Finance, Environment and Sustainable Development

Corporate Responsibility and Capital Markets
Managing Qualitative Risk Issues – January 10, 2003

European Seminar Report

A joint event of:

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Innovative financing for sustainability

ORSE

SOCIETE GENERALE GROUP

CAISSE DES DÉPÔTS ET CONSIGNATIONS

DEXIA

Finance, Environment and Sustainable Development
An Expert Seminar on Corporate Responsibility and Capital Markets
Managing Qualitative Risk Issues

Seminar Report

Editors: Paul Clements-Hunt and Kiki Lawal

January 2003

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We are also grateful to our keynote speakers Philippe Citerne of Société Générale, Jacqueline Aloisi de Larderel of UNEP and Elisabeth Guingand of Caisse des Depôts et Consignations for their assistance and introduction. Lastly many thanks go to Société Générale for the warmth of their welcome.

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Welcome & Introduction

Philippe CITERNE
Deputy Director General, Société Générale

We are honoured to have so many people present at this event, which was jointly organised by Société Générale, Caisse des Dépôts et Consignations and Dexia, all of which signed the Financial Institutions' Declaration on the Environment, United Nations Environment Program Finance Initiatives and ORSE. Given that Société Générale has made a commitment to sustainable development, we felt it necessary to enter into exchanges with other companies, and have thus become members of ORSE (Observatory on Corporate Responsibility). We would also like to thank the UNEP FI for providing our sector with a forum where ideas can be shared and discussed.

In our business, the spirit of corporate responsibility and sustainable development is traditionally to be seen in relation to our everyday stakeholders; meaning our customers, our shareholders, and our colleagues. We see it as only natural that we should extend our business responsibilities to those parties into the natural and social spheres. This belief has been reinforced and encouraged by national and international bodies to such an extent that it simply cannot be ignored. However, it is far more than an obligation. It is a concept in which we believe and to which we aspire, an area in which we want to set an example through our virtue.

I am certain that you will have numerous comments and questions. Here are a few…

- First topics to be considered with respect to social responsibility, how can we reinforce cooperation among the regulatory bodies and between companies? How can we improve our effectiveness and better understand our responsibilities, we who enable and process millions of transactions every day, throughout the world?
- Secondly, should we only propose ethically dedicated funds, eliminating all others?
- Thirdly, when we finance activities that carry an environmental risk, how much should we do to advise and prevent? To what extent should we be held accountable? How can we coordinate our actions with those of organisations such as the World Bank, the OECD and Coface, which all have their own rules? How can we try and build new forms of solidarity and share broader risks, such as those resulting from terrorist risk?

For our part, the Executive Committee of Société Générale Group made a commitment a few weeks ago on orientations to be implemented in 2003, and it decided to work in four main directions: to continue to provide information to all our employees and thereby raise awareness about sustainable development; to develop standardised social practices around the world; to clarify and systemise our policy in the field of the environment throughout the Group, including its credit activities; to gradually improve reporting at Group level of our social and environmental performance. This last target on reporting and performance is certainly one of the most important tasks for us all in order to measure, compare and make progress together.

I would like to take this opportunity to extend my sincerest thanks to Ms Jacqueline Aloisi de Larderel for the work she has carried out at the UNEP over the past years. We would not be here today without her unflagging efforts to raise the corporate world's awareness and interest in the topic of corporate responsibility**.**

Keynote Presentation

Jacqueline Aloisi DE LARDEREL
Assistant Executive Director, UNEP DTIE

On behalf of UNEP, I would like to welcome you all, and thank the organisations that joined us in preparation for this meeting. UNEP can be likened to a Ministry of the Environment within the United Nations, just as UNESCO is the "Ministry of Culture". It was founded 30 years ago, following the UN Conference on Humans and the Environment. The organisation is a small one, employing 500 people around the world and operating on a budget of USD 50 million, provided in large part by the world's governments. In addition, we receive funding for specific projects. While we are a small structure, we work as a catalyser and in partnership with many other groups and institutions, as exemplified in this meeting. Our slogan is "Environment for Development": in other words, sustainable development is impossible without a sound environmental and ecological foundation.

UNEP serves three major roles. The first is to assess the state of the global environment. Our third Global Environment Outlook Report published after the World Summit on Sustainable Development (WSSD) in Johannesburg, showed that we are facing many major problems and challenges, including climate change, water pollution and supply, biodiversity, soil degradation and general contamination of the environment by chemical products.

The organisation's second role consists of proposing solutions to these problems/challenges by building international consensus on international legislation and regulations. We were, for instance, involved in developing the Montreal Protocol, intended to protect the ozone layer, and also contributed to the Conventions on Climate Change, Biodiversity, Waste Materials and Persistent Organic Pollutants. However, as regulations alone cannot tackle these issues, we also work directly with voluntary industrial groups and businesses, in areas as diverse as tourism, telecommunications or advertising to obtain voluntary compliance.

In addition, we have worked at developing a number of measurement tools, since that which is poorly measured cannot be well managed. This was the premise behind our work on the Global Reporting Initiative (GRI), intended to develop a standard for sustainable development reports internationally.

Our third and final mission is to offer training and information about the aforementioned tools and systems, so that they can be of practical use to all parties involved. UNEP published a series of reports on 22 industrial sectors, intended for publication in conjunction with WSSD. These reports summarised what each of the sectors had accomplished since the Earth Summit in Rio in 1992. The French press was sometimes rather negative in relation to WSSD. Personally, I believe it was a success, as it received extensive participation from over 1,000 industrial entities.

This contrasts with the Rio Summit, where no one from industry was in attendance, and demonstrates how much awareness has grown since that time. WSSD also contributed to bringing a number of major issues to the forefront, including global consumption methods, energy efficiency, and industry's environmental and societal responsibility.

Lastly, it demonstrated the need to assist the poorest countries in their development. Two-thirds of the world's population is living on less than USD 2 per day. The financial sector has a major role to play in the development of these countries, whether by assisting the advancement of infrastructure in the continent or by creating micro-enterprises and making micro-credit available. It is important to emphasis the North-South issue, at a time when investment in developing countries comes mainly from the private sector.

Furthermore, France is set to host the next G8 meeting, in June, in Evian. Many of the issues raised above i.e. sustainable development, modes of production and consumption and corporate and social responsibility will most definitely be on the agenda in Evian.

UNEP's voluntary initiatives include a 10-year initiative UNEP FI (finance initiatives) with financial institutions - banks, insurance companies and the finance community at large. It consists of a public-private-partnership (PPP), managed by a Steering Committee and chaired by Michael Hölz (Deutsche Bank) and Carlos Joly (Storebrand). The Head of the initiative is Paul Clements-Hunt, also present today.

The purpose of this initiative is to encourage financial institutions to take environmental and social factors into account in all of their decision-making efforts. Sustainable development needs to be an integral part of corporate activity. UNEP FI also maintains a number of working groups on climate change and environmental management, reporting and Indicators. Our communications efforts include such components as newsletters intended to inform the general public, discussion platforms for stakeholders and open dialogue with NGOs.

It is becoming more and more obvious that if a financial institution mishandles an environmental or sustainability issue, its reputation in the market can be damaged. The aim of the meeting today is to provide an opportunity for participants to exchange information and experience. We have already heard a little about how Société Générale intends to move sustainable development ahead on its internal agenda. I hope that this event will foster networking and communication, so that the environment and corporate responsibility expand into the larger world and become widely recognised and understood topics.

Before concluding, I would like to call to your attention UNEP FI's Annual Global Round Table in Tokyo, on 20-21 October 2003. We are available to provide you with any information you may require and sincerely hope to see you there.

Keynote Presentation

Elisabeth GUINGAND
Director, Sustainable Development and Quality,
Groupe Caisse des Dépôts

First of all, its capacity as Corporate Secretary of Caisse des Dépôts Group: In 1999, Caisse des Dépôts Group decided to adopt a sustainable development policy which has been deployed over the three to four following years. We have publicly taken stock of our subsequent action in a corporate responsibility report, distributed on your arrival this morning.

It was on 14 December 2000 that the Chief Executive Officer of Caisse des Dépôts, signed the «Statement by Financial Institutions on the Environment and Sustainable Development of the United Nations Environment Programme» in the presence of Klaus Töpfer, Executive Director, and of Jacqueline Aloisi de Larderel.

Like many banks or insurance companies all over the world, alongside UNEP FI, Caisse des Dépôts thus sealed its commitment to act in favour of sustainable development, of environmental management and of awareness building concerning these issues.

We have recognised the fact that, as this Statement says, sustainable development depends upon positive interaction between economic and social development and the protection of the environment, and that this is the mutual responsibility of governments, businesses and individual citizens. Of course, the governments of all countries have clearly a leading role to play in establishing and applying priorities and common values over the long term but we consider that the financial services sector has an important contribution to make to sustainable development, in conjunction with other economic sectors.

Now, in Pierre Ducret's capacity as vice president of Observatoire sur la responsabilité sociétale des entreprises (ORSE), which is a French association whose purpose is to study the development in issues concerning both the social and environmental responsibility of companies and also ethical investments.

ORSE brings together numerous French financial establishments and, early on, became interested in their role in the development of socially responsible investment and more generally in the integration of sustainable development criteria in economic activity. This is why we set up a specific working group co-animated by the 3 partner companies to this seminar who are among the first French signatories of the UNEP Financial Institutions Declaration. That is where the idea of today's encounter originated.

We have aimed today to assemble many examples of practice which we hope will enable you to get a better grasp of the sustainable development stakes in the fields we work in, to listen to and question those actors who are the most committed, to understand the importance of the work accomplished within the framework of the UNEP Financial Initiative. And it is this initiative that the organising partners of this seminar invite you to join.

Roundtable One:
Corporate Responsibility & Capital Markets

Chair: Hanns-Michael HÖLZ, Deutsche Bank

Hanns-Michael HÖLZ, Global Head Public Affairs and Environmental Co-ordination, Deutsche Bank moderated the session on Corporate Responsibility & Capital Markets.

Today's forum allows us the opportunity to disseminate our message on corporate responsibility and capital markets to our partners and managers. With the rapid changes occurring in the financial arena at present, it is important to remember that sustainable development is an integral part of the business and not just a "green" issue.

We are accountable to our business partners and need to explain to them that this is a powerful column for enhancing business potential. One of the most important developments in the area of sustainable finance is the collaboration between UNEP and the financial sector, which bodes well for an emerging global governance. Global governance means a co-ordinated effort between government, private sector institutions and NGOs.

Panel participants included:

- **Allen WHITE, Former CEO and Special Adviser, Global Reporting Initiative**
- **Anthony SAMPSON, Director, Corporate Social Responsibility, Aviva**
- **Alan BANKS, Group CEO, CoreRatings**
- **Brian PEARCE, Director, Centre for Sustainable Investment, Forum for the Future**

The Power of Full Disclosure: The Global Reporting Initiative

Allen WHITE, Global Reporting Initiative

I. Need for Globally Comparable Metrics to Assess Sustainability Issues

The core premise of the Global Reporting Initiative (GRI) is simple and as follows. We have financial indicators and financial accounting and reporting systems. The market cannot function without them. We similarly need sustainability indicators, sustainability accounting and sustainability reporting in order to do business in the 21st century. Consider the case of human capital, surely a sustainability indicator by any standard. The quality and quantity of human capital matter to managers, investors, communities, and workers. Now, let us ask if we measure human capital in a way that parties agree and understand. The answer is a decisive "no." We have neither the shared definition nor shared measurement methods.

Compare this situation with the concepts like debt/equity ratios or net earnings or turnover for which we have generally accepted definitions and metrics. Around the world, and throughout the financial sector, we use such metrics to develop strategy, manage assets, shape portfolios and assess risk - all routine activities of the firm. By comparison, we have no such measures for human capital and other sustainability information that would enable more effective markets and accelerated movement toward sustainable business practices.

We need a generally accepted sustainability reporting framework for the same reasons that we need generally accepted international financial accounting standards. In a global economy, companies, investors, regulators need a shared language to assess companies on all matters material to performance. As markets are increasingly integrated, we need universally accepted and comparable standards for both efficiency in the market and for advancing the sustainability goals to which governments have committed themselves.

GRI is attempting to build a foundation standard, one that will capture most non-financial economic information, along with environmental and social information, that is integral to fully assessing the condition, prospects, opportunities and risks of the firm. Ratings agencies, asset managers, environmental organisations and social investors all are users of such information, though for widely different reasons. With a foundation standard in place, additional sector-specific and company-specific information may be added through instruments such as surveys and questionnaires. But a generally accepted foundation standard will streamline and consolidate information collection to the benefit of all parties.

II. Role and Mission of the Global Reporting Initiative (GRI)

GRI's mission is to elevate sustainability reporting to a level as routine as financial reporting. GRI was convened in Boston in 1997 by the US NGO CERES in partnership with UNEP. It now has its Secretariat in Amsterdam, and operates as a UNEP Collaborating Centre as well in close alliance with the Secretary General's Global Compact.

From a historical perspective, sustainability reporting is evolutionary, not revolutionary. Its legacy dates to more than half century ago with the invention of standardised financial reporting in the 1930s. Concepts such as social accounting were introduced in the 1970s, and environmental reporting in the 1980s. The concept of sustainability reporting appeared only in the late 1990s. In the future, we may witness total performance reporting which encompasses and integrates all of these concepts.

We now estimate that there are 2000 companies carrying out some form of sustainability reporting and the numbers are growing. The leading countries are Japan, the US, and the UK in total numbers, though in per capita terms countries like Sweden and the Netherlands are demonstrating real leadership.

Government, business, labour and civil society leaders at the Johannesburg World Summit referenced GRI as an exemplary multistakeholder initiative. While the official Summit agenda focused on issues such as energy, water, biodiversity and health, corporate accountability emerged as a powerful theme. This, in turn, provided a platform upon which the importance of sustainability reporting was recognised by representatives across a wide spectrum of constituencies. As the World Business Council on Sustainable Development noted months after the conclusion of the Summit, the question is not *if* companies should report but *when* they will report.

III. The Key Role of Financial Institutions

GRI considers financial institutions (FIs) to play a pivotal role in advancing sustainability reporting. FIs sit on both sides of the ledger—they are both potential reporters and potential users of information contained in such reports. And, of course, the financial industry is a leading service industry, with a pivotal role in channelling capital flows. FIs through their management of capital play a critical role as accelerators or decelerators of sustainable development. In their capacity as asset managers and risk analysts, they are also report users. GRI recognises this unique, dual role. It is, and will continue to be, in active engagement with FIs through GRI's sectoral supplement program and through other mechanisms that advance our shared accountability agenda.

Environmental Reporting Guidelines for the Global Finance Sector

Anthony SAMPSON, Aviva

I. Positioning of the Guidance

There are numerous reasons for the production of guidelines on environmental reporting guidelines. However, the main reason regards the provision of a procedure to entrench into daily working practice an effective financial reporting practice.
Many financial institutions, particularly in the developing world, have not started such reporting and do not know where to begin. As a result, guidance provides a simple road map to enable financial institutions to implement an environmental management and reporting system. It also fills the gap of expected performance from UNEP FI's signatories.

Finally, there is a need to create guidance particularly for the finance sector, taking into account the very special nature of financial services due to the significant indirect effects of the financial sector. Although financial services companies have direct environmental impacts, they also cause indirect impacts through their influence on the behaviour of other firms as, for instance, in fund management, which can have a very far-reaching beyond the FI's direct impacts. The guidelines are written by practitioners for practitioners.

The Guidance is positioned as a "first step" and not a "last word". Many practitioners who have been in the business may say it does not provide much assistance on indicators. However, when companies began to produce reports 10 years ago, the process was much more rudimentary. The scenario is similar for those who are about to take the first step now. Every information request and practice has to be painstakingly defended. Therefore, the guidelines are intended more for those starting out and they seek to provide them with practical assistance to help climb the ladder that is in-line with the aspirations of the UNEP Finance Initiatives.

We spent significant amounts of time to ensure that the working group on the Guidance was balanced between more experienced practitioners and less experienced countries. Representatives from financial services companies in regions with less experience, for example, Africa and Asia, were included to render the guidelines globally relevant. We used basic guidance that had already been established in the UK as a basis and amended this to increase its meaningfulness to a world audience.

II. Guidelines Content

The current version of the guidance contains nine elements. The starting point is the business case. Cost-benefit analysis will vary from business to business and country to country. However, certain elements will always be present. Business reasons for sustainability reporting include the improvement of cost-income ratio, the reduction of risk exposure and an increase of investor confidence. It can increase value added to the business and enhance financial performance.

- Practitioners are given practical help to sketch out costs and benefits. Although the accurate measurement of value poses a problem, this can be dealt with convincingly.
- The scope positions the Guidance for those financial institutions who are starting out in different parts of the world.
- It signposts other relevant guidance such as FORGE guidance developed in the UK, VFU work on indicators developed in Germany, as well as the work done by EPI Finance Group and SPI Finance Group.
- Core elements of an Environmental Management System include strategy governance, management controls and reporting.
- The Overview describes the nature and relevance of all these issues.
- Detailed reporting Guidance.
- Annex A covers the provisions in greater detail and offers practical help to someone thinking of implementing the Guidance.
- Annex B discusses business activity guidelines. Detailed reporting guidelines are a key component of the package. Higher and basic levels of reporting are detailed. Compliance with the guidelines is an aspiration for the short-term. Management and reporting must ultimately be related to raising performance levels and to tread more lightly on the environment, which is at the heart of the guidelines. This section offers practical advice as to how one can minimise environmental damage.

III. The Future

One of the true values of the guidance remains the process by which it has been produced. The process has involved practitioners from all over the world. This underpins the legitimacy of the guidance and reinforces its universal relevance and applicability.

I would like to extend an invitation to other financial organisations to get involved and join the UNEP FI.

****** Please Note: Since this European Seminar took place on January 10, 2003, the UNEP FI Environmental Management and Reporting Working Groups (EMRwg), has been disbanded and re-launched within a new Environmental Management, Reporting and Indicators (EMRI) work programme within UNEP FI. For more information on the EMRI process, please see **http://unepfi.net/emr/index.htm**

The New Challenges of Qualitative Risk Management

Alan BANKS, CoreRatings

Background

I will discuss the subject of governance and responsibility risk and its impact on financial services, touching on valuation and regulatory issues. Until now, corporate responsibility has been pushed by the agendas of NGO's and committed, ethically minded investment funds. However, of the entire pool of equity, bond and credit capital available to corporations around the world, less than 3% is provided on the basis of a review of sustainability criteria. If these issues are to enter mainstream investing, they have to become part of the normal lexicon of investors – this has to become an investment led, not agenda pushed business.

I. Introduction to CoreRatings

CoreRatings is a sister company to Fitch Ratings, one of the world's largest rating agencies with 1,200 staff in 42 countries. CoreRatings focuses on governance and responsibility issues and provides both research (to investors) and solicited ratings (to companies). We analyse about 1,000 companies globally and our research clients control USD 1,750 billion in investment assets under management, which gives us a very good perspective on what investors want. CoreRatings is also very active in facilitating the shareholder engagement process where large institutional investors discuss responsibility and governance issues directly with companies.

II. Qualitative Risks

We define qualitative risks as all business risks of a primarily non-financial nature that have a material financial impact. These are often called non-financial risks but this is a misnomer as they have financial implications. We group these under two main areas: corporate governance and corporate responsibility. Qualitative risks impact all parts of the financial markets widely. They impact the value of equity and bonds, as well as access to capital and the availability and pricing of credit and insurance cover. They should also be taken into account by the lead managers of equity and debt issues and properly discussed and disclosed in the prospectuses. As a direct effect, financial service companies are increasingly likely to become parties to law suits, and have a high chance of suffering collateral reputation damage, as a result of the activities of their clients. Under the Basle 2 capital adequacy guidelines, banks have to put up capital against these potential legal and reputational liabilities.

III. The Link Between Corporate Governance and Value

Trust and Risk Management

Assuming a company has good products and people willing to buy them, the other elements of company value are trust and confidence in the corporation and its management of risk. Therefore, corporate governance and responsibility are important. An important reason for current low valuations ascribed to financial assets is the breakdown in trust, which takes time to rebuild. Corporate governance measures the competency of the Board of Directors to manage the enterprise, and is essential in the building of trust with investors. Corporate responsibility is concerned with managing material business risks. It demonstrates that the Board of Directors is analysing and managing those key business, operational, environmental and social risks that have an effect on value and is disclosing what they have done.

Risk, discount rate and valuation

Qualitative risks materially influence the Net Present Value of financial assets. All financial assets constitute a stream of cash flows. For equities, these cash flows are distributable earnings, for bonds they are cash flows associated with the bonds. In order to arrive at the theoretical value of a company's equity or bonds, these cash flows are discounted back to the present day. The discount rate used is a direct measure of risk. Companies with low risk have a lower cost of capital.

For a bond, the discount rate is equal to the yield to maturity, and it changes as the price of bond changes. It represents the perceived risk of holding the bond at that moment in time. The discount rate is comprised of the risk-free rate, credit risk and other risks - an area which has not yet been thoroughly analysed but which takes into account corporate governance and corporate responsibility issues.

For a bond, the proportion of the discount rate that relates to credit and other risks is called the 'Spread'; for equity it is called the 'Equity Risk Premium'. It directly affects the cost of capital.

Regulators have clearly understood the message on risk. The Sarbanes-Oxley Act is concerned with corporate governance and the control and reporting of material business risks. It is very likely that it will be interpreted to require mandatory reporting of environmental issues. Similar concepts underpin the UK's combined code and a review of UK company law is currently taking place, which will lead to a requirement also to report on material business risks, including governance and responsibility risks.

It is imperative for financial institutions conducting due diligence on a prospective issue to explain these risks in the prospectus. Qualitative risks are also becoming very important in pricing credit and insurance provisions. Liability has been extended to companies for the actions of suppliers. Through the GAP and Unico cases, we note a significant extension of liabilities for actions of suppliers.

Conclusion

A detailed analysis of qualitative risks, that is, governance and responsibility risks can improve returns through a better understanding of the pricing and value of financial assets. It lowers the investment risk of different portfolios. Further, it provides reinforcement of corporate values and can help to avoid collateral reputation damage on behalf of activity of clients.

The London Principles and Sustainable Capital Markets

Brian PEARCE, Forum for the Future

I. Overview

We have heard about three excellent systems: a corporate responsibility rating system, a data protocol system, and an environment management and reporting system. How do these all fit together to produce better investment decisions?

The financial sector occupies a unique position as it provides oil for the economic engine. It sets the pricing of debt and equity and also allocates finance to various projects and thus plays a crucial role in determining the sustainability of economic development. A London Principles Project, entitled "Financing the Future", was carried out for the Johannesburg summit. Rather than developing a code of conduct for individual financial institutions it looked at the role of the financial system and sustainable development. It is concerned with financial processes, products, markets and regulatory innovations and how sustainability is promoted in these areas.

II. Benefits to Financial Institutions from Considering Sustainability

Why will financial systems provide innovative products? Sustainability is both the right thing to do, and it (often but not always) pays. Market inefficiencies exist and products are launched to exploit these inefficiencies and hence create value. In a collaborative study with other institutions and universities entitled 'Sustainability Pays' we found evidence that financial benefits can be accrued from corporate responsibility and environmental policies.

It is important for institutions such as UNEP and policy-makers to understand how the individual parts of the financial system play a role in ensuring that debt and equity prices do reflect social and environmental risks. These risks have to be made material by a regulation, tax or reputation to attribute that value to the environmental impact or commodity. Then we need disclosure of the scale of the risk to a business. This is the role of organisations such as GRI and CoreRatings. We also need the price of environmental services to be revealed transparently, i.e. the carbon market to reflect sustainability risks in the value of financial assets. We need to see that value reflected in debt and equity prices through actively managed SRI funds. Finally, we need investor engagement services to help bring about improved corporate performance. Thus far, there is very little information provided by the brokers and sell-side research analysts in this regard. The absence of any one of these services weakens the ability of the financial system to get the price right in equity and debt markets.

In terms of measuring value, value depends on one's perspectives. Policy makers and social investors are principally interested in the impact of companies on society. Mainstream investors are interested in shareholder value. Environmentalists are interested in the impact on nature. Insurers are interested in the impact on risk. Businesses are interested in the impact on enterprise value. Therefore, different ratings and accounting services have been designed with different perspectives.

In terms of making financial market mechanisms work, it is important to understand sustainability. Have governments done enough to help create that value? Are ratings services providing the quality data required by different users and stakeholders? Does the financial system provide the complementary financial products and markets to get price and the allocation of finance right and thus maximise sustainability benefits? A further point is that we need value-based regulation as well as the business case. Business, environmental and social impacts are not all reflected in enterprise value. We need to create a climate that discourages Enron-like behaviour and creates non-financial risk. Regulating behaviour through widely accepted norms has a long history in continental Europe and could offer a lesson to Anglo-American markets.

Conclusion

Our task in taking the London Principles project forward is to encourage a broader participation by financial institutions in the financial products and markets that do support sustainable development, and we will take this forward with the UNEP/Corporation of London collaboration. We will also work with policy-makers and financial regulators on the need to consider the role to be played in creating a business climate to discourage past behaviour and in creating non-financial risk.

Hanns-Michael HÖLZ

I would like to thank the four presenters for a very good starting point for the meeting.

Roundtable 2, Panel Members

Roundtable Two: Financial Institution Case Studies in Project and Portfolio Risk Management

Chair: François DE RICOLFIS, Coface

This session was moderated by François DE RICOLFIS, Director, Medium and Long Term, Coface

Coface is a credit insurer, insuring export contracts for large equipment goods on the state account. In this respect, we are concerned by the potential environmental impact of the goods that we insure and so we have been interested in the environment for several years. Since 1999, our underwriting includes the environmental evaluation of projects within a framework developed by the OECD. Since last December, we have published public guidelines on this topic.

The environment is part of the financial risk we take and a risk to our reputation and that of our clients. Moreover, the taxpayer provides parts of our funds, we deem legitimate to use this money in a responsible fashion for both the exporters and development. In addition, we have developed our co-operation with UNEP FI and, in this regard, would like to thank UNEP FI for inviting us here today. The four presentations in the roundtable session will cover topics from the general to the more specific. Thank you to all our participants.

Panel members included:

- **George DALLAS, Managing Director, Governance Services, Standard & Poor's**
- **Rob LAKE, Head SRI Engagement and Corporate Governance, Henderson Global Investors, UK**
- **Jan Willem VAN GELDER, Director, RETRAC Research & Advice, The Netherlands**
- **Arnaud BERGER, Adviser, Environment, Banque Populaire du Haut-Rhin, France**

Corporate Governance and Sustainable Development

George DALLAS, Standard & Poor's

Long before the recent spate of large corporate failures in the United States made corporate governance a household term, Standard & Poor's has been actively involved in pioneering a field of analytics and benchmarking in the area of corporate governance. Standard & Poor's established a dedicated Governance Services unit in 2000 following research, product development and field testing which began in 1998. Largely given due to concerns about corporate governance relating to the financial crises in Asia and Russia, this development effort initially had an emerging markets focus. However the recent debacles of Enron, WorldCom, Marconi and Vivendi, among others, show that governance is a risk factor in developed, as well as in developing markets. As such, Standard & Poor's current Governance Services unit has representation in a wide range of markets globally, including London, New York, Moscow, Hong Kong, Tokyo and Melbourne. We are also working actively in the governance area with Standard & Poor's affiliates in India, Russia, and Indonesia.

Within the area of corporate governance, Standard & Poor's has developed a proprietary data set comparing transparency and disclosure practices among 1600 companies globally, and offers customized research services relating to governance issues in individual companies and countries. The main area of focus, however, is in providing corporate governance scores (a rating analysis) for companies to be used both as an analytical tool for investors and as an independent third party assessment for company managers and directors interested in better understanding and improving their corporate governance practices.

At Standard & Poor's, we believe this form of corporate governance "rating" can help investors more systematically assess and compare governance standards from company to company on a global basis. As this form of analysis becomes more institutionalized, governance risks will increasingly be factored into the investment decision-making process, both for equity and fixed income investment. We believe this market oriented solution positively complements top down efforts by legislators, regulators and exchanges to influence corporate governance practices through the introduction of new laws, regulations and listing rules.

At present Standard & Poor's approach to corporate governance is focused primarily on financial stakeholders (e.g. shareholders and creditors). We recognize the legitimacy of framing corporate governance from the perspective of a wider base of stakeholders, including the employees, the community and the environment. However, at least in our initial governance scoring service we are focusing on the *financial* dimension to corporate governance, as this is closest to our traditional skill sets and customer base.

Our current analytical approach to evaluating corporate governance in individual companies has four main components: ownership structure and concentration; financial stakeholder rights and relations; transparency and disclosure; and the board structure and process. These are all documented publicly in our governance scoring criteria document. The development of this analytical methodology drew from leading governance literature and from the feedback of investors, economists, lawyers and other governance experts. Given the global purview to our corporate governance scoring, it is an analytical challenge to accommodate the wide range of legal, cultural and structural differences that exist in the area of corporate governance. Inevitably, this involves the need to objectify and calibrate aspects of governance, which may be fairly viewed as qualitative and subjective.

On that basis, it is important to emphasize that analytical criteria for corporate governance must at once be objective, but also flexible enough to reflect the substance-not just the form- of structural differences. Ultimately, this means that our analysis is driven more by underlying principles than by structural norms. The principles of <u>fairness, transparency, accountability and responsibility</u>- which guided the formation of the OECD corporate governance principles- are also relevant to provide guidance to Standard & Poor's in its governance scoring process. In practice this means we are often agnostic about generic governance structures. The emphasis of independent, third party analysis is to evaluate on a case-specific basis whether an individual company's governance structure and culture is- or is not- consistent with the overarching principles referenced above.

What is the role of sustainable development in this analytical process? Thus far, this has not been a direct area of focus at Standard & Poor's, though we recognize there is analytical merit in addressing this issue from the perspective of non-financial stakeholders. We are actively exploring the broader dimensions of sustainability and corporate social responsibility with regard either to incorporate these areas into our existing analytical processes or to develop new analytical and information services. Within the context of "traditional" corporate governance analysis, sustainability issues can be linked to the overarching principle of *responsibility.*

At present, the so-called "specialist" investor base in corporate social responsibility (CSR) is small, as measured by funds under management. Though this area is growing rapidly, and dedicated CSR groups are forming in many investment management firms, it is likely to remain small in absolute terms relative to so-called "mainstream" investors without a specific social responsibility agenda. It is our view that if sustainability issues are to become more prominent concerns for mainstream investors, company managers and directors, there will need to be stronger basis of economic evidence linking sustainability to company performance and valuation.

As such, Standard & Poor's approach to incorporating sustainable development as an information service would likely focus on these issues as a risk factor from the perspective of a "mainstream" investor. It is likely that we would avoid trying to make qualitative assessments of a company's "social responsibility" per se. Particularly in a global context, given very different cultural norms, it is difficult, if not impossible, to do this analysis objectively. It may be more appropriate to focus first on the quality of the country's laws and regulations relating to social and environmental issues, as well as its enforcement at the macro level, before unduly penalizing companies that are in technical compliance with prevailing local law. Therefore, we would likely frame company-specific analytics to focus more on how a company's policies and actions in the social, community and environmental areas either pose fundamental risks—or can be recognized more positively as being well managed. This could involve interpreting sustainability as a contingent liability where standards are lacking or as a type of intangible asset where standards are strong.

An implicit premise of sustainable development is that companies embracing these principles have a more credible claim to longevity and, perhaps, are less vulnerable to litigation, operational disruption or loss of brand/reputation value. A challenge in adopting this more forcefully in the mainstream investment world is the lack of strong empirical evidence. Moreover, the longevity dimension of sustainable development poses a potentially problematic timeframe gap. The timeframe of many investors is notably shorter than that of those who focus on sustainability. Bridging this gap in timeframes is key.

In this context Standard & Poor's is actively following developments and research relating to sustainability. To the extent that new metrics can develop to rigorously link social and environmental risks to company performance, these have the potential to bolster existing corporate governance ratings or to serve as a stand-alone analytical service. However, there are many challenges in this. These include the analytical problems relating to building objective measures for sustainability issues and ensuring proper data quality to support the measurement of qualitative criteria. At present it would seem that framing objective and meaningful analytical criteria for sustainability metrics is challenged by the potential for even greater subjectivity in underlying assumptions than in the case of our existing corporate governance criteria.

The stage is set for more empirical work in this area to accept or invalidate claims that sustainability is a meaningful area of investor focus. A starting point is enhancing levels of transparency and disclosure about a company's practices relating to sustainability issues. More robust reporting on corporate social responsibility is increasingly on the political and legislative agenda, particularly in Western Europe. From a research perspective this should allow for more empirical studies to test for relationships between a company's sustainability profile and its financial stability/longevity/value creation. More robust reporting on sustainability will certainly help guide those investors who actively follow a social responsibility agenda. But it should also help those investors, managers and directors who are currently sitting on the fence to develop their views about sustainability and corporate social responsibility on a more informed basis.

Corporate Governance, Corporate Responsibility and the Fund Manager

Rob LAKE, Henderson Global Investors, UK

Henderson Global Investors is an international investment management company with EUR 155.4billion under management worldwide and EUR 1.63 billion of socially responsible investment funds for a variety of clients, both institutional and retail.

I. Overview

Worldwide corporate collapses such as Enron have placed a clear focus on the importance of supervising corporate structures and shareholder accountability. There is growing evidence of the business relevance of sustainability issues, and increasing awareness of the importance of good governance to minimising risk. The concept of engagement that we employ is that of an active dialogue with the companies in which we invest.

To begin the investment process, our client gives us funds to invest. Historically, the discussion on investment has focused on the investment decision process. Now, ownership and responsibility of the company has become more important as a criterion. This link is made through the concept of engagement. The aim is to enhance returns and reduce risk, as well as to ensure accountability.

The traditional principles of a classic corporate governance agenda include accountability, structures and personnel, non-executive and independent directors, and existence of committees, remuneration and transparency.

A variety of sustainable and corporate responsibility issues are material for business. I offer you the example of a mining company, Xstrata, which recently listed in London and is mainly involved in coal. At the time of listing, the company provided little information in relation to climate change and regulations such as energy taxation, which has since been the cause for discontent among investors. Formal complaints have been made to the regulatory bodies in relation to this. The Japanese government introduced a recent tax on coal to fulfil its obligations under the Kyoto protocol. As Japan is an important market for Xstrata, this caused the share price to drop immediately and sharply. Therefore, climate change is an environmental issue as well as a business issue.

II. Assessing Corporate Responsibility

Corporate standards include corporate governance as well as business ethics. We have a number of issues and indicators in this area. Some are generic while others depend on the sector and yet others depend on the particular company in question. However, we are moving towards a more standardised approach.

At Henderson, we consider the following matters: governance, vision, strategy and policy, reporting systems and accountability, stakeholder relations and performance. We have recently set out our position on climate change and human rights available on our web site.

Recently, Henderson has carried out many new initiatives. We have undertaken a global review of the pharmaceuticals sector considering issues of animal testing and adherence to competition law, as well as a review of the oil and gas sector, and a review of labour standards for suppliers of the major European retailers. French companies are now required by law to report on such matters, which is a challenge given the lacuna in internal reporting systems of some companies. Some of the companies with the most valuable reputations to protect have the worst performance and a complete absence of policy on many of these issues. We are also currently in discussion with aerospace, defence and engineering companies in the UK.

III. Capital Market Trends

Legislation in certain countries, including the UK, France, Germany, Italy and Australia requires pension funds and large institutional investors to issue a formal statement on social, environmental and ethical issues. There are very active discussions in the UK on potential changes to the listing rules and company law to require reporting on environmental and social policies and performance. Following Enron and WorldCom, there has been much lobbying in the US leading to legislation such as the Sarbanes-Oxley Act, for example, which introduces tough new corporate governance requirements, which are being followed through in the NYSE listing rules. We are seeing more moves by investment managers to integrate sustainability factors into mainstream analysis and investments.

Pension reform in many countries around the world will increase equity investment as governments introduce various incentives to boost private saving. Furthermore, “outside” investors, outside of the family group or core owners in tightly-held companies will become more important, especially for continental European and Asian companies. Their expectations will include aspects of sustainability and corporate responsibility. Further, this broadening of the investor base will likely be accompanied by greater expectations on transparency on sustainability and governance issues. Investors are already beginning to ask more questions in relation to the skills and training of board members vis-à-vis environmental and human rights issues. In this context, the Bouton Report in France makes interesting recommendations.

A further step would also be to make a link between senior executive remuneration and corporate responsibility. Investors will also expect to exercise more “informal” influence through dialogue. They will also exercise formal influence through shareholder rights. This is already occurring in France with large US-based investors, and investors will increasingly expect that their voices be heard at company meetings in order to bring about change.

The Risks of Financing Forest Conversion

Jan Willem VAN GELDER, RETRAC

RETRAC Research & Advice is a joint venture between two Dutch consultancies, focusing on trade and investment in natural resources.

Global frontier forests are disappearing rapidly. Many financial institutions are involved in this as some of their clients are directly implicated. Primary forests are of global importance for sheltering enormous biodiversity but 39% of them are currently threatened by economic activities, and over 1% are disappearing on an annual basis.

I. The Involvement of Financial Institutions

Many financial institutions are strongly involved in this issue because many of their clients are active in the logging and timber trade, the pulp and paper industry, and agribusiness and infrastructure development. Providing financial services to these sectors, therefore, involves a high level of risk. The following four cases illustrate some of the risks involved.

1. The Oil Palm Industry in Indonesia

World palm oil production has increased by 60% in the past six years. Malaysia is the global market leader while Indonesia has a 33% market share. There has been a 530% increase in production in Indonesia in the past six years, causing habitat loss for all species living there as well as a large number of forest fires, related to plantation development. RETRAC has carried out research for Greenpeace, WWF and Friends of the Earth presenting the many major foreign banks involved in financing oil palm plantations.

2. The Pulp and Paper Industry in Indonesia

Pulp capacity has expanded by 880% in Indonesia since 1988. Again, RETRAC undertook research for WWF and Friends of the Earth, which named the many major foreign banks involved in financing this industry.

3. The Soybean Industry in South America

World soybean production has increased by 46% in the past six years. South American production has increased by 92% in the past six years. This has led to deforestation of rainforests, desertification of the Brazilian cerrado, disturbance of the hydrological balance due to monoculture, habitat loss and social conflicts. RETRAC carried out research for WWF enumerating the various financial institutions involved in financing this industry.

4. The Logging Industry in Central Africa

This industry has doubled production in the past ten years. Most of the logging companies operating in this region are based in Europe, Lebanon and Malaysia. Logging activities lead to deforestation, habitat loss, access to hunting, social conflicts, and corruption and illegal operations. RETRAC carried out research for WWF showing the many major financial institutions involved in financing this industry. They include a large number of European banks.

II. Risks for Financial Institutions

The timber logging industry, the pulp and paper industry, agribusiness and infrastructure development are often involved in the conversion of valuable forests. Financial services provided to these sectors involved include financial, as well as reputation risks. Both types of risks are currently insufficiently addressed by normal due diligence procedures at financial institutions.

Financial Risks

The question for the financial institution is, simply: will your client service its debts or pay dividends? Excessive production of soybean capacity may cause the company to default on debt a few years later. New governments can also hand back land to indigenous peoples, as is happening in Indonesia, and divest companies of their plantations and productive capacity.

Taking the case of Asia Pulp & Paper, it was a company funded largely by foreign loans and securities and an erstwhile darling of the financial markets. During the Asian crisis, the company defaulted on a debt of US 13.4 billion dollars and the painful debt restructuring is still dragging on. The fundamental problem is that APP does not have a sustainable supply base to supply its pulp mills.

Reputation Risks

NGOs are raising the pressure on companies engaged in forest conversion and against the institutions that finance them. Financial institutions are attractive targets for public NGO campaigns. The reputation damage can outweigh the potential profit to be gained.

Examples of such campaigns include recent campaigns soliciting Citigroup, WestLB, and a number of Dutch banks to end their investment activities in environmentally damaging sectors.

Mitigating Risk

In order to mitigate risks, we first have to face reality. Making declarations and donations does not suffice. Instead sustainability has to be integrated in the core business. Secondly, we need to formulate objectives, policies and standards. Thirdly, we need to implement policies throughout the organisation. Finally, we need to evaluate and disclose transparently the activities of the firm.

III. RETRAC

RETRAC can assist financial institutions with:

- Formulating sector-based policies and standards
- Developing incentives to improve the operations of your clients
- Implementing your policies and training your staff
- Setting up a reporting and evaluation approach
- Dialogues with stakeholders (also on the field level); and
- Designing finance schemes for innovative forestry practices

Conclusion

Financial services to forest-related sectors involve high financial and reputation risks, which are poorly assessed. Careful implementation of clearly established policies is imperative as is transparent reporting to all stakeholders.

Financial Risk and Sustainable Development

Arnaud BERGER, Banque Populaire du Haut-Rhin, France

My presentation aims to explain the banking risk encountered by a regional bank faced with the need for sustainable development. Increasingly, the economic world is becoming more integrated in relation to sustainable development. For a long time, banks and insurers operated outside of this world. However, things have changed in the past ten years, and banks have become active in this area. This is due to regulatory pressure and pressure from shareholders and the market.

I. A New Approach to Risk

The environment is becoming a strategic element. Before reporting can take place, we must first act in relation to sustainable development. Currently, the sustainable development market remains an emerging one, as our clients assume environmental risk more frequently. Banks have not traditionally considered this type of risk. In this regard, the creation of new niche markets are developing, reflecting a lack of foresight on the part of the banks. In terms of image, demands are increasing from shareholders and society, in particular in relation to listed banks.

In a wider context, a new European Directive has been proposed in relation to environmental responsibility. Additionally, in the place of the Basel ratio, the new McDonough ratio has been introduced on equity in relation to the funds allocated to cover banking credit risk. This ratio has added qualitative criteria to the existing financial ones. Equally, the European Investment Fund has developed a guarantee on environmental loans, and new economic regulations have introduced supplementary requirements in relation to reporting in this area.

Until now, customer risk analysis by banks was concerned with financial matters, relying on extensive financial criteria. However, qualitative criteria are now being introduced, such as market position, quality of suppliers, quality of clients, management quality and environment risks. Although these risks are in the development phase, clearly, we need to pay more attention to these new risks. In this regard, a recent study carried out among the top ten European banks shows that they are increasingly interested in environmental risks.

II. The PREVair Solution

Since 1990, The PREVair loan provided by Banque Populaire has represented a new concept in the banking world. This loan has facilitated our SME customers' ecological financing and is based on four pillars. A preferential rate encourages a company to take the first steps. To receive the loan, a report is compiled by an eco-adviser on the ecological credentials of a certain company which is evaluated by an ethical committee representing all important players in the sustainable development area in our region. Applying ethical criteria to a credit activity, it represents a concept more than a loan. In practice, the industries in which we offer this product include almost all sectors in the economy. Therefore, it is clear that most sectors are concerned by the environmental path toward new initiatives.

In terms of financial application, PREVair represents 1.5% of all loans to SMEs, amounting to EUR 6.5 million. Of this amount, 50% is counter guaranteed by the EU. Recently, a journalist demonstrated that if the above mentioned 1.5% of SME loans was expanded to a national scale, it would represent an annual turnover in excess of EUR 3 billion. Equally, a 2000 study showed that one in five SMEs were not aware of sustainable development issues and risks. With PREVair, we plan to educate them in this area. Over the course of 13 years and almost 700 loans, we have only experienced four failures in the PREVair programme. Clearly, there is little risk in integrating the environment into banking credit activity.

Conclusion

There is an obvious demand for ecological investment from SMEs, which PREVair fosters. Although in general, risk analysis remains imperfect, the pressure to provide sustainable development is constantly growing. In France and elsewhere, the SME sector is increasingly supportive of ecological conformity. However, banks seem unprepared. In the credit and insurance fields, our experience has confirmed that company leaders are often unaware of the concept of environmental risk and the required insurance. In this respect, PREVair may represent a driver for reducing administrative risk, lowering insurance risk, ensuring total transparency and providing an enlarged vision beyond pure finance.

François DE RICOLFIS

Thank you to all our participants.

Roundtable Three:

Integrating Sustainability Criteria into Funds Management

Chair: Carlos JOLY, Storebrand

Carlos JOLY, Senior Vice President, Storebrand, moderated this session

Concerning the place of sustainability criteria in financial management, there are five questions to consider. Firstly, the quality of financial performance remains the *sine qua non* of all management issues. Secondly, I would underline the definition and the selection of social and environmental criteria and the way in which one analyses companies. Thirdly, we should consider the manner in which the analysis is integrated within portfolio content. Fourthly, one should discuss the ways in which we can influence the companies concerned. These ways can include engagement, feedback or stakeholder action. Finally, we should question the environmental and social consequences of our so-called sustainable investment management. Clearly, we should be capable of demonstrating any positive influences.

Sustainable development fund managers constantly face a dilemma: how can one comply with established industry benchmarks and remain in the mainstream while accentuating the different nature of sustainable development funds? Our four speakers should shed some light on these

Panel members included:

- **Wim VERMEIR, Global Head, Equity Management, Dexia Asset Management**
- **David DIAMOND, Analyst, Crédit Lyonnais Asset Management**
- **Karina LITVACK, Director, Governance & Socially Responsible Investment, ISIS Asset Management**
- **Patrick SAVADOUX, Manager, Sustainable Development, CDC IXIS Asset Management**

Sustainable Investment Performances

Wim VERMEIR, Dexia Asset Management

I. The Impact of Sustainable Criteria on Performance

The topic of sustainability as a way of managing risk was previously discussed in this seminar. The key question to be addressed when integrating sustainable criteria into fund management is the relevant impact on performance. Various academic studies have been carried out to find the link between the adoption of a sustainable strategy and a company's financial performance. Most of these studies show that the more sustainable companies are also the more profitable ones.

This is not surprising given that sustainable companies are those that have respect for their environment, human and capital resources. This is why we believe that sustainable criteria also makes sense from a purely financial point of view.

In another study, we compared a composite of four sustainable indices to the traditional financial composite. This showed that performance differences between a sustainable and traditional selection are not statistically different in the long run. We therefore cannot prove that the sustainability approach will increase financial performance. Yet, we do have positive indications. That is, most of the sustainable indices are outperforming traditional indices, and most ethical funds are performing rather well compared to traditional ones. The differences are not large enough to substantiate firm conclusions in the long run, although there are large differences in the short term. However, the sustainable effect is difficult to separate out from biases related to sector, country or style factors.

Thus, in order to attract investors, we have to provide portfolios that have the same financial and risk qualities and characteristics as traditional portfolios.

II. Investment Processes

To this end, we operate a very rigorous investment process that is comprised of two steps. First, a rigorous screening methodology and, second, a rigorous financial process.

Screening Methodology

We are concerned with sustainable development and not ethics. We are not concerned with excluding certain activities but with using a positive approach. We aim for a best-in-class approach and do not exclude particular sectors, apart from defence. We integrate the views of different stakeholders in our methodology. We base our approach on the findings of academic research. The screening needs to be very concentrated on facts and figures and not only on what companies say they are doing. That is, it must be more than just a marketing exercise. This is also the concern of the Global Reporting Initiative (GRI).

The role of stakeholders will remain a very important one. For example, in relation to social issues, we have to verify matters with trade unions. There should be a separation between the screening and investment processes to make sure that sustainable principles continue to be respected. We also need to be different and severe in the screening process. For example, our funds are invested in only about 25-35% of the market. Finally, we also need to be transparent and to have a pro-active approach. That is, analysts have to anticipate the problems of the future.

The Financial Process

We aim to have products that have similar financial behaviour on the risks side as traditional products. In terms of relative risk compared to traditional funds, we make considerable efforts in relation to our portfolio composition. Thus, the total behaviour of the portfolio remains similar to that of traditional funds.

Performance Results

Equity markets are going down. However, in comparison with the traditional funds, sustainable funds are going down less.

Conclusion

Sustainable screening makes sense, including from a financial point of view. It can be considered as a type of quality filter. Traditional investors are looking for quality, and sustainable criteria can provide them with what they are looking for.

Long term risk and return characteristics of sustainable portfolios are, at least, comparable with traditional portfolios. That is, the environmental and social added value is obtained at no cost.

Finally, it is not easy to manage sustainable funds. Therefore, in order to have sustainable performance, we need to have a structured and rigorous investment process. This will be crucial to the success of sustainable investment.

The Responsible Portfolio

David DIAMOND, Crédit Lyonnais Asset Management

I. The Crédit Lyonnais Asset Management Approach to SRI

Crédit Lyonnais Asset Management (CLAM) has been a pioneer in socially responsible investment (SRI), in France and also in Europe. We launched our first ethical fund in 1989, at the request of our Christian congregation clients. This fund uses both negative and positive screening. In 1991, we launched three humanitarian funds that distribute part of their revenue to selected humanitarian organisations. Two years ago, we launched our first sustainability fund (CLAM Euro Développement Durable), which is destined to institutional investors. At the end of 2002, we launched a sustainability fund for retail clients.

SRI

We define SRI as an investment approach that takes into account non-financial criteria either in the selection process or in terms of the overall objectives of the fund. Two years ago CLAM decided to develop its SRI research capacity by creating an internal research team made up of two full time analysts, the first at a French asset manager. In 2002, we doubled our SRI assets under management to EUR 270 million. Moreover, the company's offer of SRI employee savings plans was certified by four out of five of France's largest trade unions. We were then selected to manage SRI employee savings plans for the UNAPL, which represents over 600,000 self-employed professional workers (doctors, lawyers, notaries, architects, etc.) in France. Finally, our own employees will now have the opportunity to invest in these funds themselves.

Philosophy and Objectives

Our approach is greatly inspired by the sustainable development concept that is based on three pillars of sustainability: economic, social and environmental. We use a best in sector approach, and no particular sector of economic activity is excluded.

II. An Extension of Overall Financial Expertise

We believe that SRI represents an extension of our overall financial expertise. CLAM is an active fund manager, and we do very little passive investing. This applies both to SRI and mainstream funds.

A Global View of Companies

We consider that SRI provides a more global view of a given company, taking account of the company's relationships with all stakeholders. Companies have a number of different activities, producing products or providing services. Financial analysts see companies through the prism of the company's management, activities and financial performance. The SRI analyst is an extension of this, looking at how the products and activities impact on stakeholders such as employees, customers, suppliers, the community and the environment. The company is thus re-inscribed in the network of relations that it has with these different stakeholders. We believe that there are risks and opportunities to be found in doing this, which can have an impact on the financial health of a company and on its stock price.

Dedicated Means

CLAM has committed the following means to SRI: a dedicated research team and a specialist fund manager on the equity side.

III. An Investment Process Tailored for Financial Performance

We do everything possible to ensure that the investment process maximises financial performance. We begin with a common set of portfolio rules for all portfolios whether they are SRI or not, and SRI funds follow the same sector and geographical allocations as traditional funds. The difference between a traditional fund and an SRI fund is thus to be found only at the stock-picking level, and the same risk control methods are thus common to all portfolios.

SRI Methodology

Our SRI methodology is built on the traditional financial analysis model. Financial analysts primarily consider information provided by company management, competitors and sell-side research. Our SRI analysts broaden these sources of information, integrating both internal and external sources of expertise. We rely on information provided by different management sources within the company, such as human resource management. We also rely on information available in the public sphere, such as that provided by NGOs, consumer groups and the press. In France another extremely important source of information is the Observatoire sur la Responsabilité Sociétale des Entreprises, which also provides a valuable opportunity for companies, asset managers, and trade unions to come together to discuss CSR issues. Finally, we do not use a succession of filters (first, financial and second, environmental and social) we use instead a simultaneous evaluation process.

Overlay of Investment Universes

In the first stage, we have an overlay of the two investment universes: the financial analyst/fund manager universe and the SRI rating agencies' universe. The first stage of filtering involves identifying those companies that are positively rated both by our financial analysts and by the SRI rating agencies. Such companies are eligible for entry into our portfolio.

Cross-Analysis

In the second stage, we carry out a cross-analysis of contradictory cases (cases where our internal financial analysis viewpoint differs with that of the SRI rating agencies). That is, we prioritise our research on companies that are highly rated according to either approach. Selected companies become the focus of an in-depth study based on information from both inside and outside the company.

We use a sector specific approach and do not treat all sectors in the same way. Factors that are common to all sectors include sustainability policies, management systems, reporting systems, management commitment and organisation. In terms of sector specifics, we recently looked at the pharmaceutical sector where the availability of medicines in the first and third world is specific to this sector. In relation to the food and beverage sector, the sector specific issue is ethical trading and sourcing.

Portfolio Construction

In the third stage, following our in-depth study, we proceed to portfolio construction in close collaboration with the specialist fund manager, who makes the final choice on whether to include a company in the portfolio.

IV. A Source of Added Value

In terms of how SRI selection can add value, we compared the performance of Nokia and Alcatel in the past three years to the European telecom hardware sector. Nokia has outperformed the sector and Alcatel has under-performed. Since the end of 2000, all of Nokia's production sites have been certified ISO 14001. Nokia also asks its suppliers and customers to be certified. Alcatel has pursued a different strategy. Only 20% of its sites are certified ISO 14001 and it has a strategy of dis-engaging from industrial production. That is, it is externalising its environmental risk. We decided to privilege a company like Nokia rather than Alcatel.

Conclusion

In being a responsible fund manager, we use an "engagement" process. That is, we have extended our dialogue with companies beyond purely financial matters. This amounts to a consciousness raising process. We accompany companies engaged in progress towards sustainability. Finally, we have a responsibility to the investors in our funds to vote with their shares, and we will be doing so in 2003 on a worldwide basis.

Assessing Bank Exposure to Environmental Risk

Karina LITVACK, ISIS Asset Management

I will move away from the discussion on the mechanics of screening funds and will instead focus on the concept of shareholder engagement and its role in socially responsible investment. I will specifically focus on the banking sector.

I. ISIS Asset Management

ISIS Asset Management is a UK based fund manager with EUR 100 billion of assets under management. We are distinguished by the fact that socially responsible investment is at the core of our business. Philippe CITERNE raised a very bold and provocative question earlier today:

- should we offer dedicated socially responsible funds; or
- should the SRI principles be applied across the board to all the funds we manage.

We began with the first view in 1984, when we introduced screened funds. Since 2000, we have come around to the second view. Therefore, the totality of our equity portfolios take account of governance, sustainability and ethical issues. While we do not exclude companies, we actively raise these issues in our regular discussions with clients. We meet with clients on a quarterly or yearly basis, and take the opportunity to ask pointed questions.

II. The Financial Sector

Our four major sectors of portfolio exposure are oil and gas, pharmaceuticals, telecommunications and financials, and we are significant investors in the financial sector.

We asked ourselves how we would apply our ***Responsible Engagement Overlay*** to the financial sector. We decided to look at how commercial banks take into account environmental risk factors in making their credit decisions.

III. Benchmarking Study

We approached ten banks from our European portfolios in order to identify elements of good practice and gaps in good practice: Barclays, The Royal Bank of Scotland Group, Credit Suisse Group, HSBC, Santander Central Hispano, ING, Standard Chartered, Société Générale, Lloyds TSB and UniCredito Italiano. Given that engagement aims to improve the performance of companies, we hoped to encourage the adoption of better practice.

Banks that were already in the forefront of this area saw an interest in participating in the study in terms of improving the overall level of performance throughout the industry. There was thus a genuine desire to share information so that the industry as a whole could progress. Other banks, which were lagging behind, saw an interest in making up for lost time. This is an area where there is much to be learnt from the experience of others.

We worked with a UK professor of accounting who was experienced in this area, Dr. Andrea Coulson. We carried out half-day visits with each of the ten banks. We then held a workshop bringing the ten banks together to identify the areas of concern, agreement and disagreement.

IV. Key Findings

As a result of the study, we published an in-depth report. The aim was to provide detailed and practical information for participants and other banks in the sector.
There was unanimity on the importance of these issues. However, there were interesting divergences in how particular banks approached the practical aspects of these issues.

Varying Levels of Experience

The report illustrated that there was a wide range of levels of sophistication and experience among the banks. The three banks that were found to be in the "race leaders" category have been publicly accused of being associated with problematic loans in troublesome parts of the world. We are by no means suggesting that these banks are perfect, however, they have come the furthest in developing procedures such as assessment, training, performance measurement, auditing and reporting.

Default Risk

The key driver for all of the banks was default risk. This is of greater significance than reputation risk, licence to operate or threats of NGOs. Default risk is the key factor for banks in terms of their lending decisions.

Pricing the Default Risk

Price is integral to the issue of default risk. We heard earlier today of the gaps in the financial sector in relation to pricing environmental or sustainability-related risk. However, the study revealed that there is a great reticence on the part of banks in pricing this risk. All of the banks stated that they would not raise interest rates. Instead they would rather walk away from business or continue to do business while engaging with customers.

Engaging with Customers

Engaging with customers is a very labour-intensive and risky exercise. One bank expressed the concern that, as a lender, making loans conditional on certain activities may lead to a shared responsibility for outcomes. Nevertheless, banks do not want to walk away from business unless the default risk is excessive.

Due Diligence

Banks may find that they are too stringent in terms of due diligence when they are competing against less scrupulous competitors, particularly overseas where this issue is more acute. Relationship managers will be reluctant to impose certain loan conditions recommended by the risk management departments given that the borrower will simply move to the competition. This is a major driver for banks to come together and agree on raising the bar communally.

Use of Indicators

There was also much reticence in relation to indicators and measuring performance. Some of these objections are justified. Given that these issues are so integral to the business, it is very difficult to distinguish between loans that were refused for environmental concerns and those that were refused for poor management quality or poor business propositions. Furthermore, banks do not necessarily want to publicly report on the companies that have been refused or even on the numbers of loans refused. Obtaining consistency on the use of indicators thus represents a major challenge. As investors, we evaluate banks on the basis of the principles they apply in assessing credit quality. We are not particularly interested in the detail of which companies have been refused.

Local versus Global

Banks may have made much progress in relation to their home markets, where there is a great deal of awareness. This is not the case when they go global and are competing against less sophisticated local competitors.

Implementation

Banks in the middle or bottom group have made progress but experience real difficulties in respect to implementation. This is ultimately a question of training. Human resources departments can be very instrumental in having these issues integrated into the basic training of all credit officers.

V. Next Steps

Our next step is to extend this research to a broader range of banks, complementing the work carried out by UNEP FI in developing guidelines for environmental management and reporting. It is also important that this level of analysis is integrated into the advice received from ratings agencies and analysts. We also need to look at a broader range of sustainable risks than simply environmental ones.

Conclusion

The world is changing and investors are taking a significant interest in these issues. The focus now is on the implementation side. We are very pleased to have had this opportunity to make a contribution to participants and other users. Our objective in carrying out the study was to learn how to pick winners for our funds. However, it is not always easy to associate brilliance in this area with overall share price performance. Thus, where a stock is performing well but the bank is trailing in this area, the answer is to encourage it to boost its game rather than sell the stock. This encapsulates our approach to shareholder engagement.

Management for Sustainable Development

Patrick SAVADOUX, CDC IXIS Asset Management

My presentation will explain the work we carry out at CDC IXIS concerning the management of socially responsible assets. Belonging to the Caisse des Dépôts, responsible investment has always been a primary concern. Indeed, with Crédit Lyonnais, we are one of the pioneers of this type of investment in France.

In 1985, we launched the first socially responsible fund in France, “Nord-Sud Developpement”. Later, in 1994, following the initiative of the CLDT, our Group created the Insertion Emploi fund, which was the first joint action of its kind. With a fund value of EURO 500million we are market leaders in France.

Our team consists of five people, which should be expanded in 2003. Our goals remain in harmony with the overall goals of the Group; to apply the values of responsible financing to all our activities. In the view of CDC IXIS, companies that adopt the values of socially responsible investment can only improve their accountability.

I. The Management Process

The first stage of our investment process consists of using the criteria provided by our customers to identify suitable investment opportunities. In this regard, we use a variety of sources of information, including rating agencies, consultants, NGOs as well as site visits and interviews with company leaders. In 2002, we met over 90 companies on purely sustainable development issues. Subsequently, we examine data internally, using the criteria provided by specific customers before establishing a shortlist of about 90 companies.

At this point, we apply the traditional financial analysis, where we cross non-financial criteria with common financial ratios. Before assembling a portfolio, we listen to the demands of our customers, who can be extremely strict. At present, we invest in 90 European companies, of which 50 are French-based.

II. Non-financial Criteria

The Danone Example

In June 2001, Danone announced a redundancy scheme for their French interests. Obviously, this action provoked lively reactions from the media and the public. Although certain funds dropped Danone from their portfolio, our internal analysis convinced us to maintain their stock. Eventually, the rating agencies awarded Danone a more positive rating, proving the wisdom of our actions.

Air Liquide's Standoff

In early 2002, a certain rating agency degraded Air Liquide's rating for not having ratified the global compact project on social issues. Following consultations with the company, we agreed with them on the merit of the project but also agreed that it did not represent a guarantee in itself. In addition, we learned that the agency did not receive confirmation of some of the company's positive attributes, such as good will concerning renewable energy. Consequently, our team maintained the Air Liquide stock.

The TotalFinaElf Case

TotalFinaElf is a French company with a reliable performance record. However, they have encountered some communication problems, including AZF and the Burma question. As a result, we withdrew them from our portfolio. Taking account of the importance of oil stocks in European indices, we replaced their stock with others, such as Royal Dutch. Of course, over the coming months, we do not exclude reviewing our decision.

III. CDC IXIS's Range of Responsible Funds

Our share investment fund, created in 1994, includes a 90% level of investment in French or European companies who have not laid off any employees recently and demonstrate an advanced level of social harmony. Equally, it features associations or companies that assist people in serious difficulty. In this regard, we work in co-ordination with France Active, an association created by the *Caisse des Dépôts* and the French Foundation. Since its creation, the fund has created 6 000 jobs and in 2002 alone, it grew by 40%. In this regard, we have demonstrated that one can create a responsible investment while posting results comparable to traditional funds.

Regarding our other two funds, the "*Nord-Sud Developpement"* fund remains our Group's longest lasting fund, which invests up to 10% in emerging markets. Our most recent fund, the "Meridian Tomorrow fund", invests on the international scale.
For CDC IXIS, despite significant constraints, responsible investment funds have proven their worth against traditional funds.

Carlos JOLY

I would like to thank the speakers for their very interesting presentations that reveal a variety of approaches and products.

In my capacity as a member of the UNEP FI family, I would like to make an appeal. We have three working groups in the Financial Initiative: a working group on environmental management and reporting; a working group on climate change; a working group on asset management.

We have an over-representation from UK, German and Swiss financial institutions in our working groups and I would be delighted if we had an over-representation of French financial institutions in our asset management working group.

I would therefore invite those financial institutions and asset managers who are not yet members to become members of UNEP FI and to actively participate in one of our working groups.

Roundtable Four: Climate Change, Fiduciary Responsibility and Disclosure

Chair: Pierre BOLLON, French Association of Asset Managers

This session was moderated by Pierre BOLLON, Director General, French Association of Asset Managers

It is vital for all investors to consider the importance of climate change. It is very appropriate that we will now be hearing from insurers and re-insurers, who are important players in this field.

Panel members included:

- **Thomas LOSTER, Head, GeoRisks Research, Munich Re Group**
- **Pierre TREVET, Managing Director, Innovest Strategic Value Advisors Inc., Paris**
- **Andrew DLUGOLECKI, Andlug Consulting**

Predicting Disaster, Managing Losses

Thomas LOSTER, GeoRisks Research, Munich Re Group

I will be presenting the perspective of insurers to the discussion, in addition to the presentations already made in relation to banking and financial issues.

I. Loss Trends

Weather related disasters can have major consequences. For example, the “Lothar” winter storm in Europe in December 1999 resulted in insurance losses of EUR 6 billion and economic losses of EUR 12 billion. Munich Re has been collecting information on loss events since 1974. It has the largest such database in the world, containing loss information, scientific information and monetary loss information. Information on so-called great disasters is available in relation to events that occurred over 50 years ago. All of this information can be used to derive loss trends.

Charts on loss trends show that pressure on the insurance world is growing considerably, not because weather is changing significantly but because more values are to be found in exposed areas. The concentration of people and values in cities means that one particular event can affect many more values. This results in an increase in loss curves, even in stable environments.

II. Changing Risks

There has been a four-fold increase in major weather related events since the 1960s. As insurance density grows, the consequential insurance losses also grow. In addition, we are now seeing the start of global warming, and the volatility and variability of weather patterns is now at a very high level. Global warning is manifested in increased greenhouse gases, and increases in air and sea temperatures. This results in greater humidity, manifested in widespread flooding disasters. Just one week ago, we had flooding throughout Europe, not just in a particular river bed or country. This widespread quality of natural events and loss events is a new one. We can also expect a rise in the sea level, which will further increase loss curves.

In a warmer atmosphere, we will see more rain and flooding. In a warmer climate, the pattern of extremes is also changing, with many more extreme cold winter days and extreme hot summer days. We are thus facing a dramatic situation, and climate scientists predict that temperatures could go up by 5.8° by the end of this century.

Therefore, even if we consider only French or German data for the past two years, we can see very extreme weather related events throughout these two countries. This illustrates that the predictions made by climate scientists are starting to become reality.

III. Tasks

In relation to loss potential analysis, scientists working in the insurance area carry out analyses of wind speeds, for example, in relation to the "Lothar" winter storm of December 1999. We also analyse the intensity of hailstorms, which will become more prevalent in a warmer climate. To this end, we use the latest computer techniques in overlaying and calculating values such as buildings, land use, storm tracks, flood levels, sums insured etc. This enables us to develop the loss potentials of selected natural disaster scenarios. We also work with insurance tools, which enable insurers to cope with potential losses.

As well as natural disasters, we also have to deal with human-made disasters such as the "Prestige" oil spill. The awareness of environmental issues is growing among bankers, and the economy and society at large, and these issues are now an integral part of broader societal issues. The awareness of all our stakeholders can only be expected to grow further in the coming few years, and financial institutions have to prepare for this. It is not sufficient to pay lip service to these issues through the writing of reports and statements. This has to be followed up with genuine action.

IV. Environmental Issues and Sustainability

Our philosophy is based on meeting the expectations of all stakeholders: shareholders, clients, ratings agencies, public interest and employees. We therefore carefully monitor what is going on in our stakeholder environments.

The 20 scientists working at Munich Re use high power loss potential analyses and insurance tools. We are also involved in asset management, screening our own assets very carefully. Certification processes are very important and, as a large company, real estate management is very important to us. The group has about 700 premises and we need to consider the CO_2 performance of these premises. Finally, we are very concerned with education and publish extensively on the issues of climate and environmental change both for our own employees and for society at large.

We also support the political process and are active in UNEP and UNEP FI. We believe that the Kyoto Protocol must be a success. We have been exploring the development of supporting products to the Kyoto Protocol. We continue to advise the political world on what the private insurance or banking industry needs in order to support positive political developments such as the Kyoto Protocol.

Linking Sustainability Performance to Fiduciary Responsibility

Pierre TREVET, Innovest Strategic Value Advisors Inc.

I. Introduction

A number of speakers have shown that global warming may not be material enough to be taken into account by fiduciaries. In the past, most investment managers, trustees and fiduciaries would have argued that environmental and social issues are cost centres for companies. However, there is now mounting evidence of the correlation between environmental and social performance on the one hand and portfolio performance on the other.

We can therefore now ask whether *not* taking into account climate change and other environmental issues represents a non-fulfilment of fiduciaries duties. A number of pro-active banks have made very bold statements in relation to the relevance of climate change.

II. Innovest

Innovest is a financial advisory firm specialised in environmental and social rating activities with a staff of 35. In addition to our EcoValue'21 and Intangible Value Assessment (IVA) performance rating products, we have a particular product related to this area, Carbon Risk Exposure. This product assesses the differential between the various carbon beta or risk profiles of companies in a given sector.

We are also involved in the "Value at Risk: Climate Change and the Value of Governance" project led by CERES, which is aimed at educating major industrial actors and investors on the relevance of climate change to their fiduciary duties. We also work with the UNEP Financial Initiative in mapping the climate change risks to the financial services industry and demonstrating the opportunities to be gained by companies in mitigating carbon risks.

We have been working on the Carbon Disclosure Project (CDP), which involves 35 major asset managers representing over USD 4.5 trillion in assets. This Project has sent a letter to the boards of directors of the FT500 Global Index companies, the 500 largest companies throughout the world, asking them whether they consider climate change as part of their fiduciary duties. They were also asked to disclose the amount in which they believe it will impact on their portfolios and assets. We are in the process of collecting this information and the results will be disclosed in the following months. It would seem that many large companies are still not aware of the impact of these climate change issues.

We have also made a presentation to the US Senate on the importance of climate change, although we have not been very influential in this area.

III. Loss Trends

Relevant data shows that the total amount of economic losses in the past 15 years due to climate change are estimated at about USD 1 trillion. In each decade, the amount of economic loss has doubled. Scientists therefore expect USD 150 billion worth of losses each year in the next decade.

In terms of scenarios, we are not yet seeing the material effects of this climate change because the costs have not been internalised or insured.
Based on the range of possible global emission scenarios, we can see that there are many opportunities to assess the risk differential of various scenarios of the cost of carbon. The largest differential is to be found in relation to company strategies aimed at anticipating and mitigating climate change risks.

IV. Shareholder Value

In the context of the impact of climate change on shareholder value, there are two main sources of risk:
- Economic and competitive risks from climate change itself.
- The exposure to the regulatory and competitive implications of attempts to mitigate greenhouse gas emissions.

These two sources of risk affect corporate financial performance in various ways: through direct cash flow and earnings; through brand or reputation; and through the cost of capital. They also affect corporate financial performance at different investment levels: project level; company level; and sector level. For example, various scenarios for internalising the cost of carbon are likely to change the internal rate of return. At the sector level, various threats and opportunities are to be found. At the same time, we can envisage both climate-related impacts and Kyoto-related impacts.

Negative Impacts

Examples of negative climate-related and Kyoto-related impacts include Canadian National, a railway company. The revenue stream on their grain freight business has been dwindled due to droughts, leading to redundancies and a revision of forecasts. Nexen/BP had to interrupt its business in the Gulf of Mexico in October 2002 due to hurricanes and extreme weather conditions. Potash, a fertiliser company, has lost a major part of its sales due to droughts. Intrawest, a ski resort company, is investing in snow cannons, which paradoxically reinforce the climate change process.

Positive Impacts

Examples of positive climate-related and Kyoto-related impacts include BP, which has received a USD 350 million payback due to the fact that it exceeded its Kyoto targets. Alcan has seen an increase in the demand for aluminium as opposed to steel as car manufacturers attempt to reduce the weight of cars. Inco, a nickel mining company, is benefiting from the increased use of nickel in batteries for hybrid vehicles. Dupont has saved USD 30 million in energy conservation in the period 1992 to 2001. STMicroelctronics has reduced energy costs by USD 900 million. A growing number of major institutional investors are capitalising on their preparedness to mitigate risks and reap opportunities.

V. Ratings Models

Innovest has been developing models destined for asset managers and institutional investors who want to assess the risk profile differential in a given sector in order to better position their portfolios. The Carbon Risk Exposure model shows that, on the basis of various enforcement mechanisms, companies are likely to oscillate between minimum case scenarios and maximum case scenarios. It allows us to see the risk exposure of a company, which could be up 11%-25% of current market cap in the high carbon impact sectors. This is a huge cost that is not factored into major risk assessment processes.

Conclusion

The concept of fiduciary responsibility has been extended to include environmental and social criteria. Climate change and other sustainability issues in a number of ways will impact shareholder value and portfolio performance. First, through direct cash flow: market share, higher value applications, operating costs, taxes, penalties and other incentives. Second, through brand/market perceptions: market perception of stock value and the relationship with regulators and communities. Third, through the cost of capital: debt financing, discount rates, insurance conditions and credit risk ratings.

Insuring the Uninsurable

Andrew DLUGOLECKI, **Andlug Consulting**

The simplest way to insure the uninsurable is to ensure that it does not occur. This principle applies, in particular, to the management of climate change.

I. Gaps in Insurance Cover

There are many problems associated with the insurance system as it stands today. Even without the impact of climate change, insurance poses a number of major problems. First, 80% of losses are not insured at all. Second, it represents a very inefficient process, where 30% of funds collected are not recycled to victims. This percentage is even higher in third world countries. Third, insurance is generally restricted to rich people. Fourth, product design has resulted in short-term, restrictive products. This has negative consequences for the rest of the financial industry. Finally, there is a lack of capital, with unstable prices and volatile demand.

II. The Way Forward

Public Policy

To deal with these problems, we can deal with risk through greater collaboration with governments on public policy. In France, for example, the natural catastrophe, government re-insurance system is quite satisfactory. The UK has a private market system, and other systems can be found throughout Europe. We therefore need to decide how to manage this area. Will premiums be based on risk or will we opt for the French system, where everyone pays the same premium regardless of the level of risk? Will we follow the US approach, which seeks to identify a guilty party? Most importantly, we should be dealing with physical risks rather than financial systems. This raises issues of design and construction.

The Human Factor

We also need to consider the human factor. The insurance industry currently has some of the worst calibre management in the world. We therefore need to raise the quality of people in the insurance industry through selection, training and personal development.

Capital Formation

There is currently not enough capital to deal with these problems. Governments are beginning to act on this through taxation breaks, and the market has been exploring catastrophe bonds and weather derivatives. Unfortunately, not enough has been done in this area, as the rest of the financial community is rather uneasy about disasters, which are becoming more frequent.

Internal Processes

Finally, we need to improve our internal processes to design systems that are more flexible, and can reach people more easily. This is particularly true for the third world, where a concept such as micro-insurance, in parallel to micro-investment, could be developed. In this context, on-line purchasing of insurance is likely to grow. Call centres are another useful tool for development.

III. Investment for the Future

Reduction of Greenhouse Gases

In order to stop the problem of global warming, we have to have a major cut in greenhouse gases. The IPCC has cited a cut of 60% as necessary to stabilise the level of greenhouse gases. Given this figure, the impact of the Kyoto Protocol is minimal and ends in 2012. A study by the US National Academy of Sciences is available on the Internet. It points out that climate change does not follow the smooth predictions contained in graphs. Instead, at some point in the process, the climate changes suddenly and dramatically.

The Need for Major Economic Change

If we take these risks seriously, we need to make major economic changes. An Exxon report published in December 2002 states that, by 2010, half of the oil we will need would have to come from new sources. However, rather than encouraging the development of renewable energy, for example, the report recommends a significant increase in spending on oil technology. This illustrates the fact that investors cannot rely on managers or on politicians, who show a lack of vision and short-termism.

Rising Pressure on Investors

Pressures are rising on investors to address these issues, in particular, as the pace of developments increases. Very recently, the New York Times reported that the US cities of Oakland and Boulder had joined with Friends of the Earth and Greenpeace to sue the US Export Credit Agency for contributing to climate change that is disrupting their water supplies. They based their argument on the fact that the Agency did not consider climate change in its guidelines on environmental impact analysis. The Carbon Disclosure Project shows that the financial industry is now doing something about this issue rather than just talking about it. Swiss Re now asks whether companies have strategies in relation to climate change. The fact that they do not have such strategies is a negative factor in providing liability insurance to the directors and officers of the company.

Safety versus Poverty

The argument that safety equals poverty is wholly untenable. In fact, an IPCC report demonstrates that we could cut emissions by 20% using today's technology at no extra cost.

IV. The Carbon Disclosure Project

The project is a very cheaply financed one. It is composed of a group of 35 investors representing over USD 4 trillion in assets. It has asked the world's top 500 companies for information on their awareness of, and action on, climate change issues, including in relation to product life cycle and supply chain impacts. The report will be released in London on 17 February 2003. Two-thirds of companies have responded. The quality of responses varies from poor to excellent.

V. Contraction and Convergence

In relation to the political aspects of this issue, an NGO (the Global Commons Institute) has proposed that we aim for globally equal levels of greenhouse gas emissions to keep the climate safe. We can fill the energy gap by being more efficient and by using renewables. There is no doubt that this would lead to greater wealth and a better quality of life.

Questions and Answers: Key Points of Discussion

Roundtable One: Question and Answer

From the floor

You noted that banks and insurers could be sued for financing a project or a company. Could they also be sued for insuring a project? What would such a scenario look like?

Kai HOCKERTS, INSEAD

From your figures, qualitative risk is twice as high as the credit risk. Could you explain this further please?

Employee, Price Waterhouse Coopers

It is clear that risk influences the cost of capital. However, this depends on the perceived risk and not always the actual risk. The Enron case makes it clear that perceived risk was much lower than actual risk. Therefore transparency is still very low and the belief that managers have sophisticated internal mechanisms for measuring risk is false. What we see in external reporting is not based on internal reporting of intangible values. Companies need to find a solution internally to measure risk and should then model external reporting on their internal reporting. What we see today is not the internal reality in enterprises.

Alan BANKS

It is actually “other risk” which is twice as high as credit risk and the data relates to risk-return profile of Ford Motors’ bonds taken over time. We believe that corporate governance and responsibility risk can explain a part of the “other risk”.
In relation to the question on whether insurers are less likely to be insured than banks, I believe that banks are more likely to be sued than insurers. The problem is working out where the risk went. Banks taking project finance activity will seek insurance. No primary insurer will accept the risk before discussing with his re-insurer. Ultimately, there may not be any hiding place as a court or trial process seeks to follow through the risk transfer route.

Anthony SAMPSON

In relation to reporting, one truth has persisted since the early days: you start with internal reporting. Reporting is the end of the story. It tells people what has happened and what is about to happen. There can be no report unless you have actions to fill it. Your staff needs to be convinced and be your first warning system if there is anything ungenuine. I would strongly underscore the importance of internal reporting.

Allen WHITE

Governance is an excellent example of a concept integral to the prosperity of the firm but lacking in standard measuring tools. We can envisage a situation five years from now with a general accepted set of metrics to measure the quality of a business. This would appear in every single financial statement or sustainable report and would lend itself to comparability across organisations. It would require major business input to define these governance metrics as governance is bigger than business itself. When governance collapses, employees lose jobs, investors lose asset value, and entire communities are destroyed. We need to ensure that the qualified people are engaged in the process of defining the appropriate metrics.

Kai HOCKERTS, INSEAD

Do you believe there is a link between corporate governance and corporate responsibility? Do they influence each other positively or negatively?

Justin KEEBLE, Arthur D. Little

Corporate impacts remain outside the business case. What will be the incentives to pull companies to address these impacts?

Arthur LEVI, International Finance Corporation, France

When you talk about corporate responsibility, could you give us some specific criteria you use?

Alan BANKS

Governance and responsibility are linked. I think far too much of governance debate has been seen as a debate aside from the main business itself and as somewhat of a box-ticking exercise. We start with governance itself and believe that it exists to ensure that the Board of Directors implements, develops and discloses policies, which achieve four objectives:

- Increase in shareholder value,
- Lowering the cost of capital,
- Management of business and operational risk; and
- Responding to reasonable stakeholder concerns.

In relation to the criteria used, we have a very long list of issues. A rating is a market tool, answering a question the market wants answered. With credit ratings, the question is the probability of long-term default. In relation to responsibility, the question is to what extent the management of a company is measuring and analysing risk. There are 70 to 100 metrics involved in this regard.

Brian PEARCE

In relation to the drivers for companies to take note of risks that are currently outside the business case, businesses are increasingly concerned that the impact they are having may lead to them becoming material business risks through either action of governments in imposing regulations or through action by consumers. This provides incentives for companies to assess these risks systematically.

Anthony SAMPSON

In relation to the drivers, there is a large number of which the most important remains enhanced liability vis-à-vis shareholders, customers and staff who are the people that determine the company's right to be in business. Businesses are always being appraised according to a constantly changing set of criteria and expectations of performance are constantly being re-defined. This is the most important driver.

Roundtable Two: Question and Answer

Peter CLARKE, SRI Media plc

Mr Dallas, given that S&P's rating services are paid for by companies, how can the retail user be sure of not being manipulated by the ratings themselves?
Mr Lake, assuming an armed conflict takes place in Iraq, do you agree that investors will flock to the oil and defence sectors? If so, how is your institution addressing the issue of potential changes to equity weightings in your investment portfolios? What would be your stance on investing in these sectors?

From the floor

Given that land is cheap in Indonesia, why are Greenpeace and WWF not investing in replanting in this area? Secondly, how effective have the NGO campaigns against banks in the US or France been? Is there not another risk: the potential for companies to de-list if there is too much pressure placed on them?

John BUTLIN, Royal Holloway, University of London

Addressing the question of activities that are inherently unsustainable such as the tobacco industry, for instance, how do investment management companies deal with this problem? Do you include them in you portfolios or not?

George DALLAS

Ultimately, there are limits to what can be understood through an external analysis and ratings, on a stand-alone basis, are not perfect. For example, Enron simply provided incorrect information. Ratings cannot provide forensic analysis in the presence of incorrect information. With respect to the business model, we work with companies on a self-selecting basis. It is not possible to achieve this in a non-superficial manner without meeting with company directors and interacting with personnel at all levels of the company. We approach this from a sustainability perspective ourselves and believe this to be the best way to ensure the quality of analysis.

Rob LAKE

If there is a war in Iraq, investors are likely to flock to the mining, oil and gas, and tobacco sectors. Unfortunately, there is no perfect match between investment time-scales and sustainability time-scales. For the short and medium term, these sectors will continue to be good investments in financial terms. Investors work to a short-time scale and this points to inherent flaws in the system. To integrate sustainability issues into the investment process, we need to consider externalities that are currently not internalised, as is for example the destruction of social capital by the tobacco industry. In relation to the de-listing of companies, I believe that we remain at quite a distance from a situation where companies would deliberately de-list. Should this start to eventually happen on a large scale, credit ratings would assume a larger importance, as these companies would presumably still need some form of capital.

Jan Willem VAN GELDER

The frontier forests in France disappeared a long time ago. The 1% annual depletion figure is from the FAO and this implies that in 100 years, there will be no frontier forests left. While land may be cheap in Indonesia, setting up a sustainable plantation is an expensive exercise. We are discussing possible solutions with WWF. NGOs see campaigns as a new way of reaching their goals and such campaigns are likely to increase in the future.

Roundtable Three: Question and Answer

Stefan ROSTOCK, Germanwatch

Climate change represents a direct and indirect risk to investment. What information do you need from companies in order to deal with climate change as an investment risk?

Karina LITVACK

Unfortunately, the impact of climate change on most companies is a long-term one. Our studies have shown that the impact of the ability to manage climate change risk on share price is fairly negligible. Therefore, we are very involved in an engagement mode but have no real proof to show that companies will suffer in the near or medium future. However, in some areas, the impact could be expected to occur in the short term, for example, in relation to coal. Many factors affect the share price, and climate change is but one of them.

Carlos JOLY

There are 40 asset manager signatories to the Carbon Disclosure Project, a data gathering effort launched by a group in London. It aims to collect information on emission and greenhouse gas adaption strategies from the 500 largest companies in the world. The Project report will be published next month. The World Resources Institute has published a study that claims that the effect of the Kyoto Protocol on the evaluation of energy companies is very small. This indicates that there is a problem in relation to the internalisation of the real costs of climate change into the pricing of the economy.

Kai HOCKERTS, Insead

Karina LITVACK stated that it was not enough to have SRI specialised funds but that it was necessary to integrate these issues into mainstream investment. In my experience, this is not really happening. What do you do in your own organisations to ensure that your mainstream investor colleagues take up these issues? How seriously do your colleagues take you?

Wim VERMEIR

Initially, our colleagues were very sceptical about our work on sustainable investment. However, we are now producing good results. Our sustainable teams work together with traditional investors, who now accept the concept that sustainable criteria affect the risk profile of a company.

Discussion

Gilles GOEPFERT, TSO

What types of products would you propose to CDM developers?

Thomas LOSTER

We have built up a team of specialists dedicated to new products. I cannot provide detailed comments here as I am not familiar with your project.

Carlos JOLY

Insurance mechanisms work by providing coverage for large population of persons or entities at risk, setting premiums, and hoping for few events that will lead to claims. In the context of a large systematic change, such as climate change, we can foresee a multiplicity of claims of increasing dimensions. How can the insurance industry expect to provide insurability coverage for large scale, macroeconomic, systemic risks?

Thomas LOSTER

Insurance premiums are determined on the basis of loss histories. For example, premiums paid on car insurance reflect the losses caused by a particular class of car. Given that there will be a change, we should carry out more prospective underwriting and charge higher premiums. However, if we do so, we will lose our standing as a non-political, monitoring organisation in the world of environmental change. We have analysed the loss trends and know what losses to expect in the coming years. However, up until now, premiums are only calculated on the basis of loss histories.

Tom BUTLER, GRI Investments

It may be that these issues are being driven by consumers. This is made possible by technology, that is, the Internet. It is important that this task is not reduced to the ticking of boxes, which will not result in getting the job done. We have to be flexible in our approach. It is important that our investors, shareholders and other stakeholders understand the methodology that is being applied. This is a question of communication.

Laurent DITTRICK, International Energy Agency

The majority of investments are currently not driven by the principles that have been presented today. Issues such as climate change, market liberalisation, energy and developing countries point to major disruptions in the economy as we know it today. When those risks materialise, companies and markets are often on the verge of defaulting. How can we cover ourselves for this? Socially responsible investors cover themselves by investing in “good” products but how can we make mainstream markets take this into consideration? Are risk-adjusted discount rates a solution?

Pierre TREVET

We live in a highly competitive world. The main concern is not related to risk defaulting. In any given sector, there will be a broad range of carbon risk exposure, and companies that are most exposed will lose market share. Regulators will adapt their political programmes to reduce carbon emissions. There will thus be a progressive enforcement and internalisation of carbon costs. It is therefore crucial to be able to differentiate between the various risks profiles in a given sector.

Jacqueline Aloisi DE LARDEREL
Assistant Executive Director, UNEP DTIE

Closing Remarks

Jacqueline Aloisi DE LARDEREL
Assistant Executive Director, UNEP DTIE

The world today is changing; consumers, professionals, workers and governments are becoming more aware of the issues discussed at this meeting. Obviously, even if the risks associated with the environment and social issues are still unclear, companies and the financial sector have to respond.

Today, we learnt of new tools and solutions dedicated to the evaluation of these risks. In this regard, we saw that environmental reports have emerged as one of these fundamental tools. As Andrew highlighted, the education and training of tomorrow's managers remains a challenge. In my case, when I decided to study the environmental area over 30 years ago, most of my peers at INSEAD were shocked. However, today, they have changed their mind.

Secondly, the objectives of this meeting have certainly been achieved. We have succeeded in exchanging our experiences and information. In particular, I am pleased to note the involvement of external partners, such as RETRAC. In addition, we have succeeded in involving more French and European banks in the UNEP FI and in ORSE. In my opinion, many delegates have realised the significance of the added value of such conferences where one can exchange experiences with people from other sectors. Finally, from the length of the coffee breaks, I believe that substantial networking occurred.

As we were discouraged from distributing feedback forms, we invite you to offer your opinions via email over the coming weeks. In the context of our conference in Tokyo next October, such feedback is very important to us. Finally, since the success of any conference depends on the participation of its delegates, I would like to thank you all for your contributions. In addition, I would like to thank the speakers for the quality of their presentations and Société Générale for their efforts in co-hosting this event.

Michele LAVIALE Société Générale

Unfortunately, Philippe CITERNE has been delayed in a Board of Directors' meeting. In his place, I would like to take this opportunity to thank all the delegates, speakers and organisers, especially those of UNEP FI and Société Générale. Finally, I would like to wish Jacqueline Aloisi DE LARDEREL the best of luck in her upcoming retirement. Nevertheless, knowing Jacqueline Aloisi DE LARDEREL it will be a very active retirement.

Information on Organisers

The UNEP Division of Technology, Industry and Economics (DTIE)
http://www.uneptie.org

The mission of DTIE is to help decision makers in government, local authorities and industry develop and adopt policies and practices that:

- Are cleaner and safer;
- Make efficient use of natural resources;
- Ensure adequate management of chemicals;
- Incorporate environmental costs;
- Reduce pollution and risks for humans and the environment.

UNEP DTIE activities focus on raising awareness, improving the transfer of information, capacity building, fostering technology cooperation, partnerships and transfer, improving understanding of environmental impacts of trade issues, promoting the integration of environmental considerations into economic policies, and catalysing global chemical safety.

UNEP Finance Initiatives
http://www.unepfi.net

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UNEP FI is a global partnership between the finance, insurance and public sectors that develops and promotes sustainable best practices in financial institutions.

In 2002 almost 300 signatories in 51 nations work with UNEP FI towards the common goal of maintaining the health and profitability of their businesses within the framework of sustainable development.

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Finance, Environment and Sustainable Development

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