UNEP Finance Initiative
Innovative financing for sustainability

THE GLOBAL COMPACT

# THE WORKING CAPITAL REPORT

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Responsible investment matters because we are talking about where people's savings meets society's goals.

By July 2007 assets approaching USD 10 trillion, owned or managed by more than 200 major investment organizations from 25 countries, had committed to the Principles for Responsible Investment.

In the future this commitment by investors to the PRI could have a huge impact on the way capital markets work and indeed on how we collectively address the pressing global social and environmental issues of the 21st century.

The Working Capital Report is a snapshot in time describing how the PRI came about and capturing the views of leading thinkers in the field of sustainable finance and responsible investment.

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## Foreword

# Georg Kell

### Executive Director, UN Global Compact

The world of finance and investment has a pivotal role to play in the realization of sustainable development. Capital markets also will have a fundamental influence on investment for the ideas, technologies and companies of the future that will drive solutions to many of our common environmental and social challenges.

The Working Capital Report provides an up to date examination of the inspiring steps that so many individuals and institutions have taken in recent years to embed responsibility and sustainability at the heart of our financial activities. The arrival of the Principles for Responsible Investment in April 2006, backed now by assets approaching USD 10 trillion, is a testament to the fact that the world's largest investors understand that integration of environmental, social and governance issues is fundamental to good business and thriving societies.

The work of the finance and investment companies supporting the UN Global Compact and UNEP Finance Initiative has been an important contribution in efforts to mainstream sustainability thinking and action in the sector. More than anything it is the leadership positions taken by an increasing number of executives from finance and investment that is driving change and this must be further encouraged and recognised.

The perspectives presented by contributors to this report highlight the dynamism, energy and innovation that exist within the financial services and investment communities and which have created a positive, forward-looking agenda that supports sustainable development.

While acknowledging the significant steps forward this report confirms also the need for renewed commitment to ensure that the values of the Global Compact are welded firmly into all aspects of our markets.

**Introduction**

# Sustainable finance and responsible investment – the state of play

In this introduction Paul Clements-Hunt of UNEP FI and Gavin Power of the UN Global Compact review the exciting recent history of responsible investment. From their positions within the two UN agencies that spawned the PRI, they offer both personal and historical perspectives on its emergence.

## Purpose of the report

Over the past four years, the acronym ESG – environmental, social, and governance – has rooted itself in the lexicon of the financial services community. Some of the largest finance and investment companies have begun to grapple with the complex business of mainstreaming ESG values within their core business activities.

The Working Capital Report traces a number of the key developments that have accelerated the evaluation of ESG issues within mainstream finance, investment and the capital markets. The report also provides an opportunity for a group of recognised global thought leaders to provide their perspective on recent achievements and the challenges ahead. It closes with an assessment – informed by the perspectives gathered – of what might be needed to ensure that ESG values are truly integrated in the marketplace.

As with any evolving area of activity, sustainable finance and responsible investment has created its own community. This community has developed initiatives, institutions, language, including an inevitable growth of acronyms, and a way of operating and interacting. When you combine these developments with the unfathomable mystery that, for many people, surrounds the world of high finance then it is easy to understand why non-specialist audiences can often be left behind. Part of the purpose of the report, therefore, is to provide a straightforward, and to the extent possible, jargon free description of the developments that have contributed to the growth in sustainable finance and responsible investment activity. In summary, the purpose of this report is to:

- explain the major developments in a manner that enables the broader sustainability community to understand what has happened in the fields of sustainable finance and responsible investment;
- highlight the drivers for this change within the financial services sector and investment communities and to explore whether the activities underway are driving real change in the marketplace;
- and draw on the experience and insight of global thought leaders in the area to provide comment on what is working, what is not and what should come next.

The Working Capital Report will employ a lens that focuses principally on United Nations supported efforts that focus on systemic change to promote sustainable finance and responsible investment in the global marketplace. More specifically, the report will highlight and crystallize the lessons to be learnt from activities undertaken and driven by the United Nations Global Compact and the United Nations Environment Programme Finance Initiative (UNEP FI). The Working Capital Report should be read in conjunction with the first annual overview assessing the actions undertaken by the more than 200 signatories to the Principles for Responsible Investment (PRI), which were launched in April 2006. The 2006-7 PRI progress report, published in July 2007, provides an in depth analysis of how responsible investment is evolving in the marketplace.[1]

## Background

Whether you probe the investment, banking, or insurance fields, the period 2003-2007 has witnessed a staggering range of new initiatives as institutions, individually and collectively, have focused on their role in responsible investment and sustainable finance.

In April 2006, the launch of the Principles for Responsible Investment (PRI), now backed by more than 200 institutions representing assets approaching USD 10 trillion , heralded a significant step change for the world's largest institutional investors. The change has profound implications for the way capital markets work, for the financial service organisations that compete in those markets and for the companies that raise capital on those markets.

Some observers allege that the work underway is little more than a public relations exercise at a time when the public, clients and politicians have become increasingly sensitised to environmental issues, notably climate change, and also to scandals in the marketplace as a result of the high profile corporate debacles in the early years of the century. Those sceptical about the upsurge in ESG focused activities within financial services and capital markets also often question the real impact of voluntary initiatives.

Others see that forward-looking financial institutions are re-casting their policies and operations, in effect embedding a new ESG supporting DNA that plays a role in determining corporate identity, values and activity, to finance the entrepreneurs, technologies and companies of the future rather than being seen as institutions and investors associated with the grime of the industrial past.

Increasingly, anecdotal market evidence suggests that the relevance of ESG risks and the emergence of new ESG market opportunities are rapidly being accepted as mainstream themes that are part of the core business thinking of the most forward-looking institutions rather than being a marginal issue of no or limited use to hard-nosed, deal-hungry financiers. The extent to which the "Heavies" of Wall Street and The City of London – including the largest investment banks – are staffing up new units with ESG savvy executives is further confirmation of the sea change taking place within financial services. The next section of this overview takes a brief look at major developments in the investment, banking and insurance sectors.

## Responsible investment

Importantly, the emergence of the PRI reflects a growing understanding and appetite amongst the world's largest institutional investors – pension funds, special government reserves and foundations – that a fuller integration of ESG in their investment policy-making and investment decisions can provide a more effective tool to manage new risks and builds a better understanding of new market opportunities. In time, dynamic implementation of the commitments created by the PRI has the power to align more effectively the entire investment chain with ESG thinking and values. The PRI came about, in part, because the timing in the marketplace was right. That is reconfirmed by the fact that just one year after the former UN Secretary General Kofi Annan launched the PRI nearly USD 10 trillion in assets is now backing this voluntary set of Principles. The sheer size and influence of the asset owning institutions backing the PRI, in many cases the largest universal investors owning chunks of entire markets, is driving change within the asset management community as more and more fund managers realise their biggest clients want to work with money managers that understand ESG. In the marketplace there is growing evidence of how fund managers are reacting to serve this growing ESG demand from the institutional investment community.

1. http://www.unpri.org/report07/PRIReportOnProgress2007.pdf

## Banking

Few of the world's leading global banks do not now understand the need to set in place policies and procedures that set out their position with respect to sustainable finance. The challenge of driving this thinking and approach through the core business lines of massive institutions, often with tens if not hundreds of thousands of employees, is a formidable one that will occupy the next decade. In many instances there remains significant internal resistance to change amongst banking business units where the mantra of "results, results, results" has often undervalued or ignored ESG issues. What is changing rapidly amongst an influential group of the most senior banking executives, however, is the understanding that good ESG practice often helps deliver sustainable results for the institution. At the same time, and as the "war for talent" intensifies, it becomes apparent that valued professionals coming into the financial services labour market increasingly want to work for institutions where responsibility is part of the fabric of the organization rather than just part of the public relations department. A combination of this evolving "top down" belief from the most senior management and this "bottom up" desire from bank staff to work for organisations that understand both value and values will drive and accelerate change within the largest of the institutions.

From climate change, water and ecosystems services and onto human rights issues, as well as the responsibility of financial service organisations in regions of conflict, the sustainability and responsibility agendas for the banking sector have grown exponentially since 2003. At the same time, the basic tools for analysing, reporting and measuring the impact of the various policy and practice approaches have evolved. For example, the Global Reporting Initiative (GRI) convened a process during 2004-6 that saw a group of major banks, cooperating with insurers and asset managers, as well as a multi-stakeholder group, to develop a financial services sector reporting protocol. The GRI Financial Services Sector Supplement has been piloted by a group of banks during the 2006-7 sustainability and Corporate Social Responsibility reporting cycle. Critically, the GRI reporting protocol was based on the need to report indirect impacts of financial service organisation operations thereby extending the reporting requirement to the impact of the institutions' products and services

Taking examples from two contrasting areas of activity, project finance and private banking, gives a sense of how very different banking organisations are striving to understand complex issues and build them into their operations, products and services.

For banks involved in project finance, the emergence in 2003 of the Equator Principles, based on International Finance Corporation (IFC) guidelines, has been a revelation. By June 2007, some 51 banks representing more than 85% of global project finance volume signed the ten principles that cover environmental and social issues related to projects with a total capital cost above USD 10 million. The original principles were revised and strengthened in 2006. A recent client memo[2] co-authored by Paul Q. Watchman, a Partner in international law firm LeBoeuf, Lamb, Greene & MacRae, states:

"Though the EP are non-binding, they have become an extremely important factor in the project finance market. There are no sanctions for breach of the EP but given their prevalence, the importance attached to compliance with the EP by leading bankers and the ever-increasing scrutiny of projects by civil society, it can be said that there is strong pressure to adopt the EP."

Separately, the private banking community that serves the rich and super rich, as well as institutional clients, are waking to the growing demand for responsible investment products from their clients. By 2010, the expectation is that global assets of High Net Worth Individuals (HNWI) will reach more than USD44 trillion[3]. Market analysis indicates that 32% of the HNWI community find ESG investment concepts attractive and, yet, to date just 4-5% of HNWI assets integrate ESG factors in any way. Increasingly, innovative private banking institutions are seeing ESG-inclusive investment as a business opportunity and source of competitive advantage.

2. http://www.equator-principles.com/documents/ClientBriefingforEquatorPrinciples_2007-02-07.pdf
3. http://www.unepfi.org/fileadmin/documents/unlocking_value.pdf

## Insurance

The insurance industry is a strong lever for implementing sustainability due to its size, the extent of its reach into the community and the significant role it plays in the economy. In 2005, the worldwide premium volume exceeded USD 3.4 trillion, making insurance the largest industry in the global economy, while its global assets under management stood at USD 16.6 trillion.

The insurance and reinsurance community were amongst the first financial service organisations to engage and explain the long-term economic risks posed by climate change. A group of the largest financial companies now agree that a USD1 trillion loss in a given year by 2040 is a viable scenario[4]. The Stern Report[5], commissioned by the UK Government, underpinned work undertaken in recent years by insurers and re-insurers highlighting the potentially catastrophic global economic costs of no or low climate action.

Apart from climate change, the insurance industry is now starting to explore the commercial viability of conceiving, developing and rolling out new products and services that address global sustainability issues[6]. The insurance industry is beginning to realise the macro potential of micro-insurance – insurance for the poor – as both a prime business opportunity and a powerful tool for sustainable development. Products and services that address environmental impairment liability, aging populations and lifelong income, modern day health risks, and weather insurance for farmers are coming to the fore. Potential new markets include insurance for emerging manmade risks and the protection of natural resources, in particular, biodiversity, ecosystems and water. The insurance industry is also awakening to the fact that acting sustainably, as in the cases of internal resource efficiency and the recycling of damaged assets, save money and are concrete ways of leading by example. Beyond their raison d'être of managing and carrying risks, insurers are major institutional investors and increasingly recognise that responsible investment is a critical component of the overall sustainable insurance agenda. A group of insurers is set to develop during 2007-8 the Principles for Sustainable Insurance for the global industry and provide a responsibility framework that mirrors the PRI conceived for the investment community.

## Key milestones since 2003

In the activities described below, undertaken by the UNGC and UNEP FI, there was a unifying theme that strove to understand how financial institutions, investors and the capital markets deal with ESG issues. These key activities gave real momentum to the emergence of the PRI. Within weeks of the publication in June 2004 of the first UNGC and UNEP FI reports focused on responsible investment, the UN launched an initiative to create a responsible investment framework for pension funds and other large institutional investors. In time, this framework would become the PRI. On 16 July 2004, The Financial Times reported: "The United Nations has launched a campaign with leading pension funds and other large asset managers to develop a set of guiding principles for responsible investing."

### The UNGC Who Cares Wins series and Stock Exchange Engagement

The "Who Cares Wins" report series was a joint initiative of leading financial institutions invited by then UN Secretary-General Kofi Annan. The research process leading to the first Who Cares Wins report, which was initiated in late 2003, involved some of the investment world's most innovative thinkers in the field of responsible investment. The research, forged through a collaboration of leading asset management companies, enhanced clarity on the respective roles of different actors in the financial market – from companies, regulators, stock exchanges, investors, to asset managers, brokers, analysts, accountants, financial advisers and consultants – and outlined recommendations on how ESG issues can be better integrated into financial

4. http://www.unepfi.org/fileadmin/documents/CEO_briefing_adaptation_vulnerability_2006.pdf
5. http://www.hm-treasury.gov.uk/independent_reviews/stern_review_economics_climate_change/stern_review_report.cfm
6. http://www.unepfi.org/fileadmin/documents/insuring_for_sustainability.pdf

analysis, asset management and securities brokerage. The UN Global Compact launched the first report, "Who Cares Wins – Connecting Financial Markets to a Changing World"[7] at the UNGC Business Leaders Summit that was held at UN Headquarters, New York, in June 2004.

The report, endorsed by the CEOs of more than twenty leaders in the financial industry, articulated the growing body of evidence and consensus that good management of ESG issues enhance company value. It provided a critical impetus to embed ESG issues in mainstream investment practices to achieve the long-term goals of stronger and more resilient financial markets and, accordingly, more sustainable societies. The report also provided one of the key foundation stones that supported the process leading to the PRI. The "meeting of the minds" that generated such an in-depth report likewise underscored that collaborative action among stakeholders is imperative in order to realize significant progress.

In June 2004, the UN Global Compact also established a bridge to an integral component of the capital markets – stock exchanges. The UN Global compact issued a statement[8] endorsed by ten of the world's stock exchanges that would explore collaborative initiatives to advance the tenets of good corporate citizenship and trust-building in society. This laid the foundation for the UN Global Compact's continuing work with the World Federation of Exchanges, the international umbrella organisation comprising the world's leading markets, propelling an even broader engagement with public companies to which the unequivocal message of responsible investment is fundamental.

## The UNEP FI Materiality series

In late 2003, UNEP FI's Asset Management working group, at the time a group of 14 asset managers collectively representing USD1.7 trillion in assets under management, asked whether the "materiality" of a range of ESG issues traditionally overlooked or undervalued by many investment approaches should be reconsidered.

To move the exercise forward, the UNEP FI Asset Management working group invited a group of the world's leading investment research companies to explore the financial materiality of ESG issues in a range of business and industry sectors. At the heart of the exercise stood the challenge of understanding how different ESG issues in various sectors impacted the value of securities. The resulting studies yielded more than 1,000 pages of research contained in 11 analytical reports undertaken by 10 research companies. These financial companies sell their research into the mainstream investment community and, in the jargon of the industry, are know as the "sell-side". Participating institutions included Deutsche Bank, Dresdner Kleinwort Wasserstein, Goldman Sachs, HSBC and UBS. The research was synthesized into a 52 page UNEP FI summary report entitled: "The Materiality of Social, Environmental and Governance Issues to Equity Pricing"[9]. The report was published in June 2004. The robust conclusions of the "Mat1" project, as it became known, prompted UNEP FI to convene a meeting of Europe's largest pension funds in Paris in June 2004 during which the results of the research were presented.

The success of the "Mat 1" exercise, persuaded the UNEP FI Asset Management working group to launch a second call to sell-side researchers to produce further ESG-inclusive research. The resulting 'Mat 2' study has broadened the work on financial materiality to look at more sectors and more methodologies. Institutions participating in the Mat 2 research include: ABN AMRO, Deutsche Bank, Goldman Sachs, JPMorgan, Merrill Lynch, Morgan Stanley and UBS. The resulting summary report, entitled "Show Me The Money: Linking Environmental, Social and Governance Issues to Company Value",[10] found that the increased sophistication of the work undertaken by analysts compared with the original work was striking. In short, the sell-side's ability to integrate and analyse ESG issues had moved on a great deal in a very short time. The

7. http://www.unglobalcompact.org/docs/news_events/8.1/WhoCaresWins.pdf
8. http://www.unglobalcompact.org/Issues/financial_markets/gc_and_stock_exchanges_statement.doc
9. http://www.unepfi.org/fileadmin/documents/amwg_materiality_equity_pricing_report_2004.pdf
10. http://www.unepfi.org/fileadmin/documents/show_me_the_money.pdf

reports submitted for the Mat 2 process begin to describe an emerging taxonomy of ESG risk categories. While not all the reports use the same language, many acknowledge similar factors. Additionally, there are issues that are uniquely important to certain industries or sectors. The findings of "Mat 2" re-confirmed that company valuation is not complete unless it includes a consideration of ESG issues.

### The Freshfields Report – the legal underpinning

In parallel to the work undertaken to conceive, frame and launch the PRI, a discussion was started in late 2004 between members of UNEP FI's Asset Management working group with one of the largest law firms in the world, Freshfields, Bruckhaus, Deringer. The asset managers wanted to understand the legal implications and realities of integrating ESG issues into investment processes within the major capital market jurisdictions worldwide.

Paul Q. Watchman, at the time a partner with Freshfields and lead author of the legal interpretation that became known as the Freshfields Report, wrote: "Despite the evidence that ESG issues often have a material impact on the financial performance of investments, many institutional investors still insist that their legal duties prevent them from taking such issues into account."

"In short, institutional investors who hide behind profit maximisation and the limits supposedly placed by their legal duties do so at their own peril. There is no legal bar to the integration of ESG considerations into decision making (provided the focus is always on the beneficiaries'

## The emergence of the PRI – the UN perspective

During 2003-4, UN Global Compact and UNEP Finance Initiative began a separate exploration of how key actors in the investment chain – asset owners, asset managers, investment consultants, analysts and stock brokers – integrated ESG factors into their work. The thrust of the UN efforts were to work with mainstream financial industry players to explore the barriers and drivers that either prevent or promote the integration of ESG issues into investment policy-making, analysis and action. As part of this process, the UN opened a conversation with the world's leading stock markets and sought to engage the very largest institutional investors in the responsible investment debate.

What the UN discovered were the seeds of a coming revolution in investment world. The UN teams working on the project, the UNGC based in New York and UNEP FI in Geneva, found that rather than having to drag the mainstream financial services sector into the ESG arena there was, already, a vibrant and growing community of convertees who realised that appropriate consideration of ESG factors was essential for the long-term growth and protection of investments. Equally, management of ESG risks was becoming integral to risk assessment and risk management for those forward looking institutions covering a growing range of core financial service activities from investment, to project finance or new insurance products .

In essence, for those forward looking financial institutions the nature and understanding of risk itself was evolving and broadening to include a wider range of qualitative issues. As a new understanding of ESG inclusive risk emerged, there came also a better appreciation of bankable ESG opportunities and a heightened understanding around the emergence of new markets for carbon, clean-tech, sustainable natural resources, environmental utilities and infrastructure, and the technologies of the future.

The result of the 2003-4 work was the UNGC's "Who Cares Wins" reports and UNEP FI's series of "Materiality" reports . The first reports from both series were presented at the UNGC Business Leaders Summit held at UN Headquarters, New York, in June 2004. Within weeks of the publication of the reports, the UN announced an initiative to work with the world's largest institutional investors to create a framework for responsible investment. Nearly two years later, in April 2006, and after a complex series of negotiations managed by UNGC and UNEP FI this effort would become the PRI.

## The emergence of the PRI – a historical perspective

Without the headline grabbing corporate governance scandals that marked the early years of the 21st century, of which Enron, Andersens, Worldcom, and Parmalat were the most notorious examples, and the relentless climb of climate change as a looming material risk issue for industry, the PRI would not have emerged so quickly. In short, the scandals that scarred the markets in recent years and the growing perception that global warming along with other looming global environmental crises pose a real threat to the world economy, worked to blow open a space that allowed the PRI to develop.

It was not just the turn of the century corporate governance meltdowns that catalysed a change in thinking around risk. Earlier systemic failings of the financial system, also linked to corporate malfeasance and downright criminality, also paved the way for a shift which sees a growing appreciation amongst mainstream investors for the pivotal power and fundamental need for both Return on Investment and Responsibility of Investment – the two ROIs – as equal partners in the fiduciary business of protecting asset value over the long-term.

Through the Asian market melt down of 1997, onto the Russian crisis of August 1998 and then into the free-for-all roller coaster scandals as the new century started, the institutional investment community increasingly began to understand governance as a core risk issue that large listed companies need to get right if their long-term asset value is to be adequately protected.

In effect, the corporate governance scandals that pot-marked the dawn of the 21st century worked to broaden the "risk radar" of leaders in the investment community. Governance issues are a "natural" to be considered as part of the risk game as good governance sits at the heart of sound business and the corporate meltdowns simply reaffirmed this. The role, however, of environmental and social issues, sometimes termed extra-financial, and their connection to or influence on "core" governance considerations was more complicated.

While investors can intuitively understand the need for a company to have a well balanced board with strong non executive directors and appropriate checks and balances, the leap to a whole myriad of environmental and social issues, either as part of governance considerations or standing in their own right as full blown risk issues, is not so straight forward for an investment community where the thinking and jargon of sustainability is, quite often, totally foreign.

However, as institutions broadened their risk radars in response to losses approaching USD7 trillion as one corporate governance scandal after another hit the market, the willingness to consider a broader range of risks developed. At the same time, the ability to quantify environmental and social risk to investment, although far from perfect, was emerging. Growing evidence concerning the economic impacts of climate change also accelerated the need for the financial and investment communities to internalise and value non traditional risks more effectively as well as the flip side of the risk coin, new opportunities.

The PRI, conceived, negotiated and delivered by the heads of more than 20 of the world's largest institutional investors is the structure mainstream investors needed to bind the two ROIs and to make a real difference in the global game of investment.

Drawn from an original article by Paul Clements-Hunt contributed to a report for the 2006 meeting of the Commonwealth Finance Ministers.

best interests), and indeed failure to have regard for such considerations may itself amount to a breach of duty," Mr Watchman concluded.

Freshfields lawyers undertook a pro-bono exercise that developed a 150-page plus legal interpretation covering nine capital market jurisdictions[11]. The report was launched in October 2005, at the UNEP FI Global Roundtable at UN headquarters, New York, and has worked to "stand on its head" the traditional market view of ESG considerations. Traditionally, many market actors have argued, and still do, that factoring in ESG issues was not in line with the traditional

11. http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf

understanding of fiduciary duty. Freshfields' study came back with an unequivocal conclusion that the integration of ESG issues into investment analysis, so as to more reliably predict financial performance, is clearly permissible and is arguably required in all jurisdictions.

At the heart of the Freshfields research was the question: "Is the integration of environmental, social and governance issues into investment policy (including asset allocation, portfolio construction and stock-picking or bond-picking) voluntarily permitted, legally required or hampered by law and regulation; primarily as regards public and private pension funds, secondarily as regards insurance company reserves and mutual funds?" The jurisdictions examined included: Australia; Canada; France; Germany; Italy; Japan; Spain; the UK; and the US.

Behind the question raised for the Freshfields work is an immensely complex set of interacting legal and investment drivers that are themselves influenced by a myriad of jurisdictional, national market, and cultural norms that have evolved in the investment field in different countries over many decades. In short, there was no simple answer to the question asked.

After 25 lawyers undertook many man months of work around the globe, Freshfields found that: "those seeking a greater regard for ESG issues in investment decision making often encounter resistance on the basis of a belief that institutional principals and their agents are legally prevented from taking account of such issues". This was despite the growing body of evidence that ESG issues can have a material impact on the financial performance of securities and an increased recognition of the importance of assessing ESG-related risks.

Freshfields legal interpretation catalysed a robust discussion within both the legal and investment communities with respect to the extent to which investors are required, obliged and or mandated to build ESG issues into their investment policy and investment decisions. That debate continues in 2007.

## Recent initiatives and meetings

The momentum and pace of change, if measured by the number of new initiatives and meetings, has been exceptional. A "grab sample" from the global activity list of recent months highlights the growing importance placed on sustainable finance and responsible investment by the various components of the world of financial services. Some notable developments include:

- In early July 2007, investors engaged in the UN Global Compacts "Who Cares Wins" and stock market activities, including the PRI, gather in Geneva for a series of annual meetings. The investors visit the Swiss city at the same time as thousands of business leaders convene for the latest UNGC summit.
- In mid June 2007, a group of African financial institutions launch a UNEP FI report exploring the integration of environmental issues within the credit risk process. The report highlights work undertaken by banks in South Africa and Nigeria. The report is launched at the World Economic Forum African summit held in Cape Town, South Africa.
- In early June 2007, more than 250 bankers gather in central London for an awards ceremony focused on sustainable banking. The event, co-hosted, by the Financial Times and the IFC, has grown exponentially in the course of a year since its launch in 2006. ABN AMRO win both sustainable bank of the year and emerging markets bank of the year.
- In mid-May 2007, sixteen of the world's largest insurers gather at Lloyd's of London, the iconic insurance market that traces its origins to a 17th century coffee shop opened by Edward Lloyd, to launch a UNEP FI report highlighting how the sector is already contributing to sustainability in the development and roll out of new products and services.
- In early May 2007, the heads of some of the world's largest pension funds join an investment summit for 400 senior institutional investment executives in Montreux, Switzerland. The meeting

is addressed by Al Gore and discussions around responsible investment, climate change and the prospect of booming global markets for environmental technologies and services dominate the three-day meeting. A key question put to participants is: "how can the world's largest institutional investors manage emerging ESG risks while investing to create the technologies, companies and markets of the future?"

- In early May 2007, a group including some of Switzerland's most senior private bankers gather for lunch at the historic United Nations Palais des Nations to explore their institutions roles in responsible investment and sustainable finance. The meeting builds on a UNEP FI gathering of more than 50 private bankers that took place at the UN in Geneva in November 2006.
- In March 2007 Bovespa, the Sao Paolo stock exchange, hosts an event that sees 14 Brazilian pension funds signing up to the PRI. Just days before, members of Brazil's private banking community gather to explore how to address the ESG needs of high net worth clients.
- In November 2006 in Tokyo, Mitsubishi UFJ Trust and Banking Corporation expects 150 attendees at a pensions summit on responsible investment. On the day, more than 400 executives – including senior decision-makers from well over 200 pensions funds – attend the event. A follow up summit is planned for November 2007.
- In October 2006, the UNEP FI North American Taskforce hosted a workshop on climate change at Citigroup headquarters in New York. The event included presentations on the latest climate change science, opportunities in the carbon markets such as emissions trading and the Clean Development Mechanism. A number of regional perspectives were given, including an update on Canada's Climate Change Programme, and the US North-East Regional Greenhouse Gas Initiative.

## What's next?

Clearly, the energy and activity levels for sustainable finance and responsible investment are high but two simple questions rest at the heart of the responsible investment debate.

- Firstly, is the activity of the past four years contributing to positive change in the way finance is conducted and investments are made?
- Secondly, what must come next to ensure more effective integration of ESG values in the marketplace?

These are the questions we put to a number of leading thinkers in the responsible investment industry. Their answers to these questions, followed by a section of conclusions forms the rest of this report.

## Responsible investment and sustainable finance research chronology

| | |
|---|---|
| **May 2003** | UNEP FI presents on responsible investment challenges to pension funds at the Amsterdam gathering of the International Corporate Governance Network (ICGN). |
| **November 2003** | UN Global Compact commences work with the broker community to develop the first “Who Cares Wins” report and the ground is paved by UNGC for collaboration with the world’s leading stock exchanges. |
| **November 2003** | UNEP FI invites a group of mainstream research companies to research the financial materiality of ESG issues to securities valuation and commences research for the “Materiality” report series. |
| **May 2004** | UNEP FI convenes a meeting of Europe’s largest pension funds in Paris to discuss responses by institutional asset owners to calls for more responsible investment practices. The idea for a framework for responsible investment is floated. |
| **June 2004** | The first UNGC “Who Cares Wins” report and the first UNEP FI “Materiality” report are launched at UN Global Compact Leaders summit, New York. |
| **July 2004** | The UN unveils plans to work with pension funds and other institutional investors to develop a framework for responsible investment grounded in fiduciary duty. |
| **August 2004** | The first UNGC “Who Cares Wins” annual meeting is held. Goldman Sachs is one among a number of sell-side analysts who present their first ESG focused sectoral reports. |
| **December 2004** | The investors forming the PRI development group are invited by Former UN Secretary-General, Kofi Annan, to join a process to develop a responsible investment framework. The process is to be co-managed by UNGC and UNEP FI. |
| **March 2005** | UNEP FI commissions a legal opinion from the law firm Freshfields Bruckhaus Deringer, seeking clarification on whether the law in the largest capital markets jurisdictions permit institutional investors to consider ESG issues in their investment decision making and ownership practices. The report is presented at UN Headquarters, New York, in October. |
| **April 2005** | The first meeting of the 70 strong PRI “expert group” convenes in Paris to prepare the ground for a meeting of the heads of more than 20 of the world’s largest institutional investors. |
| **May 2005** | UNEP FI launches a second call to sell-side researchers to produce ESG inclusive research for the second report in the Materiality series. |
| **June 2005** | The first meeting at UNHQ, New York, of 20 of the world’s largest investors to commence the development of the PRI. The initial “investor group” meeting is addressed by the UN Secretary General. The group meets three more times after the initial New York meeting, then gathering in Toronto, London and Boston, between June and January 2006. The final draft PRI is concluded at the Boston meeting in January 2006. During the year, the meetings are supported by a group of more than 70 experts on responsible investment. |

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| **April 2006** | UNSG Annan launches the Principles for Responsible Investment (PRI) at the New York Stock Exchange after ringing the NYSE Opening Bell for the US markets. A few days later a European PRI launch takes place at the Old Bourse in Paris. Within a month of launch assets totaling USD4 trillion commit to back the voluntary Principles. |
| **June 2006** | UNEP FI publishes its second materiality report entitled, "Show Me The Money". The summary report contains 12 reports produced by 10 different brokerage houses. US headquartered investment consultant CRA RogersCasey completes an independent summary review of each report. |
| **June 2006–June 2007** | More than 200 institutions take the step to commit to the PRI. The 200th signatory joining in June 2007 is the Swiss private bank, Lombard Odier Darier Hentsch & Cie. During the year the PRI interim board meets to develop PRI's governance and operational structures. |
| **July 2007** | The PRI convenes its first annual meeting in Geneva at the same time as thousands of business leaders gather in the Swiss City for the UNGC Leaders Summit. The UNGC "Who Cares Wins" annual meeting is held in the same week and the UNGC and UNEP FI publish an on-line version of The Working Capital Report. |

# Perspectives on the big picture

Why are some of the world's most forward-thinking, aggressive and successful financial institutions moving to differentiate themselves through their ESG capabilities? In the next section, executives from Innovest Strategic Value Advisors, Goldman Sachs, Axa Investments and Rio Bravo Investments provide their perspective on why the tectonic plates of investment are shifting in favour of responsibility. A leading global law firm, LeBoeuf, Lamb, Greene & MacRae, shines a torch on the legal currents influencing responsible investment.

## Capturing next-generation alpha drivers

Dr. Matthew J. Kiernan, Chief Executive, Innovest Strategic Value Advisors

Matthew Kiernan, Co-founder and CEO of Innovest Strategic Value Advisors, has defined the cutting-edge in responsible investment thinking for well over a decade. Here he looks at how new thinking and new forms of analysis are required to capture real value in a complex global market-place where the nature of risk and opportunity are evolving rapidly.

Investors of the world, unite – you have nothing to lose but your intellectual chains!

Global hyper-competition, accelerated by a "perfect storm" convergence of powerful global megatrends, has created both challenges and opportunities for investors which are quite literally unprecedented. In order to confront those challenges and seize the opportunities, investors will need both a radically different mindset and an entirely new arsenal of analytical tools.

Traditional, accounting-driven investment analysis appears to have reached the limits of its usefulness. As recently as the mid-1980's, financial statements were arguably capable of capturing 75-80% of the true risk profile and value potential of major corporations. According to New York University accounting guru and business professor Baruch Lev, however, by the early 21st century that figure had dropped to less than 20% on average. This tectonic shift reflects the inexorable transformation of developed economies to the point where wealth is now created primarily by knowledge and other intangible assets, rather than by land, factories, physical labour, or even finance capital. Intellectual capital has become the most important factor in creating wealth; ergo, identifying and managing it has become the single most important driver of competitive advantage and sustainable value-creation. Yet accounting statements have almost no light to shed on these "nontraditional" value – and investment risk – drivers.

As we move deeper and deeper into the era of knowledge-value and intangibles, conventional balance sheets and profit and loss statements are capturing less and less of a company's true value, investment risk, and competitive potential. What is needed instead is a new, more dynamic "iceberg balance sheet" approach, one which focuses investor and senior management attention where it properly belongs: on the roughly 80% of companies' true value which cannot be explained by traditional, accounting-driven securities analysis. In short, one which provides a focus on leading indicators of company performance, not trailing ones.

Increasingly, it is this unseen part of the "value iceberg", that much larger portion below the surface, which contains the primary drivers of the company's future value-creation capabilities, risks, and unique comparative advantages. Among the most potent of these intangible value drivers are four of the key pillars of "Sustainability": Environment, Human Capital, Stakeholder Capital, and Strategic Governance.

But why have these four meta-factors become so critical to companies' competitiveness and financial performance? Because, quite simply, they respond directly to the newly emerging tectonic forces which will shape the competitive zeitgeist for the foreseeable future:

- The ongoing shift in the focus of both industrial and investment competition and opportunity creation to emerging markets, where ESG risks tend to be most acute.
- Accelerating natural resource degradation, scarcity and constraints, driven in large part by the explosive pace of both industrial development and urbanization, especially in the BRICs countries.
- Dramatically increased levels of both public and investor expectations for companies' ESG performance, turbocharged by unprecedented levels of transparency with which to assess it.
- The growing economic, socio-political, and competitive impact of major public health issues such as HIV/AIDS, malaria, and tuberculosis.
- The increased professionalism, credibility, and communications capabilities of the leading global NGOs, with a concomitant growth in their potential impact on companies' reputational capital and brand equity.
- An institutional investor base which is increasingly sensitized to ESG issues, newly equipped with better information, and both willing and able to act on their concerns. Both the UN Principles for Responsible Investment ($10 trillion) and the Carbon Disclosure Project ($40+ trillion) are merely harbingers of the new imperatives for those who seek to manage their assets.

Wealth is now created primarily by knowledge and other intangible assets, rather than by land, factories, physical labour, or even finance capital.

Taken collectively, these megatrends are driving a comprehensive global industrial restructuring. They have already begun to transform the very basis of competitive advantage for both corporates and investors. Any investor myopic or complacent enough to disregard this radically changed competitive environment does so at his/her peril.

Indeed, there is now a compelling body of both academic and empirical evidence that a sophisticated, returns-oriented analysis of ESG performance and strategic positioning can indeed enhance investor returns and/or reduce risk. This simply confirms what should have been intuitively obvious a decade or more ago. Going forward, the most successful investors will be those best able to combine fundamental, quantitative, and the newly-emergent, "non-traditional" sources of alpha (out-performance). Investors of the world, unite – you have nothing to lose but your intellectual chains!

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## Sustainable corporate performance

Anthony Ling, Managing Director and
Sarah Forrest, Executive Director, Goldman Sachs

The leadership position taken by Goldman Sachs has sent the strongest of signals to the broader financial services sector that ESG issues are a serious piece of the investment rubric. Here two of the bank's most innovative ESG ambassadors explore why sustainable corporate performance is becoming a key to enhanced asset value.

24th June 2004 is a date etched in our memories and is likely to remain so for some considerable time. Anthony Ling was fortunate enough to present the "Who Cares Wins" initiative on behalf of the finance industry at the Global Compact Summit in New York. As he nervously made his way to the lectern in the UN General Assembly Hall Kofi Annan told him that he thought Anthony was about to make history.

Quite a moment! Anthony highlighted that the CEOs of 20 major financial institutions had endorsed incorporating ESG measures into the investment process, and promised that we would stand up to have our progress measured. Well, we are delighted to tell you that we genuinely believe that a tremendous amount has been achieved since then. The debate has moved forward in leaps and bounds over the last three years and is almost unrecognisable from what it was.

In 2003 we responded to an invitation from a group of investors forming the Asset Management Working Group (AMWG) of UNEP FI to identify environmental and social issues likely to be material for company competitiveness in the global energy industry, and to the extent possible, quantify their potential impact on stock prices. We have subsequently extended our approach into a framework for helping to identify sustainable advantage across all industries. Our approach is to work from first principles to build a quantifiable and objective picture of performance.

In our view, companies are operating in a more rapidly changing and challenging world than previously. Globalization and a changed political landscape are combined with significant changes in populations, urbanization, resource utilization, climatic patterns, and employee and consumer attitudes. The evolution of communications networks means that there is greater connectivity than ever before and, in conjunction with the rise of the NGO, companies operate in a more transparent environment than previously.

More capital is now focused on sustainable business models and the market is rewarding leaders and new entrants in a way that could scarcely have been predicted even 15 years ago. The more globally oriented resource and financial sectors are unrecognizable from the way they looked in the 1990s, with up to 35% of the top 20 energy companies by market capitalization now coming from BRICs countries.

More capital is now focused on sustainable business models and the market is rewarding leaders and new entrants in a way that could scarcely have been predicted even 15 years ago.

New industries have emerged specifically to target many of the issues mentioned above. Given that the pace of change is increasing, we believe that future changes will be even more profound.

However, valuation of companies isn't changing. In our Director's Cut series, we highlight that there are far greater valuation correlations between return spreads than between multiples and growth for mature industries. On average, companies stay in a quartile of growth relative to their peer group for about a year, compared with longer than three years for returns. It is not surprising that the market should find it easier to ascribe value to returns than to growth. Companies that have been able to generate first-quartile returns for more than three years trade at a premium to the regression line suggested by return spreads. The market is willing to pay a premium for sustainable competitive advantage as expressed by superior returns.

Our proprietary ESG framework reflects the fact that all companies have to interact with the four pillars of: the economy in general, their industry, society and the environment. All companies will have some issues that surround them in respect of one of the pillars. Our methodology is not designed to be comprehensive, nor is it designed to be prescriptive in judging what is good or bad practice. It is based on a consistent approach of analyzing objective, quantitative measures which can be adjusted by industry as appropriate.

It incorporates corporate governance, social issues with regard to leadership, employees and wider stakeholders, and environmental management. We believe that it is a good overall proxy for the management quality of companies relative to their peers and, as such, provides an insight into their ability to succeed on a sustainable basis. We incorporate the ten principles of the UN Global Compact covering human rights, labour standards, environment and anti-corruption into our ESG framework to the extent possible in every sector and believe that leadership on these issues is crucial.

GS SUSTAIN focus list members have to score well on a combination of ESG score and industry positioning. This must then translate into improving financial performance.

It is precisely because we are making investment recommendations within this framework that we will differentiate ourselves and create value in our opinion. Yes you did hear it from a financial institution, and yes, we are a US firm. We are under no illusions that this is not the finished article and that others have responded in kind. We hope we have raised the bar and that others will come along and do the same. In my opinion this is how players in the finance industry can do most to advance corporate citizenship and the Global Compact. Pigeonholing ESG issues will kill them. They must be embraced as mainstream – that is how we can make a real and lasting difference.

For those who are frustrated at the rate of progress by the finance industry we suggest that we are like an incoming tide and our high water mark keeps getting higher. In 2004 we said that the launch of "Who Cares Wins" was "the end of the beginning". Much has been achieved by the Global Compact in the last seven years. Within the next five years our actions, both collective and especially individually, must ensure that this is no sideshow but the real deal. Then the tide really will have come in.

## Is RI/SI changing the way capital markets work?

Raj Thamotheram, Director of Responsible Investment, Axa Investments

Raj Thamotheram, one of the most dynamic and influential thinkers in the global responsible investment field, offers his views from 'the two sides of the coin' as he has been both asset owner and investment manager.

For those who are frustrated at the rate of progress by the finance industry we suggest that we are like an incoming tide and our high water mark keeps getting higher.

When Henry Kissinger met with Chou En-lai, Mao Tse-tung's long time right hand man, Kissinger asked Chou what he thought about the French Revolution. Chou is said to have replied: "It is too soon to tell".

With that caveat, here are some personal opinions based on my seven-year experience on the two sides – asset owner and investment manager – of the RI/SI coin.

What is happening today greatly exceeds what I thought possible when I joined this sector. There is now global acceptance that corporate governance is a mainstream investment concern. In the UK at least, many investment professionals now understand that climate change is the same. There are collaborative initiatives that challenge deep-rooted investment beliefs and mental models (eg the PRI, the Marathon Club). Other initiatives change incentive signals in concrete ways (eg the Enhanced Analytics Initiative). These initiatives and firm level behaviour changes form a positive feedback loop so system transformation is happening.

One reason why change has been faster than expected amongst the leaders in this field is that the financial sector is actively recruiting staff with personal beliefs and professional skill sets which are quite different from and complementary to the typical City/Wall Street professional. In a sector not known for embracing diversity, and given that diversity of mental models is critical for sustained superior investment performance, this is no mean achievement for senior management.

However, progress varies noticeably among markets with least progress in the most important market, the USA. In the same way that the US business and political communities have been late to accept the science of climate change, let alone acknowledge their share of responsibility for doing something that reflects the seriousness of the situation, so mental models amongst US asset owners and the American investment industry will inevitably change.

Given the slow and fickle nature of consumer trends, and the difficulty politicians in all countries have to do the right thing, especially when there are powerful interests that face short-term costs, we shouldn't be surprised if the G8 type of "agreement" on climate change – it sounds good but where's the beef? – becomes the norm.

But running the earth as if it was a business in liquidation means we will hit more and more "predictable surprises". These include serious climate change impacts, regulatory (or worse) backlashes against growing wealth differentials and the like. Thus, the thematic issues which RI/SI specialists have developed considerable expertise on will become critical investment matters for mainstream investment professionals. This will be a major opportunity for RI/SI professionals, assuming we can build on our strengths and define roles that are value-adding. What is clear is that business model change within this sector is coming fast.

For example, the RI/SI sector is, today, overly focused on equity investments and within this, on EU/US large cap companies. Contrast this with where the growth is: hedge funds, private equity, real estate, and structured products. Another example of this narrow focus is the fact that of all RI/SI funds, only 0.1% is focused on emerging markets. In contrast, the hedge fund industry has 9% of its assets in Asia alone. There are huge innovation opportunities and a clear first mover advantage for asset owners and fund managers that have the leadership needed for this to happen.

There is now global acceptance that corporate governance is a mainstream investment concern.

Another change relates to the current focus on analyzing extra-financial factors to add alpha (or avoid negative alpha). This is easy to say but difficult to deliver. One litmus test of commitment is whether fund managers who talk about doing this have changed their research supply chain management processes in a meaningful manner like joining EAI.

If this wasn't a hard enough challenge for "today", the focus "tomorrow" will be on safeguarding beta. This will be driven by well-informed and highly diversified asset owners. As a result of their more sophisticated understanding of risk, they will ensure an alignment of interests up and down the value chain from their end beneficiaries through to directors of investee companies. That will do more to drive mainstreaming than anything else.

Someone asked me today whether I was an optimist or a pessimist.

I said I was hopeful.

**Raj Thamotheram**
Director, Responsible Investment

## The role of financial institutions and sustainability

Luiz Maia, Partner, Rio Bravo Investments

Since hosting the Rio Earth Summit in 1992, Brazil has been at the very heart of innovative sustainability thinking. Here Luiz Maia, a driving force behind sustainable finance in the country, takes a look at how forward- looking institutions can position to benefit from the sustainability transformation in the market-place.

### Initial observations

The world is changing at a fast pace. Regarding the financial markets we are witnessing the creation of new criteria to measure performance in investments at large. This multidimensional tool blends financial, social and environmental concerns all together. Investors today are facing a clash between models and business strategies before deciding where to invest, which, in turn, leads them to create a wrong vision regarding the benefits of introducing sustainability-driven policies. This process has nothing to do with cost increase, quite the contrary, it is closely related with extra value (alpha generation in the financial world jargon) for all stakeholders.

The globalization phenomenon is creating more wealth, which will elevate consumption levels of all kinds potentially damaging the standard of living of future generations if nothing is done now.

The mission that financial market players must tackle now is to create a long-term plan that promotes sustainably-driven actions for the benefit all stakeholders.

### Facts to be taken into consideration

Sustainability is still in its infancy as far as the financial world is concerned. However the dominance of the capitalism model is generating more wealth with freedom to invest and mobility to move among markets. Liquidity is starting to face some adversities due to roadblocks in the developed countries, terrorism, bad income distribution and large pockets of poverty in the developing world. All that is forcing financiers to see their business through new lenses – to combine social and environmental demands.

Global warming is affecting rich and poor countries alike because shortage of natural resources will impair the development of all humankind. It is not an isolated problem anymore but a global one.

That said, what are the fiduciary duties of institutional investors and the moral obligations of HNWI regarding those facts? The answer leads to establishing a sustainability-driven development plan to construct a better society based on social inclusion, connectivity, justice, prudence and longevity.

### Sustainable geared investments

It is neither a myth nor charity. It is a process that considers values and principles that generates social, environmental and financial results. It uses different sources of information when compared to other investments, reducing risks that are not perceived by ordinary analysis. This new approach creates capabilities and qualifications transforming the mindset of all players. The role of financial institutions, as a result, is to disseminate this new culture while generating returns for all stakeholders – doing well and feeling good.

The role of financial institutions, as a result, is to disseminate this new culture while generating returns for all stakeholders – doing well and feeling good.

### Sustainable private equity/venture capital and hedge funds

Looking at the financial markets' ecosystem we can identify many vacuums to be filled. The ones that concern me the most at the present moment are those related to the importance that private equity/venture capital and hedge funds play due to their size, degree of sophistication and reach. Those vehicles can today influence markets that they invest in. This is a powerful tool when associated with sustainability-driven policies whenever forming their portfolios. Besides setting the pace towards a remodeled financial industry they disseminate a new investment culture generating additional value.

They can also engage other stakeholders in the discussion interacting with universities and business communities. The support to entrepreneurs is essential to prepare future leaders for a new reality that they will face while managing other businesses.

### Dilemmas and opportunities

Making social investments, despite what many people think, is not philanthropy. Although charity is indeed very important for some causes, SRI seeks to support sustainable lasting businesses powered by visionary entrepreneurs. It is a symbiosis with the future and value creation.

It creates innovation and new processes that enhance relationships, builds loyalty and retains clients/employees, grouped by a common interest. For many this is a new approach – quite different from the ordinary product selection process. Investments made under these criteria show engagement in a better society instead of apathy regarding major issues and concerns that humanity is facing. It is also an opportunity to have a fruitful dialogue with new money while keeping an eye on old money that was earned under a different philosophy.

### Emerging markets (current situation and realities)

A new force is under construction in emerging economies at the present moment. Countries such as India, China, Russia and Brazil will drive the world down a different path as their need for food, water, consumer goods, wealth accumulation and energy etc grows at a very fast pace. That demand will create opportunities to several financial institutions to serve a new class of savers, borrowers and investors searching for financial aid and assistance. The reality will transform financial institutions substantially as they are not prepared to cope with the potentialities in dealing with the BoP. As a consequence their role will expand beyond the ordinary banking relationship that they are used to. If they ignore this fact, they probably will not survive in the long run.

## Sustainable finance and the market: Paradigm shift, watershed or tipping point

Paul Watchman, Partner, LeBoeuf, Lamb, Greene & MacRae

Paul Q. Watchman, lead author of the landmark legal interpretation of how ESG issues relate to fiduciary duty, advocates the need for businesses seeking success to embrace the disciplines of sustainable finance.

The business of business remains business, but the accepted view of what doing good business involves has radically altered.

In another age, Milton Friedman coined an elegant business maxim that "the business of business is business". The repetitious simplicity of this maxim allows it to be understood by even the most Neanderthal of barbarians at the gate. Perhaps it was born out of fear of the new and controversial ideologies that were developing in the 1970s. Nevertheless, it focused the attention of business leaders on the single bottom line: Financial profit and loss. For the remainder of the twentieth century this view of "business" polluted the rich well of commonsense. It inhibited analysis of the relevance of environmental, social and governance (ESG) issues, which are the foundation stones of sustainable finance, when assessing companies' long-term viability. It is only now, fuelled perhaps by enhanced information resulting from sustainability or CSR reporting, that we can observe a sea-change in corporate behaviour. The business of business remains business, but the accepted view of what doing good business involves has radically altered.

In the same way that the discovery of gravity and the theory of relativity revolutionised physics, ESG issues and climate change have revolutionised the way in which businesses and financial institutions conduct their activities and interact. Over the last seven years, the catalyst for this reaction has been the United Nations, and in particular, UNEP FI. This phenomenon has been described alternatively as a "paradigm shift", a "watershed" and a "tipping point". In fact, all such nomenclatures are appropriate.

The UN and UNEP FI have introduced sustainable finance into the mainstream of "business". In doing so, they have not been alone. For example, the Equator Principles were forged and re-forged by commercial banks acting jointly with the IFC and the insurance industry has been forced to reconfigure its products in unexpected ways. Throughout this transformation UNEP FI has acted as a safe harbour for pursuing initiatives that have helped to reshape the single bottom line into a triple bottom line.

Though the Equator Principles, together with other developments such as the UN Global Compact, the UN Draft Norms and the OECD Guidelines for Multinational Enterprises have been important factors in shaping the triple bottom line, it is the genesis of the Principles of Responsible Investment (PRI) to which direct testimony can be given. The PRI are underpinned by economic research carried out by a large team of financial institutions and legal research carried out by over 40 lawyers throughout the world. They are, like the Equator Principles were when first launched, revolutionary in that private bodies have developed a key element of what can be termed "sustainable development law". The PRI require that, subject to the legal duties of pension fund trustees and asset managers, investors abide by six principles, including to incorporate ESG issues into (i) the investment analysis and decision-making processes and (ii) ownership policies and practices. The fact that PRI membership now numbers more than 200 signatories who account for USD9 trillion underpins the strength of commitment to the triple bottom line.

Like love, UNEP FI and climate change have together changed everything. Few people had the vision to see that companies and financial institutions would recognise the need for progress. In fact, progress has been rapid. International banks are developing radical financial solutions to the problems of funding inoculations in developing companies. Other financial institutions are investing in green technology and divesting themselves of securities of companies with poor human rights, labour relations and environmental records. Finally, there is the recent example of KKR, the original barbarian at the gate: KKR, when negotiating to purchase a US power company, agreed to a package of measures endorsed by NGOs in order to reduce the negative environmental effects of the proposed transaction. KKR appears to have taken on board the message that "the business of business is business" and that this "business" involves adopting the values of sustainable finance.

Who should get the credit for such a Damascene transformation? Like love, the answer is the UN.

# Perspectives on risks and opportunities

In this section three contributors from Pax World Funds, Fauna and Flora International and UNEP FI in Asia-Pacific, in turn look at the evolution of financial materiality, an innovative approach to bridge the world's of finance and biodiversity and the need for financial service companies to assume a leadership position in collective efforts to tackle climate change.

## Materiality

Julie Gorte, Senior Vice President, Sustainable Investing, Pax World Funds

Julie Gorte promotes the power of ESG attentiveness for investors seeking out performance and hoping to avoid investment "duds". The changing nature of materiality means financial institutions need to be fast on their feet to stay ahead in understanding how ESG issues impact the investment environment.

Investors who pay attention to ESG issues know that disasters are often not surprises.

Investors have long acquaintance with the financial materiality of environmental and social disasters. These date back to the asbestos liabilities in the late 1980s or early 1990s and more recently, investors suffered when major accounting irregularities or governance problems came to light in companies like Enron, WorldCom, Tyco, Parmalat, and Vivendi.

Furthermore, investors everywhere are beginning to understand the powerful implications of climate change on portfolio performance across sectors. Since the entry into force of the Kyoto Protocol and the advent of the European Union's (EU's) Emissions Trading Scheme (ETS) in early 2005, carbon dioxide (CO2) and other greenhouse gas (GHG) emissions have a price, and emission reductions have value in most of the major developed markets of the world. When BP announced programmes to go "Beyond Petroleum" and established its own emission reduction programme, and GE unveiled its Ecomagination initiative, these companies were signaling that they understood the new opportunities created by climate change on the competitive landscape. On the risk side, there has been a nearly threefold increase in the number of Category 4 and 5 hurricanes in the past two decades, attributable to the warming of the oceans. Infrastructure and property losses soared into hundreds of billions of dollars in 2005, following the formidably destructive typhoon Damrey that struck south China and Vietnam only days after Katrina devastated the Gulf Coast of the USA.

Social factors, too, are growing ever more important. The widely respected management consulting firm, McKinsey, points out:

"Increasingly, a company's sources of long-term value (for example, its brand, talent, and relationships) are affected by a rising tide of expectations among stakeholders about the social role of business. Two forces are colliding: an emerging set of sociopolitical megatrends… that are upending the lives of people, communities, and societies, as well as ever-more-powerful stakeholders wielding wide influence."

Investors who pay attention to ESG issues know that disasters are often not surprises. Nothing plagues markets more than uncertainty and imperfect information, and much of the business of finance is the relentless pursuit of better information. With it, investors can anticipate, and anticipation means fewer surprises, the bête noire of the prudent investor. Increasingly, it has been found that looking at corporate environmental and social performance can impart an extra measure of advance notice of well-managed, or equally important, poorly-managed, enterprises. Moreover, looking under these lamp posts is often a hedge against deviousness: companies that are skating on thin financial ice often have small armies of accountants devoted to arranging financial statements designed to lull investors into a false sense of security. Few companies have – or even can have – similar power over their social and environmental reporting, for they are seldom in sole control of such information.

Well-managed companies generally do not abuse the planet, or unfairly exploit their workers, their suppliers, or their communities. Seeking good investments under these lampposts, as well as looking at more familiar financial factors, can often give excellent insight into a company's quality of management and corporate governance. Clues are often seen to large unpleasant surprises – the thing investors dislike the most – as well as undervalued opportunities in day-to-day management of environmental, social, and governance factors. The key, of course, is simply attentiveness: those who believe that ESG issues are important, and assess them, are much more likely to be prepared for the events that surprise the inattentive.

## Biodiversity

Annelisa Grigg, Director of Corporate Affairs, Fauna & Flora International

Annelisa Grigg of Fauna and Flora International highlights how an innovative financial tool is transforming the way investors can assess biodiversity related risks in the companies and assets they invest in.

Biodiversity is an unaccounted-for risk within the financial markets, in much the same way as climate change was 10 years ago.

Biodiversity – plants, animals and the interactions between them – and the goods and services that it gives rise to, underpins our economy. Healthy functioning soils, raw materials for food and medicine and the maintenance of stable climate patterns are closely linked to the existence of significant areas of unspoilt natural habitat. The global economic costs of failing to conserve biodiversity and losing these ecosystem services have not yet been calculated in their entirety. It is clear, however, from the Stern report that biodiversity plays a key role in the storage of greenhouse gases and the destruction of natural forest alone will have a significant impact on global GDP through its contribution to climate change.

Growing scarcity of natural resources, increasing development pressures and escalating public concern about the resulting loss of biodiversity, pose a strategic threat (and offer potential competitive advantage) to companies. This is increasingly being recognised by the finance sector and within the companies in which they invest. Asset managers F&C and Insight Investment have both identified biodiversity as one of the issues that can contribute to the risks and opportunities faced by a given company. They link this risk to licence to operate, liabilities, damage to reputation and increased operational costs but recognise that strong management controls over biodiversity issues and impacts can also confer competitive advantage. However, tools to enable a rigorous evaluation of environmental performance are scarce despite a rapid growth in ethical investment in financial markets and corporate responsibility within companies. Biodiversity is therefore an unaccounted-for risk within the financial markets, in much the same way as climate change was 10 years ago.

Since 2004, UK based investor Insight Investment has been collaborating with Fauna & Flora International (FFI) and the Dutch network of socially responsible investors, VBDO, to evaluate the biodiversity management practices of 22 (2004) and 36 (2005) companies in the mining, oil and gas and utilities sectors. Drawn from the key elements of a management system, they applied a benchmarking methodology which examines four aspects of biodiversity management: 1) governance, 2) policy and strategy, 3) management and implementation and 4) monitoring, assurance and reporting.

They found that levels of activity varied considerably within each sector and that it was extremely difficult to tell from public disclosures alone the extent to which the companies understood their impacts on biodiversity and had systems in place to avoid, minimize, mitigate or offset their impacts on it. Leading companies showed similar characteristics of:

- an ability to demonstrate an understanding of the links between their impact on biodiversity and business risk
- communication of an unambiguous statement that described their vision for biodiversity which could be used to drive progress
- elaboration of management tools and processes that addressed key biodiversity risks and meant the companies could deliver upon their policy commitments
- development of partnerships with environmental NGOs as a means of gaining greater understanding of the issue, accessing local information and expertise and gaining credibility with stakeholders.

The range of activities within sectors was significant with a number of companies failing to make the link between biodiversity risks and potential business issues.

Two years on, the tool has been endorsed by a range of stakeholders – governments, banks, companies and NGOs – as an effective tool for evaluating company performance and encouraging changed business behaviour. It remains the only comprehensive means of analysing biodiversity risk that is in existence. UNEP FI and FFI are seeking to form an international collaboration of financial institutions, NGOs and business schools, with the aim of piloting a methodology to assess biodiversity risks within the food and drink industry. This is part of a wider UNEP FI project aimed at raising awareness of the links between biodiversity, investment value and the finance sector.

## A low carbon society

Takejiro Sueyoshi, UNEP FI Special Advisor in the Asia Pacific region

Takejiro Sueyoshi, longtime fund manager and now a media personality in Japan, promotes the finance sectors role in driving the type of over-arching societal collaboration needed to address the global challenge of climate change.

At the meeting in Heiligendamm, G8 leaders agreed that they would seriously consider a 50% reduction in global greenhouse gas emissions by 2050. Although it is just a compromise to ensure more talking about climate change rather than committing to action, I do believe that it will be remembered as a turning point in the history of a fight against global warming.

Collaboration among a variety of actors is a key to mitigate climate change. Who can organize the collaboration? My answer is the financial sector.

In order to gain a victory over global warming, every actor has a responsibility to make a contribution. What responsibility should the financial sector take to reduce global greenhouse gas emissions? Needless to say the financial sector's role is to supply sufficient capital to projects, corporations, civil organizations, and individuals that are fighting climate change. Without support from banks and investors, a fight against the 21st century's most serious problem could easily be lost. In other words, the financial sector's most fundamental function as part of the basic social infrastructure is to keep a flow of money going into places where it is most needed.

As time goes by, the seriousness of climate change dramatically increases and becomes more and more difficult to solve. There is no single actor in society who can tackle climate change on their own. Collaboration among a variety of actors is a key to mitigate climate change. Who can organize the collaboration? My answer is the financial sector. Finance can be a conduit through which all social actors can work together to resolve worldwide problems such as global warming. The financial sector can provide a framework where collective actions can be taken by social actors from different areas. The more serious a problem, the greater the demand from society that the finance sector take more responsibility in addressing the issue. Financial institutions need to listen to the voices in the community and live up to society's expectations. This is what being socially responsible means for the finance sector.

It is a very encouraging that the Principles for Responsible Investment are rapidly prevailing all over the world. My dream is that a day comes soon when the PRI fades away. On that day every investor will be applying the PRI principles on a daily basis in their investment decision-making process.

# Perspectives on investment

In this section the most senior executives from two of the largest pension funds in Brazil and the USA, PREVI and CalPERS respectively, outline why a responsible investment approach is transforming the way the biggest institutional investors think about the future protection and growth of the assets they safeguard. The views of the pension fund leaders are complimented by those of an executive from one of the largest US socially responsible investment funds, Calvert, who sees increasing credibility for ESG approaches persuading more fund managers to come to the responsible investment "banquet".

## Information for integration

Sérgio Rosa, President, PREVI

Sérgio Rosa of PREVI, the pension fund of Banco de Brasil, stresses the critical need for institutional investors to integrate ESG issues into their daily investment decision-making practices

Sustainability has become the number one issue for both companies and mainstream investors. The companies, mainly the listed ones, as well as those that depend on their public image (and which companies can survive in the market without a good image?) do their best to show that they are taking steps to mitigate environmental risk and the negative social effects of their activities. Every company needs to illustrate that it is firmly engaged with transparency, ethical and equitable practices.

Each day more companies publish social reports, include sustainability issues in their communication policies and aim to comply with the best corporate governance practices. The concern is not from the specialists anymore and it has begun to reach the CEOs and Board members. Project initiatives such as the Global Compact, the Ecuator Principles, the Global Reporting Initiative (GRI), the Carbon Disclosure Project (CDP), and the Principles for Responsible Investment (PRI) are becoming increasingly well-known and widespread as tools to drive improvements in companies and investors alike.

Institutional investors, in turn, are even more attentive in relation to the companies in which they invest. Through the PRI, institutional investors are being challenged to develop clear methodologies for integrating environmental, social and governance issues in their daily investment decision-making practices.

Through the PRI, institutional investors are being challenged to develop clear methodologies for integrating environmental, social and governance issues in their daily investment decision-making practices.

Environmental, social and governance issues are clearly part of the business world at all levels now. There is no doubt that UNEP FI initiatives have played a significant role in seeding such issues, bringing companies together and setting minimum expected standards of behaviour.

We should applaud our efforts to date but recognise that there is still a lot to be done. We know, for instance, how important it is to compare the profitability of the companies or the investment funds and how such comparison can be a powerful tool to promote the continuous improvement of financial and corporate institutions. On the other hand, it is still difficult to compare the level of social and environmental responsibility of such institutions. It is still difficult to evaluate and measure whether a good communication strategy is really the output of a consistent strategy of action regarding environmental, social and governance issues, and one that is appropriate to that company or investor's size and impact.

Anyway, the world has woken up to ESG issues and both the UN Global Compact and UNEP FI are helping coordinate and integrate efforts to meet these challenges.

## The role of good corporate governance in achieving improved long-term performance

Fred Buenrostro, CEO, CalPERS

A speech delivered in May 2007 by Fred Buenrostro, CEO CalPERS, to four hundred senior pension fund and institutional investor decision-makers, gathered in Montreux, Switzerland, was a "hidden" magical moment for the environmental community, very few of whom were there to hear him. It captured the essence of how open-minded investors can transform the future and deliver sound returns for their beneficiaries. The full text of the speech follows.

"I'm pleased to be here with you in Switzerland. Few spots on Earth speak so eloquently of our natural treasures as this beautiful country. I hear that Switzerland had the warmest winter on record – bad news for resort operators and skiers. I can appreciate their pain. In California, I spend many of my weekends skiing on the slopes around Lake Tahoe. At Tahoe, we're experiencing the same warming trend. The area where I've been a ski instructor shut down two weeks early this spring. That's earlier than any time I can remember. Now I'm thinking about summer recreation and wondering if the rivers will be deep enough to navigate them.

So what does the weather have to do with my subject today? Well, quite a lot.

As a major investor, we're seeing that climate change is having a big impact on capital markets. In fact, our investment officers think that – partly because of climate change – we're going to be dealing with big oil and energy issues for at least the next 10 years. Like it or not, we're facing a big market shift in the global economy brought on by climate change and the increased volatility of energy-related commodity pricing.

Institutional investors are trying to digest the implications of this trend to find new market opportunities. As we do that, it's a matter of following the approach that's served us so well – to identify new spots where capital is needed and find the best way to deploy that capital.

### Responding to a changing environment

Today, I want to share how we're investing in response to environmentally-driven market changes, how we're trying to improve the corporate reporting of environmental information and why we're calling for government action.

The world that we see ahead is very likely to be different than the world we see in our rear-view mirror. Looking back 75 years, the pension fund that I represent has had many, many good years. But we wouldn't have come this far ($240 billion+) unless our predecessors hadn't been looking ahead.

Investors who rely on a rear-view mirror to commit capital are like generals who keep fighting the last war. They're like the American railroads that went broke because they were still thinking railroads when they should have been thinking transportation.

Today, I'm pleased to report that many companies are starting to look ahead in our new carbon-constrained world. In recent months, we have been meeting with oil companies to discuss their efforts to become broad-based energy companies rather than traditional oil and gas producers. It's interesting to hear what they're planning to do with the profits that they're accumulating from recent operations and the rising price of fuel in the market. Today, renewable energy is on their radar screens in a big way. One oil company (BP) has committed $8 billion over the next 10 years to explore eight different areas of renewable energy – not as a novelty or good deed – but to generate profit.

### Is environmental investing profitable?

Well, many companies are betting big dollars that it is – and so are investors. Here's why we think there's money to be made in environmental investing. The key word is sustainability – sustaining the ability to generate investment returns. That, of course, means sound environmental stewardship. It goes like this:

- As an investor, we need to secure long-term returns so we'll be able to keep the pension checks flowing to our members.
- But we can't secure long-term investment returns without a healthy economy.
- And we can't sustain a healthy economy if the natural resources it depends on aren't there down the road.

Our Chief Investment Officer believes about half of corporate profits by 2020 will come from investment in energy and natural resource materials.

That's why we're investing hundreds of millions of dollars in alternative energy products. That's why we're pushing companies to fully report carbon emissions that may harm the environment, long-term. And that's why we're urging government leaders to create incentives and penalties to protect the environment. Without such efforts – and much more action – we risk sawing off the branch that we're sitting on.

First, let me say that we're not alone in thinking that environmental investing pays off in the market. The Financial Times recently quoted Roy Sullivan, head of investor responsibility at Insight Investment. He said, and I quote:

"Companies that fail to manage their environmental and social impact effectively, or fail to adopt robust ethical policies and governance practices, are likely to suffer either direct financial harm or damage to their reputation."

Here's a case in point.

### Water and climate change

A few weeks ago, our investment staff met for a few hours with a global beverage company. The topic was most unusual: it was about their environmental footprint. Company representatives said this was the first time they had ever met with investors to talk about the issue. Now, to get some idea of how big that issue is, they told us that the company sells one and one-half billion cans of soda every day, worldwide. That's the equivalent of about 140 million gallons, or 540 million liters of water. That's only water in the beverage itself. It doesn't account for the uncounted millions of gallons of water needed to grow and process corn syrup, cane sugar, and beet sugar. The actual water that they put in that can is a small quantity compared with what's being used upstream – which is huge.

The company is concerned about the availability of water supplies that's greatly complicated by global warming. So climate change is a big factor in how this company proceeds. Today, they're studying worldwide weather patterns and drought conditions since climate change is shifting where water is available. Since they see shortages coming, they're trying to adapt to them.

Investors must do the same.

### Our environmental investments

This year, our Board began a long-range assessment of where our fund needs to be in the coming decades. This assessment is coming not a moment too soon. As a supertanker in the financial waters, we need lots of time for course corrections. That's actually a good thing. As a long-term investor, we don't rush to judgment but take time to explore new market options. We start small, but think big. Yet it's also true that we can't afford to dally. Russell Read, our Chief Investment Officer, believes about half of corporate profits by 2020 will come from investment in energy and natural resource materials.

So to stay properly on course, we must adapt to this new market reality. As Newsweek Magazine recently observed, and I quote:

"The prospect of $60-a-barrel oil for the foreseeable future concentrates the minds of America's corporate managers powerfully on the goal of reducing the consumption of energy and raw materials."

Meanwhile, CalPERS is already investing in energy technologies that are more efficient and less polluting.

Our private equity program has committed $600 million to clean technologies and products that reduce emissions, manufacturing processes that minimize the use of natural resources and systems that don't contaminate air, water, and land.

It's no surprise, of course, that utility companies have big carbon footprints that are difficult to offset. But it's a very big deal indeed that most of them don't even know how big those footprints are.

Our newest cleantech partner in this program has just invested $5 million in a company that makes building materials from the mineral residue of coal-burning plants. They use such waste products as fly ash to make concrete block and sheetrock substitutes.

On the public equity side, we've earmarked $500 million for managers who screen companies for compliance with environmental guidelines. We have also invested an additional $75 million in a Barclay's Global Investors fund that focuses on large companies that have positive environmental profiles.

In the real estate sector, the CalPERS Board has set an energy reduction goal of 20 percent over the next five years in our core portfolio, which includes investments in office, retail, industrial and apartment properties.

We're also moving into what's called green real estate. That's property developed to be more energy-efficient and ecologically sound than conventional buildings. A key part of this is the recently created Hines/CalPERS Green Development Fund, a $120 million venture in sustainable office buildings.

We're also supporting green building initiatives and continue to explore real estate investments that meet Leadership in Energy & Environmental Design requirements – widely known as the LEED program. Practicing what we preach, we recently expanded our headquarters with the highest standards of conservation in mind. We installed 18-hundred solar panels, and received a Gold LEED certification for sustainable design.

Looking ahead our Board is considering a proposed new Inflation-Linked Asset Class that would include investments in natural resources commodities, timber, and infrastructure for water, waste treatment, transportation, and port networks, and alternative energy projects.

We hope to develop a road map for this venture as early as November, when our Board holds its Asset Allocation Workshop.

Well, that's an overview of our environmental investments. Now, I want to talk about some steps we're taking in other arenas to preserve the environment.

**Our environmental stewardship**

First, we have made environmental stewardship a key part of our corporate governance strategy. This involves making sure shareowners get information about environmental liabilities so they can make informed decisions.

Second, we're a strong supporter of the Carbon Disclosure Project. This year, for the first time, we released a joint report (with CalSTRS) based on a survey of 265 global power companies.

- We asked them about commercial risks and opportunities posed by climate change, the impacts of greenhouse gas regulation and their technologies and innovation.
- Analysts calculated how much economic value those utilities produced – after they accounted for the environmental impact of their carbon emissions.
- Of 265 companies, only 25 had complete information about energy costs, emissions, reduction programs and targets, and emissions trading agreements.
- So take a guess: how many of those 26 companies created overall economic value – after subtracting the cost of their carbon footprint? Twenty? Fifteen? Five? Six. Only six companies added value to the economy.

It's no surprise, of course, that utility companies have big carbon footprints that are difficult to offset. But it's a very big deal indeed that most of them don't even know how big those footprints are. This is important to us as investors since electric utilities lead all sectors in accounting for about a fourth of Earth's total greenhouse gases.

Besides working with the Carbon Disclosure Project, we're supporting shareowner requests for improved disclosure on environmental issues. There were 26 such proposals last year and up to 42 already this year.

This year's proposals include requests for improved disclosure on:

- the business risks and opportunities of climate change
- the feasibility of developing policies that will minimize a company's impact on climate change
- the response to rising regulatory, competitive, and public pressure to significantly increase energy efficiency, reduce carbon and other greenhouse gas emissions, and develop renewable energy resources

Besides utilities, we're focusing on the auto, airline, and oil and gas exploration and production industries. We're engaging companies to meet the Global Framework for reporting purposes – we helped launch the United Nation's Principles for Responsible Investment a year ago. Other options for noncompliant companies will include filing shareowner proposals and private or public collaboration with other shareowners.

So how are these efforts working? I'm pleased to say that many companies are getting the message. This spring, Ford Motors created a new post of senior vice president for sustainability, environment, and safety engineering (Susan Cischke). Ford's CEO (Alan Mulally) said in announcing the action, quote:

"I clearly believe the vast majority of data indicates that the temperature has increased. And I believe the correlation and analysis that it's mainly because of greenhouse gases." Unquote.

Beyond the corporate world, we're asking government to pick up the pace on this issue of climate change. A few weeks ago, we joined several institutional investors and asset managers with $4 trillion in combined assets, as well as about a dozen businesses, in a joint call to action to the federal government.

So let me say now what I said then:

"Global warming presents enormous risks and opportunities for US businesses and investors. But the lack of a national climate change policy is hindering their ability to respond.

"To tap American ingenuity… to unleash American progress and innovation in tackling this global challenge… we need the right national policies. And we need them now."

Today, the absence of a national U.S. policy on climate change creates tremendous uncertainty that undermines strategic planning, capital budgeting and asset management. So we urged the government to:

- establish a mandatory national policy on climate – to reduce emissions
- stimulate deployment of new and existing technologies and
- have federal regulators (the SEC) provide guidance on material issues that should be disclosed.

**California state action**

As a Californian, I'm pleased to say that my state in many ways is leading the effort to address climate change. Not only do our pension funds commit to environmental investment strategies, but our state government has the nation's most aggressive plan to cut emissions by 2020 to 1990 levels. That represents a 25 percent reduction in emissions, compared with business as usual. That's a significant impact.

The State (California's Global Warming Solutions Act) also requires an 80 percent cut in greenhouse gas emissions by 2050. On the regional level, California has signed a compact with four other Western states for a cap-and-trade system for emissions.

**Conclusion**

In conclusion, let me share what the Prince of Wales told institutional investors at a meeting last fall. He said, quote:

As a major investor, we're seeing that climate change is having a big impact on capital markets.

"Addressing the growing list of environmental threats to our long-term scenario will generally require a massive and coordinated response from all sectors of society, and all nations…

"Political courage, good judgment, well-designed regulations and wise investment policies are all essential if business is to produce benefits to the environment and to posterity – as well as to shareholders."

He said in conclusion:

"If that were done, the benefits would be felt all around the world and for generations to come. And some of the people who perhaps can do more to make it all happen are right here in this room."

Well, he could have been talking about investors in this room as well. This is what institutional investors do. We secure the future. So let us secure the future by responding to the environment challenge."

## The value of sustainability

(Bennett Freeman, Senior Vice President for Social Research and Policy, Calvert)

Here Bennett Freeman of Calvert, a socially responsible investor that has defined industry best practice in the US, calls for better ESG data from companies, greater evidence of integrated ESG approaches that produce superior returns and better cross-sector collaboration between governments, ngos, corporations and investors.

As one of the largest families of socially responsible funds in the US, with US$15 billion in assets under management, Calvert continuously works to integrate the analysis of environmental, social, and governance (ESG) factors into our investment decision-making process. We are increasingly not alone as many traditional SRI and more mainstream institutional investors are working to solve the holy grail of capturing the signal from sustainability indicators, whether

> We still find that many companies are choosing not to report or reporting data sporadically without the type of standardization necessary for analysts to compare apples to apples.

in terms of reduced risk to portfolios, identifying individual company names with higher alpha, or macro trends that can impact entire sectors like climate change. This is an exciting time of innovation that is already sending an important message to international capital markets that there is value in managing sustainability risks and opportunities.

In order for this evolution to take root even more widely than the current actors, we believe we need to see the following developments:

1. better access to comparable sustainability data from companies

2. clearer demonstration of integrated ESG approaches that produce superior risk adjusted returns, and

3. more examples of cooperative projects between governments, NGOs, corporations, and investors that lead to tangible outcomes that directly address pressing social and environmental issues with bottom line impacts.

We'll treat these three in turn.

First, access to information is the bedrock of any financial market. While we certainly have seen progress over the last 10 or so years in the development of a common international framework for reporting (the Global Reporting Initiative – GRI), we still find that many companies are choosing not to report or reporting data sporadically without the type of standardization necessary for analysts to compare apples to apples. Over time, we believe we need to see mandatory reporting of social and environmental data as a listing requirement or legal requirement and the development of more formal international standards, much as we have seen accounting standards evolve over time.

Second, we need to see more proven track records of firms that are using ESG factors to produce portfolios with better risk-adjusted returns. Nothing succeeds like success. And while many managers are experimenting with new ESG approaches, and even more are giving lip service to an integrated approach, we need to see demonstrated evidence that quantitative and fundamental research strategies can emerge that actually produce measurable results. As with any new concept, we need a few bright lights that can help lead the way for the others groping in the dark.

Third, and finally, we believe that we can forge new partnerships that combine the resources of governments, NGOs, corporations, and investors to address global crises. We are already seeing the benefits of cooperative projects like the Carbon Disclosure Project to address climate change and the targeted divestment movement that is working to end the suffering in Sudan. We need to set more examples such as these for how we, as a collective force, can work to solve international problems that, if left unchecked, could potentially sabotage the productive functioning of international financial markets and undermine the ability of companies to produce sustainable profits.

In short, evolution in these three areas will help demonstrate the value of sustainability to markets in a way that will bring more to the banquet.

# Perspectives on banking

In this section we have four very different perspectives – two from the UK followed by views from India and Hong Kong – of the sustainability challenges for the global banking community. The themes of leadership, trust, innovation and the necessity of thinking globally are covered by our contributors. No serious bank can now afford not to integrate ESG thinking into its strategic, policy-focused and operational disciplines of doing business.

## Working capital

Martin Hancock, Chief Operating Officer, Westpac Banking Corporation; Chair, UNEP FI

Martin Hancock of Westpac Banking Corporation, and recognized as a "bankers banker" who still manages to challenge the status quo, focuses here on the sea-change that has taken place in banking in recent years. He believes that the triple bottom line has truly come of age.

We certainly need the policy makers to move in parallel in setting the parameters in which we operate, the carbon market being top of the list at the moment.

Working capital is generally defined as operational liquidity, something that any healthy company needs to be cognisant of. In a sustainability sense, working capital relates to natural capital, without which the ability of the environment and society to operate effectively can be seriously undermined.

When I look back on just the last three years it is a constant encouragement to me see how the financial markets are embracing the whole concept of sustainability. No longer are the proponents of ESG pushing against a closed door. What were once considered fringe issues on the ESG agenda, are now becoming increasingly mainstream. Sustainability is a core business issue.

There is a general consensus that things need to change, and while many talk, others act. It is in this respect that the finance sector stands out as the one industry that can be the most effective in promoting sustainability, it reaches the parts of commerce and society that others cannot. The depth and breadth of its influence covers the retail, insurance, banking and investment sectors.

UNEP Finance Initiative, which my company Westpac Banking Corporation Chairs currently, and the UN Global Compact have been at the forefront of this change in recent years. UNGC brings a truly global and cross-sectoral perspective to the complex issue of corporate responsibility. The Compact's "Who Cares Wins" series of reports, another investor initiative Westpac has supported since inception, coupled with direct engagement with the world's stock exchanges, has been ground-breaking for the investment community. At the same time, UNEP FI's work with the broader financial services sector has raised the bar and raised it quickly. UNEP FI's role is to understand upcoming issues, generate technical guidance and formulate voluntary standards. The 170 plus UNEP FI member companies, from banking, insurance and asset management, work collaboratively to define the sustainable finance and responsible investment agenda.

UNEP FI's future programme is centred on 'Awareness to Action'. What we hear constantly from our membership is yes, we recognise there is a problem, but what can we do about it? UNEP FI is committed to empowering its members with the means to identify the ESG risks and opportunities of their operations. By working globally, and specifically providing capacity building in developing countries, where skills and associated resources are scarce, then we can, and will, make a real difference.

How climate change will manifest itself around the globe has raised a host of issues and concerns, not limited to the effects on biodiversity and ecosystem services, the quality and quantity of water, and human and environmental security. Understanding the implications of these changes, developing practical toolkits, and finding ways to adapt and mitigate, is the prime purpose of the UNEP FI workstreams, which now cover Insurance, Property, Sustainability Reporting, Water, Biodiversity, and Human Rights, in addition to the long established Climate Change and Asset Management Working Groups. Working in conjunction with the Regional Task Forces in Africa, Asia-Pacific, North America, Latin America and Central and Eastern Europe ensures that these initiatives are truly global in nature.

Does this really make any difference? I certainly believe so. Imagine if none of the above existed, and bear in mind all of this is voluntary. We would probably be decades away if we waited for something similar from a national public policy perspective, and we would probably be waiting even longer for a global initiative. That said, we certainly need the policy makers to move in parallel in setting the parameters in which we operate, the carbon market being top of the list at the moment. Hardin's Tragedy of the Commons is unfolding in front of us, or as he later corrected – The Tragedy of the Unregulated Commons. No one is underestimating the difficulty of the task ahead, but this is where the precautionary principle comes into it's own – prevention is invariably better, and it looks like a lot cheaper, than the cure.

The integration of sustainability principles into our organisational DNA is the ultimate test.

The clock is certainly ticking away, not a week now passes without some eminent scientists revealing their latest findings on the imminent dangers to the sustainability of the planet to support the business as usual scenario. Leadership is absolutely paramount. The integration of sustainability principles into our organisational DNA is the ultimate test. It is also reassuring to see that metrics are now being developed to assess this integration.

The current initiatives coming from the finance sector should be applauded. At the end of the day, this is the sector that 'finances the future' and by doing that in a responsible way really can lead to a 'win win' situation – for the environment, for society and for business. The Triple Bottom line has truly come of age.

## Trust me, I'm a banker

(Leo Johnson, Partner, Sustainable Finance)

Here the irreverent and irrepressible Leo Johnson, co-founder of Sustainable Finance Ltd, brings his own unique sense of humour and wickedly crafted wisdom to the very serious challenges of sustainable banking.

What holds a great bank together? What is the one emotion you as the depositor must feel towards your bank? In a word, trust.

Hug a banker. Yes they get some meaty bonuses. They are also, finally, beginning to get the grief. It started with project finance. If they were an Equator Principles adopter and they did a project finance deal over USD50 million total project cost that looked a little dodgy, they could expect a certain amount of NGO heat. That was a time of innocence. Cucumber sandwiches – crustless, on the croquet lawn of civil society. Now it's open season.

Take the case of "Shake-N-Go" real-hair wigs, a provider of quality follicle-based solutions that happened to have remarkably low-cost suppliers of the raw material (hair), based in East Asia. Why so low-cost? Well, alleged the South China Morning Post, this is just the sort of cost advantage you may run into if you're using a touch of prison labor.

These are horrific allegations. But who got targeted? Not the company, not its suppliers, but the banks. A load of beautiful blue-chip banks – whose names I won't mention for the excellent reason that some of them belong to that elite group of not-yet-former clients – were targeted for investing fractionally through their asset-management groups in a US company, one of whose multiple suppliers was, unbeknownst to the banks, accused of using prison labor for part of its operations. Think of it. One day you're sipping frappucinos in the City. Next thing you know, you're the target of an Amnesty International human rights inquiry. Shocking.

But what is the real impact on a bank – a great deposit taking bank – from a campaign of this type? Forget credit risk, forget legal risk. Let's look at the brand. What holds a great bank together? What is the one emotion you as the depositor must feel towards your bank? In a word, trust. Why? When you give a bank your savings, you are putting your life in their hands. Not just that, they are unverifiable. You can't kick the tires. Banks are the accumulation of a mass of individual credits each of them in turn of continuously shifting asset quality, (coupled with a propensity to collapse wherever the IMF and World Bank implemented their 1990s financial sector stabilization plans). It's not that banks are black boxes. They are risk soup. Potage de risque. Risk-zuppen. The result? No one agrees how to even rate them. Moody's and Standard & Poor's, according to a recent IMF analysis, disagree with each other 15% of the time on average across all industry sectors. On the financial sector they disagree 34% of the time. Moody's, most recently, disagrees with itself on how to rate banks.

One day you're sipping frappucinos in the City. Next thing you know, you're the target of an Amnesty International human rights inquiry.

With one caveat. It's the experts, who haven't got a clue how to evaluate them. For the depositor, though, it's much simpler. Forget the numbers. Forget the identical, globally commoditized set of offerings. There is just one question you want the answer to. Do you trust them? And the core index of that is one thing. Will they do what they say they are going to do? Or will they stitch me up? Interest rate hikes. Overdraft fees. Terms and conditions that are just a little more complex when it comes to payout than it seemed.

So what are the impacts of these campaigns on trust? When a bank gets accused of financing prison labour the depositor can draw only two possible conclusions. Either this is a group that doesn't have any policies (run screaming). Or they do, but they just don't implement them (find the exit). What's lost either way is trust. What the bank really seems to care about is making money for themselves.

How are the world's leading financial institutions responding? Not with a policy vacuum. Not with aspirational policies plugged in the media then blown apart with partial execution. Maintaining trust is about something different, something simple. First they are talking regularly to their key stakeholders – from investors, to employees to civil society – hearing what their current issues are. Second, they are forming practical policies to take them into account. "We will not work with any companies for example that have first level suppliers using slave labour." Third, they are implementing. That is the basis for maintaining long term depositor trust in the bank.

This piece is adapted from an article that first appeared in the Wall Street Journal in July 2007.

## Sustainable financing in emerging economies: India's growth story

(Rana Kapoor, Managing Director & CEO, YES Bank Limited)

Rana Kapoor of Yes Bank Ltd brings a sustainable banking perspective from one of the emerging economic dynamos of the 21st century, India, where sustainability challenges go hand in hand with largely untapped commercial opportunities to finance ESG serving technologies and companies that will drive the solutions of the future.

The banking sector is the driving force in the financial sector of any economy. In emerging economies like India, it has emerged as a crucial facilitator for sustaining the growth momentum of the economy. It is expanding at a significant pace, showing exemplary growth, thanks to improving economic conditions, liberalisation, changing consumer demographics and large market opportunities.

As the overall competitiveness of the banking industry has sharpened over the years, most home country banks are offering better products as they increase focus on quality. The sustainable finance niche in the emerging economies represents a hitherto untapped yet potentially tremendously rewarding opportunity, and the time is right for socially responsible and sustainable investing (SRSI). Banks are viewed as trustees of public funds and thus have an inherent 'social responsibility' to validate this trust. In recent times, the collapse of some banks and the resultant erosion of stakeholder value suggests an even stronger need for initiatives that extend the role of banks to include larger sustainability and development issues. The concept of "sustainable finance" and the recognition of availability and use of municipal financial resources determine the future of every community. It links four basic elements – vision, environment, plan and public – for a comprehensive planning approach.

The Indian financial sector can use sustainability as a strategic tool to enhance its own as well as the country's competitive advantage.

In the past few years, the Reserve Bank of India (RBI) has evolved guidelines for greater financial inclusion, even as the financial sector aims at helping the economy attain a sustainable growth trajectory of 10% GDP per annum, which would offer an opportunity to restructure policies for a new vision based on faster and more broad-based growth.

Efforts are being made to mainstream niche products and services by bringing them into the conventional framework of day-to-day financial sector functioning. Banks are proactive on this, either through a direct intervention model or by partnering with MFIs to originate loan facilities. This has enabled us to extend services to vast numbers of the disadvantaged.

I believe that there are several sunrise sectors that can be profitable on a standalone basis, which fit within our vision of "responsible banking". This involves instituting sustainability principles within the organization as well as in the broader financial community.

As India emerges, it needs a growing supply of resources in terms of energy and raw materials. Currently, the country is heavily dependent on conventional fuel resources (coal and oil), and is already paying an environmental price in terms of higher pollution and related diseases. And while it grapples with meeting its resource demands, India also needs to address the problem of deepening income disparities with their associated social instability risks to growth.

Unlike the developed counterparts in the West, emerging economies like India, have the opportunity to grow in a way that mitigates the costs of environmental and social degradation. This, in turn, presents a vast range of opportunities for the financial sector, given its unique role as an economic intermediary and vast ambit of influence over diverse stakeholders. The need for comprehensive social welfare in emerging economies means that there is a growing expectation from business to take on the challenges. Banks not only need to make direct investments in sustainable development, they also need to leverage their indirect control over investment and management decisions to influence business into aligning with broader goals. Banks are equipped to weigh and price risks, and use price differentiation to foster sustainability.

There are numerous global voluntary initiatives focused primarily on the financial sector, such as the UNEP FI, the PRI and the Equator Principles, that banks can use as tools to translate their respective visions of sustainability into action plans. In addition to mitigating risks and enhancing a bank's risk management capabilities, the incorporation of these principles opens up new markets and avenues for product differentiation. Those financing infrastructure projects, for example, can focus on green businesses or support initiatives in microfinance to help alleviate poverty.

I believe that India's growth story provides tremendous opportunities for its financial intermediaries – for example funding sustainable projects in the areas of efficient resource management and offering innovative products and services in the areas of carbon emission trading and microfinance. The Indian financial sector can use sustainability as a strategic tool to enhance its own as well as the country's competitive advantage.

### Is progress being made, are banks more sustainable now?

(Tessa Tennant, Executive Chair, The ICE Organisation; Co-Founder and Former Chair, Association for Sustainable & Responsible Investment (ASrIA))

One of the great thinkers and innovators in responsible investment and sustainable finance, Tessa Tennant, stresses the need for the global banking sector to work with others to forge a shared ecological understanding to avoid un-ecological deal-making.

Investor governance has arrived, the media and NGO lens is on financiers.

In the late eighties, very few people considered the environmental impacts of banks to be serious. Most people thought the main problems were how much paper banks used, whether it was recycled and perhaps how much energy their offices needed. So in asking the question "Is progress being made, are banks more sustainable now?", the answer has to be yes. More accurately the answer should be a guarded 'yes', from a very low starting point. At that time there was rarely any critical news coverage on banks that were financing potentially destructive construction activities, there was no community of individuals working within banks across the world to develop internal policies, provide appropriate ESG risk assessment and to improve competencies of bank staff. Shareholders were asking no questions about ESG related risks. There were no industry-wide support networks or codes of conduct such as UNEP FI and the Equator Principles. This meant that banking employees with responsibility for the "environment" had little external support to draw on and even less internal impact. All that has changed now, investor governance has arrived, the media and NGO lens is on financiers and there are sufficient people in place across the industry for the major work to begin.

What major work should begin? It is taking the broad themes captured within the Principles for Responsible Investment and the Equator Principles and translating them into lending and investment activities that are fully aligned with, for example, UNEP's priority concerns such as climate change, water scarcity and pollution, biodiversity and desertification. With over 6 billion of us a consumer (or soon to become one) bankers have the opportunity to do well by making sure the goods and services they finance are sustainable in ecological as well as economic terms. Planetary management – delivering the goods and services we need within the resource constraints of one planet – won't happen without bankers. The emerging appetite to finance clean energy technologies is evidence of the substantial capital flows that can be aligned with environmental priorities when bankers become involved. We need to see more financial innovation in other ways – for example to address water scarcity issues, to protect forests as a highly necessary and productive part of the global economy, to build sustainable cities and finance the transformation of those that aren't. The involvement of banks in the city projects of the Clinton Global Initiative on Climate Change and with The Climate Group is critical and to be applauded.

Additionally, the work is about further changes in the culture of banking, across the industry and within each bank. The reward systems in banking and investment are frequently at odds with the laudable aims of the PRI, with little or no incentive to remain accountable for the longer-term outcomes of a financing deal. In such a competitive industry it may be difficult for one bank to act unilaterally on such matters and the industry, perhaps through the Basel process, could be encouraged to set new norms.

Finally, the major work is about bringing all the world's banking industry into a shared ecological understanding. There is no point in turning down deals where at least some standards are being applied if another bank, with no "sustainability DNA", is going to do the deal instead. Bankers who do not yet understand the grave commercial risks of this runaway unecological global economy are a threat to everyone, not least themselves.

# Perspectives on insurance

The insurance and reinsurance sectors, which took the early lead for financial services sector when it came to addressing and understanding the economic risks of climate change, are now focusing on how to underwrite new products and services to tackle broader sustainability challenges. The world's largest industry, with annual premiums exceeding USD 3.4 trillion, can become one of the fundamental levers that drives the transformation to sustainable development.

## Mastering risks for a sustainable tomorrow

Butch Bacani, Insurance and Sustainability Advisor, UNEP FI

Butch Bacani, now based at UNEP FI in Geneva, spent over a decade in the insurance and reinsurance business in Southeast Asia. Here he brings his expertise and developing market experience to bear on a sustainable future for the global insurance industry.

One-off, reactive solutions are not enough – the key is to integrate sustainability into the business model.

Insurance is the largest industry in the global economy. In 2005, the worldwide premium volume exceeded USD 3.4 trillion, while the industry's global assets under management stood at USD 16.6 trillion.

Insurance is essential for a viable economy since it assumes risks that could potentially result in financial ruin for an individual or enterprise. Sustainability reduces risks. It makes good sense that risks that perform well on environmental, social and governance (ESG) issues – the key ingredients of sustainability – are conceivably better risks to insure. One can therefore view sustainability as a good proxy for risk management. And if risks are understood and managed well, it opens the door to new opportunities. A sustainable market is an impetus for greater financial stability and growth. The fusion of insurance and sustainability is a strategic business approach with twofold aims – to enhance long-term company value and to contribute to sustainable development. It is not philanthropy.

Today, the insurance industry faces the great challenge of coping with a risk landscape (the totality of risks confronting society and the environment) that is rapidly changing, one from which global sustainability issues have emerged, and continue to emerge. The risks that these issues entail are serious, while the opportunities, largely untapped. It is insightful, as a starting point, to look at what leading players are doing in addressing some of the most challenging global sustainability issues, and to recognise the vital role the insurance industry can play.

### A new era

UNEP FI's association with the insurance industry dates back to 1995 and the insurers and reinsurers which have become part of the partnership have been proactive and influential in understanding the economic risks posed by climate change. In 2006, UNEP FI decided to establish a new Insurance Working Group that looks beyond climate issues and takes on board a global perspective of the role of insurance in the broader ESG and sustainability debate.

The group launched its inaugural report, "Insuring for Sustainability: Why and how the leaders are doing it," at a gathering of industry leaders in London in May 2007. Upfront, the report asks the fundamental question that must be answered: Why? Why does sustainability matter in insurance? Why is the insurance industry uniquely positioned to tackle some of the most serious global challenges? Why does it have an integral role in the economy? Why does it have tremendous scope to encourage sustainable behaviour? It also addresses the how. How can sustainability be embedded in insurance products and core processes? How can barriers to insurability be diminished? How can sustainable insurance markets be developed?

Insurance and sustainability are intrinsically linked. Insurers view knowledge as the key to understanding risks and managing them effectively. Risk management entails that risks are dealt with strategically through research and analysis, with loss prevention and loss mitigation being integral components. Because of their extensive reach into the community, insurers have tremendous scope to encourage sustainable behaviour.

The report identifies nine global sustainability issues vital for this generation of insurers. Indeed, climate change is a big part of the sustainability agenda – it is the greatest environmental risk. Yet one must bear in mind that it is one of many issues. Sustainability is more than being "green". Social issues are just as important. For example, asbestos-related illnesses have been a curse to the insurance industry for decades. Could nanotechnology be the next asbestos? With aging populations, will "baby boomers" have enough for their retirement years? Then there are modern day health risks such as genetically modified organisms, mad cow disease and avian flu. But as serious as these risks are, they can become tangible business opportunities. Thomas Edison comes to mind: "Opportunity is missed by most people because it is dressed in overalls and looks like work." Just change work to risk. That said, will climate change be the "perfect storm" or will it be a golden opportunity? Has the industry recognised the macro potential of micro-insurance?

The insurance-sustainability nexus in today's inter-connected world requires adapting to a risk land-scape that is changing at an increasingly greater speed.

Leading by example is powerful – concepts are crystallised by case studies of best practice. The report does not resort to prophecies of doom or scaremongering, which can often and ultimately be counterproductive. While it is instructive, it is not meant to provide ready-made solutions. The primary aim is to provide illumination by imparting knowledge and a deeper understanding of the issues. This is a critical first step towards finding solutions and uncovering new opportunities.

Unfortunately, notwithstanding the material link between insurance and sustainability, there is not enough understanding of the benefits in engaging in sustainability issues. Sustainability issues are often viewed by the insurance industry with a veil of ambiguity, leading to insufficient and, at times, flawed understanding of the risks. Worse, to the unenlightened, the fallacy that sustainability is the antithesis of profitability exists. It is not surprising that many opportunities remain untapped. To cascade sustainability across the entire organisation effectively, there has to be a clear mandate from the top. One-off, reactive solutions are not enough – the key is to integrate sustainability into the business model. However, the reality is that many companies, particularly those in developing countries, lack the resources to do it on their own.

### The road ahead

A Swiss Re publication states that in 2005, premiums per capita in developed countries translated to around USD 3,300. For developing countries, it was a meagre USD 77. It also reports that OECD countries alone accounted for over 90% of the worldwide premium volume. Thus, a critical question is: How can insurance assist developing countries grow more sustainably? The UN Millennium Development Goals (MDGs) encapsulate the eight key sustainability challenges in developing countries. The target date of achieving the MDGs – 2015 – is fast approaching. Micro-insurance can support most of the MDGs by delivering products such as weather derivatives for farmers and health insurance for families. The solvency of these schemes could be underpinned by natural catastrophe pools, public-private partnerships and alternative risk transfer products such as catastrophe bonds. On the one hand, micro-insurance represents a prime business opportunity. On the other hand, it is a powerful tool for sustainable development in the context of social security. It can help the most vulnerable escape the poverty trap – the poor remain poor because they could not hang on to the ladder of economic development. Economic shocks, such as those wrought by natural catastrophes, bring them back to square one, or worse.

Clearly, the time to develop Principles for Sustainable Insurance (PSI) for the global insurance industry has arrived. The UNEP FI Insurance Working Group has taken the initial steps of the journey to realising these Principles, knowing that a common set of guidelines to embed ESG criteria in core processes, products and services is essential to propel the sustainable insurance agenda. Moreover, the Principles will pave the way for the establishment of a global network of sustainable insurers. Is it achievable? Certainly. One can look at the evolution of the Principles for Responsible Investment (PRI) and learn much from it. While insurance and investment are different in many ways, investment is a core process in insurers' operations. The PSI will not be an exact replica of the PRI, but they are envisioned to be complementary. One addresses the underwriting side of insurers' operations, the other, investment. The PSI initiative, after the PRI, has the potential to be the next global collaborative undertaking in sustainable finance.

Sixteen leading insurers – the largest in the world, if not, the largest in their respective markets – have united. Together, these institutions represent trillions of US dollars in assets. Such coming together of industry giants, regardless of the reason, is significant. And with the United Nations' synergetic role, this strategic alliance becomes even more robust.

The mission of advancing sustainability throughout the insurance industry is Herculean. Global sustainability issues require collective action, and collective action requires a shared vision. A group of sixteen leaders is not the answer, but it is a powerful catalyst – a microcosm of what the insurance industry can do together for sustainable development.

From its ancient roots to its 17th century origins at Edwards Lloyd's coffee house in London, through to the global village of today, the insurance industry has evolved to become a pillar of economic progress. Moreover, it is society's early warning system, crucial to recognising risks and making informed decisions. The insurance-sustainability nexus in today's interconnected world requires adapting to a risk landscape that is changing at an increasingly greater speed. This calls for greater knowledge, deeper understanding, and relentless innovation. For the insurance industry, the promise of a sustainable tomorrow lies in how it can master the risks of today, and mine the opportunities these entail.

In insurance jargon, premiums can be gross or net, written or earned. I say it is earned, as a sustainable future is. That is a convenient truth.

# Conclusions

The following conclusions reflect key sentiments captured in earlier sections of The Working Capital Report and also will touch upon the discussions around responsible investment and sustainable finance that took place during the UN Global Compact Leaders Summit in Geneva on 5-6 July, 2007. The UNGC Summit gathered more than 1200 business leaders, government and intergovernmental officials and civil society representatives. Subsequent versions of the on-line TWCR will reflect more fully the focus on finance and capital markets at the Geneva gathering as well as the satellite PRI and "Who Cares Wins" meetings that took place in the Swiss City during the same week.

The UN Global Compact and UNEP Finance Initiative staff who have worked to compile TWCR would like to again thank all of those contributors who, to date, have contributed to this "living" on-line document that will develop further as the debate continues.

The next major UN backed global meeting on the subject convenes in Melbourne, Australia, on 24-25th October, 2007, when UNEP FI hosts the latest in its decade old series of Global Roundtables ( for more see www.unepfi.org ). More than 500 thought leaders in the field of sustainable finance and responsible investment are expected to join the roundtable.

## Sustainable finance and responsible investment – tomorrow's game

Embedding sustainable finance and responsible investment within the world's of investment, banking and insurance is a work in progress. The most forward-thinking players in the capital markets are making a serious investment to mainstream and integrate ESG issues in the working of our global markets but these institutions and investors are the exception not the rule.

Importantly, and as a precursor of coming systemic change, the world's largest institutional investors have a growing understanding of the fundamental need and true value of ESG integration and the mainstreaming of responsible investment. The USD 10 trillion of assets and more than 200 institutions backing the Principles for Responsible Investment (PRI) confirm this.

The reality of the current market-place, however, shows us that the USD 150 trillion of overall global assets, and the USD 50 trillion of assets held on capital markets as part of that figure, to a massive extent, do not effectively value, price in or integrate ESG issues. The transformation in thinking, behaviour and collective action that will ensure ESG issues become a thread within the DNA of capital markets is one of the key challenges for capitalism in the 21st century.

Throughout the perspectives section of TWCR contributors independently came back to a series of core themes. These include: the business model; data and analysis; incentives and talent; and trust and reputation. Snapshots of this joint thinking included:

**Business model:** The planet cannot be run as a business in liquidation and doing so will lead to more and more "predictable surprises" with potentially devastating environmental, economic and social shocks. Our financial systems and capital markets need to understand the true risks of a "runaway unecological global economy". At the same time, forward-looking investors and financiers are beginning to understand the immense opportunities associated with new ESG markets.

**Data and analysis:** Traditional financial analysis does not effectively factor in the "the risk profile and value potential of major corporations" driven by emergent ESG issues. These issues are increasingly relevant to a global market where capital flows across borders. In developed economies wealth is created by knowledge and other intangible assets where ESG issues form an important part of the financial calculus. Pigeon-holing ESG issues will "kill them". They must be embraced as mainstream.

**Incentives:** Perverse incentives are embedded within the financial system and capital markets that reward short-term thinking. Individual executives are not incentivized to adopt and adapt their behaviour in a manner that integrates ESG thinking. In the current system, there is " little or no incentive to remain accountable for the longer-term outcomes of a financing deal."

**Talent:** The upsurge in ESG activity and the renewed focus by the world's largest financial institutions exploring both ESG risks and opportunities is creating a "War for Talent." Increasingly, the best and brightest seek out institutions whose approach to value creation are aligned with its values. An institutions approach to ESG will determine, notably for up and coming "Generation Y" executives and leaders, the ability of financial organisations to attract, reward and retain the best staff.

**Trust and reputation:** Effective collaboration and productive partnerships are the key for financial institutions to build trust and protect reputation in a global market place where advances in communication have created a "death of distance." New types of hybrid partnerships, bringing together the best of public and private innovation, are emerging in a manner that supports both better policy development and shines a light on new commercial opportunities. The smartest financial institutions, while remaining "red in tooth and claw" in a competitive sense, have "got it" in terms of the crucial role trust and reputation plays in the global market-place. Those that ignore this truth do so at their peril.

In closing, it is worthwhile noting two points made by participants at the UNGC Summit. Anthony Ling of Goldman Sachs looking to the future of sustainable finance and responsible investment noted the passion that an increasing number of executives from the financial services sector have for the issues. He stressed that the on-going transformation to embed ESG thinking in the sector, and also within capital market activity, would greatly depend on the "institutionalization of personal commitments."

Prince El Hassan Bin Talal of Jordan, also addressing the summit, challenged business and finance to speed new thinking with respect to global inequity. The Prince noted that a new paradigm was favouring the world's richest 1.7 billion in a "continuing asymmetry" among global consumers. Market-based globalization was not a panacea, he stressed, while urging an "ethics-based globalization" to drive a mutually assured survival.

# Appendix: Materiality of extra-financials on corporate performance

Dr Olaf Weber*, Gesellschaft für Organisation und Entscheidung

The spotlight on sustainable and responsible investing is on and getting brighter by the hour. High profile coverage in respectable finance media and keynote addresses by industry pundits leave no doubt about the investment community's seriousness in the matter. And they are right to do so: the materiality of non-financial parameters on corporate performance is uncontested. Socially responsible and financially sound investments are becoming synonymous.

Accordingly the pressure rises on private and institutional investors not to miss out. In particular for asset managers, recognising the corporate behaviour in environmental, social and governance matters (ESG) in their investment decision process increasingly becomes mission critical: not only to satisfy their clients' investment principles but also performance requirements. Our data demonstrates that the forecasting power of ESG factors on corporate performance is significant and increasing.

In a first approach, we analysed the general influence of ESG factors on the total return of companies over time. We selected some 150 large global corporations and ranked them according to their total return in 2001. By the median, we split the group in two portfolios and plotted their performance development over the next five years. Not surprisingly, the better half of the group continued to overperform the lesser half and in the five years up to 2006 achieved an overperformance of about 100 percent.

In this example, extrapolating the past performance provided a reliable method to forecast future performance notwithstanding the many complex factors that also influence the performance of firms.

We then added ASSET4 ESG data to this equation and we attributed a score based on the companies overall ESG performance in 2001. We then integrated total return and ESG performance by adding the standardized values of both to get a new ranking, which we split again by the median into two portfolios. Companies in the "better" portfolio had demonstrated a) a very high total return and medium ESG performance, b) an above average performance in total return and ESG, or c) a very high ESG and a medium total return performance. If we follow up the performance development of the two portfolios, we find the overperformance over 5 years is higher than for the pure total return approach described above. It is 120%. We conclude that incorporating knowledge about ESG performance can improve the investment research process considerably.

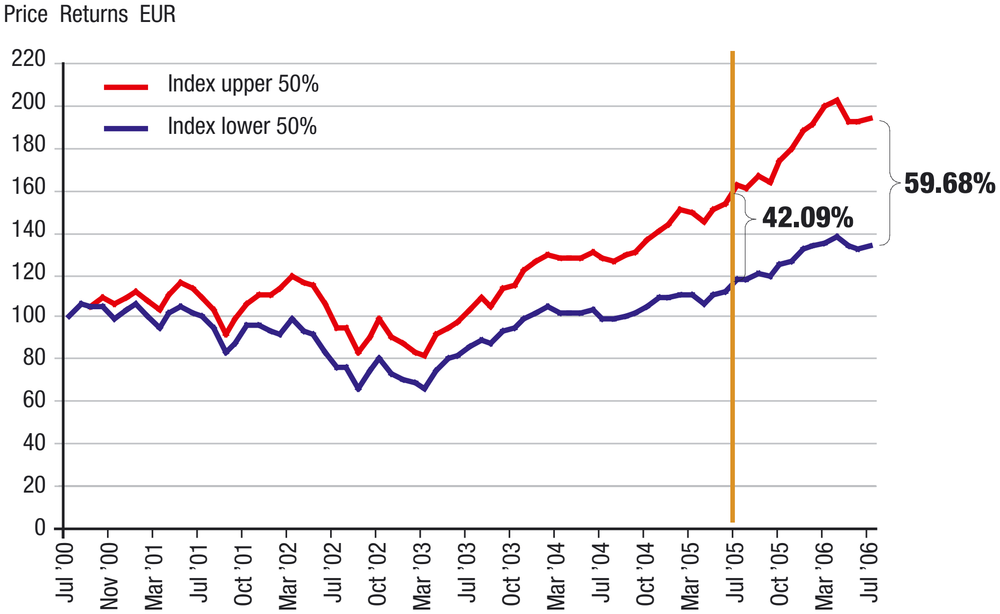
This first approach demonstrates that ESG factors are able to give some indication about the future performance of firms. In the following second approach we demonstrate that the forecasting power of ESG factors is actually rising over time. Indeed, the performance gap between companies that had demonstrated in the past good ESG track records and the benchmark MSCI World Index is gradually widening.

With a statistical algorithm, the effectiveness of ESG factors to forecast company performance was analysed. In July 2005, we selected a representative subset of the MSCI World Index encompassing 160 firms. This portfolio was divided into two groups of equal size, with the top and the lower 50% of companies with regard to their combined performance in both total return and ESG factors as measured in July 2001. The corporate performance of the two portfolios was then computed over the following four years. As expected, based on the results from our first approach described above, the overperformance developed consistently over the period.

The hypothesis was thus clear on how the two portfolios would develop in the future. And indeed our findings based on data from July 2006 confirm the trend we saw last year. The performance gap is increasing. The range of outperformance equals almost 60%, demonstrating the forecasting power of ESG data when used in combination with total return figures.

**Figure 1: Amplifying performance gap between two portfolios based on their combined ESG and total return performance as of July 2001**

Source: Independent study by GOE, data provided by ASSET4 and Thomson Financial.




Further studies indicate that corporate ESG performance has a forecasting ability to explain 10% of total returns for a significantly larger sample of companies. This study, which is still being independently verified, suggests that ESG is complementing rather than replacing traditional financial analysis, and therefore should be looked at by professional investors in a more detailed and systematic way.

Based on such results it seems safe to argue that responsible investing is no longer an issue of ethics or social responsibility but rather common sense. Why then so few had tried to implement a quantitative ESG investment approach? The main obstacle in following an ESG focused investment strategy used to be the lack of reliable, comparable ESG performance data. First, how to measure the environmental achievements of, say, Exxon? Second, how to compare that measure across time, and – even more difficult – across industries, for instance with Novartis or UBS? ASSET4 constructed an initial list of nearly 3,000 factors, which was tested for relevance and the most objective 250 indicators were retained. These are the backbone of the evaluation. There are two types of indicators: driver indicators and outcome indicators. Driver indicators provide information on management quality and are thus lead indicators forecasting future outcome. Outcome indicators give a picture of actual performance, transparency and areas with risk exposure.

The 250 indicators, reflecting the best possible extra-financial fundamentals, are grouped into four pillars (economic, environmental, social, governance) and run through several layers of processing and analysis up to the top of the structure, where an overall rating is generated for each company within the system. All processes and analyses are fully accessible, transparent, and controllable by the user. All input is based on public data sources only. In combination with the transparent methodology, this ensures objective results and comparable ratings on the non-financial performance of the global corporate leaders.

The economic pillar measures a company's capacity to generate sustainable growth and a high return on investment through the efficient use of all its resources. It is a reflection of a company's overall financial health. The environmental pillar measures a company's impact on our ecosystems. It reflects how well a company uses best management practices to avoid environmental risks and capitalize on environmental opportunities in order to generate long-term shareholder value. The social pillar measures a company's commitment to generating trust and loyalty with its workforce, its customers and society. It is a reflection of the company's reputation and the health of its license to operate. The corporate governance pillar measures a company's systems and processes that ensure its directors and managers act in the best interests of the company's long-term shareholders.

Moving from standalone ESG approaches into the integrated investment approach calls for consistency in terms of the data used, but also for decentralisation in terms of how this data is implemented in the investment process. It is ASSET4's objective to lead this space and to meet the needs of various users, ranging from ESG specialists to traditional analysts and portfolio managers.

ASSET4 is striving for leadership in close cooperation with professional investors, recognising that the mainstreaming of ESG across their organisations can be a way for reducing risk, improving alpha, enhancing beta and offering quality products.

* Dr Olaf Weber, Managing Director of Gesellschaft für Organisation und Entscheidung m.b.H., is an independent expert on the development of company ratings and the combination of financial and extra-financial aspects influence on corporate performance, and develops statistical algorithms for ASSET4.

# Glossary

**Alpha** "Alpha" is a measure of value added by an asset (or fund) manager. Specifically, alpha is the excess portfolio return compared to the risk-adjusted benchmark.

**Asset Management** Asset management may be defined as a comprehensive and structured approach to the long term management of assets (such as financial securities) as tools for the efficient and effective delivery of community benefits. The emphasis is on the assets being a means to an end, not an end in themselves.

**Beta** "Beta" is a statistical measure of risk or volatility indicating the sensitivity of a financial security or portfolio to movements in the market index (the overall market). Higher beta stocks or portfolios are expected to outperform in rising markets and vice versa.

**BRICs** BRIC or BRICs are terms used to refer to the combination of Brazil, Russia, India, and China. General consensus is that the term was first prominently used in a thesis of the Goldman Sachs investment bank. The main point of this 2003 paper was to argue that the economies of the BRICs are rapidly developing and by the year 2050 will eclipse most of the current richest countries of the world.

**Broker** A broker is an individual or firm which acts as an intermediary between a buyer and seller, usually charging a commission. For securities and most other products, a license is required.

**Equator Principles** The Equator Principles are a voluntary benchmark for the financial industry to manage social and environmental issues in project financing.

**Fiduciary Duty** Fiduciary duty is the highest standard of care imposed at either equity or law. A fiduciary is expected to be extremely loyal to the person to whom they owe the duty (the «principal»): they must not put their personal interests before the duty, and must not profit from their position as a fiduciary, unless the principal consents

**Financial Fiduciary** A financial fiduciary is a person legally appointed and authorized to hold assets in trust for another person. The fiduciary manages the assets for the benefit of the other person rather than for his or her own profit.

**Institutional Investor** An institutional investor is an entity, company, mutual fund, insurance corporation, or other such group that has a large amount of money or assets to invest. These investors are responsible for a great percentage of the overall volume for stocks, bonds, mutual funds, and commodities. Because they are generally assumed to have a greater knowledge of investments and risk, they are less restricted in their investment activities than individuals are.

**Insurer** Enterprise which accepts risks from policyholders in return for payment of a premium.

**Market CAPitalization – Large, Medium and Small CAPs**
The market capitalization of a company is the sum derived from the current stock price per share times the total number of shares outstanding. Although the market cap of a company is an indication of the value of the company, it is only a temporary metric based on the current stock market. Companies are usually classified as large cap, medium cap, small cap, or micro cap, depending on their market capitalization, but the dividing lines are somewhat arbitrary. As a general guideline, the market capitalisation is $5 billion or more for large caps, $1 billion to $5 billion for medium caps, $250 million to $1 billion for small caps, and less than $250 million for micro caps.

Materiality – Material Information
Material information is information which would be likely to affect a stock's price once it becomes known to the public. Examples include a takeover, a divestiture, significant management changes, and new product introductions also called material news

Multiple – P/E Ratio
The P/E Ratio of a share is its current price divided by trailing annual earnings per share or expected annual earnings per share. The higher the multiple, the more the market is willing to pay for each dollar of the company's annual earnings

Pension Fund
A pension fund is an institutional investor which collects regular contributions from employers to provide retirement income for employees.

Premium
The payment, or one of the periodical payments, a policyholder agrees to make for an insurance policy.

Private Banking
The business line of "private banking" comprises the providing of banking and investment services to very wealthy individuals and families. Many financial services firms require a person or family to have a certain minimum net worth to qualify for private banking services. Private banking primarily is a credit service, and is less dependent on accepting deposits than retail banking.

Private Equity
A private equity transaction means the provision of Equity Capital to non-listed companies. Ranges from early through to late stage investment. A key feature of the asset class is the "hands on" involvement by the investor to help in the growth and development of the company.

Project Finance
A project finance approach comprises the financing of long-term infrastructure, industrial projects and public services based upon a non-recourse or limited recourse financial structure where project debt and equity used to finance the project are paid back from the cash flow generated by the project.

Project financing is a loan structure that relies primarily on the project's cash flow for repayment, with the project's assets, rights, and interests held as secondary security or collateral.

Public Equity
A public equity transaction encompasses either the provision of equity capital to listed companies on a primary market or a transfer of a company's shares between a buyer and a seller on a secondary market. Listed companies are such companies whose shares are traded on stock exchanges.

Reinsurer
Company which accepts a share of the primary insurer's risks in return for payment of a premium.

Risk
Insured object, hazard or interest, or the peril insured against.

Risk Management
Management tool for the comprehensive identification and assessment of risks based on knowledge and experience in the fields of natural sciences, technology, economics and statistics.

# Acronyms

| | |
|---|---|
| AMWG | The Asset Management Working Group of UNEP FI |
| BRICs | The countries of Brazil, Russia, India, and China viewed as a group of emerging economies with large potential markets. |
| ESG | Environmental, Social and Governance – (Issues) |
| EU | European Union |
| EU ETS | European Emissions Trading Scheme |
| HNWI | High Net Worth Individuals |
| OECD | Organisation for Economic Cooperation and Development |
| PRI | Principles for Responsible Investment |
| ROI 1 | Return on Investment |
| ROI 2 | Responsibility of Investment |
| SRI | Socially Responsible Investment |
| UNEP FI | United Nations Environment Programme Finance Initiative |
| UNGC | United Nations Global Compact |

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## UNEP Finance Initiative (UNEP FI)

UNEP FI is a unique global partnership between UNEP and the private financial sector that works closely with approximately 170 financial institutions to develop and promote linkages between sustainability and financial performance. Through regional activities, a comprehensive work programme, training and research, UNEP FI carries out its mission to identify, promote and realize the adoption of best environmental and sustainability practice at all levels of financial institution operations.

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## UN Global Compact

The United Nations Global Compact is the world's largest corporate citizenship initiative, encompassing nearly 3,000 companies and stakeholders from 90 countries. Participating companies commit to advancing ten principles in the areas of human rights, labour conditions, environmental stewardship and anti-corruption. The objective of the Global Compact is to help achieve a more stable and inclusive global economy by rooting markets and societies in universal principles.

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