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**CSM/WWF Research Project:
The Business Case for Sustainability**

**FINANCIAL SERVICES
Sector Report**

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Executive Summary

The report looks at the business case for sustainability (BCS) and its exploitation in the financial services sector. A BCS signifies that environmental and social issues have an impact on the value creation of a financial services company and that an economic rationale exists for managing these issues.

The focus on the banking side is on the credit business within corporate and investment banking. On the insurance side the focus is placed on the property & casualty and re-insurance sub-sectors that have strong business ties with multi-national and national companies (where appropriate the report also refers to asset management operations and other financial services). In the course of the research, 62 interviews with representatives of European and US-American financial institutions, consultancies and NGOs were conducted and a survey was carried out.

The research showed that the issues that affect the researched financial companies are very diverse, ranging from environmental pollution, resource depletion and climate change to social issues in industrialized and emerging markets. However, from a company's perspective the issues go through different stages: from the point in time when they are for the first time identified as potential problems, to the point when they are resolved or attended to within the mainstream business rationales of companies. Sustainability issues can have a significant impact on financial firms through their relations with their customers and also via public pressure.

Many different business cases exist for managing environmental and social issues. A BCS is often company specific, in the sense that it firstly depends on the business operations pursued, secondly the markets (regions where the company is active), thirdly the country of origin (location of headquarters) and fourthly the size of the company (market leadership and visibility to the public). Case studies on emission-intensive industries, climate change, palm oil, asbestos, pulp & paper and the chemical industry show that sustainability issues can impact the value creation of financial companies through:

- Reputation (changing stakeholders' perception in such a way that the business is influenced)
- Credits (creating a default or increasing the loss in case of default)
- Insurances (creating liabilities)
- New products and services (creating revenues)
- Asset management (changing the value of investments).

Even though business cases are company specific and very diverse, the interviewed managers perceived that the most important underlying value drivers - and therefore the opportunities behind business cases - are risk management (RM) and reputation (managing risk to reputation).

Business cases are not exploited for several reasons: social and environmental risks are often seen separately from financial risks. Industry knowledge and appropriate tools to define sustainability risks are often missing. Also, incentive systems are focused on the very short-term and can minimize the staff's interest in tackling sustainability risks. Additionally, customers are naturally not very interested in disclosing their sustainability risks.

Different strategies or measures do represent business rationales because they help to manage relevant sustainability issues: a number of the researched companies have functions which deal with sustainability through issue management, internal and external communication. These units can help financial firms to better deal with emerging issues and outside pressure. But units can also play the role of a "challenger" in order to encourage business units to take into account relevant sustainability issues.

In the core business, RM processes that are anchored within the code of conduct can be an innovative solution. The voluntary adoption of World Bank minimum guidelines for project finance can also be a promising strategy as demonstrated by the "Equator Principles", an initiative of ten international banks, and the International Finance Corporation (IFC) is testing a new framework intended to sharpen the view of the business side to sustainability opportunities in order to improve projects and decrease the risk of default on loans. Overall, the strategies show that for generating a positive sustainability impact and for capturing the value behind business cases, real changes should take place in the core business. Companies should assess their business operations and processes in order to localize relevant sustainability risks - and the opportunities that are inherent to their proper management.

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1 Sector Specific Approach

The objective of the research undertaken at IMD is to shed more light on the business case for sustainability (BCS) and its exploitation in the financial sector. The report focuses on the business activities of banks and insurance companies with commercial customers that have a major influence on environmental and social issues.

The research is based on interviews and a survey carried out within the financial sector by IMD's Corporate Sustainability Management Forum. The interviews were focused on Western European and US-American banks and insurance companies that operate internationally and have a corporate structure. Some smaller financial companies and two banks with a public mandate (IFC and KfW) were also included in the sample because of their specific engagement within the field of research. In each company interviews were carried out with staff in sustainability or environmental units and if possible with at least one additional line or functional manager. Altogether 52 interviews with managers in the financial sector took place. Additionally consultancies with sustainability practices were asked to participate in meetings, as well as NGOs and the UNEP, accounting for 10 interviews. A complete list of participating organisations is presented in figure 1. The survey was distributed to participants in IMD programmes and was also put online. Sixty-eight managers working within the finance sector returned the completed questionnaire.

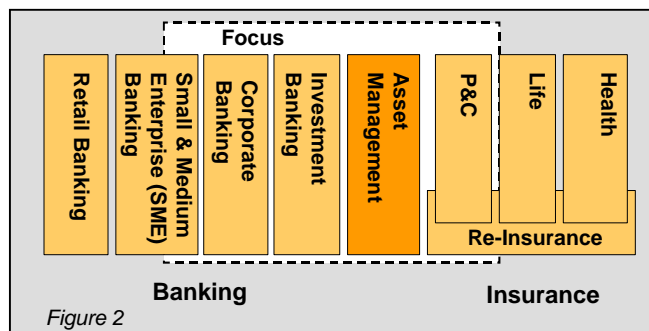
Banks & Insurances		Consultancies
ABN AMRO	IFC	ADL (Cambridge)
Allianz Group	ING Group	Deloitte & Touche (Zurich)
Bank of America	KfW	ECOFAC AG, (Zurich)
Citigroup	Morgan Stanley (UK)	Ecos Corporation (Boston)
Credit Swiss Group	Rabobank	PwC (Zurich)
Dresdner Bank	Sarasin Bank	NGOs & others
Fleet Boston Financial	Storebrand	Friends of the Earth (USA)
Friends Provident	Swiss Re	GermanWatch
HVB Group	Züricher Kantonal Bank	SAM Group
		UNEP Financial Initiative
		WWF (UK)

Figure 1

The study gives a brief industry analysis and will focus in section 3 on the BCS and in section 4 on strategies that address relevant sustainability issues. Section 5 summarizes the conclusions.

2 Industry Overview

The financial sector is very heterogeneous. The insurance industry is composed of firms with diverse businesses such as primary insurance (property-and-casualty (P&C), life, health insurance) re-insurance, asset-management and other specialty financial services. In the banking industry the business sub-sectors include retail, small-and-medium enterprises, corporate banking and investment banking as well as asset management. The focus on the banking side is on the credit operations within corporate and investment banking. On the insurance side the focus is placed on the P&C and re-insurance sub-sectors which have strong business ties with multi-national (MNCs) and national companies (NCs). Where it is appropriate and important the report also refers to sustainability issues within asset management and other financial services (see figure 2).



In the last few years stock markets have gone through the most severe and prolonged decline since the 1930s. Falling equity prices have put many firms under a “stress-test” and even asset management operations – capable of making as much money as almost any other business when stock markets are rising steadily – have been losing money.

Large international banks have come through the economic crisis almost undamaged. In mid 2003, British, French, Swiss and US-American global financial institutions such as BNP Parisbas, HSBC, Royal Bank of Scotland, UBS and Citigroup, reported strong increases in earnings and even record results. Similarly, Germany's main private banks, which had to reverse the costs of their past investments in investment banking and still have to cope with a fragmented domestic banking market, are once again reporting profits.

Even with bankruptcies rising sharply in all sectors (the downfall of WorldCom and Enron alone wiped out loans of roughly \$34 billion), only a couple of millions of losses, rather than billions, are showing up in the credit books of big financial institutions; they have shifted large amounts of their lending risk over to smaller banks and out of the banking system (e.g. to insurers offering credit insurance). The Economist recently stated that the traditional image of main-street banks with their armoured vaults stuffed with bullion has little to do with the way banks make their money: “These days they [big international banks] make loans and then pass them on as quickly as possible, pocketing the margin. That leaves more room to take bigger risks elsewhere: in trading securities, derivatives, and foreign exchange, for example, or investing in private equity” (Economist 16 August 2003).

The international P&C insurance and re-insurance business suffered in 2001 after the September 11 terrorist attacks. In 2002, insured losses due to natural catastrophes and man-made disasters overall were comparatively low. However, storms and floods revealed their high loss potential in 2002: according to Swiss Re (sigma, No. 2/2003) flood related losses were the highest ever and insurers must expect to be confronted in the future by an increasing number of extreme weather events. Additionally, many asbestos claims are still pending and big risks for insurers lie within America's tort laws. After years of major price reductions in the commercial P&C segment, an increasing demand for coverage and a shortage of supply has raised rates by 15-20% in 2002 (Economist 8 March 2002). Overall, in mid-2003, the financial statements of big international insurers such as Allianz, Axa and Swiss Re are showing profits.

3 Sustainability and the Business Case

Sustainability or sustainable development is a theoretic and value-driven concept: there are many different ways of looking at and understanding the issue of sustainability. Definitions of the term are generally global and rather address goals for society as a whole than operational goals for companies. A common denominator of most definitions is an emphasis on the long-term view to protect the natural environment from irreversible damage. The research was not intended to add any new definition. It followed the quite fundamental definition of the “Brundtland-commission” - satisfying today’s needs without sacrificing future generations’ possibilities to meet their own needs - and the widely known “three pillar model” of economic growth, ecological balance and social progress, as it is used by the WBCSD.

The research looks at sustainability in respect to private companies. Firms see it as a prerequisite to operate profitably in order to stay in business. Therefore the research is not looking at what some managers call “sustainable” profits or finance, instead it looks at environmental and social aspects, how they influence profits (value creation), and how they are taken into consideration by companies in the financial services sector. A business case for sustainability (BCS) is present when sustainability issues have an impact on value creation - as a threat or opportunity - and a financial company is in a position to craft strategies addressing these issues. If a BCS is apparent, it is not a luxury to manage environmental and social issues but rather a business rationale.

The following section will first describe sustainability issues and how financial companies are affected. It will then discuss characteristics and evidence of business cases and why they are not exploited.

3.1 Sustainability Issues

The study focuses on sustainability issues with regard to protecting the environment and includes adverse environmental impacts on human populations, environmentally important eco-systems and natural resources. It also includes man-made environmental impacts such as climate change. Where social aspects are concerned, the study focuses on issues in emerging markets such as human rights, participation, democracy, corruption and local economic growth. In industrialized countries the spotlight is on issues connected to the widening of social inequalities.

Financial sector companies should handle sustainability issues responsibly within their own companies. The interviews revealed that the meaningfulness of internal environmental management should not be underestimated as it is visible and tangible for the whole organisation and helps to raise

consciousness concerning internal and external sustainability issues. Environmental in-house management also makes sense since money can be saved by reducing the consumption of paper, electricity or airline mileage. But the relative direct impact of financial firms is perceived as being limited compared to that of their commercial clients. MNCs and NCs have a significant impact on environmental and social conditions, and here banks/insurances have their most important “sustainability leverage”. In September 2002, eleven CEOs and Chairmen of financial institutions – including ABN AMRO, Allianz, Rabobank, ING Group, Storebrand and Swiss Re – signed a statement pointing out that: “We recognize our role as drivers for change, although the limits of responsibility and influence of the financial services industry need to be further explored ... Because we influence the way our clients conduct their business (through policies and processes), the financial sector is a driver for sustainable development rather than the executor of change.” (Working Group Finance; CEOs’ and Chairmen’s statement: www.wbcsd.org).

Figure 3 shows topics that were encountered during the research and were perceived as sustainability issues by financial institutions. It is not an exhaustive list because issues are a moving target and their importance varies for most companies in different lines of business. In other words, a bank or insurance company conducting its business mainly in Western Europe will be less affected by issues that are of importance in emerging markets.

The interview process showed that the researched companies deal mostly with environmental but seldom with social issues. The results of the overall survey confirmed this finding. Why is this the case? Probably because extensive environmental laws and regulations exist for commercial customers. Banks, for example, habitually give loans to companies striving to meet new environmental standards, and insurance companies offer products which help their customers to cover environmental risks such as insurance covering site-specific clean-up costs or damages to third parties, casualty insurance with pollution coverage, and D&O insurance providing coverage if directors or officers of a company are sued because of an environmental incident or loss.

<p>Environmental Pollution</p> <ul style="list-style-type: none"> • Air, water, and soil pollution due to building activities and operations (financing/insuring of mining operations, oil & gas extraction, agrobusiness, chemicals etc.) • Existing residual pollution & contaminated property (financing/insuring real-estate) • Waste disposal (financing/insuring incineration, landfills etc.) • Hazardous materials & workplace safety (insuring of asbestos etc.) • Nuclear energy (financing and insuring of plants) <p>Resource Depletion</p> <ul style="list-style-type: none"> • Water scarcity (impact on financial products via ecosystems, humans & industries) 	<ul style="list-style-type: none"> • Deforestation & habitat loss (financing of logging, plantations such as oil palm, soybeans etc.) • Depletion of exhaustible raw materials (financing/insuring of mining operations and oil & gas extraction) • Distinction of eco-systems (financing/insuring of water dams, landfills etc.) <p>Climate Protection</p> <ul style="list-style-type: none"> • Reduction of GHG-emissions (carbon trading solutions, renewable energy financing, CFC financing ban, impact of regulation on customers’ credit risk profiles) • Extreme weather conditions such as floods & storms (insuring catastrophe risks, evaluating underlying credit risks etc.) 	<p>Social Issues in Industrialized Countries</p> <ul style="list-style-type: none"> • Community/society development (providing financial services for ethnic & underprivileged groups) • Transparency <p>Social Issues in Emerging Markets</p> <ul style="list-style-type: none"> • Human rights and working conditions (financing/insuring large dams involving resettlements, companies using child labour etc.) • Democracy and transparency (offering financial services for despotic regimes, financing corruption and illegal operations etc.) • Participation and local development (financing operations which bear social conflicts, bypass local markets etc.)
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GHG = Greenhouse gas GMOs = genetically modified organisms

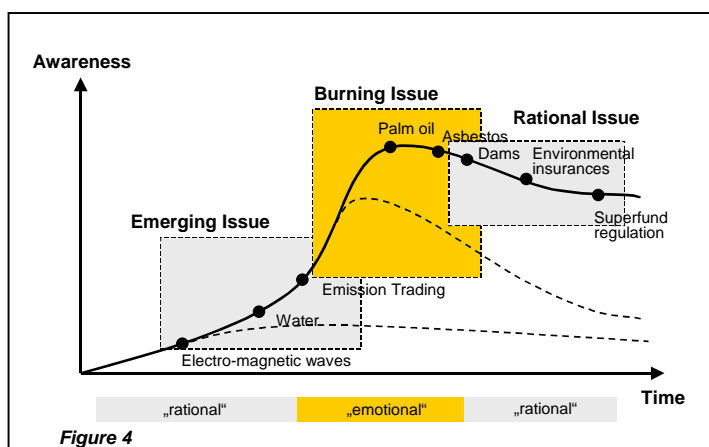
Figure 3

Some companies, especially the re-insurers Swiss Re and Munich Re, approach very global sustainability topics such as climate change and water. The efforts to come to terms with these issues are intended to help in anticipating, identifying and prioritising risks and opportunities that could affect their business. For international banks in the trade finance business the “burning” issues of the moment mainly concern operations in emerging markets. Here, the pressure from NGOs is most severe and public awareness is high. It appears that internationally operating insurers are so far less exposed to this kind of pressure. Overall, the sustainability issues financial companies are exposed to are quite diverse compared to other sectors, because they are closely linked to their, often, mixed portfolio of customers.

However, an important pattern emerges when looking closely at the issues. Seen from a company’s perspective, they go through different stages: from the point when they are for the first time identified as potential problems, to the point when they are resolved or attended to within the mainstream

business rationales of companies. Figure 4 shows how the awareness of issues develops over time. The examples of current sustainability issues are based on a subjective judgement and should illustrate the curve.

Initially, an issue is an idea developed by scientists and experts and it is generally discussed quite rationally outside the company. An emerging issue is recognized either as a potential problem or an opportunity by a company. However, it is often hard to predict at an early stage how an “emerging” issue – e.g. radiation of mobile phones or water scarcity – will impact on the organisation and when it will materialize. A “burning” issue has passed the point of take-off and the organization is affected and aware of the problem. This might be “emotional”, going hand-in-hand with media attention, protestors in front of the building or a case pending in court. A burning issue could, however, be short lived and disappear like other emerging issues, or it could become a “rational” issue and be integrated into mainstream business policies and processes.



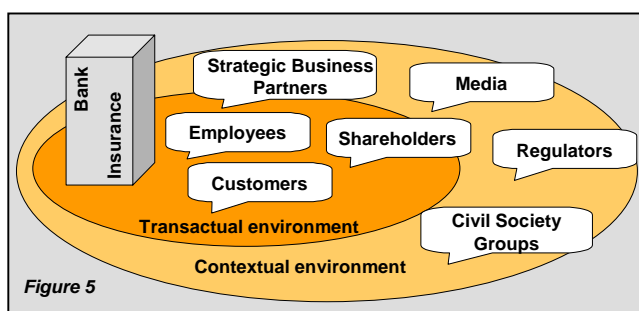
A good example of a rational issue is the US-specific “Superfund” regulation which creates potential liabilities for banks for clean-up costs of hazardous contamination. Because of the regulation, environmental assessments of pollution and soil contamination have been integrated within the risk management process of transactions and loans secured by property. The awareness curve of an issue (which is not in line with its economic rationale) falls as the issue becomes integrated and the accompanying business case or rationale is “sucked up” by existing processes.

3.2 Rising Importance of Issues and How They Affect Companies

The following section will firstly shed more light on the stakeholder groups and societal trends that increasingly get sustainability issues on the agenda of companies, and secondly it will look at the ways issues affect banks and insurances.

Stakeholder Groups and Societal Trends

A company in itself constitutes a complex social structure and its value creation depends on numerous social factors such as the qualifications and motivation of employees, its “social competencies” with strategic business partners and customers as well as shareholders. These groups have in common that they interface directly with companies as transactional stakeholders (see figure 5) negotiating contracts, transactions, etc. with company managers. Companies usually have a relatively good understanding of the needs and expectations of these stakeholders: employees want more work to be rewarded by higher salaries, customers expect better service. The understanding that firms have to manage these social aspects, and especially their social capital, is not new and reams of academic HR, marketing and management text books have been written on these subjects.



A new development in the context of sustainability is the rising importance of some contextual stakeholder groups (which do not have direct business relations with companies). Especially activist and other civil society groups are increasingly placing environmental and social demands on companies. This development has been spurred by developments in information technologies, which permit rapid and inexpensive diffusion of information worldwide. The Swiss bank UBS describes this

new environment in one of its recent reports (see box below). These contextual stakeholder groups are not replacing governments but are an additional influence to persuade companies of societies' interests. Where a group finds that a company should alter its practices - even though it might not be breaking the law - it may start putting pressure on it. It is worth noting the circumstances which made this relatively new development possible:

- A large section of society believes that while companies created wealth (especially for their top management) and were busy transforming themselves into big “global players”, they were also creating problems. The public therefore increasingly expects companies to accept their responsibility and provide solutions.
- Another factor is the abolition of borders that goes hand-in-hand with globalisation. MNCs are perceived as being able to circumvent local laws because governments only have jurisdiction within their own borders. Civil society groups are seen as welcome “referees” pointing out the wrongdoing, the shedding of standards in other countries and the need for transparency.
- Last but not least, a large section of society has lost confidence in traditional authorities. In the study “Perspektive Deutschland 2002”, the world’s largest on-line survey ever conducted on socio-political issues, Germans rated their institutions by the need for reform and trust. All governmental organisations received very low grades in terms of trust. Political parties got the worst ratings: 61% of respondents have no trust in them. At the other end of the scale are the institutions which are perceived as trustworthy: the German Automobile Club (ADAC), the Protestant and Catholic church social service organizations and Greenpeace (www.perspektive-deutschland.de).

UBS Handbook 2001/2002 (p.111)
 “We realize that simply meeting existing legal requirements is not sufficient. Society’s expectations are constantly evolving and often precede formal legal and regulatory requirements; we find that we are being held to ever higher standards. Globalisation has added to these demands as multinationals are accused of arbitrating social standards to boost their bottom line.”

These developments are in line with a growing awareness in industrialized countries (and also nowadays within emerging markets) that the environment needs to be protected from irreversible damage. Environmental catastrophes from the Exxon Valdez disaster in Alaska in 1989 to the floods in Austria, Germany and the Czech Republic in the summer of 2002 have helped to sensitise much of society. Consciousness also grew in public society groups about the asymmetric allocations of resources which result in a growing social divide between North and South, and within the industrialized countries themselves, where the underprivileged are excluded from basic financial services etc.

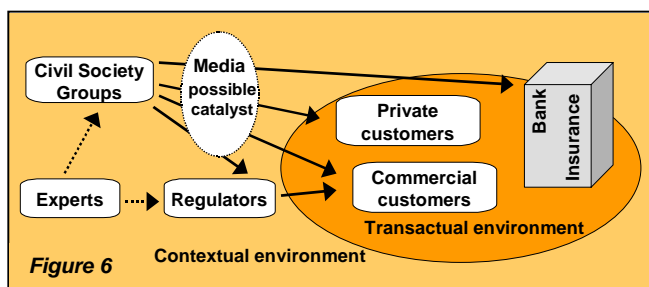
How are banks and insurances affected?

Up to the late 90s, pressure groups focused on putting pressure on “dirty” customers of financial institutions such as oil, gas and chemical companies. Then something happened that banks and insurances did not expect: “The old view was that we are a service industry which is only shifting papers,” a banker observed, “we never thought that we would be questioned about the activities of our clients”. The Financial Times remarked (FT 6 April 2003) that “Financial institutions have until recently largely escaped the wrath of environmental groups, which have tended to shower their criticism on international institutions, such as the International Monetary Fund and World Bank, or manufacturers accused of operating sweat shops in developing countries. But at this year’s World Economic Forum in Davos, over 100 advocacy groups signed the so-called Collevccio Declaration [www.foe.org/camps/intl/declaration.html], which called on financial institutions to implement more socially and environmentally responsible lending policies.” In the eyes of civil society, public pressure on financial sector companies is only just beginning. As an interviewee from an NGO put it: “It’s an innovative thing. So far banks have not been targeted.” Certainly insurance companies also run the risk of being targeted for their underwriting policies, e.g. for controversial dam or pipeline projects.

It is interesting to look closer at the ways in which demands, initially found on the banners of civil society groups, can influence banks and insurances. Protestors with banners in front of a sleek bank tower will not make a big difference, and when they are gone business-as-usual will most certainly resume. It is far more threatening if groups can find allies within the business environment, e.g. customers who are willing to close bank accounts or cut their credit cards in protect against companies' actions. The media are in many cases an important catalyst for reaching a broad base of private customers. Reputation is important for banks and insurance companies as their business depends on the trust of their clients and their ability to provide products and services discreetly and professionally.

The survey found that 74,6% of financial managers think that name or reputation is important for their company and 19,4% think it is of very high importance. Yet commercial customers are apparently rarely influenced by public pressure to the extent, that they boycott their providers of financial services (see figure 6).

On the other hand, regulators also represent a “transmission belt”, but one which is rather indirect and slow moving: regulation of sustainability issues can directly influence financial products and services. However, this is only rarely the case, such as the Montreal Protocol (limitations on financing CFC activities) or a recent UK regulation requiring pension funds to disclose how they



consider environmental and social issues. More important for financial companies is the indirect impact of regulations on their commercial customers. “Risks of our customers”, one interviewed manager pointed out, “are also our risks.” Certainly, this also includes regulatory risks.

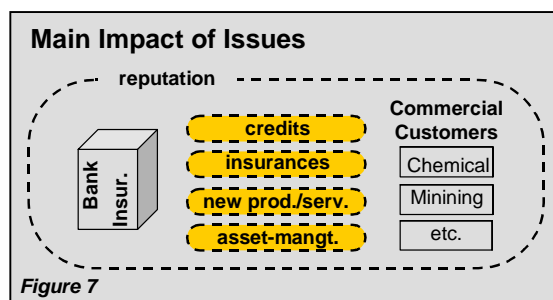
3.3 Characteristics and Evidence of a Business Case

The preceding discussion focused on the way issues are brought up within the environment of financial firms and how they affect them from the outside. This section looks at tangible consequences of relevant issues for financial companies and shows business cases for sustainability. It also looks at the value drivers behind business cases.

Tangible Impacts of Issues and Business Cases

Sustainability issues can impact the value creation of financial companies in the following ways:

- Reputation (linked to products/services and not independently manageable; see figure 7): by damaging or improving stakeholders’ (commercial customers, private customers, investors, analysts etc.) perception in such a way that the business is influenced.
- Credits (credits to commercial clients, project finance etc.): by creating a default on loans or by increasing losses in the case of default.
- Insurances (P&C, D&O policies etc.): by creating liability claims.
- New products and services (socially responsible investment funds, carbon trading solutions, etc.): by creating new revenues.
- Asset management (management of investments / equity capital, assets under management for third party investors etc.): by changing the value of investments.



The following actual cases were encountered during our research and indicate that business cases do exist and that environmental and social issues can influence profits in financial institutions.

Emission Intensive Industries: Carbon trading schemes and taxes to help combat climate change¹

The carbon disclosure project – an initiative of 35 institutional investors asking the FT500 Global Index companies for information relating to GHG (Greenhouse gas) mitigation – found that companies and industry sectors vary widely in their degree of risk exposure and the sophistication of risk management capabilities. GHG regulation will be felt most strongly in emission-intensive sectors (steel, manufacturing, chemicals, cement production, smelting, transportation, automotive, paper and pulp) and the energy industry itself (oil and gas exploration and production, pipelines, refining, distribution, electricity utilities). The initiative also found that GHG induced loan impairment in emission intensive sectors could have a significant impact on banks' bottom-line and share-price.

An example of the effects of carbon taxes and the analysts’ blind spot over climate change was provided by the IPO of Xstrata, a London-listed mining company, in 2002. In a 350-page prospectus, precisely one line was devoted to climate change. Yet within weeks, the Japanese government began talking publicly about imposing a carbon tax. As a substantial portion of Xstrata’s revenues come from exporting coal to Japan, the market

Impacts on financial companies

- loans to carbon-intensive companies exposed to impairment risk
- equity valuations at risk
- opportunity for new products (carbon trading solutions)

responded by lopping 8% off the company's market capitalization.

Pulp and Paper: Resource depletion, environmental pollution and missing community involvement²

From the late 80s onwards, cheap labour, lax environmental controls and, most of all, inexpensive resources attracted large investments in the Indonesian pulp & paper industry. In ten years over US\$ 15 billion were poured into large pulp & paper mills. Indonesia's pulp production capacity increased by 700% between 1988 and 1999. The Indonesian company APP emerged as the world's eighth largest paper and board producer, listed on the New York and Jakarta stock exchanges. International financial institutions financed the heavily debt driven expansion but failed to sufficiently recognize and react to a number of risks inherent to the business: such as the government's weak financial regulation enabling a greedy management to engage in a variety of illegal practices to obtain cheaper finance. Even more astonishing was that financial institutions had a blind spot for the "cheap" wood supply. The massive capacity growth was not matched by efforts to secure a sustainable supply of raw materials: it is estimated that between 1988 and 1999 only 8% was harvested from plantations and 92% was sourced by clear cutting - often illegally - highly biodiverse rainforest. Given the high fixed cost for the production facilities, APP's failure to secure an adequately legal and sustainable raw material supply implied that the company carried a significant degree of financial risk. Additionally, international investors did not recognize the high level of social conflict and risk of APP's logging operations, leading to serious conflicts with indigenous populations. With a debt burden of over US\$12 billion the company announced a freeze on all debt repayments on 12 March 2001. Financial institutions are expected to have lost as much as 90% of their investments in APP.

The fate of the Indonesian paper pulp and rayon fibre producer PT Indorayon Inti Utama (now called Toba Pulp) and its investors is also worth being cited. Indorayon's beleaguered Porsea plant was effectively closed down by local protests and blockades from 1998 to 2002. In response to long-standing complaints from the surrounding community about air, water and noise pollution, land rights violations, lack of employment and unfair compensation, the government ordered a complete review of the environmental and social impacts of the fibre plant in 1999. Violent confrontations have resulted in over a dozen deaths and hundreds of serious injuries during the past years, and protests are gaining momentum again as the plant re-opened in late 2002. In fact, already when the plant was built in the 80s it was an alien element in a rural and Christian area of Indonesia. Even the environmental minister at the time spoke out against the project. Additionally, the workers were not recruited in the nearby communities. They came from other islands and lived in separate complexes on the firm's property. At the beginning of 2001 Indorayon had outstanding bonds amounting to US\$ 285 million and owed US\$ 70 million to banks.

Impacts on financial companies:

- losses/ write-offs on loans
- losses/ write-offs on equities and bonds
- exposure to reputation risk

Chemical Industry: Toxic Leakages and Spills³

A chemical gas leakage (of methyl isocyanate) at the Union Carbide Plant in Bhopal/India killed over 2000 people immediately and caused well over 100,000 injuries in 1984. Before the accident the company had a reputation for excellence in environmental management. Researchers at MIT described Union Carbide as "possibly the best corporate citizen among multinationals studied". Union Carbide concluded after an examination of the incident that the storage tank had been sabotaged. However, during the plant operation Union Carbide purportedly neglected oversight and responsibility, e.g. ensuring that appropriate maintenance was conducted or that recommendations of audit teams were implemented. The stock price of the company plummeted after the accident and major segments of the corporation were divested to protect shareholders' investments - including its main consumer brands which suffered from the company's damaged reputation. Incurred losses were large but never estimated officially: one decade after the Bhopal disaster sales had dropped from US\$ 12.5 billion to 5 billion annually, and in 1989 the Supreme Court of India ordered Union Carbide and its Indian subsidiary to pay US\$ 470 million in damages to the Government of India. Various legislations resulted from the incident. While developing the "Clean Air Act Amendments" the US Senate considered an "Environmental Protection Agency" analysis that compared chemical incidents in the early to mid-1980s in the US to the Bhopal incident. It found that of 29 US incidents considered, 17 released sufficient volumes of chemicals with such toxicity that the potential catastrophe - depending on the weather and plant location - could have been even more severe than in Bhopal.

Impacts on financial companies:

- insurance liabilities
- losses/ write-offs on equity holdings

Palm Oil: Resource depletion and social conflicts⁴

Palm oil is the most widely traded edible oil and world production has seen a significant rise over the last years. In Indonesia and Malaysia production almost doubled from 1990 to 2001. Only in the years from 1995 to 1999 domestic and foreign investments of US\$ 20 billion poured into the sector. For economic reasons and due to the lack of control by the government, especially in Indonesia, companies cleared natural forest land without obligatory permits: this brought widespread social conflicts and destructive forest fires causing air pollution (affecting around 70 million people) and huge economic losses. Pressure groups perceive that the influence which foreign financial institutions exert on their customers in the palm oil business, has increased due to the financial crisis the region and companies are in. A successful joint campaign was conducted by Sawit Watch (the Indonesian oil palm advocacy network), Friends of the Earth and Greenpeace Neatherlands which even led to a submission of questions by members of parliament to the government on the role of Dutch banks in Indonesia. To emphasize the need of action FoE also distributed 250,000 postcards in Feb 2001 enabling account holders to call upon their banks to stop investing in environmentally damaging plantation projects.

After a series of meetings with the campaigners ABN AMRO, Rabobank, Fortis and ING agreed in early 2002 to stop or restrict financing for oil palm development in Indonesia on environmental and social grounds (no destruction of rainforests, no burning, acting within legal frameworks and respecting rights/wishes of local communities). ABN AMRO went even further and opted to apply the bank's new policies to all investments that might affect forests. In other European countries, however, similar campaigns were much less successful and financial institutions could withstand the pressure as their account holders were not interested enough and politicians did not become active.

Impacts on financial companies:

- exposure to reputation risk
- account holders threatening to leave

Asbestos: Environmental Pollution and Workplace safety⁵

The aggressive expansion policy of its former management left the Swiss-Swedish engineering group ABB with many poor performers and a heavy exposure to asbestos suits. ABB bought the Connecticut boilermaker Combustion Engineering (CE) in 1990. The subject of asbestos never came up when ABB announced the takeover: CE stopped using asbestos in the early 70s and corporate lawyers seemed to have liabilities under control. ABB ran the numbers and the risk seemed to be manageable. However, as far as known, no proper environmental due-diligence was done. After an industry-wide class action was rejected by the US Supreme Court in 1997 the mass of liability claims began to surge again. Only a small part of the liabilities were covered by ABB's insurance and the firm announced in November 2002 that it might seek bankruptcy protection for its US subsidiary CE as asbestos claims ran out of control. The next day Moody's downgraded its debt to the lowest possible investment rating and ABB shares lost more than 40% of their already declining value. ABB reached a settlement of US\$ 1.3 billion, which was approved by a US court in June 2003.

It is also noteworthy, that a number of European insurers acquired US American subsidiaries in the 90s and massively underestimated their exposure to asbestos claims, first and foremost the German insurer Gerling which so far has narrowly avoided to go out of business. Observers point out that asbestos is only one cause of litigation: "tobacco, lead paint and pharmaceutical products are all ripe business opportunities for lawyers, who routinely earn 30-50% of settlements" (Economist, 26 Nov 2002).

Impacts on financial companies:

- insurance liabilities
- losses/ write-offs on equity holdings

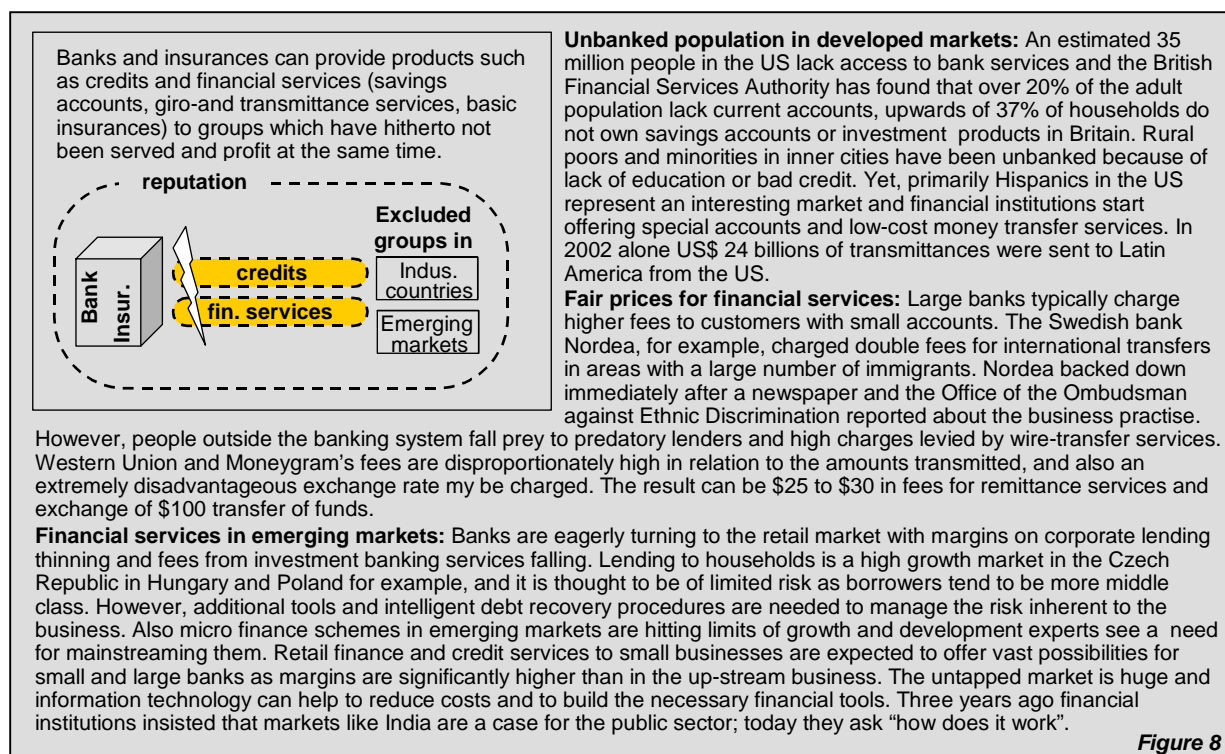
Climate Change: Natural Disasters⁶

Economic losses worldwide due to natural disasters appear to be doubling every ten to twelve years. Each year now brings four times as many weather related disasters as 40 years ago, resulting in eleven times the insurance losses or the equivalent to US\$ 10 billion per year during the 1990s. Given that current trends persist, annual losses will within the next decade come close to US\$ 150 billion, of which a significant part will be insured. Re- and primary insurers are still writing catastrophe policies, but they have been excluding more risks and tightening conditions. Experts stress that companies should better take a holistic view of their catastrophe risk rather than writing policies too cheaply in good times and turn down new business irrationally after each unexpected disaster. Most re-insurers have done their "homework" and quantify more carefully their exposure to natural disasters, e.g. with the help of computer modelling. A need for action is especially seen with primary insurers, where risks from single customers are being covered: here local risk factors need to be analysed and inserted into insurance products as risk maps and models of the re-insurers are too wide-meshed. First computer tools like ZÜRS in Germany (identifying areas with a high risk of flooding) are coming on the market and increase risk management capabilities. Due to their direct contacts with customers, primary insurers can identify and mitigate risks before policies are written (e.g. by encouraging customers to take precautionary measures against storms or heavy rainfalls). Better instruments and risk analysis of primary insurers can therefore help to anticipate negative impacts of climate change.

Impacts on financial companies:

- insurance liabilities

The cases described focused on the business with commercial customers. However, it is also important to shed light on a direct sustainability issue for financial institutions: financial exclusion in industrialized as well as in emerging markets. In Western countries, the strategic objective of main-street banks over the past decade has been the cross-selling of services such as brokerage accounts and insurance products to wealthier clients, often ignoring low income groups and rural populations. Also, in emerging markets financial institutions in their business strategies focused on the wealthy, municipal clientele. Figure 8 below looks at the fact that large untapped markets exist in industrialized countries and emerging markets which can be cautiously opened up.⁷



Company Specific Factors behind Business Cases - Value Drivers

The examples and the preceding section showed that many different business cases exist and that there is no such thing as a single BCS in the financial sector. A business case is company specific, in the sense that it depends firstly on the **business operations** pursued, secondly on the **markets** or regions where the company is active, thirdly on the **country of origin** (location of headquarters) and fourthly on the **size of the company** (market leadership and public visibility):

- First of all, and most importantly, business operations characterize the sustainability issues companies are exposed to. A financial company that mainly conducts its business within the real-estate business will deal mostly with issues of residual pollution and contaminated property.
- Secondly, markets / regions where a company conducts business are important: a trade finance bank that is involved in emerging markets will be significantly exposed to emerging market issues. Markets of operation also determine which regulations (legal system), official approvals or certified standards are of importance for client companies and therefore indirectly for financial institutions.

The remaining two aspects - country of origin and company size - are closely linked to the likelihood of the organisation serving as a target for activist groups and to the idea that reputation represents a "transmission belt" for issues:

- The country of origin and headquarters location play an important role in determining whether sufficient pressure can be put on financial institutions. The example of the Dutch palm oil campaign shows that the awareness of the general public, the politicians and also the account holders was sufficient to exert pressure on Dutch banks in such a way that they altered their practices. When this case was presented at a UNEP FI conference in Paris in January 2003, a French banker remarked that he could not see the relevance for French institutions because he had never noticed any similar protests in France (however, an emotional issue for the "French market" might turn the tide).
- Market leaders and companies with well-known public images are more likely to be targeted. An interviewee at a smaller bank pointed out that: "The outside pressure on us is not great. It is greater on the other [national] banks, which are larger and also well known internationally. What we are doing is internally motivated, whereas they mostly react to external pressures, for example from NGOs." Also, it was stressed by interviewees that stand-alone investment banks with limited ties to private customers and an unknown public face, are less exposed to public demands.

Even though business cases are company specific and very diverse, the interviewed managers perceived that the underlying value drivers - and therefore the opportunities behind the strongest business cases - are risk management (RM) and reputation. This is apparently the case because sustainability issues mostly represent risks for financial companies. As one banker pointed out, a business case is primarily about influencing down-side risks, as there is no “direct feedback mechanism”. In other words: if commercial customers are performing better due to better management of sustainability issues, the financial institutions will not receive higher interests, fees or insurance premiums. They can only indirectly profit from the reduced likelihood that customers will default on credits or create insurance or compensation liabilities.

The risk to reputation due to sustainability issues also represents a down-side risk. West LB for example, the fifth largest German bank, was attacked by Greenpeace in 2002 for financing the construction of an oil pipeline in Ecuador. Climbers protested on the façade of the main building for two weeks. One of our interviewed banks indicated that it had refused to take on the project before West LB came under pressure, due to the environmental sensitivity of the project. However, as the interviewee stressed, there is no public reward for refusing a deal and for having taken a right decision.

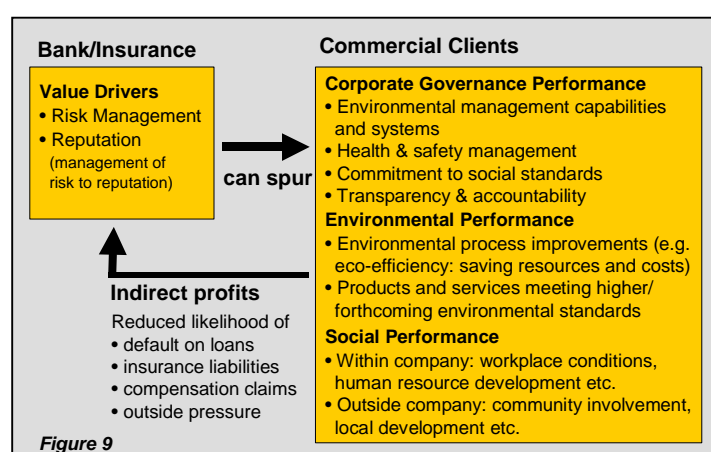
The financial sector has always focused on being informed and managing risk, but it is not the norm for companies to have managers and risk experts who are sensitive to sustainability issues. As a banker stressed, “social and environmental risks are often seen separately from financial risks. They are not seen as actually belonging together.” Interestingly, most interviewees on being asked what is the benefit of the company’s management of environmental and social issues, answered that it is better management of risks to their reputation. However, this result could be biased as a number of interviewees worked in staff functions that are often concerned with sustainability

The SRI-business case

SRI funds which usually invest with the help of broadly defined environmental and social criteria do still represent a niche market, yet, one with high growth rates. In Germany for example SRI funds account for about 1% of managed capital. However, due to regulators institutional investors might become more interested in SRI products, as a new law requires certain pension funds to disclose on how they consider sustainability issues.

For most banks/insurances it is mostly not a major challenge to open an SRI fund. Normally a large number of funds already exists, and the available expertise is used in combination with the chosen SRI criteria. The real challenge is to adequately monitor relevant sustainability risks in “normal” funds which are managed with a strong reliance on mathematical models.

Seen from a financial company perspective an SRI fund is a business case if investors want to buy the product and are willing to pay an extra amount for the transparency and for knowing to where their money goes. A business case can therefore exist for a bank/insurance, even though an SRI fund is under-performing. Research shows that SRI funds are normally neither performing much worse, nor better than baseline indices.



issues representing a reputation risk for firms. New products and business opportunities are not major value drivers: carbon trading solutions or broadly defined socially responsible investment funds (SRI), for example, are seen as niche markets in the near future (see text box above).

Critics might brush aside this assessment, saying it is too reactive. However, this study of banks and insurance companies shows that as drivers for their commercial customers, risk management and reputation are by far the most important value drivers. Additionally, they can spur proactive reactions: serious RM and reputation management in financial companies can mean that customers are obliged to manage their sustainability risks and opportunities appropriately (see figure 9).

3.4 Why are Business Cases not Exploited

The following section will try to shed some light on why business cases for sustainability are not exploited by banks and insurance companies. Barriers at commercial clients are explored first, and then barriers in financial companies.

Barriers in Client Companies

Companies generally have little incentive to disclose risk relevant sustainability issues because these might make it harder to receive funding or insurance cover. Clients can have management systems in place which help them to control sustainability issues. In the case of certified environmental management systems - such as ISO and EMAS - it is even obligatory to regularly update checklists with environmental risks. However, companies may also be unable or unwilling to spend resources on a proper management of sustainability issues. ABN AMRO, for example, found itself unexpectedly attacked in 1998 for its investment in the Freeport Mine in West Papua / Indonesia. After having cross-checked the presented allegations of pollution and human rights abuses in connection with the mining activities, the financial institution came to the conclusion that the campaigners were right. The bank's initial assessment of their client was "based on paper", but in reality things were out of control: promised standards were not being met by the mining company and the environmental impact was considerable. Therefore the assessment of corporate governance and the management's commitment to adequately manage sustainability issues is important from an investor or insurer point of view.

Barriers in Financial Companies

Financial companies do not always know which issues are of importance for their clients. This is understandable, because there is a natural limit of inside knowledge and expertise since bankers and insurers do not run the business operations of their commercial clients themselves. However, social and environmental risks are apparently often seen separately from financial risks in the short-term. Also, it is rare for staff to have specific country experience and industry background. An interviewed banker said that some colleagues accept numbers and costs provided by clients which are unrealistic and fail to scrutinize them sufficiently. The WWF found in its study on Indonesia's pulp & paper industry ("Profits on Paper", November 2000) that due-diligence reports are often based on information provided by companies. An interviewed financial analyst stated in the WWF study that he generally visited pulpwood plantations once a year, but since he had no training in forest management he could not know if he was seeing 50,000 hectares or 100,000 hectares. The documents of audits, made by forestry consulting firms for clients, were actually not consulted as firms treated them as highly proprietary. And commissioning independent audits was not possible because the companies operated behind "a corporate veil". Besides not taking due notice of the risks, some potential issues are also not properly addressed by analysts or risk officers because new risk models and as yet unknown calculations, which cost time and money, are needed.

In fact, investment banks and their staff may have strong incentives to avoid looking too closely at the projects they finance. With bond offerings in particular, these banks make substantial profits on commissions, which are generally based on the number of notes or shares that investors purchase and the total value of the capital raised. The incentive structures for investment bankers mostly have a very short-term horizon, as their bonus usually rewards them for doing the deal. The time perspective of incentive systems is an especially critical issue in the primary and re-insurance businesses, where long-term risks might only materialize long after the policies were written. Bonuses which are directly linked to a specific deal do not motivate underwriters to be cautious. Also, in the case of reputation risks, it is hard to balance the interests of the firm and the business unit. Business units sell their products and services to meet their targets, and they might not see any advantage in putting their own interests behind the firm's.

Direct and long-term contact with clients is important in order to influence and improve a project. An interviewee stated: "Where you have contact with a client, you have more information and you can exert influence. Units which have no direct customer relations often underestimate the importance of sustainability management." However, the risk-spreading strategies to finance projects in consortia restrict the direct contacts of each bank with the clients they are financing, and time is often too short to properly cross check available data. Yet the leading banks of a consortium are in close contact with

the clients, and they play a crucial role in exerting influence at company level. A similar situation also exists in the insurance industry, where premiums are written in the re-insurance market or major exposures are shared by consortia. The company in close contact with the end-customer plays an important role in mitigating risks.

Asset management arms of banks and insurance companies can also influence firms whose stock they own, for example via shareholder resolutions and activism. However, fund managers who are in a highly competitive business remain extremely reluctant to interfere with companies. John Plender found in his book (“Going off the Rails – Global Capital and the Crisis of Legitimacy”, 2003) that asset managers, who are seen to adopt an active interventionist stance with companies, may alienate corporate clients whose pensions fund they already manage as well as potential clients. If fund managers are part of an investment bank, activism may also be a deterrent to companies using the corporate finance services of the same bank. Within insurance companies conflicts of interest can exist, e.g. if insurance clients transfer their policies to a more compliant insurer in response to activism. John Plender also points to the fact that the performance of asset managers “is assessed by consultants and trustees on the basis of short-term deviations from their competitors. And while their approach to investment is now very theoretical, with growing reliance being placed on mathematical models, their ability to monitor company management is relatively unsophisticated in comparison. And since monitoring is costly, fewer resources are devoted to the task than it deserves from a wider economic and social perspective”.

4 Strategies Addressing Sustainability Issues

Sustainability issues can impact the value creation of financial companies and many different forms of business cases exist. This section looks at measures or strategies which represent a business rationale for companies because they help to manage relevant issues. The section first looks at the management of sustainability issues through a staff unit at the corporate level. Then three measures within the core business are described: the “Equator Principles”, an industry approach for assessing and managing sustainability risks in project finance, an IFC strategy which helps to improve sustainability criteria for financing projects, and a process implemented by Swiss Re which can help to better address sustainability risks.

4.1 Corporate Sustainability Management Staff Unit

Of the 18 companies interviewed, 12 had corporate staff units dealing officially with environmental and social issues, four had environmental management units which have not officially established the concept of sustainability, and two companies did not have any special unit but only a single manager and temporary teams in charge. Our research indicated that corporate sustainability units (those units which deal officially with environmental and social issues) are primarily charged with the internal and external communication of sustainability efforts and the monitoring of issues. But the units are anchored at different places in corporate centres, and their integration within the companies varies. The following section takes a closer look at the tasks of these units and their organizational set-up.

External Communication

One of the crucial goals of external communication is to satisfy the demand for more transparency. However, for inherent business reasons, transparency has its limits. The head of a sustainability unit pointed out: “Already in the past, deals were refused for environmental and social reasons. Now we are forced to make it explicit, write it down and measure it against our policies. But a bank cannot be fully transparent for reasons of confidentiality. We have to find a proper balance between business confidentiality and transparency.” Units help to inform the public about achievements and, in rare cases also, failures and difficulties are addressed openly. It is expected that this approach will increase credibility and help to address the fact that not only transparency but also the responsibility of single organizations have their limitations.

Companies can propagate their message in several ways: articles in newspapers, articles in corporate publications, speeches by top management, participation in conferences, colloquiums etc. In many cases much time is spent by corporate units on generating environmental, sustainability or CSR

reports. Yet, different perceptions exist about the value of reports, as our interviews revealed: one group of interviewees thinks that sustainability reports are unimportant because they do not find readers. Media reports or newspaper articles are, in their eyes, more effective. Information concerning the in-house management are placed on the Internet and other issues are covered from time to time in a corporate journal. Another group, however, is keen on pushing sustainability reporting in the direction of “value reporting” and to place it in the company’s main annual report to better demonstrate the link between corporate sustainability efforts and other business issues. Different perceptions also exist about the timing of reports. Whereas one group maintains that a complete environmental report should be published annually, another group thinks this is not necessary: in this instance, in-house management information is available on the Internet and reports are published every two to three years. This is considered sufficient as changes within a one-year time span are seen as incremental.

As no common standard exists, the structure and contents of reports vary widely. An interviewed consultant noted: “Up to now, surprisingly, reports are well perceived by normally critical groups, even though they are weak on indicators, tasks and their relation to business.” One environmental manager also pointed out that he had the impression that “in many financial institutions sustainability is being replaced by a sustainability report.” An NGO representative said that activist groups are becoming increasingly impatient with corporations handing out glossy brochures and giving “Sunday sermons” about changes, while their day-to-day management is not involved and moves in another direction. Also, organizations such as the UNEP FI, that provide a forum for financial sector companies’ activities in the field of sustainability management, are increasingly seen by activists as a “talk-shop”.

Internal Communication

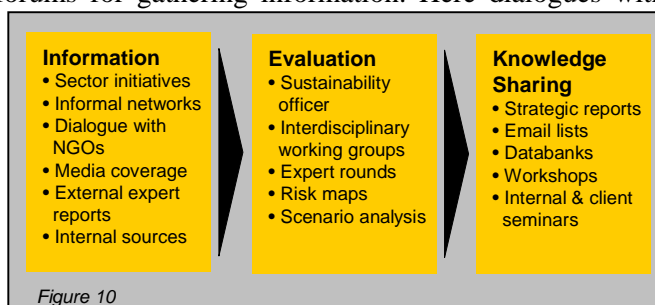
Information in the form of reports and articles primarily targeting the general public, is also used to create awareness within the organisation. In some cases, extensive intra-net resources are made available, including databases for emerging and known sustainability issues, guidelines etc. The IFC has built up an easily accessible database of a significant number of case examples of potential client companies, ranging from cost savings due to operational efficiencies in a bank to risk reduction through stakeholder involvement in a coal-mining project. This information is intended to sensitize employees to risks and opportunities arising from sustainability. Units see the education of upper management as key to creating awareness also within business units. Swiss Re, Allianz and ABN AMRO for example have seminar sessions for upper-management members on sustainability and its impact on business. In presentations and seminars, corporate sustainability staff often relies on case studies, success stories and risk maps to present the value of business cases.

Units in most companies are involved in anchoring sustainability criteria within codes of conduct and mission statements. It is expected that this will raise awareness and trigger changes in behaviour within the company to better exploit existing and future business cases. But it was also stressed by interviewees that it is difficult to alter the values and culture of a company. If the leadership cannot plausibly live up to the values - because they are not compatible with the short-term business goals it pursues - changes will have limited effects on the organization in the long run because organizations may listen to what managers say, but in the end they believe in what managers actually do.

Issue Management

In half of the companies interviewed the sustainability officer himself – with his formal and informal network – was seen as an early-awareness-system (EAS). Some companies have also set up procedures and computer-based systems to support EAS capabilities: Allianz created an intuitive tool based on functionality and efficiency requirements. An interdisciplinary trend assessment team regularly evaluates external reports. Swiss Re has created a database system - “a systematic, interactive risk perception platform” - which supports the risk recognition process. This database of loose indicators, inferences and solid facts is fed by risk management and underwriting staff and is supported by interdisciplinary workshops. The main problem, as an interviewee stressed, is usually not the availability of signals or information, but their evaluation in the RM process. Companies with elaborate early-awareness-systems have found that it is important that an efficient and transparent process be set up and applied to regularly assess information. Figure 10 shows the main elements of EAS that were found in the researched companies.

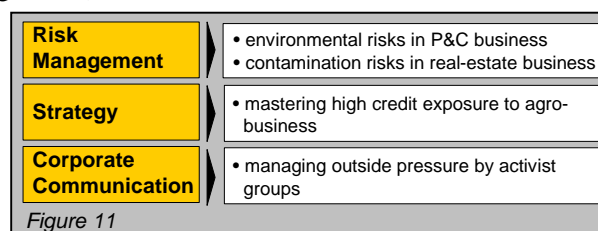
With few exceptions, all companies considered sectoral initiatives and networks, such as the UNEP FI and WBCSD Finance Group, as important forums for gathering information. Here dialogues with opinion leaders, such as experts and NGOs, are often easier to establish than outside. And firms find that they can here learn from their competitors' experiences. For example, when hearing about the Dutch campaign against the financing of palm oil, an interviewed sustainability officer from another European bank sat down with the responsible business people and they decided to divest their own engagements.



In the case of a “burning” issue that has just erupted – e.g. when activist groups or the media target a financial firm – sustainability units in some companies act as a coordination function beside the “fire department” (PR/communications) to ensure that the right signals are being sent to the outside world. An activist noted that financial institutions are sometimes badly coordinated – meaning that departments communicate and interact with pressure groups independently from each other – thus creating misunderstanding.

Organization and Integration of Units

Sustainability units are anchored mainly in three departments at the corporate centre – risk management, strategy, and corporate communications – because companies were initially confronted with issues in different ways (for examples see figure 11). A number of interviewees, who worked in sustainability units attached to risk management and strategy departments, raised concerns about the placement of units in communications/PR, as this function was not seen as a strong enough basis for supporting actions in the core business. Of the 18 companies interviewed, all except two American units reported directly to a board member. It was stressed by interviewees that such a “personified responsibility” at the highest level is crucial. The size of units varied. In a few companies only one person was responsible, but in ten companies three to five persons were employed.



In most cases, a committee with high ranking members from different functions and divisions helps to integrate the unit with the company. Swiss Re even set up two committees for more effective integration: a strategic steering committee consisting of top-management representatives which influences corporate sustainability management actions “top-down”, and an operational committee consisting of divisional representatives which influences activities “bottom-up”. Also, the importance of informal networks – inside and outside the company – should not be underestimated. Comrades-in-arms have to be found within the company, and champions in the management are needed to achieve the broadest possible base of support. An American officer put it this way: “It’s a bottom-up and a top-down approach. It is important to find the right internal advocates: it’s politics, it’s sales.”

Corporate sustainability units mainly interact with the human resources (HR), communications (PR, investor relations etc.) and risk management departments. Questionnaires from sustainability rating agencies are filled out jointly. Seminars, training and communication concepts are developed together. Fields of competence are well defined. HR, for example, is already established as the internal social conscience: “One gets a bloody nose when trying to poach within HR’s territory”, an officer said. None of the functional units was organized as a profit centre. The allocation of a budget – allowing for staffing, project work and travel expenses – is seen as essential.

Comments on the Findings

The adequate organisational set-up of units and the issues they deal with are company specific: a big trade-finance bank like ABN AMRO, with a strong private customer base, is more prone to reputation risks originating from activist groups than a re-insurance company like Swiss Re. Sustainability units can help financial firms to better deal with outside pressure on a corporate level but they can also play

the role of a "challenger" in cases where the core business units fail to take relevant issues into account as well as help to create adequate solutions (see strategies in the following sections which were crafted with the help of sustainability units). However, the existence of a sustainability unit is no guarantee for effective changes within the core business. Besides people who have communication skills and are able to think "out of the box", sustainability units clearly need officers with a thorough understanding of the business the company is in.

Assessing the benefit of sustainability units and their activities is not obvious, since they do not directly contribute to a company's business success. Other departments, such as IT, HR, RM, communications and strategy, face similar problems. Sustainability managers can learn from colleagues in these departments how to move business cases forward. Even a simple back-of-the-envelope calculation can be helpful in presenting business rationales and convincing managers; success stories and best-practices can also be useful as cost-benefit arguments are sometimes closely connected. In some cases, however, clear language is lacking when sustainability units communicate with other departments, and the use of sustainability jargon and fuzzy definitions can disconcert managers. Failure to demonstrate benefits in stringent management terms can have significant negatives: firstly, line management might formally accept guidelines backed up by the board without being convinced and supporting the decision internally. Secondly, if a change in top management takes place, or the company finds itself in a crisis, economic justification of existing activities, and even of the unit itself, might be demanded.

4.2 Equator Principles

Internationally operating banks have often been attacked for their project finance activities, especially in the mining, oil and gas, and forestry sector in recent years. Project finance, or limited resource finance, refers to projects where the repayment of the loan is dependent upon the revenues that a project is expected to generate. In June 2003, ten leading banks adopted a voluntary set of guidelines, called the "Equator Principles", for managing environmental and social issues relating to the financing of projects in developing countries. The guidelines will be applied to project financing with a capital investment of US\$ 50 million or more. The ten committed banks - ABN AMRO, Barclays, Citigroup, Credit Lyonnais, Credit Suisse Group, HVB Group, Rabobank, Royal Bank of Scotland, WestLB, and Westpac Banking Corporation - underwrote approximately US\$ 14.5 billion of project loans in 2002.

The principles are based on the policies and guidelines of the World Bank and IFC. A screening process is used which categorizes projects as A, B or C, meaning high, medium or low environmental or social impact. For projects falling in categories A and B, the borrower will have to carry out an environmental assessment (EA), which addresses issues shown in the text box.

An EA will have to refer to the minimum standards applicable under World Bank and IFC sector-specific pollution guidelines, and will also have to indicate compliance with applicable host country laws, regulations and permits required for the project. After consultation with affected stakeholders, high-risk, and if necessary medium-risk, projects will have to prepare environmental management plans which address the mitigation and monitoring of environmental and social risks. The borrower is obliged to comply with such plans during the construction and operation of the project, and to provide regular reports on compliance.

The initiative has been received positively by the NGO community as it helps to meet their insistence on more transparency and better monitoring of the activities financed. Also, the "Equator Principles" help banks to use a common terminology in the sustainability assessment of projects financed in consortia. A manager of a bank participating in the initiative stressed that "the principles are to be applied to all deals, as a leader or a participant". The common approach can therefore improve

- Protection of human health, cultural properties, and biodiversity, including endangered species and sensitive ecosystems
- Use of dangerous substances
- Occupational health and safety
- Socio-economic impacts
- Sustainable development and use of renewable natural resources
- Land acquisition and land use
- Involuntary resettlement
- Impacts on indigenous peoples and communities
- Participation of affected parties in the design, review and implementation of the project
- Efficient production, delivery and use of energy
- Pollution prevention and waste minimization, pollution controls (liquid effluents and air emissions) and solid and chemical waste management

restricted control in a non-leader position. However, as guidelines are adopted voluntarily and independently by banks, it remains to be shown in practice that they can be applied credibly.

4.3 IFC's Sustainability Framework

IFC's Sustainability Framework is applied in the financing of private companies in regions and sectors underserved by investments from private sources and goes beyond World Bank and IFC minimum standards (which are also applied within the "Equator Principles"). The underlying assumption of the Framework is that private investments in developing countries may contribute to environmental, social, or corporate governance improvements besides the productive use of capital. The Framework is intended to open the views of investment officers to risks, and especially opportunities, in the area of sustainability. It defines what going beyond minimum "no harm" requirements means and as one officer pointed out: "It is not about high sounding goals. It is about making the project better."

Based on the research of a group from across the IFC (whose findings are also presented in the study "Developing Value - the business case for sustainability in emerging markets", published by SustainAbility and IFC in 2002), the Framework divides the sustainability landscape of potential commercial customers into three main areas: firstly **management commitment and governance**, secondly **environment** and thirdly **socio-economic development**. These three overall themes have been further subdivided into eight "sustainability factors", which in the eyes of the IFC competently represent the areas where projects are most likely to contribute to sustainable outcomes and sound business management (see box). Project teams assess, on a voluntary basis (where it makes sense for clients), whether sustainability factors can further strengthen the value creation of the companies. Depending on each business case, the payoff to the client firm in the case of a "win-win-situation" is seen within six financial drivers: a) cost savings, b) revenue growth and market access, c) access to capital, d) risk reduction, e) human and intellectual capital, f) brand value and company reputation.

- | |
|--|
| <ul style="list-style-type: none"> • Management commitment and governance <ol style="list-style-type: none"> 1) Environmental management, social development commitment and capacity 2) Corporate governance 3) Accountability and transparency • Environment <ol style="list-style-type: none"> 4) Process eco-efficiency and environmental footprint 5) Product/service environmental performance • Socio-economic development <ol style="list-style-type: none"> 6) Local economic growth and partnerships 7) Community development 8) Labour force health, safety and welfare |
|--|

In the Framework each sustainability factor is differentiated into 4 performance levels. A "level 1" performance indicates that a project complies with IFC and national minimum standards. A "level 2" project handles environmental and social issues in such a way that they exceed minimum standards. The criteria for each factor and the respective performance levels are closely defined in the tool. Figure 12 shows the details of the Framework with the performance levels and the respective development benefits. The IFC is aware that in some frontier markets minimum standards may be all that can realistically be achieved, and to do more may be inappropriate or counterproductive. To encourage investment officers to strengthen projects and improve their development impact, the department scorecard is linked to the measured development or sustainability impact. The percentage of the departments' new commitments, which meet criteria for "high impact" according to the Framework, is reported monthly. Reviews of the project and its performance level take place once it is completed. Yet, there are also sceptical voices. One officer said, when asked what had changed with the new Framework, that "... you have to write better English now in order to explain that a project has a high development impact". Currently the Framework is in its first year of pilot implementation, and its impact and utility is being tested.

Performance Level	Development Benefits
Level 1: Complies with IFC and national minimum guidelines	<ul style="list-style-type: none"> • The economic activity conducted by the project or company is in accordance with accepted national and international (IFC) standards for mitigating potential environmental or social harm stemming from the activity.
Level 2: Added environmental, social, or corporate governance value	<ul style="list-style-type: none"> • Handling of environmental/social issues materially exceeds minimum standards. • In so doing, the project or company creates local or global benefits in terms of reduced waste, emissions, or use of natural resources of its economic activity or helps spread the benefits accruing from its economic activity to the local community or to groups which often fail to benefit from such activity. • Corporate governance practices are good enough to affect positively views of investors about investing in the country.

Level 3: High performance	<ul style="list-style-type: none"> • Handling of environmental and social issues materially exceeds World Bank minimum standards. Formalization of practices or other steps enable good practices on environmental, social and corporate governance issues to leverage change broadly within a region, a sector or a supply chain. • Economic activity beyond the firm is influenced in the direction of improved resource intensity and inclusion of new beneficiaries. • Corporate governance attributes of the project are sufficiently advanced so that a demonstration effect is possible.
Level 4: Leadership	<ul style="list-style-type: none"> • Company is actively engaged on many fronts in the dissemination of best practice • Economic activity well beyond the firm is influenced in the direction of improved resource intensity and inclusion of new beneficiaries. • Firm is seen as a global governance leader, with wide influence.

Figure 12

The Framework can increase the transparency and monitoring capacity of activities being financed. It can also motivate officers to strengthen a project and its sustainability performance during the investment process allowing IFC's extensive environmental and social review process to be better aligned. Indirectly, the IFC can also profit from a better performing project, as it decreases the risk of default. Privately owned financial companies may consider the Framework as costly in time and resources and that they cannot afford a large environmental and social development department to support their investment staff. But the tool is a first and innovative step, and ten years ago when the first World Bank minimum standards were drafted, it was by no means clear that international banks would adopt them in the form of the "Equator Principles".

4.4 Swiss Re's Risk Review Process for Sensitive Risks

To encourage staff to bring up potential sustainability risks, Swiss Re has developed a special process (especially for cases where reservations are present within business units to address these). If staff members are in doubt about sustainability or ethical aspects of a proposed transaction, they are asked to contact their compliance officer or the group compliance officer for guidance. If required, group compliance will convene an ad-hoc task force composed of competent Swiss Re specialists. A formal recommendation is issued by the task force which can be escalated up the management line. The final underwriting decision has then to be made within the business unit (see figure 13).

The procedure is anchored within the group code of conduct and makes it clear that there are experts within the organisation who can be officially consulted, and not only a sustainability unit to give advice. The process can provide better monitoring of sustainability-related risks and more transparency on decisions made in difficult cases.

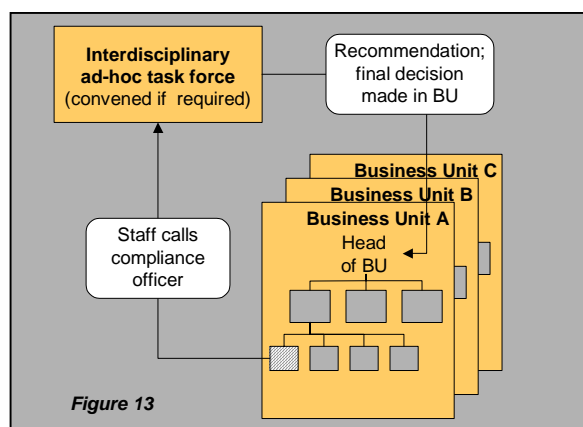


Figure 13

5 Conclusion

The goal of this research was to gather evidence for a business case for sustainability in the financial services sector. The research results indicate that sustainability will pay in the long run, though it certainly does not always make good business sense to take environmental and social factors into consideration, especially in a limited short-term perspective. Our research shows, however, that many different business cases exist. They are company specific and depend, inter alia, on the business operations pursued, the markets where the financial company is active, the country of origin and the size of the firm. But business cases are often not exploited for several reasons: Customers have limited interests in disclosing their risks; industry knowledge and appropriate tools and guidelines to identify sustainability risks are sometimes missing; incentive systems are focused on short-term results and do not motivate staff to tackle sustainability issues.

Several strategies exist for exploiting business cases. The approach of forming sustainability units, adopting RM processes, introducing minimum guidelines (the "Equator Principles") and the IFC's

Framework encapsulating sustainability factors for customers have been discussed in this report. However, these are strategies adopted by companies for their specific needs and line of business. But when leafing through the glossy sustainability brochures, it appears that many firms copy very generic sustainability or CSR approaches from their competitors. This is probably because it is easier to get top management acceptance by presenting sustainability jargon rather than applicable, concrete measures. Non-binding agreements are normally easy to reach.

It is ultimately in the core business operations that sustainability risks are being “acquired”, through credits, insurances and other products and services. Useful communication and issue management strategies exist but they do not necessarily involve changes here. When trying to build strategies which involve the core business, companies should try to set small and realistic goals. Strategies should strike a balance between potential costs and benefits. In the eyes of the author, companies should regularly assess their business operations and processes in order to localize relevant sustainability risks - and the opportunities that are inherent to their proper management. Based on company-specific assessments, strategies can be developed for different activity levels: the corporation, business unit, product and employee level.

Results are often hard to measure because relevant sustainability activities, such as risk and reputation management, only contribute indirectly to a company’s business success. There is generally no direct feedback mechanism. Business and risk management models of companies are complex and already need to be adapted to different cultural backgrounds. The additional complexity caused by sustainability measures should be as low as possible and they should be easy to integrate into existing processes and procedures.

Besides an economical rationale, there is also an ethical and political component to sustainability that has not been developed in this report. Financial companies certainly cannot take on responsibility for all of the demands some contextual stakeholders are placing on them. Yet, companies need to discuss where their respective limits of responsibility lie and to take into account changes in stakeholders’ expectations about responsible corporate conduct. In our eyes, financial firms have to be aware of the fact that they cannot unconditionally dismiss responsibility for the projects they are financing or insuring. The presented findings allow the assumption that societal groups increasingly expect financial firms to exercise the influence they have on the private sector.

List of Interviewed Companies and Organisations

	Interviews (number of interviewees)	Functions (of interviewees*)	Time (hours)
Companies			
ABN AMRO	3	SM; COM	3
Allianz AG	2	SM; HR	3
Bank of America	1	EM	1
Citigroup	1	EM	2
Credit Swiss Group	3	SM; COM	3
Dresdner Bank	4	SM; COM; LM	4
Fleet Boston Financial	2	EM	3
Friends Provident	1	SM	2
HVB Group	1	SM	3
IFC	15	SM; EM; LM; SD	12
ING Group	1	SM	1
KfW	1	EM	2
Morgan Stanley	1	SM	2
Rabobank	3	SM; LM; ST	4
Sarasin Bank	1	RE	1
Storebrand	3	SM; RE	5
Swiss Re	8	SM; COM; LM; SD	10
ZKB	1	EM	1
Consultancies			
Arthur D. Little (Cambridge)	1		2
Deloitte & Touche (Zurich)	1		1
ECOFAC AG (Zurich)	1		2
Ecos Corporation (Boston)	1		1
PwC (Zurich)	1		2
NGO's & others			
Friends of the Earth (USA)	1		2
GermanWatch	1		1
SAM Group	1		1
UNEP Financial Initiative	1		1
WWF-UK	1		1
	62		77

* COM (communications / public affairs); EM (environmental management); HR (human resources); LM (line management); RE (equity / SRI research); SM (sustainability / CSR management); SD (strategy development)

End Notes / Sources

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