THE ROLE OF FINANCIAL INSTITUTIONS IN ACHIEVING SUSTAINABLE DEVELOPMENT

REPORT

TO THE EUROPEAN COMMISSION

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Executive Summary

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Introduction

The European Community Programme of Policy and Action in Relation to the Environment and Sustainable Development (the Fifth Environmental Programme) (OJ 93/C 138/27) recognised the importance of financial institutions by stating that "financial institutions which assume the risk of companies and plants can exercise considerable influence - in some cases control - over investment and management decisions which could be brought into play for the benefit of the environment". Despite this, little work has been done by the Commission on the role of the financial institutions in achieving sustainable development.

An even more fundamental relationship is indicated by an alternative definition of sustainable development: *"a process of development which leaves at least the same amount of capital, natural and man-made, to future generations as current generations have access to".* This makes it clear that sustainable development is about capital allocation and thus should be at the core of financial markets activity.

On a more practical level, financial institutions interact with the environment in a number of ways:

- as *investors* - supplying the investment needed to achieve sustainable development.
- as *innovators* - developing new financial products to encourage sustainable development - e.g. in energy efficiency.
- as *valuers* - pricing risks and estimating returns, for companies, projects and others.
- as *powerful stakeholders* - as shareholders and lenders they can exercise considerable influence over the management of companies.
- as *polluters* - while not "dirty" industries, financial institutions do consume considerable resources.
- as *victims* of environmental change - e.g. from climate change.

Financial markets present an opportunity for environmental policy, particularly useful in view of the need for a wider range of policy instruments. In view of the indirect nature of many of the interactions above, policies are likely to be most effective if they aim to complement and work with existing financial activity.

To that end, a transactional model of the financial markets is used, to indicate how it is possible to influence financial transactions. It illustrates the key roles of information and analysis.

The Commercial Banking sector

The greatest potential of the commercial banking sector is in its relationship with Small and Medium sized Enterprises, where banks can be very influential through their lending practices and by providing information. Commercial banks have less influence over most larger companies. There is, however, scope for them to influence consumer behaviour through the financial products they offer.

To date the most commercial banks have focused on two areas: Firstly. many have made considerable progress in developing *internal environmental management* systems to reduce their own environmental impact. Secondly, most banks include some environmental analysis into their *credit assessment* process although this tends to be focused on liability.

The United Nations Environmental Programme (UNEP) has established a statement on Banks and the Environment which over 90 banks have signed, including a substantial number from the EU. It is the leading international initiative on banks and environment and is certainly encouraging a number of banks to take the environment seriously.

A smaller number of leading banks have taken their activities further, and for instance have started to take a *wider view of environmental factors in credit assessment*, including developing checklists and other procedures.

One particularly encouraging area of activity is providing *practical support to small businesses* on how to manage their environmental impacts, through information packs and other support.

Where banks have been less progressive is in developing *new financial products* with an environmental perspective for both business and individuals, such as energy efficiency loans. Encouraging the development of such products appears desirable.

There has been considerable work in developing *environmental management systems* (EMS) and reporting for banks, including possibly an extension to EMAS. It is important that such initiatives focus on the environmental impacts of financial products rather than merely the impact of internal operations. In view of the generally systematic approach to business by commercial banks, further use of EMS appear to be an effective way forward for the sector.

The Investment sector

The potential of the investment sector lies in the influence it has over large companies. It can send signals to industry in the pricing of new capital for companies and in the on-going valuation of quoted companies as well as directly through the use of its rights as shareholders and owners.

To date, as whole, investors are probably less interested in the environment than bankers. However, a number of pressures are emerging on the investment sector:

- *Leading companies* have become increasingly frustrated with the failure of the investment community to recognise and reward the environmental progress they have made. In particular, the international business organisation, WBCSD, has been active in this area, developing the concept of eco-efficiency and encouraging its use among investors.
- There is growing interest from *individual investors* in environmentally responsible investment, and this has led to the development of some progressive environmental investment funds. Institutional investors have also started to explore this area, reassured by the good investment performance of such funds. As a “green” product with no price or quality premium, the potential market for such products is likely to be substantial.
- Another avenue that some investors have pursued is *shareholder activism*. They have become frustrated with the indifference of investing institutions and are taking their concerns directly to large companies. This has proved effective in the US, but is more limited in Europe where shareholders’ rights are less developed - there may be scope to develop it in the EU.
- *Environmental NGOs* have also started to target fund managers and investment banks over their investments and involvement with environmentally damaging companies. To date they have not had major success, but have started to influence the sector.
- Finally, a few organisations among the investment sector have started to take environmental issues more seriously and may be creating some *peer pressure* for change. While much scepticism exists and should not be underestimated, there are signs that attitudes may be changing.

A key concern for the investment sector is the relationship between environmental performance and investment performance. Here the evidence on balance suggests that environmental performance does contribute to good financial performance. However, many in the investment sector remain unconvinced, and action is needed both to persuade doubters and reinforce signals, e.g. through the development of environmental taxation.

To encourage the investment sector to incorporate environmental issues a number of obstacles need to be overcome. Two key obstacles are market inertia in investment practices, and the balance between long term and short term analysis. However, the most important issue is probably difficulties in obtaining good quality information in ways that the sector can understand and use. Ways need to be found to provide relevant information to the sector.

The Insurance sector

The potential of insurance sector in achieving sustainable development lies in its ability to price various types of environmental risk and to help pay for environmental damage. Potentially environmental issues can affect risks in a number of areas, but to date the industry has taken an issue based approach and has focused on the environment in two main areas:

- *Environmental liability* has had a seriously adverse affect on the industry, particularly in the US and has resulted in the industry taking a very cautious approach to environmental issues. It is important that in any development of environmental liability in the EU the insurance industry be actively involved and reasonably supportive. Unrealistic expectations of the extent to which the industry can price environmental risks accurately should be avoided.
- The industry has also become clearly concerned about the potential impact of *climate change* on its business. Changing climate at best undermines the historic basis for evaluating risk and at worst could significantly increase losses, from increased storms and floods, to the extent that even the very viability of the industry could be threatened. In response, the leaders in the industry have developed a comprehensive set of measures, ranging from an increasing lobbying at the climate change convention, through working with governments on research and preventative measures, to adjusting premiums and their areas of activity.

UNEP has also launched an Insurance Industry Initiative on sustainable development. It too has been successful and has strong European representation. Members of the initiative have been particularly active in the areas of climate change and asset management.

Beyond these areas, however, there has been little research by the industry of the implications of sustainable development for the insurance sector at a fundamental level. Similarly, many outside the industry have a poor understanding of the practicalities of the industry, leading to limited work on how insurance could contribute to sustainable development.

Companies, Investors and the Environment

Companies increasingly see environmental issues as being of relevance to their business development, yet financial markets, particularly investors are uninterested. Companies are increasingly aware of the environmental pressures they are under and have developed a range of practical tools to address them.

There is increasing understanding of the financial implications of these pressures among leading specialists, yet most in the financial community pay only limited attention to them.

Information is the key to financial evaluation, but there is limited useful information on environmental performance and management. The main existing sources of information are not geared to financial audiences:

- Environmental reporting is targeting multiple audiences and many companies do not report.
- The potential with annual reports is erratically exploited and lacks standardisation.
- Publicly available information faces substantial practical obstacles.

To address this there is potential to *develop standardised and financially useful environmental reports*, potentially as part of the annual reports, encompassing financial information, environmental performance data and qualitative information on environmental policy and management.

An alternative approach is through the development of *environmental rating agencies* who can provide a summary analysis geared to the needs of the financial markets. At present such services have only limited appeal, but they offer long term potential. An effective way of encouraging the development of these services would improve the quality of information made available through the public regulators.

The Environmental Business Sector

The environmental business sector consists of businesses ranging from traditional environmental businesses, such as waste management, to emerging “green” pioneers, such as renewable energy and eco-tourism. They have a critical role to play in achieving sustainable development and thus ensuring they have access to private sector finance is crucial.

Despite apparently good prospects, with rapidly growing markets, the financial performance of the sector has been disappointing to date. Indeed, the poor performance of many high profile companies has been a major factor in creating a negative impression about the environment with financial institutions.

A number of factors are identified for this. Several of them are closely related to the public sector and policy issues, both in the way that the environmental markets are often dependent on policy development and in the active role of public sector finance in this area.

In response to the challenges faced by environmental sector companies, a number of innovative approaches and specialist organisations have developed, including project finance, venture capital, leasing, environmental and ethical banks, specialist environmental financiers, and environmental funds. However, the sector may place excessive emphasis on emerging sources of finance or stretch existing finance into new areas and there is a continuing need for innovation.

To encourage the financial markets to support the sector, there is a need for measures at both a macro level, such as clear policy development and dissemination, and micro level, such as training on financial markets for environmental entrepreneurs. There is scope to support innovation in finance to the sector. In addition, public sector financial support programmes to the sector could be adapted to work more closely with the financial sector.

Environmental Policy

Environmental policy can be developed in a number of areas to encourage financial institutions to support sustainable development.

- The EU directly *provides funding* to protect the environment in a number of ways. Particularly where such support is targeted at the private sector there is scope to ensure that it complements and encourages the involvement of financial institutions.
- There is scope for the European Environment Agency to improve the *quality of information* made publicly available, so that it can be used by financial institutions, and additionally to brief financial institutions on environmental pressures and policy development within the EU.
- There is increasing pressure to alter the structure of *taxation* in favour of environmental issues. Such issues would help strengthen the contribution that environmental performance enhances financial performance. There is widespread support for such taxes among the financial community.
- *Liability* is potentially another effective market mechanism. However, as it requires the involvement of the insurance industry to be effective, they should be actively consulted as to how best make it work.
- There is scope to expand both the *EMAS scheme* and the *Eco-label scheme* to encompass financial institutions and products. EMAS would encourage financial institutions to take a systematic approach to environmental management. An Eco-label on green financial products would aid marketing and reward innovation.

Financial Policy

Existing European financial policy regarding banks, insurance and investment services is principally focused on creating a single market for financial services. There appears only modest scope to encompass environmental issues in most areas, as it is not evident that the environmental risks are sufficient to warrant special treatment by regulators.

In *bank regulation* there is a potential argument for making some form of environmental management compulsory or by requiring the disclosure of lending to high risk sectors.

There is a potential for action in the areas of *consumer protection*, where the Commission has a clear mandate and effective policy actions are possible, desirable and justifiable.

The EU also regulates *disclosure and listing requirements* for companies and there is potential to develop a formal standard for environmental disclosure by companies.

Analysis

A key issue in the inclusion of environmental issues is the *significance* of environmental issues - while potentially of some relevance, many environmental issues are of insufficient importance to be a priority, particularly in view of other concerns and practical difficulties.
Improving information flows would be an effective way of making it easier for financial institutions to incorporate environmental considerations.
There is still potential to reinforce the link between environmental performance and financial performance, notably through the use of economic instruments such as environmental taxes.

Recommendations

Ten policy options are recommended for consideration by the Commission. The options have been chosen on the basis of the potential to have a major long term environmental benefit. In addition many of the policy options chosen do not involve the expenditure of substantial public funds or impose major burdens on industry. Indeed, one of their key aspects is that they are likely to improve the functioning of existing policy measures.

The Commission should take a lead role in *improving the flow of environmental information* relevant to the financial markets. This could be done:

1. through standardisation and improvement of information currently being collected and made available by environmental regulators
2. through the development of environmental reporting standards targeted at the financial markets.

The Commission should also consider taking action to *increase the demand for environmentally responsible investment*. Such actions would create substantial demand based incentives for financial institutions to develop environmental expertise and products. Actions include:

3. as part of its involvement in consumer investment protection, requiring financial institutions to ask investors if they are concerned about how their money is invested environmentally or ethically
4. developing, as part of its eco-labelling scheme, a label for environmentally responsible investments.

The Commission should encourage the *development of environmental management* at financial institutions, through:

5. supporting information dissemination on best practice for financial institutions
6. the extension of the EMAS scheme to include financial institutions. This would require a greater focus on impacts of products.

More formal control through the financial regulatory mechanism is possible, for instance by making environmental management mandatory, by requiring disclosure of exposure to high risk sectors, by looking at the potential for voluntary investment agreements, and by looking at the role of the European Central Bank. However, they are probably not a priority at present.

The Commission should consider ways to encourage the *development of environmental financial products* for business and consumers. One cost effective mechanism for the Commission would be:

7. to support awards for innovation in environmental finance. This would provide an incentive for companies, and would enable publicity and dissemination.

The Commission could also consider the use of direct financial support in the product development stage of new environmental financial products and initiatives, recognising that the cost and risks of product analysis and development are a major obstacle to their deployment, although this may be best left to Member States.

The Commission is also advised to consider ways to *improve its existing support* to the environmental business sector:

8. by investigating the potential role for public sector investment banks to take the lead in encouraging private sector finance to support the sector
9. by improving the quality of information on the Commission's environmental support activities, and using financial institutions to disseminate it more widely
10 by involving the financial markets more closely in these support activities, thus ensuring that the recipients are aware of broader financing issues and the financial sector is able to step in as public sector support ends.

Taken together these policy actions could help actively involve financial institutions in achieving sustainable development and could be a powerful tool in achieving the objectives of the Fifth Action Programme.