

Sustainable Finance in Brazil

overview

Brazil spent the eighties and nineties going through what many call two “lost decades.” Sluggish GDP growth, high unemployment, and inflation rates — deepening the already unequal income distribution — distinguished this period (which continues today). On the environmental front, deforestation in the Amazon rain forest hit its highest levels. However, Brazil also has seen great gains during this period:

- ▶ The consolidation of a solid democracy, where a left -wing candidate recently won, with no threats from the generals
- ▶ A free press
- ▶ A vociferous and effective civil society activism
- ▶ An active liberal corporate elite

There is a link in this apparent contradiction. Recession plus environmental and social (E&S) unrest in the eighties led the liberal corporate elite to join forces with workers under the leadership of Luiz Inácio Lula da Silva — then a lathe operator, today president of Brazil — to press for a return to democracy. Direct elections in 1989 gave Brazilians a new sense of ownership of their country, which in the nineties led to the creation of several reputable corporate think tanks and partnerships between companies and NGOs (see box).

This context created the ideal atmosphere for a Corporate Social Responsibility (CSR) movement that permeated all sectors of the economy, including the financial industry. The Brazilian financial industry's adoption of sustainability had its roots in a CSR “avant garde” movement, organically incubated within Brazilian society, absent any precedents in the developing world. NGOs and the federal government also began to address sustainable finance.

These three stakeholder groups were driven by a combination of macro-level trends, the CSR movement, and several unique incentives:

INDUSTRY DRIVERS

- ▶ Risk reduction
 - Reputation
 - Credit & guarantees (collateral)

- ▶ Opportunities
 - Access to funding from multilateral institutions
 - Market differentiation
 - New products/services
 - Banking services for underserved populations
 - Biodiversity pool
 - New markets (carbon, renewables)

NGO AND CIVIL SOCIETY DRIVERS

- ▶ Expansion of existing campaigns from international financial institutions to private financial institutions
- ▶ Realization that the financial industry must play an important role in CSR
- ▶ Growth of sustainability reporting, which attracted the attention of civil society

GOVERNMENT DRIVERS

- ▶ Access to funding from multilateral institutions
- ▶ Banking services for underserved populations

PIONEERING CSR INITIATIVES

1990 — The Statute of Children's and Adolescents' Rights was proclaimed; ABRINQ Foundation for Children's Rights was founded.

1994 —The Brazilian Institute for Social and Economic Research (IBASE) was created.

1995 — The Brazilian Institute for Corporate Governance (IBCG) was founded.

1997 — IBASE proposed and circulated a social reporting model for use by corporations; the Brazilian Business Council for Sustainable Growth (CEBDS) was established.

1998 — The Ethos Institute for Corporations and Social Responsibility (ETHOS) was created.

These institutions offer a forum for Brazil's largest corporations to discuss and promote transparency, corporate governance, and sustainability. By using media tools, they have played a major role in moving these issues into the mainstream of the Brazilian corporate world. CSR today is a commonly used term, with a secure place in Brazilian newsrooms. A decade ago, Brazilian CEOs did not want to be associated with NGOs and social movements. Today this is considered a reputational asset.

facts & figures

PRIVATE FINANCIAL INSTITUTIONS

Private Equity/Venture Capital

Sustainable finance initiatives originated in Brazil's venture capital segment via investments in environmental projects. The country has considerable competitive advantage in new eco-businesses, especially those related to forestry. It is still covered by vast expanses of rain forest that offer great potential for bio-prospecting, ecotourism, and sustainable forest management. It also offers opportunities for biomass- and wind-powered energy generation and recycling.

Drivers: PE/VC

- ▶ Biodiversity pool
- ▶ New products/services

Environmentally focused VC investments originated with the former Banco Axial, which was founded in 1996 through a partnership between Swiss investor Pierre Landolt and Brazilian investment executives. Its mission was to focus on environmental businesses in addition to its traditional treasury and corporate finance activities. Banco Axial ran Terra Capital, the first Brazilian VC fund to invest in companies focusing on biodiversity. In 2000, Banco Axial split into two entities: A2R Fundos Ambientais, which took Terra Capital with it, and Axial Par, focusing on environmental projects including sustainable agribusiness, forestry, carbon, renewable energy, and clean technologies. Errors of judgment, not necessarily linked to the sustainability of the target projects, compelled A2R to close shop in 2003, leaving Axial Par as the only company actively involved in the environmentally oriented VC market.

Banks

Sustainable efforts in the banking sector began with social reporting in the nineties, when Banco do Estado de São Paulo (Banespa), today owned by Banco Santander, published Brazil's first financial sector social report. In 1993, the Brazilian Banking Federation (Febraban),¹ with the support of the



Association of Analysts and Professionals of Capital Markets (Apimec), issued the first social report for the financial industry. Currently, five of the largest banks in Brazil make non-financial information available, either in the form of a separate social report or integrated into their annual reports.

Drivers: Banks

- ▶ Access to funding from multilateral institutions
- ▶ Reputation and credit management
- ▶ New products/services
- ▶ New markets

Sustainability reached the heart of financial activity in 2000 when Banco BBA Creditanstalt, today Itau BBA, became the first Brazilian bank to set up formal procedures to manage E&S risks for credit purposes. Its board then approved the inclusion of environmental issues for long-term project analysis. In 2002, Unibanco launched an E&S risk management system for the credit process, with one dedicated employee. In both cases, the procedures originated with training on the relationship between sustainable development and financial institutions. Advantages included easier access to multilateral institutions such as the EIB, DEG, NIB, FMO, and IFC.

In 2002, ABN AMRO's Brazilian branch, Banco ABN AMRO Real, was the first bank to introduce an E&S risk policy for virtually all corporate clients. This policy was initiated with an extensive training program carried out in partnership with the Eco-Finance Project, an initiative of Friends of the Earth-Amazonia. Over a six-month period, they gave 61 five-hour training sessions to 1,100 branch managers and middle managers across the country. ABN AMRO Real also created an innovative E&S Business Development Department, with four employees who are tasked with developing a set of products with direct social and environmental impact and with more competitive spreads.

Finally, the financial sector has recently entered two new markets: the Brazilian carbon market and the renewable energy market. To date, the only significant carbon operation has been the deal between Rabobank and Plantar, a FSC-certified reforestation company. The project plans to use charcoal as a reducer for pig-iron manufacturing; this is the first Brazilian carbon project approved by the World Bank's Prototype

drivers

MACRO-LEVEL

- Sluggish GDP growth
- High unemployment rates
- High inflation rates
- High deforestation rates



INDUSTRY-SPECIFIC

- Reputational and credit risks
- Access to funding from multilateral institutions
- Market differentiation
- Development of new products and services
- Extension of banking services to underserved communities
- Exploration of Brazil's biodiversity pool
- New markets
- Expansion of NGO campaigns to private financial institutions
- Realization that the financial industry must play an important role in CSR
- Growth of sustainability reporting, which attracted the attention of civil society

Carbon Fund (PCF). Rabobank advanced \$5 million, to be paid by the proceeds from PCF carbon credits generated by the project.

Unibanco has also been active in the carbon trading market for some of its customers, especially sugar producers and transportation companies. Unibanco and its São Paulo branches became self-sufficient in renewable energy in 2004. The bank developed a methane-powered generation plant at the Bandeirantes landfill in São Paulo. This is the first biogas plant in Brazil and the largest in the world. The cost of the electricity fed back into the grid will be deducted from Unibanco's electricity bill. Unibanco estimates that the agreement will pay for the entire São Paulo branch network's electricity bills.

Asset Management

The asset management sector has demonstrated the most innovative and sophisticated initiatives within Brazil's financial industry. In 2001, Unibanco's brokerage launched a research service for foreign socially responsible investors (SRI) by producing E&S reports of listed companies. This was a new service in the emerging markets and it was the first time that such a product was offered by a financial institution. The service was offered free of charge with the objective of attracting foreign SRI funds to the Brazilian capital market through the bank's brokerage. Thirty-two companies have been researched to date.

Drivers: Asset Management

- ▶ New products/services

Although these efforts are small in volume, their success could further stimulate CSR in Brazil. By the end of 2001, ABN AMRO/Banco Real

launched Brazil's first SRI fund, Ethical Fund, which invests in Brazilian listed companies only. The fund has a portfolio manager, an SRI analyst, and a board composed mostly of outside members with veto power. Between its launch date and February 2004, Ethical grew by 92%, compared to 75% realized by the Ibovespa² benchmark.

After the Ethical Fund was introduced, several banks (HSBC, Unibanco, Banco Santos) created fixed income funds offering a community outreach element. These instruments divert part of the gains that the investor would have earned, or part of the management fee, into a separate fund for helping community associations. These funds offer individual investors (retail and private) a secure investment with a quasi-market financial return plus a social investment opportunity. Environmental and social considerations are not part of these portfolio managers' investment criteria, but they have a strong synergy with the SRI market, presenting a high potential for conversion.

São Paulo Stock Exchange (Bovespa)

Bovespa is moving ahead on three fronts:

- ▶ The New Market, which seeks to attract new companies to the stock market by setting strict corporate governance requirements such as voting stock-only listings.
- ▶ Three levels of corporate governance, which allow companies to step up from where they are now to level one, then two and then three (which is equivalent to the New Market).
- ▶ The Sustainability Index Working Group: multi-stakeholder group comprised of representatives from leaders in the sustainability field and capital markets preparing the launching of a Bovespa

¹ Febraban's Social Report improved substantially in 2003, when a profile of its internal readership and a section on supplier relations were included. The discussions on philanthropic activities was reduced to make space for a (short) discussion on sustainability indicators (DJSI, FTSE4Good) and social and environmental criteria in the credit segment.

² Ibovespa is the index; Bovespa is the stock exchange.



Sustainability Index. IFC has agreed to provide grant funding from its Sustainable Financial Markets Facility to help design and launch the index.

Micro-credit

Unibanco has offered micro-credit since 1998 through its affiliate Fininvest, focusing on Rio de Janeiro and the consumer segment. It recently inaugurated a São Paulo service through a joint venture with the IFC, called Micro-Invest. ABN AMRO launched its micro-credit business in 2002, and Banco Santander also works with micro-credit, but its presence is still very small.

Drivers: Micro-credit
 ▶ New products/services
 ▶ Reaching underserved populations

NGOs AND CIVIL SOCIETY

NGOs and civil society have been very proactive in the field of sustainable finance in Brazil, offering specific incentives for the industry. This has created the synergy and cooperative environment required to foster the initiatives generated within the industry itself.

In 2000, Friends of the Earth-Amazonia set up the Eco-Finance Project (EF), a program designed to boost the awareness of the private banking industry on E&S issues. EF had a non-confrontational approach that was conducive to building partnerships with private financial institutions.

Drivers: NGOs & Civil Society
 ▶ Expansion of existing campaigns from international to private financial institutions
 ▶ Realization that the financial industry must play an important role in CSR
 ▶ Growth of sustainability reporting

Outcomes were the 2001 and 2002 SRI International Seminars and the ABN AMRO Real training program.

In early 2001, Apimec formed a committee on SRI. Its activities have focused on educating market analysts. Both EF and Apimec have launched newsletters that reach a wide audience among Brazilian financial institutions, NGOs, government, and multilateral organizations.

The Ethos Institute of Business and Social Responsibility created Social Responsibility Indicators, which were landmarks for the dissemination of the CSR concept in Brazil. These instruments enhanced the profile of transparency as a corporate asset and improved sustainability reporting standards. More recently,

Ethos has been developing sectoral indicators based on international standards and consultations with companies and professionals. It has completed models for the financial, mining, and pulp and paper sectors. The Global Reporting Initiative (GRI) has also attracted the attention of several Brazilian groups. To date, six corporations have followed the GRI format, either partially or wholly: CPFL, McDonald's Brasil, Natura, Petrobras, Souza Cruz, and Usiminas.

Ethos has also been working with the pension fund industry association (Abrapp) to incorporate E&S criteria into investment decisions. In mid-2002, the three largest Brazilian pension funds, Previ, Petros, and Funcef, began this process. Abrapp plans to circulate the CSR agenda to Brazil's private pension funds, which represents a unique opportunity for the SRI industry to attract part of the \$66 billion invested by these companies. This volume is expected to increase considerably in the next few years, after the implementation of Social Security Reform approved in 2003.

“Once we start being more concerned with socially responsible investing, a host of other investors will follow the good example.”

Wagner Pinheiro, Chairman of Petros, Petrobras Pension Fund Valor Econômico, Sept. 19th, 2003

NGOs are also involved with the micro-credit industry in Brazil. The second largest player in this market is CEAPE, a network of Support Centers for Small Entrepreneurs. These Centers are private NGOs dedicated to improving low-income families' economic and social standards through commercial or service activities.

GOVERNMENT AND PUBLIC FINANCIAL INSTITUTIONS

Although it holds major stakes in the largest Brazilian banks and its distribution network reaches remote areas, the federal government historically has played a relatively small role in sustainable finance. Over the past several years, however, it has undertaken a few initiatives.

Banco do Nordeste do Brasil, a federally owned bank in the Northeast, is the only public-sector bank to present a consistent strategy. This institution developed in-house training programs, designed new products targeting agricultural activities with a conservation

approach (“Northeast Green Fund”), and has a distinctive track record in the micro-credit market. It has been operating in this field since 1997, with a focus on urban areas. In partnership with NGOs, the program has managed to maintain a low-cost administrative structure and personalized service.

Drivers: Government
 ▶ Access to funding from multilateral institutions
 ▶ Reaching underserved populations

The other major public banks, Banco do Brasil and Caixa Econômica Federal (CEF), have restricted their activity to improving access to banking services. In 2003, the new government introduced a policy of encouraging credit and the expansion of banking services to the needier layers of the population. The plan, rolled out through these two institutions, is structured as personal loans, where the proceeds are likely to be spent on consumption and/or debt repayment.³

In 1998, Congress passed the Environmental Crime Bill, establishing penalties of up to US\$17 million for environmental crimes, compared with the previous US\$1,400 maximum penalty, a major step in raising the profile of E&S issues.

In the asset management segment, the CEF fixed income community outreach fund directs 50% of its administration fees to the “Fome Zero” Program, one of the social flagships of the Lula government.

LESSONS LEARNED AND CHALLENGES

Despite the variety and depth of Brazilian sustainable finance initiatives, there are still many challenges.

PE/VC

Almost all endeavors in this area — public, private, non-governmental — have faced obstacles on the ground:

- ▶ Training: shortage of professionals for small and medium enterprises
- ▶ Entrepreneurship: lack of entrepreneurial spirit among communities that depend on subsistence-level extraction activities
- ▶ Logistics: transportation structure
- ▶ Finance: shortage of financing for sustainable businesses (e.g., clean technologies, biodiversity, forestry)

³ Neither of these two initiatives is focused on productive micro-credit initiatives, which is credit used to fund productive economic activity rather than consumption.



- ▮ Scale: “small is beautiful” production scale often doesn't yield the returns needed by private equity funds.

Banks

In implementing formal procedures to manage E&S safeguard policies for credit purposes, both Itau BBA and Unibanco reached the same conclusions: developing a system allowed them to manage risks not considered previously and created a culture of project monitoring. Training and developing an analytical and documentary framework were some of the needs that still had to be addressed.

Both of these banks, major players in project finance, are now facing the “Equator Principles dilemma.” These banks are very aware of the international systematic movement toward the Principles and they are faced with major competition for the \$100 billion public and private local investment portfolio foreseen in the next four years.

Two years into this initiative, the lesson has been clear: there is a definite correlation between companies that have serious environmental or social problems and those that present financial problems or lack of transparency. ABN AMRO/Banco Real discovered tangible credit risk plus reputational risk after studying more than two thousand corporate clients in 2003.

“I have never seen a company that is great on environmental protection, treats its employees well and that is also broke,” says ABN AMRO/Banco Real environmental risk manager Christopher Wells. “Yet, I've seen plenty of companies with serious environmental and social problems that also have financial statements that are poor or not trustworthy. There's a definite correlation.”

Asset Management

In launching a research service for SRI funds in January 2001, Unibanco faced the first important obstacle: promoting transparency in E&S areas, segments in which Brazilian corporations were not prepared to report. The process evolved as the market started to recognize this initiative as a value-added possibility. However, much effort went to educating corporate CFOs and following up with information. Companies in general did not have all the information required for disclosure and felt insecure about the whole process.

The research service and the launching of the Ethical Fund still have to contend with some obstacles:

- ▮ Low levels of capitalization and liquidity on the Brazilian Stock Exchange (Bovespa): in some cases, a listed company could be both the best and worst in class, if it is the only company represented in that sector.
- ▮ Low transparency: although financial and sustainability reporting has improved greatly in recent years, investors are still subject to surprises.
- ▮ Institutional investors are still not in the game: if and when the pension funds or mutual funds take in SRI, then the impact will be very large.

Micro-credit

The implementation of local micro-credit strategies has proved to be a very challenging process. Scale and civil society partnerships are key elements to their success.

trends

The Brazilian financial industry has reached a point of no return regarding sustainability. The well-organized CSR movement and the leadership of some already successful initiatives in sustainable finance will exert continuous pressure across the industry to incorporate the concept of sustainability into their decision-making processes.

The private sector will continue to be the major force. Without safeguard policies and guidelines and effective stakeholder engagement, reputational, credit, and collateral risks will continue to rise. Increasingly, private investments will face organized stakeholders ready to defend their basic rights and equipped with increasingly sophisticated means of communication.

Conversely, from SRI to microfinance, from bio-prospecting to biomass, plenty of opportunities are available to be explored.

The banking activity places the financial industry in a position of great influence over corporations, government, the community and finally over the life of people in general. For this reason, the financial sector is increasingly relevant to the promotion of sustainable development and fostering of corporate responsibility.

Social Report 2002, Brazilian Banking Federation (Febraban)

WHAT'S NEXT

The continuous development of market incentives and ongoing support of existing initiatives are key elements for the expansion of the sustainability path within the financial sector.

PE/VC

Several products will be attractive in the near-term: bio-prospecting, sustainable forest management, renewables, alternative fuels, biomass, ecotourism, SRI, and micro-credit.

Banks

At least five international Equator Principles signatory banks have major activities in Brazil: ABN AMRO, Citibank, HSBC, Bank of America-FleetBoston, and WestLB. As signatories, these banks will put pressure on local banks — especially Bradesco, Itau BBA, and Unibanco, major players in project finance — to join the club.

Asset Management

The recently approved Social Security Reform could, in the medium term, represent a considerable boost to the capital market. Long-term investment options will be at a premium, and with the right incentives, such as the launching of the Bovespa Sustainability Index, pension funds may divert part of their portfolios to socially responsible investments.

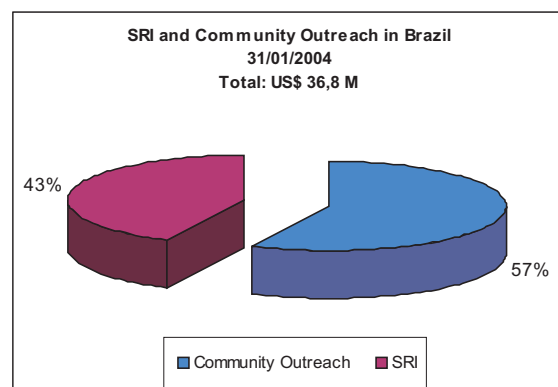
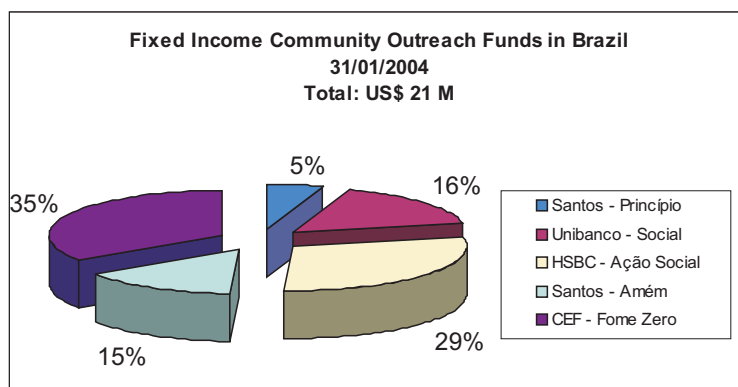
Micro-credit

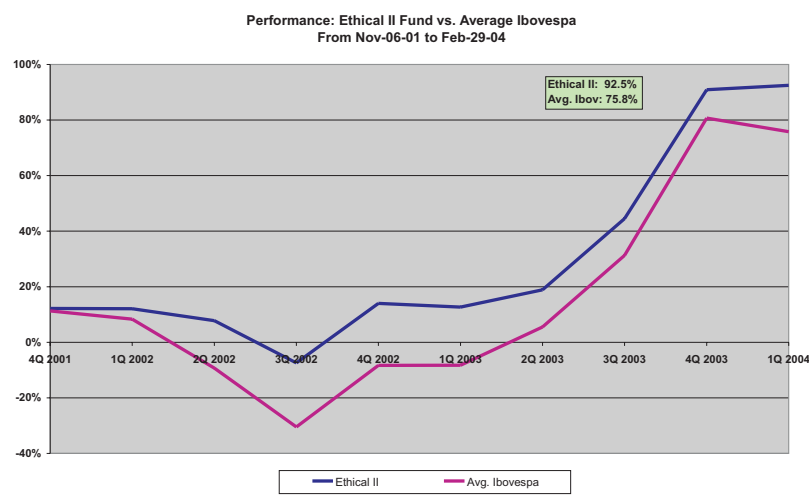
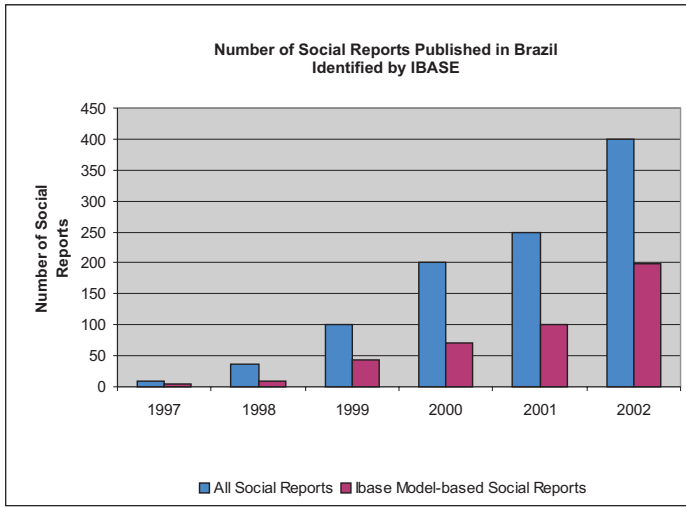
Enhanced by the government's drive to increase banking for underserved populations, micro-credit is expected to grow.

WHAT'S NEXT IN THE REGION AND EMERGING MARKETS

Brazil has always taken a leadership role in the region. The success of the initiatives on sustainable finance in Brazil can provide tremendous incentive for the region and other emerging markets to undertake similar efforts. However, these efforts cannot be exported if a combination of fundamental ingredients — activist civil society, free press, liberal corporate elite, a democratic institutional framework, and industry-specific drivers — are not in place.

TYPE OF FI	EXAMPLES OF PRODUCTS & SERVICES
Banks	<p>ABN AMRO</p> <ul style="list-style-type: none"> Provided 61 five-hour training sessions to 1,100 branch managers and middle managers across the country Hired 2 full-time E&S analysts, who analyzed more than 1,000 clients <p>Unibanco</p> <ul style="list-style-type: none"> Developed a power generating plant fired by methane gas - 22 MW of installed capacity and investments of \$21 million <p>Rabobank</p> <ul style="list-style-type: none"> \$5 million project with Plantar
Asset Management	<p>Unibanco - Research Service for SRI Funds</p> <ul style="list-style-type: none"> 32 Reports ABN AMRO Real Ethical Funds \$15 million in assets \$4.3 million raised in January 2004 <p>Fixed-Income Community Outreach Funds (assets as of Jan 2004)</p> <ul style="list-style-type: none"> Banco Santos Pro-Amém — \$3.1 million Banco Santos Principio — \$1.1 million CEF Fome Zero — \$7.3 million Unibanco Social — \$3.4 million HSBC Ação Social \$6.1 million
PE/VC	<ul style="list-style-type: none"> Axial Par — \$10 million for the forestry, agribusiness, carbon, renewable energy, and clean technology sectors
Financial Advisory	<ul style="list-style-type: none"> EcoInvest — 600 MW in windpower, small hydro, thermoelectric, and biomass plants Econergy support services to Econergy International in Brazil for the \$24 million Clean Tech Fund Unibanco biomass cogeneration projects in sugar and alcohol sectors; 170 MW of additional electricity; total investment = \$137 million, of which \$83 million in long-term financing
Micro-credit	<ul style="list-style-type: none"> BNB — portfolio: \$39 million; 130,000 clients (65% market share) CEAPE — active portfolio: \$6 million; 28,000 active clients ABN AMRO Real — portfolio: \$200,000; 580 clients Unibanco Micro-Invest: Unibanco \$3.7 million; IFC \$1.25 million





information

- ABERJE - Brazilian Association for Business Communication (www.aberje.com.br)
- ABRINQ - Abrinq Foundation for Children's Rights (www.abrinq.org.br)
- ADCE - Association of Christian Business Managers (www.adce.org.br)
- AMCE - Sustainability and Corporate Responsibility (www.amce.com.br)
- APIMEC - Association of Analysts and Professionals of Capital Markets (www.apimecsp.com.br)
- AXIAL PAR (www.axialpar.com.br)
- BANCO ABN AMRO REAL (www.bancoreal.com.br)
- BANCO DO BRASIL (www.bb.com.br)

- BANCO DO NORDESTE (www.bnb.gov.br)
- BANCO SANTOS (www.bancosantos.com.br)
- BANKBOSTON (www.bankboston.com.br)
- CAIXA ECONOMICA FEDERAL (CEF) (www.caixa.gov.br)
- CEBDS - Brazilian Business Council for Sustainable Development (www.cebds.org)
- ECOINVEST (www.ecoinv.com.br)
- ECONERGY BRAZIL (www.econergy.com.br)
- ECOSECURITIES BRAZIL (www.ecosecurities.com)

- ETHOS - Ethos Institute for Social Responsibility (www.ethos.org.br)
- FEBRABAN - Brazilian Banking Federation (www.febraban.org.br)
- FIDES - Foundation for Business and Social Development (www.fides.org.br)
- HSBC (www.hsbc.com.br)
- IBASE - Brazilian Institute for Socio-Economic Analysis (www.ibase.br)
- ITAUBBA (www.itaubba.com.br)
- SANTANDER (www.santander.com.br)
- UNIBANCO (www.unibanco.com.br)

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.

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