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# Lenses and clocks

Financial stability  
and systemic risk  
June 2012



Paul Clements-Hunt,  
The Blended Capital Group

Foreword by the Rt. Hon. Gordon Brown MP

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### **Financial Stability and Systemic Risk: Lenses and Clocks**

June 2012

Paul Clements-Hunt, The Blended Capital Group

Foreword by the Rt. Hon. Gordon Brown MP

A joint paper presented by the United Nations Environment Programme Finance Initiative (UNEP FI), the International Institute for Sustainable Development (IISD), and The Blended Capital Group (TBCG)

## ***Opening Thought***

For a more stable and resilient financial system, all public and private actors involved in the investment and financial intermediation chains will benefit from the use of wider and better quality “lenses” that give greater depth, breadth and granularity to our vision and understanding of a wider range of risks. Also, those same market actors should employ “clocks” that heighten their appreciation of the temporal nature of risk\* by neither over-emphasizing those short-term and apparently more easily quantifiable risks nor under-emphasizing the slow, creeping risks that destroy value over the long term.

Paul Clements-Hunt  
The Blended Capital Group

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\* C. Goodhart and J. Danielsson, 2003, “The inter-temporal nature of risk,” in *Technology and finance: Challenges for financial markets, business strategies and policy-makers*, Balling, Lierman and Mullineux.

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## Foreword

Global markets are here to stay. But they can be managed well, or managed badly. The future role of the worldwide investment and financial services industry is pivotal if we are to achieve vibrant, robust and sustainable growth that creates wealth, reduces poverty and protects our natural capital.

Given the current economic fragility of so many parts of the world, it is easy to forget that the 21st century offers the prospect of an incomparable era of worldwide growth, opportunity, equality and environmental rejuvenation. The global community possesses the knowledge to address the very real risks of food security, climate change, access to energy, water shortages and high unemployment if the right choices are made early.

I welcome this new report, "Financial Stability and Systemic Risk: Lenses and Clocks," and I commend the United Nations Environment Programme Finance Initiative, the International Institute for Sustainable Development, and The Blended Capital Group for having the vision to collaborate and ask such timely questions. The document will catalyze a new conversation about the role of finance and investment as a force for good in society and will build on the hard lessons of the recent past. There remains a great need for such an exploration and ongoing discussion of these critical issues of our time.

Our need to understand the full range of systemic risks, whether the risks of greater financial and economic volatility or the "creeping risks" associated with income inequality, global warming, resource depletion and ecosystems destruction, sits at the heart of our collective challenges during the course of this century. Understanding these threats will also inform the choices we make to benefit from the opportunities ahead of us and, in doing so, improve life for billions of our fellow human beings, rebuild the planet's natural capital and foster markets based on fairness and equality.

History tells us that communities, companies and markets only flourish in the long term when they are underpinned by shared values that promote stability. Through the centuries it has become clear that values build value and morals make markets. Seventeen years before *The Wealth of Nations*, the great Scottish philosopher, Adam Smith, gave us *The Theory of Moral Sentiments*. The moral compass Smith provided for the markets in the 18th century will enable us to steer a better course in the global markets of today.

Gordon Brown MP

## Introduction

“If we experience a 50 percent draw down on our investments every few years then we can simply forget development, sustainable or otherwise....”

—Head of a large European national pension fund, referring to the systemic impacts of the financial crisis, March 2010

This paper highlights how thinking that underpins sustainable finance and responsible investment can inform the financial stability debate. The paper urges financial policy-makers to integrate measures that promote the values of transparency, accountability, responsibility and trust as they seek to formulate and refine policies that deliver a more stable and resilient financial system to support globalized markets. The importance of a deeper understanding of broader systemic risk issues, improved governance and clearer fiduciary responsibility—all central to both the overhaul of our financial systems and to the principles and practices of sustainable finance and investment—is a focus of the paper. Essentially, the paper seeks to foster ongoing and informed discussions between policy-makers and those financial services and investment institutions that are working with the United Nations and the International Institute for Sustainable Development (IISD) to promote the idea that markets need resilient institutions, strong business cases and robust values to flourish.

We are delighted that the Rt. Hon. Gordon Brown MP, building on his work in 2011–2012 for United Nations Secretary-General (UNSG) Ban Ki-moon, has contributed a Foreword to the document. The paper also draws on policy recommendations on financial stability and sustainability made by Mr. Brown to the UNSG’s High Level Panel on Global Sustainability in September 2011.

### The Link: Stability, Resilience and Sustainability

The April 2010 Communiqué from G-20 Finance Ministers<sup>1</sup> presented “The G20 Framework for Strong, Sustainable and Balanced Growth” and is a good policy foundation to build the links between stability, resilience and sustainability. The framework proposes that “the objectives of strong, sustainable and balanced growth are closely related and need to be pursued in a way that is mutually reinforcing.” The framework states that sustainable growth should be (a) in line with underlying potential growth over the medium term, thereby providing a firm basis for long-term growth; (b) based on sustainable public finances and price and financial stability; (c) resilient to economic and financial shocks; (d) determined primarily by competitive market forces; and (e) consistent with social and environmental policy goals.

The G-20 statement, with its emphasis on growth and stability as well as social and environmental goals, makes the strongest of connections to sustainable finance in a manner that provides a foundation for high-level financial policy-makers who seek a more stable and resilient global financial and economic system.

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<sup>1</sup> G-20 Communiqué: Meeting of Finance Ministers and Central Bank Governors, April 23, 2010.



The paper is a collaborative effort between the United Nations Environment Programme Finance Initiative (UNEP FI), a partnership between the United Nations and financial services dating back to 1992, the International Institute for Sustainable Development (IISD), and The Blended Capital Group (TBCG).<sup>2</sup> After briefly detailing the context of the financial and economic crisis of 2007–2012 and the ongoing response to that crisis, the paper highlights six areas related to the re-engineering of our financial system and outlines the relevance of sustainable finance and investment thinking to these areas. The six areas are:

1. Dark Pools and the Shadow Side: Stability and Over-the-Counter Markets
2. Ownership That Counts: Institutional Investors and Accountability
3. Listing for Stability: Stock Exchanges and Listing Requirements
4. Banking Risk for the Long Term: Systemic Risk and the Basel Committee
5. Rating Right: The Role of Rating Agencies within the Financial System
6. Insuring the Future: Stability and Solvency II

A set of policy recommendations for follow-up action is presented in the concluding section of the paper. The paper is not presented as a comprehensive analysis of the causes and impacts of the financial crisis and the resulting economic downturn and debt crisis affecting many countries globally; those issues are covered in great detail in a broad range of current publications.

This paper is the final version of a working document that evolved throughout the course of wide-ranging global consultations with the banking, insurance, investment and capital market communities in 2010–2012.<sup>3</sup> This consultation culminated in the October 2011 UNEP FI Global Roundtable in Washington, DC, USA, when nearly 600 bankers, insurers, and investors joined with policy-makers and civil society representatives to explore the theme, “The Tipping Point: Sustained Stability in the Next Economy.” As UNEP FI participants gathered in The Ronald Reagan Building and International Trade Center at the heart of Washington, representatives of the Occupy Wall Street movement were camped outside. Thought leaders close to Occupy Wall Street were invited into the conference to join the UNEP FI bankers on the stage in what became a robust and rich discussion that deepened the value of the Global Roundtable for many participants. It is clear that the complex and contentious issues covering what our financial system should look like, how it should contribute to society, and the roles of banks, investors and insurers, is a critical issue of our time. A simple clarifying question posed by this paper is: “When would we know that our financial system is fit for purpose to deliver a sustainable global economy in the 21st century?”

This paper seeks to play an educational role for people not intimately involved in the high-level policy-making geared to financial stability and efforts to make the financial system more resilient after the crash of 2007–2008 and the ensuing economic downturn. The paper refers to a number of the key groups and institutions working to re-engineer the international structure of the finance sector. Understanding the roles of these different groups and how they interrelate is an important step in understanding ongoing efforts to create a more effective financial system. Box 1 highlights some of the main institutions driving new policy to enhance global and regional financial stability.

<sup>2</sup> IISD (see [www.iisd.org](http://www.iisd.org)) is a Canadian policy research institute dedicated to sustainable development. TBCG is an investment and corporate advisory firm established by Paul Clements-Hunt, the former Head of the UNEP FI (November 2000 to February 2012).

<sup>3</sup> The final paper will be published at a forthcoming joint IISD/UNEP FI/TBCG event in Geneva to take place in early Q3 2012.

#### BOX 1. KEY BODIES IN FINANCIAL STABILITY.

- **The Group of 20 (G-20):** A group of leading countries that plays an increasing role to enhance coordination of macroeconomic policies and to ensure political support for financial regulatory reform.
- **The Financial Stability Board (FSB):** Created by the G-20 in 2009 to replace the smaller Financial Stability Forum (FSF), FSB is part of the Bank for International Settlements (BIS).<sup>4</sup> The FSB is mandated by the G-20 to coordinate and monitor progress in strengthening financial regulation. The FSB coordinates the work of national authorities and standard setters to ensure international consistency. The board is made up of senior representatives of national financial authorities (central banks, regulatory and supervisory authorities and ministries of finance), international financial institutions (e.g., the International Monetary Fund, the World Bank) and standard setting bodies such as the European Commission (EC) and the Organisation for Economic Co-operation and Development (OECD).
- **The Basel Committee on Banking Supervision (BCBS):** Also part of BIS, the BCBS internationally coordinates the standard setting of banking supervisory matters. For example, BCBS sets international agreements on minimum capital and liquidity requirements for banks. The Committee's work on addressing systemic risk is part of a wider effort of the FSB to address the risk of systemically important institutions.
- **Enhanced Disclosure Task Force (EDTF):** In May 2012 the FSB created a private-sector driven Enhanced Disclosure Task Force. The EDTF's key goals are, firstly, to derive principles for enhanced and comparable disclosure by financial institutions and, secondly, to identify "leading practice risk disclosures" for end-year 2011 corporate reports. The press release<sup>5</sup> announcing the EDTF indicates the broad international reach of the new task force, stating that it "will have dialogue with standard-setting bodies, such as the International Organization of Securities Commissions, the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, the International Accounting Standards Board, the US Financial Accounting Standards Board, and the International Auditing and Assurance Standards Board, at key stages as it develops its recommendations." EDTF will report its recommendations by October 2012.

<sup>4</sup> The Bank for International Settlements (BIS) was established on May 17, 1930 and is the world's oldest international financial organization. The BIS fosters international monetary and financial cooperation and serves as a repository for central banks. See <http://www.bis.org/about/index.htm>.

<sup>5</sup> Financial Stability Board, 2012, "Formation of the Enhanced Disclosure Task Force," press release, May 10.

## Overview

Looking back on the past five years, it is clear we have witnessed a period that almost broke and certainly will reshape a new model of global finance. The ability of our financial and investment institutions to effectively assess, mitigate, manage and transfer a broad range of risks is under question. Whether these risks stem from the complexity of modern financial engineering in a seamless, electronic global marketplace or result from the slow, creeping risks of climate change, resource depletion and ecosystems destruction, our collective faith in financial institutions has been shaken to the core.

Myriad examples have come to light of activities across the financial services system and within many different financial institutions that were characterized by poor judgment, incompetence, malfeasance and possible criminality that saw executives and institutions miss, ignore or underestimate risks. The May 2012 disclosure<sup>6</sup> of a US\$2 billion trading loss by US investment bank JPMorgan Chase, followed quickly by the much criticized mishandling by investment banks of the Initial Public Offering (IPO) of Facebook, are just the latest in a litany of losses, scandals and crises within financial institutions that gathered pace from August 2007 onwards (see Box 3, “Questions to answer,” and Box 4, “Libor manipulation unfolds”).

At the same time, many parts of mainstream financial services continued to deliver essential products and services that provide the very cornerstone of our societies and economies. The beneficial services provided by many banking, insurance and investment institutions, although often overlooked given the heat and emotion generated by the crisis and its aftermath, emphasize how a thriving, vibrant, stable and resilient financial system is fundamental for development.

One lesson is clear: in a globalizing marketplace where vast, complex and powerful financial institutions play a crucial role in a borderless, deregulated and privatizing world, correlation of risk within and among institutions can intensify while remaining hidden. The ongoing lessons learned from the crash and how finance is reshaped and reshapes itself to handle systemic financial risk (as well as broader risks connected with our natural systems) will determine whether trust—the foundation upon which all financial intermediation is based—can be restored.

## From Wall Street to Main Street

In the period since August 2007, when the first rumblings of the coming global financial crisis were heard on Main Street, the very model of modern financial services has been questioned. Financial policy-makers have called for “radically changed regulations and supervisory approaches” and one of the world’s most senior bankers has asserted that certain complex financial products were “of no real use to humanity.”<sup>8</sup> In the late spring of 2010, the sector was warned that post crisis, “private players will be held accountable to new and stricter standards of economic integrity and prudent management.”<sup>9</sup> There have been numerous calls for a root and branch reassessment of how this powerful sector, more globalized than any other, either contributes to or undermines our economies, society and environment. The Occupy Wall Street movement that emerged in late 2011 brought the issues of responsible capitalism and questions concerning a future financial system that works for all into the public domain, in a manner that framed the emerging Zeitgeist in 2012.

<sup>6</sup> D. Henry, 2012, “FBI launches JPMorgan probe, shareholders back Dimon,” Reuters, May 15.

<sup>7</sup> Speech by Lord Adair Turner, Chairman, Financial Services Authority, at the City Banquet, the Mansion House, London, September 22, 2009.

<sup>8</sup> Speech by Sir Stephen Green, Chairman, HSBC, and Chairman, British Banking Association, at the Banking in the Process of Change Conference, Frankfurt, September 9, 2009.

<sup>9</sup> Keynote speech by Jean-Claude Trichet, President, European Central Bank, at the 9th Munich Economic Summit, April 29, 2010.

After nearly four years of almost continual analysis of the causes of the financial crisis, it is clear that misaligned incentives, conflicts of interest, a predominance of short-termism (see Box 2, “Patience and Finance”) and failures of both accountability and responsibility and, in some cases, fiduciary duty have occurred at many different points along the investment chain and throughout the processes of financial intermediation. Across the various market reform processes, the themes of transparency, accountability, responsibility, improved governance, legitimacy, financial inclusion and equity are repeated in different jurisdictions. Ideas presented for the overhaul of our financial markets cover both institutional reform (fixing the current system) and broader functional reform (re-engineering finance to serve society and economies more effectively). Some observers<sup>10</sup> have argued that a change in our regulatory philosophy from “horizontal to vertical” regulation is needed to strengthen the whole chain that governs the financial system. Proponents of such ideas believe that such a change would yield a system appropriate for the needs of interconnected financial markets in an age of globalization. Others stress the critical need for greater competition and diversity across the financial markets, notably with an increased emphasis on institutions with clear cooperative, mutual, social and environmental missions to balance the dominance of “too big to fail” financial institutions. The launch in 2012 of the United Kingdom’s Green Investment Bank plays to that idea. The concept of Long Finance,<sup>11</sup> which poses the question, “When would we know our financial system is working?”, is also gathering support.

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<sup>10</sup> S. Davis, J. Lukomnik and D. Pitt-Watson, 2009, “Towards an accountable capitalism,” *Private Sector Opinion*, Issue 13, Global Corporate Governance Forum/International Finance Corporation.

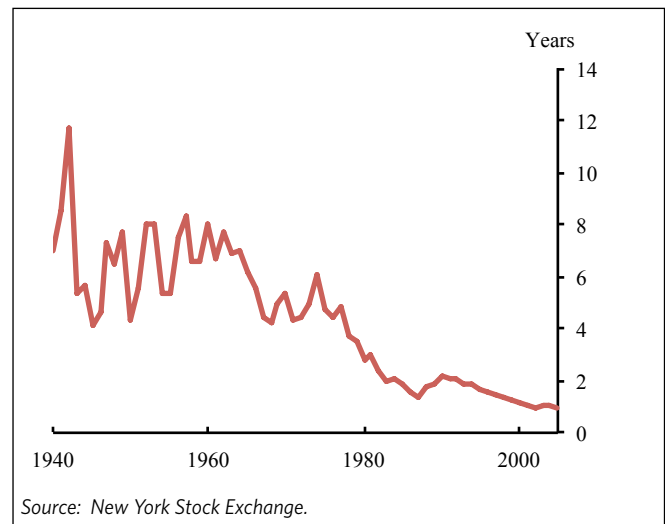
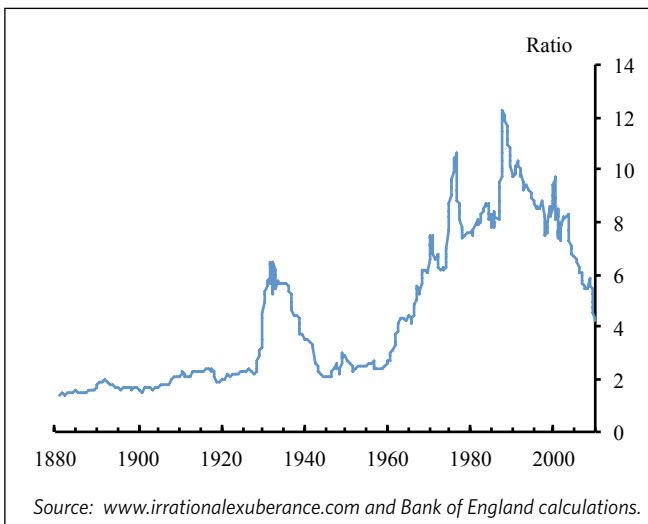
<sup>11</sup> For more on Long Finance, see <http://www.zyen.com/long-finance.html>.

**BOX 2. "PATIENCE AND FINANCE."**

If impatience in the financial system is growing, Andrew Haldane argues in his speech, "Patience and Finance," there should be evidence of financial prices having become more volatile and divorced from fundamentals over time. As Figure 1 shows, stock prices have indeed become more volatile than fundamentals—from twice as volatile until the 1960s, to anywhere between six and ten times more volatile since 1990. Furthermore, as Figure 2 illustrates, the average holding period of shares has seen a drop from seven years in 1940, to around seven months in 2007. Impatience is mounting, according to Haldane.

Figure 1. Ratio of volatility of returns on real S&P 500 price index and its Dividend Discount Model-implied value (assumes real dividend growth rates and real discount rates equal to average values since 1923; volatility calculated as standard deviation over ten years annualized monthly returns).

Figure 2. New York Stock Exchange average holding period, 1940-2005.



Source of Box 2 text: Haldane, A.G., 2010, "Patience and Finance," retrieved from: <http://www.bankofengland.co.uk/publications/Documents/speeches/2010/speech445.pdf>

### BOX 3. QUESTIONS TO ANSWER.

“After all, you only find out who is swimming naked when the tide goes out. At Berkshire, we retain our risks and depend on no one. And whatever the world’s problems, our checks will clear.”<sup>12</sup>

—Warren E. Buffett, Chairman of the Board, in annual letter to Berkshire Hathaway Inc. shareholders, February 28, 2002

The period 2007–2012 has been marked by prominent examples of the world’s most prestigious financial institutions becoming involved in risk-taking that either caused them to fail, exposed them to unknown institution-threatening levels of risk or, at the very least, jeopardized their reputations. A few of the most significant examples are highlighted below.

**American International Group (AIG) Inc.**<sup>13</sup>: The large US-based global insurer, AIG, suffered a loss of US\$99 billion in 2008 with its fourth-quarter loss that year, the largest in corporate history to that point. The sale by a London-based unit of AIG of Credit Default Swaps,<sup>14</sup> a form of insurance for corporate and other types of debt, was at the centre of the company’s difficulties. In exchange for a 79.9 per cent stake in AIG, based on a stock warrant, the US Federal Reserve Bank (the Fed) effectively “bailed out” the company with a US\$85 billion credit facility after the company’s credit ratings were downgraded below “AA” levels. With a ratings downgrade, companies have to post more collateral and the government credit facility enabled AIG to do that. By May 2009 the Fed and the US Treasury increased the total amount available to AIG to US\$182.5 billion.

**Bear Stearns**<sup>15</sup>: The June 2007 collapse of two Bear hedge funds, followed in December by disclosure of its first quarterly loss (US\$854 million) in eight decades, as well as a US\$1.9 billion write-down of mortgage-related securities, marked the beginning of the end for the investment bank. In March 2008 Bear was acquired by JPMorgan Chase.

**Goldman Sachs & Co.:** In July 2010 the US Securities and Exchange Commission (SEC) announced that Goldman Sachs would pay US\$550 million and reform its business practices to settle charges that the institution misled investors in a subprime mortgage product. The settlement, at that time, was the largest ever penalty paid by a Wall Street institution. Earlier, Senator Carl Levin, the Chairman of the US Senate sub-committee investigating the financial crisis, had stated, “ Investment banks such as Goldman Sachs were not simply market makers, they were self-interested promoters of risky and complex financial securities that helped trigger the crisis. They bundled toxic mortgages into complex instruments, got the credit rating agencies to label them AAA securities, and sold them to investors, magnifying and spreading risk throughout the financial system, and all too often betting against the instruments they sold and profiting at the expense of their clients.”<sup>16</sup>

<sup>12</sup> The quote is lifted from the 2002 annual letter where Mr. Buffett, Chairman of Berkshire Hathaway, is discussing the group’s reinsurance business and risk exposures.

<sup>13</sup> T. Alloway, 2009, “AIG 2008 loss: \$billion,” Ft.com/Alphaville, March 2.

<sup>14</sup> National Public Radio, 2008, “AIG and the trouble with Credit Default Swaps,” United States, September 18.

<sup>15</sup> “Bear Stearns Cos. Inc.,” *The New York Times*, May 6, 2012.

<sup>16</sup> “Goldman Sachs & the Financial Crisis,” *The New York Times*, April 24, 2010.

**JPMorgan Chase:** In early Q2 2012, the mainstream press started to flag up commentary from the financial media that suggested the iconic US universal bank, JPMorgan Chase, was exposed to liabilities associated with trading positions taken on by one of its London units related to the complex financial derivative products known as Credit Default Swaps. Then in May 2012, the bank, one of few to come out of the 2007–2008 global financial crisis with its reputation reasonably intact, announced a US\$2 billion trading loss. The news of the loss saw a 10 per cent decline in the bank's share price<sup>17</sup> in mid-May and the bank also suspended plans for a US\$15 billion share buyback.<sup>18</sup> It is estimated<sup>19</sup> that the bank's market value was reduced by US\$30 billion during May 2012.

**Lehman Brothers Inc.:** The collapse of Lehman Brothers Inc. on September 15, 2008,<sup>20</sup> when the 158-year-old bank filed for Chapter 11 bankruptcy citing bank debt of US\$613 billion, US\$155 billion in bond debt, and US\$639 billion in assets was the iconic failure that instantly exported the growing fears of financial executives in Wall Street and the City to main street globally. The failure of Lehman's was the largest in US history. The bank had been an aggressive actor in the securitized mortgage markets and deepened its exposure by retaining seemingly safe "Super Senior Debt" on its balance sheet that, when the crisis in the US housing market erupted, was unsafe debt tied to lower-rated mortgage investments. Additionally, Lehman's had resorted to accounting techniques known as "repos," or repurchase agreements, that a March 2010 court-appointed examiner described as allowing "a materially misleading picture of the firm's financial condition in late 2007 and 2008."<sup>21</sup>

**MF Global:** In late October 2011<sup>22</sup> a "material shortfall" of funds belonging to customers of prime broker MF Global was reported to the Chicago Mercantile Exchange and the Commodities Futures Trading Commission. It became apparent that hundreds of millions of customers' funds held in segregated accounts had been transferred to the company. MF Global then admitted transferring US\$700 million from the customer accounts and a further US\$175 million to a British subsidiary. MF Global Inc. then filed for bankruptcy. Later exploration estimated the shortfall might have been as high as US\$1.2 billion. Before its failure, MF Global marketed itself as "one of the world's leading brokers in markets for commodities and listed derivatives."<sup>23</sup>

**Morgan Stanley:** In mid May 2012 the US investment bank, Morgan Stanley, acted as the lead underwriter for the flotation of shares of the social media company, Facebook, through an Initial Public Offering (IPO) on the US market, the NASDAQ. The bank valued the company's shares at US\$38 and "boosted the size of the IPO by 25 percent in its final days."<sup>24</sup> When launched, the young company was valued at US\$104 billion. However, the stock fell by 20 per cent in the two days after launch and it is estimated investors lost US\$20 billion. A combination of apparent technical hitches on the NASDAQ and an alleged non-uniform circulation of information material to the IPO for investors were highlighted as possible causes of the botched IPO. The process is under investigation by the SEC and the Massachusetts Regulators.

<sup>17</sup> "Jamie Dimon blames bank's \$2bn trading scandal on badly monitored strategy," *The Independent*, May 14, 2012.

<sup>18</sup> "JPMorgan halts \$15bn buyback to preserve capital after \$2bn loss," *Financial Times*, May 22, 2012.

<sup>19</sup> Ibid.

<sup>20</sup> Investopedia, 2009, "Case study: The collapse of Lehman Brothers," April 2; Wikipedia, "Lehman Brothers: Subprime mortgage crisis."

<sup>21</sup> M. Trumbull, 2010, "Lehman Bros used accounting tricks amid financial crisis—and earlier," *The Christian Science Monitor*, csmonitor.com, March 12.

<sup>22</sup> "MF Global Brokerage Liquidation, Trustee Approved by Judge," *Bloomberg Businessweek*, November 8, 2011.

<sup>23</sup> Ibid.

<sup>24</sup> R. Waters, 2012, "How Facebook's IPO went from triumph to disaster," *Financial Times*, May 24.

**Northern Rock**<sup>25</sup>: In September 2007 the bank Northern Rock experienced the first run on a British bank since 1866. When trouble in international credit markets accelerated in quarter three of 2007, the bank was exposed because of its high leverage and dependence on short-term lending. Northern Rock had been one of the most active players in the mortgage securitization markets. The bank was taken into public ownership in 2008 and acquired by Virgin Money in 2012. The Northern Rock brand will be phased out in 2012.

**UBS**: In September 2011 a US\$2.3 billion loss due to an alleged “rogue trader”<sup>26</sup> was disclosed by UBS. This followed hard on crises at the bank in 2009–2010, caused by allegations that UBS staff had assisted clients in US tax evasion practices, which, itself, came after losses at the time of the 2008 financial crisis. It is estimated<sup>27</sup> that UBS has written down US\$50 billion in losses from its sub-prime mortgage investments and reduced the bank’s workforce by 11,000.

<sup>25</sup> H.S. Shin, 2008, “Reflections on modern bank runs: A case study of Northern Rock,” Princeton University, August.

<sup>26</sup> H. Bachman, 2011, “Can UBS bounce back from the ‘Rogue-Trader’ scandal?” *Time*, September 19.

<sup>27</sup> Wikipedia, “Impact of the financial crisis 2008–2009,” UBS.



An intense period of analysis by many different bodies worldwide has highlighted the fact that, while many actors along the investment and financial intermediation chains were acting rationally and legally in their own self interest, the “collision of all these self interests brought the system to its knees.”<sup>28</sup> Questions over the ethical, governance and legal aspects of decisions taken by individual executives and institutions continue to be raised. A 2011 report<sup>29</sup> by the United Nations Environment Programme (UNEP) states:

It is clear that across banking, investment and insurance—the core activities of the financial system—significant changes in philosophy, culture, strategy and approach, notably the overwhelming dominance of short-termism, will be required if capital and finance is to be reallocated to accelerate the emergence of a green economy.

There also has been a widespread recognition of the systemic nature of the failure that saw a global financial crisis turn into a severe economic downturn for many major economies. The role and effectiveness of lawmakers, the financial policy community, and supervisory bodies and regulators, both international and national and pre- and post-crisis, have come under close examination. The former President of the European Central Bank acknowledged in late April 2010 that “the vast expansion of the financial sector would not have been possible without supportive macroeconomic conditions and inadequate prudential regulation.”<sup>30</sup>

**BOX 4. LIBOR MANIPULATION UNFOLDS.**

For those global “blue chip” banks at the heart of the alleged Libor manipulation scandal, the post-crash spotlight, in terms of banking scandals and wrongdoing, never seems to fade. Financial regulators around the world have been working in collaboration since 2008 to establish whether banks sought, at the height of the crisis, to manipulate to their own advantage an interest rate benchmark that, through its influence on home, education, auto and credit cards loans, touches the lives of billions of ordinary people around the planet. The benchmark also underpins markets where hundreds of trillions of dollars in complex derivatives contracts are traded between banks, hedge funds and non-financial institutions to hedge against a very broad range of risks. Now, the first criminal charges have been brought in Canada and the United States. The unfolding legal narrative suggests that certain units within banks allegedly placed their own interests ahead of clients and customers, possibly breaching fiduciary expectations. Several banks have agreed to cooperate with authorities to position for judicial leniency if the charges are proven. The reflex argument offered by the sector is that this was reckless or illegal behaviour by a limited number of traders within banks and, yet, this ignores the deeper questions that arise over how an institution creates a culture where these actions are considered acceptable in any way. “This is just another example of the slow drip of sleaze across the industry,” stated one senior industry figure in early 2012.<sup>31</sup> A case brought by the Canadian Competition Bureau indicates that traders in different banks communicated to discuss Libor: “The court documents suggest that a group of traders regularly contacted one another to discuss how to

<sup>28</sup> Davis, Lukomnik and Pitt-Watson, 2009, “Towards an accountable capitalism.”

<sup>29</sup> UNEP, 2011, Finance chapter in “Towards a Green Economy: Pathways to Sustainable Development and Poverty Eradication—A Synthesis for Policy Makers,” [www.unep.org/greeneconomy](http://www.unep.org/greeneconomy).

<sup>30</sup> Trichet, April 29, 2010.

<sup>31</sup> “Probe reveals scale of Libor abuse,” *Financial Times Online*, February 12, 2012.

influence the yen LIBOR rate. If true, that would have breached two principles. One is that traders from different banks should not be aligning their positions in this way. The other is that traders are supposed to be separated from staff within the same bank who estimate LIBOR.<sup>32</sup>

Various commentators, examining many different aspects of the financial system, have repeatedly called for:

- A thorough rethink of the overall governance of our financial system and how the architecture of the system interrelates
- Finance to revisit its basic role in order to more effectively serve its primary social and economic functions
- A new vision where a re-engineered financial system with a culture based on values, not just value, builds lasting economic, social and environmental benefits

Importantly, a re-engineered financial system needs to reflect the type of structures upon which future economic, social and environmental stability, as framed in 2010 by the G-20 Heads of Government, can be based.<sup>33</sup>

<sup>32</sup> "The LIBOR probes: An expensive smoking gun," *The Economist*, April 14, 2012.

<sup>33</sup> Steps to create a financial system capable of delivering a green economy are covered in detail in the Finance chapter of the Green Economy report, UNEP, 2011.

## **Part 1**

### **Finance under the Lens**

Following the crash of 2007-2008, the modern financial system has undergone a molecular forensic examination that continues today. For politicians, policy-makers, legislators and financiers, as the crash shifted from a crisis for the financial system's survival, through economic downturn and into a sovereign debt crisis with implications for long-term economic growth, the question remains: "How do we create a stable, resilient and robust financial system that can deliver sustained and balanced economic growth?"

#### **Resuscitation, Analysis, Regulation and Litigation**

Since the weekend of 20-21 September 2008, a few days after the Lehman Brothers Inc.<sup>34</sup> failure, financial policy-makers around the world have focused collectively on preventing a collapse of the global financial system. After the initial financial doomsday fears of 2008 and early 2009 subsided, finance ministers, central bank governors and the Bretton Woods Institutions<sup>35</sup> shifted their attention from the emergency resuscitation of a failing financial system to a focus on how to recatalyze economic growth and reconfigure the system to counter the likelihood of such system-threatening events in the future. The all-encompassing nature of these policy discussions and negotiations covers a broad spectrum of needs, ranging from calls "to converge on a common solution"<sup>36</sup> for global financial challenges, to efforts to address capital requirements, accounting conventions and incentive structures within finance. The globe's leading financial policy-makers are battling to understand and to coordinate a latticework world of intertwined policy discussions taking place at international, regional and national levels.

Central to these discussions have been the questions of how our increasingly interconnected financial systems work and what degree of control and preventive action is required from public lawmakers and agencies to head off severe events that are happening with greater frequency. The question and desirability of how the financial services and investment communities might reform and regulate themselves is also in the spotlight. The highly diverse sector operates in a complex environment of evolving international policy norms that are not aligned with fragmented policy, legislation and regulation at the regional and national level.

Financial engineering and aggressive product innovation, often geared to short-term opportunities, have meant that important parts of the industry were able to forge hidden and unimaginable levels of systemic risk under a belief that the processes ensured diversification of risk across uncorrelated asset classes. The crash of 2008-2009 proved this simply not to be the case and confirmed the dangers of the largely unrecognized systemic risk inherent to the "originate and distribute" model of financial engineering by banks, as distinct from the traditional "originate and hold" approach to banking.

<sup>34</sup> For a good summary of the Lehman Brothers Inc. collapse, see <http://www.investopedia.com/articles/economics/09/lehman-brothers-collapse.asp>.

<sup>35</sup> The Bretton Woods Institutions include the International Monetary Fund (IMF) and the World Bank Group, which both became operational in 1945.

<sup>36</sup> D. Strauss-Kahn, Managing Director of the IMF, 2010, "Nations must think globally on finance reform," *Financial Times*, February 18.

The G-20<sup>37</sup> Finance Ministers, the Financial Stability Board (FSB)<sup>38</sup> and the Basel Committee on Banking Supervision,<sup>39</sup> as well as a host of contributing international bodies, are central to these discussions. At the same time, the international accounting community, notably the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), were asked by the G-20 in September 2009 to come up with a “high quality global accounting standard—a single way of measuring all the world’s companies.”<sup>40</sup> It appears, however, that international efforts to bring about convergence around one standard, the International Financial Reporting Standards, have faltered and the accounting community has to a large degree accepted that, at this stage, an integrated global accounting system is beyond its reach, with many of the key unresolved issues still on the table in 2012. Agreement over the valuation and pricing of banking assets, notably the complex financial products such as derivatives that sat at the heart of the initial sub-prime crisis in the United States, as well as loans and loan-like instruments,<sup>41</sup> appear to be, once again, at the epicentre of the schism across the accounting world. Instead, the leaders of the global accounting community hope to achieve, at a minimum, better coordination across accounting principles and practices.

Essentially, all of these discussions and the subsequent work to forge effective policy action, whether at the global, regional or national level, seek to understand how governance of our financial and market systems, as well as the governance of individual institutions and the agencies that have oversight authority for them, have failed and can be improved in order to safeguard the overall system that underpins global economic and social development.

## Transition Point

The second quarter of 2010 marked a significant transition point in the various phases of the 2007–2012 financial crisis and global economic downturn. Over the course of a few weeks, the world saw a shift from the assessment and reporting phase characterized by initiatives to analyze why a system-threatening crisis of such severity took place, to a period that saw the regulatory overhaul executed and when prospective litigation against financial service institutions by governments and investors gathered pace. Naturally, litigation against the finance and investment community was a facet from the earliest stages of the crisis, and the analysis and discussion of the “why and how of the crisis” will continue for many years to come, but the period March–June 2010 will be viewed in the future as a transition point from “analysis to regulatory roll out and litigation.” During this period two significant reports<sup>42</sup> were released: one exploring the September 2008 collapse of the Wall Street investment bank, Lehman Brothers Inc., and the second

<sup>37</sup> The G-20 was created in 1999 after the 1997 Asian Financial Crisis, to explore how the world’s most advanced economies and major emerging markets could work together to prevent financial instability. For more on the G-20, see <http://www.g20.org>.

<sup>38</sup> The FSB was established to address vulnerabilities and to develop and implement strong regulatory, supervisory and other policies in the interest of financial stability. For more on FSB, see <http://www.financialstabilityboard.org>.

<sup>39</sup> The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters; see <http://www.bis.org/bcbs>.

<sup>40</sup> “Analysis: Carried forward,” *Financial Times*, April 20, 2010, p. 7.

<sup>41</sup> “Accounting standards divide set to widen,” *Companies & Markets, Financial Times*, May 27, 2010.

<sup>42</sup> The 2,200-page Valukas Report, prepared by Chicago-based lawyer Anton Valukas, explores the collapse of Lehman Brothers Inc.; the Icelandic Truth Commission report catalogues the drivers of the country’s near sovereign default.

cataloguing the reasons for the 2008 near sovereign default by Iceland and the collapse of its three major banks. In many ways, the release of these two reports marked an end point to the early assessment and reporting phase of the crisis. And then the transition:

- On April 16, 2010, the US Securities and Exchange Commission (SEC) “charged Goldman, Sachs & Co. and one of its vice presidents for defrauding investors by misstating and omitting key facts about a financial product tied to subprime mortgages as the US housing market was beginning to falter.”<sup>43</sup> At the time, Goldman, Sachs & Co. strenuously denied the allegations, saying they were “completely unfounded in law and fact.”<sup>44</sup> Subsequently, in July 2010 the SEC announced that the bank would pay US\$550 million and reform its business practices to settle charges that the institution misled investors in a subprime mortgage product. The settlement was the largest ever penalty paid by a Wall Street institution.
- As April 2010 slipped into May, it became clear that regulators in the United States, in Europe, and in other countries worldwide were ready to unveil a raft of new regulations in 2010 as part of the post-crisis overhaul. The passage on May 20, in the US Senate, of the landmark Restoring American Financial Stability Act<sup>45</sup> was a significant case in point, as was the arrival in the second half of 2010 of a range of financial directives from EU regulators.

Two years onward from the initial policy, regulatory and legal responses to the 2008 crisis, the initiatives underway are manifold (see Box 5, “A new regulatory architecture emerges”) and, ultimately, their goal is to engineer at national, regional and global levels, financial systems where:

- Systemic risk is safely contained through identification, analysis, management and monitoring
- There is early warning of systemic threats
- Sustainable financial and economic development is supported by productive financial innovation
- Options for institutions and individuals to game the system are reduced

In May 2012, at the time of writing, commentators are busy pointing out technicalities on which the laws and regulations on both sides of the Atlantic are being watered down, especially those associated with the regulation of over-the-counter markets and the alternative non-bank investment vehicles. To which extent these regulations will succeed in increasing transparency and curbing systemic risks is difficult to ascertain and this debate lies outside the scope of this report. The authors are of the view revised supervision and regulation is essential to restoring the health of the global financial system, and the impending laws should serve as the first step in the right direction.

<sup>43</sup> US Securities and Exchange Commission home page, <http://www.sec.gov/news/press/2010>.

<sup>44</sup> Goldman, Sachs & Co., <http://www2.goldmansachs.com/our-firm/press/press-releases/current/response.html>.

<sup>45</sup> Restoring American Financial Stability Act, as amended. S. 3217 is a comprehensive financial regulatory reform bill that includes provisions to consolidate existing consumer protection authorities into a new Consumer Financial Protection Bureau, establish a council to monitor and address systemic risk, implement a resolution authority to end the problem of firms being considered “too big to fail,” and regulate derivatives markets. Source: <http://www.lexology.com/library>.

**BOX 5. A NEW REGULATORY ARCHITECTURE EMERGES.**

Since the scrambled response of the world's financial policy-makers in the days after the precipitous crash of October 2008, there has been a relentless effort to set in place a new policy framework and regulatory architecture to enhance the stability of the global financial system and to control risk-taking amongst systemically important financial institutions. In the United States, the Dodd-Frank Act; across the European Union, the European Markets Infrastructure Regulation (EMIR); and globally, Basel III; are all examples of the policy community's response to the crash and its aftermath. Additionally, the Solvency II standards developed for the insurance industry will also have implications for the investment arms of insurers and for banks with insurance interests. Some observers claim that for multinational financial institutions the intersection of these new policies, legislation and regulation make it "exceptionally difficult for firms to achieve a holistic understanding of the new market reality."<sup>46</sup> At the same time and in different jurisdictions, there have been ongoing calls for a deeper examination of the role policy-makers played in the run up to the crash and whether financial lawmakers and regulators could have been more effective to head off the crisis. For example, in the United Kingdom and after three years of pressure, the Bank of England agreed in mid-May 2012 to enact three independent reviews to explore its role in the financial and economic crisis: "Ideally, any review would cover the Bank of England's performance throughout the whole period of the crisis. It would also involve an overall judgment on how its institutional framework has functioned since independence in 1997 and why it was unable to prevent the crisis."<sup>47</sup>

## Part 2

### The Ticking Clock of Long-Term Systemic Risk

Distanced from the immediate remit of the financial policy-makers with a focus on classical risks to the financial system, another process has been building momentum in recent years. This work seeks to define how a broader range of systemic risks may, in time, also jeopardize economic, social and financial stability to varying degrees. Resource scarcity, climate change, threats to our biodiversity and ecosystems, the demographics of aging populations, and the impact of chronic diseases are prominent examples of a growing list of risks that may threaten the stability of economic and financial systems. In early 2010 the World Economic Forum suggested that "the biggest risks facing the world today may be from slow failures or creeping risks."<sup>48</sup>

Work undertaken since 2003-2004<sup>49</sup> exploring the fiduciary<sup>50</sup> implications, as well as the financial materiality of a range of these risks, promotes the need for greater engagement by investors and financial intermediaries to understand the nature and possible impacts of these risks. Notably, a focus on the legal (see Box 6, "The emergence of the new fiduciary") responsibilities of fiduciaries,<sup>51</sup> as well as the legal responsibilities between different

<sup>46</sup> "Regulatory reform and collateral management: The impact on major participants in the OTC derivatives markets," JPMorgan, Sponsored Commentary, Investment & Pensions Europe, May 2012.

<sup>47</sup> "Glasnost reaches Threadneedle St.," *Financial Times*, May 24, 2012, p. 10.

<sup>48</sup> World Economic Forum, 2010, "Global risks 2010: A Global Risk Network report," executive summary, p. 6, January.

<sup>49</sup> UNEP FI/Freshfields Bruckhaus Deringer, 2005, preparatory work for the report, "A legal framework for the integration of environmental, social and governance issues into institutional investment," October; commenced in 2004.

<sup>50</sup> Fiduciary: An individual, corporation, or association holding assets for another party, often with the legal authority and duty to make decisions regarding financial matters on behalf of the other party. See [www.investorwords.com/1932/fiduciary.html](http://www.investorwords.com/1932/fiduciary.html).

<sup>51</sup> UNEP FI/Freshfields Bruckhaus Deringer, 2005, "A legal framework for the integration of environmental, social and governance issues into institutional investment," October.

actors in investment processes, has shone attention on how emerging risks, including governance issues, should be accounted for within the dynamics of investment policy-making and decision-making. Some legal observers recognize the emergence of a new “soft law framework that is already influencing decisions by large asset owners (pension funds, sovereign wealth funds, insurance reserves) in the marketplace and which, in time, may become firmer in nature as different capital market and legal jurisdictions address the issues of legal liability raised by reports such as Freshfields<sup>52</sup> and Fiduciary II.<sup>53</sup>

In the first decade of the 21st century there has been an upsurge in initiatives<sup>54</sup> drawing long-term institutional investors together to press the case for a deeper understanding of systemic risk issues and for a more effective integration of these risks along the entire investment chain. The Universal Owner<sup>55</sup> Theory provides an academic context for the evolving discussion around the roles and responsibilities of institutional investors in dealing with long-term systemic risk.

## Governance of Markets and Institutions

It is clear that governance of both markets and individual institutions is central to many of the discussions around the stability of the financial system, as well as to the oversight of how financial and investment institutions account for the impacts of the creeping systemic risk. The paper acknowledges that a degree of volatility within the financial system and across capital markets is a natural part of the free-market capitalist system associated with business and economic cycles, including asset bubbles and their aftermaths. Equally, as our understanding of new risks develops and public policy advances to address these risks, the system will require time to develop new structures and systems to account for emerging risks. What the paper questions, however, is that:

- Firstly, the intensity, depth, increasing frequency and far-reaching nature of financial system failures in a globalized marketplace<sup>56</sup> is not an inherent part of properly functioning, well supervised markets with the ability to adjust to and internalize developments driven by the innovation inherent to modern financial markets.
- Secondly, a properly functioning and well supervised free market should also have the ability to identify, assess, account for and price systemic risks—the so-called “slow failures or creeping risks”<sup>57</sup> that are longer-term in nature. As such, and as part of a transition to a more stable and resilient financial system, the balance between short-term quantifiable risks for which our analytical, rating, capital market and accounting mechanisms are purportedly set up and those mid- to long-term risks, systemic in nature and otherwise, for which our systems are not effectively configured, needs to be addressed.

<sup>52</sup> Ibid.

<sup>53</sup> UNEP FI, 2009, “Fiduciary responsibility: Legal and practical aspects of integrating environmental, social and governance issues into institutional investment,” July.

<sup>54</sup> Prominent such initiatives include the Principles for Responsible Investment ([www.unpri.org](http://www.unpri.org)); the P8 (<http://www.princeofwales.gov.uk>); the Investor Network on Climate Change (<http://www.incr.com>); and the Carbon Disclosure Project (<https://www.cdproject.net>).

<sup>55</sup> J. P. Hawley and A. T. Williams, 2007, “Universal owners: Challenges and opportunities,” *Corporate Governance: An International Review*, 15(3), 415–420.

<sup>56</sup> For example, Mexican “Peso” Crisis 1994; the Asian Crisis 1997; the Russian “Ruble” Crisis and failure of the US hedge fund Long-term Capital Management 1998; the dot-com “Boom & Bust” 1997–2000; the corporate governance failures of 2001–2002 (e.g., Enron, Worldcom, Arthur Andersen LLP) and the financial crash of 2007–2010.

<sup>57</sup> World Economic Forum, 2010, “Global risks 2010.”

- Thirdly, an important fundamental test for long-term financial market stability and resilience is the ability of the financial system to identify, assess and manage the new slow, creeping risks in an effective manner that also incentivizes the market to deliver a low-carbon, resource efficient economy that reduces inequality within and between countries.

**BOX 6. THE EMERGENCE OF THE NEW FIDUCIARY.<sup>58</sup>**

In October 2005 a landmark<sup>59</sup> legal interpretation covering the nine major capital market jurisdictions was published. This legal opinion opened up a new potential for the world’s largest institutional investors to consider a broader range of risk issues in their investment processes. In fact, the legal interpretation argued that for the law as it stands in most major capital market jurisdictions, the appropriate consideration of a fuller range of environmental, social and governance (ESG) issues—from both risk and rewards standpoints—was an obligation for many and mandated by law for some. Traditionally, the institutional investment community shied away from considerations of what were often termed “non-traditional, extra financial or non-financial” risks, citing the rationale of fiduciary duty and arguing that any form of special provision or consideration of special interest issues might compromise their duties to ultimate beneficiaries such as pensioners or a country’s citizens, in the case of Sovereign Wealth Funds. This legal interpretation, which became known as the Freshfields Report within the investment industry, greatly strengthened the case around the need for investors to fully integrate material risk considerations in all aspects of their investment processes. In short, this work moved forward the discussion on the need for key market actors to integrate, account for and price the risks associated with a broader range of externalities than had previously been the case in investment practice. The Freshfields legal interpretation was followed in July 2009 by the Fiduciary II<sup>60</sup> report that built on the initial interpretation and argued that investment advisors who do not proactively raise ESG issues for their clients open themselves to potential legal liabilities. This evolving process that sees a broader range of risk issues being embedded in the thinking around fiduciary responsibility and legal considerations goes to the very heart of many investment policy-making and decision-making processes. In parallel to the legal work exploring fiduciary duty that was underway, in 2003 a group of asset managers,<sup>61</sup> collectively representing US\$1.7 trillion in assets under management, asked whether the “financial materiality” of a broader range of risk carrying issues should be reconsidered. What was, essentially, a simple question then drove a six-year-long process that unfolded between 2003 and October 2009 and that yielded three major reports currently transforming thinking within important parts of the mainstream investment world. In the “Materiality Series,”<sup>62</sup> mainstream financial analysts explored the relevance of a range of risk issues, systemic and otherwise, such as climate change, occupational and public health, human labour and

<sup>58</sup> Box 6 draws from a report prepared by Paul Clements-Hunt, Head, UNEP FI, for a presentation at the December 2008 Symposium sponsored by the German development bank, KfW.

<sup>59</sup> UNEP FI/Freshfields Bruckhaus Deringer, 2005, “A legal framework.”

<sup>60</sup> UNEP FI, 2009, “Fiduciary responsibility.”

<sup>61</sup> UNEP FI Asset Management working group (AMwg).

<sup>62</sup> The “Materiality Series” comprises three reports published by the UNEP FI Asset Management working group—Materiality I: “The materiality of social, environmental and governance issues to equity pricing,” June 2004; Materiality II: “Show me the money: Linking ESG issues to corporate value,” July 2006; Materiality III: “The materiality of climate change: How finance copes with the ticking clock,” October 2009.



political rights, and both corporate trust and governance, across a range of commercial and industrial sectors (including aviation, auto industry, aerospace and defence, chemicals, food and beverage, forest products, media, non-life insurance, pharmaceuticals, property and utilities). The third and, to date, final report in the series focused on climate change and was published just two months ahead of the December 2009 United Nations climate change summit in Copenhagen. The report mainly takes the form of a review of key financial analyst research on climate change. What the Materiality Series was so effective in doing was to make a clear, mainstream financial case that a broader range of risk factors have financial relevance and are as useful in constructing a synthesis of management quality as strictly financial factors. Both the fiduciary legal work and then the Materiality Series were fundamental in laying the groundwork for the development of the Principles for Responsible Investment<sup>63</sup> (see Appendix 1), now backed by close to 1,000 institutional investors representing US\$30 trillion in assets.

## **Part 3**

### **Remaking the Markets**

When approached from a systemic and long-term standpoint, the linkages between financial stability and issues of broader systemic risk, fiduciary legal concerns and the governance of systems and institutions are clear. It would appear intuitive that stability in a complex global financial system requires a sound understanding of both short- and long-term risks, demands fiduciaries take full account of such risks when managing capital held in trust, and needs to be underpinned by effective macro and micro governance structures to keep systems and institutions in balance. However, the nature of the linkages between financial system stability and environmental and social risk issues, many longer-term in nature, are not so apparent or quantifiable when viewed over the short term and this is the reason why so many actors along the investment chain simply discount these considerations when dealing in a market with an increasingly short-term perspective. Certainly, viewed from the perspective of the World Economic Forum's "slow failures or creeping risks,"<sup>64</sup> the relevance of these environmental and social risks to financial stability become apparent. The overwhelming predominance of short-termism in the markets, compounded by a system ill-suited to integrate and account for externalities, simply removes many of the broader systemic risks from the financing and investment equations driven by existing market norms. Equally, when one tries to draw a direct line of sight between sustainable finance and investment approaches with the complex realities of macro and micro prudential regulation, the arcane technical specificities of banking capital requirements, and efforts to prevent instantaneous electronic trading on opaque platforms from destabilizing the financial system, the task becomes immeasurably more complicated.

For this reason, the paper limits its exploration of the relevance of the evolving sustainable finance and investment thinking to six areas of the financial markets that are relevant to the overhaul of the financial system. The paper does

<sup>63</sup> The Principles for Responsible Investment (see [www.unpri.org](http://www.unpri.org)), or PRI, is an investor collaboration formed as a result of a joint UNEP FI/UN Global Compact initiative, 2003-2006.

<sup>64</sup> World Economic Forum, 2010, "Global risks 2010."

not pretend to be an exhaustive analysis but rather a reflection on how new thinking and approaches can, in time, feed into financial policy discussions and work to bolster the stability and resilience of the system. The six areas the paper explores are:

1. Dark Pools and the Shadow Side: Stability and Over-the-Counter Markets
2. Ownership That Counts: Institutional Investors and Accountability
3. Listing for Stability: Stock Exchanges and Listing Requirements
4. Banking Risk for the Long Term: Systemic Risk and the Basel Committee
5. Rating Right: The Role of Rating Agencies within the Financial System
6. Insuring the Future: Stability and Solvency II

At the end of each section, a brief overview of how the developments in the six areas relate to sustainable finance and responsible investment is presented.

## Dark Pools and the Shadow Side: Stability and Over-the-Counter Markets

Trading on Over-the-Counter markets, or OTC markets, as they are commonly known, has come under forensic examination by lawmakers across the world who are concerned that these lightly regulated markets enabled incalculable amounts of risk to build up in the global financial system.

OTC markets started on a trial basis in the United States in June 1990<sup>65</sup> as one of a number of market reforms to boost the transparency of stock trading in companies not listed on public exchanges. The difference between OTC markets and public markets is that on the OTC markets, where there has been an exponential increase since 2000 in the trading of a range of derivatives contracts,<sup>66</sup> the quoted entities do not have listing standards.

Since the early experiments, the size of derivatives trading on OTC markets, essentially alternative trading platforms used by private counter parties to trade without the same reporting or disclosure requirements of exchange-based markets (such as the New York or London Stock Exchanges), grew to US\$100 trillion by 2000 and then up six-fold to US\$600 trillion by late 2008, a figure equivalent to 10 times global gross domestic product.<sup>67</sup> According to the International Swaps and Derivatives Association,<sup>68</sup> the outstanding notional amount of derivatives stood at over \$454 trillion in mid-year 2009, which is 30 times the Gross Domestic Product of the United States. When the net figure of overlapping contracts (simply put, contracts that cancel each other out) is calculated, the Bank for International Settlements (BIS) estimates the net figure for derivatives contracts stood at US\$34 trillion by the end of 2008. The implications of the growth of OTC markets can be appreciated when it is understood that “trading activity on the OTC is 60 trillion dollars annually, while turnover on the public market is 5 trillion.”<sup>69</sup> Some market observers have questioned whether a global market that is only “8% transparent”<sup>70</sup> is actually a market.

<sup>65</sup> For a description of the evolution of Over-the-Counter markets, see <http://www.qwoter.com/college/Trading-Basics>.

<sup>66</sup> Derivative: A security whose price is dependent upon or derived from one or more underlying assets. The derivative itself is merely a contract between two or more parties. Its value is determined by fluctuations in the underlying asset. The most common underlying assets include stocks, bonds, commodities, currencies, interest rates and market indices. Most derivatives are characterized by high leverage. See <http://www.investopedia.com/terms/d/derivative.asp>.

<sup>67</sup> “Let battle commence,” *Financial Times*, May 20, 2009, taken from BIS figures.

<sup>68</sup> International Swaps and Derivatives Associations (ISDA), Inc. market survey to end,” 2008. See <http://www.isda.org/statistics/pdf/ISDA-Market-Survey-annual-data.pdf>.

<sup>69</sup> “‘Dark pools of liquidity’ are crossing networks that provide liquidity that is not displayed on order books. This situation is highly advantageous for institutions that wish to trade very large numbers of shares without showing their hand,” in C. Quigley, 2010, “The day the free market died,” *Financial Sense University*, May 13. See [www.financialsense.com/fsu/editorials](http://www.financialsense.com/fsu/editorials).

<sup>70</sup> Ibid.

The growth of more opaque markets, many associated with a new breed of electronic trading platforms, have also attracted what have become known as “Dark Pools”<sup>71</sup> of capital or liquidity that seek to benefit from the more lightly regulated markets and enable trading in equities and other instruments to be masked. Within this so called “shadow side” of finance, the trading and speculative roles played by, for example, hedge funds and the proprietary trading arms of banks, dealing for themselves or on behalf of large institutional investors, has come under intense regulatory examination since the financial crash. The ability to mask trading activities, some market observers suggest, acts to rob or restrict information from the market and poses the risk of spreading liquidity thin. Proponents of OTC markets contend that these markets enhance efficiency, minimize transactional costs, reduce “information leakage” and give large institutions more freedom to trade without the “retail herd” tracking their every move. Given the political and regulatory outcry over OTC markets, many of these entities and the traders who are active on them understand that they will have to become more transparent “hybridized exchange model[s].”<sup>72</sup>

In the aftermath of the 2008-2009 financial crisis and, understandably, given the size, opacity and complexity of the OTC markets, the overhaul of regulation of these markets, with an urgent need for greater transparency, became a high political priority, as these markets were considered to have heightened those systemic risks leading to financial instability. Concerns have been highest in the major OTC markets of the United States, the United Kingdom and the European Union, where regulations are being introduced to increase transparency and prudential governance across these markets. Governments are going to great lengths to assure their citizens that the threat of “systemic failure” will be controlled and are moving to ensure that all OTC derivatives and derivatives dealers will be regulated and that all swap instruments (interest rate swaps, currency swaps, commodity swaps, credit default swaps and equity swaps) will be closely scrutinized and that no new swap instrument will slip between the “regulatory cracks.” In their June 5, 2010 Communiqué, the G-20 Finance Ministers “committed to accelerate the implementation of strong measures to improve transparency, regulation and supervision of hedge funds, credit rating agencies, compensation practices and OTC derivatives in an internationally consistent and non-discriminatory way.”<sup>73</sup> They also “called on the Financial Stability Board to review national and regional implementation in these areas and promote global policy cohesion.”<sup>74</sup>

In the case of the European Union, commentators are already warning about coordination and execution hurdles, given that reforms are encompassed in several directives—the European Market Infrastructure Directive, the EU Capital Market Directive, and the Alternative Investors Fund Management Directive. In the United States, most of the proposed changes are encompassed in the Dodd-Frank Wall Street Reform and Consumer Protection Act,<sup>75</sup> signed into law on July 21, 2010.

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<sup>71</sup> Ibid.

<sup>72</sup> “The hybrid dark pools puzzle,” November 25, 2010, <http://www.marketsmediaonline.com>.

<sup>73</sup> G-20 Communiqué: Meeting of Finance Ministers and Central Bank Governors, Busan, Republic of Korea, June 5, 2010.

<sup>74</sup> Ibid.

<sup>75</sup> Restoring American Financial Stability Act of 2010.

Essentially, the goals of the ongoing reforms across the United States and the European Union are to:

1. Regulate all OTC derivatives markets
2. Regulate all OTC derivatives dealers and other market participants
3. Prevent manipulation, fraud, insider trading and other market abuses
4. Protect unsophisticated investors

**BOX 7. THE REGULATORY OVERHAUL FOR FINANCE.**

Since 2010, regulation has swept across other facets of international finance, as well as the Over-the-Counter (OTC) derivatives markets. In the United States, the Volker Plan, for example, proposed to separate the retail banks from investment banks in order to keep a check on the size of banks before they assume the status of “too big to fail.” A bank bailout tax was backed by the United Kingdom, United States, Germany and France, although there was a strong disagreement with other governments, led by Canada, against the idea of such a tax at the June 5–6, 2010 G-20 Finance Ministers’ meeting in Busan, Korea. Over the past two years, variations on such a “bailout tax” have been floated and have ranged from mechanisms that would act as an insurance for banks, safeguarding both the taxpayers and the banks by creating a pool specifically for future bailouts, to mechanisms that would enable an “orderly closure” of failing or failed financial institutions. The United States Treasury outlined broad objectives in the Financial Regulatory Reform Report, which defined five major objectives: (a) Promote robust supervision and regulation of financial firms; (b) Establish comprehensive supervision of financial markets; (c) Protect consumers and investors from financial abuse; (d) Provide the government with tools to manage financial crisis; and (e) Raise international regulatory standards and improve international cooperation. To achieve these ends, the proposed OTC/derivatives reforms can be broadly considered to propose the following:

- Promote the standardization of OTC derivatives
- Provide a definition for standard OTC derivatives
- Require central clearing of standardized OTC derivatives in accordance with the September 2009 G-20 Communiqué, which called for “all standardised OTC derivative contracts to be cleared through central counterparties by end 2012 at the latest”
- Require standardized OTC derivatives to be traded in regulated exchanges
- Move more OTC derivatives into Central Clearing and Exchange Trading through higher capital requirements and higher margin requirements for non-standardized derivatives
- Require transparency on transactions and positions in OTC derivatives markets
- Regulate all OTC derivatives dealers and other major market participants
- Provide regulators with the tools and information necessary to prevent manipulation, fraud and abuse
- Protect unsophisticated investors
- Require the registration of all relevant OTC derivatives trades in trade repositories

### *Relevance to Sustainable Finance and Investing*

The immediacy and scale of trading activities on modern financial markets creates a fundamental gap between the short-term, opportunistic philosophy of the trading community and the more reflective stance of the proponents of sustainable finance and investment approaches. A combination of liberalizing global markets, technology advances creating powerful, interconnected international trading platforms and the ability to leverage high-frequency trading<sup>76</sup> activities in a low interest environment have resulted in daily markets where contracts worth hundreds of billions (US\$) are transacted. For traders, “slow or creeping” risks are rarely on the radar screen unless a clear trend is seen to be driving “events” with significant market implications, while short-term environmental crises (British Petroleum’s oil slick disaster in the Gulf of Mexico being a case in point) quickly become trading opportunities as markets adjust to those events instantaneously.

Market-makers and trading activities bring the liquidity and volume upon which vibrant and diverse markets thrive and, as some would argue, play the instantaneous clearing role that is a unique strength of free-market capitalism. However, others would point to the May 6, 2010 so-called “flash crash” when trading activity saw “some stocks briefly losing 99% of their value”<sup>77</sup> and the major indices dropped by 9 per cent, including “a near 7% decline in a roughly 15 minute span”<sup>78</sup> as evidence that high-frequency trading and speculation means the market system remains unstable. There is a sense that the scale, speed and interconnectedness of trading across markets has come to be the dominant factor in how global equity markets interact.

Sustainable finance and responsible investment advocates “active ownership” that seeks to heighten the accountability between the ultimate owners of capital and the assets in which they are invested. Increasingly, the trading activity in modern capital markets runs counter to this as market actors with no interest in the long-term success of the companies in which they trade come to dominate. Michael Gordon, Chief Investment Officer, Equities, at BNP Paribas Asset Management, captured the sentiment well when describing the scale of high-frequency trading:

One example is the growth of high frequency trading. In the US, it has left the market often hostage to the consequences of behaviours that have little to do with the underlying long, medium or short-term economic realities of the stocks. This is so because as much as 70 per cent of the share trading volume on the US exchanges is now high frequency.<sup>79</sup>

<sup>76</sup> “High-frequency trading is a set of computerized trading strategies characterized by extremely short position-holding periods. In high-frequency trading, programs running on high-speed computers analyze massive amounts of market data, using sophisticated algorithms to exploit trading opportunities that may open up for only a fraction of a second,” Wikipedia quoting M. Durbin, 2010, “Fixing Wall Street’s autopilot,” *The New York Times*, May 7, and E. Brown, 2010, “Computerized front-running,” April 23, at [www.counterpunch.org](http://www.counterpunch.org).

<sup>77</sup> M. Gordon, 2010, “Move towards ‘progressive’ equity trading no longer rocks,” *Financial Times*, June 8.

<sup>78</sup> “SEC Chairman admits: We’re outgunned by market supercomputers,” *Wall Street Journal*, [wsj.com](http://wsj.com); Securities & Exchange Commission, “SEC testimony concerning the severe market disruption on May 6, 2010,” May 11, 2010.

<sup>79</sup> Gordon, 2010, “Move towards ‘progressive’ equity trading no longer rocks.”

The challenges that trading across modern financial markets poses for the sustainable finance and responsible investment communities are considerable. At many points along the investment and financial intermediation chains, there are increasing examples of a total disconnect between financial institutions as they “move further and further from their customers and the knowledge of the products they are buying, selling or trading inevitably suffers.”<sup>80</sup>

It is clear that the requirements of transparency and accountability sit at the heart of regulatory efforts to reform OTC and derivatives markets and these include practical and pragmatic steps to see centralized clearing and trading on regulated exchanges. As noted, the values of transparency, accountability and responsibility are core to sustainable finance thinking and they feature heavily in the regulatory overhaul underway. The clearest link between trading activities, OTC markets and derivatives with sustainable development is the systemic risk that instability in capital markets poses potentially for balanced long-term economic, social and environmental development. The area needs much deeper exploration.

### **Ownership That Counts: Institutional Investors and Accountability**

The collective holdings by institutional investors (such as pension funds, sovereign wealth funds and insurance reserves) in financial services’ equity and fixed income positions grew exponentially during the boom years, in the first decade of the 21st century. The degree to which such asset owners, who hold and manage money in trust for their end beneficiaries, exercised their fiduciary responsibilities by questioning the governance, policy and operational practices and innovative products of financial institutions ahead of the crash is in question. Also, the role of those agents in the investment chain who make influential asset allocation decisions, notably pension fund consultants and brokers, is also being closely examined.

Whether through the origination and distribution of mortgage backed securities, the development of exotic derivatives products, and/or high-frequency trading practices, financial service companies helped to create a positive capital market wave during the boom period of 2002–2007. Those asset owners holding financial services stocks and bonds benefited greatly until late 2007, only to see a precipitous decline in the value of their holdings as the crash accelerated in 2008. As one market observer has noted: “In one week of October 2008, the value of global retirement assets took a hit of about 20 per cent.”<sup>81</sup>

<sup>80</sup> “The ecology of finance: An alternative white paper on banking and financial sector reform,” 2009, New Economics Foundation, November.

<sup>81</sup> J. Authers, 2010, “Market forces,” *Financial Times*, FT weekend, May 22/23.

The same institutional investors were also in the market for a range of asset-backed securities and associated derivatives products at the epicentre of the initial sub-prime collapse. In essence, institutional investors were both fractional owners of financial institutions and at the same time were actively buying the innovative products those same institutions were bringing to the markets, in what has become known as an “originate and distribute model” rather than the traditional “originate and hold” model of banking. For banks, this evolution to “originate and distribute” meant they could shift risk from their balance sheets through the process of securitization and sale of various “income generating financial assets,”<sup>82</sup> including bundled mortgages. The upside of the “originate and distribute” model was that it “permitted a potential improvement in the efficiency of the economy-wide mechanisms for intermediation and risk sharing.”<sup>83</sup> The downside of “originate and distribute” was that it “destroys information.”<sup>84</sup> Economist Willem Buiter explains:

The information destruction occurs at the level of the originator of the assets that are to be securitised. Under the “originate and hold” model the loan officer collecting the information on the creditworthiness of the would-be borrower is working for the Principal in the investing relationship (the originating bank or non-bank lending institution). Under the “originate and distribute” model, the loan officer of the originating banks works for an institution (the originating bank) that is an Agent for the new Principal in the investing relationship (the Special Purpose Vehicle (SPV) that purchases the loans from the banks and issues securities against them). With asymmetric information and costly monitoring, the agency relationship dilutes the incentive for information.<sup>85</sup>

If such financial innovation does lead to “information destruction,” then it would appear legitimate to raise questions concerning the degree to which institutional investors understood what they were buying or the activities of the financial institutions in which they were investing. In the United Kingdom, regulators “questioned whether investors have in all cases truly understood the products they were buying and if there had been more effective and collective shareholder intervention whether the financial crisis”<sup>86</sup> would have been as severe. Equally, in 2009 a group of asset managers<sup>87</sup> noted: “Some have argued that the ongoing financial crisis may not have been so deep or so protracted if institutional investors had been collectively willing to challenge the financial institutions that were at the heart of creating the systemic risks within the financial system.”<sup>88</sup> Others put it more bluntly, referring to “the banks’ investors who did little to stop the free for all.”<sup>89</sup>

<sup>82</sup> W. H. Buiter, 2007, “Lessons from the financial crisis: Part 1,” October 26, Maverecon/ft.com.

<sup>83</sup> Ibid.

<sup>84</sup> Ibid.

<sup>85</sup> W. H. Buiter, 2007, “The information problems of securitisation of bank loans,” in *Lessons from the 2007 financial crisis*, CEPR Policy Insight No. 18, December, reported in “*The global credit crisis: How could it happen*,” July 2008, in P. M. Liedtke, 2010, *Anatomy of the credit crisis*, an insurance reader from The Geneva Association, January.

<sup>86</sup> Hector Sants, Chief Executive, Financial Standards Authority, 2009, “The Crisis: The role of investors,” National Association of Pension Funds Investment Conference, March 11.

<sup>87</sup> UNEP FI’s Asset Management working group is a group of 15 asset managers representing approximately US\$2 trillion in assets under management.

<sup>88</sup> UNEP FI, 2009, “Fiduciary responsibility.”

<sup>89</sup> Davis, Lukomnik and Pitt-Watson, 2009, “Towards an accountable capitalism.”

The losses incurred by institutional investors when “unrecognised and systemic risks wiped out more than a decade of investment returns”<sup>90</sup> have focused attention on whether our traditional understanding of fiduciary duty is adequate for our complex, interconnected global financial markets, where product innovation has been such a focus. For example, in the United States, the large banks opposed a provision in proposed regulation “that would give banks a ‘fiduciary’ duty of care when dealing with pension funds or state and municipal governments.”<sup>91</sup> Although US lawmakers contended that banks do have a fiduciary duty to clients when selling products, the industry view was that such responsibilities should come under softer “business standards, transparency, reporting and disclosure”<sup>92</sup> or else would threaten banks’ roles as market-makers and their ability to bring liquidity at scale to new markets.

A fundamental question, therefore, for institutional investors is whether they have “an obligation to measure and manage exposure to those risks”<sup>93</sup> and where their fiduciary duties, and those of other actors in the investment chain, lie.

**BOX 8. DAVID PITT-WATSON, CHAIR OF THE UNEP FI INVESTMENT COMMISSION, ASKS, “WHY HAS LONG-TERM PENSION INVESTMENT NOT RESULTED IN A FINANCIAL SYSTEM WHICH MORE OBVIOUSLY SERVES THE INTERESTS OF SAVERS? HOW BY RE-ENGINEERING INSTITUTIONAL AND EXECUTIVE INCENTIVES DOWN THE INVESTMENT CHAIN WE CAN ENCOURAGE LONG-TERMISM?”**

“The majority of the shares in the world’s largest companies are managed through “institutional investors,” typically representing the long-term savings of millions of people. These include pension funds, insurance companies and sovereign wealth funds, as well as mutual funds/unit trusts and other for-profit intermediaries used by savers. That is they are investing on behalf of hundreds of millions of people across the world economy. And they are invested for the long term; a typical pension fund liability will have an average life of 25 years. As de facto owners of shares, such institutions should encourage the companies they commonly control to promote sustainable long-term profitability. That implies they should also promote sustainability.

But while, in theory, the ownership of companies should help promote sustainability and a long-term view, the practice of financial markets is very different. This is evidenced not only by reports from company managers, by academic studies, and by the increased turnover in securities over the last 20 years. For example, the average share of a company listed on the New York Stock exchange is held for about nine months. While there are specific investment strategies that can benefit from rapid trading, the overall short-termism of the financial markets is not economically rational. A recent Bank of England paper finds that institutional investors continuously misestimate the appropriate discount rate to equalize short- and long-term returns, and a study from the IIRC Institute finds that institutional investors trade more than they anticipate and more than they should for their investment strategies to be successful. This short-termism has real world effects, including:

- Investors act as rapid-fire traders, converting exchanges to casinos rather than rational allocators of capital, even while the churning adds trading costs and decreases performance;

<sup>90</sup> Network for Sustainable Financial Markets (NSFM), “Greater focus being given to understanding the role of fiduciary duty in economic sustainability.”

<sup>91</sup> “Democrats open to derivatives talks,” *Financial Times*, May 17, 2010, p. 4.

<sup>92</sup> Ibid.

<sup>93</sup> Network for Sustainable Financial Markets (NSFM), “Greater focus being given to understanding the role of fiduciary duty in economic sustainability.”



- Corporate managers fail to invest in research or capital expenditures which can help economies and job growth, simply because they refuse to allow a quarterly decline in earnings, even if it could result in an increase in firm value a few years out;
- Pension plan sponsors underfund their pension funds so as to make a particular year's budget look better even while ignoring the building long-term under-funding crisis, all the while hiring and firing external asset managers for short-term underperformance.

So an ownership system which in theory should promote long-term sustainability fails to do so. We need to understand why markets are dysfunctional and set in train reform which will allow them to fulfil their proper purpose of delivering results which are in the best interests of their many long-term universal investors. There are many reasons why the market does not deliver results which are in its ultimate client's interest. They include:

- At each stage in the investment chain, information is "asymmetric." Providers know more, and control the information flow to those whose money they manage;
- Incentive systems and measurements are therefore inadequate, and often short term in nature;
- These characteristics are exacerbated by the assumption that all activities can be delegated to suppliers (despite the substantial evidence that the most effective investment institutions are ones which manage the majority of their funds in house);
- Investment mandates are therefore "decomposed" into different "asset classes," with measurement based on relative returns, not on meeting the ultimate clients needs;
- Many of the activities required of the investment industry are "public goods," for example ensuring the good ownership of companies. The diversification of investment portfolios into thousands of minority positions reduces the incentive for any institution to undertake this activity.<sup>94</sup> The incentive is already low since the fund manager receives a fee which is a very small proportion of any value which they add;
- Regulation is increasingly encouraging long-term investors to hold investments which are liquid, and whose mark-to-market values are stable. These are typically short term, low risk securities.

However, over the last 20 years there have been a number of successful initiatives which have sought to counter some of these short term and irresponsible trends. Some are market solutions, others by voluntary initiatives, and others through regulation. There are a number of investment institutions which have sought to address these issues.

- In the field of ownership and responsibility, pensions funds such as PREVI in Brazil, the pension fund of Banco de Brazil, and the Government Employees Pension Fund of South Africa in South Africa (GEPF SA) have led in creating better governance and accountability from their domestic corporations;
- CalPERS in the USA, Hermes in Europe, Nippon Life in Japan, Cartica in the developing economies have all established funds and services which advocate for improved corporate performance, and indeed will invest in companies where performance is poor and use their power as shareholders to improve it;
- PGGM in Holland has established a fund which aims to counter the trend towards excess diversification by investing a substantial portion of their equities in a fund with a very limited number of deeply researched investments where the intention is to hold them indefinitely; to manage the risk in a limited number of companies rather than seek to avoid it by investing in many;

<sup>94</sup> Davis, Lukomnik and Pitt-Watson, 2006, examples in "The New Capitalists," p. 69.

- Dutch, Danish and Canadian funds, such as APG, APT and Ontario Teachers have resisted pressures to “outsource” and now enjoy lower costs and better performance than many of their counterparts.

There has been a considerable growth in institutions and initiatives which help coordinate, advocate, codify and assess the sustainability of investment institutions. For example:

- The United Nations Environment Programme Finance Initiative (UNEP FI): The UNEP FI was the founding body of the Principles for Responsible Investment (PRI), an aspirational code, which has now been adopted by 1,000-plus investors representing \$35 trillion;
- The International Corporate Governance Network (ICGN) has created a professional body of global expertise, which offers policy and best practice assistance to investors around the world;
- Institutions like the Concil of Institutional Investors (CII) in the USA or Eumideon in Holland coordinate shareholder action;
- Other countries have established best practice code, such as the UK Stewardship Code, to which all fund managers are asked to subscribe.

There have also been significant regulatory changes with over 50 countries passing new laws of corporate governance in the past 10 years.

In summary, there are at least two principal reasons why capital markets do not effectively allocate capital, and they are linked:

- Firstly, market failure: caused by a lack of action by policy makers to make the sustainable development issues actually matter to corporate cash flows, and, therefore, the market. Fundamentally, this is a failure of the governments to create a market price mechanism that ensures that companies have to pay the cost of their externalities. Market failure arises because our current systems of valuing assets and returns on investment do not account for the depletion of assets that underpin our lives - whether natural capital such as clean water, climate regulation or biodiversity, or social capital such as strong and stable communities;
- Secondly, short-termism: arises because the various agents in the finance sector are incentivised to deliver short-term financial returns rather than making investment decisions that take longer-term sustainability into account. Essentially, market short-termism is a failure of the predictive power of investors.

Increasingly, long-term responsible investors understand that the financial implications of unsustainable development on pension portfolios could be catastrophic. Such investors have a duty to intervene and help shape the debate.

As yet however, there has been little, if any formal assessment of whether, how and why these initiatives have been successful. As a result, it is difficult for participants to improve their performance, or for policy makers to decide what changes to promote.

Therefore, there is an urgent need for a comprehensive assessment of how institutional investment is currently adding or detracting from sustainability; to assess what initiatives have worked, how public policy and private practice can best be brought together in different jurisdictions and coordinated globally, and thus how the contribution of the investment industry toward long term sustainability can best be improved.”

### *Relevance to Sustainable Finance and Investing*

Since publication of the Freshfields Report<sup>95</sup> in October 2005, there has been a development of “soft law” across various jurisdictions that highlights a clear and developing trend whereby a consideration of broader risk issues by investors, including environmental, social and governance (ESG) considerations, is not just permissible but in many cases is obligated. In the case of institutional investors and the subprime collapse that led to the financial crisis, many questions surrounding the governance of banks in which they invested, including policies and practices regarding the fundamentals of risk management at the institutional and systemic levels, appear to have gone unasked at worst and raised but not pressed at best. The Foreword to the Freshfields legal interpretation states:

In our business, the investment business, ethical conduct extends beyond not breaking the law to properly interpreting what is in the best interests of the savers who are the ultimate beneficiaries of the institutional pools of money we are engaged to oversee or manage. This is where the interesting questions concerning fiduciary responsibility come to the fore: are the best interests of savers only to be defined as their financial interest?<sup>96</sup>

The 2009 follow-up work to the Freshfields interpretation, “Fiduciary Responsibility,”<sup>97</sup> goes further when it states: “Fiduciaries will increasingly apply pressure to their asset managers to develop robust investment strategies that integrate ESG issues into financial analysis, and to engage with companies in order to encourage more responsible and sustainable business practises.”<sup>98</sup>

As noted previously, the April 2006-launched, UN-backed Principles for Responsible Investment (PRI)<sup>99</sup> (Appendix 1) is now signed by close to 1,000 institutions,<sup>100</sup> representing in excess of US\$30 trillion in assets. The six PRI core principles are supported by a list of 30 or so “possible actions” that signatory organizations can take in order to operationalize their commitment to the Principles. Going forward, adherence to these voluntary Principles would demand a greater engagement with and more demanding requirements for disclosure by investee companies, including financial service organizations. An extract from the first three of the six Principles highlights the point, in that institutional investors commit to the following:

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.  
Possible actions: Develop and disclose an active ownership policy consistent with the Principles; Develop an engagement capability (either directly or through outsourcing); Participate in collaborative engagement initiatives.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.

<sup>95</sup> UNEP FI/Freshfields Bruckhaus Deringer, 2005, “A legal framework.”

<sup>96</sup> V. Zeller and C. Joly, Foreword to the 2005 “Freshfields report,” October.

<sup>97</sup> UNEP FI, 2009, “Fiduciary responsibility.”

<sup>98</sup> Ibid.

<sup>99</sup> For more on the UN Principles for Responsible Investment (UNPRI), see [www.unpri.org](http://www.unpri.org).

<sup>100</sup> Figures presented to the PRI Board meeting in Durban, South Africa, 2011: 246 asset owners, 572 investment managers and 161 investment service providers.

Deepening the aspirational commitments of the Principles, the Fiduciary II report<sup>101</sup> of 2009 explicitly calls for the following:

Global capital market policy-makers should also make it clear that advisors to institutional investors have a duty to proactively raise ESG issues within the advice that they provide, and that a responsible investment option should be the default position. Furthermore, policy-makers should ensure prudential regulatory frameworks that enable greater transparency and disclosure from institutional investors and their agents on the integration of ESG issues into their investment process, as well as from companies on their performance on ESG issues.

## **Listing for Stability: Stock Exchanges and Listing Requirements**

***(This section draws heavily on work underway by Steve Waygood of Aviva Investors)***

High quality, comparable information and supporting verifiable data are the most critical commodities for well governed and smoothly functioning capital markets. Without the flow of accurate, trustworthy information and sound data, capital markets are challenged in their primary functions of allocating fairly priced capital to productive companies that are capable of sustained success and, in turn, rewarding their investors and ultimate owners. In 2012 policy and industry backed initiatives, such as the European Union's support for narrative reporting and the Integrated Reporting work convened by the Prince of Wales Accounting for Sustainability initiative,<sup>102</sup> are gaining backing from a range of capital market participants.

Progressive companies around the world, in an increasing number of important extractive, industrial and commercial sectors, have come to understand that long-term shareholder value is enhanced by both embedding environmental, social and governance (ESG) considerations into their long-term strategies and by fully disclosing their progress to investors. Only when investors have high quality, business relevant information at their fingertips can they truly assess one company relative to its peers and allocate capital accordingly.

More generally, it is clear that one of the underlying causes of the financial crisis was the incentive structure throughout the markets. This focused too many market participants on short-term profits. They looked only so far as the next quarterly earnings, at the expense of paying attention to the longer-term fault lines that were emerging. A compounding problem was that much of the information available to investors—on executive pay, the environmental and social impact of a company, on financial structuring and business practices—was itself short-term and inadequate. It was challenging for investors to assess with any accuracy which companies were suitable candidates for their investment and which would provide them with the best long-term returns. This lack of information eventually negatively affected the entire market.

<sup>101</sup> UNEP FI, 2009, "Fiduciary responsibility."

<sup>102</sup> The Accounting for Sustainability initiative brings organizations together to enable environmental and social performance to be better integrated with strategy and financial performance. See <http://www.accountingforsustainability.org/home>.

An increasing number of institutional investors, in light of the financial crash and as a result of a growing appreciation of the actual and potential value destruction stemming from a failure to account for a broader range of financially material business risks, are “calling for all stock market listing authorities to make it a listing requirement that companies, firstly, consider how responsible and sustainable their business model is, and, secondly, put a forward looking sustainability strategy to the vote at their annual general meetings (AGMs).”<sup>103</sup>

Building on a rapidly evolving body of research<sup>104</sup> exploring financial materiality and a range of systemic risks as well as more narrowly focused ESG risks, the German bank, WestLB, published a study in 2007<sup>105</sup> reviewing the materiality of such factors based on a sample of 540 European firms. The WestLB report found evidence of a link between extra-financial risk, cost of capital to a firm and shareholder value. The report suggested that compiling a sustainability report was among the most important catalysts for change—contributing to accumulation of knowledge, questioning of processes and the establishment of suitable structures and practices.

Also, investment bank Goldman Sachs has carried out analysis of the relationship between how companies address these ESG issues and the returns they generate. It contends that in a number of sectors there is a direct correlation between sustainable business practices and the longer-term financial success of the company. However, in a 2009 report<sup>106</sup> Goldman Sachs explained that the quality, quantity and nature of reporting still holds great scope for improvement of writing:

While the volume of reporting has increased significantly, a material number of companies do not report even relatively undemanding data points. Regionally, disclosure tends to be less complete in emerging markets in particular. Where data is reported, analysis is challenged by differences in reporting standards and guidelines across regions and companies...more widespread disclosure across companies and reporting on a wider range of issues, on a consistent basis, will be key to ensuring investors are able to fully assess the effectiveness with which companies are addressing the breadth of issues facing their industries.

This is further evidenced by the challenges that the business information and news organization Bloomberg is facing with its efforts to populate its terminals with ESG data on the companies that the organization covers. Only around 15 per cent<sup>107</sup> of the almost 20,000 companies that Bloomberg examines publish data of sufficient quality and consistency to be used in that exercise.

<sup>103</sup> “Collaborative engagement proposal for more sustainable stock exchanges,” 2010, a paper prepared for the Sustainable Stock Exchanges event, Xiamen, China, co-hosted by the United Nations Conference on Trade and Development (UNCTAD), the UN Global Compact (UNGC) and the PRI, a collaborative investor initiative in association with UNEP FI and UNGC, September 8.

<sup>104</sup> The UNEP FI Materiality Series (a series of three reports exploring the financial materiality of a range of environmental, social and governance issues to equity pricing), 2004–2009. See <http://www.unepfi.org/publications/investment/index.html>.

<sup>105</sup> H. Garz and C. Volk, 2007, “What really counts: The materiality of extra-financial factors,” WestLB, February.

<sup>106</sup> Goldman Sachs, 2009, “GS sustain: Challenges in ESG disclosure,” GS Sustain Series, October.

<sup>107</sup> According to recent estimates by Bloomberg.

**BOX 9. MERVYN KING, CHAIR OF THE INTERNATIONAL INTEGRATED REPORTING COMMITTEE (IIRC) WRITES:**

“For 100 years there has been financial reporting and still there is no universal consistency in the standards of reporting. There are the Financial Accounting Standards Board standards in the United States and the International Financial Reporting Standards by the International Accounting Standards Board. Discussion on the convergence of these two standards continues.

There are two controversies raised by this initiative. First that the date which is reported is calculated in a way which portrays a true and fair view of the enterprise. Second, that the data is comprehensive, reporting not just the private financial profit and loss of the enterprise, but also its impact on other aspects of sustainability.

It is a well know adage that “you get what you measure.” If we want to create a sustainable financial system, we need to put every effort into measuring our success in doing so. Due to climate change and the reality that companies, individuals and governments have used the natural assets of Planet Earth faster than nature can regenerate them, sustainability reporting has been gathering momentum. Companies have operated on the false assumptions of limitless resources and that the earth has an infinite capacity to absorb waste. This take, make, waste approach to business was never sustainable.

In the context of the appreciation of these false assumptions, sustainability reporting has moved from a tributary to mainstream. Today most companies report on the sustainability issues material to their businesses, as water is to the beverage manufacturer. The confluence of these two mainstreams of reporting has led to the concept of Integrated Reporting. Most modern companies’ Acts provide that the annual financial statement can be placed on the web and sustainability reporting according to the G3 guidelines of the Global Reporting Initiative or any other standard can also be on the web.

The collective mind of the Board, however, should take the material financial and sustainability matters and highlight them in an integrated report which should clearly indicate that the collective mind of the Board has been applied to the issues of sustainability material to the company’s business.

An Integrated Report will be a representation in clear and understandable language of the material financial and non-financial matters relevant to the business of the company and how the sustainability issues have been embedded into the strategic long term planning of the company. The reporting of such information is likely to have a profound impact on company behaviour. And, if it does not, the provision of the information can allow the user, such as investors and regulators to make an informed assessment of long-term sustained value, in a world where natural assets are being depleted faster than nature can regenerate them. If detail is wanted by the user on any financial or non-financial aspect, he or she can drill down on the company’s web into the financial statement or the sustainability report.

A central goal of such integrated reporting will be to allow a user to be able to tell that the company has not profited at the expense of: the environment; human rights; society at large; integrity, a lack of adequate controls to monitor and manage material risks and opportunities; remuneration not being linked to financial, societal and environmental factors relevant to the business of the company; no interactive communication with stakeholders who are strategic to the company’s business. In other words that its business practices are sustainable.

Further, the user will be able to discern that management is acting on the informed basis of knowing the needs, interests and expectations of stakeholders. It will be seen that the Integrated Report is based on two pillars, namely transparency and disclosure. These two pillars are critical to financial stability as has been appreciated by the financial stability board since the financial crises of 2008. In 2010 the International Integrated Reporting Committee (IIRC) was formed which is an umbrella body in which the constituent members include the Who's Who of corporate reporting, such as the International Accounting Standards Board, the Financial Accounting Standards Board of America, the International Auditing and Assurance Standards Board, the Global Reporting Initiative, Accounting for Sustainability, the World Business Council, World Wide Fund, Chartered Institute of Management Accountants, the United Nations Development Programme, the United Nations Environment Programme Finance Initiative, the Association of Chartered Certified Accountants, and the Chairman of the Big Four including the Chairman of Grant Thornton. A framework for Integrated Reporting is being developed by the IIRC for international comment which was launched in late 2011. A pilot Integrated Reporting round is now underway in 2012 with some of the world's leading companies offering to trial the framework. The world does not have 100 years to ensure Integrated Reporting is practised by all companies. Reporting influences behaviour. Integrated Reporting is a clear and understandable statement of the business of the company highlighting the financial and non-financial aspects. Getting this right, and having it adopted globally could be a major step forward in creating sustainability. In the run up, and at Rio+20 there is a unique opportunity to critique and improve the IIRC, to endorse a new reporting framework, and to ensure that the work of the IIRC has the profile and momentum which the issues require.

This information is linked to the other aspects of governance which we seek to improve. It will for example permit a stakeholder, particularly the trustees of pension funds, which have become the great shareholder of today, that they can make an informed assessment of the long term sustainability of the business of a company in the context of the new world order in which the company is operating, namely financial, climate change and ecological crises.

Companies do not operate in a vacuum but in the context of the new world order. The Annual Financial statement is no longer fit for purpose - to inform the user about the sustainability of a business. The well-known one sentence on prospects for the future does not inform stakeholders, such as trustees of pension funds about long-term sustainability. A trustee cannot discharge his duty of care to his ultimate beneficiaries - the pensioners of tomorrow - on corporate reports in their current format. It must satisfy the reality of declining natural assets, increased transparency and the growing expectations of customers, suppliers, society, environmentalists, employees and regulators. Integrated Reporting meets all these needs. In short, Corporate Reporting is not what it used to be."

### *Relevance to Sustainable Finance and Investing*

The incentives structures in the capital markets that promote short-termism mean the markets themselves have become too near-sighted in the way they evaluate companies. One root cause is that fund management organizations are evaluated by their clients—for example, pension funds—based on criteria that are themselves too short-term. This, in turn, motivates fund management institutions to incentivize and evaluate their individual fund managers and analysts based on performance over time frames that are excessively short, leading to too much attention on short-term financial performance. The behavioural problem with this is that when these individuals meet with

company directors, the tenor of their questions and their consequent trading decisions leads company directors who wish to enhance shareholder value to focus too much attention on the quarterly earning figures at the expense of investing in the long-term health of the company.

This maximization of short-term results is a long-term problem for the economy as a whole: if the capital market does not sufficiently factor in long-term capital investment returns, then it undermines long-term investment decision-making by company directors as a whole and leads them to allocate insufficient capital to invest in the long-term health of companies overall. Although a lack of focus on the long-term financial health of a company is a general problem, as many sustainable development issues are inherently long-term, short-termism is also a particular problem for sustainable development—it systematically erodes incentives for company directors to invest in sustainable businesses.

In November 2009, the UN Secretary-General, Ban Ki-moon, addressing an event exploring sustainable stock exchanges in New York,<sup>108</sup> told the event: “Stock exchanges and other financial bodies have a key role to play. Many of you have taken important steps to advance this agenda. I welcome your efforts to incorporate ESG issues into new stock exchange indices, listing rules and regulatory frameworks.”

Subsequently, and in the run up to the United Nations Rio+20 Summit to be convened in Rio de Janeiro, Brazil, in June 2012, a broad global coalition of investor and civil society groups are backing the idea of a protocol to promote more effective corporate sustainability reporting to enhance information and data flowing into markets concerning ESG issues.

## **Banking Risk for the Long Term: Systemic Risk and the Basel Committee**

The Basel Committee on Banking Supervision (BCBS),<sup>109</sup> part of the BIS, sits at the centre of efforts to balance the need for banks to set aside more capital and ensure stronger liquidity to bolster the stability and resilience of the financial system while ensuring sufficient lending to foster economic growth. BCBS’s current work, building on lessons being learned from the financial crisis, also seeks to pre-empt and counteract the worst impacts of future financial system crises.

BCBS concerns itself both with macro prudential regulation, working to ensure the stability of the whole financial system, and micro prudential regulation, which seeks to bolster the stability of individual institutions. Since its 1988 publication of the Basel Accord, known as Basel I, the BCBS has worked to deliver banking standards and these have been updated in the decade since 1999 as part of the Basel II process. This updated Basel II standard was being rolled out by the banking systems in a number of developed economies when the 2007–2008 financial crisis hit. Current efforts underway to overhaul the global financial system, in part, reflect criticisms of the Basel II agreement that was viewed by some observers as encouraging the “pro-cyclical” nature of finance by, essentially, feeding asset bubbles

<sup>108</sup> “Sustainable Stock Exchanges,” an event convened at UN Headquarters, New York, hosted by UNCTAD, UNGC, and PRI, November 2, 2009. See <http://www.unpri.org/sustainablestockexchanges09>.

<sup>109</sup> The BCBS is convened under the auspices of the Bank for International Settlements based in the Swiss City of Basel. The origins of the BCBS date back to the collapse of a German Bank in 1974.



and deepening economic downturns. The stated intention of BCBS is to see implementation of the rapidly promulgated Basel III agreement between January 1, 2013, and January 1, 2019. BCBS's current consultations are to:

1. Strengthen the resilience of the banking sector.
2. Provide an international framework for liquidity risk measurement, standards and monitoring.

The BCBS's consultative document<sup>110</sup> published in December 2009 states directly:

The objective of the Basel Committee's reform package is to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spillover from the financial sector to the real economy...Through its reform package, the Committee also aims to improve risk management and governance as well as strengthen banks' transparency and disclosures.

The Chair of the BCBS acknowledged in May 2010<sup>111</sup> that proposed banking rules as part of international efforts to boost the financial system's and the sector's resilience could cut world economic growth by up to 1 per cent. The Chair suggested also that this was a price worth paying for a more stable and resilient banking system to underpin sustainable, long-term economic growth and development. Some banking industry observers have argued that the new rules, which will go to a BCBS vote in November 2010 for implementation by 2019, will cut global economic growth by as much as 5 per cent, although this has been dismissed by policy-makers.

The executive summary of the BCBS's consultative document echoes the plain language of the April 2010 Communiqué<sup>112</sup> by G-20 Finance Ministers when it describes the importance of the banking sector to promote stable growth:

A strong and resilient banking system is the foundation for sustainable economic growth, as banks are at the centre of the credit intermediation process between savers and investors. Moreover, banks provide critical services to consumers, small and medium-sized enterprises, large corporate firms and governments who rely on them to conduct their daily business, both at a domestic and international level.

As noted, the Chairman of BCBS estimated in May 2010 that the cost of the new banking rules to ensure a stable and resilient financial system could see a reduction of 1 per cent of global Gross Domestic Product (GDP). In October 2006 the UK Treasury's Stern Review<sup>113</sup> suggested that early action on climate change would require an investment of 1 per cent of global GDP per year to head off the risk of a potential reduction of global GDP by some 20 per cent if no action is taken to combat the impacts of climate change. In June 2008 the Stern Review's 1 per cent estimate was increased to 2 per cent<sup>114</sup> as a result of faster-than-expected climate change. The Stern Review states: "Our actions over the coming few decades could create risks of major disruption to economic and social activity."

This prompts the question, how do long-term systemic risks, such as climate change, figure into the BCBS considerations? The short answer is that they don't.

<sup>110</sup> "Strengthening the resilience of the banking sector," 2009, BCBS Consultative Document (for comment by April 16, 2010), Bank for International Settlements, December.

<sup>111</sup> N. Wellink quoted in "Basel regulators weigh cost of shake up," *Financial Times*, May 4, 2010, front page.

<sup>112</sup> G-20 Communiqué: Meeting of Finance Ministers and Central Bank Governors, April 23, 2010.

<sup>113</sup> See Stern Review at UK Treasury Archives, [http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/sternreview\\_index.htm](http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/sternreview_index.htm).

<sup>114</sup> J. Jowit and P. Wintour, 2008, "Cost of tackling global climate change has doubled warns Stern," *The Guardian*, UK, June 26.

When the financial materiality of a given risk falls into a “grey area” whether because public policy is not working to internalize the risk, the issues are long-term in nature and beyond the normal considerations of the financial system, or the risk is not sufficiently hard-wired into current financial and accounting practice, then significant long-term systemic risks have been largely underplayed in the capital requirement calculations. To date, the degree to which ESG risks are factored explicitly into BCBS considerations is limited, due largely to a focus over the past 30 years on classic banking factors in BCBS considerations and partly because of the historical difficulties in establishing the financial materiality of such risks.

Where shifts in public policy set in train processes to strengthen the financial materiality of a range of these risk issues, the case for inclusion in financial policy considerations and supervisory regulations for both the financial system and individual institutions builds. However, there is a significant lag between a clear reflection of such risks in public policy at global, regional and national levels and the hard wiring, notably pricing of risk, into the inner workings of our financial system at the most granular level (such as, for example, the capital adequacy calculations). Notably, this relates to the system’s inability to establish adequately the short- to long-term relevance and financial materiality of the emerging risks, the subsequent limited ability of our accounting and financial analytical frameworks to assess direct quantifiable liabilities that impact asset valuation and, particularly for the banking sector, understanding and quantifying the credit risk and default implications, as well as the negative impact on collateral, of the emerging risks. Also, the speed with which financial institutions are able to transfer risk into the system by removing the liability from their own balance sheets is an important factor in the assessment of how these emerging risks impact banking operations and the degree to which they are financially material for individual institutions.

Recent international developments back the financial materiality argument for inclusion, in time, of a broader range of risks issues within BCBS considerations and perhaps for an explicit recognition of emerging systemic risks. There are continuing difficulties in correlating both long-term systemic risks and certain shorter-term ESG risks with credit default events.

### *New Risks in BCBS Processes*

To highlight the case made above for the explicit inclusion, in time, of a broader range of emerging systemic risk issues in BCBS processes, the paper looks briefly at two areas of emerging banking risk: first, at the changing financial materiality of risks related to climate change, including liabilities associated with greenhouse gas emissions given the emergence of a price for carbon; second, at the financial liabilities associated with the use of chemicals in production processes and products.

### *Risks around Climate Change*

As carbon liabilities are more effectively internalized within our accounting and financial systems, banks will be affected increasingly, both directly through impacts on the value of their own capital and indirectly through changes to the value and risk profiles of the loan portfolios of institutions and the collateral held against those loans. Climate change creates concerns at the macro prudential level in terms of its long-term systemic risks that jeopardize whole regions, economies and industries, as well as at the micro prudential level in terms of risks embedded in the financing and investment undertaken by banks. The policy, legislative and regulatory changes underway in many countries to more fully account for a broader range of ESG risks will also strengthen the fiduciary duty<sup>15</sup> and fiduciary legal<sup>16</sup> arguments that call for a full and proactive effort to integrate financially material risks into all aspects of investment policy-making and investment decision-making. These changes have implications for banks as well as the many other

forms of financial intermediaries that exist along the investment chain, from the large asset owners who have fiduciary responsibility for the assets of the ultimate beneficiaries, such as pensioners, to the broad spectrum of companies, projects and asset classes that make up the investee ecosystem.

Within the context of climate change, key international developments that will set in train processes to internalize climate-related risks into the financial and investment systems include, but are not limited to:

1. **In the United States**, there are several important developments enacted or pending, including the Securities and Exchange Commission's (SEC) Interpretive Guidance on Disclosure Regarding Climate Change; on January 27, 2010, the SEC voted to provide public companies with interpretive guidance on existing SEC disclosure requirements as they apply to business or legal developments relating to the issue of climate change.
2. **In the United Kingdom**: The Climate Change Act 2008 places a legally binding long-term framework to cut carbon emissions and also creates a framework for climate change adaptation policy.
3. **In the European Union**: The "EU 2020" strategy (approved in June 2010) aims to transform the region into a low-carbon, eco-efficient economy.
4. **China**: Circular Economy Law (2009).
5. **Korea**: Basic Law on Low Carbon and Green Growth (2010).
6. **Japan**: The Bill for the Basic Law on Climate Change Counter Measures was agreed upon by the Cabinet in March 2010 and will be presented to the Diet.

Other non-legislative international developments creating demand for financial and investment approaches that more fully reflect carbon risk include frameworks for carbon footprint disclosures such as ISO 14067, introduced in October 2010, with a focus on the carbon footprint of products. Also, the Carbon Disclosure Project (CDP),<sup>117</sup> a voluntary initiative backed by investment institutions representing assets in excess of US\$50 trillion, will expand its work to explore the carbon footprint of companies.

Although climate change, with the slow emergence of a global policy framework and a hard carbon price already embedded in some regional markets, is a clear focus for policy-makers and financial markets, the arguments above apply equally to a broader range of systemic risk issues such as resource scarcity and biodiversity and ecosystems degradation. The paper now takes a brief look at one area where hard financial liabilities for the banking sector have been recognized for some time.

<sup>115</sup> UNEP FI, 2009, "Fiduciary responsibility."

<sup>116</sup> UNEP FI/Freshfields Bruckhaus Deringer, 2005, "A legal framework."

<sup>117</sup> The Carbon Disclosure Project is an independent, not-for-profit organization holding the largest database of primary corporate climate change information in the world. See <https://www.cdproject.net/en-US/Pages/HomePage.aspx>.

### *Financial Risks of Toxic Corporate Footprints*

In April 2010, 1,500 Britons were awarded compensation payout of US\$30 million as a settlement against severe burns from “toxic sofas” manufactured in China. This is believed to be the largest consumer group litigation in British history.<sup>118</sup>

In 2002, in the United States, toxic litigation risks linked to asbestos amounted to US\$70 billion in the form of 730,000 personal industry claims; 66 firms were driven to bankruptcy.<sup>119</sup> By 2005 it was estimated<sup>120</sup> that the total cost of asbestos litigation in the United States was US\$250 billion.

In 2001, The Netherlands banned the sale of Sony PlayStation consoles because the amount of cadmium in accessory cables exceeded regulatory limits. Sony then began to review its specifications and supply chain management processes but incurred losses (in lost sales and costs) of about US\$150 million.<sup>121</sup>

The increasing spate of lawsuits linked to toxic and chemical risks in products and supply chains is having important implications on investment decisions, shareholder value and fiduciary duty. The Fiduciary II<sup>122</sup> report concludes that “there is significant evidence of the positive and negative impacts environmental, social, and governance issues can have on share prices.” This report also opens the discussion on the fact that as ESG risk affects shareholder value, it falls into the category of information that a reasonable investor would consider to be significant and therefore needs to be considered by all fiduciaries.

Under corporate and investment law (in North America and the United Kingdom), fiduciaries are under a clear duty to monitor their investments. For example, the Uniform Prudent Investor Act (United States) states that there is “continuing responsibility for oversight of the suitability of investments already made.”<sup>123</sup> This includes a duty “to examine information likely to bear importantly on the value or the security of an investment.” As further stated in the Restatement of the Act, “the trustee has a related duty of care in keeping informed of rights and opportunities associated with those investments.”<sup>124</sup>

Although many would argue that caveats appear in the application of the law (for there is little additional guidance from the courts and regulators on the scope of the duty to monitor), there are increasing numbers of fiduciary-linked initiatives to assess and evaluate environmental and worker or public health risks posed by chemicals mismanagement that have potential to result in significant costs for negligent companies, including accident clean-up/remediation, compensation payments and loss of brand value. The most notable is perhaps the Investor Environmental Health Network (IEHN), which in 2007 was involved in 11 shareholder resolutions on toxic chemicals and environmental health in the United States.<sup>125</sup> The IEHN works through engagement and shareholder resolutions to encourage companies to adopt policies to reduce and eliminate the toxic chemicals in their products, processes and supply chains. As of early 2008, IEHN members managed more than \$41 billion in assets.<sup>126</sup>

<sup>118</sup> “Victims of toxic Chinese sofas to receive \$30 million payout,” 2010, *The Epoch Times*, April. See <http://www.theepochtimes.com>.

<sup>119</sup> “Asbestos costs US companies \$70 billion so far,” 2004, Reuters, February.

<sup>120</sup> “Tort reform in America,” *The Economist*, January 26, 2005.

<sup>121</sup> R. A. Liroff, 2005, “Benchmarking corporate management of safer chemicals in consumer products—A tool for investors and senior executives,” Investor Environmental Health Network and the Rose Foundation.

<sup>122</sup> UNEP FI, 2009, “Fiduciary responsibility.”

<sup>123</sup> Uniform Prudent Investor Act (USA), 1992, Section 2.

<sup>124</sup> Uniform Prudent Investor Act (USA), 1992, The Third Restatement of Trusts.

<sup>125</sup> See <http://www.iehn.org/home.php>.

<sup>126</sup> *Ibid.*

One of the multiplier effects of this wave of shareholder activism has been that proxy advisors such as Institutional Shareholder Services (ISS) have begun to revisit their policies on the prudence of considering environmental risk factors. ISS now recommends a FOR vote on shareholder resolutions requesting disclosure of policies related to toxic chemicals, a notable step given that until 2006, the institution did not have a policy on toxics.<sup>127</sup>

### *Relevance to Sustainable Finance and Investing*

The assessment and deeper understanding of a full range of economic, environmental, social and governance risks, whether systemic or local, is central to the philosophy of sustainable development. Both the Precautionary Principle<sup>128</sup> and the softer Precautionary Approach<sup>129</sup> have been central to those intergovernmental policy-making discussions since the mid-1980s that have sought to foster the ideas behind sustainable development and promote global and national policy frameworks that will facilitate such development paths. The intergovernmental community took science and high policy as their start point as they sought to frame how mankind should deal with the “tragedy of the commons”<sup>130</sup> or, as an economist would put it, how environmental and social externalities should be integrated into political, economic and social systems that traditionally had not sought to price or account for them.

With risk as a central theme, however, these policy-focused intergovernmental concepts and the discussions driving them have been far removed from the risk-focused deliberations around the BCBS. Since 1988, BCBS has convened narrow discussions with a definitional, legal and technical focus that hold profound implications for how banking is carried out throughout the world. In many respects, the evolution of sustainable finance and responsible investment disciplines has been an unspoken effort to bridge the risk considerations of the intergovernmental policy world with that of the banking and other financial and capital market supervisory communities.

The banking supervisory community might argue that there is ample scope to consider sustainability risk issues within the existing BCBS parameters and that such risk is actually already factored into the Committee’s well structured deliberations. Equally, the sustainability community might contend that rapid acceleration in public policy, legislative and regulatory efforts to quantify sustainability risk and see them embedded in the markets normal assessment, pricing and accounting standards means that they deserve a specific focus within both the structural (macro prudential) and operational (micro prudential) considerations of BCBS.

<sup>127</sup> “Fiduciary guide to toxic chemical risks,” 2007, Investor Environmental Health Network and the Rose Foundation for Communities and the Environment, March.

<sup>128</sup> The precautionary principle states that if an action or policy has a suspected risk of causing harm to the public or to the environment, in the absence of scientific consensus that the action or policy is harmful, the burden of proof that it is not harmful falls on those taking the action.

<sup>129</sup> “In order to protect the environment, the precautionary approach shall be widely applied by States according to their capabilities. Where there are threats of serious or irreversible damage, lack of full scientific certainty shall not be used as a reason for postponing cost-effective measures to prevent environmental degradation,” Principle 15 of the Rio Declaration, 1992 United Nations Conference on Environment and Development (UNCED), Rio de Janeiro, Brazil.

<sup>130</sup> G. Hardin, 1968, “The tragedy of the commons,” *Science*, 162 (3859): 1243–1248, December 13.

## Rating Right: The Role of Rating Agencies with the Financial System

In the aftermath of the financial crisis, the products and services provided by the three largest international Credit Rating Agencies (CRAs),<sup>131</sup> which together control the vast majority of the market, serving the rating needs of the financial services and investment sector, have come under an intense spotlight in terms of their transparency, independence and potential conflict of interests. Some of the most pointed political criticism to date came in early May 2010 when the President of the European Union, Jose Manuel Barroso, highlighted what he termed the “deficient work”<sup>132</sup> of the agencies. Lawmakers in the European Union and United States have signalled a much tighter regulatory environment for CRAs and notably for those rating activities related to sovereign debt. Also, EU regulators have cited their concerns relating to the overwhelming market dominance by the three largest CRAs, Standard and Poor’s, Moody’s, and Fitch.

Post the financial crisis, the G-20, the International Organization of Securities Commissions (IOSCO),<sup>133</sup> the US SEC and the European Union have all strengthened codes, standards and regulation to bring greater oversight to the CRAs and it appears that with ongoing market volatility, specifically linked to sovereign debt ratings, they are preparing to promulgate and enforce still stronger regulations. In their June 5, 2010 Communiqué, the G-20 Finance Ministers reiterated that they were “committed to accelerate the implementation of strong measures to improve transparency, regulation and supervision of hedge funds, credit rating agencies, compensation packages and OTC derivatives in an internationally consistent and non-discriminatory way.”<sup>134</sup>

Also, in June 2010 it was confirmed that the European Securities and Markets Authority (ESMA) will “take control of the registration and supervision of credit rating agencies”<sup>135</sup> to provide a centralized system.

As an indication of the speed of regulatory changes in the CRA field, the move to centralized control by ESMA itself supersedes an earlier plan for the Committee of European Securities Regulators (CESR) to “coordinate a supervisory model based on cooperating national authorities.”<sup>136</sup> While introducing the changes, the European Commission recognized that the regulations “did not deal with important issues, such as whether European and national legislation relies too heavily on credit ratings, and how to create more competition in the market.”<sup>137</sup>

<sup>131</sup> Moody’s Investor Services and Standard & Poor each control 40 per cent of the world credit rating market, while the third of the world’s three largest raters, Fitch Ratings Ltd., has a significantly smaller but growing share. Source: Wikipedia.

<sup>132</sup> Reuters, Brussels, May 5, 2010.

<sup>133</sup> IOSCO brings international security regulators together to ensure higher standards of securities and market regulation and to maintain the integrity of markets. See <http://www.iosco.org/about>.

<sup>134</sup> G-20 Communiqué: Meeting of Finance Ministers and Central Bank Governors, Busan, Republic of Korea, June 5, 2010.

<sup>135</sup> “European Securities and Markets Authority (ESMA) will take control of the registration and supervision of credit rating agencies,” Investment & Pensions Europe (IPE), online edition, June 3, 2010.

<sup>136</sup> Ibid.

<sup>137</sup> Ibid.

The role of CRAs during the rapid growth and investor uptake of structured financial products, instruments brought to market by a limited number of investment banks that were at the centre of the subprime collapse, has come under particular scrutiny, as has the “issuer pays” model underpinning the highly profitable CRA business. Essentially, the CRA model evolved in a manner that reduced “the burden on investors to research the creditworthiness of a security or issuer.”<sup>138</sup> Some argue also that elements of the regulatory function in some jurisdictions, in effect, were outsourced to the CRAs.<sup>139</sup>

The oligopolistic concentration of three dominant CRAs, 15 major investment banks and four large global accounting and auditing firms “reduced diversity and encouraged herd behaviour,”<sup>140</sup> according to Professor Michael Mainelli, one of the thought leaders behind the concept of Long Finance.<sup>141</sup> This oligopolistic core “failed in an environment of increasing money supply and global saving imbalances.”<sup>142</sup>

In essence, the CRAs were instrumental in a process that saw a superacceleration of structured products, often poorly understood by mainstream institutional investors, into the marketplace in a manner that outstripped the ability of regulators and supervisory bodies, internationally and nationally, to keep pace with and understand fully the systemic implications of these market innovations.

Historically, the role of CRAs, providing opinions on the creditworthiness of issuers of securities and other financial obligations, has played a critical role in “the investment decisions of both investors and the availability of capital to companies.”<sup>143</sup> For a long time, the large CRAs retained a peculiar status with regulators in the United States, that of financial information providers similar to the status of journalists, that protected them from the type of private litigation often seen in other parts of the financial regulatory standards, such as capital adequacy requirements for financial institutions and determining disclosure requirements “predicated on credit ratings.”<sup>144</sup>

The financial crisis prompted a range of regulatory reforms targeting CRAs and, with the recent legal action by the US SEC<sup>145</sup> against Goldman Sachs and one of the company’s executives, attention has again turned to the role of the raters in the growth of the structured finance markets.

<sup>138</sup> “Credit rating agencies no easy regulatory solutions,” 2009, crisis response note number 8, The World Bank Group, October.

<sup>139</sup> Ibid.

<sup>140</sup> M. Mainelli, 2009, “Long finance: When would we know our financial system is working?,” presentation to The Insurance Institute of Ireland, 3rd Annual Industry Leaders Summit, Dublin, October 8.

<sup>141</sup> M. Mainelli and B. Giffords, 2009, “The road to long finance: A systems view of the credit crunch,” Centre for the Study of Financial Innovations, July.

<sup>142</sup> Ibid.

<sup>143</sup> “Risk on trial: The changing face of non quantitative risk,” 2003, summary report, UNEP FI Roundtable, Paris, January 8.

<sup>144</sup> “Credit rating agencies no easy regulatory solutions,” 2009, The World Bank Group.

<sup>145</sup> US Securities and Exchange Commission home page, <http://www.sec.gov/news/press/2010>.

### *Relevance to Sustainable Finance and Investing*

Issues related to transparency, the impact of CRA products and services on market and corporate governance, and conflicts of interest related to the “issuer pays” forge a direct link between CRA activities that run counter to the sustainable finance and investing approach. The seeming inability of mainstream rating models to factor in a full range of financially material considerations, or at least adjust to a changing policy environment that, in time, will demand the integration of a broader range of ESG risks, is a problem with systemic implications when there is such market dominance by just three institutions.

The regulatory response toward CRAs has been swift, and notably so, given the association of their sovereign ratings to heightened volatility in several European markets. In June 2010 the European Union Internal Market and Services Commissioner, Michel Barnier, clearly indicated a future regulatory focus on CRAs when he said, “The changes to rules on credit rating agencies will mean better supervision and increased transparency in this crucial sector. But they are only a first step. We are looking at this market in more detail.”<sup>146</sup>

But concerns about the role of CRAs are not new. From the dot-com collapse of 2000, through the corporate governance scandals of 2001–2002 and now on to the financial crisis of 2007–2008, the question has been asked repeatedly, “How are rating agencies evaluating the non-financial side of risk, and given the rapidly changing nature of material business risk, how should non-financial risk be assessed in the future by rating agencies?”<sup>147</sup>

In answering this question there has been a clear split between the large, dominant CRAs and smaller specialist rating agencies that, as part of their model, seek to integrate a full range of ESG issues. For mainstream raters, the material threat of non-financial risks largely depends on the nature, timing and sectoral impact of the risks because “if risks are long-term, they generally do not tend to be factored into mainstream ratings that assess default risk over a limited period and short-term performance.”<sup>148</sup>

When questioned on the potential conflicts of interest inherent in the “issuer pays” business model of the CRAs, the raters have traditionally contended that the importance of their brand independence and the accuracy of their ratings act as an efficient internal regulator. Questions raised around CRA performance in the run up to and during the financial crisis have placed this argument under pressure.

Historically, mainstream CRAs have insisted that integration of “non-traditional” risks into their ratings depends upon:

- When the business case is satisfied and can be quantified as material to the company’s default risk or market performance
- Whether those ESG risks have immediate financial implications that are material to gauging default risk and equity performance
- The precise financial materiality of reputation risk, as this type of risk is often short-lived and holds limited relevance in the long term with respect to a company’s ability to meet its obligations

<sup>146</sup> “European Securities and Markets Authority (ESMA) will take control,” 2010, IPE.

<sup>147</sup> “Risk on trial: The changing face of non quantitative risk,” 2003, UNEP FI Roundtable, Paris, January.

<sup>148</sup> Ibid.



Given criticism of the whole CRA model since the financial crisis, a January 2003 report, written at a time shortly after markets turned down following the dot.com collapse and corporate governance scandals, was prophetic when it stated:

The bottom line is that financial systems have changed over the longest bull market of the 20th century and it is only given the current downturn that the rating agencies have been responding to these changes. Anticipation of developments regarding non-financial risk in the current bear market may be critical in defending the reputation of individual rating agencies and accurately assessing company liabilities.<sup>149</sup>

## Insuring the Future: Stability and Solvency II

### Introduction

The solvency margin is the amount of regulatory capital an insurance undertaking is obliged to hold against unforeseen events.<sup>150</sup> A solvency regime seeks to ensure that insurers maintain financial soundness at all times, thereby protecting policyholders and the stability of the financial system.

The EU Solvency II project aims to establish a modern regulatory system for the European insurance industry through a revised set of harmonized EU-wide capital requirements and risk management standards. It is designed to underpin the stability of the financial system through the proper economic evaluation of risks on both sides of an insurer's balance sheet. Its key objectives are better regulation, deeper integration of the EU insurance market, enhanced policyholder protection, and improved competitiveness of EU insurers.

### From Solvency I to Solvency II

The EU insurer solvency regime has been in place since the 1970s. In the 1990s, the European Commission conducted a review of the EU solvency regime, and adopted in 2002 a limited reform known as Solvency I. Essentially, the calculation of capital requirements under the Solvency I framework is based on volume, either premiums or claims. However, it became clear during the Solvency I process that a more fundamental and wide-ranging reform was necessary, which led to the Solvency II project. Solvency II is similar to the Basel II capital adequacy requirements for banks.

### What is New about Solvency II?<sup>151</sup>

Solvency II will introduce economic risk-based solvency requirements across all EU member states for the first time. These new solvency requirements will be more risk-sensitive and more sophisticated than in the past, thus enabling a better coverage of the real risks run by any particular insurer. The new requirements move away from a crude one-model-fits-all way of estimating capital requirements to more entity-specific requirements.

Solvency requirements will also be more comprehensive than in the past. Whereas at the moment the EU solvency requirements concentrate mainly on the liabilities side (i.e., insurance risks), Solvency II takes account of the asset-side risks. The new regime will be a "total balance sheet"-type regime where all the risks and their interactions are considered. In particular, insurers will now be required to hold capital against market risk (i.e., fall in the value of insurers' investments), credit risk (e.g., when third parties cannot repay their debts) and operational risk (e.g., risk of systems breaking down or malpractice). These are all risks that are currently not covered by the EU regime. However, experience has shown that all these risk types can pose a material threat to insurers' solvency.

<sup>149</sup> Ibid

<sup>150</sup> "Solvency II FAQs," European Commission.

<sup>151</sup> Ibid.

Although one of the big steps forward under the new regime will be the introduction of more risk-sensitive solvency requirements and adopting the “total balance sheet” approach to measuring solvency, the new regime also emphasizes that capital is not the only (or the best) way to mitigate against failures. Under Solvency II, new rules will for the first time compel insurers specifically to focus on and devote significant resources to the identification, measurement and proactive management of risks.

Together with a greater focus on risks and their management, the new solvency system will also adopt a more prospective focus. Whereas at the moment solvency requirements are based on largely historical data, the new rules will require insurers also to think about any future developments, such as new business plans or the possibility of catastrophic events that might affect their financial standing. A new development in this area will be the introduction of the Own Risk and Solvency Assessment (ORSA).

Another new requirement is the Supervisory Review Process (SRP). The purpose of the SRP is to enable supervisors to better and earlier identify insurers who might be heading for difficulties. Under the SRP, supervisors evaluate insurers’ compliance with the laws, regulations and administrative provisions adopted pursuant to this directive and its implementing measures.

The new rules require insurers to disclose certain information publicly to a far greater extent than currently is the case. This will bring in “market discipline,” which will help to ensure the soundness and stability of insurers, as market players will be able to exercise greater supervision over and offer greater competition to other insurers. Insurers applying “best practice” are more likely to be rewarded by lower financing costs, for example.

Finally, the new framework will strengthen the role of the group supervisor who will have specific responsibilities to be exercised in close cooperation with the solo supervisors. This will mean that the same economic risk-based approach will be applied to insurance groups, which can now be better managed as a single economic entity. Furthermore, the new solvency provisions will foster and force greater cooperation between insurance supervisors and will further supervisory convergence.

### ***Solvency II Architecture***

Solvency II marks the transition from the current rule-based regulatory approach to one that is principle-based. It adopts three pillars of mutually reinforcing regulation.

The first pillar comprises quantitative requirements that ensure adequate financial resources through harmonized standards for the valuation of assets and liabilities and risk modelling of capital requirements. The second pillar comprises qualitative requirements that ensure insurers have effective governance and risk management systems in place, as well as the effective supervision of insurers. The third pillar comprises public disclosure and regulatory reporting of risks that would foster transparency, competition and market discipline.

## *Solvency II, the Financial Crisis and Systemic Risks*

Solvency II requires insurers to adopt proactive and forward-looking risk management based on a total balance sheet and market-consistent approach, which should lead to enhanced risk-adequate pricing. This overall view will enable capital requirements to be calculated with much greater precision. The importance of this was illustrated by the financial crisis, which was at least in part a consequence of reckless handling and inadequate evaluation of risks. The financial crisis has demonstrated that risks cannot be artificially calculated away. Strict risk- and principle-based rules are therefore needed more than ever.<sup>152</sup>

Furthermore, Solvency II's reporting and disclosure requirements with respect to an insurer's risk profile and governance and risk management systems will promote greater transparency, competition and market discipline as regulators, policyholders, investors and other market participants would have more information available. Accordingly, Solvency II is expected to reduce the dependence of market participants on the information provided by rating agencies, whose role in the financial crisis had attracted much criticism.

Finally, the financial crisis revealed that markets have truly become global and that there is a real need to better understand and manage systemic and long-term risks. In this vein, Solvency II represents a major step in the right direction. It captures both quantitative and qualitative aspects of holistic risk management, promotes a better risk culture and risk communication between market participants, and provides incentives for insurers to run their business more prudently.

### *Going Forward*

Solvency II aligns capital requirements more closely with an insurer's complete risk profile. Equally important is that it is designed to improve governance and risk management, and enhance reporting and disclosure. Indeed, as the Chairman of the European Commission's Committee of European Insurance and Occupational Pensions Supervisors has said, "Solvency II is not just about capital. It is a change of behaviour."

Overall, Solvency II is expected to result in more efficient allocation of capital, greater financial stability, enhanced policyholder protection, and increased competition in the market. It will be implemented by the end of October 2012 and is bound to influence the development of insurance regulations in other jurisdictions. Moreover, its principles could potentially pave the way for a global model that would set the same solvency framework and risk management standards for all participants in a global market.

Nevertheless, it is important to bear in mind that the many safeguards built into Solvency II do not translate to a "zero-failure" regime. In other words, Solvency II is not an ironclad guarantee that no insurer will ever fail.

### *The Principles for Sustainable Insurance Initiative*

The UNEP Finance Initiative is undertaking a multi-year initiative, which will culminate in 2012, to develop Principles for Sustainable Insurance (PSI), including concrete actions to implement each Principle. The PSI will act as the global best practice framework to facilitate the systematic identification, analysis, management and monitoring of ESG risks and opportunities in core insurance company strategies and operations, including underwriting, product

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<sup>152</sup> "Solvency II: The key to the future of the insurance industry," 2009, Munich Re Topics.

development, claims management, sales and marketing, and investment management. Equally, the initiative aims to establish a United Nations-backed global initiative of insurers proactively addressing ESG risks and opportunities based on their commitments to implementing the Principles.

### *The Insurance Industry and Systemic ESG Risks*

The insurance industry has long been in the vanguard of understanding and managing risk and has served as an important early warning system for society by amplifying risk signals. Through loss prevention and mitigation, by sharing risks over many shoulders, and as major investors, the insurance industry has protected society, catalyzed financing and investment, shaped markets and underpinned economic development.

The global risk landscape is rapidly changing and global ESG factors<sup>153</sup> require new risk management and financing approaches. Given their multiple roles as risk managers, risk carriers and institutional investors, insurance companies have immense capacity to understand and manage ESG factors.

UNEP Finance Initiative research<sup>154</sup> articulates that:

- The insurance industry is complex and requires a differentiated view on ESG factors (e.g., according to lines of insurance, insurance company operations).
- ESG factors influence risk underwriting, can have varying degrees of impact across lines of insurance, and can be material to both the insurance and investment sides of insurance company operations.
- Insurance practitioners increasingly find ESG factors material to their underwriting and product development, as well as to other core operations such as claims management, sales and marketing, and investment management. Therefore, ESG factors can enhance insurance company earnings, business performance and long-term company value.
- Insurance practitioners judge ESG factors to have significant loss potential in terms of their risk frequency, severity and uncontrollability. Equally, they judge that the societal response to managing the global, long-term and systemic risks posed by ESG factors is lagging and that prudential regulatory or legal frameworks are underdeveloped.
- The long-term economic health, resilience and stability of the insurance industry will increasingly be shaped by its ability to accurately assess and proactively address the impact of ESG factors on the insurance business. Accordingly, the global, long-term and systemic risks posed by many ESG factors can undermine the solvency of an insurance company and the long-term economic health, resilience and stability of the insurance industry, including insureds and entities financed by insurance capital.
- Effective ESG risk management and financing entail the systematic integration of ESG factors into core insurance company strategies and operations (e.g., underwriting, product development, investment management, claims management, sales and marketing).

<sup>153</sup> Examples of global ESG factors include climate change, biodiversity loss and ecosystem degradation, water scarcity, pollution, financial inclusion, human rights, emerging manmade health risks, aging populations, regulations, disclosure, ethics and principles, and alignment of interests.

<sup>154</sup> See "Insuring for sustainability: Why and how the leaders are doing it," 2007, UNEP FI Insurance Working Group; and "The global state of sustainable insurance: Understanding and integrating environmental, social and governance factors in insurance," 2009, UNEP FI Insurance Working Group.

- Through the systematic integration of ESG factors into core insurance company strategies and operations, the insurance industry—along with the individuals and entities that it protects, and the entities in which it invests—will be able to sustain its economic activities and play its role in the transformational process to a sustainable and inclusive global economy.
- Policy-makers and regulators should ensure prudential regulatory or legal frameworks on ESG factors, where appropriate. For example, potential frameworks that could enable greater transparency and disclosure from companies across sectors (including insurance) on their holistic ESG performance can help insurance companies assess their indirect ESG performance embedded in their insurance, reinsurance and investment portfolios and their supply chains. Such frameworks should be explored in close consultation with the insurance industry, and must carefully consider all aspects of insurance operations given the unique and multiple roles of insurance companies as risk managers, risk carriers and institutional investors, as well as the complex systems in which insurance companies operate. Accordingly, these frameworks should be prudent, effective and efficient, and should enable, not stifle, innovation. Over the years, ESG-related mandatory disclosure requirements have stemmed from different jurisdictions. At the same time, investors are increasingly calling for mandatory ESG-wide disclosure frameworks.

### *Systemic Risks, Systemic Challenges*

In a highly competitive, highly fragmented and highly regulated insurance industry, tackling ESG factors to drive collective action and long-term solutions entails overcoming major challenges:

- Absence of insurance industry frameworks and methods enabling the systematic identification, analysis, management and monitoring of ESG factors in core insurance company strategies and operations.
- Absence of agreed insurance industry norms, standards, benchmarks and reporting on ESG factors.
- Absence of insurance industry platforms for common learning and to pool information and resources in addressing ESG factors.
- Absence of substantial and reliable data and track records for ESG risks, which are often global, long-term and systemic in nature, hinders forward-looking risk assessments and the development of insurance products and services with positive ESG outcomes.

### *The Principles for Sustainable Insurance: Why They Make Sense*

It is clear that the insurance industry—whose core business is to manage risk—must lead in understanding a rapidly changing risk landscape and address global ESG risks with rigour and innovation. By doing so, the insurance industry can help identify future challenges within the financial system, mitigate systemic risks and avert crises, such as the potentially highly complex and profound “natural resources crisis” arising from the unsustainable use of a wide range of natural resources such as the climate, biodiversity ecosystems, and water. The scale of these risks is too big for any one institution to tackle and requires collective action and long-term solutions.

Decades of sustained profitability and capital growth have led to the evolution of large, influential and omnipresent insurers and reinsurers that have penetrated insurance markets worldwide and implanted themselves in the financial system and the broad economy. For these “universal risk carriers,” the negative externalities associated with many ESG factors (e.g., activities of insured companies and individuals that emit greenhouse gases and induce climate change; deforestation and destruction of habitats resulting in loss of ecosystem services; health issues and pandemics) have the potential to adversely affect both their underwriting profitability and investment returns in many territories and to

threaten their long-term company value. Since many global ESG factors are inherently longer-term and pose systemic risks, then it could be in the best interests of universal risk carriers to quantify the costs of negative externalities linked to the ESG performance of their insureds. It can therefore be argued that these universal risk carriers must adopt a very long-term strategic perspective since sustainable value creation is largely dependent on the long-term health of markets and economies, and that it would be prudent for them to ensure proactive action on systemic ESG risks. This long-term strategic perspective for universal risk carriers is rooted to the “Universal Owner Theory” developed for large and highly diversified institutional investors who own a wide range of asset classes across sectors and markets. These investors effectively own a slice of the broad economy; hence the term, “universal owner.” The theory has underpinned collaborative action by investors on ESG factors, including many of the world’s largest institutional investors that are signatories to the Principles for Responsible Investment. The concept of universal risk carriers could be a powerful incentive for long-term thinking and collective action on ESG factors within the insurance industry (and conceivably in conjunction with the investment industry) in order to tackle long-term and systemic ESG risks.

The recent global financial and economic crisis reinforced the necessity for the financial sector, including the insurance industry, to reassess fundamental thinking and practices and to more prudently and responsibly manage long-term and systemic risks, including those related to ESG factors.

To effectively promote and adopt ESG risk management and financing at the industry and global levels—and to accelerate collective action on ESG factors—UNEP Finance Initiative research<sup>155</sup> has shown that the insurance industry should develop and adopt a set of Principles for Sustainable Insurance focused on ESG factors, tailored to the insurance business, grounded on risks and opportunities, and in line with the goals of sustainable development.

The dynamic characteristics of ESG risks need an equally dynamic framework for the insurance industry to systematically identify, analyze, manage and monitor the evolution and impact of current and emerging ESG risks and to bridge the gap where regulatory or legal frameworks are underdeveloped by guiding an industry-led response to many global ESG risks. The Principles for Sustainable Insurance can respond to this need in a proactive way, acting as the global sustainability framework that can guide the industry toward best practice, pool information and resources, inform regulators and policy-makers, create a global sustainability forum for the industry and its many stakeholders, foster inclusiveness across markets, drive innovative solutions, and accelerate collective action.

The Principles for Sustainable Insurance can be designed in such a way that they are complementary to and aligned with the existing United Nations-backed Principles for Responsible Investment, and can complete a truly holistic global sustainability framework for the insurance industry. Investor signatories (e.g., insurance companies, pension funds, sovereign wealth funds, mutual funds, investment managers) to the Principles for Responsible Investment seek better long-term investment returns and sustainable markets through better analysis of ESG factors in their investment process and their exercise of responsible ownership practices. For insurance companies, by enhancing value creation through the systematic integration of ESG factors into their insurance and investment activities, they can potentially enhance long-term, sustainable company value from the perspective of investors as well.

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<sup>155</sup> See “The global state of sustainable insurance – Understanding and integrating environmental, social and governance factors in insurance,” 2009, UNEP FI Insurance Working Group.

Overall, the Principles for Sustainable Insurance will:

1. Provide the global best practice framework to facilitate the systematic identification, analysis, management and monitoring of ESG risks and opportunities in core insurance company strategies and operations.
2. Contribute to more prudent, responsible and sustainable insurance thinking and practices that can reduce risks, create new opportunities and markets, and enhance financial returns, business performance and long-term company value.
3. Harness the insurance industry's unique and immense capacity to tackle ESG factors as risk managers, risk carriers and institutional investors.
4. Contribute to more stable, resilient, responsible and sustainable insurance and financial markets through holistic and systemic risk management approaches and increased transparency.
5. Accelerate the transformational process to a resource efficient, low-carbon, inclusive and sustainable global economy.
6. Help fulfill a wide range of United Nations aims, including the Millennium Development Goals.

### *The Principles for Sustainable Insurance and Solvency II: Voluntary Complementing Mandatory*

The initiative to develop Principles for Sustainable Insurance (PSI) is aligned with the underlying principles of Solvency II, which entail holistic risk management, total balance sheet and forward- looking approaches.

The PSI Initiative will encompass not only the insurance (liability) side of insurance company operations, but also the investment management (asset) side. On investment management, the PSI will integrate the framework afforded by the Principles for Responsible Investment (PRI). Taken together, the PSI and PRI will create a holistic global sustainability framework for the insurance industry, addressing ESG risks and opportunities stemming from both the asset and liability sides of an insurer's balance sheet. Indeed, the PRI is increasingly being adopted within the insurance investment management industry. As of May 2010, the PRI signatory base of more than 740 institutions included 49 "insurance-affiliated entities" (i.e., entities that are part of an insurance- focused group, or part of a financial services group providing insurance products and services), representing nearly US\$4 trillion in assets under management.

The PSI Initiative also aims to develop an annual reporting and assessment mechanism that will monitor and evaluate the progress of signatories (risk carriers, intermediaries and service providers) in implementing the Principles. Equally, this will act as an accountability, integrity and transparency mechanism for the Initiative, as a learning tool to identify best practices and areas of improvement, and as the global standard for ESG reporting by insurance companies. Again, this is consistent with the risk reporting, disclosure and transparency requirements of Solvency II.

Clearly, the PSI Initiative can become a highly effective complement to Solvency II in bolstering the long-term economic health, resiliency, stability and sustainability of the insurance industry and the financial system. The PSI-Solvency II link could be a model for how voluntary sustainable finance initiatives and prudential regulatory frameworks on financial stability can be mutually reinforcing.

## Part 4 Rewiring the System

Some 1,200 financial, investment and insurance institutions<sup>156</sup> now support United Nations-backed principles and statements that advocate firm steps toward a sustainable financial system and a responsible approach to investment. The various documents supporting these principles and statements of commitment were drafted and agreed by financial and investment institutions in several UN-facilitated initiatives from the early 1990s onwards. Furthermore, legal interpretation<sup>157</sup> and technical analysis<sup>158</sup> generated by the initiatives have deepened the business case for a sustainable approach to finance and investment.

These commitments were developed by financial and investment institutions in collective efforts to better align the broad policies and practices of the banking, insurance and investment institutions with a range of societal, environmental and governance goals. In 1992 banks recognized “sustainable development depends upon a positive interaction between economic and social development, and environmental protection, to balance the interests of this and future generations”<sup>159</sup> (see Appendix 2). In 1995 the insurance industry stated “that economic development needs to be compatible with human welfare and a healthy environment. To ignore this is to risk increasing social, environmental and financial costs”<sup>160</sup> (see Appendix 3).

In 2002, ahead of the World Summit for Sustainable Development (WSSD) in South Africa, the financial services community recognized that there was a need to “raise awareness of key players in the financial markets, including analysts and financial rating agencies, toward financial risks related to non-sustainable behaviour in order to encourage them to integrate sustainability criteria in their evaluation process”<sup>161</sup> (see Appendix 4).

<sup>156</sup> In March 2012, more than 200 banks, insurers and investment organizations were signatories to the UNEP FI ([www.unepfi.org](http://www.unepfi.org)), and a further 1,000 investment organizations, including service organizations, support the UN-backed Principles for Responsible Investment ([www.unpri.org](http://www.unpri.org)). Also, 380 financial organizations are signatories to the United Nations Global Compact. There is some overlap with respect to organizations adhering to more than one of the initiatives named.

<sup>157</sup> For example, “The Freshfields report,” UNEP FI/ Freshfields Bruckhaus Deringer, October 2005, and “Fiduciary II,” UNEP FI, July 2009.

<sup>158</sup> The UNEP FI Materiality Series (a series of three reports exploring the financial materiality of a range of environmental, social and governance issues to equity pricing), 2004–2009. See <http://www.unepfi.org/publications/investment/index.html>.

<sup>159</sup> The UNEP Statement by Financial Institutions on the Environment and Sustainable Development was signed initially by 28 banks that gathered for a UN-convened meeting in New York on May 28, 1992.

<sup>160</sup> The UNEP FI Statement of Environmental Commitment by the Insurance Industry was first signed by a group of insurance and reinsurance companies at a meeting in Germany in 1995.

<sup>161</sup> Recommendations from the UNEP FI presented to the World Summit for Sustainable Development (WSSD), Johannesburg, South Africa. See [www.unep.org/wssd/Documents/UNEP%20FI%20WSSD\\_Recommendations\\_Final\\_2%20Sept.doc](http://www.unep.org/wssd/Documents/UNEP%20FI%20WSSD_Recommendations_Final_2%20Sept.doc).



By April 2006 the institutional investment community was more explicit when it stated:

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society.<sup>162</sup>

The sentiment of these three statements—in essence, recognizing the need for finance and investment to take a broader economic, social and environmental view—has been echoed post-crisis by senior financial policy-makers. The Chairman of the UK’s Financial Services Authority (FSA) called for the sector “to reflect deeply on their role in the economy, and to recommit to a focus on their essential social and economic functions, if they are to regain public trust.”<sup>163</sup> The former President of the European Central Bank urged “finance to come back to basics” where profitable business is justified because it mirrors the “social value of the intermediation function.”<sup>164</sup>

The language of sustainable finance and responsible investment, where accountability, transparency, disclosure, long-termism and responsibility are the common currency, reappears repeatedly in the analyses of the crisis by policy-makers, academics and industry bodies and in much of the new thinking presented as a response to the institutional and functional flaws of the financial system exposed by the crash.

Clearly, along the investment chain and throughout the processes of financial intermediation individual institutions, although operating legally and rationally in their own self interests, did not take full account of their voluntary commitments to sustainable finance and responsible investment in all of their daily operations. As such, a period of honest self-examination is required across the board for those institutions working with the United Nations in the areas of sustainable finance and responsible investment.

<sup>162</sup> The UN Principles for Responsible Investment were initially signed in April/May 2006 by 53 institutional investment organizations collectively representing US\$4 trillion in assets.

<sup>163</sup> Speech by Lord Adair Turner, Chairman, FSA, at the Mansion House, London, September 29, 2009.

<sup>164</sup> Keynote speech by Jean-Claude Trichet, President, European Central Bank, at the 9th Munich Economic Summit, April 29, 2010.

Equally, it is clear that the financial policy-making and supervisory communities have come to understand how gaps in both international and domestic financial system governance, the pace of financial innovation outstripping the capacity of regulation to keep ahead of new risk promoting products, and regulatory authorities missing the buildup of systemic risk from supposedly risk diversifying securitization of uncorrelated assets, contributed to the severity of the financial crisis. A broad range of questions covering market and institutional governance, as well as options for collaborative action, can be raised.

## Market Governance

- Where and how can the goals and aspirations of sustainable finance and responsible investment bolster the new regulatory and supervisory frameworks that are being developed?
- How can we work with financial policy-makers, regulators and supervisory bodies to ensure deeper integration of emerging systemic risk considerations into the new mechanisms forged for financial system stability and resilience?
- How can we collectively ensure greater accountability amongst institutions along the investment chain and throughout the economically and socially critical processes of financial intermediation?
- How can financial services foster a sea change in the quality, speed and coverage of ESG disclosure by requiring comprehensive ESG disclosure and reporting?
- How can rejuvenated self regulation and voluntary activity support the overhauled regulatory framework and contribute to strengthened market governance?

## Institutional Governance

- How can we make accountability, transparency, disclosure, responsibility and long-termism an integral part of our activities across all policies and mainstream business areas?
- How can the financial services sector contribute to the accelerated development of an integrated international reporting standard that enables comparability between companies regarding ESG performance?
- Where clear conflicts of interest exist within and between financial institutions, how can financial institutions act collectively to deal with these issues?

## Collaborative Action

- How can we accelerate the proliferation of sustainable finance and responsible investment thinking and action along the entire investment chain from end beneficiaries to investee targets?
- How can we ensure relevant, focused and timely research?
- How can more of the valuable research and analysis undertaken by financial services and investment around new systemic risk issues, such as climate change, resource scarcity, and threats to biodiversity and ecosystems services, be accelerated into the processes of policy formulation geared to financial stability and resilience?
- How can the sector work to support the evolution and growth of financial service institutions that—through the market—serve broader environmental and social missions including cooperative activities that address financial exclusion, as well as microfinance, microcredit and microinsurance services that support financial activity for the base of the pyramid?

A drop-down menu of the crisis issues that the financial services sector should put through a thorough “sustainability screen” would include, amongst other issues, the following:

**The Crash:**

- Failure of systemic governance
- Political and policy failures
- Supervisory failures
- Institutional failures

**Problems along the investment chain and in financial intermediation:**

- Short-termism
- Moral hazard <sup>165</sup>
- Misaligned incentives
- Conflicts of interest

**Corrosion of financial foundations:**

- Breakdown of trust
- Failures of accountability
- Failures of responsibility
- Failures of fiduciary duty

**Results:**

- Economic slow down
- Uncertainty
- Unpredictability
- Volatility
- Scope for speculation

**Responses:**

- Political response
- Regulatory overhaul
- Investor backlash
- Client backlash
- Litigative upsurge

**New thinking for functional and institutional change:**

- Vertical regulation
- Responsible investment
- A new ecology of finance
- Long finance

<sup>165</sup> John Authers described “moral hazard” as “the belief that there was no penalty for undue risks,” in J. Authers, 2010, “Market forces,” *Financial Times*, FT weekend, May 22/23.

## Recommendations

Clearly, financial and economic stability and global sustainability go hand in hand. To address the G-20 objectives of “strong, sustainable and balanced growth,” consistent with social and environmental policy goals, we therefore propose that the following practical steps be agreed by the international community to address issues raised in this report. The following recommendations reflect several made in a paper presented in September 2011 by the Rt. Hon. Gordon Brown MP to the High Level Panel on Global Sustainability convened by the United Nations Secretary-General.

***Proposition 1: Build a deeper understanding of how policy-makers, market regulators and international financing institutions can support the growth and mainstreaming of responsible investment and inclusive finance approaches. Examine, identify, assess and replicate how innovative approaches can be scaled and accelerated to have a direct impact on meeting basic needs and supporting sustainability.***

### **Delivering proposition 1:**

Toward this, develop a global reference tool detailing the most successful policies, procedures and collaborative approaches that accelerate and scale responsible investment and inclusive finance. Since 2000, there has been an upsurge in innovation around responsible investment, impact investment and inclusive finance. For example, amongst the sovereign wealth fund community, now controlling assets of US\$4.7 trillion,<sup>166</sup> certain funds have been at the forefront of moves to explore how their investments can address development challenges while fulfilling a broader understanding of fiduciary duty. The Development Investment Policy Statement<sup>167</sup> of the Government Employees Pension Fund (GEPF) of South Africa states: “Developmental investments have been shown to generate impressive returns, and returns which are uncorrelated to global markets and are thus a good form of investment diversification.” Others funds have implemented policies requiring greater transparency, accountability, responsibility and disclosure in their worldwide investments with respect to environmental, social and governance (ESG) issues. For example, the Norwegian Pension Fund Global,<sup>168</sup> one of the largest sovereign wealth funds in the world, has a broad ownership in approximately 8,400 companies worldwide. The pension fund is largely passively invested and holds an average ownership share of 1 per cent in each company in which it is invested. As a universal owner, the fund seeks to ensure that ESG issues are duly taken into account. Fiduciary responsibility for the pension fund includes safeguarding widely shared ethical values.

Social impact bonds are another approach that require creativity, innovation and flexibility from public and private sector actors. The global reference tool, therefore, would describe the most effective approaches for the development of “Social Impact Bonds” and related enabling hybrid legal structures. The purpose of such bonds is to drive new capital and private sector solutions to solving critical and often chronically under-funded social causes, many of which are covered by the Millennium Development Goals.

<sup>166</sup> July 2011 estimate of assets controlled by Sovereign Wealth Funds.

<sup>167</sup> GEPF Developmental Investment Policy Statement, August 2010.

<sup>168</sup> Norwegian Government Fund section drawn from UNEP Finance Initiative work toward the UNEP Green Economy Report, 2010.

Finally, investment funds dedicated to micro-finance and micro-insurance have proliferated in recent years. The global reference tool would seek also to:

- i. Catalyze the development of micro-finance and micro-insurance and their institutions that can meet the borrowing, saving and insurance needs of all the world's women and men.
- ii. Establish standards to ensure that such institutions are ethical and sustainable in their business practices.

***Proposition 2: Establish a monitoring body, which ensures that our global financial architecture is managed on sustainable fiduciary principles. The initiative will identify where there are flaws in the architecture, and advocate solutions.***

**Delivering proposition 2:**

To be stable, markets need to behave within a framework of responsibility. Yet we have no institution, either global or even national that is charged with promoting this framework. We need such an institution. We recognize the good work of the Financial Stability Board (FSB) in identifying the twelve standards of regulation, which have been established by various international bodies. The problem is that no one systematically investigates whether or not the standards are being met on a market-by-market basis and then reports that data to the public and to policy-makers. Even if they did, we know that regulation alone is inadequate to ensure financial stability, unless it is supported by responsible and accountable financial institutions. We propose, therefore, to back the formation of an institution ideally working within or under the auspices of the International Monetary Fund with the appropriate status, resources and capabilities to monitor the governance of our financial system and to ensure that it is being managed on accountable and sustainable principles. Where flaws in the existing financial architecture are identified, the new institution will advocate solutions at the highest level of the global financial policy-making community.

To support the work of this new institution, we propose the implementation of a globally accepted code of responsible and ethical behaviour, integrating a commonly agreed understanding of fiduciary obligations, for all facets of the financial services and the investment community. It follows from the above that policy-makers should:

- i. Be very mindful of the fact that it is not just the law that creates fiduciary behaviour. It is the culture, the institutions and the governance of the industry concerned. The practice of fiduciary duty stands very close to the need for honesty and uprightness, if business is to prosper.
- ii. Where the law is used, there is the need for legal certainty: this is potentially a legal minefield, taking into account the case law and regulatory backdrop. A well-drafted and thoroughly considered code (of international application) should, however:
  - a. Improve certainty in an area that has become somewhat uncertain.
  - b. Take into account the possible need to distinguish between different types of customers.
  - c. Consider to what extent freedom of contract can prevail or whether systemic risk "trumps" that freedom.

d. Try as hard as possible to spell out what they mean when they talk of fiduciary duties: perhaps a settled menu of specific duties of a fiduciary nature needs to be drawn up, from which appropriate selections can be made for particular cases.

e. Possibly adopt different approaches for different kinds of instruments, e.g., freedom of contract should largely prevail for equity instruments.

***Proposition 3: Investigate why long-term pension investment has not resulted in a financial system that more obviously serves the interests of savers and supports global sustainability.***

**Delivering proposition 3:**

People worried about their pensions are most concerned about the pension's long-term value. Thus the investment of pension funds should be seen not just for the short-term changes in position, but for the long-term benefit to be achieved. Yet for all the long-term requirements of pension funds, this does not seem to have resulted in a financial system that more obviously serves the long-term interests of savers. There is an urgent need for a comprehensive assessment of how institutional investment is currently adding or detracting from sustainability, to assess what initiatives have worked, how public policy and private practice can best be brought together in different jurisdictions and coordinated globally, and thus how the contribution of the investment industry toward long-term sustainability can best be improved. Also, the international community needs to foster a dedicated policy-making initiative to understand and re-calibrate the current incentives that exist in the investment chain that have seen a proliferation of short-termism in the markets and that have contributed to a system that does not serve the long-term interests of savers. The international community needs to agree on steps to:

- i. Effectively re-engineer institutional and executive incentives along the investment chain to encourage long-termism and support sustainability.
- ii. Minimize areas where evolving market practices, such as trading activities that exacerbate extreme volatility in the markets or those that enable hoarding of physical assets such as agricultural commodities, create instability and undermine global sustainability.
- iii. Develop globally agreed "soft law" guidelines, codes and/or rules of conduct for use across electronic trading platforms where evolving market practices risk greater instability.

***Proposition 4: Build on the work of the Integrated Reporting Committee and others to promote transparency in the operations of financial and commercial organizations. This should include ensuring the principles upon which reports are based are sound and sustainable, and that those who provide such information are independent and that it is properly reported.***

**Delivering proposition 4:**

High quality, comparable information and supporting verifiable data are the most critical commodities for well-governed and smoothly functioning capital markets. Not only does information affect the market outcome after it is reported, it affects the behaviour before the reporting is done. So, unless financial, social and environmental sustainability are properly measured and unless this information is professionally adjudicated and reported, we cannot expect that capital

markets will promote these features. Indeed, without the flow of accurate, trustworthy information and sound data, capital markets are challenged in their primary functions of allocating fairly priced capital to productive companies that are capable of sustained success and, in turn, rewarding their investors and ultimate owners. Markets are driven by information. If the information they receive is short-term and thin, then these characteristics will define our markets.

The international community should agree to the adoption by stock exchange authorities and market regulators worldwide of a United Nations protocol that requires listed entities to abide by an integrated reporting standard covering sustainability issues promoting transparency in the operations of financial and commercial organizations. Such a protocol would build on the work of the International Integrated Reporting Committee<sup>169</sup> and would embed a requirement to include a vote on the quality of the integrated report at the annual general meetings of listed corporations. Such reports would deal with the strategic sustainability issues relevant to the company's business model, from the standpoint of short- and long-term factors.

Several of the world's leading accounting bodies, UN agencies and leading non-governmental organizations, understanding that current reporting and disclosure practices are inadequate as noted, are engaged in an international effort to establish a new integrated reporting framework that combines financial factors with a broader basket of environmental, social and governance (ESG) issues. Increasingly, it is understood that if companies do not provide an assessment of the broader ESG risks and opportunities to which their business model is exposed, how can the market assess the sustainability of that company's growth?<sup>170</sup> To address these issues, the international community should:

- i. Agree upon global protocols to require standard corporate ESG/sustainability reporting in an integrated manner alongside financial reporting to cover, as a minimum, all listed entities on the 50-plus major exchanges worldwide (building on Johannesburg Stock Exchange requirements and aligned with Integrated Reporting).
- ii. Solicit support from stock exchanges to back this initiative and promote the idea of a vote on the quality of strategic sustainability reports at the annual general meetings of listed corporations.

Given that many of these tasks cross national boundaries and require permanent monitoring of what is being achieved not just by official organizations but by non-governmental actors, the case for a Global Foundation for the Sustainable Economy that is a monitoring body needs to be made. It is suggested that work be done to see how this centre of expertise independent of governments can be financed.

<sup>169</sup> The International Integrated Reporting Committee (IIRC) was convened in July 2010 by the Prince of Wales Accounting for Sustainability Initiative and the Global Reporting Initiative (GRI).

<sup>170</sup> Consider, for example, both the reputational damage and the actual remediation costs of continuously poor environmental risk management at British Petroleum and Massey Energy.

## Final Word

Such actions may, in time, help to gently redirect the relationship between “financial capacity” and “political perspicacity” captured by the late economist John K. Galbraith in his exploration of the causes and impacts of The Great Crash of 1929. The US economist’s concluding words in his iconic 1954 script are as relevant to the crash of 2007-2008 as they were to that of 1929, and also cut to the heart of the relationship between stability, resilience and more balanced economic, environmental and social development that is central to the United Nations’ mission.

The thought that this seemingly cast-iron relationship might be diluted, redirected or reversed in any way would bring a wry smile to the academic’s face, but he would agree, perhaps, that it was worth trying:

But now, as throughout history, financial capacity and political perspicacity are inversely correlated. Long-run salvation by men of business has never been highly regarded if it means disturbances of orderly life and convenience in the present. So inaction will be advocated in the present even though it means deep trouble in the future. Here, at least equally with communism, lies the threat to capitalism. It is what causes men who know that things are going quite wrong to say that things are fundamentally sound.<sup>171</sup>

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<sup>171</sup> J. K. Galbraith, 1954, “The Great Crash of 1929.”



## Appendix 1

### The Principles for Responsible Investment

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that ESG issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

1. We will incorporate ESG issues into investment analysis and decision-making processes.

Possible actions:

- Address ESG issues in investment policy statements
- Support development of ESG-related tools, metrics, and analyses
- Assess the capabilities of internal investment managers to incorporate ESG issues
- Assess the capabilities of external investment managers to incorporate ESG issues
- Ask investment service providers (such as financial analysts, consultants, brokers, research firms, or rating companies) to integrate ESG factors into evolving research and analysis
- Encourage academic and other research on this theme
- Advocate ESG training for investment professionals

2. We will be active owners and incorporate ESG issues into our ownership policies and practices.

Possible actions:

- Develop and disclose an active ownership policy consistent with the Principles
- Exercise voting rights or monitor compliance with voting policy (if outsourced)
- Develop an engagement capability (either directly or through outsourcing)
- Participate in the development of policy, regulation, and standard setting (such as promoting and protecting shareholder rights)
- File shareholder resolutions consistent with long-term ESG considerations
- Engage with companies on ESG issues
- Participate in collaborative engagement initiatives
- Ask investment managers to undertake and report on ESG-related engagement

3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.

Possible actions:

- Ask for standardised reporting on ESG issues (using tools such as the Global Reporting Initiative)
- Ask for ESG issues to be integrated within annual financial reports
- Ask for information from companies regarding adoption of/adherence to relevant norms, standards, codes of conduct or international initiatives (such as the UN Global Compact)
- Support shareholder initiatives and resolutions promoting ESG disclosure

4. We will promote acceptance and implementation of the Principles within the investment industry.

Possible actions:

- Include Principles-related requirements in requests for proposals (RFPs)
- Align investment mandates, monitoring procedures, performance indicators and incentive structures accordingly (for example, ensure investment management processes reflect long-term time horizons when appropriate)
- Communicate ESG expectations to investment service providers
- Revisit relationships with service providers that fail to meet ESG expectations
- Support the development of tools for benchmarking ESG integration
- Support regulatory or policy developments that enable implementation of the Principles

5. We will work together to enhance our effectiveness in implementing the Principles.

Possible actions:

- Support/participate in networks and information platforms to share tools, pool resources, and make use of investor reporting as a source of learning
- Collectively address relevant emerging issues
- Develop or support appropriate collaborative initiatives

6. We will each report on our activities and progress towards implementing the Principles.

Possible actions:

- Disclose how ESG issues are integrated within investment practices
- Disclose active ownership activities (voting, engagement, and/or policy dialogue)
- Disclose what is required from service providers in relation to the Principles
- Communicate with beneficiaries about ESG issues and the Principles
- Report on progress and/or achievements relating to the Principles using a “Comply or Explain”<sup>172</sup> approach
- Seek to determine the impact of the Principles
- Make use of reporting to raise awareness among a broader group of stakeholders

The Principles for Responsible Investment were developed by an international group of institutional investors reflecting the increasing relevance of environmental, social and corporate governance issues to investment practices. The process was convened by the United Nations Secretary-General.

In signing the Principles, we as investors publicly commit to adopt and implement them, where consistent with our fiduciary responsibilities. We also commit to evaluate the effectiveness and improve the content of the Principles over time. We believe this will improve our ability to meet commitments to beneficiaries as well as better align our investment activities with the broader interests of society.

We encourage other investors to adopt the Principles.

<sup>172</sup> The Comply or Explain approach requires signatories to report on how they implement the Principles, or provide an explanation where they do not comply with them.

## Appendix 2

### UNEP Statement by Financial Institutions on the Environment and Sustainable Development

#### 1. **Commitment to Sustainable Development**

1.1 We regard sustainable development as a fundamental aspect of sound business management.

1.2 Believe that sustainable development can best be achieved by allowing markets to work within an appropriate framework of cost-efficient regulations and economic instruments. Governments in all countries have a leadership role in establishing and enforcing long-term common environmental priorities and values.

1.3 We regard the financial services sector as an important contributor towards sustainable development, in association with other economic sectors.

1.4 We recognize that sustainable development is a corporate commitment and an integral part of our pursuit of good corporate citizenship.

#### 2. **Environmental Management and Financial Institutions**

2.1 We support the precautionary approach to environmental management, which strives to anticipate and prevent potential environmental degradation.

2.2 We are committed to complying with local, national, and international environmental regulations applicable to our operations and business services. We will work towards integrating environmental considerations into our operations, asset management, and other business decisions, in all markets.

2.3 We recognize that identifying and quantifying environmental risks should be part of the normal process of risk assessment and management, both in domestic and international operations. With regard to our customers, we regard compliance with applicable environmental regulations and the use of sound environmental practices as important factors in demonstrating effective corporate management.

2.4 We will endeavor to pursue the best practice in environmental management, including energy efficiency, recycling and waste reduction. We will seek to form business relations with partners, suppliers, and subcontractors who follow similarly high environmental standards.

2.5 We intend to update our practices periodically to incorporate relevant developments in environmental management. We encourage the industry to undertake research in these and related areas.

2.6 We recognize the need to conduct internal environmental reviews on a periodic basis, and to measure our activities against our environmental goals.

2.7 We encourage the financial services sector to develop products and services which will promote environmental protection.

**3. Public Awareness and Communication**

3.1 We recommend that financial institutions develop and publish a statement of their environmental policy and periodically report on the steps they have taken to promote integration of environmental considerations into their operations.

3.2 We will share information with customers, as appropriate, so that they may strengthen their own capacity to reduce environmental risk and promote sustainable development.

3.3 We will foster openness and dialogue relating to environmental matters with relevant audiences, including shareholders, employees, customers, governments, and the public.

3.4 We ask the United Nations Environment Programme (UNEP) to assist the industry to further the principles and goals of this Statement by providing, within its capacity, relevant information relating to sustainable development.

3.5 We will encourage other financial institutions to support this Statement. We are committed to share with them our experiences and knowledge in order to extend best practices.

3.6 We will work with UNEP periodically to review the success in implementing this Statement and will revise it as appropriate.

We, the undersigned, endorse the principles set forth in the above statement and will endeavor to ensure that our policies and business actions promote the consideration of the environment and sustainable development.

## Appendix 3

### UNEP Finance Initiative's Statement of Environmental Commitment by the Insurance Industry

#### Preamble

The insurance industry recognizes that economic development needs to be compatible with human welfare and a healthy environment. To ignore this is to risk increasing social, environmental and financial costs. Our Industry plays an important role in managing and reducing environmental risk, in conjunction with governments, individuals and organizations. We are committed to work together to address key issues such as pollution reduction, the efficient use of resources, and climate change. We endeavor to identify realistic, sustainable solutions.

#### 1. General Principles of Sustainable Development

1.1 We regard sustainable development, defined as development that meets the needs of the present without compromising the ability of future generations to meet their own needs, as a fundamental aspect of sound business management.

1.2 We believe that sustainable development is best achieved by allowing markets to work within an appropriate framework of cost efficient regulations and economic instruments. Government has a leadership role in establishing and enforcing long-term priorities and values.

1.3 We regard a strong, proactive insurance industry as an important contributor to sustainable development, through its interaction with other economic sectors and consumers.

1.4 We believe that the existing skills and techniques of our industry in understanding uncertainty, identifying and quantifying risk, and responding to risk, are core strengths in managing environmental problems.

1.5 We recognize the precautionary principle, in that it is not possible to quantify some concerns sufficiently, nor indeed to reconcile all impacts in purely financial terms. Research is needed to reduce uncertainty but cannot eliminate it entirely.

#### 2. Environmental Management

2.1 We will reinforce the attention given to environmental risks in our core activities. These activities include risk management, loss prevention, product design, claims handling and asset management.

2.2 We are committed to manage internal operations and physical assets under our control in a manner that reflects environmental considerations.

2.3 We will periodically review our management practices, to integrate relevant developments of environmental management in our planning, marketing, employee communications and training as well as our other core activities.

2.4 We encourage research in these and related issues. Responses to environmental issues can vary in effectiveness and cost. We encourage research that identifies creative and effective solutions.

2.5 We support insurance products and services that promote sound environmental practice through measures such as loss prevention and contract terms and conditions. While satisfying requirements for security and profitability, we will seek to include environmental considerations in our asset management.

2.6 We will conduct regular internal environmental reviews, and will seek to create measurable environmental goals and standards.

2.7 We shall comply with all applicable local, national and international environmental regulations. Beyond compliance, we will strive to develop and adopt best practices in environmental management. We will support our clients, partners and suppliers to do likewise.

### 3. **Public Awareness and Communications**

3.1 Bearing in mind commercial confidence, we are committed to share relevant information with our stakeholders, including clients, intermediaries, shareholders, employees and regulators. By doing so we will improve society's response to environmental challenges.

3.2 Through dialogue with public authorities and other bodies we aim to contribute to the creation of a more effective framework for sustainable development.

3.3 We will work with the United Nations Environment Programme to further the principles and goals of this Statement, and look for UNEP's active support.

3.4 We will encourage other insurance institutions to support this Statement. We are committed to share with them our experiences and knowledge in order to extend best practices.

3.5 We will actively communicate our environmental activities to the public, review the success of this Statement periodically, and we expect all signatories to make real progress.

## Appendix 4

### UNEP FI Principles for Sustainable Insurance

**Presented to the World Summit for Sustainable Development (WSSD), Johannesburg, South Africa, 2002**

The following statement has been prepared and approved by those 295 financial institutions who are supporters of the United Nations Environment Programme Finance Initiative (UNEP FI). For full details on UNEP FI, see [www.unepfi.net](http://www.unepfi.net).

#### **Promoting a sustainability dynamic in the financial system.**

Action by UNEP Finance Initiatives

The UNEP Finance Initiative (FI) will seek to promote further amongst its members:

1. Linking of the core competencies of the financial sector to the sustainable development agenda.
2. Increased use of sustainability criteria when investing and lending, thus promoting companies that are conducting or seeking to conduct their business in conformity with sustainability criteria. The use of such sustainability criteria should be included in investments in listed bonds and equities, and in lending for unlisted companies.
3. Annual reporting of members progress in implementation of environmental management systems and corporate social responsibility activities.
4. For those members with international retail operations, increased access of underserved people (poor) and countries (out of capital flows) to financial services as a supplementary means to fulfill unmet social and economic development needs in developing countries. Promising examples could include microfinance products and appropriate information technologies which support up take of financial services by the poor.
5. Raise awareness of key players in the financial markets, including analysts and financial rating agencies, towards financial risks related to non-sustainable behavior in order to encourage them to integrate sustainability criteria in their evaluation process.

#### **UNEP FI Recommendations to WSSD**

UNEP FI recommends that the UN World Summit for Sustainable Development adopts the following recommendations, so that banks, insurers and funds managers can better implement our shared goals for sustainable development:

1. Capital markets in developed economies need to be stimulated to invest more in small and medium-sized businesses in developing economies. This requires:
  - a. more technical assistance for small and medium-sized businesses in developing economies,
  - b. sovereign risk reduction instruments for investors,
  - c. the creation of public and private funds and mechanisms that will facilitate private equity and listed equity investments in developing countries.
2. Promote a sound investment climate to support the confidence of investors. A sound investment climate includes a broad variety of aspects such as protection of property rights, contract enforcement, control of corruption, stability-oriented macroeconomic policies, sound financial regulation and supervision, and financial transparency. Furthermore, it should also incorporate environmental and social regulations to ensure that investments contribute to sustainable long-term growth. In developed and emerging economies, review and reform

the tax, tariff and finance regulatory structures that have impeded environmentally and socially sound investment.

3. Promote internalization of true environmental costs, including greenhouse gas emissions and climate change risks, into accounting principles and practices, thereby recognizing these risks as potential business liabilities.
4. Promote the creation of insurance and other financial products in developing countries which are structured to cover natural and man-made risks and thereby to introduce mechanisms and behaviors for risk avoidance, control, and reduction. Such products and mechanisms should provide additional support to public sector regulatory and planning approaches fashioned to mitigate the impacts of natural and man-made disasters.
5. Promote transparency and responsibility in:
  - a. Official Development Assistance (ODA) particularly as regards job creation, income creation, and improvement in living, working and environmental conditions and
  - b. Foreign Direct Investment (FDI), particularly as regards reinvestment of profits in the local economies, job creation, income creation, and improvement of living, working and environmental conditions in the local economies which will make both ODA and FDI more legitimate and effective. Explore mechanisms to create innovative and integrated ODA-FDI financing mechanisms that leverage greater sustainability benefits. The strengthening of NGOs, media, local government and overall institutional capacity will enhance the transparency around and benefits stemming from FDI and ODA.
6. Use debt relief mechanisms that are environmentally and socially beneficial, and improve the investment climate thereby reducing vulnerabilities and creating new opportunities.

*Significant elements of this statement were drawn from two earlier UNEP FI documents generated at the 2002 UNEP FI Global Roundtable in Rio de Janeiro, Brazil (March 14-15). These documents were first outlined publically during a UNEP FI Panel event at the UN Financing for Development Conference (UNFfD), Monterrey, Mexico, on 18 March, 2002. The final statement results from a rigorous UNEP FI member companies' consultation process implemented during the period April-end July 2002.*







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