Sustainable finance goes global

As we step into the hopes and uncertainties of 2003, the UNEP Finance Initiatives can look back on a two-year period of sound achievement.

Also, UNEP FI is thrilled to be starting 2003 with a major finance and sustainability event in Paris on 10 January for 240 Western European institutions. The event will be hosted by Société Générale and supported by Caisse des Dépôts, Dexia and ORSE.

**Highlights 2001-2002**

In April 2001 UNEP FI embarked on a global tour, covering Africa, Asia-Pacific, Latin America and the Caribbean, and the European transition economies, to make the sustainability agenda relevant for financial institutions around the world.

Starting in Manila, UNEP FI invited financial institutions from the respective regions to a series of two-day conferences in the Philippines, Chile, South Africa and Hungary. The global conference series assisted UNEP FI in developing a set of policy and practice recommendations and a finance and insurance sector report both of which were presented to the August 2002 Johannesburg Summit.

**Corporate Governance**

When worlds collide

A dramatic re-engineering of corporate and capital market governance systems is playing out in major economies worldwide. The implications for the markets and financial institutions are far-reaching.

A question which remains unanswered, however, is the extent to which environmental and social considerations will be embedded firmly in the emerging governance architecture.

In this special New Year 2003 edition of 0.618... we explore what new challenges and opportunities will emerge for finance globally as the worlds of governance, environment and Corporate Social Responsibility (CSR) collide.

**Integrity dissolving**

As governments gathered for the Johannesburg Summit in August last year, the integrity and credibility of an ever increasing number of listed corporate powerhouses and the financial markets they are traded on appeared to be “dissolving”. Regulators, CEOs, analysts, market pundits, auditors and accountants were – and remain – under the spotlight.

Ordinary investors were asking: “How could the
guardians of the markets have failed so fundamentally to protect us?"

While Business Action for Sustainable Development (www.basd-action.net), a coalition representing business, was presenting the very best examples of corporate environmental and social responsibility to the landmark summit in South Africa, the capitalist free market system itself was "on trial", both figuratively and, in some cases, literally. There did not appear to be enough column inches or prime time television to cover the scandals that unfolded daily as the longest bull market in history collapsed.

The investing Wizard of Omaha, Warren Buffet, captured the chaos at the end of such a bull market with the memorable line: "It is only when the tide goes out that you can see who's swimming naked."

At the heart of the debate over where corporate environmental and social responsibility lies with respect to broader governance concerns, and more specifically, the role and responsibilities of the finance sector, there exist several questions with no simple answers. These questions include:

- Do the issues which make up the corporate environmental and CSR agenda contain "material risks" which regulators, markets, investors and companies should take full account of?
- Is it enough to prove to the financial markets the materiality of environmental and CSR risks, or do the actual values of the market system itself need re-engineering, and if so, is this possible or desirable?
- What systemic changes, whether stemming from revised regulation or enhanced voluntary action, are required to plant environmental and associated social concerns firmly at the heart of capital market and financial institution considerations?
- What can the governments of the leading industrial economies do to provide leadership in this area?

Several finance sector thought leaders in the areas of governance, environment and CSR have contributed insightful and challenging articles to this edition of Corporate Governance. It is hoped that the articles will promote a deeper understanding of the issues surrounding the complex questions raised above. Articles include:

- In the "Through a different lens" column, CoreRatings CEO Alan Banks takes an in depth look at why corporations and markets need to consider a broader range of qualitative risk issues, and also asks what are the real objectives of good corporate governance.
- Matthew Kiernan, Chief Executive of Innovest Strategic Value Advisors Inc., probes the challenges for the finance sector, markets and investors.

Corporate governance reform in developing countries

In OECD countries, the existence of strong and viable capital markets is often a significant lever in bringing about corporate governance reform. With the exception of a few of the larger emerging markets, capital markets in developing countries are generally small and insignificant as vehicles for socially- and environmentally-oriented private sector reform.

Two areas where significant leverage for change in developing countries can be achieved are the state-owned sector and the financial sector. In many developing countries, the state-owned sector is a
the broader corporate world stemming from carbon liabilities. Also highlighted in a parallel article is the UNEP FI climate change study published in October 2002. The study raises questions related to corporate disclosure of potential carbon liabilities and associated fiduciary issues.

Sean de Cleene, Vice Chair of the UNEP FI African Task Force, and Philip Armstrong, Chair of the African Institute of Corporate Citizenship, outline the particular challenges of corporate governance in the context of developing countries’ capital markets.

Brian Pearce, Forum for the Future and lead author for the London Principles, provides a perspective on governance and the finance sector from the non-government community.

Peter Clarke, of SRI Media, explores the implications of the July 2002 US Sarbanes-Oxley Act for European corporations.

It is clear that the governance debate, as well as the analysis of the roles and responsibilities of the finance sector and capital markets, will shift into a new phase in 2003. For the sustainable development community, the manner in which environmental and social considerations are built into the new governance architecture will be critical. If environment and CSR get a strong position within the new governance rubric, many different avenues will be opened to further influence the ways in which these issues are integrated into the considerations of capital markets and the operations of financial institutions.

Some observers will argue that the efforts underway to re-cast the corporate and capital market governance models have no – or very limited – room for environmental and CSR issues. The contributed articles in this edition of 0.618… highlight the material nature of environmental and CSR risks to an ever widening group of companies operating in globalizing markets. Clearly, for our contributing writers, environmental and CSR issues should be part of the new governance equation, either as material risks that translate into the spreadsheets of investors, or as part of institutions’ business ethics.

We hope that this special edition of 0.618… shines a more intense light on the complex set of factors that govern how environmental and CSR issues are drawn into the mainstream capital market and financial institution considerations. If the “People, Planet, Prosperity” ethic is to underpin responsible capitalism, then our financial institutions and capital markets must import a rigorous sustainable development approach into the heart of their operations. We believe that the proactive member companies of UNEP FI are taking important steps to make the goal of balanced development based on the “People, Planet, Prosperity” concept a reality.

Paul Clements-Hunt
Head of UNEP FI

major supplier of goods and services. A focus on influencing government to address corporate governance issues in the state-owned sector could lead to a significant improvement in the quality of services which communities receive, thereby reducing their overall vulnerability and improving their quality of life.

The financial sector is also a key leverage point. The creation of banks of integrity in developing countries is increasingly critical in attracting FDI (foreign direct investment) flows. Central banks could prioritise regulation on issues of corporate governance reform that include social and environmental risk and opportunity creation. One of the problems, however, is the efficiency of national regulatory agencies and their capacity for enforcement. Donor governments should also be looking more closely at how they lend to developing countries and how donor funding and debt funding are being structured in order to take into account corporate governance and broader issues of risk.

Ultimately, corporate governance is about corporations and there is a need to look at the financial sector in developing countries and to determine how best to incentivise the sector to create a certain form of behaviour that promotes sustainability investing. Active promotion of the business case for corporate governance reform, which would include sustainability related issues, is vital for increasing FDI flows into developing countries and for ensuring that these flows lead to more effective nation building.

Sean de Cleene is Director of the African Institute of Corporate Citizenship and Co-Chair of the UNEP Finance Initiatives African Taskforce.

Philip Armstrong is Chair of the African Institute of Corporate Citizenship and Principal Convenor of the King Committee and editor of the King Report 2002 on Corporate Governance for South Africa.
Corporate governance, writes Brian Pearce, has been around as an issue ever since we have had social institutions. As a term it is has only been around for the past two decades and, for most of that time, only as an arcane aspect of commercial law. No longer is that the case. On the anniversary of Enron filing for bankruptcy in the United States corporate governance is perhaps one of the most pressing issues around the world. The collapse of socialism and central planning a decade ago had already led to the current heated debate about different styles of capitalism. Types of corporate governance both reflect and influence those styles. One of those styles, the Anglo-American capital markets model, is now under intense scrutiny as a result of the succession of unsavoury corporate scandals which followed the Enron bankruptcy. As a result the view of corporate managers as agents of shareholders is being challenged by an alternative model of managers as trustees of corporate assets, both tangible and intangible. Issues of corporate governance and corporate responsibility are merging. The challenge is to be clear on what needs to be done.

The problem is that important economic and commercial assets are being managed badly

Enron and the string of subsequent failures of corporate governance are a tragedy for those who lost their jobs, pensions and money. There is, however, a wider economic impact, as John Plender points out in the Financial Times (3/12/02). Ethical conduct builds trust, as important a business asset as machinery and finance, which reduces the cost of doing business. The value of this asset can be seen in economies such as Nigeria and Russia where trust is lacking and the cost of transactions is so high that it seriously damages economic activity. An appropriate response to this problem is therefore in the economic interest of us all and not just an issue for social investors concerned with avoiding sin stocks. As witnessed by the graph on this page, the cost of managers not acting as trustees of key commercial assets can be catastrophic.

Better shareholder agents or trustees of corporate assets?

There are two paths to a solution to this crisis. Perhaps the consensus view today is to reinforce the role of corporate managers as agents of shareholders. Certainly this has been the recommendation of the Myners Review of Institutional Investment in the UK. However, the economist John Kay points out that this was the model followed by the British Government as principle shareholder of its nationalised industries, with unfavourable results. Is there an alternative? If senior management is not the agent of shareholders what is it? European and Japanese managers would recognise the well-established structure in English law that governs the behaviour of individuals or groups who control and manage assets they do not own – the concept of trusteeship. This may differ from the value of the corporation’s shares. Not only because the market may value assets incorrectly, but also

Rules, ratings or values?


Newfoundland cod catch (tons) 1850-2000

Enron, market value, 1985-2002
because the assets of the company will also include the skills of employees, expectations of customers and suppliers, certain environmental resources, and the company's reputation in the community. The duty of the manager is to preserve and enhance the value of these assets under this view of corporate governance.

How can trusteeship be incentivised?

There are three policy responses to bring about good corporate governance and responsibility. The first, minimalist, approach is to do nothing on the basis that government intervention in the wealth-creation process does more harm than good. The second, rules-based, approach has met with favour in the past in the US. The Sarbanes-Oxley Act certainly imposes tougher penalties on directors as well as restrictions on auditors providing non-audit services. However, as John Plender points out, it does much less to address the perverse incentives inherent in the way auditors are appointed and paid by management. Nor does it do much to create what John Kay describes as value-based regulation, the third option. This requires the creation of a business climate that makes it difficult for Enron-like behaviour. Taking a UK context we may name and shame the company, ensure the people running it did not receive invitations to cocktails at 10 Downing Street, or the knighthoods which have often been the reward for successfully running a large company. As Kay suggests, one might create a climate in which the likely effects of such behaviour would ultimately be commercial damage to the company. Non-financial risk ratings are a vital piece of information in that respect. However, the business climate that brings about that non-financial risk needs to be created in the first place. This is the bigger challenge.

Brian Pearce
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New Zealand SRI Conference

UNEP FI in conjunction with its Australasian Partner, EPA Victoria, hosted the inaugural Socially Responsible Investment (SRI) conference in New Zealand during 2002. Specifically, the conference addressed the current and future state of SRI in New Zealand, providing an educational opportunity for those interested in understanding SRI and its many forms.

Paul Hawken Lunch

A large number of superannuation trustees, executives, NGO and government representatives attended a forum conducted by Paul Hawken on “The Business Case for Sustainability.” The event was sponsored by EPA Victoria, with support from SAM Sustainable Asset Management and VicSuper.

Hawken’s address was timely, as many Australian superannuation funds have been considering SRI. Market research indicates that at least 60% of superannuation funds in Australia are likely to provide their members with an SRI or sustainable investment choice in the near future.

EPA Victoria / UNEP FI / Environment Australia Finance and Sustainability Forum

The Forum provided a coverage of a broad range of issues spanning the impacts of climate change on the insurance industry; legislation covering socially responsible investment; an institutional investor view on managing the risk of non-financial corporate performance; and Triple Bottom Line (TBL) reporting.

UNEP FI Australasian Advisory Committees

The committees are undertaking the following activities:

- Working on the implementation of the recently passed Financial Services Product Disclosure Statements Legislation, requiring examination of the extent to which labour, social, environmental and ethical standards are taken into consideration in the investment management of the product;
- A research project considering the extent to which environmental risks are managed by companies and the implications this may have for the insurance industry; and
- Discussion to assist companies with operational environmental management and reporting issues.

For further information, see www.epa.vic.gov.au or contact: Helen Bloustein on +61 3 9695 2687 or Gabrielle McCorkell on +61 3 9695 2538

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Other 2001-2002 highlights included:
- The March 2002 UNEP FI Global Roundtable held in Rio de Janeiro, Brazil, attended by more than 300 participants.
- UNEP FI’s major climate change study presented to the October 2002 gathering of governments in New Delhi, India.
- The development of UNEP FI’s draft international EM&R guidelines for the finance sector. The final round of multi-stakeholder consultations for the guidelines begins in January 2003.

To all 0.618… readers we thank you for your past support and look forward to working with you in the year ahead.

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UNEP FI deepens roots in Asia-Pacific

Around three hundred delegates from across the financial services spectrum gathered for the Annual International Conference of the Association for Sustainable and Responsible Investment in Asia (ASrIA), held from 26-30 October 2002 at the United Nations University in Tokyo. Louisa Mitchell, Executive Director of ASrIA, explained that “this was the first international SRI conference in Japan and the only international SRI conference in Asia this year. ASrIA is pushing out the barriers on developing SRI in Asia and the conference provided a learning platform to discuss SRI and Asian issues, and to develop thinking on practical solutions for developing SRI in the region.” Topics of discussion included the challenges for developing SRI in Asia and SRI strategies for pensions in Asia.

Paul Clements-Hunt, Head of UNEP FI, provided the keynote presentation for the event. He also took the opportunity to sign a Memorandum of Understanding between UNEP FI and ASrIA, signalling their intentions to cooperate in the promotion of sustainable development and environmentally sound business practices across the financial services sector in Asia-Pacific. Praising the hard work of the ASrIA team, he emphasised that “ASrIA has achieved breathtaking results in its first two years. The ASrIA team have done an amazing job to drive SRI ever more firmly onto the agenda for financial institutions and capital markets across this vibrant Asia-Pacific region.”

For more information about the ASrIA International Conference, visit www.asria.org/

HVB Group Publishes Sustainability Report 2002

Transparency can be a catalyst for progress. With its recently published sustainability report, the HVB Group aims to lay out the ecological, social and economic aspects of the Group’s activities and operations, and thus to pave the way for further improvements in its contribution to sustainable development.

The HVB Group, which comprises the Bayerische Hypo- und Vereinsbank AG (HVB AG), Bank Austria, Vereins- und Westbank, and a few selected capital investment and real estate companies, had already established a sustainability focus in its 2000 environmental report. The new report, adhering to the guidelines of the Global Reporting Initiative (GRI), is a landmark in the group’s efforts to promote sustainability. The HVB group has also been a member of the Dow Jones Sustainability Index (DJSI) since autumn 2000 and is included in the FTSE4Good indexes.

The full report is available at: www.hvb-group.com/sustainability (English) or www.hvb-group.com/nachhaltigkeit (German)
For further information on the Sustainability Report or to order printed copies, please contact: Stefan.Loeibbert@hvbgroup.com; Telephone +49 (0) 89/378-297 65

UNEP FI Annual Global Roundtable Tokyo, Japan

UNEP FI is pleased to announce that the Development Bank of Japan has offered to host the UNEP FI Roundtable in Tokyo, Japan during the fourth quarter of 2003.

The Annual Roundtable is the premiere opportunity for signatories to the UNEP Finance and Insurance Initiatives to showcase best practices and to discuss new ideas and future challenges.

We are also happy to announce that at the Tokyo roundtable UNEP FI and the Royal Awards Foundation, Copenhagen, Denmark, will present the first-ever Royal Award for Sustainability in the financial services sector.

More details will be posted as they become available at: www.unepfi.net/tokyo

For further information, contact trevor.bowden@unep.ch
The recent debate about corporate governance has spawned a raft of regulatory and voluntary codes of practice:

- The USA’s Sarbanes-Oxley Act (SOX)
- The Institutional Shareholders’ Committee (ISC) guidelines on shareholder activism
- The UK’s Myners report
- The UK’s Higgs review of the role and effectiveness of non-executive directors (NEDs).
- The creation of the International Corporate Governance Forum (ICGF) by the World Bank and the OECD

In order to police these new codes of practice, writes Alan Banks, we have seen a number of moves to increase the regulatory oversight of companies:

- The formation of the Public Company Accounting Oversight Board in the USA
- A significant increase in funding to the Securities and Exchange Commission (SEC)
- Convergence of global accounting standards through the work of the International Accounting Standards Board
- The impending finalisation of the UK’s company law review
- The 2003 introduction of mandatory environmental and social reporting in France

Against this background, it is somewhat surprising that the corporate governance debate has focussed on a very limited number of themes:

- Board organisation
- Shareholder rights and voting on resolutions
- Independence of auditors
- Role and independence of NEDs
- Transparency and accuracy of financial statements

These are all very important issues, particularly with regard to maintaining confidence that the Directors of a company can be trusted to manage the business in the interests of investors.

However, it does leave corporate governance detached from day-to-day business operations.

**What do we want good governance to achieve?**

In focussing on the details and procedures of governance, the market has failed to debate the central question, which is “What do we want good corporate governance to achieve?”

In our opinion corporate governance is there to ensure that the Board of Directors develops, implements and explains (i.e. discloses) policies that:

- Increase shareholder value
- Lower the cost of capital
- Reduce financial, business and operational risk
- Address reasonable stakeholder concerns

This is a much broader definition of corporate governance than usual and positions it in the heart of business operations. In essence, governance is there to ensure that companies control and report on material business risks.

**How do we define material business risks?**

The most recent of the new codes of practice, Sarbanes-Oxley, requires Directors of US-listed companies to maintain a system of controls that allow them to report accurately on material business and financial risks. Crucially, SOX does not define risk and materiality.

Under the SEC regulations, companies filing their annual financial statements have to include a supplemental statement discussing material business risks – again not defined. However, the SEC regulations have been tested in the US courts and various cases have defined material business risks as being “those things that would be material to investors’ interests”. In other words anything which, if the information were known, would lead to a material change in the price of a company’s shares or bonds (listed securities). This goes far beyond the commonly-held views of risk and materiality.

Let us illustrate this with reference to an emotive issue: The use of animal testing...
Healthcare companies use animal testing during clinical trials to check a drug’s mechanism of action, to identify safe dosage levels and to look for side effects. Although it is required by drug regulators, animal testing is something that regularly causes clashes between the NGO community, the public and the healthcare companies. Rats are acceptable, puppies and monkeys are not. This issue can materially impact the value of a company’s quoted securities through several “investment value levers”, for example: consumer boycotts (affects the value of a company’s brands); collateral reputation damage (investors avoid the company’s shares because of the risk of association – e.g. Huntingdon Life Sciences); long-term access to people skills (quality people do not want to work for companies with a bad reputation); potential regulatory interferences; and now (with Germany passing a bill of rights for animals) even class legal actions on behalf of animals.

Under the SOX regulatory regime, shareholders could sue the Directors for not disclosing the details of their use of animal testing, and for not having policies and controls in place to manage the reputational risk. For getting this wrong, Directors could go to jail for 20 years – plenty of time to think about the real risks the company had been running!

**The role of rating agencies in building trust**

What has been demonstrated in this article so far is that companies have increasingly onerous legal obligations to put in place strong corporate governance, and to link those processes to the management and reporting of material business risks. Given the breakdown in trust between companies and their backers, all stakeholders now want some form of independent verification of how companies are doing.

Enter the ratings agencies. S&P and Fitch Ratings (through its sister company Core Ratings) have announced that they will be providing corporate governance ratings, and Core Ratings is going further by also offering ratings of corporate responsibility.

A Core Governance Rating looks at 70 to 100 metrics across such issues as intangible values, regulatory interference, liability to remediation or class legal actions, collateral reputation damage, brand value impairment, and long-term access to people skills.

**The relationship between CSR risk and investment value**

The new regulatory regimes are putting CSR risks at the centre of the debate. If CSR risks are likely to have a material impact on investment values, then they must be managed properly and reported on to investors.

Luckily, in almost every case, environmental, social and CSR issues can be mapped against a handful of investment value levers that indicate the potential of the particular issue to have a material impact on investment values. These investment value levers include such concepts as permanence of
Corporate Governance

“In essence, governance is here to ensure that companies control and report on material business risks.”

Board policy and CSR, ownership and control, Board organisation, investor rights, Board compensation and financial reporting and verification.

A Core Responsibility Rating starts with a detailed analysis of the major issues, impacts and risks for a particular sector and maps these back to their potential effect on investment value. Then the company is assessed as to how well its policies, processes and controls have managed those impacts and risks in its business which are most likely to have a material effect on investment values.

Governance and responsibility ratings sit alongside credit ratings and give investors, bond holders and lenders a broad and holistic view of how the Board of Directors are managing and reporting on the company’s material business risks.

How can owners of companies enforce good governance and responsibility?

The other very important question we have to answer is, “what options do owners have in enforcing good corporate governance and corporate responsibility?”

Essentially there are only three options:
- Vote on shareholder resolutions
- Work through NEDs
- Intervene directly

Voting on shareholder resolutions has a very limited effect. There are few institutional investors who propose resolutions and the ones offered by Boards do not often cover material business risks. Most investors have opted to outsource the process to one of the proxy voting agencies, such as the Investor Responsibility Research Center (IRRC), the Institutional Shareholders Services (ISS) or Pension Investment Research Consultants (PIRC), and this removes voting still further from any direct involvement by shareholders.

Extending the number, independence, qualification (and by association responsibility and culpability) of NEDs has been hotly debated, and is enshrined in SOX. It is a seductive concept, but there are genuine problems with how much NEDs can realistically be expected to know about the details of company operations, and how can they be made more directly accountable to shareholders.

Direct engagement as a way of ensuring corporate governance and responsibility

The most effective way shareholders can ensure good corporate governance and responsibility is by direct intervention (engagement). The Institutional Shareholders’ Committee (ISC), which speaks on behalf of the ABI, IMA, NAPF and AITC, encourages engagement by institutional shareholders.

A number of institutional investors have become very active in direct intervention and the trend is increasing. In the UK, BGI, Isis, Insight, Aviva, Henderson, CIS, and Hermès are leading the way with active company engagement programmes. Scandinavian pension funds have been doing the same for some time, and in continental Europe ADAM (Alliance) and AXA are starting along this route.

Direct engagement with companies is proving to be the only effective way to ensure that corporate governance achieves its aims. By raising key business and operational risk issues with companies and seeking commitment to solutions, shareholders are directly exercising their power and responsibility as owners of the business. From their side, Boards appreciate the opportunity for a discreet but constructive discussion with their owners, and the opportunity to make changes before the issue becomes a public spat.

However, direct engagement is time consuming and expensive for both shareholders and companies. As they become more established in the market place, corporate governance and corporate responsibility ratings may start to be used as an effective proxy for direct engagement, as the ratings process assesses in detail most of the issues shareholders would wish to discuss directly with companies.

Alan Banks is Group Chief Executive of Core Ratings, a sister company to Fitch Ratings. Core Ratings provides Corporate Governance and Corporate Responsibility ratings to companies worldwide.
Sarbanes-Oxley: impacts on Europe

In July 2002, President George W. Bush signed into law the Sarbanes-Oxley Act of 2002, hailed as the greatest reform of U.S. securities law since the Great Depression. Foreign issuers who list their securities on U.S. exchanges are not exempt from the Act. Reviews of corporate governance activities should begin by considering section 302 of Sarbanes-Oxley, which suggests greater disclosure of risk activities. These greater disclosures might include more detailed analyses in annual filings of procedures and policies of corporations in the areas of social, environmental, human rights and like practices.

Disclosures

Section 302, “Corporate Responsibility for Financial Reports” requires the CEO and CFO of each issuer to prepare a statement to accompany the audit report to certify the “appropriateness of the financial statements and disclosures contained in the periodic report, and that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the issuer”. (Emphasis added.)

“This particular section of Sarbanes Oxley will have considerable impact upon foreign issuers”, states Sara Hanks, a partner with the international law firm Clifford Chance LLP. “Internal control structures vary by each EU jurisdiction, so it is fair to say that Dutch and German companies are going to be most impacted by this provision of the Act. Their corporate governance policies are dictated by domestic law, which in certain instances is different from certain provisions of Sarbanes Oxley.”

The Securities and Exchange Commission is considering proposals to deal with unique corporate structures of European enterprises as opposed to their U.S. counterparts.

“Revenue recognition above all is an issue very important to the SEC” stated Hanks. “Foreign issuers are going to have to consider very carefully these new requirements for disclosure of internal management controls, particularly disclosure of how issuers account for revenue, and ensure to the maximum extent possible revenue is properly recognized throughout the organization.”

Section 302(a)(4) may be of interest to those lobbying for mandatory “triple bottom line” reporting. Corporate governance analysts may well wish to consider to what extent activities by U.S. and non U.S. listed companies, whose operations impact upon such areas as the environment, the local population, and health and safety, are caught by the disclosure provisions of this section of the Act.

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Historically, writes Mathew Kiernan, mainstream institutional investors have unquestioningly accepted the conventional industry “wisdom” that the pursuit of corporate ‘sustainability’ – that is, superior performance on environmental and social issues - can only be achieved at the cost of higher risk for investors, lower financial returns, or both. An important corollary of this argument has long held that, since environmental and social factors are, at best, irrelevant to the risk/return equation and at worst injurious to them, fiduciaries are actually precluded from considering them. It turns out that both the conventional wisdom and its corollary are quite wrong-headed.

Prudence
The “prudent fiduciary” equation is now – quite rightly – being turned on its head. Since there is now growing and incontrovertible evidence that superior environmental and social performance does in fact improve the risk level, profitability, and stock performance of publicly-traded companies, fiduciaries can now be seen to be derelict in their duties if they do not consider environmental and social performance and risk factors. Take climate change, for example, an issue described by both business and government leaders at the Davos World Economic Forum as “the most urgent problem facing humanity”. It is but a short logical leap to suppose that climate change must also be the world’s most pressing environmental challenge. Since companies’ environmental and financial performance are increasingly becoming intertwined, it follows that companies’ response – or lack of response – to climate change could have a material bearing on their risk levels, financial performance and therefore on shareholder value for investors.

The stakes are high indeed. Depending on which sectors companies are in and what their specific risk exposures are, climate change could cost shareholders hundreds of millions of pounds and require major strategic shifts in companies’ business models. In a worst-case, yet entirely plausible, scenario, their very survival could be threatened. Our own company’s research has demonstrated that, in some high-impact sectors, even under highly conservative scenarios, as much as 45% of earnings and 35% of total market capitalisation are at risk from the potential financial consequences of climate change. Yet City and Wall Street analysts continue to dismiss these risks as improbable or immaterial.

One recent illustration of the analysts’ collective blind spot vis-à-vis climate change was provided by the recent IPO of Xstrata, a FTSE 100 coal mining company. The IPO was led by a top-tier, global investment bank. In the 350-page prospectus supporting the underwriting and outlining its risks, precisely one line was devoted to climate change. Yet within weeks the Japanese government began musing publicly about imposing a carbon tax to help combat climate change. Inasmuch as a substantial portion of Xstrata’s revenues come from exporting coal to Japan, the market responded by lopping off a full 8% of the company’s total market capitalization, temporarily knocking it out of the FTSE 100. Arguably, this risk might have warranted more than one line in the offering memorandum!

Recognising risk exposure
Another striking characteristic of climate risk is that it varies dramatically among companies, even within the same industry sector. For example, Innovest research has revealed variations in climate-driven financial risk exposures among major companies in the electric
utility sector of up to ten times! Under these circumstances, prudent fiduciaries simply cannot afford not to know which company is which.

It might surprise some investors and analysts who are currently in advanced stages of climate change denial to learn that a growing number of their institutional confrères have already begun to think quite differently. In May 2002, a group of 35 institutional investors with combined assets in excess of $4.5 trillion wrote to the board chairman of the 500 largest companies in the world by market capitalisation. Their message: As significant shareholders in your companies, we are persuaded that the risks of climate change are genuine. We therefore urge you to disclose to us what you believe the specific financial impacts will be at your company, and what measures – if any – you propose to take to minimise them.

This so-called Carbon Disclosure Project comprises a veritable “Who’s Who” of global institutional investors: Allianz/Dresdner, Sweden’s massive AP2 and AP3 pension funds, Credit Suisse, Munich Re, Swiss Re, and the U.K.’s University Superannuation Scheme (USS), to name but a few. To my knowledge, this is the largest collaborative initiative of its kind in history. (Incredibly enough, however, even $4.5 trillion of investor firepower has failed to persuade some ‘leading’ corporates to cooperate. Short sellers should find out which ones!)

**Drivers of change**

However, at least three factors are likely to accelerate the emergence of this “new fiduciary” paradigm even further. Changing attitudes and legislation expanding the purview of legitimate fiduciary responsibility to include environmental and social performance and risk; legal requirements for broader and faster disclosure of company risks from non-traditional sources; and the growing convergence of the corporate governance and “sustainability” agendas. Pension fund trustees and other fiduciaries in the UK and continental Europe would be well advised to monitor these trends – and their own deportment as prudent fiduciaries can now be seen to be derelict in their duties if they do not consider environmental and social performance...”
Corporate Governance

A “wake-up call” for the global finance sector

Climate change, through the related increase in extreme weather events, can have significant impacts on companies’ financial performance. Yet, the full range of connections which exist between market risk, greenhouse gas regulations, and global warming has not made its way into directors’ thinking and the way they understand their companies’ risk exposure, writes Scott Flemming of UNEP FI.

To come to terms with these complex issues, a number of critical questions need to be asked: Are the scientific, political and economic uncertainties of climate change looked at carefully enough by different actors in the market? Does climate change present real, tangible risks to investors? What role does the issue play in consultations between investment banks and their clients?

In a study published in October 2002 (www.unepfi.net/publications), the UNEP FI Climate Change working group, chaired by Swiss Re, throws new light on these key questions. It also highlights the need for the global finance sector to wake up to the threats and opportunities posed by climate change.

The climate risk to the global economy, described in the study, is well captured by a summary document that was presented to the New Delhi UNFCCC climate change negotiations in October 2002. The summary states: “Climate change poses a major risk to the global economy. The increasing frequency of severe climatic events, coupled with social trends, has the potential to stress insurers, reinsurers and banks to the point of impaired viability or even insolvency. Worldwide economic losses due to natural disasters appear to be doubling every 10 years and, on current trends, annual losses will reach almost $150 billion in the next decade.”

In terms of moving forward, the study recommends that UNEP FI initiate three task forces:

1. An awareness raising task force of senior finance sector executives to inspire individual financial companies to engage on climate change.
2. A project team to develop a quantitative methodology for asset managers that will capture the implications of climate change regulations.
3. A team to develop a project finance methodology that integrates the full range of projects’ environmental aspects, including climate change.

The finance sector has a strong interest in increasing the consideration and disclosure of companies’ exposure to climate change risks. Recent cases where climate change risks were neglected in companies’ reporting and financial markets failed to pick it up, are prime examples of the importance of accurate reporting and transparency as part of proper corporate governance and corporate responsibility. In the preceding article, Dr. Matthew Kiernan of Innovest highlights examples where attention to carbon liabilities has been less than rigorous in offerings to the market.

Scott Flemming, UNEP FI secretariat to the Climate Change working group. scott.flemming@unep.ch
UNEP Fi at the World Summit on Sustainable Development (WSSD)

Discussions at the summit in Johannesburg brought out very clearly that the role of finance has become one of the key issues in the context of sustainable development. UNEP Fi’s presence at the summit demonstrated that financial institutions are proactively engaging with sustainable development challenges, and it also advanced the discussion on how the finance sector might contribute to environmental protection, poverty alleviation, and social stability.

Please visit www.unepfi.net/wssd for:
- the recommendations presented to the WSSD from the UNEP Fi Rio Roundtable
- a summary report on the various events organised by UNEP Fi at WSSD
- speaker presentations for download
- the Memoranda of Understanding signed between UNEP and the Corporation of London, and between UNEP Fi and the IUCN

Two additional reports that were presented at WSSD are available for download at www.unepfi.net/publications
The UNEP Finance and Insurance Industry Sector report looks at the experience of ten years of engagement since the Earth Summit in 1992 and the tasks and challenges ahead.

Financing for Sustainable Development, a report produced jointly by the World Bank, the IMF, and UNEP, looks at innovative macro and micro-economic solutions for sustainability challenges in developing countries.

If you have any further questions regarding UNEP Fi’s involvement at WSSD, please contact mareike.hussels@unep.ch

Financing Sustainable Energy Directory: a listing of lenders and investors

With the release of the Financing Sustainable Energy Directory, project developers have a new tool to help raise capital. The Directory will help investors, project developers and entrepreneurs to find capital providers to finance projects in the renewable energy and energy efficiency sectors (together referred to as ‘sustainable energy’).

For more information and to download the Directory contact:
fsed@unep.ch www.unepfi.net/fsed

The State of Sustainable Venture Finance in 2002

In this 35 page report, twenty top experts from a variety of sectors explore the links between sustainable development and venture capital. The report can be downloaded from www.unepfi.net/venture
The discussion and research will continue in June 2003 at an expert workshop on this topic. Contact: jacob.malthouse@unep.ch to attend or contribute.

UNEP Fi Global Consultation on Finance and Sustainability

In April 2003 UNEP Fi will be releasing a comprehensive publication, documenting the experiences of UNEP Fi’s global outreach over the past twenty-one months.

The publication will include:
- Comprehensive summaries of key UNEP Fi finance and sustainability meetings from around the globe including participant lists.
- Super summaries of the UNEP Fi events at the World Summit on Sustainable Development (WSSD) including coverage of the day-long UNEP Fi African Task Force conference.
- A summary report from the March 2002 UNEP Fi Global Roundtable in Rio de Janeiro, Brazil.
- Coverage of UNEP Fi climate change events in Bonn, Marrakech and New Delhi.
- A CD-ROM containing more than 240 presentations drawn from 12 UNEP Fi meetings held during 2001-2002.
- The CD-ROM will also contain free copies of the following: the UNEP-World Bank-International Monetary Fund (IMF) report “Financing for Sustainable Development”; the Finance and Insurance sector report for WSSD; and the UNEP Fi October 2002 landmark report exploring the finance sector’s role in confronting climate change.

The full price of this report is US$500, but a discount of 30% is available for orders submitted before the January 31, 2003.

For further information or to order the report, please visit www.unepfi.net/gcr or contact robert.reid@unep.ch
Why “0.618…”?

The UNEP FI newsletter is named: 0.618…. Many readers will ask “Why?”. The reason behind our choice of name for the newsletter is given in Peter L. Bernstein’s book: “Against The Gods. The Remarkable Story of Risk.”

In a fascinating section in Chapter two – covering the very beginnings of our modern day understanding of risk – Bernstein explains: “The Greeks knew this proportion and called it “the golden mean.” The golden mean defines the proportions of the Parthenon, the shape of playing cards and credit cards, and the proportions of the General Assembly Building at the United Nations in New York …The golden mean also appears throughout nature – in flower patterns, the leaves of an artichoke, and the leaf stubs on a palm tree.”

Also known as the Fibonacci ratio, after the 13th century Italian mathematician of that name, the ratio defines the shape of a spiral which appears in some galaxies, seashells and the coil of ocean waves. The journalist William Hoffer remarked: “the great golden spiral seems to be nature’s way of building quantity without sacrificing quality.”

0.618… believes that for financial institutions the challenges and opportunities posed by sustainable development centre around an ability to build wealth for shareholders and communities while contributing to the protection of the natural environment – in essence, building quantity without sacrificing quality.

Innovative financing for sustainability

Mission
To identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

UNEP FI
The United Nations Environment Programme Financial Initiatives (UNEP FI) is a unique global partnership between UNEP, the Financial Institutions Initiative (FII), and the Insurance Industry Initiative (III).

Financial Institutions Initiative (FII)
FII was founded in 1992 to engage a broad range of financial institutions in a constructive dialogue on economic development, environmental protection, and sustainable development. Signatories to the UNEP FI Statement by Financial Institutions on the Environment and Sustainable Development commit to the integration of environmental considerations into all aspects of their operations and services.

Insurance Industry Initiative (III)
In 1995, UNEP launched another partnership with the Insurance Industry. Signatories to the III statement of environmental commitment have played a high-profile role in various intergovernmental negotiations, notably those under the United Nations Framework Convention on Climate Change.

Quality Services
We provide our signatories with practical research; capacity building; and information exchange services. The products we provide range from professional development programmes and action-oriented reports to international conferences that bring together professionals from around the globe.

Practical Support
Our job is to provide quality support for your organisation. In addition to our dedicated team, UNEP FI opens up a vast network of sustainable development contacts, information and networking services that are dedicated to helping you and your organisation make a difference.

Structure
UNEP is headquartered in Nairobi, Kenya. UNEP has eight divisions through which it carries out its activities, including the Division of Technology, Industry and Economics (DTIE) based in Paris, France. The Economics and Trade Branch (ETB), based in Geneva, Switzerland, is a branch of DTIE. The Finance Initiatives is a unit of the ETB.

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