



environmental
guide for
banking &
insurance sector

It might be thought that the banking and insurance sectors are less affected by the drive to sustainability - after all their activities are largely office-based, however that would be too narrow a view.

As has been seen so dramatically over the past few years the global nature of modern banking and insurance has global effects – effects that ripple much further than banking halls, trading floors and insurance offices in which their activity is conducted.

This short guide acts as a starting point for anyone interested in sustainability in Banking and Insurance, giving a concise overview of the true effects of its global reach and outlining how changing social attitudes and legislation are changing and challenging the status quo.

environmental guide for banking & insurance sector

this outlines: Relevant legislation, codes and guidelines, Key issues for the sector, Responsible investment, Project finance, Climate change risk.

The year 2008 has been a rocky one for the financial services sector. With a global economic downturn beginning to bite, and the failure of some major financial institutions worldwide, the sector has come under scrutiny as never before. The risk management and governance practices of certain major banks and investment houses are under review, emphasising the need for rigorous processes and implementation of good corporate responsibility practices in the sector.

As an office-based industry, banking and insurance may not appear to have many sustainability impacts. But look a little closer, and you find that the environmental and social reach of the sector is wide-ranging, particularly in the context of investment practices and the financing of major projects around the world.

The indirect environmental impacts of a financial institution therefore include those resulting from its commercial activities – those associated with financing, investment and other business activities that may entail financial, legal, operational and reputational risks ¹. In terms of direct environmental impact, this is mainly associated with internal operating activities including energy, water and paper use, transport and procurement activities.

This diverse sector is also an important employer. In the UK, for example, the banking sector employs nearly half a million people. Taking the wider financial industry and related services into account, some three million people rely on the industry for their jobs ².

relevant legislation and codes / guidelines

THE COMPANIES ACT 2006

The Act provides a comprehensive code of company law for the UK, and is relevant to all sectors. The Act replaced and codified the principal common law and equitable duties of directors, but it does not purport to provide an exhaustive statement of their duties. Traditional common law notions of corporate benefit have been swept away, and the new emphasis is on **corporate social responsibility**. Directors must continue to act in a way that benefits the shareholders as a whole, but there is now an additional list of non-exhaustive factors to which the directors must have regard, including:

- information on **environmental matters, employees and social issues**; and
- information on contractual and other arrangements essential to the company's business.

The Act came into effect in November 2006. For more information: <http://www.freshfields.com/publications/pdfs/2006/Companies Act2006.pdf>

THE BANKING CODE (UK):

This is a voluntary code setting standards of good banking practice for financial institutions to follow when dealing with personal customers. It provides protection for customers and explains how financial institutions are expected to deal with them day-to-day and in times of financial difficulty. The Business Banking Code provides similar levels of protection for business customers, including sole traders, partnerships, limited liability partnerships, and limited companies with an annual turnover of under £1 million. The Code's sponsors - the British Bankers' Association, The Building Societies Association and APACS, the UK Payments Association, issue guidance. The Business Banking Code is sponsored by the BBA and APACS. For more information: www.bba.org.uk

- the long term consequences of decisions
- the interests of employees
- the need to foster the company's business relationships with suppliers, customers and others
- the impact on the **community** and the **environment**
- the desire to maintain a reputation for high standards of business conduct
- the need to act fairly as between members.

The Act also seeks to promote greater shareholder involvement, and a number of new requirements are introduced for public companies. The Act imposes additional requirements for companies listed on the main board of the London Stock Exchange in their annual report and accounts (in the Business Review), including:

- main trends and factors likely to affect future development, performance and position of the business;



CARBON REDUCTION COMMITMENT (CRC)

The CRC is a cap-and-trade emissions trading scheme targeting energy use emissions from large non-energy intensive organisations such as large retail organisations, **offices, banks, universities, hospitals, large local authorities** and central government departments. Organisations will be covered by the scheme if their half-hourly metered electricity consumption is greater than 6,000 MWh a year, generally affecting organisations that pay annual electricity bills of over £500,000. The proposed qualification year for assessing entry into the CRC will be 2008. The first stage of identifying CRC participants will start in 2009 and detailed information packs will be sent out in early 2009. The scheme is expected to begin in January 2010. For more information: www.defra.gov.uk/carbonreduction

key issues

As mentioned above, the banking and insurance sector's key sustainability impacts tend to be those that are indirect - those related to financing, investment and other business activities.

RESPONSIBLE INVESTMENT

Responsible investment (or Socially Responsible Investment – SRI) has its roots in the religious movements of the Quakers and Methodists. The first UK SRI fund was established in 1984, and since that time SRI has grown at a remarkable rate across Europe. In the UK,



the estimated total fund value for ethical retail funds as of December 2007 is £8.9bn³.

There are three main areas of SRI:

- 1 Positive/negative screening:** the inclusion or exclusion of stocks in investment portfolios on social, environmental and ethical (SEE) grounds. Screening is usually split into 'negative' (to exclude unacceptable stocks from the portfolio) and 'positive' (to select companies with superior SEE performance). Screened SRI funds use a range of social, environmental and ethical criteria to include/exclude stocks from portfolios, such as corruption, human rights, diversity, climate change and environmental degradation
- 2 Shareholder engagement:** the process by which investors seek to improve a company's SEE performance by means of dialogue and/or voting at a company's Annual General Meeting
- 3 Integration:** many institutional investors are integrating key ('material') SEE and governance issues into their traditional investment decision-making.

PRINCIPLES FOR RESPONSIBLE INVESTMENT (PRI)

The Principles for Responsible Investment, launched in 2006, comprise a set of 'global best practice' guidelines for responsible investment. They were developed in partnership with the UNEP Finance Initiative and the UN Global Compact. Signatories to the six Principles are incorporating environmental, social and governance criteria into their investment decision-making processes, therefore directly influencing companies to improve performance in these areas. The Principles are voluntary, and provide a selection of possible actions for incorporating environmental, social and governance issues into mainstream investment decision-making. There are three main categories of signatory: asset owner, investment manager and professional service partners. The Principles are open to all institutional investors and investment managers to support. A signatory event is held each year, along with a PRI Reporting and Assessment Survey to help signatories evaluate their progress.

There are two main indices used by investors and financial organisations that are relevant to all sectors. The **FTSE4Good** was established to measure the performance of and facilitate investment in companies that meet globally recognised corporate responsibility standards. Eligible companies must meet criteria in five areas: environmental, social and stakeholder, human rights, supply chain labour standards and countering bribery. The **Dow Jones Sustainability Index (DJSI)** was launched to track the financial performance of sustainability leaders on a global scale. The Index provides a performance baseline and investment universe for funds, based on the concept of sustainability. Sustainability leaders in 57 industry groups are identified and assessed against criteria including climate change strategies, energy consumption, human resources development, knowledge management, stakeholder relations and corporate governance.

PROJECT FINANCE

The banking sector plays a fundamental role in the provision of finance to major capital projects. The Equator Principles (EPs) were drafted in 2003 by the World Bank Group's International Finance Corporation (IFC) and a small number of banks as a set of voluntary standards for financial institutions to manage environmental and social risk in project finance transactions. The EPs are now considered the financial industry 'gold standard' for sustainable project finance.

3. Market statistics, <http://www.eiris.org>

key issues

They were revised in 2006 to reflect current implementation experience (including introduction of a public reporting requirement) as well as changes made by the IFC to its environmental and social standards. They continue to evolve as more sophisticated funding is undertaken. In 2007, US\$52.9 billion of project finance debt in emerging market economies was subject to the Principles. There are currently 63 adopting financial institutions from 25 countries.

CLIMATE CHANGE RISK

According to the Association of British Insurers (ABI), insurance 'underpins every sort of economic activity and is viewed as essential protection in many areas of our personal lives'⁴. The insurance industry recognises the particular challenges that climate change brings and is working with Government, customers and other stakeholders to address these. The sector also recognises the opportunities emerging to develop new products and services and the potential market for both 'climate-friendly' and 'climate-proof' products and services. Reinsurer Munich Re, for example, recently urged world leaders to reach an agreement to address climate change, or face growing insurance losses⁵. The company states that 'driven by high losses from weather-related natural catastrophes, 2008 was, on the basis of figures adjusted for inflation, the third most expensive year on record, exceeded only by the hurricane year of 2005 and by 1995, the year of the Kobe earthquake'⁶.

Climate change will affect every aspect of insurance, including residential, commercial, contents, motor and buildings. The ABI estimates that almost 40% of UK homeowners are interested in a 'climate-proof' policy for their home insurance⁷.

The insurance industry faces several challenges with regard to climate change, including:

- Overcoming customers' barriers to adopting climate-friendly (reducing carbon emissions) and climate-proof (managing climate risk) measures
- Understanding customers' changing needs
- Understanding changing climate risks – for example, new underwriting skills will be needed to evaluate and price new measures
- Existing insurance covers will need to be updated

Benefits and opportunities for the industry include:

- Business opportunities in terms of commercial renewable and microrenewable energy markets
- Securing competitive advantage
- Significant potential markets for climate-friendly and climate-proof products and services
- Helping customers understand changing risks
- Partnering with Government, suppliers and other stakeholders
- Building on existing dialogue with consumers



A group of insurance companies and organisations have signed up to the **ClimateWise Principles**, committing them to take action to reduce climate change risk, support climate change awareness and lead the way in analysing and reducing risks. UK members account for 60% of the general insurance and nearly 50% of the life insurance sectors.

Five major banks and insurers have recently launched another set of guidelines, **The Climate Principles**, intended to shape the sector's response to climate change. About twenty organisations helped to develop the Principles, but only five have publicised their commitment to date. Signatories agree to assess the climate and carbon risk (physical and regulatory) to their business across relevant product and service areas. In terms of project finance, for example, signatory banks will demand that carbon intensive projects disclose greenhouse gas emissions and invest in the latest technology (or buy carbon offsets) to cut emissions.

4. Insuring our Future Climate: Thinking for Tomorrow, Today, Association of British Insurers, September 2007.

5. GreenBiz website at <http://www.climatebiz.com/news/2009/01/05/munich-re-calls-global-climate-agreement>

6. MunichRe website at http://www.munichre.com/en/press/press_releases/2008/2008_12_29_press_release.aspx

7. Insuring our Future Climate: Thinking for Tomorrow, Today, Association of British Insurers, September 2007.

conclusion

There are no specific legislative drivers to encourage better performance in terms of sustainable lending or project finance, however, several voluntary standards and sets of principles exist. Leading organisations in the sector have signed up to these but there is, as yet, no incentive for laggards to do the same. The current economic downturn and specific problems faced by the sector means that sustainability and environmental issues risk being neglected or moved to the bottom of the list, however, good corporate governance, improved risk management and a focus on longer term value are more important than ever.



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USEFUL LINKS

Association of British Insurers

www.abi.org.uk

Association of Investment Trust Companies

www.aitc.co.uk

Banking Code Standards Board

www.bankingcode.org.uk

British Bankers Association

www.bba.org.uk

Building Societies Association

www.bsa.org

The Climate Principles

www.theclimategroup.org/about/corporate_leadership/climate_principles

ClimateWise Principles

www.climatewise.org.uk

Dow Jones Sustainability Indexes

www.sustainability-index.com

Equator Principles

www.equator-principles.com

Financial Services Authority

www.fsa.gov.uk

FTSE4Good Index Series

www.ftse.com/Indices/FTSE4Good_Index_Series/index.jsp

International Finance Corporation (IFC)

www.ifc.org

Investment Management Association

www.investmentuk.org

Principles for Responsible Investment

www.unpri.org

UK Social Investment Forum (UKSIF)

www.uksif.org



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