*

(3) <http://www.sam-group.com/>

(4) Full details of the Rio Resolution may be obtained from the United Kingdom Social Investment Forum Web site, <http://www.uksif.org/publications/archive-rio-1992-05/frameset.shtml>

## ASrIA

ASrIA is a not for profit members association dedicated to promoting SRI within the Asian capital markets. Formed in late 2000, ASrIA has already begun to make a mark on the Asian investment scene. ASrIA now boasts over 60 founding members and is looking to increase its network over the next 12 months.

Working in partnership with both public and private organisations, ASrIA has begun to lead both the debate and practice of SRI within the Pacific Rim. ASrIA's inaugural conference took place in Hong Kong and was attended by SRI professionals from around the globe. ASrIA has also worked with SRI bodies in Taiwan and China as well as participating in CLSA's major investment conference. This year's annual conference will be held in Japan and a seminar will also be held in Singapore for the Monetary Authority.

Building on the success of its first year, ASrIA aims to increase momentum for sustainability by: raising awareness and providing information; facilitating the provision of high quality SRI products and services; driving the development of policies both within the financial and public sectors; and, developing an outreach programme to educate the investment industry in SRI techniques and practices.

*and cultural priorities. Such analysis deserves wider recognition as a key mechanism by which sustainability can be achieved.'*

The letter went on to say: *'Financiers are the pump primers of the global economy – they can withdraw funds or give their full support to any enterprise. They can therefore uniquely and powerfully influence the course of industrial development so that it is compatible with the sustainable development agenda'*. For this reason, sustainable asset management is vital for the planet. Much has been achieved in the last decade but there is still much more to be done.

## Unfinished business: Tools for implementation in the asset management sector

**By Sarita Bartlett, Storebrand**

The good news is that many mainstream asset managers have made steps towards sustainable development and, for this, they should be commended. There still remains much work to be done. Even using the most liberal definition of 'socially responsible', assets under that type of management only represent a small fraction

of asset managers' total assets. In most cases, SRI tools and techniques are still segregated from mainstream asset management. So, although SRI has reached the mainstream, it is still not mainstream. At the same time, asset managers are not alone; even the most proactive governments and NGOs have not used SRI to manage their total assets.

The Johannesburg Summit 2002 will provide asset managers with the opportunity to play a key role in accelerating the progress towards sustainable development. However, in addition to confronting new challenges, managers must address business left unfinished since Rio. Asset managers need to take a proactive stance towards addressing their fiduciary responsibilities, with environmental protection and social justice being integrated into these responsibilities.

In particular, asset managers need to continue to work on the following:

- communicating SRI policies and reporting the financial, environmental and social performance of products to investors and

- other stakeholders;
- developing or extending verifiable methods for SRI management;
- engaging with corporations to encourage change, and if change is not forthcoming, exercising voting power, whenever possible or divesting;
- establishing policies that integrate environmental and social issues into the management of all assets.

### Reporting performance

Greater transparency must be offered through disclosure information in annual reports. This does not just mean reporting on the results of performance, but also includes disclosure of management's vision/policy and integration into management and operational systems. Moreover, these disclosure rules should not only apply to global corporations, but should be gradually extended to those companies that do not currently participate in global markets.

To ensure the reliability of the information being disclosed, introduction of independent verification is indispensable. The further development and spread of the GRI is very important.

GRI's goal is to provide a framework for reporting economic, environmental, and social data so that international comparisons among companies can be made with a far greater degree of confidence.

One of the many positive features of this initiative is that it is grounded in a multi-stakeholder approach. Hundreds of organisations, including a wide range of businesses, academia, government and non-governmental organisations, representing over 50 countries have contributed to the GRI process. GRI is a win-win proposal, because companies report in a standard format, so it is far easier for stakeholders – including asset managers – to judge and benchmark companies' performance without the use of lengthy questionnaires.

### Developing and extending verifiable methods for SRI management

In the United Kingdom, pension funds are required to disclose whether their policies address environmental and social issues. Germany has enacted a similar regulation, and Australia is following suit. The Swedish government has legislated that its government-controlled pension funds must implement socially responsible criteria into investment processes.

In addition to pension legislation, other forms of public policy can help promote sustainability. At WSSD, governments should give serious consideration to the following measures:

- the expansion of environmental liability legislation in ways that makes a more direct connection between certain major well-defined environmental risks and a concomitant financial risk to lenders, insurers, and investors;
- the adoption of environmental reporting requirements for initial public offerings (IPOs) and stock market-listed companies;
- the adoption of generally accepted environmental and social reporting standards, of varying scope and complexity depending on the size of firm and its type of activity;
- the introduction of environmental and social criteria for pension funds, life insurance funds and government-controlled funds.

### Encouraging corporate change

As intermediaries between investors – both private and institutional – and the companies in which they invest, asset managers are in a unique position to encourage corporate change. In exercising their fiduciary responsibility to clients, they can undertake to include environmental and social, as well as financial considerations.

If, for example, the company is engaging in undesirable activities, managers can use

shareholder activism to invest in those companies, and then attempt to alter the companies' policies and practices by introducing shareholder resolutions at the companies' AGMs. If change is not forthcoming, managers can opt to sell investments. Alternately, a decision not to invest at all might be made. It is clear that we will see a growth in shareholder – both individual and institutional – activism in coming years. Governments at WSSD should recognise this and develop innovative public policy mechanisms to support the process without impinging on the flexibility of the markets.

To reward companies which are taking steps toward sustainability, the 'best in class' approach pioneered by Bank Sarasin, Storebrand and SBC (now UBS) can be utilised. This positive screening approach identifies companies whose environmental, social, and financial performance as measured by a defined set of criteria, are among the best in their respective sectors. By limiting negative criteria to exclude the 'worst' companies or sectors, almost all corporations are encouraged to contribute to sustainable development.

### Integrating environmental and social issues into the management of all assets

The following is a blueprint for action for the mainstream asset management community, if SRI is to be effectively incorporated in broader investment activities:

- develop a policy for integrating the ethical, social and environmental dimension into the investment strategy;
- assess investment managers on their ability to take social and environmental performance into account in stock selection and to influence companies towards best practice. Ensure that they don't act counter to long-term corporate social responsibility;
- exercise voting power to encourage responsible behaviour;
- review portfolios for unacceptable stocks and exclude the very worst, or invest just a small percentage of the fund socially and assess the resulting performance;
- integrate the social investment dimension into venture capital and property investments as well as equities and bonds.

## Corporación Andina de Fomento (CAF)

### Summary of key specific sustainable development programmes of a financial institution in Latin America

The Corporación Andina de Fomento (CAF) is a multilateral financial institution with the mission of supporting the sustainable development and integration of its member countries. With total assets of USD5.8 billion, it serves both the private and public sectors in its shareholder countries: Bolivia, Colombia, Ecuador, Peru, Venezuela, Brazil, Chile, Jamaica, Mexico, Panama, Paraguay, and Trinidad and Tobago.

To fulfil this mission, in 1995, CAF created its sustainable development department to reduce the environmental and social risk of all direct investments, improve the management of natural assets of its shareholder countries, promote social participation and values, support research and training, and develop environmental business opportunities.

To foster sustainable development in Latin America CAF has developed several programmes and tools including the Human Development Fund (FONDESHU – *Fondo para el Desarrollo Humano*), the Latin American Carbon Program (PLAC – *Programa Latinoamericano del Carbono*), Financial Institutions and Sustainable Development, the Biodiversity programme, and CONDOR: Regional Analysis Tool for Sustainable Development.

## Mainstreaming best practice: The potential of voluntary initiatives and creative regulation

**By Carlos Joly, Storebrand, chair of the UNEP Insurance Industry Initiative**

Since the 1970s, public awareness of environmental problems has led to the passage of many environmental laws, most of which are directly aimed at industrial manufacturers. These regulations seek to control emissions (toxic and otherwise), to promote recycling and reduce waste in all its forms, and to protect earth, water and air. In the United States and Europe, environmental legislation has been instrumental in fostering corporate environmentalism, forcing reticent companies to become better corporate citizens. Along with control and command legislation, and as a result of the perceived regulatory inefficiencies or shortcomings, business has moved forward as well with voluntary initiatives. UNEP FI Programme is an example of voluntary progress in this area.

A form of legislation that has been extremely consequential is environmental liability. That is, laws that internalise and create a pricing mechanism for an environmental risk by assigning its responsibility to a business operator or financial backer. It has added an important dimension, with substantial ripple effects. Environmental liability has made environmental risks directly relevant for lenders and investors.

By making banks and investors liable and at risk, environmental liability has provided a wake-up call that cannot be ignored. Chemical fires and oil spills have prompted some of the world's largest industrial companies to become serious about environmentalism. But banks, insurance companies, and investors started becoming serious about the environment when environmental liability became financial liability. To the extent that environmental risk becomes financial risk, the financial markets pay attention. Not to do so would be financially irresponsible.

Beyond the motivation for risk reduction, a handful of forward-looking banks, insurers, and investors are also starting to gain significant competitive advantages by the systematic application of corporate environmentalism and, more generally, by exploring how to address sustainable development in their day to day business. Not unlike other large multinational companies, some leading banks and insurance companies are adopting environmentalism and corporate social responsibility as drivers of brand development, product differentiation and competitive advantage. Noteworthy in this respect are names such as Swiss Re, Gerling, Storebrand, Hendersens AMP, and many of the firms that are involved with the UNEP FI.

But despite significant change and progress in the past ten years, corporate environmentalist leaders are not the mainstream, just as socially responsible investors are not the mainstream. The challenge to public policy is to devise efficient mechanisms that will prompt the few to become the many.

In general, the financial community has been a laggard. Credit, insurance and investment portfolios incorporate environmental risks and opportunities only to a limited extent, though more banks, insurers and investment managers are now at the point of making the business link from corporate environmentalism to sustainable finance.

Sustainable finance should mean not only that investors exclude stocks in some categories of companies, but rather that they seek to invest in firms which are eco-efficient and gain competitive advantages through good environmental, human rights, and social practices. Many niche funds championing various socially responsible agendas have emerged. But the bulk of money in portfolio management continues to be invested without specific regard to social and environmental impacts. A similar observation applies for credit and insurance products.

How can governments help?

The process can be accelerated by governments acting in creative ways. One way is to create reporting legislation that obliges pension funds to state their policy on socially responsible investment, as the United Kingdom and Germany have done. Another way is the application of environmental criteria to government-controlled funds, for example, as Sweden has legislated for its government-controlled pension funds. Yet another way would be to require implementation of generally agreed upon reporting requirements of varying scope and complexity for all stock market listed companies, depending on their size and their type of activity.

In short, in the United States and Europe we are beginning to see the outlines of what could become a virtuous circle, connecting public concerns, environmental legislation, corporate environmentalism and financial markets. The concept of fiduciary responsibility is in the process of being expanded to include the broader social and environmental interests of the owners of pension and life insurance funds. There is a growing realisation that there need be no systematic conflict between profitability and environmentalism.

This phenomenon is not circumscribed to Germany, Switzerland, or the United Kingdom. In France, for instance, 20 companies, such as CDC, AXA, Storebrand, Total Fina Elf, have joined in with labour unions to establish ORSE, with the intent of developing analytical tools for the French capital market to provide a better understanding and appreciation of the social and environmental issues facing French companies.

ORSE's working groups do research on socially responsible investment ranking and screening methods, environmental and social reporting and accounting systems, business ethics and other related topics. Similar voluntary awareness-building and tool-developing initiatives are taking place in Japan, in Latin America (BCSD Latin America, Fundacion Futuro Latinoamericano, etc.) and in other regions.

But what is common to all these voluntary initiatives is that they have so far been largely dependant on the passion and drive of a handful of senior or middle managers in larger corporations or in selected non-governmental organisations. This, we must be willing to admit, is not enough given the enormity of the tasks at hand. Governments have got to get more involved in lending a hand.

## Future challenges and goals of the asset management sector

By Takejiro Sueyoshi, Nikko Asset Management

### Changes in the business environment

A set of clearly identifiable changes are taking place that will greatly influence the business environment in which the asset management sector operates. These changes are likely to intensify in the coming decade and will define the agenda for many of the future sustainability challenges of the asset management community.

Key emerging challenges include:

- individual responsibility. The materialisation of global networks, owing to advancements in IT, are likely to emphasise the need for greater corporate and investment disclosure as individuals pay more attention to the social and environmental impact of their investments. The importance of the sustainability role of individual investors and networks of investors will heighten;
- intensifying corporate social responsibility. With respect to corporate competitiveness, the failure of companies to respond in a timely fashion to environmental and social issues will directly impact management decisions;
- the emergence of new investors. Changing demographics – mainly the growth in the number of senior citizens, particularly in OECD countries – will boost the weight of investment through pension funds and vehicles such as 401k, the United States pension and retirement plan. Driven by such demographic changes, there will be a move for investments to be more directly linked to the achievements of long-term social sustainability.

Increasingly, the shared values of all stakeholders will be incorporated into the concept of sustainability. Expectations for the positive role of the asset management community are growing as it is seen as a powerful conduit to redirect investment capital to more closely support sustainability goals.

### The future of asset management

The goal of the asset management community is to play an active role as the intermediary between investors in capital markets and corporations pursuing economic effectiveness, and increasingly, sustainability. For example, under the provisions of the Kyoto Protocol, asset management can generate industrial capital for use in the reduction of CO<sub>2</sub> emissions. In other words, asset management can serve as a key channel providing capital needed for the transition of business and industry to a more climate friendly stance and, at the same time, enhance sustainability goals.

This section highlights future environmental and sustainability issues and opportunities the asset management industry will face.

#### Increased variety of products

Two critical points should be made. Firstly, SRI factors will become an innate element of any active fund product (even those not specifically SRI-oriented) as long as a sound investment philosophy and appropriate screening approach are implemented. Secondly, we will see a diversification of SRI funds.

We will most likely see the development of a variety of funds focusing on the specific interests of individuals or investor groups. For example, various pooled investment vehicles could address and support companies contributing positively to the reduction of CO<sub>2</sub> emissions or companies promoting renewables and the maximum use of natural energy. Another category could be super compliance funds. Furthermore, we are likely to see a broader line-up of passive SRI fund products with the development of a common

global SRI index (covering more countries and a wider range of stocks than current SRI indexes).

#### **Increased research activity**

In research, we are likely to see two areas of growth. Firstly, securities analysts are likely to begin including analysis of companies focusing on SRI as a part of their normal research activities. In other words, the standards of evaluating corporate value are likely to change. Assessment of a company thus far has focused mainly on financial performance, but in the future mainstream evaluations will likely have to take into account a company's environmental and social activities. This is likely to become an indispensable factor as one aspect in judging a company's competitiveness.

Secondly, research institutions are likely to undertake their research with a more detailed exploration of specific activities. Specialised research institutions will be established for the purpose of analysing environmental and social issues.

#### **New client services**

Services are likely to include the disclosure of information via a fund, supplying information to investors, and the sponsoring of seminars to nurture environmental education for investors. In addition, we are likely to see the appearance of other important functions such as products customised for green investors and the redesigning of management schemes.

#### **New bargaining power of money managers**

In working toward the creation of a sustainable society, asset management companies are likely to take on a more important role. For example, asset managers could promote immediate action by companies to improve CSR, or become an entity with a positive influence over corporate management.

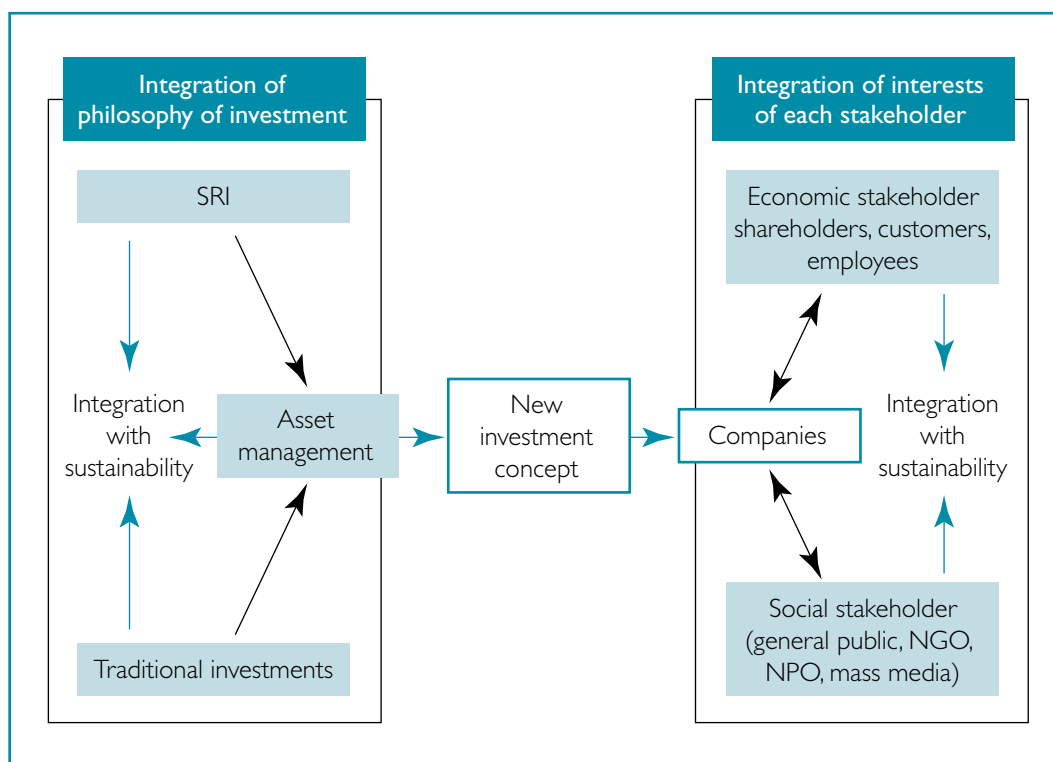
Critical changes in the approach of the asset management community to social, environmental and economic challenges and opportunities are captured in the diagram on the opposite page.

### **SAM sustainable water fund**

On 29 September 2001, the independent asset management company Sustainable Asset Management (SAM) launched a Sustainable Water Fund. This targeted investment fund, which allows a portfolio approach to water finance, was created in order to respond to trends facing the sector and to provide a vehicle for diversified investment targeted at companies practicing sustainable management by 'adding value in environmental and social as well as economic terms'<sup>(5)</sup>. The fund focuses investment in four segments of the industry: distribution and management; advanced water treatment; demand-side efficiency; water and food. Its scope is wider than many water investment approaches to date.

While the portfolio of investments is largely focused on the developed world, inclusion in the fund will identify those transnationals operating in distribution and management and advanced water treatment who are deemed by the fund to be operating a sustainable business. Additionally, the fund manager can influence private sector investment in less developed countries (LDCs) by valuing such investment highly in assessing sustainable business practice. In doing so, the fund may lead other trans-nationals to pursue investment in LDCs and emerging markets.

<sup>(5)</sup> SAM Sustainable Water Fund Prospectus, 2001.



### Meeting future challenges

We must advocate the expansion of mainstream analysts' duties to include social criteria. This means that analysts and fund managers will focus on environmental and social activities, not just financial issues, when evaluating a company's potential. We hope this will lead to open dialogue on related issues with management. The goal is wider and higher quality research coverage by analysts and expansion of coverage to small- and mid-cap companies which exhibit strong CSR, as well as strong financials.

Clearly, senior management's commitment to environmental and social issues is essential. Companies in the asset management industry are working to improve the quality of staff, analysts and fund managers through the diffusion of management concepts that include CSR. Social responsibility training for staff will indicate further commitment.

This training will help managers to diversify the types of assets used in investment instruments, such as the creation of Green Bond Funds, which incorporate environmental and social activities into bond ratings. Bond rating agencies will need to acquire expertise in making 'green' evaluations. It will also help in the development of dedicated funds serving highly specialised sectors covering specific environmental needs.

There is also the potential to develop products that promote the provision of capital to SRI-oriented companies in a joint partnership between the asset management company, other investment banks and the issuer. This will lead to a higher level of satisfaction for both those seeking capital and those looking to provide it.

Further, it is necessary for asset managers to provide their customers with information and promote communication to encourage the enlightenment of social responsibility.

## Potential threats

### Constraints on the investment universe

The implementation of SRI screening could reduce the number of investment targets (stocks), which could limit fund management performance. Increased disclosure of the environmental and social activities of both global and local companies could help to alleviate this problem by expanding the potential investment universe. Currently, the content and standards of disclosure are under debate.

### Reputational risk of the asset management company

Unless SRI criteria are clearly defined and evaluated, asset management companies could unknowingly invest in companies that are not compatible with SRI objectives. This could result in negative attention from NGOs and the mass media.

### Gap between regional economies

Without economic growth, companies will not be in a position to consider environmental and social issues. Considering the significant gaps between regional economies, especially between developed and developing nations, environmental and social issues may not be a priority in all economies.

### Clashing cultures

Owing to differences in culture, religion and regional attributes, contradictions in sustainability screening standards could possibly hinder the sharing of values. Global standards are not equal to western standards. Therefore, forcing western CSR ideas upon companies in other countries could bring about opposition. To achieve the goals set herein, thorough debate is necessary.

## 'Capital is a coward, it flees from risk ...'

This is an extract, taken from a keynote speech by Iqbal Sharma-Meer, Department of Trade and Industry, Government of South Africa, at the UNEP FI African Outreach Event (Midrand, South Africa, 28 to 29 January 2002)

*'On a recent visit to the United States, 35 sub-Saharan trade and foreign ministers took part in a roundtable meeting. One of the key themes for the event was – 'Capital is a coward, it flees from risk.' I disagree; capital is an inanimate object. The claim that capital is a coward, is more an indictment on the owners of capital rather than capital itself. Where capital from the United States has failed to take up African opportunities investors from Asia have come. Does this capital carry a different risk analysis? The largest flows of foreign direct investment (FDI) are from countries of the north to each other. Is there a race dimension to capital? Does capital only have to seek a financial profit or can human development be seen as good return on one's investment?'*

*It is essential to ensure adequate participation of African countries in the formulation of financial standards and codes. International efforts must be made to help build capacity on the continent, to enable progressive, voluntary implementation of internationally accepted standards and codes. Sovereign risk assessments made by private sector must be based on strict, objective and transparent parameters.*

*We believe that each country has the primary responsibility for its own economic and social development, and the role of national policies cannot be over emphasised. That is the primary responsibility of NEPAD. At the same time, domestic economies are now interwoven with the global economic system, and national development efforts need to be supported by an enabling international economic environment.'*

## Conclusions

SRI has experienced strong growth in funds under management over the last decade, and there has been a steady increase in the number and types of SRI products offered.

Today, investors can choose from a menu of SRI products that includes negatively screened, positively screened, best in class, stakeholder activism and engagement-based portfolios, SRI index-based portfolios, country and regional funds, sector funds, SRI venture capital products, and SRI bond funds. Several asset managers have implemented SRI criteria on real estate portfolios as well.

In the future, we can expect to see more products focusing on the specific interests of individuals or investor groups, and an increase in passive SRI fund products based on the development of common more comprehensive global SRI indexes.

Going forward, to achieve the goals of sustainable development companies must clarify their economic, environmental and social activities and disclose them to improve transparency. Accordingly, the fiduciary authorities should help to promote disclosure of CSR activities among public companies. In principle, companies not committed to disclosure standards should not be targets for investment.

To aid in transparency, governments should provide guidance for disclosure, including the adoption of environmental reporting requirements for IPOs and publicly listed companies. In addition, there should be consideration of systemising the publication of sustainability reports.

Governments should also follow the lead of the handful of European countries leading the way with pension fund disclosure requirements. Continued work on setting standards for environmental and social

activities, including the introduction of environmental and social criteria for all pension funds, life insurance funds, and government-controlled funds, will help to ensure sustainability.

Rating and auditing agencies must also do their part. Rating agencies must evaluate the environmental and social risks inherent to a company's business activities, not just financial performance when issuing credit ratings. To ensure that company statements are accurate, inspection agencies will need to be created. For this purpose, it is necessary to strengthen the GRI. The reporting style of sustainability and environmental reports must become as universally common as financial reports. International standards must be set for those areas which can be quantitatively be measured, through the use of such methods as environmental accounting.

As global players, asset managers must acknowledge their responsibility for contributing to solve global challenges, such as poverty, inequity, healthcare, climate change, and access to clean water. These challenges are complex and solving them will require creativity and innovation, as well as the support of other stakeholder groups.

Nonetheless, as our experience since Rio has shown, SRI is one tool for successfully meeting those challenges. In addition, mainstream asset managers will be called upon increasingly to integrate or sustainability dynamic into their broader activities.



## Part 2: Insurance

Insurers and reinsurers are deeply involved in environmental matters and increasingly attuned to the challenges and opportunities presented by the emerging broader sustainability issues. Environmental issues and aspects of sustainability have become a central concern for society because many individuals have suffered from damage to the environment or from loss of resources. Catastrophes around the globe show the great vulnerability of many regions and their populations.

Before exploring the links between the broad insurance sector and sustainable development considerations, here is a brief overview of the structure, dynamics and key trends associated with this diverse industry.

The world private insurance market<sup>(6)</sup> had a premium volume of USD2.4 trillion in 2000. The annual growth rate has fluctuated between 2% and 7% over the last ten years, with an annual average of 6% – a substantial achievement. Ten of the world's biggest insurance markets are European or American, with only Japan and South Korea finishing in the top 12 in 2000. The United States and Japan generate some 50% of the premiums, followed by the four biggest European markets with a share of 29%. Industrialised countries clearly dominate the global insurance market with a 90% share. Emerging markets combine only 10% of the premiums, while their population represents 85% and their GDP 23%.

The insurance density is diverse. Whereas industrialised markets show an average premium income per capita of USD 2,384 the average in emerging markets is merely USD 42. The insurance penetration, on the other hand, measured by the percentage of premiums against GDP is much 'healthier' with 3.2% in emerging markets compared with 9.1% in the others.

These figures underline a huge structural discrepancy between the various individual markets. They also lead to the simple conclusion that private insurance is by far less important in less developed countries, and to the question of how this could be changed.

Nevertheless the growth rates of insurance in emerging markets are impressive and indicate growing wealth in a number of countries. Over the period 1990 to 1999, life business in emerging markets grew on average by 11%, against 5% in industrialised countries. The respective figures for non-life business are 7% versus 2%. Today South Korea, Taiwan, Bahamas, Barbados and South Africa have reached a level of insurance density and penetration similar to that of the more advanced industrialised countries. The situation is still unsatisfactory in countries with a large population like China, the Philippines, India, Indonesia or Bangladesh.

The insurance industry has become more global over the last decade, despite a fairly small number of global players. The main driving factors of this growth were insurers following their existing clients, and also realising the potential of growth in emerging markets. On the other hand, there is in emerging markets a greater demand for insurance cover and capital as a consequence of strong economic growth, increasing trade, new risks and new products. Insurance know-how needs to be developed quickly or imported.

A major obstacle of worldwide financial services are national regulations in respect of market access. Attitudes have changed in recent years in Latin America, central and eastern Europe and also in Asia Pacific. Joint ventures are a common approach in these markets, although sometimes as a minority participation only. The opening of branch offices or subsidiary companies is still exceptional.

(6) Direct life and non-life business only, except reinsurance written

Breaking down barriers to international expansion has been aided by the activity of World Trade Organisation (WTO) and its General Agreement on Trade in Services (GATS) component, achieving a major breakthrough in 1997. Now, 102 countries have committed to liberalisation of financial services. The GATS agreement offers legal security and protection to global insurance players. In this respect it is of special importance that China joined the WTO recently.

Eastern European countries will in particular benefit from developments in the EU, as has Mexico by the widening of North American Free Trade Agreement (NAFTA). On joining the EU Bulgaria, Estonia, Latvia, Lithuania, Poland, Romania, Slovenia, Slovakia, Czech Republic and Hungary will allow the complete freedom of services, including the setting up subsidiaries and will accept the system of a single licence and home country control.

### Insurance and sustainability

Risk assessment and risk management sit at the heart of many of our sustainability challenges. Understanding and dealing with many different kinds of risks is the particular expertise of the insurance sector. As a result, the connectivity between sustainability issues and the insurance sector is strong and will be increasingly appreciated by broader society.

In considering 'what has been achieved by the insurance sector?' in terms of sustainability, it is necessary to explore how risk and sustainability are connected and where the insurance sector plays a role in mitigating both traditional and emerging risks such as climate change. The involvement of the insurance sector in environmental and sustainability concerns is easily summarised:

- insurers and reinsurers are involved in the settlement of all sorts of environmental losses, be they man-made or natural, catastrophes or not;
- insurers have considerable know-how in risk management and claims handling. They have given loss prevention advice to their customers and to the general public for hundreds of years. More and more they also advise and work with local or regional administrations and governments.
- they control substantial assets that are open to sustainable management.

Although considered a 'clean' industry, insurance companies have many opportunities to support sustainability and have responded positively to these opportunities since the 1992 Rio Earth Summit. So what has been achieved in the last decade by the insurance sector?

## What has been achieved by the insurance sector?

**by Walter Jakobi, Gerling Group, former chairman of UNEP Insurance Industry Initiative**

In considering economic and social achievements of the sector, one has to bear in mind that the private insurance industry is only a part of the social security system in every country, quite often only a small part of the overall system, based on premium income or costs involved.

The private insurance industry is largely a national industry rather than a global one. The number of truly global insurance players is in the range of 20 to 30 only. Another 70 companies operate significantly in more than one continent through branch offices. Only 1.2% of global insurance premiums comes from cross-border business.

Against these figures, thousands of small to large-sized companies exist with national, limited regional or professional importance. This has, of course, an impact on product range, product design and pricing, service and marketing and the sector's broad perspective

with respect to sustainability issues, the many problems faced by the world community and the threats to the global environment.

The insurance industry, on the whole, has shown a considerable and fairly stable growth throughout the last decade offering stable or even growing employment conditions in most countries. Mergers and acquisitions have normally been digested smoothly.

**Table 2: Market share in percentage**

Area	Non-life business	Life business	Population	GDP
North America	48	31	5	34
Latin America	3	1	8	6
Western Europe	29	32	17	29
Central/eastern Europe	1	0	10	2
Japan	11	26	2	15
South and East Asia	4	6	50	10
Middle East/Central Asia	1	0	4	2
Africa	1	1	13	2
Oceania	2	2	1	1
Industrialised countries	90	91	15	77
Emerging markets	10	9	85	23

**Table 3: Insurance density and penetration**

Markets	Premium per capita in USD	Premiums in % of GDP
Industrialised countries	2,384	9.1
Emerging markets	42	3.2

**Table 4: Growth of the insurance business**

Period	Life		Non-life	
	Industrialised countries	Emerging countries	Industrialised countries	Emerging countries
2000	9	12	3	7
1990 to 1999 Average	5	11	2	7

Source: Swiss Re, sigma No. 6/2001

### Promoting risk management

Insurers have developed a particular skill for loss prevention, through analysing the great number of loss settlements throughout the years and the hazards that caused them. Advising clients how to prevent losses is a substantial part of their activity. This is especially true in the case of industrial insurance where almost every insurance policy is individually designed. Industrial clients, who know their own production processes and product lines quite well, welcome the additional analysis and risk assessment exercised through insurers' teams of engineers and claims experts.

Private clients benefit from the precautionary attitude of insurers as well. Insurance companies for instance continuously support research on road safety aspects and efficient motor car repairs. These concepts have helped to save thousands of lives and to reduce injury to hundreds of thousands of people every year. The global sustainability movement has much to learn from the rich risk handling history of the insurance sector:

Insurers have always analysed all sorts of risks as part of their underwriting process and portfolio management. They have participated in research and consultation on fire prevention, safety of ships and industrial sites, loss prevention in respect of earthquake or volcanic eruption events or of sea and river floods. Environmental considerations are particularly important with regard to liability insurance.

Risk management has even greater importance when it comes to natural catastrophes. Insurers and reinsurers have analysed many areas of the world regarding frequency and severity of natural disasters. The research goes hand-in-hand with that of scientists who are often surprised at insurers' immense databases concerning insured values and vulnerability. Mixing scientists' knowledge of the hazard (such as geological or meteorological), with the data of insurers allows insurers to draw vulnerability maps for the various types of hazards.

Such maps exist for floods in river systems, for earthquake zones, and for wind speeds. These maps form the foundations for improving the planning processes of local, regional or national authorities or the development or improvement of insurance products such as earthquake or flood cover. Insurers and reinsurers co-operate with planning authorities in order to improve regulation and supervision as well as practical measures such as construction of protection walls, dams or flood basins.

Proper claims handling is an additional dimension of risk management by insurance companies. Even during the fire fighting process, specific advice from insurance experts can reduce the ultimate loss amount. This is obvious in respect of man-made losses, but also regarding natural catastrophes. The claims management experience of insurance companies is wide and can be used by the authorities to improve disaster recovery actions.

Short warning periods and the sheer size of natural disasters – some possibly linked to climatic change – make risk and claims management very difficult. Earthquake shocks normally last only seconds, and windstorm events take just hours to cross countries. It is therefore necessary to mobilise strong aid forces within hours rather than days and to have contingency plans of international dimension in place since catastrophes normally do not respect national borders.

### Ascertaining insurance cover

One of the prime functions of insurers is to assume risk and reimburse customers in the case of loss. Insurance ultimately spreads losses over time and distance. Catastrophes of any nature are no exception to this rule. They generate, however, a particular problem. They are rare events and the size of losses can vary tremendously. It is therefore difficult to calculate an adequate premium for the risk and to share the loss amounts out into the reinsurance market efficiently.

Normally, the reinsurance market is recovering from past events. In other words losses will be repaid by future premiums. This system still functions although quite a few reinsurers withdrew from this market segment in the early-1990s. Insurance products were changed, with higher self-retention than before, but were always available during and after that period since new capital and capacity entered the market.

One particular problem is to find solutions for heavily exposed risks and regions such as houses or factories on river banks with flood potential or property in areas of high earthquake risk. It may be difficult to find an insurer for such risks, and more sophisticated products may become necessary. Pooling of such risks is one technique to overcome these problems. Where risks become commercially uninsurable (such as in extremely endangered zones) government recovery schemes may become necessary. Examples of this type of solution are the flood insurance scheme in United States and the Japanese earthquake scheme for private property. Even under these concepts, the insurance industry supports governmental effort through partial insurance cover and risk consulting or claims handling assistance.

The development of products that support sustainable development is another challenging task for insurers. The most successful product idea, in this respect, is the mileage tariff in motor insurance, which requires higher premium from people who drive more miles in a year, and vice versa. Non-smoker tariffs in life insurance are of a similar nature and are considered environmental friendly by the anti-smoking lobby.

Environmental liability cover is also especially designed to support sustainability. Insurance clients are insured against third party liability after a very careful risk analysis and against sudden and accidental occurrences only. Another product of a comparable nature is a

new 'clean up' insurance that covers damages to one's own property in the case of an oil spill on the property. The demand for environmental liability cover will further develop as the EU's legislation changes and sets new standards which were designed with the assistance of the insurance industry.

The most recent movement is the concerted work of the financial industry on how to assist the Kyoto Protocol measures, in particular, how to secure emission trading and to become involved in joint implementation.

### Sustainable asset management

The insurance industry is a substantial capital provider in almost every country. Trillions of dollars are invested by insurance companies worldwide. Part of the capital is invested in its property and is thereby subject to proper housekeeping and energy management. The majority, however, is invested in bonds and equity.

By far the largest part of investments of insurance companies is made 'on behalf' of their customers or claimants. We will therefore find, in almost every country, more or less stringent investment rules for insurance companies issued by the insurance supervision. The equity of insurance companies which would be eligible for a less conservative investment policy is only a fraction of the trillions, but important nevertheless.

Insurers have begun to be more proactive in their investment strategy in recent years. The success of so-called 'green' investments has stimulated great interest in the matter. Insurers, together with bankers, have begun to develop new knowledge on how to measure the environmental friendliness of an investment and develop generally accepted benchmarks for this issue. So far, the benchmarks used concentrate on security and profitability aspects.

Environmental organisations have begun to ask the management of insurance companies about the eco-friendliness of their investment policy and will continue to do so. It is therefore necessary to prepare for such questions and produce suitable results.

### Public awareness, lobby for the environment, leadership

Insurers are actively involved in lobbying for the environment. Firstly, it is in their own interest to reduce damage to the environment. Secondly, they are a business that is 'almost clean' compared with some other industries and trades. Thirdly, insurers represent a meeting point of interests. Their customers come from all parts of the society, technology and economy. Insurers and reinsurers often also play an international role. All of this makes them fairly objective observers and negotiators of environmental issues. Many insurance companies have by now

established special departments in charge of corporate environmental strategy and management. Their influence goes far beyond the issuing of glossy environmental reports, influencing all sectors of action on a systematic management basis.

Politicians and authorities are beginning to understand the economic function of insurance better, and that a functioning private insurance industry needs freedom within a range of rules and regulations. They must ensure that market mechanisms are applied properly. Insurance managers should never act as environmental police. Public authorities have also learnt that disaster prevention and rescue schemes require international action and that the actions of the many relief organisations require concerted and integrated strategies.

## UNEP Finance Initiatives

Since its creation in 1972, the United Nations Environment Programme (UNEP) has encouraged economic growth that is compatible with the protection of the environment. UNEP was convinced that the financial sector had an important role to play in the achievement of this goal and in 1992 a partnership between UNEP and the banking sector was established.

Today this partnership has grown to include 192 signatories plus two associate members in 45 nations.

In 1995, building on this success, UNEP launched another partnership with insurance companies and pension funds, which also play a key role in achieving a sustainable economy. This partnership has since grown to include 91 insurance, re-insurance and pension companies representing 26 countries. The two Finance Initiatives are governed by steering committees that are elected by the members of each initiative at an annual general meeting.

Three standing working groups have been formed: asset management, climate change and environmental management and reporting. All three working groups have been active in developing strategies and standards that support the adoption of sustainable development principles by the insurance and financial services industries.

In 2002, some 273 signatories in 51 nations work with the UNEP FI towards the common goal of maintaining the health and profitability of their businesses within the framework of sustainable development.

The discussion with environmentalists has also improved. In the past, insurers and environmentalists have had reservations about talking to each other. But, insurers have learnt that environmentalists sometimes express their views in an aggressive way in order to attract attention. They should, on the other hand, be proud to know that environmentalists appreciate the loss prevention activities and the precautionary attitude of insurers. Both parties must listen to each other more carefully for a better understanding of everyone's position.

Present insurance management shows growing ethical and social involvement. The issues are discussed in top management circles and developed further down the line in many companies. Insurance associations have taken the topic on board gradually, but competitive thinking and action still seems to prevail. A louder voice and a more devoted plea for the environment is yet to be seen from the insurance industry.

## Unfinished business: Tools for implementation in the insurance sector

**By Jan Pieter Six, Interpolis**

The insurance industry plays a diverse role in society: as organisations, with physical and human capital; as insurers of life and non-life risks; as institutional investors; as actors in society at large. As such, there exist a great number of challenges that impact the ability of industry to achieve sustainability. Progress on sustainability has been made, but there remains some unfinished business. The key concerns are:

- adoption of voluntary standards for environmental performance;
- the adoption of environmental management systems for all business processes;
- compliance with, and reporting of, regulatory standards for environmental performance;
- promotion of sustainability issues in professional education and internal communication;
- knowledge transfer to insurance industries in developing countries;
- the inclusion of sustainability objectives into asset management policies.

### Adopting voluntary standards

Undertaking sustainable activities is primarily up to individual insurers, but associations of insurers can also play an important role. The associations have the crucial task to promote awareness among their members, to inform them about best practices, and to develop common strategies. Another forward step in voluntary standardisation might be to adopt a code of conduct at the association level, either to be undersigned voluntarily or made a condition for membership of the association. An additional role for associations is to co-ordinate the implementation of formal agreements between governments and associations (for example energy-efficiency).

Governments and legislators must continue to promote and encourage voluntary activities by insurers by rewarding sustainability-driven activities and, in some cases, by making them legally compulsory. Sorting out the role of government can be complicated by the separation of responsibilities between ministries of social affairs, ministries of the economy and ministries of the environment. Too often the lack of co-ordination between these actors can result in a misunderstanding of the objectives, leading to counter-productive efforts.

Better co-ordination at the government level can result in greater acceptance and more enthusiasm on the part of insurers in pursuing the sustainable development objectives of governments.

### Adoption of environmental management systems

By nature, insurers are in favour of any activity or regulation that promotes sound risk management and prevention – particularly prevention of environmental damage. In this respect insurers generally support the development of environmental management systems, like EMAS and ISO 14001. Increasingly, they must incorporate these systems into underwriting activities.

### Transparency and reporting

Sustainability is swiftly rising on the political and social agenda, with society increasingly demanding that business, including insurers, play a pro-active role. A growing number of insurers have taken on the challenge – and much has been achieved. Progress needs time,

and apparently stakeholders are prepared to let insurers develop new strategies.

Nonetheless, stakeholders want to see evidence of progress, embodied in transparent progress reports and stakeholder involvement.

One major problem with transparency has been the lack of universally accepted reporting standards. GRI is gradually developing itself in the direction of a global standard, however, the GRI standard is a general standard – often too general for the financial world. Therefore GRI has taken the initiative to work with the financial sector on several projects including: the Environmental Performance Indicators (EPI) project; the subsequently launched Social Performance Indicators (SPI) initiative; and, in addition, the GRI is working with the Environmental Management and Reporting

## Renewable Energy: Frameworks for finance

### Eric Usher, UNEP Division of Technology, Industry and Economics

International public sector financial institutions, including the World Bank, are moving rapidly from the traditional government and subsidy-centred approach, to a financing approach that promotes renewable energy technologies (RETs) through energy markets, and where consumer financing or fee-based services are the most important financing models.

The most common *dealer model* creates cash sales by RET equipment dealers. For example, more than 100,000 Kenyan households use PV systems sold through existing rural sales points, such as general stores. The average monthly payment for a solar system is generally less than the monthly cost of kerosene or battery-charging.

The *concession model* depends on regulation, and is geared to provide large economies-of-scale where concessionaires are given franchise rights. These rights are based on bids that require the lowest subsidy to service rural households and community centres. The choice of an appropriate, cost-effective, off-grid technology rests with the concessionaires. Bank financing provides partial financing of start-up costs, while payment for energy services is made by consumers. This model can help achieve economies-of-scale from mass production by increasing market size. The Argentinean PAEPRA programme aims to supply electricity to 1.4 million rural residents and more than 6,000 public facilities through private rural energy-service concessions.<sup>(7)</sup>

In the *retailer model*, a community, organisation, or entrepreneur is given a loan, based on a business plan, to serve a local demand for electricity. The cost of the loan is recovered through a fee-based service arranged with the community and/or consumers. Currently used in Sri Lanka and Laos, the model encourages significant local involvement.

(7) In this programme, the government sets tariffs for different types of electricity services. A competitive tender is held, under which companies bid for a 15-year monopoly concession contract. Under the contract, the concessionaire is obligated to service all household and public facilities for which they receive government subsidies. Companies compete partly on the basis of how little a subsidy they are willing to accept.

group of the UNEP FI, chaired by the United Kingdom insurance giant, CGNU.

As a result of such initiatives, in the near future, insurers will be able to present progress reports in a uniform way, enabling stakeholders to compare insurers on their environmental and social performance.

### Exporting know-how

The core competence of insurers and reinsurers is to analyse and evaluate risks. This competence can contribute to the development of specific insurance schemes for people living in highly exposed areas, more specifically coastal areas in underdeveloped countries (60% of world population lives in coastal areas). Insurers and reinsurers can export their competence and experience to these areas, particularly by helping local societies to create 'micro-insurance' solutions, corresponding with 'micro-banking' solutions, made possible by banks.

### Influencing asset management

As risk carriers, insurers have an interest to reduce the negative effects of global climate change whether they are stemming from weather related catastrophes or a higher occurrence of epidemics. Since insurers are major institutional investors, a growing number are integrating ecological sustainability in their investment policy. At the same time social/ethical considerations (such as human rights) are being taken into account. In several countries the lead has been taken by pension funds. Insurance companies must also step forward and take advantage of their capacity to effect change in asset management policies.

### Strengths of the insurance sector

While the insurance industry still needs to improve its performance in several areas to meet society's future needs for financial risk management, it possesses a number of key strengths on which it can draw.

#### Ability to transfer risk efficiently

The basic insurance contract is a well-understood financial instrument, and this familiarity, as well as the continuity and mutual trust between insurers, engenders an effective process for transferring and sharing familiar risks, and experimenting with novel ones.

#### Global outlook

Some of the major players are multinational in scope, and this provides important opportunities for cross-fertilisation of knowledge and experience, and the pooling of international resources to meet temporary local priorities (such as disaster recovery).

Globalisation in insurance has not proceeded as far as in other major industries because of the delay in opening some markets to international competition, and the fact that the two largest domestic markets (United States and Japan) have been focused inwardly rather than towards international expansion.

However, the reinsurance sector is global in its outlook, and the London insurance market is truly international in the business mix it accepts.

#### Sophisticated vertical structure

The industry has evolved a number of specialised functions (broking, underwriting, risk assessment, claims handling, reinsurance) to handle different aspects of risk management, and these are provided in a flexible way by a variety of organisations, some independent, others integrated within larger organisations. This helps to stimulate competition, which in turn ensures innovation and attention to the needs of the client.

### **Flexible combination of risk management techniques**

Insurance (that is risk transfer) is not the only way to manage financial risk. For example, control of the underlying physical risk may be more effective, or self-insurance may be adequate. The sophisticated nature of the industry helps to provide a rich variety of solutions for risk management, and quite often, the service provided by the industry does not include 'insurance' where there is a more effective way of managing the risk.

### **Consumer marketing skills**

Insurance is not an attractive product to consumers with its connotations of misfortune, nor is it generally a regulatory requirement. Also, most people underestimate their true needs for financial protection, even when they do give it some attention. As a result, the industry has evolved a number of ways to promote its services to the unwilling clientele.

### **Leverage**

The insurance sector interacts with every other productive sector of the economy, as well as final consumption, since it provides risk management services to them all. It is therefore potentially a powerful instrument for cultural change through its ability to incorporate principles of sustainability into its services for all these clients. Additionally, insurers channel large quantities of purchasing power through the claims process, and again this gives the ability to set environmental standards for such goods and services in the purchasing chain.

### **Emergency service capability**

One great strength is the fact that the claims-handling function is set up to service a variety of products, some of which generate fairly uniform or predictable volumes of demand. Also, some of the claims volumes are known to be 'peaky', so that the network has a considerable capacity to handle 'overflow' demand. Taken together, these features mean

that the industry can cope with sudden catastrophes without collapsing, and at the same time can exercise a reasonable degree of control over potential problems like fraud.

## **Future challenges and goals of the insurance sector**

### **By Andrew Dlugolecki, Andlug Consulting**

Climate change, depletion of resources, excessive inequality, and new technological risks are just a few of the new sustainability challenges facing the insurance industry. To cope with these future challenges, the industry must return to basics, collaborating with other major stakeholders – especially public authorities – to redesign its services.

### **New challenges**

#### **Climate change**

The considered opinion of the Intergovernmental Panel on Climate Change (IPCC) is that economic losses are only just starting to show evidence of shifts in the underlying pattern due to climatic change, particularly precipitation. However there is little doubt that in the coming decades, human settlements will become more vulnerable to extreme events, and this will create greater demands for insurance cover against such contingencies.

The challenge lies in the fact that historical statistics and experience will not provide a satisfactory basis for risk assessment, and the scientific models are not yet precise enough to yield predictive tools. The industry will, therefore, need to develop a new approach that will deal with the greater uncertainty and higher loss potentials so that clients receive adequate cover on acceptable terms, but the insurer is not faced with a higher risk of ruin.

Almost certainly, this will require close co-operation between insurers and governments, or international funding agencies. The international political process has been rather slow to grapple with the issue, and the

business community can legitimately seek to influence policy-makers towards more courageous decisions. A start has been made with UNEP FI, which has recently called for higher priority to be given to long-range emissions targets, through the adoption of an approach like 'contraction and convergence' [UNEP FI, 2001].

Other sectors will also need to protect themselves against the risk of more variable weather, because it can affect profitability greatly, even if assets are not physically damaged. Traditionally, this has not been seen as an insurable contingency, but already the energy sector has been developing tools such as weather derivatives to deal with this problem. It is now time that insurers began to incorporate this risk into their standard basket of insurable hazards.

The fact that governments will put in place policies to mitigate climate change and to adapt to its effects, means that there will be a range of specific projects and processes to realise those strategies (for example innovative renewable energy technology, emissions permit trading, and new or altered infrastructure). The insurance industry should follow these issues closely and be willing to support them through the provision of insurance services.

One area that merits caution however, is that of guarantee insurance for emissions permits. The risk here may be too speculative to justify committing significant insurance capital, except within well-defined and controlled trading blocs. On the other hand, the use of forests as carbon sinks has been approved under the Kyoto Protocol, and insurers should now consider how to supply financial risk management to this activity. Forests have been a rather minor segment of the insurance portfolio in the past, and their carbon content has of course been immaterial.

### Swiss Re's greenhouse gas risk solutions

These are uncertain times for all businesses operating in industries that have an impact on the environment. However, what is certain is that the outcome of the climate change negotiations will affect the way businesses operate by requiring a carbon-constrained future.

Whatever the final rules of international and national legislation, there is enormous potential for the financial industry to facilitate reductions in carbon emissions. Swiss Re is positioning itself to provide financial risk services to participants in the greenhouse gas marketplace.

The firm's greenhouse gas risk solutions include:

**Investments:** Swiss Re's Sfr100 million eco-portfolio will participate in emissions reduction credit investment funds, and renewable energy funds.

**Emission reduction credit guaranties:** Swiss Re may provide or arrange emissions reduction credit guaranties to buyers of credits covering the financial performance of sellers and certain political risk affecting the sellers' performance.

**Project finance:** Joint implementation and clean development mechanism emissions reduction projects require project risk management, (re-) insurance and contingent capital expertise.

**Insurance:** Insurance solutions regarding emissions credit trading, as well as greenhouse gas professional liability insurance can be used for domestic and international trading schemes.

### Depletion of resources

The pressure of economic development has resulted in the depletion of resources, but the risk will be exacerbated to new levels in the next century owing to the increased world population and the need to eradicate poverty. This will put natural resources (forests, biodiversity, and water) under great pressure, and it may be difficult to agree and implement international protocols in this area.

The insurance industry should be aware of these issues, and take care that it does not inadvertently support activities that undermine them, either through the supply of risk management services to such parties, or by sourcing supplies from them. This will require more vigilance at the stage of assessing deals before entering into transactions.

It will likely be necessary to rely upon certification schemes to validate the bona fides of counterparties. Regarding water resources specifically, interruption of supply may be more likely – due to a combination of natural and human causes – and this risk should be carefully assessed since both the quantity and quality may fail to meet acceptable standards.

### Excessive inequality

Awareness of the problem of global poverty has become greater in recent decades. Poverty undermines the stability of society because it violates human justice. The poorer sections of society are generally deprived of financial services, because of their lack of education, and dependence on own-grown food, rather than paid work.

Traditionally, such societies have depended on a social support network (such as the extended family) to see them through disasters. As they enter the formal economy, often through migration, these traditional support mechanisms become less effective, so the need for insurance increases.

The lending sector is beginning to create new tools to assist these social groups to enter the formal economy (for example with micro-finance circles). However, these circles themselves are vulnerable to the impact of natural disasters, and this seems a fruitful area for research and development of new risk-management tools, either 'micro-insurance' to parallel the lending circles, or through more formal insurance and reinsurance for a pool of micro-finance circles. The World Bank has initiated a project called 'Provention' to consider such issues, and has enrolled some global insurance firms in the exercise.

One of the most pressing needs of the new emerging workforce is for simple life and health insurance, and the insurance industry should seek to meet this requirement. On a more general level, education and job creation are key steps in the development of a modern economy, and the insurance industry should consider what contribution it can make:

- directly, by locating operations or using suppliers in developing countries;
- indirectly, by providing insurance services to local industry;
- strategically, by priming the local education system.

### Technological risks

New technological risks are presenting themselves to underwriters, with the advancement of science in such areas as biotechnology, medicine, and sub-molecular chemistry. These advancements have implications for sustainability in several ways:

- through the possibility of environmental degradation and health damage;
- through the potential of creating new under-classes of uninsurable people, determined by their genetic make-up;
- through unintended changes in the natural gene pool.

Insurers are generally wary of new technological risks (witness previous experience with radioactive materials, or sonic booms). Such caution should be applied to these new risks also, since they may result in irreversible changes to the natural world. This need not result in any significant delay to the R&D cycle, since it should already be carefully controlled for those very reasons. Insurers should take the opportunity to become closely involved in following the development of such new technologies, so that they understand the risks, and can underwrite them effectively if they are deemed to be environmentally acceptable.

### Areas for improvement

#### **Insurance does not really help to redistribute the cost of major risks**

A large proportion (as much as 80%) of the global cost of natural disasters is not insured, and is therefore borne by the victims directly or through disaster relief. The industry is somewhat reluctant to be involved in certain specific types of risk (flood, earthquake, agricultural risks, environmental liability). The reasons for this are complex but generally revolve around matters of public policy.

#### **Distribution costs are high**

Typically, less than 70% of the pool of insurance premia is recycled to claimants to indemnify their losses. This means that often the product is seen as expensive, or irrelevant. Insurance is a 'grudge' purchase (that is with negative connotations for the purchaser), so that marketing costs tend to be high in a non-compulsory market. Also the product is complex to administer (legal issues, interpretation of application).

#### **Insurance does not benefit the poorer segments of society**

Almost every time there is a disaster, the underprivileged members of society possess no financial protection, and are faced with severe difficulties in refinancing their way of life. At the individual level, the death or illness

of a family member, or of livestock, can be a disaster. This is not just a matter of banking services, but a consequence of the absence of financial risk management. In part this reflects the fact that the conventionally high-cost distribution channels make it uneconomic to service small customers. At its most basic, the requirements include the provision of a decent funeral, and this is one of the primary insurance products in South Africa.

#### **Increasingly, the industry does not service the needs of major corporations**

As much as 50% of corporate insurance in the United States is controlled by wholly-owned subsidiaries, known as 'captives', and this trend is spreading to the United Kingdom and other major economies. This reflects the fact that the largest business entities are now more highly-capitalised than insurance companies, so they can withstand the financial shock of disasters themselves. They have also evolved sophisticated risk management approaches in-house so that they understand the risks better than an external agency could. A major stimulus to this was the liability crisis in the United States in the 1970s, when insurers were unwilling to provide the coverage required by their corporate customers.

#### **The basic product is still not flexible enough**

The insurance contract is rather short-term – generally with a duration of 12 months in non-life business – which does not fit with a long-term concern for sustainability. While this protects the insurer from unforeseen changes in the operating environment, it tends to be associated with alarming swings in the market conditions (price and availability of cover). The policy language is rather complex, and the contract will only apply to a limited range of loss circumstances. Again, this protects the insurer, but is often a source of profound dissatisfaction with the client.

#### **Lack of capital**

The industry is prone to cycles in the provision of capital. This results in 'feast or

famine' phases in the market, and is not conducive to long-term risk-bearing. A number of reasons are given for this, but the prime ones are the short-term nature of the basic non-life contract, and the burden of upfront expenses in the long-term life and pensions sector. This is exacerbated by the uneven timing of major disasters, and the fact that investors have not understood the interaction between investment returns and underwriting performance.

### The role of other stakeholders

There are many stakeholders besides underwriting organisations in the insurance process – clients, intermediaries, suppliers, regulatory authorities, the courts, the media, and wealth creators in general. All of them can influence the sustainability of wealth creation through insurance, but here we focus on three groups – regulatory authorities, the courts and the construction industry – to explore how public policy interfaces with insurance and sustainability, particularly in the critical area of the built environment. There are of course important differences between countries, and the following discussion can only be taken as a general illustration of the issues.

#### Regulatory authorities

It is essential to fix certain principles of public policy at the outset regarding the responsibility of the various stakeholders for sustainable development, and to establish clear guidelines on how the costs of failure are to be apportioned. A balance has to be struck between conflicting viewpoints after consultation with the interested parties.

On the basis of social solidarity, all those who require insurance should receive it in return for a uniform premium (the social model), but this contravenes the need for economic efficiency (that those exposed to a higher risk should contribute proportionately more). Without such a variable price mechanism based on the underlying exposure to risk, there is a serious danger that unsustainable

behaviour (such as flood plain development) will be implicitly encouraged, and so alternative ways of promoting sustainable development would be necessary (for example through regulatory standards for planning and design that recognise the varying degrees of risk present).

An important distinction that can be made is between existing risk exposure, which may have arisen before the environmental hazard was identified, and those exposures which are created after the change in the risk is recognised. In the former case it may be appropriate to apply a 'social' model, while the latter circumstance could legitimately be dealt with under a 'variable price' model.

A failure in sustainability can be compensated through the insurance system if that route is adopted, or through a social compensation approach based on say, taxation. In some cases it may be possible to attribute the failure in sustainability (for example pollution) to a human agency. This opens the possibility for compensation from the malfactor, through tortious liability, perhaps supported by insurance. In such cases, it is important to ensure that the rights of the various parties are safeguarded, and that the system created is as efficient as possible (so the transaction costs are minimised, and the compensation is directed towards the victims, proportional to their losses).

Where a market system is adopted for insurance, the regulatory framework should focus on controlling the corporate behaviour of the enterprises, rather than detailed product design, within the desired balance of social/variable price models.

#### The courts

The courts need to adopt a balanced position between the parties in a loss situation. In too many cases they have taken the view that the claimant or victim must be compensated from some other party, no matter how small their

contribution to the cause of the loss. Additionally penalties may be levied on the at-fault party, nominally as a fine, but actually as an increased compensation to the victim. This search for compensation has distorted the interpretation of legal principles such as 'joint and several liability' and by making damages difficult to gauge, has reduced insurers' willingness to accept risk, to the general detriment of society.

In other cases, the wording of insurance contracts has been re-interpreted in a rather contrived manner to force them to admit certain losses. Such instances indicate weaknesses in public policy on compensation for damages due to a failure in sustainability, and should rather be referred back to the legislature for action.

Finally there has been legitimate criticism that the legal process is an expensive way to resolve issues of liability – there is now a range of alternative dispute resolution models, and these should be adopted as often as possible.

### **The construction industry**

The construction industry is fundamental to the creation of human settlements. It comprises a wide range and scale of activities, and it interfaces with sustainability in two ways – through the use of resources, and through the creation of potentially vulnerable assets that are at risk to environmental hazards.

Many of the largest projects feature complex interactions between many interests (operator, financier, designer, constructor) over a number of phases (planning, design, construction, commissioning and operation) and sites. There is continual innovation in processes, materials, and scale and often the relevant environmental history is unknown or may be changing rapidly due to other economic activity, so that it is impossible to provide a well-defined view of the potential hazards during the project.

In the absence of such information, often projects assume there is no risk, with unfortunate results. This has led the World Bank to formally include natural hazards in its lending criteria, because of the high proportion of funds that were being diverted to repair the damage to its projects. [World Bank, 2000].

However, even the smaller-scale domestic work streams can produce significant hazards, as has been seen repeatedly after earthquakes in the developing world, or after floods and storms in Europe and the United States. Often, the subsequent analysis shows that a significant factor in the losses is that construction practices have been in breach of regulatory standards.

In addition, the construction industry often resists initiatives for more resilient design, on the basis of the increased cost. It is in insurers' interests to ensure that standards are raised, and then followed in practice, and they should consider how to become involved in the regulatory debate, and supervisory activity. Climate change will compound these issues because of the tendency for more extreme conditions to occur.

### **Future needs of the insurance sector**

To operate effectively in the future, the sector will need to address five key areas – human resources; risk information; capital formation; internal processes; and, engagement in public policy formulation.

#### **Human resources**

Successful enterprises depend on the skills of their workforce, and the strategic insight of their managerial staff. Going forward, this will entail more attention to staff selection, training, work conditions and remuneration, of course – but it will also be critical to ensure that the workforce has a clear understanding of the world around them, in particular the relevance of sustainability issues for corporate strategy. This can be achieved by career planning that includes experience outside the insurance

sector, and across a range of markets and cultures.

#### **Risk information**

To manage the unfamiliar risks of the future, a major effort must be put into upgrading the data base, and translating the raw facts into usable models and protocols. Even if public policy precludes discrimination by risk factors, gathering information is an essential pre-requisite to formulating an effective policy in collaboration with other stakeholders. In some cases, this may mean the creation of new scientific knowledge about environmental impacts. This is most appropriately carried out through publicly-funded research programmes, but the industry should participate in the planning and dissemination of such science.

#### **Capital formation**

The environmental risks of the future will present the possibility of greater economic losses. This means that the sector has to increase its capitalisation either directly through raising additional reserves, or through innovative methods of 'borrowing' capital from the wider finance sector in times of need. One way in which the latter might be achieved is by 'renting' capital from government institutions on favourable terms to cope with the temporary outflow of funds at times of natural disasters.

Another approach is to permit insurers to accumulate 'catastrophe reserves' out of untaxed revenue in order to smooth the outflow of claims payments between the infrequent and highly unprofitable disaster years and the more frequent, and ostensibly profitable, disaster-free years. The alternative of using the commercial capital markets has been investigated, but up until now has proven unsatisfactory for a number of reasons. In particular the continuity of supply has yet to be tested, and the transaction costs are rather high.

#### **Internal processes**

The operating costs of the sector must be reduced by taking full advantage of modern IT, in terms of managing customer and supplier relationships, exploiting the improved data bases referred to above, and sharing knowledge among the workforce. Currently much of the sector is still labouring under the burden of 'legacy' IT systems, but the need for more flexible IT support will be a permanent feature in order to cope with the fluid business environment.

It may also be possible to achieve more effective risk management with the use of contracts extending for longer than the conventional 12 months, but there are significant problems to be solved. For example, economic conditions or the state of risk knowledge may change during the currency of a longer contract, and this possibility deters both insurer and client from entering into such arrangements.

#### **Public policy formulation**

The insurance industry has tended to interact with other sectors on public policy, only when its own interests have been directly and imminently affected. A more foresighted approach is desirable, to work with other elements of the finance sector, and government, in order to foster the international creation of wealth in a sustainable way. It is possible that this may not provide new openings for risk management services in the short-term, but in the long run the establishment of a fairer and cleaner world will generate greater business opportunities. To do this will require the sector to invest more effort in policy debate, and in the developing world in particular.

#### **Conclusions**

Insurance losses from environmental risks have risen sharply in recent decades. Many of the drivers of damage are not 'natural', but are related to patterns of development and behaviour. This will be compounded by new

challenges in future – climate change, resource depletion, excessive inequality, and fresh technological advances.

To manage increases or uncertainty in risk, traditional insurance strategies can only extend so far before the availability of insurance is inadequate to meet the needs of the victims. Already, as much as 80% of the global economic damage from natural events is not remediated through insurance, but has to be borne by the victims, or alleviated with ad hoc disaster relief. Furthermore, the industry has been reluctant to continue its involvement with the problem of environmental impairment, following the enormous claims suffered in the United States.

This indicates that a radical rethink is needed, to ensure that the approach to managing environmental perils involves all the stakeholders in a way that improves the overall efficiency. There is no doubt that the insurance industry can play an important role, whatever the system, because it has important skills in marketing, pricing, and recovery management. Its organisational network also gives access to international resources, while providing a permanent structure that can rapidly switch to handle emergencies.

To be truly effective, the industry needs to become more proactive, and participate in the debate on public policy in such areas as disaster management, climate change, sustainable construction and the provision of financial services to the poor, particularly in developing countries [IPCC, 2001].

The insurance industry response must extend far beyond the traditional underwriting area, into the comprehensive adoption of environmental management systems, which ensure the application of sustainability principles to all business processes. At the same time, the industry must address some of the weaknesses which have hindered its response in the past – lack of capital, high transaction costs, inadequate human resources, and insufficient risk information.

As with any change, there will be new business opportunities, as well as risk for those firms which do not recognise the need to adapt. By playing an active part, the industry can expect that the other key stakeholders (government, other industries, individuals, and the media) will also become more positively engaged in the issue of sustainability.



## Part 3: Lending

The global operating environment for the lending sector has been transformed since the early-1990s. Technological progress, notably great advances in IT, the reform of financial regulations facilitating cross-border flows and the steady integration of international capital markets have catalysed an enormous increase in the quantity and speed of global capital movements. Increasing capital mobility is driving national regulators to provide adequate frameworks for the efficient functioning of capital markets.

The global reach and economic power of the largest global banks in the lending sector is captured in detail later in this section in a summary of a survey of 34 leading banks. The accumulated assets of the 34 banks surveyed are worth twice the accumulated 1999 GDPs of all low and middle-income countries. The assets of the world's top ten banks amount to the accumulated GDP for all 108 'developing countries' in 1999. The 34 surveyed banks provide work for more than 2.2 million people working in more than 95,000 offices.

Critical challenges for global lenders include: pressure from shareholders for better returns; increasing competition from capital markets (reinforced strongly by Internet banking); and greater volatility of international financial markets.

Aman Mehta, chief executive officer, The Hongkong and Shanghai Banking Corporation, summarised the new daily challenges for lending institutions when he delivered the keynote address for a UNEP FI Asia Pacific conference in Manila in April 2001. Mehta explained: *'Yesterday, our business was simple. We concentrated on collecting deposits and making loans. We competed against other banks and our relationships with customers were based on loyalty and longevity. Today, we must deliver a portfolio of products while competing against*

*non-traditional players targeting profitable sectors of our business. Relationships with customers are increasingly based on price, quality and speed. Today, technology allows information – whether it is fact or fiction – to be disseminated instantly around the globe. The same technology enables investors to react to such information with the flick of a key, jumping into and out of markets. If this isn't enough to keep us busy, we also face shrinking profit margins, volatile stockmarkets and global economic uncertainty.'*

On the regulatory front, the revision of the 1988 Basle rules for capital adequacy is a major ongoing development for the lending sector. The process aims to improve the international regulatory framework for banking. The reformed rules, which will be introduced in 2004, are an attempt to align the level of capital that banks are required to hold against credit and related risks with their true exposures. Along with the new rules for capital requirements the disclosure and reporting obligations for banks are increasing.

The inclusion of financial services into the GATS under the WTO framework facilitates the entry of banks into domestic capital markets, by bringing down access barriers and providing protection against discrimination and arbitrary treatment. At the same time globalisation of financial services means banks are operating in an increasingly complex network of different national and supernational regulatory and institutional frameworks.

### What has been achieved by the lending sector?

In assessing the achievements of the lending sector, the finance sector report draws on work undertaken by Marcel Jeucken. This section, in its entirety, is copyrighted to Marcel Jeucken, of Sustainability in Finance, The Netherlands. Jeucken is CEO of Sustainability

in Finance and author of the book *Sustainable Finance and Banking – The Financial Sector and the Future of the Planet*, published in 2001. He is also senior economist at Rabobank, The Netherlands. This section represents the personal views of the author only.

#### By Marcel Jeucken, Rabobank

This section explores the role of banks in the progress towards sustainable development through the presentation of results of a survey of 34 mainstream international banks. Due to size limitations, only some of the results can be presented in this report.<sup>(8)</sup>

#### Introduction<sup>(9)(10)</sup>

The lending sector has responded far more slowly than other sectors to the new challenges that sustainability presents. Bankers generally consider themselves to be in a relatively environmentally friendly industry (in terms of emissions and pollution). However, given their potential exposure to risk, they have been surprisingly slow to examine the environmental performance of their clients. A stated reason for this is still that such an examination would 'require interference' with a client's activities. Empirical research from 1990 concluded that (European) banks were not interested in their own environmental situation nor that of their clients [Tomorrow, 1993].

This situation is now changing. There is growing awareness in the financial sector that the environment brings risks (such as a customer's soil degradation) and opportunities (such as environmental investment funds). On the risk side, there has been an enormous raising of concern in the United States since the late-1980s. Banks could, under Comprehensive Environmental Response, Compensation and Liability Act (CERCLA),<sup>(11)</sup> be held directly responsible for the environmental pollution of clients and be obliged to pay remediation costs. Some banks even went bankrupt under this scheme.

Due to these developments, American banks became the first to consider their environmental policies, particularly with regard to credit risks. European banks were not exposed to these liabilities and only began to develop policies toward environmental issues during the mid-1990s. The focus was less on risk assessment and more on the development of new products such as environmentally friendly investment funds.

Both risk and opportunity are now becoming established elements in banking policies towards the environment. Empirical research from 1995 on the environmental activities of the signatories of the 'UNEP Statement by Financial Institutions on the Environment and Sustainable Development', which was launched in Rio in 1992, showed that 80% of the respondents made some kind of assessment of environmental risks [UNEP, 1995]. Another investigation among the signatories from 1997 concluded that many banks have set up environmental departments and are developing environmentally friendly products [Ganzi and Tanner, 1997].

In Asia, South America and eastern Europe, change is also under way, mostly through the influence of environmental standards from multilateral development banks, such as the World Bank. Strong evidence that sustainability has reached the mainstream financial community was provided by the launch of the 'Dow Jones Sustainability Group Index' in September 1999 [DJSI, 1999]. For the first time, a mainstream global index is tracking the performance of the leading sustainability-driven companies worldwide.

The role of banks in contributing to sustainable development is potentially enormous, because of their intermediary role in an economy. Banks transform money in terms of duration, scale, spatial location and risk and have an important impact on the economic development of nations. This influence is of a quantitative, but also of a

(8) The interested reader is referred to Jeucken (2001) for a broader and deeper perspective.

(9) This section is based upon Jeucken and Bouma 2001.

(10) This entire chapter is copyrighted to Marcel Jeucken, Sustainability in Finance, The Netherlands. Marcel Jeucken is CEO of Sustainability in Finance and author of the book *Sustainable Finance and Banking - The Financial Sector and the Future of the Planet*, published in 2001. He is also senior economist at the Rabobank Group, The Netherlands. This chapter represents the personal views of the author only.

(11) To cover the costs of Superfund (especially soil contamination), the United States government initiated the 'Comprehensive Environmental Response, Compensation and Liability Act' (CERCLA) in 1980. In the 'United States versus Fleet Factors Corporation' case, a bank was held responsible for the environmental pollution of its client. The outcome of this trial sent an immense shockwave through the United States (and international) banking community.

qualitative, nature, because banks can influence the pace and direction of economic growth.

### Survey sample and methods<sup>(12)</sup>

This research deviates from other research as it does not look at banks known to be active in this field (from literature, their publishing of environmental reports or by their signing of the UNEP-statement), but has selected banks on two a priori unrelated criteria. Firstly, a selected bank must have assets of at least

100 billion (this factor has a direct bearing on the banking sector's direct and indirect environmental impact). Secondly, only banks from developed countries are considered and a maximum of three banks have been used per country (this is to prevent an over-representation of a few limited countries).

The selected banks and their home country are named in table 5. The accumulated assets of the 34 banks are worth 13 trillion; twice the accumulated 1999 GDPs of all low and middle-income countries (World Bank classification). The top ten selected banks are, in fact, the world's top ten in terms of assets. Their assets alone roughly amount to the accumulated GDP for all 108 'developing countries' in 1999 [World Bank, 2000].

In total, the 34 banks provide work for more than 2.2 million people (average 65,600 employees per bank) and possess more than 95,000 offices (average 2,800 per bank). Their international reach in terms of the number and the diversity of countries and world regions in which they operate is considerable. Clearly, the banks selected have a significant stake in the development of the global economy.

In the analyses in the following sections, frequent comparison is made between the three world regions Europe (24 banks), North America (six banks) and Oceania (Japan and Australia; four banks). Where the analysis focuses on numbers of banks in a world region, standardisation for the region is applied.

This means that for the issue in question the share of banks scoring in the total banks in one region will be compared with the share of banks scoring in the total banks for another region. The environmental and social results reported below cover the period 1998 to 2000. The methods of this survey, which is entirely based on studying environmental and annual reports of banks, are explained in Jeucken (2001). Obviously, all general termed conclusions are with regard to the selected banks only.

### Codes of conduct

Codes of conduct, such as those of UNEP and the International Chamber of Commerce (ICC), are popular among the 34 major international banks studied. More than half of them have signed the sector specific UNEP declaration and half the more general ICC declaration. Although in absolute numbers (in and outside the sample) mostly European banks have signed up to the UNEP declaration on sustainability, this is not supported in the standardised analysis of the 34 large international banks in relative numbers.

Standardised for differences in numbers of banks per region, the North American banks score a little better than European banks (respectively 67% and 54%). The ICC declaration enjoys popularity in all regions, whereas European banks show a clear preference for the UNEP declaration.

### Environmental reporting

Environmental reporting by banks appears to be very much a European phenomenon. Banks in other regions lag behind. Cultural differences are a determining factor. Transparency is not highly regarded in Japan and is sometimes even considered a weakness. While European banks focus more on environmental aspects, North American and Oceanian banks concentrate more on community involvement. French and Italian banks stand out in that they report on neither the environment nor their community involvement.

(12) This section is based upon Jeucken 2001.

Twenty-three out of 34 banks currently do not publish an environmental or sustainability report (68%). Once again, conformity within a country is striking; all selected banks in Germany, Switzerland and The Netherlands publish an environmental or sustainability report. Remarkably, while the economy is global and most banks are as well, peer pressure appears confined within national or regional borders.

### Environmental management systems

The most proactive banks attempt to systematically reduce the environmental impact of their internal processes. A formal EMS can achieve this. No bank has achieved or wished to achieve EMAS or BS-7750 certification for its internal or external communication or its environmental processes. Four European banks do have ISO certification: BBVA (some locations), Deutsche Bank (national office network) and UBS and Credit Suisse (for their worldwide EMSs). It is not out of the question that some European banks will opt for EMAS II certification, despite ISO 14001 being more widely recognised. There is no sign that banks in North America or Oceania will acquire similar certification in the near future.

In the mid-1990s, UBS, Credit Suisse and HypoVereinsbank were involved in the development of the VfU standard for internal environmental care within the banking sector [VfU, 1998]. In 2000, these same banks, now together with Deutsche Bank, worked on the development of the EPI standard for external environmental care within banks [EPI Finance, 2000]. In that same year, two British banks, Barclays and NatWest, were involved in the development of an internal and external management standard for the banking sector; the modular FORGE method [FORGE, 2000].

Currently EPI is working towards a social standard for the banking community as well. While other banks in the sample have received these industry standards with interest,

they have not yet been adopted<sup>(13)</sup>. These initiatives may prove to be very promising for further progress towards sustainability within the banking community.

The Environmental Management and Reporting working party of the UNEP FI, chaired by United Kingdom insurance giant CGNU, is working to produce internationally accepted EM&R guidelines for use by the finance sector. This initiative, which is supplying input for the development of GRI finance sector guidelines, will draw on the several key developments mentioned above as well as introducing perspectives from the financial community in the developing world.

### Environmental policy

Close to 60% of the banks worldwide have an environmental policy statement: looking at the regional differentiation this applies to 67% of the European banks, 50% of the banks in North America and 25% of the banks in Oceania (standardised). A distinction can be made between banks with a comprehensive policy statement of at least one page, published separately or within an environmental or financial report (41%), and banks with a limited expression of environmental policy (only a few policy sentences on the subject in the financial report; 18%), and banks with no policy statements on environmental issues at all (41%). It is striking that some banks are signatories to the UNEP declaration, but don't report any environmental policy objectives.

### Environmental risk assessment and guidelines

A total of 56% of the banks pay close attention to environmental aspects when setting up credit and financing agreements. This percentage is low as banks have been fully aware of environmental risks since the beginning of the 1990s. In the United States, CERCLA even caused some banks to go bankrupt. What is more striking therefore is that not all North American banks conduct

(13) To understand the environmental impacts of banks, it is useful to make a distinction between internal and external issues. Internal issues are related to the business processes within banks, while external issues are connected to the bank's products.

environmental risk analyses (67% actually do). Of all European banks, 63% conduct environmental risk assessment in their financing decisions. No bank in Oceania, Belgium, France or Italy apparently conducts environmental risk analyses.

Only within the group of banks which indicate that they explicitly take into account the existence of environmental risks, do banks exist that make sector choices or use international guidelines for financing. When financing projects or companies in developing countries or countries in transition, some of these banks explicitly adhere to the guidelines of the World Bank (24%) and/or the OECD (3%) and/or set one or more sectors aside from financing (15%). North American banks seem to be more eager to use the World Bank guidelines than European banks (standardised). Particularly for investments in developing countries these guidelines are enhancing more sustainable investments.

By contrast, only European banks explicitly state sectors or activities that they will not finance. Such exclusion of sectors or activities is for banks still a delicate subject. Those with something to say on this subject, are quick to note in their annual financial or environmental reports that strict adherence to this principle is not always possible in the financial world. In many cases exclusion by one bank simply means a project is financed by another bank, whereas if the bank with an active interest in the environment was involved, it could exercise some influence over the environmental consequences. It is in this respect interesting to see that Bank of America reports that it wishes to play no part in the building of the Three Gorges Dam in China, while Société Générale reports that it is involved in this project.

### Financial products for environmental care

A bank may offer its clients a range of products and services related to sustainability. Table 5 shows a broad scope of other financial products and services offered by the selected banks. The list of products is not exclusive.

Half of all banks have specific environmental loans in their portfolio of services (see table 5). Such products are quite popular in Europe and North America. In every country except Australia and Switzerland, at least one bank offers an environmental loan.

Of the selected banks, ten offer customers the opportunity to invest in environmental funds (in total 29% of the selected banks); European banks are the most active in this field. Many differences exist between banks, however: All Swiss, German and Dutch banks are active in this area. The Dutch banks offer 'green funds', which are supported by governmental fiscal facilities, and best-in-class investment funds. Dresdner, Citigroup and ING offer wealthy customers the opportunity to compile their own sustainable portfolios.

Environmental leases are offered by European banks only. On the other hand, only North American banks offer environmental credit cards. Together with Deutsche Bank, all Dutch banks are active in the market for environmental leases (a total of 12% of the banks selected). In the Netherlands this is again complemented by governmental facilities. Only three banks (9%) have an environmental affinity credit card (or similar). In both cases, per purchase the bank makes a donation to a charity of the user's choice (at no cost to the client).

One activity of banks that requires little from the core financial services is the provision of environmental advisory services to industrial customers. Throughout the world's regions, the percentage of banks which offer this is the

Table 5: Financial products and services offered by individual banks, 1998-2000

	Env. risk assessment	Env. loans	Micro credit	Env. funds	Env. leasing	Env. insurance	Env. advice service	Climate product	Env. venture capital
<b>North America</b>									
Royal Bank Canada	X	X	X				X		
Can.Imp.Bank Com.	X								
Bank of Montreal									
Citigroup	X	X	X	X		X	X		
Bank of America	X	X	X				X		
Chase Manhattan			X						
<b>Europe</b>									
Bank Austria	X	X					X		
Fortis Bank									
KBC Bank		X				X			
MeritaNordbanken	X	X					X		
BNP Paribas									
Crédit Agricole		X							
Société Générale				X					
Deutsche Bank	X	X	X	X	X	X	X	X	X
HypoVereinsbank	X	X		X			X		
Dresdner Bank	X			X			X		
Banca Intesa		X							
UniCredito		X				X	X		
SanPaolo IMI									
ABN Amro	X			X	X	X	X		
ING Group	X	X		X	X	X	X	X	
Rabobank Group	X	X	X	X	X	X	X	X	X
BSCH									
BBVA	X	X							
Handelsbanken	X								
UBS	X			X			X	X	X
Crédit Suisse Group	X			X		X	X	X	
HSBC Holdings	X								
Barclays Bank	X	X							
NatWest Bank	X	X	X			X	X		
<b>Oceania</b>									
Nat. Australia Bank							X		
Bank Tokyo Mitsui.									
Fuji Bank									X
Sumitomo		X					X		
Number of banks	19	17	7	10	4	9	17	5	4

same: 50%, though what it involves varies from publishing brochures about the realisation of energy saving to offering customised consultancy and on-site consultancy. Unicredito and NatWest are the front runners in this area.

Just as with investment funds, insurance is a product for which an environmental version is more likely to exist. Many banks give their customers the option of taking out an insurance policy for environmental damage that they have either suffered or caused to third parties (26%). No banks in Oceania have such a product and in North America only Citigroup is active in this area. Within Europe, the Netherlands is notable – every Dutch bank in the selection offers its customers environmental damage insurance. Insurers in the Netherlands jointly developed an innovative insurance product, which was subsequently offered by all banks.

The Dutch banks are also 'all finance' institutions for which insurance activities form an important part of their portfolio of financial services. It is important when considering insurance products to see whether they really do belong to the core activity of each bank in the sample. Adjusted for those that do not, 69% of the relevant institutions offer environmental insurance to their customers.

Micro-credits are an interesting financial instrument offering an economic way out of poverty to people who normally cannot obtain regular bank financing, by supplying them with very small-scale finance. Seven banks (21%) offer micro-credits (four banks in North America, three banks in Europe and none in Oceania) although only four banks actually use this financial product in developing countries.

A whole new area is financial products and innovations related to international climate policy. This area is still new and only the progressive banks are as yet active in it (15%, all European). Four banks in total have tailored

venture capital products for environmental innovations. As sustainability will require breakthrough innovations these venture capital products can prove to be very promising for the future.

### Socio-economic activities and sponsoring

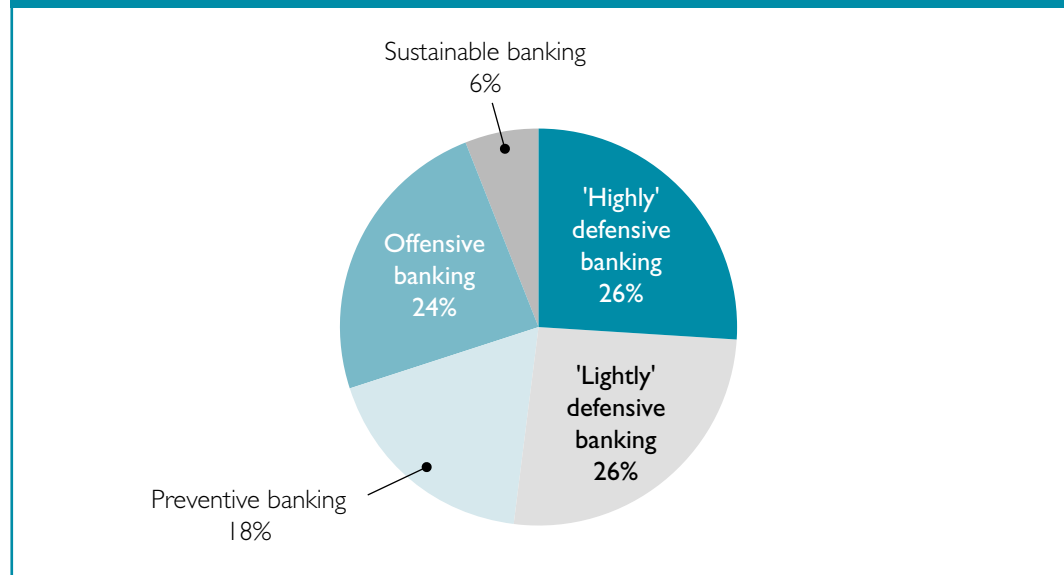
That the social component has played a role in the pursuit of sustainability alongside environmental care is apparent from the scores of banks on a number of social components. This is usually in the form of charity and sponsorship. Environmental sponsoring is an area in which nearly 60% of all banks are active. The differences between the regions are small. Community involvement is a key issue in North America and Oceania (all banks in these regions are active in this region; for Europe this is 71%). Community involvement includes voluntary projects (whether by employees or not), and investments in and sponsorship of social activities in local communities.

Banks are major employers. Over 80% of all banks are active in the field of internal socio-economic policy and activities. These policies and activities include focused training, equal career opportunities for men and women and arrangements for shares for staff. All banks in North America are active in this field. As for the other world regions, 78% of the European banks and 75% of the Oceanian banks score on this item.

### Conclusion

This section has highlighted important differences between regions, countries and banks with regard to sustainable banking. The current position of banks on a broad range of issues has been analysed. The picture created is mixed, both between banks and for each bank individually. To achieve a better picture an integrated score based on the sustainable banking typology from Jeucken (2001) can be useful. This involves creating one final score from the results in the previous sections, on

Figure 1: Banks distributed by integral sustainability score, 1998 to 2000



the basis of which it can be calculated whether a bank can be judged as engaging in defensive, preventive, offensive or sustainable banking<sup>(14)</sup>.

It appears that the majority of the banks adopt a defensive position towards the environment (53%). See figure 1. The overall picture shows a group of ten front runners (30% – sustainable banking and offensive banking) which are proactive, a group of six followers (18% – preventive banking) and a group of 18 stragglers (53% – defensive banking). This last group has subsequently been divided into two groups (26% each) labelled 'highly' and 'lightly' defensive.

Among the 'lightly' defensive banks, indications can be found for a move towards a preventive approach. Within each of the three main groups peer pressure occurs, most strongly among the front runners who quickly react when one of their peers releases a new product onto the market. Peer pressure is also visible within communication activities. In conclusion, this chapter and the figure above have shown a picture of how active banks are, not what their environmental impact is. More research into this area is needed.

## Unfinished business: Tools for implementation in the lending sector

By Iris Gold, Citigroup

In the ten years since the 1992 Rio Earth Summit, the financial services industry has worked to understand better the challenging environmental and social issues that put their companies at risk and are taking actions to improve their risk positions. In addition, concerned organisations and other humanitarian agencies are developing broad and specific strategies to encourage and assist companies and their lenders to deal with these concerns.

The 27 Rio principles, which can be applied to financing instruments, recognise that the emerging markets will not accept limitations on utilising their natural resources. Developing countries desire the same advantages that citizens of the industrialised world have enjoyed. At the same time, responsibility for good environmental practice and careful management of environmental risks must be embedded in the development process. The

(14) Defensive banking is cost-focused and aimed at blocking environmental and social legislation on the grounds of its effect on the company's competitive position. Preventive banking is also focused on costs, but this time from the perspective of achieving savings through more sustainable production processes and techniques (including risk assessment). Offensive banking is focused on profit maximisation by marketing 'sustainable' financial products. A sustainable bank is sustainable in all its aspects and dimensions: social, economic and environmental. Its impact on society and the natural world is fully sustainable, also with respect to future generations.

nexus of these two aspirations is – sustainable development and good corporate governance.

Banks have long practiced basic risk analysis to avoid or mitigate financial and legal responsibility when lending, underwriting, or financing projects. Many international financial firms have already felt the consequences of inadequately evaluating risks. For example, some firms have experienced increased costs due to the denial of government permits, leading to project delays; others have experienced losses due to contaminated land accepted as collateral. Bankers can no longer afford the exposure of loans not being repaid, difficulty when selling stocks and bonds they have underwritten, or not turning a profit for investment clients.

A newer liability, but equally important is the potential of harmful effects to a financier's own reputation by associating with a company that is viewed negatively. In recent years, numerous companies around the world have experienced financial setbacks caused by public reaction to even isolated incidents that caused harm to the natural world or humans. This reputation risk may be based on adequacies, real or perceived. Forward-looking financial institutions are prudently implementing comprehensive environmental management systems into their decision-making processes recognising the linkages between the environment and finance.

### Internal guidelines

One option many firms have chosen is to develop and embed internal guidelines. These codes of conduct generally embrace the core values of honesty, responsibility, compliance, privacy, transparency, confidentiality, and justice. Each financial institution considers the nature of its business and its intended direction of growth.

Most expansion is currently occurring in the developing world and the largest impact is caused by extractive industry enterprises such

as in mining, oil and gas development (including major pipelines), forestry, and hydropower. Financiers are well aware of their responsibility to protect the environment for current and future generations. This is not only an ethical obligation, but also vital for corporations' future capacity to conduct business in a healthy economy and strong marketplace.

### Environmental regulation

One area of transformation has been the increase of environmental regulation in the developing world. Often patterned on the systems of the western world, many developing nations have introduced strict requirements on businesses that impact the environment. Legislation that supports human rights is also beginning to get attention.

Expectations are increasing for higher environmental and social standards as governments in eastern Europe, South America, Africa, and Asia develop their own economies and interact with the global economy. Financial institutions have always followed local and international environmental laws. These days, they are also looking for counsel from other experts that allow banks to look to the future and build credibility with clients, governments, and civil society.

The financial industry is an important player in these economies, particularly as it works with a diverse range of financial intermediaries such as the World Bank, OPIC and national export credit agencies. For example, the IFC of the World Bank has identified environmental and social guidelines that evaluate transactions through a multi-layered process by sector and category. Within these partnerships, private financial firms can try to influence their clients to follow best practices as demonstrated by best in class companies. However in reality, financial firms operate in a very competitive marketplace and their leverage can be limited.

The World Bank has developed safeguard policies that project sponsors should review prior to conducting their assessments. During the appraisal process, IFC identifies which of these policies are applicable to a project. Several international financial institutions have committed to using World Bank guidelines, either in spirit or by letter. Examples of other financial 'partners' requiring that environmentally sound and sustainable development is built into the due diligence process for intermediated financing include the EBRD, the Asian Development Bank, and the Inter-American Development Bank.

### Voluntary initiatives

Voluntary international initiatives have been gaining signatories across industries, allowing both financial firms and their clients to subscribe to the same set of environmental norms and standards. A difficulty inherent in this type of 'one-size fits all' system is that applicability is strained across the various participating sectors. An early entry in the arena, ISO 14000 is a series of voluntary environmental management standards developed by the International Organisation for Standardisation to improve the internal efficiencies of a company's own 'footprint'. ISO 14063, for example, specifically deals with environmental communication and includes guidance on accountability and transparency.

The CERES principles, designed by the Coalition for Environmentally Responsible Economies, is another voluntary guidance that has brought together signatories from a wide range of sectors committed to sustainable development. Often these signatories have business relationships with each other, acting as a catalyst or furthering the intent of these voluntary programmes.

The Global Sullivan Principles, started by the late Reverend Leon Sullivan in 1977 is a code of ethical conduct with strong emphasis on human rights in less developed countries. More recently in 1997, SA 8000 addresses labour conditions for companies and their suppliers and combines standards with independent verification and public reporting. Developed in 1999, AA1000 is the Accountability 1000 Framework of accounting principles that contains social and ethical accounting, auditing, and reporting elements using stakeholder engagement.

Several of these initiatives are still evolving, because of varying expectations and needs. For example, the reporting process stemming from the GRI is yet to gain full support from an inter-national multi-stakeholder community and specific GRI guidelines tailored to the needs of different sectors are being developed. UNEP FI is working with GRI to assist in the development of sectoral environmental reporting and management guidelines that are appropriate and meaningful for the sector.

The Global Compact, a personal initiative of UN secretary-general Kofi Annan, is achieving well recognised success with the broad business community. The Global Compact is providing a value-based set of business operating principles. Undoubtedly, implementing such voluntary codes in part or full, benefits the environment and society. Indisputably, there is much room for improvement and advocacy groups are increasing the pressure on companies and their financiers to facilitate this process.

### Influencing asset management

As an additional incentive for implementing superior management systems, there is growing evidence in business literature that environmental performance may correlate to superior share performance. The socially responsive investment community has embraced this connection. The broader mainstream investment community must see long-term evidence before accepting the correlation. Beyond compliance, it is becoming recognised by a number of analysts as a proxy for good management and an indicator for better financial performance.

Although traditional financial research has included limited information to date on company and sector specific performance on issues related to sustainability, a number of other resources are evolving to supply this crucial information including research firms and rating agencies that specialise in environmental and social criteria analysis. Sustainable investment indexes such as the Dow Jones Sustainability Group Index and FTSE4Good have made it plain to business that attention to environmental and social practices, as well as positive reputation, pays rich dividends.

It should be noted that these are early days and the process of facilitating investment in sustainability-driven companies is still evolving. Neither investors, nor the businesses that hope to be included yet understand the corporate social responsibility criteria and measurement tools utilised by these indices. Although socially responsible investment is growing rapidly, the mainstream asset management community generally still does not consider sustainability issues when deciding on investment vehicles, abdicating the impetus of evolving sustainable development to governments and non-governmental organisations.

### Industry organisations

In addition, industry specific organisations such as the United Nations Environment

Programme (UNEP) Financial Institutions Initiative and the Environmental Bankers Association provide a forum for industry colleagues to come together as peers to work on common goals, often with input from a wide range of outside experts. Through regular associate meetings and special workshops, members are afforded education and experience sharing that they bring back to their respective institutions.

The UNEP Statement by Banking Institutions on the Environment and Sustainable Development presented for the 1992 Rio Summit has since expanded to include insurance companies and has seen the creation of a UNEP Insurance Industry Initiative. For most of the member institutions it serves as the backbone of the banks' environmental commitment, and through the efforts of the initiative, they stay informed on current environmental challenges and competitive advantages.

Over the years, working in partnership, other industry sectors have responded to environmental issues by formulating multilateral environmental agreements on such topical issues as climate change, ozone protection, persistent organic pollutants, and labour practices by suppliers. Several institutions already have developed sustainably oriented investment products that offer socially responsive investment portfolios and screening opportunities.

Some banks are developing products in the evolving markets of renewable energy sources, emissions trading, brownfields insurance and rehabilitation, and energy efficient technologies. Of course, real estate environmental engineering, micro-finance and public finance infrastructure projects are ongoing efforts by banks to benefit to the environment and/or the communities in which they operate.

### Caisse des Dépôts: A sustainability leader among French institutions

Caisse des Dépôts (CdD), a French public financial institution created in 1816, carries out both public service and general interest missions entrusted by the State to public institutions and businesses through its specialised subsidiaries. Focus on the long-term has been the CdD rule of conduct for almost 200 years. CdD has worked with industry, local authorities and government to finance the necessary infrastructure for French society to progress.

CdD has incorporated sustainable development in its management charter, signed by each senior executive. The operational objectives of CdD's businesses now explicitly include action in favour of sustainable development.

A CdD spokesperson said: *'In joining the UNEP Financial Institutions Initiative (FII), we wish to contribute further to building solutions and spreading the word for a more responsible approach to global economic development. We have a particular concern for the waste in resources that results from social and economic exclusion, constituting a potential threat to the sustainability of economic development. We are committed to promoting awareness of the key role of the financial sector in providing means for economic, social and environmentally friendly development. We must encourage the financial sector to widen access to its services and recognise its responsibilities to the entire community by promoting socially responsible investing and continuing to support the development of socially responsible corporate rating.'*

#### Communication

The importance of communication cannot be overstated. Publicly available corporate environmental reports and Internet sites are a necessary means for financial firms to communicate to the public. These reports also serve to provide benchmarking opportunities, which are so fundamental to fostering cross-company comparison. Indeed, the rapid growth of the Internet and public access is allowing financial firms to post more frequent updates of interest to their stakeholders and even to solicit ideas and responses from their readers – a well regarded advance for two-way communication. This trend will only continue to grow.

#### Future challenges and goals of the lending sector

By Franz Knecht, Connexis

##### The increasing importance of trust

Lending of money – debt financing – today is dominated by speed, security and liquidity. But

in future, success will also depend more heavily on *trust*:

- in the stability or at least predictability of the economic, social and political boundaries of the borrower, its industry/sector and its geographic outreach (supply, production, markets);
- in the quality of tangible (measurable, countable, assessable) value – information being disclosed by the borrower and/or assessed by a third party (accountants, rating agencies, certification organisations);
- in the accuracy of the lenders' own assessments of tangible and intangible business values such as balance sheets and P&Ls, business plans, management quality, human resources, intellectual capital, brand value and reputation, and stakeholder relations.

The level of trust is, in principle, dependant on three conditions: the complexity of the transaction; the anonymity of the transaction; and the time line (duration) involved.

- complexity. What kind of loan is it, what is the purpose of it, what are the legal constraints and boundaries in the given country and is it pure debt financing or a structured finance situation;
- anonymity: Most loan transactions today are completed with the aid of information technology, instead of face-to-face meetings. Even if there is personal contact between the borrower and lender, the banker seldom has direct experience of the physical business environment of the client;
- time line or duration. The shorter the term of the loan, the less interested the banker is in the mid- and long-term future of the client. The risk exposure of the bank is in principle seen as largest at the beginning of the loan, decreasing every year as the payments reduce the principal of the loan.

Where trust is in doubt, the lender must assess the extent of the potential risk. The most efficient and effective strategy for the lender to deal with risk is to find a way to transfer the identified risks or risk potentials back to the borrower, to other parties or to society:

- back to the borrower by asking for collateral or securities (assets of all kind if transferable),
- to third parties like insurance coverage or guarantees by individuals,
- to the society via governmental export risk, guarantee funds or development banks.

### Challenges within the lending business

One may argue that the issues discussed above are a matter of calculation, purely dependant on access to the right set of information. But, unlike insurers, lenders only 'calculate' a small part of the risk premium into their credit rates. Instead, credit rates primarily

## Governance and responsibility issues for the financial sector

### By Michael Hoelz, Deutsche Bank, co-chair, UNEP Financial Institutions Initiative

The members of the financial community who have signed the 'UNEP Statement by Banks on the Environment and Sustainable Development' (<http://www.unepfi.net>) have integrated the concept of sustainable development into their corporate guidelines and have begun to chart a new direction as they move forward to the future.

They view the active collaboration between government bodies, business and all elements of society as an opportunity to secure new markets and open up new areas of business. It is becoming increasingly clear that competency in sustainability will play a growing role in determining the market position of globally active providers of financial services. This poses new strategic challenges for the financial community while concurrently opening up new areas for generating value. All this is taking place as the players actively respond to the challenges contained in Agenda 21, with special focus on the tasks of combating poverty and sustaining our ecological system.

Over the past ten years the 'Spirit of Rio' has led to the initiation of a forward looking process that has generated concrete activities at all levels. Selected samples of these activities include:

- environmental management systems,
- financing decisions now include sustainability criteria,
- new mutual fund concepts,
- global governance,
- more open dialogue and transparent communication.

The path taken, which is individually determined by participating firms, remains open for correction, critique, new ideas and development.

Sustainability within the financial sector signifies a lasting and forward-looking approach to corporate governance. The interdependence of economic competitiveness and performance, the global environment as well as social safety and justice is inextricably linked to the concept of sustainability. For this reason the strategic integration of the concept of sustainability into a company's business philosophy is a task for executive management. Once these criteria are firmly anchored within a firm's corporate culture they will help to generate innovative solutions in a global context. By doing so, firms live up to their responsibilities as corporate citizens while also meeting the demands of their stakeholders.

As an integral element in a firm's strategic corporate development, sustainability can serve as a guarantor of market adequacy for solutions that preserve socio-ecological integrity. Relevant commitments or corporate governance agreements are indispensable requisites for defining responsibilities and creating the basis for a clear selection of options to use for taking action. Once this step has been taken, the concept of sustainability must be firmly integrated – organisationally and structurally – within the firm's management system.

Within the firm, it is vital that the system is continuously developed and advanced via concrete measures and benchmarks such as the balanced score card. As good corporate citizens, companies will actively participate in networks dedicated to broadening the concept and understanding of sustainability.

The financial community is called upon to assume responsibility and actively participate in resolving major global issues that impact on our future such as fighting poverty, climate assistance, bio-diversity education or migration. Banks can bring into play all of their competence, their know-how, and innovative strengths as part of their contribution towards resolving these global tasks. Using innovative concepts and strategies they can generate lasting solutions while concurrently entering into new alliances – interdisciplinary and across industries – to develop a steady stream of improvements.

A best practice example is the micro-finance concept. Micro, or very small, loans have proven their value in emerging countries as a tool that can help people to help themselves, and in doing so help them to break the cycle of poverty. The core of the concept consists of support for processes that enable people to actively form, and control, their own lives and livelihoods.

Experience has shown that the principle of an active 'hands-on' approach is a successful part of the global network of measures and alliances and is a clear example of a win-win partnership.

It is clear that responsibility for initiating action is not solely limited to governments. There is a clear need for active participation at all levels of society and economy, especially in the financial community - individual, local, regional and global. The 1992 Earth Summit in Rio was the impetus meeting that marked the historic start of a new strategy of configurations, alliances networks and partnerships. The path that began there represents the containment of narrow national interests in favour of a unified effort to embark on a global development plan to assist all the peoples of our world.

reflect the rates the lender has to pay on the capital market, its own capital costs, administration and overhead costs, and a profit margin. Thus in general risk is not priced – it is transferred or avoided. In many countries of the developing world there is still a lot of regulation involved in reducing the risk for lenders, which is hindering the development of a competitive, open and efficient credit market.

More accurate mathematics are not the solution to the increasing uncertainty surrounding sustainable development issues. Instead, the solution must come from within – from the organic development of business standards, accepted best practices and the tools used every day.

It is, of course, a simplification of a complex industry, but in the context of this debate we focus on three challenges which guide the lending business: reducing costs, reducing risk, and the development of new and innovative financing solutions.

### **Reducing costs**

Cost reduction has been achieved due to the increased speed of transactions (based mainly on IT and highly standardised credit risk assessment procedures). Certainly, there are large differences between the tools a credit officer in Detroit, Kyoto or Zurich is using compared with those in Harare, Bogota or Manila, but in principle cost reduction is always an issue when markets become more open and competitive.

Continuing to achieve further cost reduction depends fundamentally on having the right set of information when the initial decision for a loan is made, and for the follow up screening process. This presents a number of questions. What information is required to deal with relevant sustainable development based risks that are not directly related financially but perhaps economically? What are the tools and skills needed for intangible values evaluation? Are there IT solutions for such values or threads?

### **Reducing risks**

Some risk reduction has been achieved by aligning credit policy closer and closer to identified economic cycles. This means that the assessment of the individual borrower is of decreasing importance and is replaced by increased focus on sector and monetary system risks.

The focusing of risks on purely economic cycles is tied to 'globalisation' and its many challenges to the environment (global warming, biodiversity, waste) and society (poverty, terrorism, human rights). It also highlights the need for a wider and more precise picture of economics – the economics of environmental resilience and social/societal stability. This must lead to new ways of describing, assessing and evaluating private, corporate and public assets, liabilities, growth potential and intangible values.

### **New and innovative financing solutions**

More complex and efficient financing solutions have been developed, called 'structured finance' where debt and equity financing are combined both to reduce risk for the lender and increase access to the most competitive (cheapest) money markets. This includes the role and function of multilateral financing institutions such as the World Bank and diverse regional development banks, as well as the export risk guarantee or insurance tools developed by OECD countries, which is important in the context of foreign direct investments (FDI). In the context of this paper we will assume that micro-finance is also part of this innovation.

Innovative financing solutions designed to deal with a variety of economic risks and financial requirements are necessarily complex, reflecting the interests of more than just the borrower and lender. They must integrate many divergent – even conflicting – stakeholder expectations and levels of acceptable risk exposure. Suddenly we have investors (both funds and individuals) involved

with a major stake in equity (upside), and lenders with the traditional stake in stable and timely returns and repayments.

In the context of FDI for example, we have export risk agencies and development banks involved expecting the fulfilment of political goals, support of domestic industry or multinational development programmes. This brings into play a whole set of new stakeholders that up to now have mainly focused on stock markets and socially responsible investing.

### The future of lending/debt financing

Over the next five to 20 years, the lending industry must focus on: identifying the

information that is required to deal with non-directly financial but economically relevant sustainable development based risks; what new economic values based on the near future sustainability priorities need to be integrated actively into credit project and debt finance business considerations; and, who the new set of stakeholders to the lending sector might be.

### Dealing with sustainable development based risks

The indifference of lenders to sustainability risks is – as described above – based on a very technical risk understanding and a very much reduced time-line of engagement. This direct risk assessment does not take into consideration such things as the risks caused

## '21st Century sustainable development in Asia Pacific: Challenges and opportunities for financial institutions'

This is an extract from a keynote speech by Aman Mehta, CEO, HSBC at the UNEP FI Asia Pacific Outreach Event (Manila, The Philippines. 4 to 5 April 2001)

*'The first opportunity sustainable development offers financial institutions is increased economic activity in the communities and countries we do business in. In the past, people profited at the expense of the environment. In the future, there is an opportunity to profit even more by cleaning up the environment. Here in Asia, we face a number of environmental problems, including water and air pollution, land development concerns, and waste disposal questions. We face the challenge of finding ways to efficiently clean up the result of years of careless use of the environment. And we face the challenge of finding ways to reduce our net environmental impact going forward. Fortunately, rapidly developing technology offers some remarkable solutions in this respect.*

*The second opportunity for financial institutions is e-commerce. Now before anyone gets the wrong idea, let me clarify that I am talking about another kind of e-commerce: namely environmental commerce. The involvement of financial institutions in environmental commerce is inevitable. Consider the trading of emission permits for example. Such market mechanisms are becoming an increasingly accepted way of minimising extra cost to industry and maximising the incentive towards innovation.*

*The third and last opportunity I want to highlight today could also be described as an obligation. It is the opportunity to become active players rather than just passive observers in helping to identify sustainable solutions.*

*We already have the skills. The concept of looking after one's assets to ensure a return in the future is hardly a revolutionary practice in the banking sector. And like any business, we must constantly address questions of how to get more for less. And how to combine resources to maximise output and minimise costs, whether it be by saving, or reducing, or reusing materials.'*

by the contamination of a site, for example, the clean up costs of which directly affect the balance sheet and profit expectations of a company (thus translating into the value of collateral and the financial rating of the borrower).

Direct risk assessment also ignores the issue of labour or human rights standards of suppliers, which impact supply costs and – often with greater consequence – affect consumer opinion. Negative consumer sentiment can potentially lead to consumer boycotts and lower sales, as well as growing marketing communication costs to salvage reputation damage. Clearly, the purely technical risk assessment via IT based balance sheet and P&L evaluation does not give the true risk picture any longer.

Although there are some indicators that lenders (mainly in OECD countries) do assess at least direct environmental contamination and liability risks of borrowers, this does not mean that there is a global standard in credit risk assessment. There is also no standard in the context of the much more demanding assessment and judgment of the CSR risks a borrower may face.

Although environmental and social regulation standards are developed by the World Bank, IFC, European Bank for Reconstruction and Development (EBRD) and other regional multilateral finance organisations, they are often not enforced, or not efficiently enforced, in many developing countries. The economic logic of losses due to the destruction of the natural environment on the one hand, and the loss of sales markets due to trade globalisation and global quality standards (such as labels) on the other, is clearly visible if one is able to read it in the context of the economic situation of the industry and the country.

There is, therefore, a clear need for a broader debate on respective lending standards – beyond monetary issues – dealing with the

priorities of sustainable development in the industrial and regional contexts. The objective is to start the process of building international and national standards organisations similar to the countries' banking associations.

#### **Integration of new economic values**

One explanation often given by the financial community for avoiding action is that values without a market price are difficult to assess. In fact, we already do it in many ways.

Management's capability to deal with future business aspects, intellectual capital, brand or reputation value assumptions are widely debated 'soft values' of economic and even direct financial relevance. But why not the long-term contribution to environmental quality, societal stability, and social equity?

Current developments toward inclusion of sustainable development values are being driven by niche solutions (micro credit) or political pressure in the context of FDI and governmental export risk guarantee tools. The goal for the lending industry should be to lead debate on the issues instead of following stakeholder pressure and being pushed by questions that do not reflect the business reality of the sector.

#### **New stakeholders and their roles**

Looking at the debate within organisations such as World Wildlife Fund (WWF), UNEP, Respect Europe or World Business Council for Sustainable Development (WBCSD), there is a widely accepted conclusion that in the future, the importance in identifying, understanding and evaluating the economic dimensions of intangible societal values is of prime importance to the finance sector.

The lending sector must accept the existence of new drivers of the debate outside of the traditional set of regulators, clients and capital supplying markets. Who are these new stakeholders? A look at the new stakeholders that became accepted by the asset management sector is helpful in this regard:

### Chile's environmental management framework

This is an extract, taken from a keynote speech by Jorge Rodríguez Grossi, Minister of Economic Affairs, Mining and Energy, Chile, at the UNEP FI Latin America Outreach Event (Santiago, Chile, 26 to 27 November 2001)

*'During the past ten years Chile has experienced impressive economic growth, becoming one of the main recipients of FDI in Latin America. USD45 billion from more than 4,000 companies in over 60 different nations have invested in Chile since 1990. This has led to more and better jobs, more competition, a more efficient tariff system and better basic services.*

*An increase in environmental awareness has accompanied this economic growth, leading Chile to adopt and develop many new international treaties and regulations. Market mechanisms have also become a key means to address some of the most pressing environmental challenges.*

*A recent publication of Chile's Foreign Investment Committee Chile's Environmental Management Framework: Business and Investment Opportunities provides a diagnosis of Chile's current environmental situation, recommends pertinent regulation and describes possibilities for environmental investment. Environmental services in the areas of treatment, engineering, transport and monitoring of residuals, and recycling are in demand, with renewable energy, ecotourism and sport fishing showing high potential.*

*In this context, the financial sector can become the preventive auditor of environmental management as they screen investments related to environmental and social issues. Companies are learning that environmental management is directly related to competitiveness and that it constitutes a powerful tool to obtain better financial results.'*

NGOs, new types of clients, the SRI community, and new types of rating agencies. In the context of lending, the focus might also be on the political side through new kinds of regulation about governmental FDI support and export risk guarantee standards. The role of these new stakeholders could be two-fold. Firstly, they could help create publicly accepted standards in which sustainable development issues should be seen as primary intangible values. Secondly, they could serve as an efficient link to assess the sustainable development performance outcome - for example, in developing countries when standards on FDI or export risk guarantee conditions need to be assessed. These assessments will be primarily based on a dynamic understanding of what is of priority in which context, so exporting companies and

their financiers can achieve high acceptance in the respective society. Fair trade organisations have useful experience in how to deal with these issues and the challenges they present.

#### Meeting future challenges

Clearly, there is a need for a distinction between the systemic sustainable development challenges for lending (risk understanding and integration) and the functional expectation of society (or at least a growing family of stakeholders) related to lending businesses and its representatives.

The challenge of risk understanding and integration can, and almost certainly will, be met by systematic work and efficient communication about the results.

Dealing with the expectations of society is a much more demanding challenge because it requires the sector to step outside of its black-box of technical understanding, learning to address and understand the sustainable development side of lending.

In the EU alone, over 90% of all companies are SMEs of 1 to 500 employees. The financing of these companies is not based on equity financing through financial markets, but instead by debt financing through lenders and creditors. This is markedly different from the United States that has a different tradition of financing and highly developed risk finance markets. In Latin America, Africa, Asia and Oceania, the situation is very similar to Europe: the economies are based on SMEs, not on (often multinational) publicly listed, stock market traded corporations.

Based on this perspective, the first step is to debate the functional boundaries, possibilities, and visions of the lending sector, similar to the debate which has taken place within the asset management industry over recent years. The expected result would be the alignment of public expectations based on a broader understanding of what lending is, from where loans are financed, and what sustainable development issues can be dealt with in the context of different lending solutions.

## Conclusions

Despite being slower to respond to the new challenges presented by sustainability, there is growing awareness in the lending sector that the environment brings both the risks and opportunities. Currently, sustainability-related risks are not adequately addressed by the lending sector, as the direct risk assessment method generally used does not take into consideration such things as the environmental clean-up costs of contamination, or the issue of labour or human rights standards of suppliers.

Except in the United States where banks can be held directly responsible for the environmental pollution of their clients and be obliged to pay remediation costs, the focus has been on the development of new products such as environmentally friendly investment funds, instead of on assessing risk.

Despite the lack of attention to dealing with the calculation of risk, addressing sustainability issues is not just a matter of more accurate mathematics. Instead, the solutions must come from within - from the organic development of business standards, accepted best practices and the tools used every day.

Because of their intermediary role in an economy, the role of lenders in contributing to sustainable development is potentially enormous. In order to take advantage of this potential, the lending sector must continue to come up with innovative financing solutions designed to deal with a variety of economic risks and financial requirements, and that integrate divergent stakeholder expectations.

## Concluding remarks

As we have seen in this report, the financial community has engaged rigorously in the sustainability debate since the 1992 Rio Earth Summit. More than that, significant steps have been taken to introduce a range of both policy oriented and practical measures to address both internal and external sustainability concerns across the banking, insurance and asset management sectors.

At the same time, the tasks ahead of the finance and insurance community in the years following the Johannesburg WSSD will be formidable. It is likely the finance sector will come under increasing scrutiny from the NGO community, concerned investors and regulatory authorities with respect to the broad social and environmental impacts of their operations.

Portfolio, project and technology focused investment are likely to be examined in greater detail as governance, transparency and disclosure disciplines tighten across the global economy. The finance sector has a challenging road ahead as it positions to be recognised as a foundation block of a sustainable society.

## Annexe I: Abbreviations and acronyms

<b>ASrIA</b>	Association for Sustainable and Responsible Investment in Asia
<b>CERCLA</b>	Comprehensive Environmental Response, Compensation, and Liability Act
<b>CoP</b>	Conference of the Parties
<b>CSR</b>	Corporate Social Responsibility
<b>DJSI</b>	Dow Jones Sustainability Indexes
<b>EBRD</b>	European Bank for Reconstruction and Development
<b>EMAS</b>	Environmental Management Assessment System
<b>EPI</b>	Environmental Performance Indicators
<b>EU</b>	European Union
<b>EuroSIF</b>	European Social Investment Forum
<b>FDI</b>	Foreign Direct Investment
<b>GATS</b>	General Agreement on Trade in Services
<b>GDP</b>	Gross Domestic Product
<b>GRI</b>	Global Reporting Initiative
<b>HERA</b>	Human and Environmental Risk Assessment
<b>IADB</b>	Inter American Development Bank
<b>IFC</b>	International Finance Corporation
<b>IPCC</b>	Intergovernmental Panel on Climate Change
<b>IPO</b>	Initial Public Offering
<b>ISO</b>	International Standards Organisation
<b>IT</b>	Information Technology
<b>IUCN</b>	International Union for the Conservation of Nature
<b>LDC</b>	Least Developed Countries
<b>NGO</b>	Non Governmental Organisation
<b>ODA</b>	Official Development Assistance
<b>OECD</b>	Organisation for Economic Co-operation and Development
<b>OPIC</b>	Overseas Private Investment Corporation
<b>ORSE</b>	Observatoire Responsabilite Social Enterprise
<b>NAFTA</b>	North American Free Trade Agreement
<b>NIB</b>	Nordic Investment Bank
<b>RET</b>	Renewable Energy Technology
<b>R&amp;D</b>	Research and Development
<b>SMEs</b>	Small and Medium-sized Enterprises
<b>SPI</b>	Social Performance Indicators
<b>SRI</b>	Socially Responsible Investment
<b>UNEP</b>	United Nations Environment Programme
<b>UNFCCC</b>	United Nations Framework Convention on Climate Change
<b>VfU</b>	Verein für Umweltmanagement in Banken
<b>WBCSD</b>	World Business Council for Sustainable Development
<b>WTO</b>	World Trade Organisation
<b>WWF</b>	World Wildlife Fund

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## UNEP contribution to the World Summit on Sustainable Development

The mission of the United Nations Environment Programme (UNEP) is to provide leadership and encourage partnerships in caring for the environment by inspiring, informing, and enabling nations and peoples to improve their quality of life without compromising that of future generations. The UNEP Division of Technology, Industry and Economics (DTIE) contributes to the UNEP mission by encouraging decision-makers in government, business, and industry develop and adopt policies, strategies and practices that are cleaner and safer; make efficient use of natural resources, ensure adequate management of chemicals, incorporate environmental costs, and reduce pollution and risks for humans and the environment.

This report is part of a series facilitated by UNEP DTIE as a contribution to the World Summit on Sustainable Development. UNEP DTIE provided a report outline based on Agenda 21 to interested industrial sectors and co-ordinated a consultation process with relevant stakeholders. In turn, participating industry sectors committed themselves to producing an honest account of performance against sustainability goals.

The full set of reports is available from UNEP DTIE's web site (<http://www.uneptie.org/wssd/>), which gives further details on the process and the organisations that made it possible. The following is a list of related outputs from this process, all of which are available from UNEP both in electronic version and hardcopy:

- industry sectoral reports, including
  - accounting
  - advertising
  - aluminium
  - automotive
  - aviation
  - chemicals
  - coal
  - construction
  - consulting engineering
  - electricity
  - fertilizer
  - finance and insurance
  - food and drink
  - information and communications technology
  - iron and steel
  - oil and gas
  - railways
  - refrigeration
  - road transport
  - tourism
  - waste management
  - water management
- a compilation of executive summaries of the industry sectoral reports above;
- an overview report by UNEP DTIE;
- a CD-ROM including all of the above documents.

UNEP DTIE is also contributing the following additional products:

- a joint WBCSD/WRI/UNEP publication entitled *Tomorrow's Markets: Global Trends and Their Implications for Business*, presenting the imperative for sustainable business practices;
- a joint WB/UNEP report on innovative finance for sustainability, which highlights new and effective financial mechanisms to address pressing environmental, social and developmental issues;
- two extraordinary issues of UNEP DTIE's quarterly *Industry and Environment* review, addressing key regional industry issues and the broader sustainable development agenda.

More generally, UNEP will be contributing to the World Summit on Sustainable Development with various other products, including:

- the Global Environmental Outlook 3 (GEO 3), UNEP's third state of the environment assessment report;
- a special issue of UNEP's *Our Planet* magazine for World Environment Day, with a focus on the International Year of Mountains;
- the UNEP photobook *Focus on Your World*, with the best images from the Third International Photographic Competition on the Environment.

## Sustainability profile of the Finance and Insurance industry

### • Achievements

- The finance and insurance industry has made steps toward sustainability through the development and adoption of internal codes of conduct and environmental regulations, and by becoming signatories to voluntary initiatives (such as ISO 14000) and industry organisations (such as UNEPFI).
- Socially responsible investment (SRI) has experienced strong growth in funds under management over the last decade, and there has been a steady increase in both the number and types of SRI products offered.
- Asset managers, insurance companies and banks have responded to the challenges of sustainable development by introducing innovative products like micro-finance unit trusts, mileage tariffs in motor insurance, and environmental loans.

### • Unfinished business

- Sustainable development principles must be incorporated into all asset management decisions throughout the finance and insurance industry, not just for niche SRI products.
- The industry should continue to adopt voluntary standards and environmental management systems (EMS), and to transfer knowledge to developing countries.
- Efforts to attain a universally accepted reporting standard through the Global Reporting Initiative (GRI) – including the Environmental Performance Indicators (EPI) and Social Performance Indicators (SPI) – should continue.

### • Future challenges and possible commitments

- Challenges facing the finance and insurance industry include: constraints on the investment universe as SRI screening is more widely applied; gaps between the interests of developed and developing countries; culture clashes if attempts are made to apply western standards globally.
- The industry must face new risks including climate change, depletion of resources, excessive inequality and technological risks created through biotechnology and sub-molecular chemistry.
- Issues surrounding human resources, risk information, capital formation, internal processes, public policy formation and expectations of society will all play important roles in the future of the industry.

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