

# Sustainability and Financial Institutions

## overview

### CAPITAL AT RISK

The 1980 US Superfund Act forced US banks to quickly become aware of the serious risk it posed to their bottom line — it meant that contaminated land might be worth a fraction of its former value or, worse, might represent a major liability. Banks responded by incorporating formal environmental risk management procedures into their lending policies to reduce their lender liability and default rate. Although their potential liability was eventually reduced,<sup>1</sup> banks built on their environmental experience by reducing their internal ecological footprint, undertaking environmental audits, and introducing environmental conditions into loan agreements. In turn, this drove the insurance industry to exclude certain types of environmental risk from their standard policies and to introduce new environmental impairment liability insurance products.

Today, environmental risk management is routine good business practice for most leading banks around the world, and environmental risk is understood to encompass a broader range of issues than contaminated land alone. The insurance industry also has become only too aware of the costs of major industrial accidents and, in particular, natural disasters linked to global environmental problems such as climate change.

### A CHANGING WORLD

While the financial sector has been dealing with the reality of environmental risk directly affecting its core business practices, it also has had to adapt to the treatment of E&S issues in a changing world. Developed countries launched the modern environmental movement during the 1960s. Rachel Carson's *Silent Spring* was the first to point out that humans can harm the environment; by the end of the decade, the US and other nations introduced environmental legislation. During the 1970s, people became aware of the challenges to growth and the magnitude of poverty and hunger in developing countries. This was followed by the emergence of "sustainable development" in the 1980s, a movement that forced a country to examine its pursuit of economic growth while addressing environmental protection and social development.

The 1990s' shift to globalization merged these issues under an international lens — not only did the free flow of information shrink the world, but there was a growing awareness that companies had a role to play in sustainable development and that their activities had global ramifications. Several conferences helped formalize this view in EMs: 1992 Rio/UN Conference on Environment and Development, 2002 Monterrey Conference on Financing for Development, and 2002 Johannesburg World Summit on Sustainable Development.

By the new millennium, most major companies responded to the call for

## facts & figures



### Evolution of IFC's E&S Requirements

- 1989** — First environmental advisor appointed
- 1993** — IFC-specific environmental policy and procedure adopted
- 1999** — Ombudsman office established; first liaison to NGO community appointed
- 2000** — E&S staff = 50 professionals
- 2001** — Sustainability initiative launched
- 2002** — Three E&S facilities launched

social responsibility by implementing internal environmental management systems, reporting on their environmental activities, adopting voluntary E&S codes/guidelines,<sup>2</sup> and/or joining public-private partnerships.<sup>3</sup> FIs also undertook these efforts, but, as relatively "clean" industries, their internal E&S goals were fairly straightforward. Some FIs began to adopt FI-specific sustainability guidelines, which have a wider operational impact. The three most popular are:

- ▶ **UNEP FI** — launched in 1992; developed in response to 1992 Rio Conference; 290 signatories in 47 countries;
- ▶ **London Principles** — launched in 2002; proposes conditions under which financial markets can promote sustainable development financing;
- ▶ **Equator Principles** — launched in 2003; 15 major banks have adopted; contains specific E&S standards and policies.

All of these companies have one thing in common. They realized that they had to make a choice — be proactive and undertake these voluntary efforts or

<sup>1</sup> The 1996 US Asset Conservation, Lender Liability, and Deposit Insurance Protection Act excluded lenders from the CERCLA definition of "owner or operator."

<sup>2</sup> e.g., ISO 14000, Global Reporting Initiative

<sup>3</sup> e.g., Energy Star, WasteWi\$e, Green Power Market Development Group

remain unprepared for the requirements of globalization and/or future legislation.

## GROWING VALUE

FIs have been pursuing efforts that not only reduce environmental risk and improve their ecological footprint but also add value via new products/services. Their experience demonstrates that adhering to sustainable development allows them to: uncover latent, potentially harmful downstream risks, save money, respond to the increasing call for socially responsible behavior, upgrade their reputations, strategically position them as market leaders, access new markets, and generate revenue; perhaps most important, it has become standard practice for involvement in the international financial community.

Within this community, multilateral/bilateral institutions were the first to include E&S requirements as part of their financing terms. The World Bank Group (including IFC), the European Bank for Reconstruction and Development, the Asian Development Bank, and the Inter-American Development Bank all have such policies/procedures in place. As the largest financiers in EMs, including E&S conditionality can significantly influence FIs' contribution to sustainable development.

## Banks

Commercial banks are the largest group within FIs and developed country banks are the most active in pursuing sustainable development. Superfund turned environmental risk management into a routine business operation. Many banks have reduced their ecological

### Banks Face Three Environmental Risks

#### **Direct Risk**

("polluter pays" concept)

#### **Indirect Risk**

(borrower's ability to pay is weakened)

#### **Reputational Risk**

(from NGOs/the public)

footprint, publish environmental reports, adhere to voluntary codes/guidelines, and avoid predatory lending practices. Some banks have also leveraged their newly gained E&S expertise to offer new products and services such as sustainable development funds, environmental advisory services, and environmental credit cards.

In the EMs, the multilateral development institutions have been the main driver to date because of their E&S requirements. Recently, however, savvy NGO campaigns began to isolate banks and hold them accountable for unsustainable projects in EMs. Both developed country and EM FIs are now seeing E&S issues in a different light — not as pure financing requirements but as necessary tools for successfully operating in the international arena. The latest example is the adoption of the Equator Principles, which applies to any project finance effort greater than \$50 million.

## Asset Management Companies

Asset management companies include mutual fund companies and institutional investors. Their portfolios typically consist of public companies<sup>4</sup> and they service both retail and commercial clients. In general, they assume a long-term, fairly conservative investment strategy. The sustainable development approach allows asset managers to offer new products to a growing segment of socially responsible investors (SRI).<sup>5</sup>

The SRI industry believes that corporate social responsibility has a direct impact on an investor's financial health. Specialized FIs offer socially screened mutual funds which include companies

that were evaluated on issues such as environmental protection, labor rights, and corporate governance. Once the investment is made, the FI undertakes shareholder engagement (pursued by most of the major SRI FIs). SRI has a long history, but its modern roots are in the 1980s' anti-apartheid divestment efforts; recent US corporate scandals increased company scrutiny and solidified a link between business practice and investor behavior.

Today, SRI is a \$2.7 trillion global industry, with the US and UK representing \$2.6 trillion of this total. Both institutional and individual investors support SRI. US pension funds such as CALPERS and TIAA-CREF are choosing companies for their social responsibility record. In the UK, the government feels strongly enough about SRI that it now requires pension funds to declare whether and how they use social and environmental criteria in their investments. Belgium, Germany, and Australia have similar requirements.<sup>6</sup>

Although SRI is still in the early stages in the EMs, currently, there are 55 SRI funds with assets in EM countries.<sup>7</sup> Asia, South Africa, and Brazil are the most active; they offer the most indigenous funds, they are included in more foreign SRI funds, and they are building up a network (i.e., ASrIA, AICC, INCAE) to share ideas and promote SRI in their countries.

## Private Equity/Venture Capital

Private equity (PE)/venture capital (VC) firms invest only in private companies (i.e., those not publicly traded). PE and VC account for 0.6% of global GDP, with the US and Europe controlling nearly 90% of this market.<sup>8</sup> PE firms invest in larger, established companies and have a long-term, risk-averse strategy. Adhering to sustainable development broadens their investment universe while reducing risk and provides them with important indicators for their exit routes. A comprehensive understanding of company risk and operations can finalize a successful equity transfer.

<sup>4</sup> Some pension fund companies (e.g., CALPERS, TIAA-CREF) also invest in private companies.

<sup>5</sup> For more information, refer to IFC's "Socially Responsible Investing in Emerging Markets" MIB (forthcoming).

<sup>6</sup> De la Cuesta, M., et al., 2003, "Principles, Guidelines and Institutional Initiatives for CSR Promotion."

<sup>7</sup> Enterprising Solutions, 2003.

<sup>8</sup> UNEP FI and INSEAD, 2002, *Sustainable Venture Finance: Workshop Report*, p. 6.

VC firms differ from PE firms in that they take the riskiest approach and invest in small, young companies, often startups. Despite a boom and bust history, their growth in the US is significant; in 1980, VC firms raised (and invested) nearly \$600 million and in 2002, they raised \$4.5 billion.<sup>9</sup> VC firms typically go well beyond the traditional level of lender involvement, often by taking active management control of their investments. As such, their risk encompasses lender liability plus management liability, so operational failings are a direct concern.

In spite of this increased vulnerability, VC firms struggle with their role in sustainable development. On one hand, it is a way to reduce investment risk and support visionary, socially responsible industries and entrepreneurs. This helps fill a large gap in EM investment. Conversely, the need for high returns, immature financial sectors, inadequate government incentives, and relatively short investment horizons (4.7 years on average<sup>10</sup>) limit VC's sustainability-related investment choices in these countries.

### **Insurance**

Insurance and reinsurance companies share the burden of client risk. Basic risk assessment and calculation of premiums, however, rest with the reinsurance company. As such, they faced environmental issues first. Asbestos problems in the US and damage from weather catastrophes such as Hurricane Andrew in 1985 established a relationship between the environment and insurance and created new markets such as natural disaster-related insurance. The growing awareness of global climate change and demand for socially responsible behavior led reinsurers to assess their exposure to a

client's environmental liability. This became another risk management tool, and environmental liability insurance is now a significant industry.

Reinsurers are long-term investors who need a large capital stock in reserve at all times. Their risk-averse strategy was exacerbated after 9/11, so they are hesitant to experiment with something new. However, the industry has begun to recognize the benefits of sustainable development and some major reinsurers, such as Munich Re and Swiss Re, now offer sustainability-related products and services. Munich Re publishes an environmental report, receives environmental audits, and has in-house staff devoted to climate change research, genetically modified plants, and liability law. Swiss Re publishes a sustainability report, offers solutions for greenhouse gas emissions reductions, develops green certificates and renewable energy products, invests in environmental funds and VC projects, and raises awareness of sustainable water management. Both companies are members of the Dow Jones Sustainability Index.

Environmental awareness, risk mitigation, demands for corporate social responsibility, and investor perceptions are the major drivers for developed country reinsurers. The EM insurance industry is not as well developed, so it has been slower to adopt sustainability than its Western counterparts.

### **Microfinance**

Microfinance provides financial services (credit, deposits, insurance) to the poor to help them start up or expand an economic activity. It differs from traditional lending in that it provides small loans at higher interest rates and shorter-term maturities, and the lenders rely on character rather than collateral.<sup>11</sup> EM entrepreneurs have used their loans to establish enterprises such as agricultural cooperatives, rural cottage industries in textiles and handicrafts, and cellular phone rental services. Microfinance embodies sustainable

development because it promotes economic self-sufficiency for an EM population that was excluded from mainstream financial services.

### **THE EMERGING MARKETS**

Developed country FIs have undertaken most of the sustainable development efforts in EMs — the EM FIs are lagging behind (see table, p.4). There are several exceptions, but embracing even basic E&S efforts has yet to reach a critical mass. Most EM FIs still do not believe that these issues are their problem to solve, but perversely, it is in their marketplaces that E&S challenges for business and society as a whole are most profound. Another problem is a dearth of in-country capacity. In recent years, development agencies such as IFC have begun to bridge this knowledge gap by training FIs on E&S issues.<sup>12</sup>

#### **trends** *Demand for corporate social responsibility will be a major driver.*

- ▶ "No place to hide" — NGOs will continue to expose FI activities.
- ▶ Investors increasingly will scrutinize companies for their transparency, governance, and E&S efforts.
- ▶ IFIs will continue to include E&S conditionality for EM projects.
- ▶ Weak EM regulations/enforcement will spawn more informal E&S "regulators."
- ▶ Best practices will become more documented.
- ▶ FIs will be pressured to apply E&S standards to their entire operation.

***Fragility of brand name will stem from two sources: how the FI runs its own operations and how its investments run theirs.***

***Equator Principles could significantly affect entire banking sector via their depth and traction.***

***Banks, SRI, PE, and microfinance will be at the forefront of sustainable development; VC and insurance will undertake more piecemeal efforts.***

<sup>9</sup>The Venture Capital Institute, 2003.

<sup>10</sup>Aylward, A., 1998, *Trends in Venture Capital Finance in Developing Countries* (IFC Discussion Paper).

<sup>11</sup>Berger, Marguerite, 2000, "Microfinance: An Emerging Market within the Emerging Markets."

<sup>12</sup>IFC's SFMF offers a Competitive Environmental Advantage workshop to EM FIs.

TYPE OF FI	EXAMPLES OF PRODUCTS/SERVICES IN EMs
Banks	<ul style="list-style-type: none"> <li>Co-Op Bank's assessment/monitoring of its service channels' sustainability impacts</li> <li>South Africa's Standard Bank will provide carbon finance and trading services</li> <li>UBS has a Global Environmental Risk Policy</li> </ul>
Asset Management	<ul style="list-style-type: none"> <li>55 developed country and indigenous SRI funds with a combined \$2.7 billion in assets contain EM holdings<sup>17</sup></li> <li>One of IFC/SFMF's missions is to promote SRI in EMs</li> </ul>
PE/VC	<ul style="list-style-type: none"> <li>IFC's Environmental Opportunities Facility invests in small-scale environmentally friendly projects in EMs</li> <li>Terra Capital invests in commercially viable and sustainable biodiversity enterprises in Latin America</li> <li>Solar Development Capital finances off-grid solar power systems in EMs</li> <li>Quadris invests in a Brazilian teak plantation that operates according to sustainable forestry guidelines</li> <li>Norfund invests in private enterprise and promotes business development in EMs, using good governance and long-term view criteria</li> <li>Investments (2001)<sup>18</sup>: China and South Korea \$1.8 billion each, India \$1.1 billion, South Africa \$0.27 billion, Poland \$135 million</li> </ul>
Insurance	<ul style="list-style-type: none"> <li>AIA/Thailand gives reduced premiums to businesses that educate employees on HIV/AIDS</li> </ul>
Microfinance	<ul style="list-style-type: none"> <li>Grameen Bank, BancoSol, Bank Ratyat Indonesia, Micro Enterprise Bank of Kosovo, ShoreCap International</li> </ul>
Miscellaneous	<ul style="list-style-type: none"> <li>Leasing <ul style="list-style-type: none"> <li>IFC's CEEF project offers a leasing option for energy efficiency projects in Eastern Europe</li> <li>Finarca, a private leasing company in Nicaragua, leases agricultural machinery/industrial equipment to small and medium enterprises</li> </ul> </li> <li>Carbon trading <ul style="list-style-type: none"> <li>replanting 10,000 hectares of forests in India equals \$300,000/year in carbon payments<sup>19</sup></li> <li>financing renewable energy projects in EMs and obtaining carbon credits via Clean Development Mechanism</li> </ul> </li> <li>Weather derivatives <ul style="list-style-type: none"> <li>IFC and Aquila will offer weather derivatives in EMs</li> <li>IFC is funding weather insurance derivatives for the Moroccan agricultural sector</li> </ul> </li> </ul>

### NGO Efforts Targeting FIs

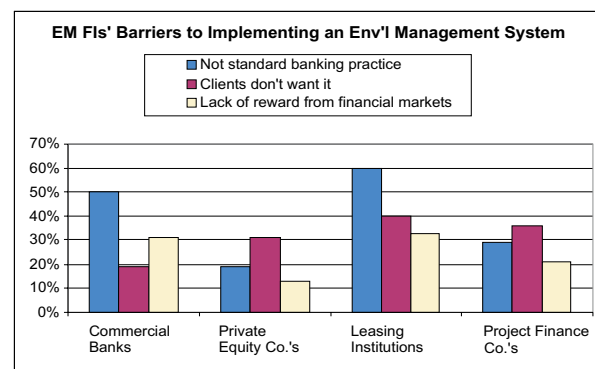
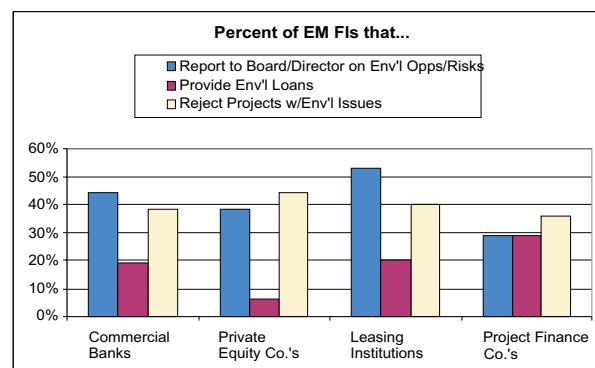
- 100 NGOs released the "Collecchio Declaration on FIs" asking FIs to take responsibility for clients' E&S activities
- NGO efforts shut down Rabobank-financed Indonesian pulp and paper plant for unsustainable forestry practices
- Rainforest Action Network's campaign against Citigroup's projects in several EMs including Thailand, Indonesia, Peru
- NGO protest against Morgan Stanley's involvement in China's Three Gorges Dam
- National Wildlife Federation's Finance and Environment Program ensures FI efforts are sustainable

## the numbers

### PE/VC

- global PE/VC investment in 2001 = \$100 bill.<sup>13</sup>
  - US is largest market
  - highest growth in China, Australia, India
  - investments received in EMs (China and Korea = \$1.8 bill. each, India = \$1.1 bill., South Africa = \$0.27 bill., Poland = \$135 mill.)
- VC stock in Asia and Central & Eastern Europe (CEE) (combined) = \$7 billion in 1995<sup>14</sup>
  - India receives most of the VC funds in developing Asian countries, followed by Indonesia and Thailand<sup>15</sup>
- Poland, Hungary, Czech Republic = 66% of VC funds in CEE; Poland alone = 40%<sup>16</sup>

Equivalent data for banks, asset management firms, microfinance, and insurance companies are not readily available.



Source: IFC, *Beyond Risk*, 2003

<sup>13</sup> 3i Group and PricewaterhouseCoopers, 2002, *Global Private Equity 2002*.

<sup>14</sup> Aylward, A., 1998.

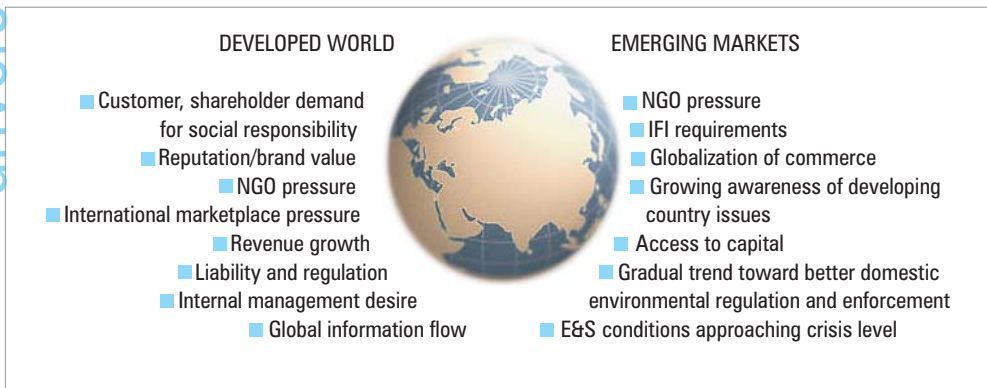
<sup>15</sup> *Asian Venture Capital Journal*, January 2003.

<sup>16</sup> Aylward, A., 1998.

<sup>17</sup> Enterprising Solutions, 2003.

<sup>18</sup> 3i Group and PricewaterhouseCoopers, 2002, *Global Private Equity 2002*.

<sup>19</sup> Clarke, Tom, 2002, "Communities Make Forest Carbon Trading Work," *Nature*, October 21.



To obtain a copy of IFC's publication *Beyond Risk*, contact [MIB@ifc.org](mailto:MIB@ifc.org).

#### IFC/SFMF

([www.ifc.org/enviro/EnvironmentFacilities/SustainableFinancialMarkets/sustainablefinancialmarkets.htm](http://www.ifc.org/enviro/EnvironmentFacilities/SustainableFinancialMarkets/sustainablefinancialmarkets.htm))

**Equator Principles** ([www.equator-principles.com](http://www.equator-principles.com))

UNEP FI (<http://unepfi.net>)

#### Citigroup

([www.citigroup.com/citigroup/citizen/socialresponsibility/index.htm](http://www.citigroup.com/citigroup/citizen/socialresponsibility/index.htm))

#### ABN Amro

([www.abnamro.com/com/about/citizen.asp](http://www.abnamro.com/com/about/citizen.asp))

#### HVB Group

([www.hvbgroup.com/english/aboutus/sustainability/index.html](http://www.hvbgroup.com/english/aboutus/sustainability/index.html))

#### Standard Bank

([www.standardbank.co.za](http://www.standardbank.co.za))

**ASrIA** ([www.asria.org](http://www.asria.org))

**AICC** ([www.aiccafrica.com/index.htm](http://www.aiccafrica.com/index.htm))

**INCAE** ([www.incae.ac.cr/EN](http://www.incae.ac.cr/EN))

**Swiss Re** ([www.swissre.com](http://www.swissre.com))

**Munich Re** ([www.munichre.com](http://www.munichre.com))

#### BancoSol

([www.bancosol.com.bo/en/index.html](http://www.bancosol.com.bo/en/index.html))

**Grameen Bank** ([www.grameen-info.org](http://www.grameen-info.org))

#### All About IFC

The International Finance Corporation (IFC) is an international organization which promotes sustainable private sector development in its developing member countries as a way to reduce poverty and improve people's lives. Since its inception in 1956, IFC has committed more than \$34 billion of its own funds and has arranged \$21 billion in syndications for 2,825 companies in 140 developing countries. In terms of annual investment, the financial markets sector has become the single largest recipient (49% of total investment in FY2003).

#### About SFMF

IFC's Sustainable Financial Markets Facility (SFMF) is a donor-funded technical assistance program focused on the private financial sector in the emerging markets. Through the Facility, IFC provides a range of capacity building, best practice development and market-making activities to promote environmental and socially responsible and sustainable business practices in banking, insurance and investment. The Facility currently receives funding from IFC and the Governments of Switzerland, the Netherlands and Norway.

#### About MIBs

This Market Intelligence Brief (MIB) is produced by IFC through the support of SFMF. The goal of the MIB series is to collate, analyze and disseminate intelligence on sustainability business issues relevant to emerging market lenders and investors.

The information provided in this document is not intended to be nor should it be construed as investment advice. Recipients should undertake their own independent evaluation and analysis with respect to any potential investments discussed herein.

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