SUSTAINABLE BANKING & FINANCE

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Crisis and disasters boost zeal for reform

The financial collapse and a run of environmental disasters are among the issues driving change, writes **Patrick Jenkins**

Japanese medical personnel check a mother and son for radiation exposure in Kawamata village, Fukushima prefecture Asahi Shimbun

It was not just the excesses of the credit boom that made the world think twice. There has been a run of bad environmental news stories in the past year, from the BP oil spill in the US Gulf to the Fukushima nuclear disaster in Japan.

Meanwhile, there has been continued rapid growth in emerging economies' need to back small businesses. And financial regulators have continued to build a banking system that steers towards longer-term gains.

All this has given the concept of sustainable finance momentum over the past year. The values of sustainability – a longer-term horizon and a greater focus on the counterparties with which banks do business – are becoming mainstream.

A minority in the banking world has long specialised in "ethical" behaviour, restricting investments to a "whitelist" of companies deemed to act responsibly. But the environmental disasters in particular have been a spur to such institutions, says Joachim Straehle, chief executive of Bank Sarasin, whose predecessors turned the Swiss institution into a "sustainable bank" after a domestic chemical disaster 25 years ago.

"We have a sustainable matrix system that allows us to invest in high-impact sectors like oil only if the company is exceptionally sustainable," Mr Straehle says.

The bank's only such investment is in Statoil of Norway, because of its renewables focus. Sarasin has even blacklisted US government bonds because some states use the death penalty. "But it doesn't mean you have to be green," he says somewhat sheepishly. "You can still drive a Ferrari and you don't have to wear sandals. It's about making money but in a socially responsible way."

Even big blue-chip banks showed a knee-jerk aversion to nuclear energy financing in the aftermath of the Japanese earthquake, with a "green rush" by some, such as BNP and Deutsche Bank, away from a high-profile Indian nuclear project that was set to be built in the Jaitapur earthquake zone.

It remains to be seen how permanent that caution is, but the political shift away from nuclear in Europe, particularly in Germany, could restrain European banks from funding such projects further afield.

This may just be current pragmatism, but it reflects homegrown changes in business strategies by banks with international reach.

For example, in recent months mainstream British banks have been drawn, sometimes screaming, into doing more to assist the broader society. The so-called Project Merlin agreement between the big UK banks was centred on government lending targets, but it also bound the banks into several other do-good projects that are more ambitious in their scope than standard government-sponsored financing initiatives.

The biggest idea is the creation of a £2.5bn ($4.1bn) private equity-style Business Growth Fund to kick-start small business investment, while a further £200m has been committed to the Big Society Bank, a project conceived by David Cameron, UK prime minister, to support regional development ventures.

There is a theoretical promise of commercial returns for the banks, but few expect them to be generous.

Project Merlin also covers the vexed issue of bankers' pay, though the substance of the deal – a pledge that total bonuses for 2010 would be lower than the previous year – was easy enough to adhere to, given that profits were substantially down.

But there have been genuine reforms to pay structures at a regulatory level, particularly in Europe, that push banks to structure bonuses over longer time frames and introduce "clawback" measures that reclaim money in the event of a blow-up.

Under new European Union rules, enforceable by national regulators, senior executives' cash bonuses are limited to 20 per cent of total pay, with the rest deferred for as much as five years. The structures – echoed by similar, but less punitive guidelines in the US – are designed to motivate bankers to prioritise longer-term profitability over short-term gains that may backfire.

At the same time, in the usual spirit of a clean-up era, tax authorities worldwide, but particularly in the US, have been on a mission to put a stop to the more egregious ways in which banks have helped citizens and companies avoid tax.

Swiss banks, notably UBS, have seen their schemes exposed by the authorities, and the institutions' reputations have been hurt. Switzerland is now trying to reinvent its image as a banking location that remains big on reliability, but is no longer the home of "bank secrecy".

Other areas of regulatory reform – particularly rules on bank capital enshrined in the so-called Basel III rule book – do even more to encourage sustainable practices.

Over the eight years to 2019, the world's banks must adopt a series of measures designed to make sure their activities are backed by sufficient reserves – high-risk trading, for example, is now much more costly in an effort to ensure banks are not derailed by outsized risks.

The volume of liquid assets banks must hold will also rise to protect them from short-term runs on their funds by nervous investors. More stable foundations should foster a more sustainable financial system, the thinking goes.

Profitability will be lower, with most banks having trimmed return on equity goals to less than 15 per cent, compared with 20 or 25 per cent in pre-crisis years. This should help avoid the huge swings into the red every few years.

Even now, before implementation of the rules has really begun, there are dissenting voices – and not just from banks eager to mitigate the impact of costly changes. Specialist firms have sprung up alongside the traditional restructuring experts from investment banks to help banks arbitrage their regulatory capital costs.

At the same time, regulators have woken up to the fact that clamping down hard on the core banking industry could simply push problem areas, particularly trading risk, into less supervised "shadow banks", such as hedge funds, money market funds and energy companies.

Perhaps, critics argue, the financial market is actually being made more unstable rather than more sustainable.

But ultimately it is the growing body of willing reformers, rather than the regulated recalcitrants, that really define the spirit of sustainable banking. Mergers, such as the combination of the UK's Co-operative Bank with Britannia building society, are helping to enlarge the ethical market.

Microfinanciers, some of whom were hard hit by the financial crisis, are bouncing back to help small businesses in emerging markets. And in those fast-growing regions, some specialist sustainable banks are now very much part of the mainstream.

Vasily Vysokov, chairman of Russia's Center-Invest, says the crisis was an important lesson in sustainability. "In 2008, we didn't increase credit costs as other banks did," he explains.

"We allowed clients to finish their investment programmes. What's more important, to keep profits or to keep clients? So in 2008-09, we broke even. But now we're being rewarded with bigger profits."

Sustainable Bank of 2011 award nominees

- **Africa/Middle East** Access Bank, Lagos, Nigeria; Exim Bank, Dar-es-Salaam, Tanzania; National Bank of Abu Dhabi, United Arab Emirates
- **Asia-Pacific** Bank BNI, Jakarta, Indonesia; Bank of the Philippine Islands; YES Bank, India
- **Europe** Co-operative Financial Services, Manchester, UK; GLS Bank, Germany; TSKB (Industrial Bank of Turkey), Istanbul
- **Americas** Banco de Galicia y Buenos Aires, Argentina; Grupo Financiero Banorte, Mexico; Itaú-Unibanco Holding, Brazil
- **Cross-regional** Bank of America, Charlotte NC, USA; Bank Sarasin, Basel, Switzerland; Sumitomo Mitsui Banking Corporation, Japan; Citigroup, New York, USA; Japan Bank for International Cooperation (JBIC), Tokyo

For more details and for nominees in other categories, see Page 2

Strong principles foster growth

Ethical banking

Consumers are seeking alternatives, says **Sharlene Goff**

Banks are falling over themselves to trumpet new-found ethical credentials as they attempt to rebuild their battered reputations following the fierce customer backlash sparked by the financial crisis.

Some of the biggest lenders in markets that have been propped up with billions of pounds of taxpayers' money have run advertising campaigns positioning themselves as the most "helpful" bank or promising to be "here for good".

Meanwhile, new entrants have sprung up, particularly in the UK, where the banking industry has borne some of the deepest scars, claiming they will revolutionise customer service.

However, analysts say the pool of genuinely ethical financial services providers remains small. Only a handful, including Triodos, the Dutch bank, the UK's member-owned Co-operative Financial Services (CFS), Germany's GLS Bank and Italy's Banca Popolare Etica, stick rigidly to a policy of responsible investment.

These tend to take in money from savers and lend it to socially responsible businesses and organisations, such as renewable energy and social housing providers. Some, including Triodos and Banca Etica, inform savers where their money goes and invite them to visit groups they fund.

These organisations also try to adopt fairer policies for staff. Triodos, for example, ensures that its highest paid executive does not earn more than 7.5 times the salary of its lowest.

They also aim to offer fairer products. The Co-op, one of a small number of self-styled ethical banks to offer a full range of retail services, has launched schemes including a motor insurance policy that monitors drivers' behaviour using a tracking device and alters the price they pay accordingly. It also offers a credit card that rewards ethical product purchases.

Many ethical organisations have enjoyed a boost in demand for their services since the crisis. Lending at Triodos's UK arm, grew 20 per cent last year and by almost the same amount again in the first four months of 2011.

Meanwhile, the Co-op has increased the size of its corporate loan book by 40 per cent in 2010 and saw 80 per cent more retail customers switch their current account to the bank than in the previous year.

Ethical lenders say customers have become more aware of alternative approaches to banking and are frustrated with their existing providers.

Neville Richardson, chief executive of CFS, says: "Some people have been feeling angry with their banks. They went with a big provider, as they thought it would be there long-term and they feel let down."

Charles Middleton: expecting competition in the ethical arena

One downside is that these organisations tend not to offer a full range of banking services. Triodos does not yet offer UK current accounts or mortgages, for example, while few could provide the kinds of sophisticated risk and debt management services larger companies require.

Some analysts warn that some socially-minded businesses, which tend not to prioritise profit growth as aggressively as others, could be deemed higher risk. However, Charles Middleton, managing director of Triodos UK, says there is no shortage of ethical businesses that "stack up well commercially".

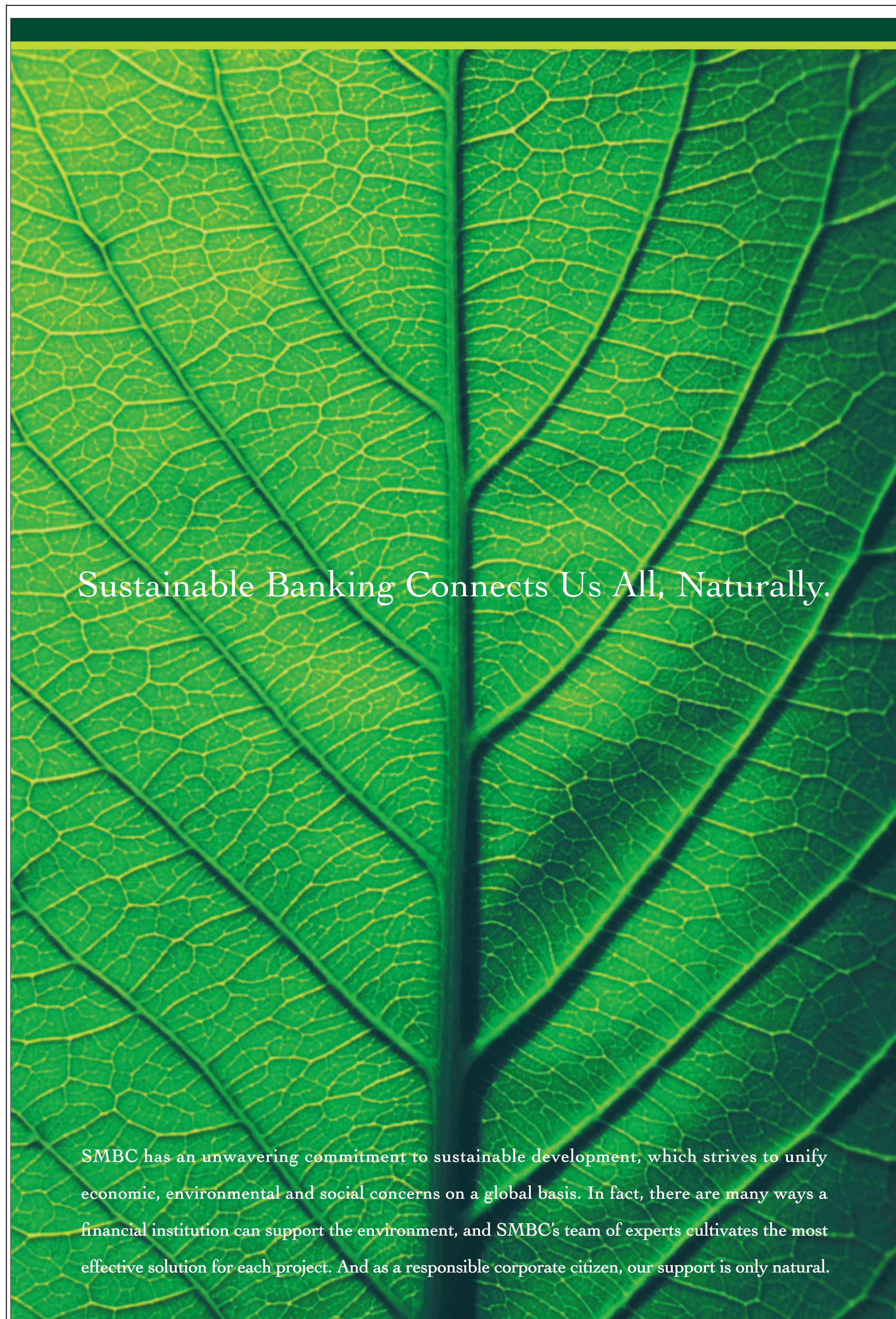
But with regulatory pressures hitting profit margins and banks finding it more challenging to raise funds, some ethical lenders are taking bold steps to sustain and expand their businesses. The Co-op, for example, merged with Britannia Building Society in 2009 to form an institution with more than 300 branches and 9m customers.

Ethical lenders are determined that financial pressures will not force them to compromise their values.

Mr Richardson says the Co-op and Britannia had similar beliefs that are now embedded across the group.

Mr Middleton expects competition to increase in the ethical arena as the economy recovers.

"I'm quite surprised it hasn't already," he says. "I think, once banks recover, they will see opportunities to get more involved in sustainability. But there is a long way to go. Some are more about managing the reputation of their brand than genuinely engaging."



Nominees on the Bank of the Year shortlist

These descriptions of institutions nominated for the FT/IFC Sustainable Finance Awards are based on information provided by them ahead of tonight's awards dinner in London. The 2011 Sustainable Bank of the Year award recognises the bank that has shown excellence in creating environmental, social and financial value across its operations. This category is open to banking institutions in developed and emerging economies and there is one overall global award and prizes for regional leadership in Africa/Middle East; Asia Pacific; Europe; and the Americas. There is also be a prize for Cross-Regional Sustainable Bank of the Year.

Africa/Middle East

Access Bank, Lagos, Nigeria
Access was the first Nigerian bank to adopt the Equator Principles, is a signatory to many international sustainability initiatives and has introduced mainstream environmental, social and governance principles across its operations. Initiatives include a programme to encourage female entrepreneurs, finance for renewable energy projects and the convening of sustainability events to inspire other Nigerian financial institutions.

Exim Bank, Dar-es-Salaam, Tanzania
Exim Bank's slogan is "Innovation is Life", and it is constantly searching for products and services to meet its sustainability objectives. Examples include the encouragement of renewables in financing energy projects, the innovative Faida savings account aimed at the base of the pyramid, Tanzania's first women entrepreneurs finance programme and its Selfina microfinance scheme, also aimed at women.

National Bank of Abu Dhabi, United Arab Emirates
National Bank of Abu Dhabi first created a sustainability strategy in 2009. It is committed to signing up to the Equator Principles in 2011 and is providing services for those without accounts with its Ratibi card for low-paid labourers. It has also launched the simplified Dow Jones OneShare exchange traded fund to encourage investment.

Asia-Pacific

Bank BNI, Jakarta, Indonesia
BNI signed up to the UN Environment Program Financial Initiative in 2005. It now provides microcredit for farmers and villages, has introduced a green mortgage for environmentally friendly property development, financed geothermal and hydropower generation, supported sustainable palm oil production, and invested in projects to cut greenhouse emissions.

Bank of the Philippine Islands
In 2008, BPI became the first bank in the Philippines to publish a report reviewing progress on its sustainability framework, including reducing its environmental footprint. It funds energy efficiency and renewable energy projects via its sustainable energy financing programme, the first of its kind in the Philippines. And it is expanding financial access to underserved groups through its BPI Globe BanKO mobile microfinance arm.

YES Bank, India
When YES Bank was nominated as Asian Sustainable Bank of the Year in 2008, it was commended for its transformational vision and urged to deliver real results. Three years later there is much to report, with the launch of a sustainable investment bank to fund environmental and social businesses and a private equity arm sponsoring a clean energy fund.

Europe

Co-operative Financial Services, Manchester, UK
Named Sustainable Bank of the Year in 2010, CFS has devised an ethical operating plan that integrates sustainability targets into its three-year business plan. It includes emissions reductions of 35 per cent, a new head office that is part of a £800m sustainable regeneration project and £1bn funding for clean energy solutions.

GLS Bank, Germany
Established in 1974, GLS Bank calls itself the first social and ecological universal bank, offering the full range of sustainable banking products from current accounts to corporate finance and investment. It finances only ecologically, economically and socially sustainable projects.

TSKB (Industrial Bank of Turkey), Istanbul
Named Sustainable Bank of the Year in the eastern Europe Emerging Markets category in 2007, 2008 and 2009, TSKB has continued to finance renewable energy projects, added energy efficiency projects to the mix and become the first Turkish financial institution to publish a sustainability report. The only carbon-neutral bank in Turkey, it has the second highest corporate governance rating in the Istanbul Stock Exchange's index.

Americas

Banco de Galicia y Buenos Aires, Argentina
This medium-sized bank is the only Argentine bank to have adopted the Equator Principles and has incorporated sustainability into its core business. It seeks to reduce its own environmental impact and to open its doors to as many people as possible. But it also seeks to influence its corporate clients – many in agriculture – to adopt sustainable practices.

Grupo Financiero Banorte, Mexico
Banorte is Mexico's third largest financial institution and the only large bank controlled by Mexican shareholders. A leader in providing financial services to underserved groups, it is incorporating social, environmental and ethical dimensions into its business. Its sustainability framework has four pillars: equality and governance, community commitment, and environmental responsibility.

Itaú-Unibanco Holding, Brazil
Two years after the merger of Itaú and Unibanco, the institution in February 2010 announced its vision to be the leading bank in sustainable performance and customer satisfaction. The only large local bank to withhold support for a large hydropower project in the Amazon, it seeks by 2013 to have 80 per cent of assets under active strategy management compliant with environmental, social and governance criteria.

Cross-regional

Bank of America, Charlotte NC, USA
Bank of America has invested more than $11.6bn to address climate change since 2007 through lending, investments, capital markets activity, philanthropy and its own efforts, which are part of a 10-year, $20bn commitment. It is the first large US bank to make a public commitment on climate change, it has financed forest conservation, wind farms and affordable green housing and helped raise capital for companies addressing climate change.

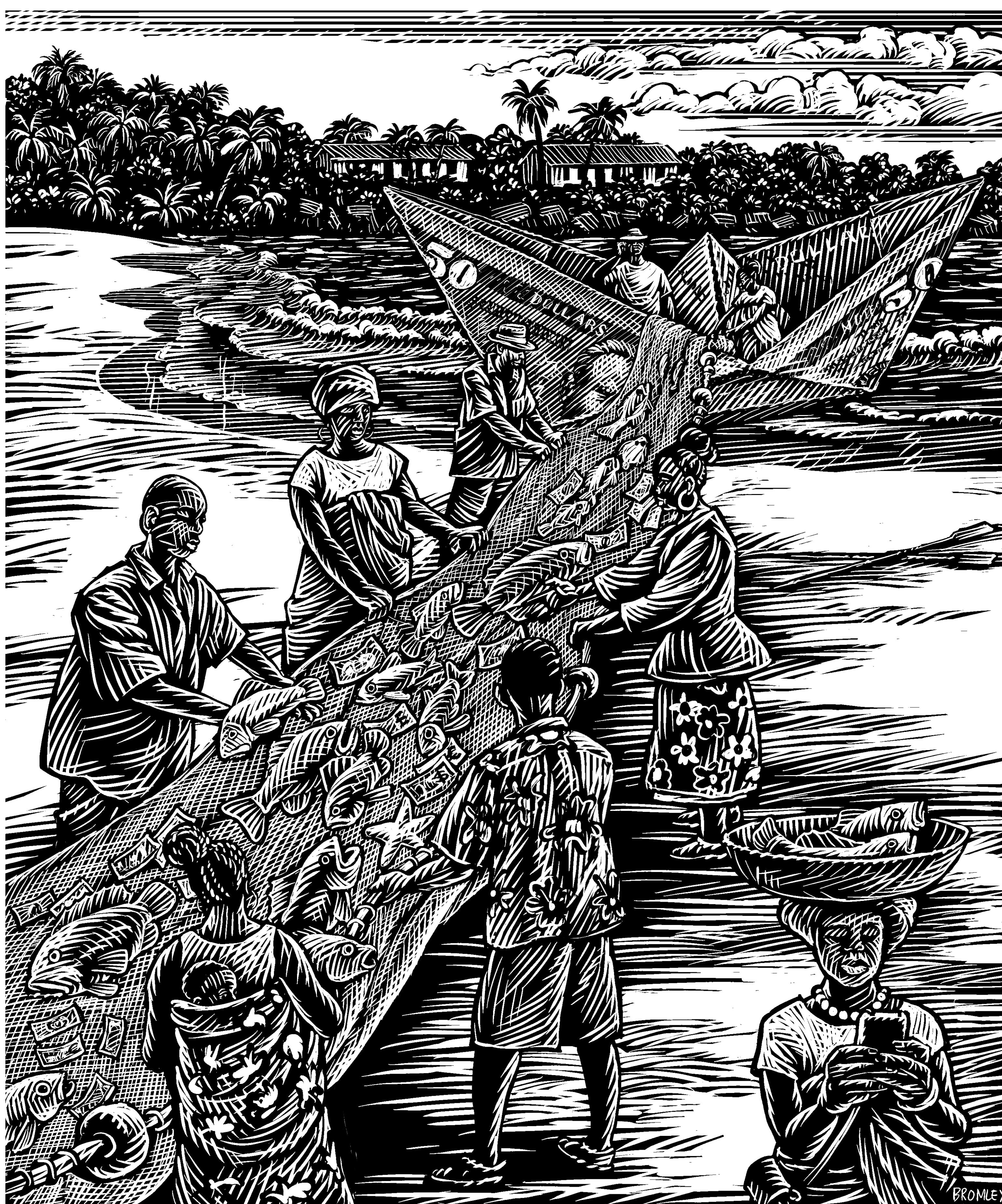
Bank Sarasin, Basel, Switzerland
With its claim of "Sustainable Swiss Private Banking since 1841", Sarasin restructured its strategy in 2010 to define its sustainability objectives through five key indicators. All of its private client mandates in Switzerland are managed on a sustainable basis, as benchmarked on its proprietary two-dimensional sustainability matrix developed over 20 years. In 2010, it added sustainable US and emerging market equity funds to its stable of sustainable funds.

Sumitomo Mitsui Banking Corporation, Japan
The goals of SMBC's sustainability strategy include reducing its own environmental impact, managing environmental risk in lending and promoting environmental businesses. Its global operations finance green infrastructure, carbon trading, renewable energy generation and eco-product development.
It promotes environmental businesses by co-ordinating different activities to provide clients with one-stop sustainable solutions.

Citigroup, New York, USA
In 2010, Citigroup built on its long-standing sustainability strategy with a responsible finance framework in dealing with customers, the financial system and the broader community. It focuses on two areas: financial inclusion, through microfinance which has already funded 900,000 borrowers, 92 per cent of them women, through bond issues, equity raising and securitisations; and environmental innovation, working with clients to reduce impacts and financing green businesses.

Japan Bank for International Cooperation (JBIC), Tokyo
A Japanese government institution, JBIC focuses on global environmental and social sustainability issues. With partners, it supports developing countries in tackling climate change, invests in clean energy, energy efficiency, water infrastructure, urban transport, and finances greenhouse gas emissions reduction projects.

Contenders line up for the top prize in other categories



Sustainable Asset Owner of the Year
This award highlights achievement in the area of sustainable investment, recognising the institution that has shown innovation or leadership in creating environmental, social and financial value. Nominees are:

Caixa de Previdência dos Funcionários do Banco do Brasil (PREVI), Rio de Janeiro, Brazil
All PREVI's plans employ socio-environmental criteria as defined in its sustainability policy and codes of best corporate governance practice in line with the UN Principles for Responsible Investment, which it helped develop.

Environment Agency, Bristol, UK
One of the world's leading environmental organisations, the Environment Agency has reduced the environmental footprint of its actively managed equities by 30 per cent in its $2.4bn pension fund in the past five years.

London Pensions Fund Authority, UK
The LPFA aims to be a responsible long-term investor that encourages best environmental, social and governance practice in the companies in its $5.3bn portfolio. In 2009 it began to develop a responsible investment strategy on issues such as voting, monitoring fund managers and regular reporting to fund members.

National Pension Service, Seoul, South Korea
The National Pension Service, which with $284bn in assets is the world's fourth-largest pension fund, believes sustainability affects long-term investment performance. A signatory of the UN Principles for Responsible Investment, it organised a summit of Korean asset managers to promote green leadership and is expanding its investments into green technologies.

Storebrand, Lysaker, Norway
As a leading Nordic insurance and pensions provider, Storebrand – with assets under management of $73bn – had a pioneering role in sustainable investments in Europe, with group-wide policies on negative screening and engagement.

Sustainable Asset Manager of the Year
This award highlights groundbreaking achievement in the area of sustainable fund management, recognising the management firm that has shown innovation or leadership in integrating environmental, social and governance factors into its investment philosophy and approach. Nominees are:

Aloe Group, UK
Aloe is a private equity firm that promotes the creation and growth of environmental and socially sustainable companies globally, focusing on recycling, clean energy and eco-processes tackling pollution in Asia.

Dragon Capital Group, Ho Chi Minh City, Vietnam
Dragon Capital is an integrated investment group focusing on Vietnam, investing $450m annually in listed and pre-IPO companies with attractive growth prospects, good corporate governance and alignment with the country's growth drivers.

F&C Management, London, UK
Within its ESG business, F&C offers clients a range of responsible investments, including ethical growth and income funds, global sustainability themed funds and its proprietary real estate opportunity business, Responsible Engagement Overlay, which engages almost 7,000 companies in 60 markets and covers £80bn in assets.

Pictet Asset Management, Geneva, Switzerland
Part of one of Europe's largest private banks, Pictet Asset Management offers sustainable core equity portfolios to meet clients' environmental, social and governance objectives while delivering superior risk-related returns

Rabo Equity Advisors, New Delhi, India
Rabo's India Agri Business Fund invests growth capital averaging $5m-$12m in Indian food and agribusiness companies in return for significant minority stakes. It has made six investments in the past two years, including in Sri Biotech, which produces crop protection and improvement products derived from microbial organisms and plants that leave no residues in the farm or the produce.

SAM (Sustainable Asset Management), Zurich, Switzerland
A pure play investment boutique focused exclusively on sustainability investing, SAM's offering is asset management, sustainability indices and cleantech private equity. It offers two sustainability core strategies, seven sustainability theme strategies and the Dow Jones Sustainability Indexes – as well as heavyweight publications from its in-house research department.

Stratus Group, São Paulo, Brazil
In 2010, Brazilian private equity firm Stratus invested in Unnafibras, which converts 1bn polyethylene terephthalate bottles annually into a raw material for the textile industry. Unnafibras, which collects the bottles via 4,000 of the poorest people in Brazil, raised $60m to double its capacity and is working with Stratus to identify acquisitions ahead of an initial public offering in 2012/13.

Achievement in Basic Needs Financing
This award recognises transactions, programmes and initiatives that use the power of finance to address the scarcity of essential goods (including food, water, housing and energy) across society. Nominees are:

Al-Amal Microfinance Bank (AMB), Sana'a, Yemen
Yemen is a country where three-quarters of the population are under 25 and only one in eight young people have access to financial products. Al-Amal Microfinance Bank provides current accounts, savings, loans and insurance to more than 15,000 young people, with special products to attract young women.

Financiera Educativa de Mexico (FINEM)
The largest provider of student loans in Mexico, FINEM has granted more than 10,000 long-term loans in more than five years to help students with higher education. FINEM's approach is "we finance students but get paid by professionals", which is achieved by insisting students' grades must never fall below seven on a 10-point scale.

Itaú-Unibanco Holding, São Paulo, Brazil
Barely one in seven young Brazilians go to university. Itaú University Credit provides finance to more than 7,000 students, mostly women, from low-income homes whose parents have mostly never attended university.

One Acre Fund, Bungoma, Kenya
One Acre Fund targets the 75 per cent of the world's poor living in rural areas, and who are beyond the reach of traditional microfinance, by providing seed and fertiliser on credit. It also trains farmers and helps them to market.

YellowPepper, Digicel, Scotiabank
TchoTcho Mobile is a mobile wallet in Haiti, where just 5 per cent of economically active people have bank accounts. YellowPepper provides the payment technology, Scotiabank the banking services and Digicel the mobile network. The service allows non-governmental organisations to pay cash-for-work recipients who live in tent cities.

Mahindra Rural Housing Finance, Mumbai, India
Villagers often lack legal documents and credit histories to access home loans. This company has lent $80m to more than 20,000 rural dwellers, using its own credit evaluation metrics based on cash flow rather than income, which is often not documented.

Social Finance, London, UK
Social Finance launched a £5m social impact bond in 2010 to finance services that reduce reoffending by prisoners serving sentences of under 12 months in Peterborough jail. Reoffending rates within one year are more than 60 per cent, and the government pays if reconviction rates fall at least 10 per cent, using money saved from the prison budget.

Achievement in Financing at the Base of the Pyramid
This award recognises financial transactions and initiatives that address the Base of the Pyramid, the more than 4bn people who live on less than $2 a day. Nominees are:

Al-Amal Microfinance Bank (AMB), Sana'a, Yemen
In a country where only one in eight young people have access to finance, Al-Amal Microfinance Bank has created a Youth Fund in partnership with Silatech of Qatar to provide loans averaging $250 to entrepreneurs under the age of 30, especially women. It has financed 10,000 businesses, including 1,346 start-ups and has a 100 per cent repayment rate for these loans.

Au Financiers (India) Private Limited (Jaipur, Rajasthan)
Two-thirds of Indians live in the countryside, and a third of their agricultural production rots due to lack of transport and storage. Au Financiers provides rural customers with loans for vehicles from three-wheelers to trucks for public and commercial transport, encouraging them to use CNG and LPG vehicles.

Bank of America Merrill Lynch, London, UK
In return for options on carbon credits, Bank of America Merrill Lynch finances the provision of affordable and clean LED lighting in sub-Saharan Africa through entrepreneurs who buy a pedal generator to recharge them. The local people who buy the lights recoup the $5 cost in just 22 days through savings on kerosene, which swallows 10-40 per cent of their income.

JPMorgan's Social Finance Unit, New York, USA
JPMorgan's Social Finance Unit makes social-impact investments and provides capital-market services to social enterprises, funds, foundations, non-profits, development finance institutions and others serving the base of the pyramid. A business unit rather than a foundation, it aims to attract clients and influence asset allocation by showing that investing for social good and financial return is viable.

The Jordan Micro Credit Company (Tamweelcom), Amman, Jordan
Tamweelcom provides loans on a commercial basis for small business projects in poor communities, while offering training, market support and community programmes as part of its social responsibility remit. It has disbursed more than 193,000 loans worth $120m since 1999, almost all to women who produce embroideries, mosaics, baskets, pots and the like – or who supply the materials.

MicroEnsure, Cheltenham, UK
MicroEnsure provides funeral insurance in Ghana, where people spend a higher percentage of average per capita income on funerals than any other nation. The policies have very low premiums, because they are sold through mobile network operators, with little need for agents or paperwork – and the coverage is growing at 30,000 customers every 20 days.

Tameer Microfinance Bank, Karachi, Pakistan
Pakistan has 64 per cent mobile phone penetration, but more than 80 per cent of its people are unbanked. Pakistan's second-largest mobile operator Telenor and Tameer have created Easypaisa, which provides a full range of financial services to those underserved by the existing system with a combination of mobile banking and more than 16,000 merchant outlets, which act as branches.

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Signatories consider a wider use of rules

Equator Principles

Supporters say the guidelines promote responsible lending, says **Sarah Murray**

An oil pipeline project promising everything from employment to ecosystem degradation is the kind of development that, since 2003, has been covered by Equator Principles, the voluntary set of social and environmental standards governing project finance lending.

But while campaigners claim the principles have not yet halted damaging projects, others argue that they have promoted sustainability in the banking sector and could influence other types of lending.

Developed by ABN Amro, Barclays, Citigroup and West LB with the International Finance Corporation (IFC), the World Bank's private-sector lending arm, the principles emerged in response to growing awareness of the risks of socially and environmentally irresponsible investing.

However, while many acknowledge the role they have played in reducing these risks, they have not shielded banks from criticism. In 2010, almost 100 civil society organisations sent an open letter to Equator Principles signatories calling for financial institutions to implement greater transparency, accountability and stricter compliance with the principles.

> 'We're dealing with countries where awareness of social and environmental issues is at different levels'

Those behind the principles have responded to this kind of criticism. "We've recently introduced rules where financial institutions that don't report and are not transparent will get kicked out of Equator," says John Laidlow, head of sustainability risk at HSBC and a member of the Equator Principles steering committee. "So we have heard what external stakeholders have said to us and we've introduced some more robust rules around that."

Of course, working against transparency when it comes to financing deals are banks' duties of confidentiality to clients and competition between institutions. However, Mr Laidlow argues it is possible for banks to be more open about what they do.

At HSBC, he says, PwC monitors whether the bank is implementing the Equator Principles effectively and this assessment is published in the bank's annual sustainability report.

As well as the need for increased transparency, recent debates on the Equator Principles have focused on whether or not they can be applied to other forms of lending and financial products.

"The success of Equator has been based on the fact that this has been a tight, clear product that allows Equator banks to effectively assess and manage risks within project finance deals in partnership with our clients," says Shawn Miller, global managing director of environmental and social risk management at Citi. "However, a lot of other financing products are similar in nature when raising capital for large infrastructure," adds Mr Miller, who also chairs the Equator Principles Association (EPA). "We recognise that some question why Equator doesn't apply to those products."

This is something the association is investigating. Because of the extensive assessment and monitoring they call for, some loans and other financial products do not lend themselves to the application of the principles, which govern long-term projects for which total capital costs exceed $10m.

In project finance deals, standards on social and environmental performance can be covenanted into a project's loan documentation.

However, for equity underwriting or initial public offerings, banks do not have access to covenants.

"As a financial institution you can undertake a social and environmental risk review [for these deals] but you don't have the long-term hooks that project finance has, including the covenants and long-term independent monitoring," says Mr Miller. "So they are very different animals."

Even so, among the items on the agenda of a strategic review completed by the EPA in May is the question of where, beyond project finance, banks could apply the principles.

Some are already starting to use them more broadly. Standard Chartered applies the principles to all project finance deals, even to transactions of less than $10m, while many Equator banks use the principles' risk categorisation system and the IFC standards for a range of deals.

Meanwhile, HSBC has extended the Equator Principles to corporate loans and export credit loans in cases – such as the sale of large pieces of equipment – where the funds are being used for projects whose environmental and social performance can be measured over a long period of time.

Even in cases where the Equator Principles themselves cannot be applied, many argue that the environmental and social standards they promote can inform all lending decisions. "Equator is really the backbone and it has provided good guidance in terms of informing management of risk in other types of finance," says Mr Miller.

Moreover, banks often supplement the principles with policies on environmental and social risk management. Since 2009, for example, Standard Chartered Bank has applied position statements on social and environmental performance across the company's wholesale banking business.

The principles provide a global benchmark for the industry, argues Gill James, head of sustainability at Standard Chartered. "And for a bank like Standard Chartered, where our focus is Asia, Africa and Middle East, we're dealing with countries where legislation and awareness of social and environmental issues is at different levels," she says. "So having a global benchmark is useful."

Like many of the Equator signatories, Standard Chartered sees the principles as part of a broader approach to managing environmental and social risk.

"They form one element for us," says Ms James. "But they're not the only thing we focus on."

Shawn Miller: principles are an effective tool

Interview IFC's Lars Thunell on standards and expansion

Lars Thunell: 'The standards have allowed us to do more business' Getty

When in 2006, the International Finance Corporation devised a set of social and environmental standards to govern its lending activities, some said these would limit the IFC's capacity to expand. With a record $18bn in new investments in 2010, these people "have been proved completely wrong", says Lars Thunell, the institution's Swedish-born executive vice-president and chief executive.

"The standards have allowed us to do more business because they provide us with a risk management tool," he says.

The IFC, part of the World Bank Group, invests in emerging markets and uses its advisory services and lending resources to help private enterprises expand their activities in local economies.

The standards, says Mr Thunell, allow the IFC to look at such activities through a social and environmental lens. "As a development institution, we have to recognise that companies in many of the countries we work in have practices that are not where they should be," he says. "But they could be willing to work with us in getting their standards up to a better level."

As a result of a recent review, these standards have been updated to incorporate requirements for greater disclosure and transparency about projects, including requests for prior consent from indigenous peoples and lower emissions levels.

Some have called for stronger human rights protections to be built in to the standards. However, the IFC argues that, rather than introducing a performance standard in this area, human rights are better addressed by being "fully mainstreamed" throughout the standards.

For Mr Thunell, a link between social and environmental and financial performance is emerging. "We see clearly that, for the companies that are not focusing on environmental and social standards, we have high credit losses and significantly lower return on our equity investments," he says.

And he points out that, because they are likely to be adopted by signatory banks to the Equator Principles, as well as by export credit agencies and international finance institutions, the revised performance standards will have an effect beyond the institution's own activities. "There will be a wave of adjustments based on the changes we have made," says Mr Thunell.

However, as well as promoting sustainability standards in investments that also foster development, Mr Thunell sees the IFC playing a critical role in tackling big global problems such as food security and water stress. When it comes to shoring up the world's food supplies, the IFC works across the supply chain, from smallholder farmers to the companies that process, package and deliver food.

In addition to loans for small farmers, the IFC has developed financial products such as weather insurance policies and products that help them reduce the uncertainty associated with commodity price swings.

And given that the missing factor in the food chain is often infrastructure – with about 40 per cent of food produced in developing countries perishing on its way to consumers – this is also a focus for the IFC, which is working to promote cold chains.

Closely related to food security is the issue of water scarcity, something to which the IFC has given close attention in recent years. "We can close [the water] gap but it has to be not only on the supply side," says Mr Thunell. "The issue of water efficiency is also extremely important."

For this reason, the IFC not only provides expertise to governments, but supports the expansion of private-sector companies, such as India's Jain Irrigation, in promoting water efficiency.

Mr Thunell believes that, with budgets stretched, more multilateral agencies and non-governmental organisations will embrace this approach. "A lot of aid agencies are looking at how to give more support to the private sector," he says. "And that's a dramatic shift that's taken place over the past two or three years."

Sarah Murray

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Making a profit from loans to poor carries risks

Microfinance

Balancing financial gain with society's needs is tricky, reports **Amy Kazmin**

An Indian farmer tends his cauliflower patch near Calcutta
AFP/Getty Images

In August 2010, SKS Microfinance, a Hyderabad-based enterprise making tiny loans to poor women, raised $350m in an initial public offering that valued the firm at $1.5bn. The stunning market debut seemed to affirm that microfinance – lending money to those too poor and without sufficient collateral, to access normal bank loans – could be made profitable and attractive enough to attract investors.

Other fast-growing Indian microlenders were expected to follow SKS's profitable path to market. But instead, the IPO – only the second listing of any microlender after Mexico's Compartamos went public in 2007 – precipitated an unexpected crisis.

Officials in Andhra Pradesh state, where Indian microlenders had concentrated much of their portfolios, accused firms of seeking "hyper profits" and using "coercive" collection tactics, and banned all outstanding microdebts collection and new lending.

The edict, which continues to paralyse microlenders' operations in the state, sent shockwaves through the global microfinance community, including lenders, investors and microfinance advocates.

It also served as a powerful warning about the political risks confronting commercial microfinance companies if they are too aggressive in pursuing growth to satisfy profit-seeking shareholders at the expense of their impoverished borrowers.

"We must not create, in the case of credit, unfettered access to financial services that carry harmful potential, else we risk the next subprime-type crisis," Tilman Ehrbeck, chief executive of the Consultative Group to Assist the Poor, recently told Microfinance Voices in the wake of the crisis.

"It would be distressing if we helped expand access to formal financial services, but those services were no fairer or safer than the informal alternatives they were meant to replace," Mr Ehrbeck said. "We need to offer something better, or we will have failed in our mission."

The business of microfinance is providing small loans to poor women, so they can reduce their reliance on usurious informal local moneylenders and start microenterprises to lift their families out of poverty.

Initially, microfinance programmes were mainly undertaken by social organisations and charities, funded by Western development aid, and sometimes also mobilising the savings of the poor themselves. But microfinance has undergone a dramatic transformation, as private companies, backed by private, profit-seeking capital, began to be involved.

Supporters of commercial microfinance argue that business models generating profits and returns to shareholders can overcome the reliance on scarce donor money, long a constraint to making microloans more widely available to a greater number of poor people.

However, critic Milford Bateman, author of the book *Why Doesn't Microfinance Work?* says the Indian crisis is "the almost inevitable outgrowth" of commercial microfinance, whose benefits mainly accrue to lenders' highly paid executives and shareholders, through "spectacular salaries, bonuses, dividends, and eventually the windfall profits arising from an IPO ... As microfinance was increasingly commercialised from the mid-1990s onwards, 'best practice' for a MFI was simply to pump out as much microcredit as possible, in order to grow fast, grab market share, hike up profits, and so grow even faster," Mr Bateman wrote recently.

> 'We need to offer something better or we will have failed in our mission'

Advocates of commercial microfinance acknowledge that many Indian lenders had lost sight of microfinance's social mission of poverty alleviation.

"People went for speed, numbers and efficiency, and what got dropped out were the close relationship with clients and other things," says Sam Daley-Harris, director of the Microcredit Summit Campaign, which lobbies for greater funding for microcredit programs.

Yet he and other advocates insist that commercialised microfinance is not inherently incompatible with poverty alleviation, as long as social goals are given sufficient priority in a company's structure. Within the microfinance community, there is now intense debate on just how lenders can retain their social orientation, while still generating sufficient profits so as to be financially sustainable.

The Microcredit Summit Campaign is advocating a new "seal of excellence" system, recognising microlenders based on how well they deliver on the "transformational dimension in the lives of clients and their families", by lifting people out of poverty.

The highest endorsement would be awarded to microlenders with third-party certification of clients moving out of poverty. Lenders that adopt social protection principles, or move beyond provision of pure credit to support for health or education would also be recognised.

"The bottom line is that the field and the public and the investors are desperately in need of clarity of what constitutes top-quality microfinance," says Mr Daley-Harris. "You've got to manage for social performance, not just measure it."

Elisabeth Rhyne, of the Centre for Financial Inclusion, argues commercial microlenders also require more robust client protection systems than once operated in social organisations or charities.

One of the centre's campaigns is urging microlenders to adopt six key client protection principles: taking reasonable steps to avoid over-indebtedness; transparent pricing; ensuring appropriate, non-abusive collections practices; ensuring ethical staff behaviour; creating well-functioning grievance mechanisms; and protecting privacy of customer data.

"When we first started talking to microlenders about consumer protection, they said, 'what are you talking about? We are a socially motivated organisation'," she says. "People have never focused on this particular set of issues – overindebtedness, collections practices, what to do when clients have problems.

"When they were small, they could handle client problems on a case-by-case basis. But when it's big, they need systems to do it."

Indian lenders, already grappling with their frozen Andhra Pradesh portfolios and a sharp slowdown in bank lending, are confronting these issues. They now face new central bank rules, including caps on interest rates and margins, as well as consumer protection requirements for the sector.

Vishal Mehta, co-founder and managing director of specialised private equity firm Lok Capital, says firms are still struggling to adapt. "I don't think they have a good sense of what operational changes they still need to make to their business models to comply with the changes in their regulations," he says. "That is something still to be seen."

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Push for greater integrity may help sector's image

Regulation

Can tougher rules end the boom and bust cycle? **Brooke Masters** reports

Three years after the 2008 crisis, governments around the world are busily churning out dozens, and potentially hundreds, of rules and regulations designed to make banks and the broader financial system safer and more stable.

Regulators and politicians fervently hope tough standards will help push the industry towards a more sustainable business model. And some bankers argue the industry must work with them to reassure society that the industry has the greater good in mind.

"The sustainability of the business itself has been called into question by senior people in government circles, as well as society at large," says Wilson Ervin, a former chief risk officer and now a senior adviser at Credit Suisse. "We are living in a world where people are afraid of the downsides of banking. We have to address these concerns substantively and proactively."

But the question remains whether rules for capital, liquid assets, derivatives, clearing and even pay are enough to break the decades-long cycle of boom and bust.

"Regulation is certainly a necessary part of the solution, and it will take us a long way, but whether it's sufficient is less clear," says David Strachan, a former UK regulator who is now co-head of Deloitte's Centre for Regulatory Strategy. "It needs to be supported by stable monetary and fiscal policies, and by broadly consistent international implementation."

Mr Strachan and many in the industry worry reformers will lose interest and bankers will feel pressure from investors seeking short-term results. That could lead the industry back into the kinds of regulatory arbitrage that sparked the last crisis.

"Despite all the initial good intentions, past experiences show us that as the economy picks up, supervisors will become more lax, rules will be flouted and more risks will be taken, that is until the next bubble bursts," warns Jacqui Hatfield, partner at Reed Smith.

Regulators and bankers agree that the definition of sustainable banking has changed dramatically in the past five years. Where once it was shorthand for thinking about governance and the effects of projects on environment and people, now the term refers to a banking business model that provides essential services to the broader economy and can be counted on not to destabilise the financial system.

"To be sustainable in banking today means being fully compliant with all regulations while maintaining an acceptable risk-adjusted profitability spread over the cost of equity," says Orlando Hanselman, programmes director at the consultancy Fiserv.

Much of the public discussion on sustainable banking has taken place in places where banking plays an outsized role in the economy. In the UK, where the economic cost of the financial crisis has forced painful public service cuts, the top regulator has said some pre-crisis financial products were "socially useless" and the country is discussing whether to force banks to ringfence their retail arms.

Jacqui Hatfield: 'As the economy picks up, supervisors become lax'

In Switzerland, where the balance sheets of the two biggest banks dwarf the country's gross domestic product, the parliament is debating tougher capital requirements and rules that would force bank bondholders to share in the pain of any further collapse.

"Prudential regulation, conduct of business and systemic risk monitoring could all be said to point in the direction of improved prospects for sustainable banking. But maybe the emphasis has to be on a change of culture and a recognition by investors of the worth of better enterprise risk management," says Richard Reid, director of research at the International Centre for Financial Regulation. "The trick, as ever, is to construct an environment which keeps good enterprise risk management as a rewarded business practice in the 'normal' times," he says.

In one positive sign, concern about sustainability is also starting to permeate areas that survived the financial crisis relatively unscathed.

Leah Jin, climate change and sustainability partner at KPMG China, says: "We are now seeing a clear trend in shifting the focus from profitability to sustainable development. Externally this is being driven by regulators and internally by the desire to modernise corporate governance and risk management. For example, guidelines have been issued by regulatory bodies encouraging financial institutions to fulfil economic, social and environmental responsibilities."

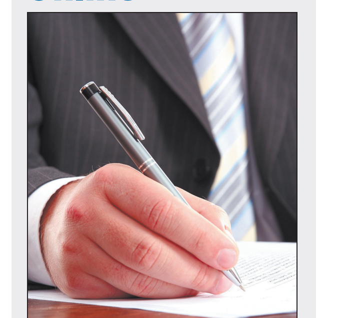
Globally, the Financial Stability Board, a group of top regulators and central bankers, is studying ways to make the very biggest global banks safer and easier to shut down in a crisis. But the solutions, which include forcing banks to hold more capital against potential losses and simplify their legal structures, may have unintended consequences.

"Balance sheets are likely to be significantly more liquid, with shorter asset durations, increasingly funded by higher cost core deposits. Such a balance sheet structure may impede both the nature and volume of lending and investments," says Fiserv's Mr Hanselman.

Competition could suffer as well. "As a result of the reforms we are likely to see more concentration rather than competition, as the smaller banks will probably be swallowed up by the better-prepared, larger banks," says Ms Hatfield.

But Credit Suisse's Mr Ervin remains optimistic. "This is eminently solvable if politicians, regulators and bankers work together and focus on implementing the lessons of the last crisis."

Online



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