UNEP Finance Initiative
Innovative financing for sustainability

# CEObriefing

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# Financing water: risks and opportunities

## Identifying financial institutions' exposure to water-related risks and opportunities for mitigating risk

## Water is an issue for financial institutions

> "Water as an asset is being mainstreamed within financial services. Better management of water risks and a sharper feel for new water markets is emerging"
>
> **Paul Clements-Hunt**
> Head of UNEP Finance Initiative

The rate of depletion and pollution of water resources challenges the commercial sector, including financial institutions (FIs) and their business partners, to take steps to ensure these resources are managed effectively. It is estimated that business 'accounts for 22% of water use globally and up to 60% of water withdrawal in some high income countries'.[1]

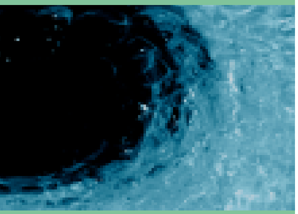
Water is becoming a high-profile business issue and banks are becoming increasingly exposed to a range of water-related risks (WrRs) through their clients, whether they are suppliers of water services or products, water intensive concerns, or others with a water footprint along the supply chain.

Business risk exposure can materialise for FIs if not identified and managed properly. Banks are also exposed to risks linked to reputation and market standing where increasing stakeholder concerns regarding water are insufficiently addressed or understood.

UNEP Finance Initiative's issues paper in collaboration with UNEP GPA, 'Financing water: risks and opportunities', is based on the need for the financial community to identify areas of WrR within the different sub-sectors of water in which they are engaged and to find appropriate measures for identifying and mitigating risk exposure and seeking opportunities for addressing the balance.

1. Sustainability, Issue Brief#9, April 2004, Water: Every Drop Counts, Kavita Prakash-Mani.

# Key findings



"With increasing stresses on water resources worldwide, financial institutions are potentially facing increased exposure in their portfolios through the businesses and industries they support. However, with these challenges come opportunities..."

**Martin Hancock**
Chief Operating Officer, Westpac London
Chairman, UNEP FI Steering Committee

WrRs can be grouped into the following categories:

- *Political* (expropriation, political interference, devaluation)
- *Commercial* (e.g. tariff, cash flow profile, credit risk)
- *Legal regulatory and contractual* (law and contract enforcement, regulation)
- *Water resource risks* (scarcity, flooding, pollution, reallocation)
- *Reputational* (corruption, stakeholder concerns, compliance with good practice)

Market conditions and competitive pressures are pushing banks further up the risk spectrum. Banks are exposed to WrRs mainly through the status and activities of their clients. However, banks can become more directly involved, when they are owners or major shareholders in businesses with important WrRs, and when loans turn problematic and require intervention.

Banks encounter different sets of WrRs depending on the business segment with which they engage. The report breaks businesses down into four principal types from the viewpoint of WrRs:

- Water infrastructure and services (utilities and and operating companies, dams and other hydraulic structures).
- Suppliers to the water sector (producers of pumps, pipes, desalination units, etc).
- Water-intensive businesses (e.g. brewing, steel, food processing, irrigated farming).
- All other firms and banks (all businesses with a water footprint or a water trail, under growing public scrutiny to account for water use and needing to manage reputational risk).

Businesses are finding themselves under a growing obligation to disclose and justify their water use and impact – at all stages of production, consumption and disposal. Some of the key factors have been:

- Growing public environmental awareness and a greater understanding of the critical role of water in different economic and commercial facets of life.
- Concerns about potential water shortages and contamination of supplies.
- The mainstreaming of responsible investment issues and the growth of special water-related investment vehicles. Amongst investors there is an increasing awareness that abuse or misuse of water can have a material, detrimental impact on business where water is a factor.
- Growth of shareholder activism leading to greater corporate disclosure and transparency around new material risk issues, including water use and water as a critical factor of production for various industries.
- Growing public pressure on firms to embed Corporate Social Responsibility disciplines in their core business lines.
- The production by influential agencies of codes of good practice and guidelines (e.g. the UN Principles for Responsible Investment, the Equator Principles and the GRI sectoral reporting guidelines).

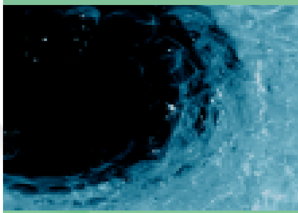
# How do banks address WrRs?

From the results of interviews and expert workshops engaging banks, it emerged that there are great differences between FIs in their perceptions of WrR and in the way they handle these risks. The broad choices are through:

- Portfolio selection;
- by influencing their clients;
- by dealing directly with risks on their own account.

In retail and relationship banking, there are a number of possible approaches for banks to mitigate their exposure to WrRs through influencing client behaviour. Key opportunities for mitigating risk include:

- Recommending that clients seek relevant advice and expertise on technical matters where appropriate.
- Exchanging views with clients, in the pursuit of due diligence enquiries in appraising financing propositions.
- For FIs holding shares with voting powers, voting on company resolutions and introducing such resolutions where the situation warrants.
- For banks that are substantial lenders to a company, to engage in the ongoing monitoring of WrRs where these are critical to the viability of a financing proposition.
- Adhering to guidelines which offer concrete areas of action where banks can influence the adoption of environmental, social and corporate governance issues (ESG) by clients, e.g. The UN's Principles for Responsible Investment.



"From an investor perspective, increasing water scarcity and the challenges for a sustainable water future present high potential for growth and business opportunities in sectors related to water"

**Kajetan Hetzer**
Research Analyst,
SNS Asset Management

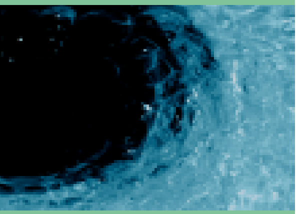
# New approaches to recognising and mitigating WrRs

Although WrRs are increasingly appearing on FI's radar screens, there are currently few means or tools for identifying risk specific to the water sector, and a majority of the tools available address environmental risk as a whole.

A number of promising new avenues are suggested for exploration.

- Systematic assessment of the *water footprints*, *watertrails* and *water balances* of firms.
- Including WrRs in sustainability indicators and diagnostic tools for internal use by FIs.
- Rating and benchmarking companies and FIs according to their exposure to, and management of WrRs.
- Including WrR in banks' risk assessment and testing models.
- Integrating water sustainability into all aspects of a FI's operations, and creating incentives for staff to apply these criteria.

Increased stakeholder engagement is critical for improved understanding and identification of potential risks. Civil society can act as a potential watchdog for upcoming risks in water. Dialogues with policy makers can provide a better understanding of local regulatory and political frameworks.



“Financial institutions need to understand the borrower’s dependency on water and the impacts that water scarcity can bring”

**Robert Tacon**
Head of Risk Monitoring and Compliance Group, Standard Chartered Bank

# How does UNEP FI propose to engage the financial sector in identifying and mitigating WrRs?

**Building on the expertise of its global network of signatory members, including commercial banks, other FIs and insurance companies, UNEP FI plans to construct a platform for FIs to identify and mitigate WrR in the following ways:**

**1** Building a set of risk management guidelines as a common framework and practical tool for FIs to identify WrRs in different scenarios across a number of sub-sectors in water.

Forming a working group consisting of UNEP FI members will be key to the process of developing a strategy for tailoring the risk management guidelines.

**2** Convening a number of expert workshops inviting FIs to present case studies where institutions have been exposed to WrR and identifying the actions taken to manage these risks.

**3** As a unique private public partnership UNEP FI will invite stakeholders outside the financial sector, potentially including relevant governmental agencies, policy makers and leading internationally recognised NGOs to contribute their insights and experiences in dealing with WrR. Opening dialogue between the financial community and policy makers, intergovernmental agencies, and civil society can provide a valuable opportunity for deepening understanding in areas where there are current information gaps.

**4** Integrating regional specific WrR into the guidelines in coordination with UNEP FI’s regional task forces in Latin America, Africa, Asia Pacific, Central and Eastern Europe and North America. Through UNEP FI’s extensive networks world-wide, the guidelines will be globally applicable with regional considerations such as political and regulatory risk integrated into these.



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